

## **True Reform for the Financial Industry**

In September of 2010, the U.S. has not shaken the Credit Crisis that began in 2007. No major financial institutions appear to be faltering, but this relative calm is due to the government's continued backing. The dominant storyline of the politicians and pundits is that banks' management teams made poor decisions in the run-up to the Crisis and Federal regulation was lax, flawed, and poorly enforced. With this diagnosis in hand, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act to ratchet up the scope and frenzy of bank regulation.

But the new regulations won't work. The old regulators (those in place up to 2007) will also be the new regulators. It's the same people and, judging by the legislative reaction, neither the Fed nor the Treasury nor Congress has learned the key lessons of the Crisis.

As an alternative to Dodd-Frank, we propose a different bank regulatory framework that solves "too big to fail" and fully protects the bank depositors. The Fed should raise the reserve requirement (currently 10%) to 100%. The key insight at the foundation of this proposal is that banks are inherently very risky enterprises due to sky-high leverage and deliberately short debt maturities. There are no rules and regulations, Dodd-Frank included, that can paper over the structural faults of high leverage and short-maturity debt to render such banks "safe".

In short, this 100% reserve requirement proposal will de-couple bank deposits from bank lending in a manner that eliminates risk to depositors. Banks and other lending institutions will then rely completely on equity and debt investors to fund and absorb the risk of lending. The greater freedom to match maturities of assets and liabilities – after having eliminated bank deposits as a source of funding – then solves one of the root causes of the Credit Crisis. Before providing details, we digress with a discussion of bank deposits and past and present regulatory attempts to protect the depositors.

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### **Retail Bank Deposits**

The financial mess feels like a huge, intractable problem because we all think we need to understand CDOs ("collateralized debt obligations") and sub-prime mortgages and what goes wrong when the latter get wrapped up in the former. But this type of deep dive into specific financial transactions is unnecessary. We just need to unpack what it is that banks do and determine which activities have been regulated over the years and why regulation has existed.

In their most basic activity, banks take deposits from retail customers. All functional adults need bank accounts to hold cash. Customers need the safety of a bank vault. Such bank accounts are convenient to the point of necessity for effecting payments to others through checks, wire transfers, and other means. Americans have used bank accounts for well over a hundred years.

The "bank deposit business" would be foolproof if banks simply received deposits and then stashed the money in their vaults. The vault cash would sit idly and wait for customer instructions of withdrawal or payment. But this is not how the business works. Rather, banks take the money they receive in deposits and use the money elsewhere – primarily in loans to other customers. Thus, the bank sees the paired retail activities of borrowing (from depositors) and lending (to local homebuyers and small businesses, for example) as the very foundation of banking.

But this borrowing-lending business model is unstable! Throughout the 1800's in the United States and into the Great Depression there were intermittent "bank runs" in which many depositors of a specific bank would ask to withdraw all funds. Generally, public rumors would contend that the bank under siege was insolvent (assets worth less than liabilities). Since an insolvent bank cannot repay all depositors and since depositors have the right to withdraw their funds on any day, it is perfectly rational to run to the bank to withdraw money when insolvency rumors swirl. Of course, this bank run itself could topple the bank since it would hold within its vaults only a small

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fraction of the total deposit base. The remaining deposits are tied up in the mortgages and small business loans the bank had made.

The key element of the instability is that bank depositors could request their funds daily whereas the bank assets (the loans it had made) could not be converted to cash to meet unexpected withdrawal requests. The best term for this situation is “asset-liability mismatch”.<sup>1</sup> The bank assets had longer maturity than the deposits (liabilities). Typically, bank deposits acted like long-term liabilities because depositors did not withdraw their funds during normal times. But in crisis, the maturity of deposit liabilities shortened dramatically and put the survival of the bank at risk.

The reason a healthy bank might become insolvent is that some of the bank loans may default. Think about this – the bank depositors do not wish to be parties to these loans. The depositor simply wants a safe and readily accessible repository for cash. Not only is the business model unstable, the deposit customer becomes hostage to the ability of the bank to underwrite loans that won’t default. This dependence on good bank performance makes sense for an equity investor in the bank but not for a retail depositor.

### **Regulatory Solution**

Congress created the Federal Reserve System in 1913 to mitigate the periodic bank panics of earlier years. The Fed imposed a “reserve requirement” that mandated that banks maintain cash at the Fed or within the banks’ vaults equal to a specific percentage of retail deposits. This reserve requirement has varied over time. It was often above 20% over the past century but is now at 10% (in the middle of 2010).<sup>2</sup> Clearly, as the reserve requirement decreases, the risk of bank failure increases.<sup>3</sup> In addition to the reserve requirement, the Fed also served as a “lender of last resort” to its

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<sup>1</sup>Another observer might use the term “illiquid” since the long-term assets cannot be readily sold for cash, but this diagnosis is incomplete. It is fundamentally unsound to incur debts that are shorter in maturity than the assets upon which one relies to repay the debts.

<sup>2</sup> See the discussion at <http://www.federalreserve.gov/monetarypolicy/reservereq.htm> and the 1993 Federal Reserve article “Reserve Requirements: History, Current Practice, and Potential Reform” at <http://www.federalreserve.gov/monetarypolicy/0693lead.pdf> .

<sup>3</sup> The key element of our “true banking reform” is that this reserve requirement should be 100% as we discuss later.

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member banks and supervised and imposed bank business practices through frequent examinations.

In 1934, the government in the form of the Federal Deposit Insurance Corporation (FDIC) began insuring retail deposits.<sup>4</sup> Hence, the creation of the FDIC transferred the risk of bank insolvency from the depositors to the government.<sup>5</sup> One principle was that the government's backing should eliminate bank runs due to insolvency rumors. Of course, protecting the FDIC and the taxpayers then became a clear objective for the Fed in its supervision of the banks.

Other government agencies and programs also materialized to regulate and oversee banking, financial, and thrift institutions that the Fed did not directly cover.<sup>6</sup> As a broad summary, the regulatory regime of the past hundred years created numerous government entities that enforced rules (such as capital and reporting requirements) for financial institutions, made frequent on-site visits to these institutions, and insured consumer deposits.

### **Regulation Didn't Work**

If the goal of bank regulation has been to prevent problems – however that word is defined – in the financial system, then such regulation has failed. The regulations and oversight of the Federal Reserve did not stem the bank runs and failures of the early 1930's. While creation of government insurance of retail deposits in 1934 has prevented losses to depositors, the additional regulation did not spare the government losses in excess of \$100 billion from the failures of savings and loan institutions in the 1980's. The Credit Crisis, of course, demonstrates massive failure of bank regulation – again, making the assumption that the purpose of regulation is to

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<sup>4</sup> See the discussion at <http://www.fdic.gov/about/learn/symbol/index.html> .

<sup>5</sup> The FDIC insurance extended to a finite limit for each bank account. But the limit was and remains high enough to cover virtually all retail accounts.

<sup>6</sup> Three of these agencies are the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and the Securities & Exchange Commission (SEC). The government created the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) over the years and the Office of Federal Housing Enterprise Oversight (OFHEO) to regulate Fannie and Freddie. But OFHEO's evident and miserable failure in 2008 prompted a name change to the Federal Housing Finance Agency (FHFA).

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prevent huge losses that topple large banks (or require taxpayers to absorb the losses to save the banks).

It would certainly seem worthwhile to examine each of these failures in turn to determine why regulation failed. One goal of this exercise might be to repair the flaws of the regulatory oversight that seem evident in hindsight in each episode. But it is more efficient to make the big-picture observation that regulation cannot prevent bank failures. By their nature and business models, banks assume a great deal of financial risk. For example, current regulations themselves permit (and encourage) a leverage ratio in excess of 10-to-1! It is simply not reasonable to expect that there exists a set of rules and regulations that would remove the risk of failure from a leveraged firm (such as a bank).

Stated differently, we ask too much of our regulators. Ineptitude of government agency employees during the 1930's, 1980's, and 2000's did not cause the bank regulatory failures in these periods. While one can always identify after the fact specific decisions and actions regulators could have taken to prevent a specific meltdown, this analysis is a mirage in that it fails to recognize the true structural problem of the banking world.

### **Structural Reform That Will Work**

Banks and other institutions that take retail demand deposits should run this activity with a 100% reserve requirement. Increasing the current 10% requirement to 100% will constitute radical and wrenching change. But it will work. Depositors will not lose funds. The task of regulators will simply be to enforce this reserve requirement by counting deposits with the Fed and vault cash rather than to understand the vast complexity of all of a bank's risky businesses. With respect to its depositors, the drama of bank insolvency rumors and loss of confidence will evaporate.

Two clear consequences of this reform are that depositors will earn zero or negative interest<sup>7</sup> and banks will need another borrowing source in order to extend loans. Regarding the former, the zero/negative interest rate

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<sup>7</sup> By "negative interest", we simply mean that banks may charge fees to depositors such that balances decline slowly over time in the absence of any other deposit/withdrawal activity.

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is appropriate for customers who desire zero risk and continuous and immediate access to their cash. Indeed, the current promise to depositors of positive interest with zero risk and immediate access to cash (as guaranteed by the FDIC and the Fed) is unsound. We view the 100% reserve requirement as the natural and prudent measure to assure depositors that banks are a safe repository.

The second consequence of prohibiting banks from lending the funds they receive from retail depositors is the ensuing disruption to bank lending. As our prior discussion of asset-liability mismatch alluded, the short maturity of retail deposits renders them improper and unstable as funding for longer term loans. Hence, we are solving the bank instability problem by prohibiting the use of deposits as funding for loans. Banks and other lenders will simply need to borrow separately in order to make loans. Regulators might specifically require that the average maturity of this separate borrowing equal or exceed the average maturity of the lending.<sup>8</sup> Such regulation would be far easier to enforce than current regulatory practice.

The separate borrowing methods that banks will primarily use to fund lending consist of commercial paper (CP), bonds issued to the public, and collateralized loan obligations (CLOs) sold to sophisticated investors.<sup>9</sup> Banks already use all of these funding choices. Prudent risk management would match the maturity of funding to the maturity of lending. Hence, funding with CP, which generally matures in three months or less, is inappropriate for lending with maturity in excess of a year. CLOs stand out as being remarkably robust by this measure since it is the repayment of the loans that directly repays the CLO funding. We view the CLO, then, as a market innovation for sound lending such that CLO volumes should increase over time.

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<sup>8</sup> Or, it may be preferable not to require this asset-liability maturity matching but rather to require disclosure to all investors of the degree of mismatch. Since these investors are not the retail depositors – whom government regulation has traditionally sought to protect – it is reasonable to permit these sophisticated investors to bear the risk of loss with no government support. Two good examples of investment vehicles that attract investors and make loans are money market mutual funds (MMF) and asset-backed commercial paper (ABCP) conduits. The MMF deliberately restrict the average maturity of assets and are extraordinarily safe (notwithstanding false impressions to the contrary). The ABCP conduits, on the other hand, assume the explicit risk of mis-matched asset and liability maturities and are prone to failure for this reason.

<sup>9</sup> CLOs are a form of CDO.

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In the context of this new framework with the 100% reserve requirement that de-couples bank deposits from bank lending, there is a straightforward solution to the "too big to fail" (TBTF) problem. Just let the bank fail. A bank may fail when a significant number of the loans it has made default. Failure of the bank means the bank equity investors lose everything and the bank debt holders (purchasers of CP, public bonds, and CLO tranches<sup>10</sup>) will suffer some level of losses as well. But the bank depositors will take zero losses since they are entirely protected by the 100% reserve requirement.<sup>11</sup> While bank debt and equity investors will lose from time to time, there is no public policy imperative to protect them. It is the bank depositors whom public policy initiatives have traditionally sought to protect in order to forestall panics in the banking system.

When a bank sinks into bankruptcy, it does mean that the market will have lost a lender. Thus, there may well be people who fret about TBTF that some banks are so large that the economy cannot "afford" to lose such a large lender. But the money lending business is an extraordinarily simple business model. The loss of any participant will simply make the market more attractive for new entrants. It is only the traditional connection with bank deposits (as a funding source for lending) that gave rise to TBTF. With this connection severed, TBTF is gone.

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<sup>10</sup> Strictly speaking, CLO investment performance is not directly linked to the originating bank's solvency in typical transactions. Our point here is that the CLO provided funding to the bank for its loans and the poor performance of these loans can result in losses for the CLO investors.

<sup>11</sup> Of course, the legal framework of a bank would clearly define deposited funds as available to repay only the original bank deposits. It would not be possible to use these bank deposits (held in reserve) to pay the losses for other activities of the bank.