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Why banking works one big confidence trick

By Zoltan Pozsar

Banking is one large, clever, and finely tuned, confidence trick.

On the one hand are bank notes which are "legal tender for all debts, public and private", trade at par and are referred to as money. They are liabilities of the sovereign. On the other are demand deposits – from savings to cheque accounts – which also trade at par and thus function as money. But, unlike bank notes, they are the liabilities of banks.

As long as the public knows it can get bank notes for its deposits, it will not ask for them and banking works just fine. In other words, the genius of banking is the arbitrage of the public's ex-ante and ex-post demand for instruments that trade on demand at par. This allows banks to conduct credit, maturity and liquidity transformation: holding assets that are riskier, longer dated and less liquid (and hence higher yielding) than its liabilities.

But if confidence goes, bank runs ensue with the public demanding liquidity at par through the withdrawal of all deposits into bank notes at par. In such instances, the banking system is insolvent. This is because at its core the system promises something it cannot deliver.

In the early 1900s, bank runs were frequent. Runs were ultimately solved by the creation of the Federal Reserve in 1913 and the Federal Deposit Insurance Corporation in 1933. These subsidiaries of the sovereign ensure public confidence in on demand liquidity at par and make banking a public-private partnership.

Pre-crisis, only retail depositors had access to publicly guaranteed liquidity on demand and at par, however. Institutional cash investors – modern-day species of the financial ecosystem that include asset managers and global corporations – did not. This was because their size was above the FDIC's pre-crisis insurance limit. Their alternative would have been to keep their cash in uninsured deposits. However, these were unsecured, undiversified and perceived as risky.

Institutional-class money funds were the answer. Like banks, money funds promise on

demand liquidity at par. However, unlike banks, which are backed by the sovereign, money funds are not. Still, they were perceived to be safer than uninsured deposits due to their diversified holdings of safe, short-term and liquid instruments.

No matter their degree of diversification, however, the crisis proved that money funds can only provide on demand liquidity at par if they are backed by the sovereign. And backed they were during the crisis through a series of liquidity facilities from the Federal Reserve for both their secured assets (repos and asset-backed commercial paper) and even some unsecured assets (commercial paper), and guarantees from the US Treasury on their promises of on demand liquidity at par. It was a 360-degree backstop of the shadow banking system by the sovereign.

An under-appreciated aspect of shadow banking is that it arose due to institutional cash investors' demand for guaranteed liquidity on demand at par, and other safe, short-term, liquid instruments.

Today uninsured institutional cash investors manage over $3,500bn in cash, up from $100bn in 1990. On an ecosystem level, the larger they grow, the more credit, liquidity and par value puts they demand from too big to fail institutions, which are expected to be backed by the sovereign.

The balance sheet of the sovereign played into the emergence of the shadow banking system and the integrity of its money claims. Therefore, solutions for shadow banking – besides regulation – must also involve the balance sheet of the sovereign. Here are two.

First, solutions for institutional demand for publicly guaranteed on demand liquidity at par could involve them undertaking repos, with central banks setting dynamic haircuts. Who has access to the central bank would need to be clarified in advance. Repos would serve as alternatives to money funds, which, as purely private money claims, defy the laws of banking. In their current circumstances, money funds should float their net asset values.

Second, solutions for institutional demand for safe, short-term, liquid instruments could include the US Treasury increasing its supply of bills, an idea similar to the Treasury Borrowing Advisory Committee's proposal of floating-rate notes. More bills would also complement regulatory efforts to design a smaller and simpler global banking system with less dependence on wholesale dollar funding. Treasury bills are as fit for the intermediation of institutional dollar cash balances as global wholesale banks.

Paraphrasing Forrest Gump: money is as money does, and in a crisis, money is only money if the public knows the sovereign stands ready to make it trade at par.

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