The Credit Meltdown and Wall Street's Shadow Banking System

What Basel III Missed

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While local banks are held in check by the new banking czars in Basel, Wall Street's "shadow banking system" has hardly been curbed by regulators at all; and it is here that the 2008 credit crisis was actually precipitated.

The banking system's credit machine is systemically flawed and needs a radical overhaul.

On September 13, the Bank for International Settlements issued heightened capital requirements that will make lending even more difficult for local banks, which do most of the consumer and small business lending today. The new rules are ostensibly designed to prevent a repeat of the 2008 credit collapse, but they fail to address its real cause, which involves a "shadow" banking system that has largely escaped regulation.

What went wrong in September 2008 was not that the existing Basel II capital requirements were too low but that banks found a way around the rules. The Basel II rules base a bank's capital requirement on how risky its loan book is, and banks can make their books look less risky by buying unregulated "insurance contracts" known as credit default swaps (CDS). This insurance, however, proved to be a fraud, when insurer AIG went bankrupt on September 15, 2008. The credit collapse that followed has normally been blamed on the collapse of the subprime housing market. But according to Yale economist Gary Gorton (whose views were recently embraced by Fed Chairman Ben Bernanke), the subprime problem was not itself sufficient to trigger a global credit freeze. What it did trigger was an old-fashioned bank run, in the not-so-familiar market known as the shadow banking system.

Bank runs don't generally occur in the traditional banking system anymore, because (a) depositors are now protected by FDIC insurance, and (b) banks that run out of reserves can borrow from the Federal Reserve, which is empowered to create money ex nihilo (out of nothing). But FDIC insurance covers only $250,000 in deposits, and there is a massive and growing demand for banking by large institutional investors – pension funds, mutual funds, hedge funds, sovereign wealth funds – which have millions of dollars to park somewhere between investments. They want an investment that is secure, that provides them with a little interest, and is liquid like a traditional deposit account, allowing quick withdrawal.

The shadow banking system evolved in response to this need, operating largely through the repo market. "Repos" are sales and repurchases of highly liquid collateral, typically Treasury debt or mortgage-backed securities. The collateral is bought by a "special purpose vehicle" (SPV), which acts as the shadow bank. The investors put their money in the SPV and keep the securities, which substitute for FDIC insurance in a traditional bank. (If the

SPV fails to pay up, the investors can foreclose on the securities.) To satisfy the demand for liquidity, the repos are one-day or short-term deals, continually rolled over until the money is withdrawn. This money is used by the banks for other lending, investing or speculating. But that puts the banks in the perilous position of Jimmy Stewart in "It's a Wonderful Life," funding long-term loans with short-term borrowings. When the investors get spooked for some reason and all pull their money out at once, the banks can no longer make loans and credit freezes.

In September 2008, investors were spooked when the mortgage-backed securities backing their repo "deposits" proved not to be "triple A" as represented. But the next time it might be something else, and Basel III has not fixed this systemic weakness. Arguably, the weakness cannot be fixed under the current scheme of private banking and credit. As noted in an article on Seeking Alpha by The Business Insider:

"Our financial system remains vulnerable to another credit crunch, with many of the same exact features as the last. All it needs is someone to strike the match of panic."

The question is how to eliminate this systemic risk:

"Regulate shadow banking more tightly, and you probably have to also provide government backstops. Shudder. Try to shut the thing down or restrict it and you suck credit out of the system, credit which much of the non-financial 'real' economy uses and needs."

The real economy needs credit, and choking it off by over-regulating the banks will kill the real economy. Indeed, according to Gary Gorton, the shadow banking system evolved because banks were already so over-regulated that they could not turn a profit. He writes:

"Holding loans on the balance sheets of banks is not profitable. . . . This is why the parallel or shadow banking system developed. If an industry is not profitable, the owners exit the industry by not investing; they invest elsewhere. Regulators can make banks do things, like hold more capital, but they cannot prevent exit if banking is not profitable. 'Exit' means that the regulated banking sector shrinks, as bank equity holders refuse to invest more equity."

Toward a Better Solution

Only a complete overhaul of the banking system can eliminate these systemic flaws, flaws that ultimately stem from a misconception about what money is. We think of it as a "thing," something that must be dug out of the ground or borrowed from someone who already has it. Since banks don't have enough of this thing to cover their loans and investments, they engage in a shell game in which they advance credit and scramble to cover it with short-term loans, exposing them to the systemic risk of sudden and unpredictable withdrawals.

That is the old model, but today money and credit are something else. No gold or other commodity backs our money today. Nothing backs it but "the full faith and credit of the United States." Money and credit are creatures merely of legal agreement, a tally of accounts keeping track of who owes what to whom. Two or more parties can enter into a legal agreement without having any money at all. They can advance credit against goods or services and engage in productive trade. The tribute exacted by a private banking monopoly actually hampers this productive flow. As Thomas Jefferson complained to

Treasury Secretary Gallatin in 1815:

"The treasury, lacking confidence in the country, delivered itself bound hand and foot to bold and bankrupt adventurers and bankers pretending to have money, whom it could have crushed at any moment."

Jefferson wrote to John Eppes in 1813:

"Although we have so foolishly allowed the field of circulating medium to be filched from us by private individuals, I think we may recover it … The states should be asked to transfer the right of issuing paper money to Congress, in perpetuity."

The "full faith and credit of the United States" could and should be overseen by a branch of the United States, just as legal agreements are overseen by the judiciary. Publicly-owned banks could issue the full faith and credit of the nation without worrying about capital or reserves. After all, if you are the United States, why do you need "reserves" of your own credit?

While we're waiting for the Calvary to swoop down from Washington and save us – something that could take a while – we might consider setting up some state-owned banks. The Bank of North Dakota, currently the country's only state-owned bank, is very stable and very profitable, returning a 26% dividend to the state. A bank of that sort could be an attractive investment for all those state and local rainy day funds, pension funds and other local government funds looking for greater returns from the low-risk investments allowed by their legislative mandates. We need to set up some banks that serve the needs of the real economy rather than those of Wall Street bankers, brokers and their super-rich clients for yet more bonuses, bailouts and paper profits. State-owned banks could fill the role the Wall Street banks have declined to fill, providing an effective credit engine for state and local economies.

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