



Rethinking the Wisdom of Resolution Authority

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Financial regulatory reform has not been handicapped by a lack of Republican support in the Senate, but rather a lack of good ideas. Instead of improving the resilience of the financial system, reformers have aimed to expand government's authority over it. If reform dies, so be it. It is not at all clear that passing the measures proposed to date would do anything more than institutionalize bailouts and protect incumbent businesses and managers.

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Instead of rehearsing the arguments about subprime loans, derivatives, and bonuses, policymakers should focus instead on the high-risk practices employed by large banks and Wall Street firms to finance their vast holdings. As of March 2008, investment banks reported financing \$4.5 trillion in securities with short-term collateralized loans known as repurchase agreements (repos). Roughly \$3 trillion of these assets were financed on an overnight basis (the loan matured the next business day). Also as of March 2008 there was \$1.8 trillion in commercial paper outstanding – standardized unsecured short-term loans – of which more than \$1.6 trillion was issued against the cash flows of financial firms or asset-backed securities. More than 80% of financial commercial paper has a maturity of less than 5 days.

So as of March 2008 roughly \$4 trillion in assets had been purchased with loans due in less than one

business week and another \$1.8 trillion in assets had been financed with loans that would mature in a month or so. Analysts accurately describe the situation when they compare Wall Street investment banks' liquidity needs to a household that must refinance its mortgage every day. But instead of being used to explain the imprudence of the financing, the comparison is generally followed by reassurance that this is how "Wall Street works" and is therefore a perfectly normal state of affairs.

When an institution needs to refinance tens of billions of dollars of loans every day, the slightest concern about its solvency could lead to a "run" where investors refuse to roll-over their loans and cause the investment bank to fail (indeed, this is precisely what triggered the bankruptcy of Bear Stearns). In the 1980s, a line of academic research argued "runs" were natural phenomena that were often no fault of the banker. The liquidity mismatch introduced by financing long-term assets with short duration liabilities (like checking accounts) created instability and made "runs" one of multiple equilibria. This provided the intellectual justification for deposit insurance as a mechanism to enhance economic well-being and systemic stability. Prior to this, deposit insurance was seen as a consumer protection measure to ensure less savvy depositors – i.e. the last ones to know to pull out – did not lose money when a failed bank was "run."

This "no fault of the banker" line of reasoning became so ingrained that by the time Bear Stearns failed in March 2008, Securities and Exchange Commission (SEC) Chairman Chris Cox spoke of the need to prevent "future occurrences of the



run-on-the-bank phenomenon that Bear endured.” That Bear endured?! The depositors were now the enemy: nothing but feckless masses looking to pull their cash at the first opportunity to topple powerless bankers. Granted, most of Bear’s “depositors” were repo counterparties (investment banks, dealers, and hedge funds) who could realistically (if not credibly) be cast as “villains” by regulators looking to pass the blame. But retail money market mutual funds also had significant exposure to financial firms and their shareholders are households.

To help stabilize the financial system in the event of the kind of shocks experienced during 2008, proposals have been put forward to establish “resolution authority.” Under these proposals, bailouts would be institutionalized so that whenever a “run” occurs the Treasury could take over the firm. This would have two effects: First, it would reduce the likelihood of a run because “depositors” would have no incentive to pull their money if they knew the government would make them whole. (The whole purpose of a run is to get out now before there’s nothing left to cover what you’re owed. This is also why the presence of deposit insurance makes old-fashioned runs a thing of the past.) Second, it would also transfer losses, to the extent a “run” materializes, from creditors to taxpayers. The sponsors of these plans contest this point, arguing that they call for the establishment of a “resolution fund” to ensure that the “beneficiaries” of bailouts pay for their cost. But if the costs and benefits of bailouts are financed by the same entities, how could a bailout possibly be more efficient than a failure? The answer given by proponents of resolution authority typically comes with a jigger of the “no fault” failure doctrine mixed in with a dash of “how Wall Street works” condescension.

Those who are skeptical should trust their instincts: if financing your next house with an overnight loan

sounds crazy, that’s probably because it is. The creditors willing to loan Wall Street all of these dollars on an overnight basis – which just happen to be other Wall Street firms – would be less willing to take on such exposures if they really believed the government would not step in to rescue them from themselves. There is a reason why hedge funds were not at the center of the panic: creditors were effective in monitoring the borrowers at the periphery of the financial system, while simultaneously turning a blind eye when dealing with the primary dealers and largest banks at its center. More distrust would have an economic cost – higher interest rates and much less borrowing – but it would be but a fraction of that imposed by institutionalized bailouts.