Financial Reform in 12 Minutes

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Is too big to fail over? No. Are we ready for the next crisis? Absolutely not.

The Dodd-Frank act is "more cowbell" – a dramatic expansion of the same regulatory structure that failed before. Unless fixed, it will fail again in even more spectacular fashion.

The basic structure of Dodd-Frank is a huge expansion of regulation – largely "discretionary, judgmental, and micro-managing" as nicely put by an earlier panelist -- to try to prevent any large and "systemically important" institution from losing money again, and a "resolution authority" in place of bankruptcy court should it fail anyway.

The premise of "resolution authority" is that large financial institutions are too complex to go through bankruptcy. So instead, the mess will be dumped into the lap of appointed officials who will figure out over a weekend who gets how many billions of dollars. If it is so complex that bankruptcy can't fixed, to write down ahead of time who gets what, how in the world are these poor folks going to figure it out on the spot? This idea is a triumph of discretion over rules.

They won't. Politically powerful creditors will scream that they too are too "systemic" to lose money, much as Goldman Sachs threatened if it should not get its collateral from AIG. "Resolution" only matters with a crisis in the background as in fall 2008, amid general panic. Of course these large and well-connected creditors will be bailed out.

Seeing this in advance, and all the rules up for grabs, other creditors will run at the first hint that resolution might be coming. Seeing that run develop, the FSOC will be forced to bail out ahead of time.

The pretense that regulators can and will spot trouble brewing and stop banks from taking risks, as they abundantly failed to do in 2008, and again when faced with European sovereign defaults, is a triumph of hope over experience.

The "macroprudential" idea that the Fed can spot "bubbles" forming, and can and will stabilize asset prices by artfully controlling interest rates, intervening in many markets, and controlling the details of financial flows, so that nobody loses any money in the first place, is a triumph of pipe dreaming. (An earlier panelist eloquently called it "profoundly misguided.")

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Like all previous crises, the next crisis will not conveniently repeat the last one, with a real estate boom and bust provoking a run in shadow banking. It will erupt from an unexpected quarter. What out there today looks today like subprime mortgages did in 2004? Sovereign debt is a good possibility. Europeans have learned that buying the bonds of high-yield "do what it takes" countries makes money, as Americans learned for subprime mortgages. A realization that sclerotic growth is settling in as the new normal, upending long-term budget projections, could be the trigger. Detroit could be LTCM, California, Illinois, and Greece could be Bear Stearns, and Italy could be Lehman Brothers.

We used lots of sovereign debt to bail out of the last crisis and stimulate in its wake. Issuing more sovereign debt remains our and Europe's fire extinguisher. We are utterly unprepared for a crisis of sovereign debt itself.

There is an alternative.

The crisis was a run. The tech stock bust did not cause a crisis, because tech stocks were stocks. When stock prices fall, it's too late to run. The housing bust led to a crisis because houses were funded, in the end, by overnight debt, which ran.

Institutions are not systemically dangerous. Run-prone *assets* are dangerous.

So, why not just ban run-prone assets? We could require that all run-prone fixed-value liabilities, including deposits, overnight debt, and money-market shares, must be backed 100% by short-term treasuries; ideally in separate or at least ring-fenced institutions. Mortgage-backed securities can be held, without government guarantee, via long-only, floating-value mutual funds in your and my 401(k) accounts, by pension funds and by endowments. Banks, and everyone else, must then finance risky investments primarily by equity, with perhaps some long-term debt. Equity will no longer be just a "cushion" but a main source of funds.

Why not? The bank answer is "the Modigliani-Miller theorem fails for banks, so borrowing will be more expensive." The MM theorem does indeed fail – because the government subsidizes and guarantees debt! Sure, banks want to maximize the value of those subsidies, and greater equity dilutes them. In addition, even if equity-financed banks charged 20 basis points more for loans, in equilibrium, remember that we lost almost 10% of GDP and 10 million jobs 5 years ago, and they have not yet returned. That's a big price to pay. If we want to subsidize borrowing, we can do it transparently, on budget, rather than by subsidizing or even tolerating run-prone debt.

The other answer is, people need a large supply of fixed-value "liquid" assets to make transactions. It is said that we need banks to "transform" liquidity and maturity, even if imperfectly.

That may have been true in 1938. In 2013 financial, transactions, and communication technology have changed everything. Instant communications – technical change – and index funds – financial engineering -- mean you no longer need fixed-value, first-come-first-serve, run-prone assets to have perfect liquidity. You could bump your iphone and pay for coffee by selling an S&P index fund share, and the store buys a share in a floating NAV mortgage-backed security fund, all in milliseconds. In fact, most current transactions are simply netted by banks, with nothing exchanged. In the 1930s we could not look up the value of the stock index to make the transaction; we needed to offer a fixed-value claim. Now we can. 2013 index funds and ETFs carry none of the asymmetric-information illiquidity that 1938 individual stocks suffer. And, as a minor benefit of our fiscal profligacy, $18 trillion of Treasuries can back every imaginable genuine economic need for fixed-value run-prone debt.

How do we get there? Much – much – higher capital requirements are a good first step. But they choke on two practical problems: First, what's the denominator? Risk weights can be gamed, and prescribing a ratio of capital to total assets incents banks to find clever ways to take on more risk at the same asset value. It's not hard to buy beta. Second, what's the minimum? 20%? 50%? 100%? The right answer is "the more the better," and "so big that it doesn't matter," but that's hardly satisfying.

I think a simple tax is the answer – though since "tax" is a dirty word, let's call it a "systemic externality fee" – on debt, and especially on short-term debt or any other contract where the investor has the right to demand payment, and fail the firm if not received. Every dollar of such funding will cost, say, a 10 cent fee. Payments due later generate smaller fees. I think we'll see a lot less run-prone debt, fast. (We could at least stop subsidizing debt!)

Then, we won't have to argue about risk weights and precise capital ratios, we won't have to intensively regulate bank assets, we won't tempt regulatory arbitrage, we won't ask the Fed to decide whether houses in Palo Alto are a "bubble," we will not hear the periodic call "we must recapitalize the banks" (at taxpayer expense), and, most of all, we can escape the chokehold on competition and innovation posed by our current expanding regulatory mess, together with the capture, cronyism, and politicization to which it is swiftly leading.

We need a financial system that can *absorb* booms and busts without creating a run or a crisis, rather than dreaming that regulators can produce a world without booms and busts. We need to regulate financial institutions' *liabilities,* not micro-manage their assets, and especially not try to manage the price of every asset in which they might invest. We must escape this crazy system in which our government subsidizes debt, guarantees debt, increases the demand for debt by regulating it as a safe asset, and then tries to regulate financial firms away from issuing that debt.

We need to insulate the financial system from looming government financial trouble rather than more deeply intertwine them.