Fixing our 21st Century Bank Run

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On Monday, JP Morgan released a report entitled "How Will the Crisis Change Markets?" which outlined the probable industry path going forward. The report is insightful in its characterization of the crisis – indeed much more so than the "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," released on Friday.

Of note for today's commentary, the JP Morgan report notes the source of leverage in securitization is not mere securitization, itself, but the senior-subordinate structure of securities used in most modern structures. Hence, only straight pass-through securities can be properly thought of as part of an "originate and distribute" securitization model (the only idea considered by financial regulators, the Financial Stability Forum included). Senior-subordinate structures create leverage, distilling risk into the bottom mezzanine and residual stakes.

The risk distillation process has two important implications. First, if the structure is inappropriately designed, risk can leak up through the structure and infect the lower-risk securities above. Second, if the structure is well-designed, the important question to be answered is not "who holds the least-risky securities," but "who holds the small proportion of securities that take on the lion's share of the risk?" The point seems to be lost on most policymakers, even financial regulators, and is therefore setting the stage for more inefficient regulation.

Of potentially greater importance is the report's appropriate characterization of the lock-up in securitization markets as a bank run. Indeed, highly-leveraged securitization structures became the mainstay of bank funding, replacing deposits in importance long ago. Unfortunately bank regulators, not recognizing the shift, never moved to ensure stability for bank securitized funding as they did decades ago for bank deposit funding (in terms of deposit insurance programs of most developed countries).

One aspect the report did not discuss is banks' continued use of the most innovative securitization structures in achieving that funding. Banks relied on the most innovative structures in order to squeeze the last few basis points of funding

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out of each securitization, thereby maximizing gain-on-sale (non-cash) revenues and maintaining the aura of profitability.

Here is where the classic lesson of most financial crises lies: banks treated their funding (treasury) operations as a profit center rather than focusing on the ability to raise cash repeatedly and reliably in any business climate. This is a lesson that was learned in other (non-mortgage) securitization markets years ago. A case in point was the credit card sector. Credit cards, hard-hit by widened spreads in the 1998 Russian default crisis, ceased issuance and several issuers came close to failing as a result. When the market came back, the sector seemed to have made a choice of continued funding over innovation and sophistication.

Policymakers, regulators, and banks need to decide together which sectors are appropriately funded by the most sophisticated innovative structures and which are appropriate for experimentation with new funding techniques. We have experienced a 21st century bank run and therefore need to look toward fostering stability and reliability for modern bank funding methods to provide a firm foundation for financial system growth and economic performance.

In the meantime, as in any classic bank run, information about the loss exposures will end the run. On Friday, the "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," recommended that banks use the second quarter of 2008 as the much-touted "kitchen sink" quarter in which they expose all expected losses in the sector. This is indeed the first step out of the crisis, but since the funding mechanism was used for more than banks, resolution will require exposure of far wider exposures than just in the banking sector. It will take a strong stomach to ride out the IMF's estimated $1 trillion of losses, but moving through the crisis is the clearest way out.