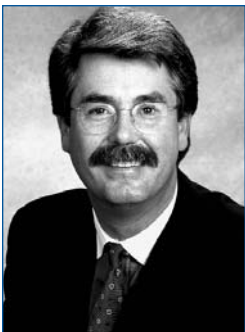


# Global Central Bank Focus

by PIMCO's Paul McCulley

## Saving Capitalistic Banking From Itself



Paul McCulley

At its core, capitalism is all about risk taking. One form of risk taking is leverage. Indeed, without leverage, capitalism could not prosper. Usually, we think of this imperative in terms of entrepreneurs being able to lever their equity so as to grow. And indeed, this is the case.

But more elementally, economies—both capitalist and socialist—require leverage because savers for very logical reasons do not want to have one hundred percent of their stock of wealth in equity investments. Rather, they logically want a portion of their portfolios in a fixed-commitment instrument that is senior to equity.

And savers want some portion of that fixed-commitment allocation in literal money, defined as a government-guaranteed obligation that always trades at par. If you have any doubt about this, put your hands into your pockets and you will find just such an instrument. It's called currency, a zero-interest, perpetual liability of the Federal Reserve, itself a levered entity, capitalized by its Congressionally-legislated monopoly over the creation of money.

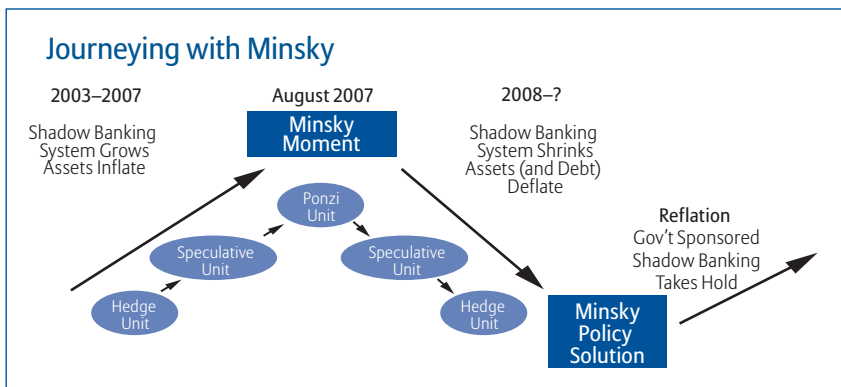
As a practical matter, of course, you don't hold all of your always-trades-at-par liquidity in currency. You most likely have a demand deposit, also known as a checking account, as well as shares in a money market mutual fund, which is putatively supposed to always trade "at the buck." You probably also have some longer-dated bank deposits, such as certificates of deposits, or CDs, which don't necessarily trade at par in real time, but are guaranteed to do so at maturity.

### The Nature of Fractional Reserve Banking

The public's demand for at-par liquidity inherently creates the raw material for leverage in the economy. Indeed, from time immemorial, fractional reserve banking has been built on the simple proposition that the public's collective *ex ante* demand for at-par liquidity is greater than the public's collective *ex post* demand for such liquidity.

Accordingly, the genius of banking<sup>1</sup>, if you want to call it that, has always been simple: A bank can take more risk on the asset side of its balance sheet than the liability side can notionally support, because a goodly portion of the liability side, notably deposits, is de facto of perpetual maturity, although it is de jure of finite maturity, as short as one day in the case of demand deposits.

Thus, the business of banking is inherently about maturity and credit quality transformation: banks can hold assets that are longer and riskier than their liabilities, because their deposit liabilities are sticky. Depositors sleep well knowing that they can always



Source: PIMCO

get their money at par, but because they do, they don't actually ask for their money, affording bankers the opportunity to redeploy that money into longer, riskier, higher-yielding assets that don't have to trade at par.

### Enter the Government

A key reason that depositors sleep well at night is the fact that since 1913 here in the United States, banks have had access to the Federal Reserve's discount window, where assets can be posted for loans to redeem flighty depositors. A second sleep-well governmental safety net was introduced in 1933: deposit insurance, in which the federal government insures that deposits—up to a limit—will always trade at par, regardless of how foolish bankers may be on the other side of their balance sheets.

Thus, the genius of modern day banking, again if you want to call it that, has always been about exploiting the positive spread between the public's ex ante and ex post demand for liquidity at par, in the context of leveraging the two safety nets—the central bank's discount window and deposit insurance underwritten by taxpayers—which provide comfort to depositors that they can always get their money at par, even if their bankers are foolish lenders and investors.

Yes, I know that sounds harsh. But it really is how the banking world works. In turn, banks can be very profitable enterprises, because the yield on their risky assets is greater than the yield on their less-risky liabilities. And that net interest margin can be particularly sweet when recomputed as a return on equity, given that banks are very levered institutions (recall, banks must hold only 8% of liabilities in the form of Tier 1 capital).

Put differently, equity investors in banks can lose only 8% of a bank's footings, but they earn the net interest margin on 100% of those footings, so long as they don't make so many dodgy loans and investments, destroying capital, that the providers of the two government safety nets cut them off.

Thus, it has always been somewhat of an oxymoron, at least to me, to think of banks as strictly private sector enterprises. To be sure, they have private shareholders. And, yes, those shareholders get all the upside of the net interest margin intrinsic to the alchemy of maturity and risk transformation. But the whole enterprise itself depends on the governmental safety nets. That's why banks are regulated.

Conceptually, as is the case in socialist countries, banks could be—and usually are—simply owned by the government, the ultimate form of regulation. Such an arrangement has the benefit of the taxpayer sharing in the upside, not just the downside. Such an arrangement also has the cost of putting the government in the lending and investing business, with little regard for the pursuit of profit, picking winners and losers on the basis of political clout.

Thus, capitalist economies usually want their banking systems owned by the private sector, where loans and investments are made on commercial terms, in the pursuit of profit. But also in the context of prudential regulation, so as to minimize the downside to taxpayers of the moral hazard inherent in the two safety nets for depositors.

### The Mae West Doctrine

But as is the wont of capitalists, they love leveraging the sovereign's safety nets with minimal prudential regulation. This does not make them immoral, merely capitalists. And over the last decade or so, the way for bankers to maximally lever the inherent banking model has been to become non-bank bankers, or as I dubbed them a couple years ago, shadow bankers.

The way to do this has been to run levered-up lending and investment institutions—be they investment banks, conduits, structured investment vehicles, hedge funds, et al—by raising funding in the non-deposit markets, notably: unsecured debt, especially interbank borrowings and commercial paper; and secured borrowings, notably reverse repo and asset-backed commercial paper. And usually—but not always!—such shadow banks relied on conventional banks with access to the central bank's discount window as **backstop liquidity providers**.

Structured accordingly, without explicit access or use of the government's safety nets, shadow banks essentially avoided regulation, notably on the amount of leverage they could use, the size of their liquidity buffers and the type of lending and investing they could do.

To be sure, Shadow Banking needed some seal of approval, so that providers of short-dated funding could convince themselves that their claims were de facto "just as good" as deposits at banks with access to the government's liquidity safety nets. Conveniently, the rating agencies, paid by the shadow bankers, stood at the ready to provide such seals of approval.

And it was all grand while ever-larger application of leverage put upward pressure on asset prices. There is nothing like a bull market to make geniuses out of levered dunces. Call it the Mae West Doctrine, where if a little fun is good and more is better, then way too much is just about right.

Also call it the Forward Minsky Journey,<sup>2</sup> where stability begets ever riskier debt arrangements, until they have produced a bubble in asset prices. And then the bubble bursts, in something called a Minsky Moment, followed by a Reverse Minsky Journey, characterized by ever-tighter terms and conditions on the availability of credit, inducing asset price deflation and its fellow traveler, debt price deflation.

This dynamic is inherently self-feeding, begetting the Paradox of Deleveraging,<sup>3</sup> where private sector bankers—conventional bankers and shadow bankers alike—all move to the **offer** side of both asset markets and bank capital markets, trying to reduce their leverage ratios by selling assets and paying off debt, and/or issuing more equity. But by definition, if everybody tries to do it at the same time, as has been the case over the last 18 months or so, it simply can't be done.

What is needed is for the government to take the other side of the trade, effectively becoming the **bid** side, (1) buying assets, (2) guaranteeing assets, (3) providing cheap funding for assets, and (4) buying bank equity securities (of both conventional banks and shadow banks that are permitted to become conventional banks after the fact).

#### Government Goes All In<sup>4</sup>

And indeed, all four of these techniques have been put into play since the fateful decision to let Lehman Brothers fall into disorderly bankruptcy. Put more bluntly, the hybrid character of banking—always a joint venture between private capital and governmental liquidity safety nets—is morphing more and more towards government-sponsored banking. Yes, I know that is harsh, but sometimes the truth is harsh. Capitalism and banking may not be divorced, but certainly are engaged in some form of trial separation.

The Treasury, the FDIC and the Fed—the big three—are caught in the middle, serving both as mediators as well as deep pockets to the estranged parties. It's not wholesale nationalization. And it's not likely to become that. But only because the big three are committed to doing whatever it takes to prevent that outcome. Along the way, the big three would also like—need!—to restart the engines of credit creation, so as to pull the economy out of its gaping hole of insufficient aggregate demand for goods and services, also known as a recession.

Will it work? Judging from the markets' collective reaction to Treasury Secretary Geithner's announcement last week of the new administration triage plans, there is room for doubt. I do not, however, take one-week swings in the markets as indicative as to where this game will end. And a key reason is actually the special powers of the Fed and the FDIC, which can lever the taxpayer monies that Congress provides for the Treasury.

As evidenced in recent months, the Fed has two incredibly powerful tools:

- Section 13(3) of the Federal Reserve Act of 1932, which permits the Fed, upon declaration of "unusual and exigent circumstances" to lend to anybody against collateral it deems adequate, and
- Total freedom to expand its balance sheet, essentially creating liabilities against itself that trade at par—also called printing money—so long as the Fed is willing to surrender control over the Fed funds rate, letting it trade at zero, or thereabouts.

The Fed has used both of these tools vigorously in recent months, expanding its lending programs mightily, to both conventional banks and shadow banks (i.e., investment banks who have re-chartered as banks, as well as primary dealers), while also doubling the size of its balance sheet, as it let the Fed funds rate fall to effectively zero.

The FDIC also has an incredibly powerful tool: the so-called Systemic Risk Exception under the FDIC Improvement Act of 1991, which allows the FDIC to forgo using the “lowest cost” solution to dealing with troubled banks if using such a solution “would have serious adverse effects on economic conditions or financial stability” and if bypassing the least cost method would “avoid or mitigate such adverse effects.”

It’s actually not an easy clause for the FDIC to invoke, unlike Section 13(3) for the Fed, which can be invoked simply by a supermajority of the Board of Governors. For the FDIC, the Systemic Risk Exception must be deemed necessary by two-thirds of both the Board of Directors of the FDIC and the Fed’s Board of Governors, as well as by the Secretary of the Treasury, who must first consult and get agreement from the President of the United States.

But where there is a will, there is a way, and the FDIC is now living firmly in the land of the Systemic Risk Exception, legally allowed to guarantee unsecured debt of banks as well as to put itself at risk in guaranteeing banks’ dodgy assets.

#### Bottom Line

The United States government now has both the tools and the will to save the private banking system, and more importantly, the real economy, from its own debt-deflationary pathologies. Not that it will be easy. But it can be done, notwithstanding the catcalls that greeted Secretary Geithner last week.

And the essential game plan is clear: use the power of the Fed, the FDIC and the Treasury to create government-sponsored shadow banks, such as the Term Asset-Backed Securities Lending Facility (the TALF) and the Public-Private Investment Fund (the P-PIF).

The formula? Take a small dollop of the Treasury’s free-to-spend taxpayer money (there is still \$350 billion left) to serve as the equity in a government sponsored shadow bank, and then lever the daylights out of it with loans from the Federal Reserve, funded with the printing press. That’s the formula for the TALF, to provide leverage, with no recourse after a haircut, to restart the securitization markets.

The same formula applies for the P-PIF, with the addition of FDIC stop out loss protection for dodgy bank assets that private sector players might buy. With such goodies, such players, it is hoped, will be able to pay a sufficiently high price for those assets to avoid bankrupting the seller bank.

Unfortunately, Secretary Geithner hasn’t laid out the precise parameters of how to mix these three ingredients, which is driving the markets up the wall. But make no mistake, these are the ingredients, along with continued direct capital infusions into banks where necessary.

Uncle Sam has the ability to substitute itself—not himself or herself!—for the broken conventional bank system, levering up and risking up as the conventional banking system does the exact opposite.

Yes, there will be subsidies involved, sometimes huge ones. And yes, the process will seem arbitrary and capricious at times, reeking of inequities. Such is the nature of government rescue schemes for broken banking systems, while maintaining them as privately owned.

You might not like it. I don't like it, because regulators should never have let bankers, both conventional bankers and shadow bankers, run amok. But they did.

So it's now time to hold the nose and do what must be done, however stinky it smells, not because it's pleasant but because it is necessary.

Only with the full force of the sovereign's balance sheet can the Paradox of Deleveraging be broken.

A handwritten signature in black ink, reading "Paul H. McCulley". The signature is fluid and cursive, with a large, sweeping "P" and "M".

Paul McCulley  
Managing Director



1. "The Paradox of Deleveraging Will Be Broken," Global Central Bank Focus, November 2008.
2. "Comments Before the Money Marketeers Club, Minsky and Neutral:Forward and in Reverse," Global Central Bank Focus, December 2007.
3. "The Paradox of Deleveraging," Global Central Bank Focus, July 2008.
4. "All In," Global Central Bank Focus, December 2008/January 2009.

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