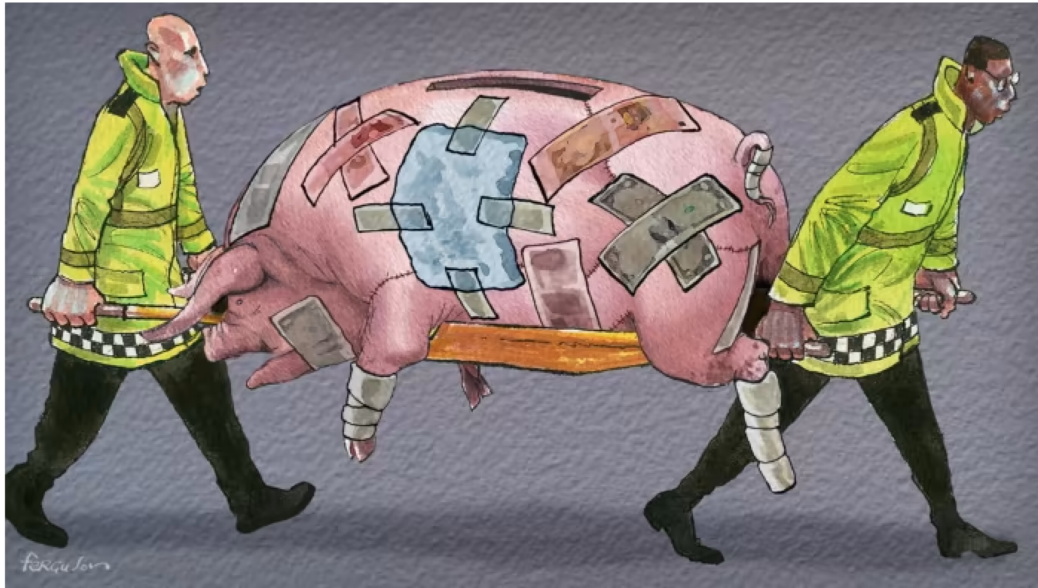
Banks in turmoil

Opinion **Financial & markets regulation**

Four ways to fix the bank problem

It is not clear how bad this crisis is going to be but reform is urgently needed

MARTIN WOLF



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Martin Wolf 7 HOURS AGO

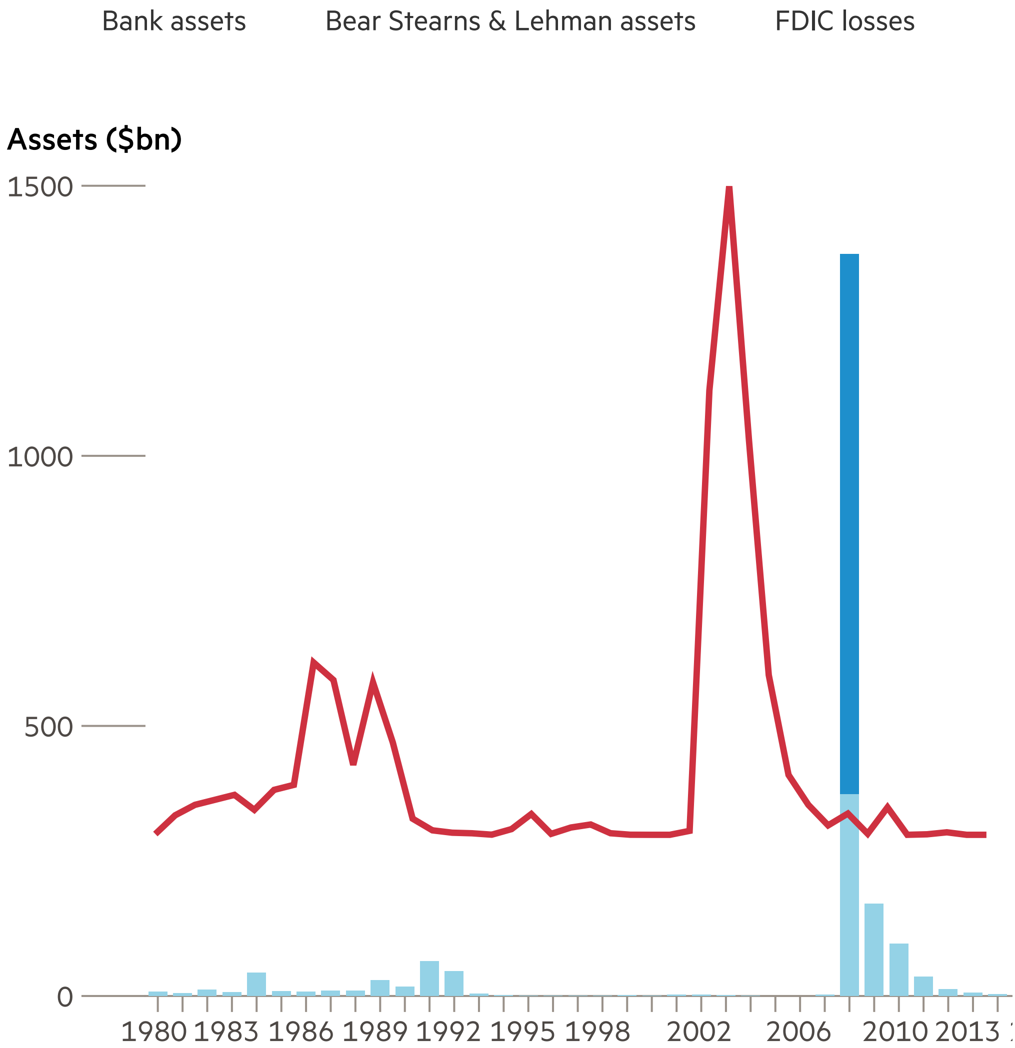
Banks are designed to fail. And so they do. Governments want them to be both safe places for the public to keep their money and profit-seeking takers of risk. They are at one and the same time regulated utilities and risk-taking enterprises. The incentives for management incline them towards risk-taking, just as the incentives for states incline them towards saving the utility when risk-taking blows it up. The result is costly instability.

If one thing is clear about the events of the last two weeks, it is that the vaunted reforms introduced after the global financial crisis have not changed any of this that much, or at least not enough.

Yes, leverage of banking systems has fallen since the crisis. But it remains dangerously high. According to the Federal Reserve, on March 8 2023, the difference between the book value of the assets and debt liabilities of US commercial banks was $2,137bn. This slice of equity backed assets that were notionally worth $22,800bn. But a recent paper suggests that mark-to-market losses are already around $2tn. A general run would force these losses into the open and wipe out the equity. To prevent this, the authorities may have to protect all deposits.

Nice words were uttered about the need for orderly resolution of failing banks, with equity the first claim to be wiped out. But, lo and behold, that is not what happened in saving Credit Suisse. Equity holders retained value and the state also provided them with guarantees indirectly, by guaranteeing UBS. Yet, we are told by the Swiss finance minister, "This is no bailout. This is a commercial solution." It is indeed a bailout. It might be the least costly solution overall. But this is not how the post-2008 crisis regime was supposed to work. I am not that surprised.

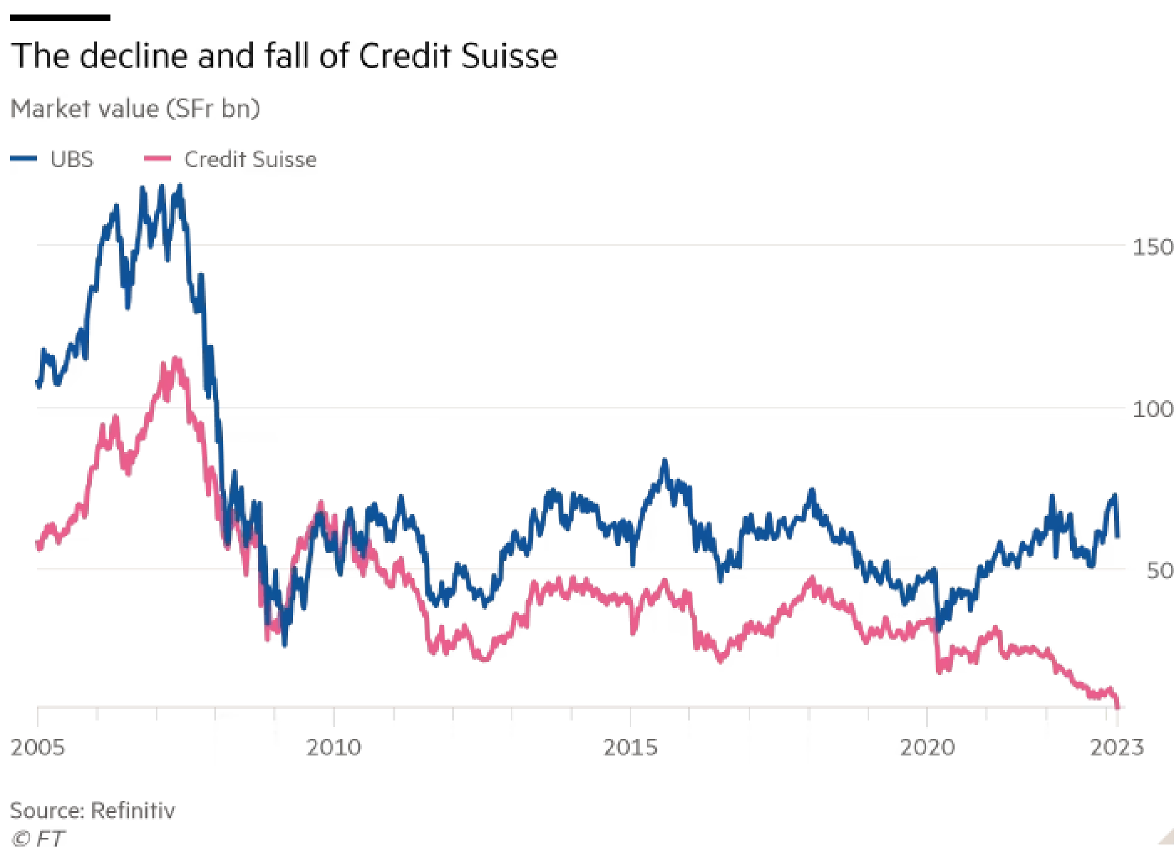
At this stage, it is still not clear how bad this crisis is going to be. But it is already evident that the reforms after the last one, though vastly better than nothing, were not enough, especially after the Trump administration tampered with them. They have not guaranteed a crisis-proof system. They have not provided a smooth way to resolve a bank in crisis, especially if the latter risks becoming systemic.



So what might be done? There are four broad approaches to reform.

First, let the market prevail, as Ken Griffin of Citadel has argued. Alas, the functions of the banks in providing money and credit are too vital to allow this. The notion that the government guarantee of deposits creates moral hazard is also complicated. Depositors are unable to monitor the soundness of banks in real time: the absence of insurance would just make them more jittery. But its presence is clearly a subsidy to shareholders and so encourages higher leverage and greater risk-taking.

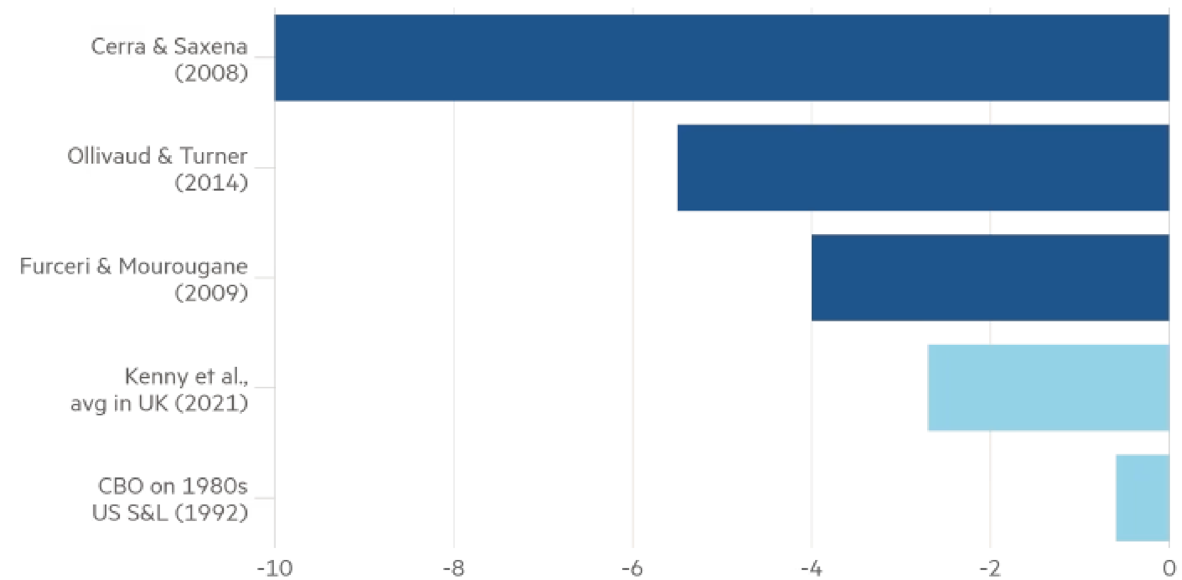
Second, tighten up current regulation. All banks with deposits that are de jure or de facto insured need to be regulated for capital soundness and liquidity in the same way. The decision to take Silicon Valley Bank out of the regulatory net for systemically significant banks was a mistake, because anything can trigger a panic if a sufficiently large number of banks have similar vulnerabilities. Also, while extending deposit insurance, increase insurance premia and link them to the risk-characteristics of banks, such as leverage. Again, make stress tests universal and brutally realistic on all risks, including interest rates.



Third, go well beyond business as usual in increasing the robustness of banks. One recommendation suggested a move to three-to-one leverage instead of the 10- or 20-to-one now common. An alternative proposal is to force banks to be funded by debt that converts automatically into equity as market valuations decline. The above ideas would go with strict marking of their accounts to market. A proposal from Mervyn King, former governor of the Bank of England, is for banks to match deposits to their liquid assets. The latter would include a pre-agreed value of collateral against lender-of-last-resort lending. This should guarantee liquidity at all times. Finally, penalties on management of failed banks should be imposed, reflecting the reality that these are utilities.

Fourth, abandon this attempt to combine the provision of money with risky loans in one sort of business. This would have two complementary elements.

Liabilities to the public that are supposed to be perfectly liquid and redeemed at par ("money") should be matched one-to-one with similar assets. This could be done by forcing intermediaries to hold reserves at the central bank or similarly liquid government liabilities. This is the famous "Chicago Plan". But members of the public could now hold central bank money directly. That was impossible when access to banking required branch networks but it would now be possible for everyone to hold central bank digital currencies that are perfectly safe, in any quantity. This idea would make the central bank the monopoly supplier of money in the economy. Management of the digital payment system could then be handed over to technology companies. The money created by central banks could be used to fund government (by replacing government bonds) or be invested in other ways.



Meanwhile, risk-intermediation could be done by mutual funds, whose value would move with the market. Less radically, the intermediation might be done by banking institutions, but ones funded by a mixture of equity, bonds and time deposits, not sight deposits.

No one is yet ready for these last approaches. But the second and third must be on the agenda. Banking stands revealed as a part of the state masquerading as part of the private sector. At the least, it needs to be far more robust. Ideally, it would be radically transformed.

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