Greece, Black Holes and Banks' Ankles

The tragedy of Greece teaches a critical but unheralded lesson: Isolate bank risk from sovereign risk.

The world's focus over the past decade on the tribulations of Greece and the Eurozone has produced many terabytes of commentary. Surely, one suspects, some columnist somewhere has explored every nuance of every aspect of this debacle. Yet we see one gigantic rock unturned.

Front and center in the Greek crisis has been the disintegration of confidence in, and solvency of, the Greek banks. Had the banks remained strong both in fact and appearance with no need of ECB ELA ("emergency liquidity assistance") while the Greek *government* defaulted on debt obligations, the present and future misery of the citizens would be greatly reduced.

Must banks fail when the government cannot pay its debt?

Financial professionals, even more so than common citizens, do not question that a developed country's banks will weaken and fail as the government approaches default. The banks and the central bank typically own government bonds as a large fraction of assets. Hence, failure of the bonds necessarily delivers insolvency to the bank balance sheets.

In addition to the direct and dramatic loss of asset value, modern governments provide explicit and implicit guarantees to the nation's banks that, of course, effectively vanish upon the failure of the government. The most notable explicit guarantee is deposit insurance. Seeing this loss of a guarantee, it is entirely rational for citizens to withdraw their deposit funding as the government's financial decline accelerates.

In theory, such an *en masse* surge of deposit withdrawals – a "bank run" – need not topple an otherwise strong bank if the national central bank remains sound and controls the nation's currency. Due to the large ownership of government debt, unfortunately, neither the banks nor the central bank are solvent. Runs on the banks will decimate the financial sector.

In addition to the crippling of balance sheets and the stripping of guarantees, failure of government strikes a psychological blow against the banks. Nowhere in the developed world do the citizens believe their banks are *above the government* in the sense that they consider the banks to be financially robust in the face of government strife. Whether fair or not (and actually it's quite fair!), the public believes its government will grasp the ankles of the banks and pull them down into any and every financial black hole.

Dependence of banks on government should not be necessary

This dependence of the banking system on the sovereign's solvency is highly undesirable. Both the payment system within a country and the safekeeping of the citizens' money are critical components of the infrastructure. To the extent that government failure immediately crushes these utility functions, we should not accept this consequence as "necessary." We should instead determine the design defects of modern banking. For example, we would not consider it "understandable" if the electricity generation and distribution system failed precisely when the government first stops making debt payments. We would not be complacent with anticipated failure of crop production as an instantaneous consequence of government debt repudiation.

To be clear, when a government fails to make debt payments, there will be challenge for all sectors of the economy. Government spending will likely fall. Other nations may abrogate trade agreements and other contracts. People, businesses, and government entities at all levels will suffer losses in one form or another. But neither the creditors nor the circumstances will quickly shut off the power or kill crop production. As with energy utilities and agriculture, there is no inherent need for the banking sector to be such a hostage to the health of government.

Choosing to release banks from the grip of government

Ultimately, releasing the banking system from its role of hostage to government is a choice. It's a society's choice. It's a political choice. The first and most important step is to prohibit banks from owning government debt. This is an extraordinarily simple step that also defies history.

The bare skeleton of the history of banking looks like this: banks need the license of government to exist and to operate; to receive this license, the banks must commit to lend to government. Past centuries have created and maintained this deliberate co-dependence of banks and government. At the level of the nation's central bank, we say "government debt backs the currency." Stated more plainly and from a different perspective, the nation's money is merely a loan to the government with no maturity date.

There's fascinating nuance and detail which we shall ignore here. To show some restraint as we defy history, our advice requires the nation's banks, but not the central bank, to sell and eschew all holdings of government debt. We permit the banks to hold reserves at the central bank if there is strong conviction that this central bank will redeem reserves even upon the default of government debt. (This conviction in turn requires a third-party central bank such as the ECB, *or* the expectation of inflationary money creation to offset loss in asset value to pay central bank liabilities, *or* the establishment of a "hard" currency alternative to government debt that the central bank controls independently of government.)

As the easier (but still difficult!) second step, government should remove its explicit and implicit guarantees of banks. The history of the "creeping" guarantees beginning roughly a century ago is that they weaken banks. Just as *Fannie Mae* and *Freddie Mac* (and other entities) in the U.S. have "government-sponsored enterprise" (GSE) status, the banks are effectively GSEs also. Due to the real and imagined government protection, banks have gradually increased leverage and decreased liquidity resources. Divorcing banks from government will be a shock that forces change to both parties.

New stress test: banks must survive the failure of government

For bank regulators such as the Federal Reserve and the European Central Bank (ECB), we suggest the creation of a new regulatory stress test with the premise that the bank should survive a failure of the government. In the U.S., the Dodd-Frank Act (DFA) legislation specifically encourages banks to avoid reliance on taxpayer funding through bailouts. Though not identical to our goal of financial system independence of government, the Survive

Government Failure (SGF) Stress Test is useful and meaningful to the DFA mission.

Of course, the first applications of the simplest SGF Stress Test will show that the banks fail! We expect this failing result since all banks hold far too much government debt. The regulators themselves encourage the excessive government debt concentration through their risk-weight allocations. An improvement would be to specify a stress test period of a year, for example, in which the bank hypothetically reduces its holdings of deteriorating government debt with mark-to-market (rather than default) losses.

Banks are part of government

Considering the current state of banks lending to government, government guaranteeing bank liabilities, and the GSE-nature of the banking business, banks are effectively part of government. This close relationship is especially evident with the observation that the Greek government's debt failure precipitated the collapse of the Greek banks. It's a bad design. Though history has given us what we call "modern banking," let us *make history* by cleaving banks from government.

Joe Pimbley (FRM) is a financial consultant in his role as Principal of Maxwell Consulting, LLC. His expertise includes enterprise risk management, structured products, derivatives, investment underwriting, training, and quantitative modeling. He is the co-author of "Banking on Failure – Fixing the Fiasco of Junk Banks, Government Bailouts, and Fiat Money."