A Former Treasury Adviser On How To Really Fix Wall Street

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Any serious program for Wall Street reform should start with two words: "term out." "Terming out" is a financial term of art, but its meaning is easily grasped. It simply means funding your business with *long-term* financing instead of *short-term* IOUs. To a far greater extent than is commonly understood, our financial sector funds its operations with extremely short-term borrowings. These IOUs must be paid back in a day, a week, or a month. By contrast, termed-out financial firms shun borrowings that come due in less than a year. A terming-out requirement would be costly for Wall Street, but the reward would be a safer and more resilient financial system. That's a trade we should be willing to make.

Short-term borrowings are fragile. Like a weak immune system, these fragile borrowings turn otherwise manageable challenges into life-threatening situations. Our financial system can deal with the occasional boom and bust without much of a problem. What it can't handle—what sends the financial system and the economy into a tailspin—is a financial *panic*. And, by definition, a panic is about short-term IOUs.

In a panic, short-term lenders abruptly stop rolling over their IOUs. The financial sector, which relies heavily on these borrowings, then goes into cash-hoarding mode. It stops making loans and buying securities. Consequently, consumers and businesses can't get credit on reasonable terms. They reduce their spending, and the economy stalls. The resulting slump can last for years—long after the financial sector has stabilized.

THE OBSERVATION THAT short-term IOUs are at the core of our financial troubles isn't novel or even very controversial. A number of economists, including Gary Gorton at Yale, have been pointing this out for several years. Yet instead of addressing this issue squarely, recent financial reforms have largely been directed elsewhere.

Nor are the dangers of short-term borrowings a recent discovery. In 1873, Walter Bagehot—an English economist who was the father of modern central banking—warned his contemporaries about this very subject."Of the many millions" in London's financial system, Bagehot wrote, "infinitely the greater proportion is held by bankers or others on short notice or on demand; that is to say, the owners could ask for it all any day they please: in a panic some of them do ask for some of it." He continued: "If any large fraction of that money was demanded, our banking system and our industrial system too would be in great danger."

Bagehot's prediction was borne out by the Great Depression. Milton Friedman famously showed that the Depression was brought about by successive waves of depositor panics. And *deposits* are, for banks, a form of short-term borrowing. (When you "deposit" money "into" a bank, you are, quite literally, lending the bank money.) So the Great Depression really was about short-

term IOUs. According to Friedman, the Federal Reserve should have flooded the banking system with money to stop the panic. It failed to do its job.

Douglas Diamond, a University of Chicago economist and a leading theorist in this area, recently said that "financial crises are always and everywhere about short-term debt." The recent crisis was no exception. In 2008, we witnessed massive runs on virtually all of the financial sector's short-term IOUs, which go by odd names like "repo," "asset-backed commercial paper," and "Eurodollars." This time, the public sector intervened on an awesome scale to stem the panic, with trillions in cash infusions and guarantees for the financial industry.

This rescue operation probably prevented another full-scale depression. However, taxpayers have paid a steep price for this support. Wall Street firms are quick to point out that they paid the money back, with interest. This is true, but it misses the point. Even before the crisis, the market was confident that the government wouldn't let the financial industry default on its short-term IOUs, at least not on any significant scale. And the mere *expectation* of public support allows the financial sector to fund itself more cheaply up front. These are real subsidies—they're extracted from taxpayers. Wall Street doesn't pay the public back for this privilege.

The dollar amounts are staggering. Andrew Haldane of the Bank of England has calculated that the five largest global banks alone receive an economic subsidy of nearly $60 billion *per year* from implicit government support. For the full set of global banks, the figure runs into the hundreds of billions of dollars a year. And these subsidies aren't limited to "too big to fail" firms. They flow to other parts of the financial sector, including hedge funds, through obscure channels. This state of affairs is economically wasteful—and it isn't fair. Indeed, to state the obvious, it isn't capitalism.

THERE'S ONE SUREFIRE way for Wall Street to avoid panics: It could vastly reduce its reliance on short-term borrowings. In other words, high finance could term out. Termed-out financial firms are immune to catastrophic runs, so they don't die suddenly. They're safe for bankruptcy; the collateral damage is minimal. The government does not need to, and should not, bail them out.

Financial firms won't term out voluntarily. Short-term funding is remarkably cheap, thanks in large part to government support. But there's nothing about the business of Wall Street that makes short-term funding essential. Investment banks and hedge funds can get along just fine with ordinary long-term financing.

To be sure, we wouldn't want the *entire* financial sector to term out. Consider deposits again. These short-term IOUs are the economy's primary medium of exchange—they function as money. Other short-term IOUs, too, have "money-like" qualities. (Hence short-term IOUs are classified as "cash equivalents" for accounting purposes.) Because we need an efficient monetary system, we really do need short-term IOUs.

But it doesn't follow that we shouldn't regulate their issuance. Instead, we might confine their issuance to a designated set of licensed firms. Here's how it would work. First, licensed firms

would be allowed to fund short, but they'd be required to meet strict safety standards. Second, other financial firms—those without licenses—would be free to take big risks, but they'd have to term out.

This might seem like an unprecedented regulatory intervention. As a matter of fact, it's not. It's how the law of banking has virtually always worked. At its core, banking law consists of two components. First, licensed banking entities must abide by strict portfolio restrictions and other risk constraints. Second, and critically, there's a sweeping prohibition: Entities *without* banking licenses are legally forbidden to fund themselves with deposits.

In its existing form, this regulatory system suffers from a fundamental defect. As we saw in the recent crisis, *all* of the financial sector's short-term IOUs, not just deposits, are susceptible to destabilizing panics. Yet we don't regulate these other short-term funding markets. The proposal, then, is straightforward. Instead of focusing narrowly on deposits, we should address short-term IOUs as a class, on a functional basis. Under this modernized approach, only safe, licensed firms would be allowed to "fund short" in large amounts. Public sector support would be strictly limited to these licensed firms, and they would pay fees to the public for this privilege.

But how would this work for big, complex financial firms, like JP Morgan and Citigroup—the quintessential "too big to fail" companies? It's actually pretty simple. These firms consist of multiple corporate entities, grouped together under a single holding company. Under the proposed approach, licenses would be granted on an entity-by-entity basis. Those entities that met the applicable safety requirements (such as commercial banking subsidiaries) could continue to fund short. But any entities that were engaged in riskier activities, such as investment banking, would have to term out.

True, there would be costs to this approach. Wall Street would be less profitable, and capital would probably get marginally more expensive—just as the removal of corn subsidies would make corn products more expensive. The removal of a subsidy is always costly to its beneficiaries. In this case, the reward would be a much more stable financial system.

TERMING-OUT ISN'T a panacea. Financial booms and busts are still going to happen. We can't cure every financial disease; however, we *can* repair the financial system's broken immune system. By addressing the problem of short-term IOUs, we can prevent occasional financial infections from turning into life-threatening disasters.

It's sometimes argued that there's an even simpler and better answer: *laissez faire*. Why don't we just let financial firms fund themselves with all the short-term IOUs they want, while denying them public support under any circumstances? Under this view, we should abolish the central bank's traditional "lender of last resort" powers and let the market work.

This position has natural appeal—but it denies both theory and history. Economic theory suggests that short-term funding is unstable, and that this instability is damaging to the real economy. Historical experience confirms this hypothesis. This is what economists call a "market failure," and it won't fix itself.

At the same time, we should avoid the opposite mistake. Too often, it is said that we need "more" financial regulation—as though the solution were just a matter of turning up some imagined regulatory dial. This impulse is just as superficial, and just as erroneous, as the *laissez faire* mindset. Good financial regulation isn't a question of more versus less. It's a matter of *design*.

The terming-out proposal embodies a simple, clean design. Furthermore, it's market-friendly. Outside the protected sphere of licensed issuers, we could let finance be finance. Finally, the proposal would put an end to our current, disastrous system of subsidies for Wall Street. Termed-out firms can go bankrupt without incident, so public support would be unnecessary. So let's have a new guiding principle for Wall Street reform: "term out." It's simple, and it works.