RUNNABLE, RUINABLE REPO AND THE GREAT RECESSION: A PANIC-PROOFING APPROACH TO FINANCIAL REGULATION

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We want a system that is not prone to panics, or, better yet, a system that does not have panics, a system where losing confidence does not happen . . . In the aftermath of the [2008 financial crisis], how can such a system be designed?
—Gary Gorton, Slapped in the Face by the Invisible Hand (2010)

INTRODUCTION

“The [2008 financial] crisis,” then Federal Reserve Chairman Ben Bernanke reflected at a 2012 conference on financial regulation, “is best understood as a classic financial panic.”¹ A “panic” occurs when short-term debt claimants decide en masse to no longer fund the banking system.² Yale economist Gary Gorton has shown that “the most important part of the panic occurred in the repo market.”³ “Run on repos,” he holds, “[was] the core problem in the financial crisis.”⁴

“Repo” is shorthand for “sale and repurchase agreement.” Institutional financiers—like money market mutual funds, pension funds, and corporate treasuries—enter into these short-term (typically overnight) “repo agreements” with Wall Street firms. Repo provides them with a sort of demand deposit

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³ GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 133 (2010). Also Laurence Ball, The Fed and Lehman Brothers 7 (July 14, 2016) (paper prepared for meeting of the NBER Monetary Economics Program) (“The fatal part of this cycle was a liquidity crisis . . . the most important problem [involving] repurchase agreements, or repos.”). Id. at 111 (“The largest liquidity drain [on Wall Street banks in 2007/2008] . . . was a loss of repo financing.”).
account for their excess cash.\(^5\) It also gives Wall Street firms access to an enormous amount of cash. The “run on repo” was a run by major financial institutions (the repo lenders) on other major financial institutions (the repo borrowers).

Demand deposit accounts and overnight repo agreements serve a similar function for retail depositors and repo “depositors” respectively. Large financial institutions, not unlike regular people, want to earn interest on their excess cash while not losing the ability to access their cash at any time. That is why they enter into these overnight repo agreements with Wall Street banks. Each day, they can either “withdraw” their cash or “roll over” their repo. If they choose the former, the repo borrower—under the terms of the repo agreement—must obviously honor that demand.

The key practical difference between demand deposits and overnight repo “deposits” is that the federal government provides deposit insurance for the former but not the latter.\(^6\) To lessen the repo lenders’ counterparty default risk (i.e., that the Wall Street bank won’t have the cash on hand to honor the repo lender’s “withdrawal”), repo deposits are collateralized. Repo lenders are fully secured creditors of their counterparty banks, contractually armed with immediate recourse to the specified collateral under each repo agreement if their counterparty bank defaults.

One of the key lessons to be drawn from the 2008 financial crisis is that this security interest was not enough of a security interest to offset the repo lenders’ counterparty default risk. In other words, having immediate recourse to collateral—even high-quality collateral—was inadequate to temper the concerns of skittish repo lenders and contain the contagious run on repo.\(^7\) Vanderbilt law professor and former Treasury bureaucrat Morgan Ricks has made this point loud and clear, most recently in his 2016 book *The Money Problem*.

Gary Gorton and Morgan Ricks are two of academia’s main proponents of the “panic-proofing” approach to financial regulation. That approach, on which

\(^5\) *Id.*, at 276 (“Entities [such as institutional investors, pension funds, mutual funds, states and municipalities, and nonfinancial firms] . . . would like to have a safe investment that earns interest, while retaining flexibility to use the cash when needed—in short, a demand deposit-like product.”).

\(^6\) The FDIC backstops retail deposits at insured banks up to $250 thousand (prior to the financial crisis, $100 thousand).

this paper ideologically stands, is based on the following logical progression and understanding of US banking history:

1 – US banking history was marked by frequent financial panics\(^8\) (and in turn macroeconomic tragedies) until the Depression-era advent of deposit insurance in 1934. Deposit insurance is to thank for the 75-year “Quiet Period”—of no systemic panics from the Depression to the Recession—in US banking history.\(^9\)

2 – A panic by institutional financiers, mainly overnight repo creditors on systemic financial institutions,\(^10\) commenced in August 2007.\(^11\) This panic reached its acute phase in September 2008, when twelve out of America’s 13 leading financial institutions faced dire threats to their survival.\(^12\) If not for this panic, the Great Recession would have been far less severe and might not have happened.\(^13\)

3 – Systemically important financial institutions (the “SIFIs,” mostly Wall Street banks\(^14\)) continue to rely heavily on runnable short-term debt to finance their long-term activities. Thus, “panics represent far and away the biggest threat that the financial system poses to the broader economy.”\(^15\) The focus of financial regulation should therefore be on “panic-proofing.”\(^16\)

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\(^8\) Id. at 108 (“Gorton uses “panic” the same way I use it here: a panic is a situation in which ‘holders of short-term liabilities . . . [refuse] to fund banks.”).

\(^9\) See GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007, at 64 (“Periodic banking panics have been the norm in U.S. history. But the panics appeared to end in the U.S. when deposit insurance was legislated in 1934.”).

\(^10\) Id. at 54 and 58 (“The run occurred in the repo market . . . depositors” were firms that lent money in the repo market.”). See also GARY B. GORTON, MISUNDERSTANDING FINANCIAL CRISES: WHY WE DON’T SEE THEM COMING 190 (“The banking system on repo became very large prior to the crisis.”).

\(^11\) See GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007, at 23 (“The current crisis is a banking panic.”).

\(^12\) FIN. CRISIS INQUIRY COMM’N, FINAL REPORT OF THE NAT’L. COMM’N ON THE CAUSES OF THE FIN. AND ECON. CRISIS IN THE UNITED STATES, 354 (January 2011).

\(^13\) See GORTON, MISUNDERSTANDING FINANCIAL CRISES, at 183 (“The deterioration of house prices and defaults in the subprime mortgage market were not enough to cause a systemic crisis by themselves.”).

\(^14\) See BERNANKE, THE COURAGE TO ACT, at 395 (“We focused on the nineteen largest U.S.-owned bank holding companies, those with assets of $100 billion or more. Collectively, they hold about two-thirds of the assets and half the loans in the U.S. banking system.”).

\(^15\) See RICKS, THE MONEY PROBLEM, at 24.

\(^16\) Id. at 122 (“[There is a] strong case that panics should be viewed as the central problem for financial stability policy.”); Id. at 3 (“Panic-proofing, as opposed to, say, asset bubble prevention or “systemic risk” mitigation, should be the central objective of financial stability policy.”). See also GORTON, SLAPPED BY THE INVISIBLE HAND, at 183 (“We want a system that is not prone to panics, or, better yet, a system that does not have panics, a system where losing confidence does not happen . . . In the aftermath of the [Great Recession], how can such a system be designed?”).
Ricks and Gorton agree that the focus of financial regulation should be on panic-proofing. They have different ideas, however, on how policymakers should go about panic-proofing the financial system. Gorton would reform the repo market by ensuring the high quality of repo collateral. Ricks would federally insure all the short-term debt obligations of systemically important commercial banks. And both would limit the exposure levels of the SIFIs to runnable short-term debt.

This paper argues for a sort of Gorton/Ricks hybrid approach to panic-proofing, whereby the federal government (1) insures the very-short-term repo obligations of the SIFIs (while also ensuring the high-quality of the collateral under those repo agreements) and (2) limits the exposure levels of the SIFIs to all other forms of uninsured runnable debt.

Section I will discuss the historical panic-proofing success of deposit insurance in the US. It will explain how deposit insurance became an anachronistic solution to forestalling panics, given the rise of the money markets and the institutional “depositor.” It will then cover the repo market, the run on repo of 2007 and 2008, and why repo lenders ran en masse from the SIFIs in the prelude to the Recession.

Section II will examine the two main pieces of financial legislation to emerge from the Great Recession, the domestic law Dodd-Frank and the international accord Basel III. It will specifically ask what these laws do to contain panics by repo lenders, as well as discuss their general “risk-constraint” (not panic-proofing) approach to financial regulation.

Section III will expand upon the panic-proofing models for financial regulation as proposed by Ricks and Gorton. It will critique these models before offering this paper’s original panic-proofing approach.

I. RUNNABLE, RUINABLE REPO AND THE GREAT RECESSION

A. Banking’s Inherent Susceptibility to Panics

The classic business model of banking involves a heavy reliance on short-term debt to finance long-term assets.17 This almost has to be the case, since

17 See GORTON, SLAPPED BY THE INVISIBLE HAND, at 52 (“[B]anking inevitably involves [borrowing short to finance long assets] because part of making the “deposit” nearly riskless is for it to be short maturity. Note that with insured deposits, the debt is effectively long maturity because depositors have no need to run their banks to try to withdraw cash.”).
“part of making the “deposit” nearly riskless is for it to be short maturity.”\textsuperscript{18} But this makes banks “inherently susceptible to a liquidity crisis or “run” in which short-term claimants simultaneously seek to redeem.”\textsuperscript{19}

Prior to the Depression-era establishment of deposit insurance in 1934, American banking was marked by regular panics and macroeconomic storms. Concerned their banks could fail, retail depositors rushed to withdraw their funds. Failure to withdraw in time could mean becoming an unsecured creditor of a failed bank in a bankruptcy proceeding—and perhaps having to wait years before receiving any money back.

B. Establishment of the FDIC and the “Quiet Period” in US Banking

The tragedy of the Great Depression, triggered by a widespread panic by retail depositors, prompted the US Congress to establish federal deposit insurance in 1934. A new federal agency, the Federal Deposit Insurance Corporation (FDIC), would now insure all bank deposits at insured member banks up to a certain dollar amount (today $250 thousand).

Retail depositors could now rest assured that, if their bank were to fail, the FDIC would promptly send them a check covering the full amount of their deposit balance. They now had no reason to withdraw their funds from their banks in a frenzy anymore—their deposits were backed by the full faith and credit of the US Treasury.

The advent of deposit insurance set the stage for the 75-year “Quiet Period” in American banking—a period marked by no systemic panics.\textsuperscript{20} Deposit insurance “stopped the cycle of runs on demand deposits and allowed them to be used safely as money,”\textsuperscript{21} creating an “unusually stable time for the US economy.”\textsuperscript{22}

C. Rise of the Institutional “Depositor” and Unraveling of the Quiet Period

The Quiet Period began to unravel in the 1980s. Wall Street firms, historically reliant on retail deposits for their cash needs, began to rely

\textsuperscript{18} Id.
\textsuperscript{19} See Ricks, The Money Problem, at 4. See also Ball, “The Fed and Lehman Brothers,” at 22 (commenting on the nature of Wall Street banks’ short-term funding in the lead-up to the Crisis: “Some of this funding was unsecured commercial paper, but a much larger part was repurchase agreements, or ‘repos.’”).
\textsuperscript{20} See Gorton, Slapped by the Invisible Hand, at 61 (“[T]here was no systemic event in banking [from the Great Depression] until 2007.”).
\textsuperscript{21} See Gorton & Metrick, Regulating the Shadow Banking System, at 268.
\textsuperscript{22} See Ricks, The Money Problem, at 108.
increasingly on institutional money—that of money market funds, pension funds, and other large financial institutions. There had been an “explosion of the modern day money markets,” and these financiers needed a safe place to store their excess cash in the short-term. Repo provided that place. Retail deposits, in turn, diminished in importance as a financing vehicle for Wall Street firms.

By 2007, a run by these institutional repo creditors would be capable of leading to large-scale liquidity problems on Wall Street. On Wall Street’s collective pre-Recession balance sheet, liabilities for repo debt far exceeded the banks’ readily available liquidity. And repo deposits were not FDIC-insured (they well exceeded $250 thousand in value). Gorton states the obvious point: “Deposit insurance works well for retail investors but leaves a challenge for institutions with large cash holdings.” FDIC insurance no longer served a panic-proofing purpose.

Commencing in August 2007—and culminating in September 2008 following the collapse of Lehman Brothers—an en masse run by repo creditors on their Wall Street counterparties brought the Quiet Period to a harsh close.

D. Repo

The “repo agreement” would overtime become an increasingly important vehicle of short-term debt financing for Wall Street firms. By the time of the Crisis, repo had become “the most important form of short-term finance in modern financial markets.” Gorton estimates the size of the “important” and “immense” repo market to have been “somewhere around $10 trillion” in 2008, roughly the same size as the total assets of the entire regulated U.S.

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23 See Ricks, “Reforming the Short-Term Funding Markets,” at 20.
24 See Gorton, SLAPPED BY THE INVISIBLE HAND, at 55.
25 See Ball, “The Fed and Lehman Brothers,” at 81, describing how the amount of collateral pledged in repo agreements greatly exceeded Wall Street banks’ liquidity pools. Using Lehman as an example: “[Lehman’s] liquidity pool could absorb some loss of repo funding, but not too much.”
26 See Gary Gorton and Andrew Metrick, Regulating the Shadow Banking System BROOKINGS PAPERS ON ECONOMIC ACTIVITY, 261, 263 (Fall 2010).
27 See Viral V. Acharya, The Dodd Frank Act and Basel III: Intentions, Unintended Consequences, Transition Risks, and Lessons for India 31 (New York Univ. Stern Schl. of Business, Working Paper 2011): “In the crisis of 2007–2009, when we faced wholesale depositor runs, the Federal Reserve had to pull out all stops—given the lack of FDIC coverage of such deposits—to effectively suspend the runs” (emphasis added).
28 “Repo agreement” is short for “sale and repurchase agreement.”
29 See Milne, THE FALL OF THE HOUSE OF CREDIT, at 32. See also Hordahl and King, at 39: “The (former) top US investment banks funded roughly half of their assets using repo markets, with additional exposure due to off-balance sheet financing of their customers.”
banking sector at the time.\textsuperscript{30} Plus, the repo market had doubled in size between 2002 and 2007.\textsuperscript{31}

How does a repo “deposit” work? The repo depositor sends the repo borrower (the Wall Street bank) its cash on three conditions: (1) the deposit will be secured by collateral (i.e., securities valued at above the amount of the cash deposit)\textsuperscript{32}; (2) the bank will “repurchase” (“repo”) the collateral on a specified future date, usually the next day, at the agreed-upon price\textsuperscript{33} (the difference between the repurchase price and the cash deposit is the “repo rate,” or the interest that accrues to the lender\textsuperscript{34}); and (3) if the bank defaults on its obligation to repurchase the collateral, the repo lender will have automatic recourse to the collateral, which it can immediately liquidate.\textsuperscript{35}

If the repo agreement is an overnight transaction (as usually is the case), then the repo depositor has a choice each day: either “roll over” its repo (i.e., not withdraw and collect another day’s worth of interest) or not roll over its repo (i.e., withdraw its funds from the bank). If the repo lender chooses to not roll over its repo, the bank has two options: either repurchase the collateral (as it is contractually obliged to do under the repo agreement) or, if lacking the liquidity to repurchase the securities, walk away from the deal and leave the collateral with the repo lender.\textsuperscript{36}

The question becomes: is automatic recourse to the collateral enough of a security interest to forestall bank runs by skittish repo lenders? Given the

\textsuperscript{30} See Gorton, \textit{Slapped by the Invisible Hand,} at 43–44.
\textsuperscript{31} See Gorton and Metrick, “Regulating the Shadow Banking System,” at 278, referring to data compiled by BIS economists Peter Hordahl and Michael King.
\textsuperscript{32} See Ball, “The Fed and Lehman Brothers,” at 22: “The cash advanced in a repo is less than the value of the collateral. The purpose of this over-collateralization, or “haircut,” is to protect the cash lender if the borrower defaults and the lender must liquidate the collateral . . . typical haircuts . . . ranged from about 1% for Treasury securities to 12% for high-yield convertible bonds.”
\textsuperscript{33} See Gorton and Metrick, “Securitized Banking and the Run on Repo,” at 9.
\textsuperscript{34} See Ball, “The Fed and Lehman Brothers,” at 23: “Because repos are safe for cash lenders, the interest rates are low. During the Summer of 2008, overnight repo rates were close to the target federal funds rate of 2%.”
\textsuperscript{35} Repurchase agreements are exempt from the automatic stay of the Bankruptcy Code. If a party to a repo agreement files for bankruptcy, the non-defaulting party can unilaterally enforce the termination provisions of the repo agreement, rather than having to become a debtor in the defaulting party’s bankruptcy case. See American Home Mortgage Corp. v. Lehman Brothers (2008), upholding the automatic stay safe harbor for repurchase agreements. See also Ball, “The Fed and Lehman Brothers,” at 23: “If a cash borrower defaults on a repo, the lender can liquidate the collateral immediately.” See also Gorton and Metrick, “Regulating the Shadow Banking System,” at 284, pointing out that “This safe harbor has real value to market participants.”
\textsuperscript{36} See Paolo Saguato, \textit{The liquidity dilemma and the repo market: A two-step policy option to address the regulatory void} 5 (London Schl. Of Econ. Law, Society, and Econ. Woring Paper 21, 2015).
panicky behavior of repo lenders in the lead-up to the Great Recession, the answer seems to be no.

E. The Run on Repo

In the summer of 2007, US housing prices began to slow at the same time subprime mortgage defaults began to pick up in pace. Wall Street banks, on the asset sides of their balance sheets, were heavily exposed to these ailing markets. Repo creditors became anxious about the fundamental health of their repo borrower counterparties. As Gorton recounts,

When news of [the housing and mortgage] shock arrived, bank creditors went to monitor the banks: Did they have the money? The run was a demand for cash, and repo agreements were not renewed . . . To meet cash demands, banks had to sell assets, causing the prices of all assets to go down—they became hard to sell to raise sufficient cash, so the Federal Reserve stepped in to buy assets. The crisis was magnified when Lehman Brothers was not bailed out. In the end, a number of major financial firms disappeared: Bear Stearns, Merrill Lynch, Wachovia, Lehman Brothers, Washington Mutual, and Countrywide. The economy became moribund.

Federal Reserve Chairman Ben Bernanke reported that, in the acute phase of the financial crisis, of the thirteen “most important financial institutions in the United States, twelve were at risk of failure within a period of a week or two.” The Great Recession was a systemic event, and it is important to realize that it began with a financial panic—a run on short-term money market instruments, predominantly overnight repo. The developments in the US housing and mortgage markets were not the main culprit. In Bernanke’s view, these developments were mere “triggering events that interacted with deeper vulnerabilities in the financial system.” In line with Gorton and Ricks,

38 See GORTON, MISUNDERSTANDING FINANCIAL CRISSES, at 182–83.
39 See FINANCIAL CRISIS INQUIRY REPORT, FINANCIAL CRISIS INQUIRY COMMISSION at 354 (Jan. 2011)
40 See GORTON, SLAPPED BY THE INVISIBLE HAND, at 47. “Subprime mortgage originations in 2005 and 2006 totaled about $1.2 trillion, a large number to be sure, but not large enough to cause a systemic crisis.” And at 115: “House price declines and foreclosures do not explain the panic.” See also GORTON, MISUNDERSTANDING FINANCIAL CRISSES, at 186: “The subprime shock was not large enough to account for the crisis.”
41 See Ben S. Bernanke, “Some Reflections on the Crisis and the Policy Response,” remarks at the Russell Sage Foundation and the Century Foundation Conference on Rethinking Finance, New York, April 13,
Bernanke believes “the Crisis [to be] best understood as a classic financial panic.” And “run on repos,” Gorton clarifies, “[was] the core problem.”

Consider for example the “sudden loss of repo financing” and ensuing collapse of the fifth-largest US investment bank, Bear Stearns. In March 2008,

Bear’s balance sheet had an asset side exposed to the housing market and a liability side that was extremely fragile and exposed to runs. In particular, Bear was rolling over each night in excess of $75 billion of repo contracts on mortgage-backed securities . . . Bear’s primary money market financiers . . . refused to roll over their repos. Bear had to draw down on its $20 billion pool of liquidity, and within a week, was brought to its knees . . . Bear faced bankruptcy by the middle of March.

In September, the same series of events plagued the fourth-largest investment bank, Lehman Brothers. In his paper “The Fed and Lehman Brothers,” Johns Hopkins economist Laurence Ball details how “fears about Lehman grew over the summer of 2008 as the firm suffered losses on its real estate investments. Eventually Lehman experienced a run . . . a liquidity crisis . . . [and] the most important problem involved Lehman’s repurchase agreements.”

Once Lehman filed for bankruptcy, the repo panic fully engulfed Wall Street. What followed was a “severe financing crunch” for consumers and
businesses in the United States.\textsuperscript{47} Costs of financing skyrocketed while the supply of available financing collapsed. Since overall economic activity is heavily reliant on outside financing, the economic output of the United States plummeted. Millions of Americans lost their jobs. The short-term debt panic, concludes Ricks, was the “proximate cause of the severe recession,” the panic-induced financing crunch the “major driver.”\textsuperscript{48}

Ricks’ takeaway point—as is Gorton’s—is that “panics should be viewed as the central problem for financial stability policy.”\textsuperscript{49}

\textbf{F. Why did Repo Lenders Run?}

If panics are “the problem” and forestalling them “the goal,” then understanding why they occur in the first place is the necessary first analytical step towards devising a panic-proofing solution.\textsuperscript{50}

Specifically, why did repo lenders—the all-important panickers of 2008—refuse to roll over their repos? Remember that repos are fully secured loans. Repo lenders have instant recourse to the collateral if their counterparty bank defaults (even if the bank files for bankruptcy\textsuperscript{51}). Given the highly secured nature of repo, “[Wall Street] firms theoretically should never lose repo funding, because lenders [should] not fear losses from default.”\textsuperscript{52} Why then did repo lenders run? Ricks and Gorton offer fundamentally different explanations for this.

Gorton believes that repo lenders panicked due to concerns over the value of the collateral under their repo agreements. Since “repos are essentially secured loans, counterparty risk [was] not an issue.”\textsuperscript{53} Rather, it was “uncertainty about the value of the collateral, should the counterparty fail,” which led repo lenders to not roll over their repos.\textsuperscript{54}

Ricks, on the other hand, believes that repo lenders panicked not due to collateral-value concerns but counterparty-viability concerns. He contends that

\begin{itemize}
\item \textsuperscript{47} See Ricks, \textit{The Money Problem}, at 121.
\item \textsuperscript{48} See Ricks, \textit{The Money Problem} at 111, 121.
\item \textsuperscript{49} Id., at 122.
\item \textsuperscript{50} See Gorton, \textit{Slapped by the Invisible Hand}, at 61 (“What should be the new regulations? The answer to that question depends on what the problem is that resulted in a panic.”).
\item \textsuperscript{51} See 11 U.S. Code § 559.
\item \textsuperscript{52} See Ball, \textit{The Fed and Lehman Brothers} at 23.
\item \textsuperscript{53} See Gorton, \textit{Slapped by the Invisible Hand}, at 133.
\item \textsuperscript{54} Id., at 54, 114 (“Confidence in the information insensitivity of repo collateral has been called into question.”).
\end{itemize}
“repo creditors do care about whether the [bank] will default” (whereas to Gorton, that’s “not an issue”). It is worth quoting Ricks at some length here, since this point is foundational to the panic-proofing proposal I make at the end of the paper.

It is sometimes argued that secured money-claimants decline to do fundamental analysis on their counterparties only because they look to the collateral, not the counterparty, for protection. This view is mistaken. This is a crucial point: secured money-claimants are not indifferent between holding the money-claim and holding the underlying collateral. They chose to hold the money-claim (instead of an asset like the collateral) precisely because of its monetary attributes; they chose to sacrifice yield for moneyness. Even if the collateral can be seized immediately upon default, the collateral lacks the moneyness property that was the very reason for holding a money-claim in the first place. Repo creditors don’t want the collateral. It’s all downside—collateral value in excess of the repo face amount must be returned to the defaulting borrower—and besides, it’s an operational hassle. Accordingly, repo creditors and other secured money claimants do care about whether the [bank] will default.

A 2010 investigatory report by a task force of repo market participants corroborates Ricks’ point: “Repo depositors focus primarily, if not almost exclusively, on counterparty concerns...even in the presence of high-quality collateral.” The Federal Crisis Inquiry Commission Report similarly found that repo lenders in the Crisis were “reluctant to risk the hassle of seizing [and liquidating] collateral, even good collateral, from a bankrupt borrower.”

In short, repo creditors just “don’t want the collateral. It’s all downside,” irrespective of the collateral’s quality.

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55 See Ball, *The Fed and Lehman Brothers* at 23 ("A firm theoretically should never lose repo funding, because lenders do not fear losses from default").

56 Repo creditors are exempt from the automatic stay in bankruptcy. See 11 U.S.C.S. § 559–560.


60 See Ricks, *The Money Problem* at 214.
G. Looking Forward: What is the Lesson from the Run on Repo?

If recourse to repo collateral is “all downside,” then clearly repo as a “secured” form of lending is not sufficiently secured to forestall panics by risk-averse repo lenders. Repo lenders need a heightened sense of security to “stick it out” (i.e., to roll over their repos) when faced with counterparty-viability concerns. How can we provide them with this increased sense of security? More broadly, how can we panic-proof the financial system?

It is a critical question because a future panic remains a real possibility. In 2016, the Volcker Alliance, a financial policy think-tank chaired by former Fed Chairman Paul Volcker and comprised of some of the world’s leading financial minds, published an important pamphlet entitled “Unfinished Business: Banking in the Shadows.” Its main point is that an excessive reliance by Wall Street banks on short-term debt (including a substantial amount of runnable repo debt) remains the key unsolved problem for financial regulation today. “Trillions of dollars of short-term debt,” they caution, “continue to roll over regularly . . . Despite the recent reforms, the financial system will remain prone to funding runs.”

Former New York Fed Governor Daniel Tarullo has similarly warned that “the levels of runnable funding . . . are [not] at safe or optimal levels, and the conditions for destructive runs that threaten financial stability [still] exist.” And Ben Bernanke himself has cautioned that “The risk of short-term funding runs has not been eliminated.”

Evidently, the post-Crisis reforms did not panic-proof the financial system. The two main pieces of financial reform legislation to emerge from the Great Recession were the domestic law Dodd-Frank and the international accord

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63 See BALKANOVA ET AL., REFERENCE GUIDE TO U.S. REPO AND SECURITIES LENDING MARKETS, Federal Reserve Bank of New York Staff Reports No. 740, at 13 (2015) (estimating in December 2015 that “U.S. repo activity is split at $1.84 trillion in triparty and $1.58 trillion for bilateral repo”).

64 See THE VOLCKER ALLIANCE at 21.


66 See BERNANKE, THE COURAGE TO ACT, at 574.
Basel III, both passed in 2010. In the next section, I will analyze this legislation with a panic-proofing comb.

II. THE POST-CRISIS FINANCIAL REGULATORY REFORMS: DODD-FRANK AND BASEL III

A. The Risk-Constraint Approach to Financial Regulation

The post-Crisis banking regulatory framework follows a “risk constraint” rather than “panic-proofing” approach to financial regulation. To understand the “risk constraint” approach, consider what then President Barack Obama said in his major “Speech on Financial Reform” in 2009—in the heart of the Recession: “The only way to avoid [another] crisis of this magnitude is to ensure that [Wall Street firms] can’t take risks that threaten our entire financial system, and [that] they have the resources to weather even the worst of economic storms.”

To fend off another Great Recession, in Obama’s view, would mean mandating “safer” balance sheets at the SIFIs. But this risk-constraint approach, Ricks laments, is an “indirect strategy,” a deliberate policy choice to “leave run-prone funding structures intact while taking aim at the sorts of things that trigger panics…various excesses that are supposedly endemic to finance—excessive leverage, excessive risk taking, “overheating” markets, and other “systemic” risks.”

And the risk-constraint approach can lead to misguided policy. Take for example Basel II’s balance sheet treatment of AAA-rated insured mortgage-backed securities in the lead-up to the Great Recession. Under the Basel II core capital requirement of capital to risk-weighted assets ratio of 8%, the top 20 US banks—heavily exposed to these securities—appeared exceedingly “safe” in 2007 and 2008, averaging a ratio of 11.7%.

Because of their AAA ratings, these securities had a significantly lower capital requirement under the Basel II arrangement . . . Credit protection in the form of credit default swaps (CDS) purchased from AAA-rated insurers on AAA-rated securities led to a 0% capital

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67 See RICKS, THE MONEY PROBLEM, at 248.
70 Basel II is the second of the international Basel accords, passed in 2004.
weight on these securities in the portfolio of banks’ balance sheets . . . . No wonder [Wall Street banks] loaded up on these asset-backed securities . . . [their] balance sheets doubled from 2004 to 2007 with only a minor increase in Basel-implied risk.72

Under the risk-constraint approach, policymakers and financial regulators must make judgment calls when predefining “risk” on a bank’s balance sheet. As human beings, they will make mistakes. That they considered CDS-backed AAA-rated mortgage-backed securities “safe” in the lead-up to the Recession should give us pause.

In sum, Dodd-Frank and Basel III are “risk-constraining” measures, imposing heightened capital, leverage, and liquidity constraints—as well as regular “stress tests”—on Wall Street firms in an effort to make them more resilient in “even the worst of economic storms.” These are welcome changes, but they “leave run-prone funding structures intact.”73

B. The Post-Crisis Framework’s Treatment of the Runnable Repo Problem

Despite the run on repo playing a central role in precipitating the Great Recession, Dodd-Frank and Basel III are “completely silent on how to reform the repo market.”74 In the 848 pages of Dodd-Frank, the phrase “repurchase agreement” appears just 37 times (including 25 times in the “Definitions” section). NYU economist Viral Acharya warns that “if [the repo] market is not reformed, runs on repo will occur in the future, potentially leading to systemic crises.”

1. Dodd-Frank §§ 210 and 1105: Maintaining Repo Depositors’ Propensity to Withdraw

There are two sections of Dodd-Frank that tangentially concern anxious repo lenders: § 210 creating the Orderly Liquidation Authority and § 1105 discussing the possibility of government guarantee programs in future financial crises.75

72 Id.
73 See RICKS, THE MONEY PROBLEM, at 249–50.
75 There is also § 610, which modifies the existing lending limits law to include “repurchase agreements” as a type of “loan and extension of credit . . . to a person outstanding at one time . . . [which] shall not exceed 10 per centum of the unimpaired capital and unimpaired surplus of the association.”
In § 210, Dodd-Frank creates a receivership program for insolvent banks called the “Orderly Liquidation Authority” (OLA). If OLA is activated,\textsuperscript{76} the FDIC, as receiver of the failed bank, “may disaffirm or repudiate any contract”—including any repurchase agreement—it deems to be “burdensome.”\textsuperscript{77}

If the FDIC finds a repo agreement to not be “burdensome,” then it may honor the repo agreement (i.e., repurchase the collateral from the repo lender pursuant to the repo agreement). But to do so, it would first have to pass two high hurdles: (1) raise enough funds from the Treasury Department, despite strict borrowing limits,\textsuperscript{78} and (2) get explicit permission to honor the repo agreement under the “terms and conditions the [Treasury] Secretary may require.”\textsuperscript{79} The FDIC has said that it would be “highly unlikely” for it to ever honor a failed bank’s repo obligations in an OLA scenario.\textsuperscript{80} Adding this all up, the incentive of repo lenders to withdraw from their Wall Street counterparties in times of uncertainty remains intact.

Turning to § 1105 on guarantee programs in future financial crises, Dodd-Frank makes it possible for the FDIC to create “a widely available program to guarantee obligations of solvent [banks and bank holding companies] during times of severe economic distress.”\textsuperscript{81} The creation of such a program would

\textsuperscript{76} See Dodd-Frank § 203; See also RICKS, THE MONEY PROBLEM, at 257, explaining the “extraordinary procedural hurdle” of activating OLA in the first place: “Bankruptcy is the default option, and activating OLA requires the approval of not only the supermajorities of the boards of the FDIC and the Fed but also the Treasury secretary in consultation with the president.”

\textsuperscript{77} See Dodd-Frank § 210(C)(1)

\textsuperscript{78} See Dodd-Frank § 210(n)(6). For the first 30 days of the FDIC’s receivership, the FDIC would be unlikely to be able to borrow from the Treasury more than 10% of the bank’s most recently reported total assets. See also § 210(n)(5), which requires congressional approval for the Treasury to issue Treasury securities in order to raise OLA proceeds if issuing such securities would exceed the statutory debt ceiling.

\textsuperscript{79} See Dodd-Frank § 210(n)(5)

\textsuperscript{80} FDIC, Interim Final Rule, “Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act,” Federal Register 76, no. 16 (January 25, 2011), at 4212, the FDIC writing, “A major driver of the financial crisis and the panic experienced by the market in 2008 was in part due to an overreliance by many market participants on funding through short-term, secured transactions in the repurchase market . . . . In applying its powers under the Dodd-Frank Act, the FDIC must exercise care in valuing such collateral and will review the transaction to ensure it is not under-collateralized . . . if the creditor is under-secured due to a decline in the value of such collateral, the unsecured portion of the claim will be paid as a general creditor claim” and also that “most importantly, under no circumstances in a Dodd-Frank liquidation will taxpayers ever be exposed to loss.”

\textsuperscript{81} See Dodd-Frank § 1105(c)(1). The Treasury Secretary “may request” that the FDIC and Federal Reserve “determine whether a liquidity event exists that warrants use of the guarantee program” for solvent institutions (1104(a)(1)). Dodd-Frank includes as a “liquidity event” “an exceptional and broad reduction in the general ability of financial market participants . . . to borrow using financial assets as collateral without an unusual and significant increase in margin” (1105(g)(3)). If the FDIC and Fed determine a “liquidity event” exists, then the FDIC “shall create a widely available program to guarantee obligations of solvent insured
require a joint resolution of Congress. 82 “Absent such approval, the [FDIC] shall issue no such guarantees.” 83 Here again, the propensity of repo lenders to withdraw from the banking system at the first sign of counterparty distress remains intact, since to “rely on a mid-crisis act of Congress [to empower the FDIC to honor repo obligations]…would seem to be a strategy fraught with peril.” 84

In sum, we should take seriously Acharya’s warning that “runs on repo will happen in the future.” Dodd-Frank does not take the requisite steps to prevent them.

2. Basel III’s Liquidity Coverage Ratio: Commendable but not Panic-Proofing

Perhaps the most important post-Crisis change in US financial regulation has been the adoption of the Liquidity Coverage Ratio of Basel III (the “LCR”). 85 Under the LCR, the SIFIs must now hold enough “high quality liquid assets” to meet 100% of net cash outflows in a hypothetical 30-day “high-stress scenario.” 86 In promulgating the LCR, the OCC defined “net cash

depository institutions or solvent depository institution holding companies during times of severe economic distress.” (1105(a)). The FDIC, “with the concurrence of the [Treasury] Secretary,” shall establish the “terms and conditions” of such guaranty program (1105(b)(2)). “The Secretary (in consultation with the President) shall determine the maximum amount . . . that the [FDIC] may guarantee.” The President then “may transmit to Congress a written report of the plan,” and “absent [joint congressional] approval, the [FDIC] shall issue no such guarantees” (1105(c)(2)).

82 Id.
83 Id.
84 See Morgan Ricks, Regulating Money Creation After the Crisis, 1 HARV. BUS. L. REV. 75, 135 (2011).
85 Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,140 (October 10, 2014). The US rule is based on the new Basel liquidity standards. See BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS (2013). See also U.S. TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES, 52 (2017), confirming the Trump administration’s support for the LCR (but only for America’s global systemically important financial institutions; “the [LCR] should be limited in application to only the largest banks”).
86 Basel III also established the Net Stable Funding Ratio (“NSFR”) requiring systemically important banks to increase the amount of their “stable funding” (short-term debt not being considered “stable). The US has not yet adopted this ratio and it appears unlikely that it will, at least in the Trump administration. In June 2017, U.S. Treasury Secretary Stephen Mnuchin recommended delaying the implementation of the NSFR in the U.S.; See also U.S. TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES 13 (2017), “Treasury recommends delaying the domestic implementation of the Net Stable Funding Ratio . . . [it] represents additional regulatory burden and would introduce potentially unnecessary capital and liquidity requirements on top of existing capital and liquidity requirements.”
outflows” as “reflecting aspects of historical stress events including...a partial loss of secured, short-term financing.”

While the LCR is a commendable initiative, it is not a panic-proofing solution. It assumes that financial regulators can correctly specify in advance the types of assets that can be easily liquidated in a panic. In a severe panic, no assets (other than perhaps the highest-quality sovereign securities) are guaranteed to sell at little or no discount.

Additionally, since the LCR treats certain illiquid securities and systemically risky funding better than others for purposes of calculating the ratio, it could “push banks towards regulatory arbitrage of the liquidity weights” (thereby fostering excessive concentration into those better-treated activities). Do not forget Wall Street’s “safe” pre-Recession balance sheets, loaded with “safe” CDS-backed AAA-rated mortgage-backed securities. The LCR could lead history into repeating itself.


89 See RICKS, THE MONEY PROBLEM, at 251. “How confident should we be in [the] capacity [of regulators] . . . to specify in advance what sorts of assets can be easily liquidated in a panic?” See also Viral V. Acharya, The Dodd Frank Act and Basel III: Intentions, Unintended Consequences, Transition Risks, and Lessons for India 22 (International Growth Centre, Working Paper, 2011), surmising that government bonds, “which would traditionally have been liquid and safe” could become “significantly credit-risky,” and asking whether the “[Basel III] risk weights on government bonds are suitably calibrated.”

90 See Viral V. Acharya, The Dodd Frank Act and Basel III: Intentions, Unintended Consequences, Transition Risks, and Lessons for India 22 (International Growth Centre, Working Paper, 2011), “Without a doubt, the implementation of the liquidity ratios will push banks towards regulatory arbitrage of the liquidity weights, in particular, to the best-treated illiquid securities and systemically risky funding. Of course, the unintended consequence will be a concentration into these activities. Regulators should be acutely aware of this problem and be prepared ex ante to adapt in an expedited way.”

91 Id. at 28.

92 Id. at 36, warning about a “sudden eruption of sovereign credit risk” given the LCR’s push for firms to hold more sovereign credit. The LCR “could constitute a significant systemic risk for the global economy in the future.”
III. PANIC-PROOFING APPROACHES TO FINANCIAL REGULATION

Hundreds of scholars have studied the Great Recession, yet Gary Gorton and Morgan Ricks stand out for promulgating the “panic-proofing” approach to financial regulation. Gorton and Ricks argue that panics are what cause severe recessions and should thus be at the forefront of financial regulatory focus. They accordingly bemoan America’s “risk-constraint” approach to financial regulation, since it is an indirect approach that fails to pointedly address the runnable short-term debt problem. They credit the Depression-era advent of FDIC insurance for eliminating the recurrence of retail panics, and implore policymakers to devise a panic-proofing scheme to forestall institutional panics.

How can policymakers go about panic-proofing the financial system, one that so heavily relies on short-term institutional money? Recall that a “panic” is when short-term debt claimants decide en masse to no longer fund the banking system.

Former Fed Governor Daniel Tarullo has alluded to a whole “menu of possible responses” to the issue of runnable short-term debt at SIFIs.93 One extreme idea, for example, would be to simply restrict Wall Street banks from relying on short-term debt at all.94 That would solve the panic problem, since there would be no potential panickers left. But, as Gorton importantly points out, if “we want to provide a safe, deposit-like account for the bulk of repo depositors”—who, as we know, “sacrifice yield for moneyness”—then we need to instead “seek to preserve [this system] while making it much less vulnerable to a run.”97

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94 See GORTON, MISUNDERSTANDING FINANCIAL CRISES, at 197 (discussing the possibility of “squelching” systemically important banks from being able to finance themselves short). See also Daniel Tarullo, Remarks at the Center for American Progress and Americans for Financial Reform Conference: Exploring Shadow Banking: Can the Nation Avoid the Next Crisis? 5 (July 12, 2016), https://www.federalreserve.gov/newsevents/speech/tarullo20160712a.pdf, discussing “outright prohibition” as a possibility of a solution to the runnable short-term funding problem.
96 See Ricks, THE MONEY PROBLEM at 213–14.
97 See GORTON, MISUNDERSTANDING FINANCIAL CRISES, at 197.
A. The Gorton Plan: A Focus on High-Quality Repo Collateral

Gorton’s panic-proofing approach, unsurprisingly, is to “regulate repo.” First, he would limit how much repo a systemically important nonbank (i.e., an investment bank or other financial institution) could engage in. Commercial banks, able to access the discount window of the Federal Reserve for desperate cash, would not be so limited in their repo exposure. Second, Gorton would focus on strengthening the quality of the “the backing collateral” involved in repo agreements.

This second point—on repo collateral quality—is the cornerstone of Gorton’s panic-proofing proposal. Gorton’s system would be “aimed at creating a sufficient amount of high-quality collateral that [could] be used safely in repo transactions.” Gorton would “place the government in an oversight role in the securitization and repo markets [to] ensure that the safety of the collateral for repo be overseen.”

Gorton’s baseline panic-proofing assumption is that, if repo collateral is always of high quality (“namely ABS, treasuries, or agency bonds”), then repo lenders will not run from their stressed Wall Street counterparties. “Collateral for repo,” Gorton emphasizes, “must have [the] property [of] . . . demand deposits and AAA securities. What is needed [by repo lenders] is only the general knowledge that [their] collateral is high grade.”

Ricks sharply disagrees with Gorton on this point, arguing that high-quality collateral alone should not be expected to forestall repo runs: “Even if the collateral is of the highest quality and can be seized immediately on default, the collateral lacks the moneyness property that was the very reason for holding the money-claim in the first place. Accordingly, receiving the

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98 Id. at 198.
99 See supra note 27, “Repos outside of banks would be constrained . . . [they] could be offered by any institution with a license and would be regulated so as to be more expensive than [repos offered by commercial banks].”
100 Id. at 289.
101 See GORTON, MISUNDERSTANDING FINANCIAL CRISES, at 197–98. “The overarching goals of the proposal are to bring securitization under the regulatory umbrella and to provide a system of collateral production that can back repo without being so vulnerable to runs.” See also supra note 27, “Eligible collateral for banks would be any bond that the regulators approve for their portfolios.”
102 Id., at 198.
103 See RICKS, THE MONEY PROBLEM, at 85: “Gorton’s preferred policy solution involves strict regulation of portfolio quality.” See also Gorton and Metrick, “Regulating the Shadow Banking System,” at 280, discussing the “imperfectly collateralized” repo that was at the heart of the financial crisis.
104 See GORTON, SLAPPED BY THE INVISIBLE HAND, at 181. See also RICKS, THE MONEY PROBLEM, at 85, describing Gorton’s proposed repo policy as being “a strict regulation of portfolio quality.”
collateral is a distinctly unwelcome outcome for money-claimants.” Ricks does not even rule out a “run on fully secured Treasury repo.”

B. The Ricks Plan: Backstoping the Short-Term Debt of Systemic Commercial Banks

Whereas Gorton would increase the federal government’s oversight and standards for repo collateral quality, Ricks would establish a federal insurance program to backstop the short-term debt obligations of systemically important commercial banks. The Ricks proposal contains five main pillars.

First, only “licensed” SIFIs—the “member banks” in Ricks’ “licensed money system”—would be permitted to access the short-term debt markets at all. To receive a license and thereby earn the privilege of borrowing short, banks would have to first meet a certain government-established “criteria of admission.” Market-making investment banks and commercial paper conduits would be strictly ineligible for licenses and precluded from accessing the short-term debt markets.

Second, the licensed SIFIs would be federally capped in terms of how much short-term debt they could engage in. There would be a “cap and trade system,” with each member bank holding a permit entitling it to engage in a certain nominal amount of short-term debt. A “monetary authority” would

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105 See Ricks, The Money Problem, at 89.
106 Id., at 214.
107 See Gorton, Misunderstanding Financial Crises, at 197, where Gorton concedes about deposit insurance, “Let’s face it, the beneficial consequences of [deposit insurance] were probably the outcome of luck.”
108 See Ricks, The Money Problem, at 17.
109 See Ricks, “Reforming the Short-Term Funding Markets,” at 12–18, introducing his plan for a “licensed money system.” At 13: “Licenses would be granted [by regulators] on an entity-by-entity basis.” And at 17: “Only the licensed entities would be allowed to fund short.”
110 See Ricks, “Regulating Money Creation After the Crisis,” at 143.
111 See Ricks, “Reforming the Short-Term Funding Markets,” at 16: “Unlicensed entities would be required to finance themselves in the long-term (capital) markets, not the short-term funding markets.” See also Ricks, The Money Problem, at 17: “Entities other than member banks are prohibited from issuing money claims. . . . This prohibition might initially seem radical. . . . and would have major consequences for the financial system as it exists today.”
112 See Ricks, The Money Problem, at 228.
113 Id., at 21. “The system’s aggregate permit capacity constitutes a cap on the quantity of broad money outstanding. Permit capacity is tradable among member banks. . . . no member bank is permitted to hold more than some specified percentage of outstanding permit capacity, say 10%. . . . the monetary authority establishes the cap. It may adjust the cap in the conduct of monetary policy . . . . Thus the size of the member banking system is determined by the conduct of monetary policy.”
establish the cap and be responsible for adjusting it periodically in the course of its monetary policy.

Third—and the crux of Ricks’ proposal—a federal insurance program would be established to backstop all the short-term debt obligations of the licensed SIFIs. All the short-term debt obligations of “critically undercapitalized” member banks would be “seamlessly honored” by the federal government. This would have the effect, in Ricks’ view, of fully protecting money-claimants and eliminating destabilizing panics.

Fourth, to raise the funds for the insurance program, the member banks would be charged risk-based fees. These fees would be priced so that “each member bank [would] incur the financing cost it would incur if it financed itself entirely in the longer-term private capital markets.” To offset this increased cost on the banking system, the member banks would bear none of the cost of paying interest to their short-term creditors (“the government [would] bear all of it”).

Finally, in order to reign in moral hazard at the banks—a natural consequence of Ricks’ insurance program—“member banks [would be] subject to portfolio restrictions and capital requirements,” with “a supervisory regime in charge of monitoring compliance with the constraints.”

C. Critiquing the Ricks Approach

I agree with the underlying ethos of the Ricks plan—of deposit insurance being the right panic-proofing fix. Remember that the advent of deposit insurance in 1934 led to the 75-year “Quiet Period” in American banking—but that, overtime, as institutional “depositors” superseded retail depositors as Wall Street’s principal source of funds, FDIC insurance became an anachronistic solution to forestalling panics. Modernizing deposit insurance to account for the institutional depositor—that is, to fend off the modern-day panic—seems a logical course for financial policy to take.

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114 Id., at 227.
115 Id., at 202.
116 Id., at 226.
117 Id., at 203. “Accordingly, the determination of how much (if any) interest is to be paid on such balances is a policy question, to be determined by the monetary authority. It is not a matter to be left to banks and their account holders.”
118 Id., at 225–26.
However, is the Ricks plan asking too much? The support of Congress—and let’s face it, the Banking Lobby—is a prerequisite to dramatically overhauling the banking system. Ricks describes his plan as “conservative” but also “radical”; in the end, it might just be politically impracticable.

The Ricks plan would be likely to face political backlash on the following four points: (1) precluding the major nonbanks from accessing the short-term debt markets, (2) capping the short-term debt exposure of the licensed commercial banks, (3) federally insuring all the short-term debt obligations of the member banks, and (4) imposing major risk-based fees.

Most contentious would be the third point. Cost-conscious and bailout-averse policymakers would be unable to stomach the sheer scope of Ricks’ proposed insurance regime, which would guarantee all the short-term debt obligations of the member banks (i.e., both secured and unsecured debt of one-year-or-less maturity). It is not clear whether the risk-based fees would be able to generate enough revenue to honor a potentially gargantuan amount of insurance claims.

D. A New Idea: Federal Government as a Secured Repo Backstop

Given the realpolitik issues of the Ricks plan and the questionable collateral-quality assumption driving the Gorton plan, I will offer a different panic-proofing approach. My plan involves two key ideas: (1) providing federal deposit insurance for the very-short-maturity repo obligations of the SIFIs (while also ensuring the high quality of the collateral under those repo agreements) and (2) limiting the access of the SIFIs to all other forms of uninsured short-term debt.

1. Federal Government as Fully Secured Runnable Repo Backstop

The crux of my panic-proofing proposal is to establish a federal guarantee program to backstop the SIFIs’ runnable repo obligations. There are three main reasons why I believe this approach makes sense.

First, an en masse “run on repo” was arguably the leading driver of the Great Recession, and it is therefore incumbent on policymakers to craft policy that directly addresses the runnable repo problem.

Second, if we wish to make the repo market much less vulnerable to a run, then it is critical that we provide repo lenders with a safe demand-deposit-like account at Wall Street banks. Instant recourse to repo collateral (even high-
quality collateral) is not enough of a security interest to forestall destabilizing repo runs. Only by guaranteeing the moneyness of repo deposits can we assuredly incentivize anxious repo lenders to roll over their repos.

Third, that repo is a form of fully secured lending makes repo insurance a relatively safe governmental (and taxpayer) endeavor. Here’s how this system would work: the federal government (perhaps the FDIC or Federal Reserve) would be party to each repo agreement. In the event of a repo borrower default, the government would simply step into the shoes of the defaulting SIFI and repurchase the collateral from the repo lender at the agreed-upon price. The government would then take title to the collateral.

There would be no naked bailouts. Nor would there be any need (as in the Ricks plan) to charge risk-based fees on the banking system to support a mammoth insurance regime. This is a crucial point: the federal government would only ever make insurance payouts to repo creditors in exchange for the high-quality collateral under each repo agreement.

This is where Gorton’s idea about collateral quality fits nicely into this system. The federal government would be tasked with overseeing the quality of the collateral under each insured repo agreement. By ensuring that repo agreements contain only high-quality collateral, the government can reduce the chance of repo panics in the first place (as is Gorton’s key panic-proofing argument) while also augmenting the security of the repo backstop program.

Moral hazard at the SIFIs becomes an issue. If the federal government agrees to backstop all of this runnable repo debt, won’t the SIFIs drive more recklessly behind the wheel? This is where the risk-constraint approach of Dodd-Frank and Basel III come back into focus. Implementing a federal backstop for the SIFIs’ runnable repo obligations does not mean abandoning federal oversight of the SIFIs’ balance sheets. Rather, the panic-proofing and risk-constraint approaches can—and should—work in tandem.

2. Limiting the SIFIs’ Exposure to Runnable Short-Term Debt

The second step in my plan is to limit the exposure of SIFIs to runnable short-term debt. For purposes of this system, runnable short-term debt can be divided into two categories: (1) insured repo debt and (2) all other forms of runnable debt (i.e., uninsured short-term debt).

With respect to insured repo debt, I would adopt Gorton’s idea: commercial banks (with access to the Fed’s discount window) would not be
limited in terms of how much repo debt they could take out. All the other SIFIs would be limited in their repo debt exposure. The overseeing federal authority would have to determine the appropriate repo-exposure levels for these nonbank SIFIs.

More importantly, on uninsured runnable debt, all of the SIFIs would be limited in their exposure, permitted to rely on only so much uninsured short-term debt such that a run on that debt could only have a benign effect (i.e., not be destabilizing to their balance sheets). Again, the overseeing regulatory authority would be tasked with determining the appropriate exposure levels of the SIFIs to this type of uninsured short-term debt.

In sum, this system envisions the SIFIs financing themselves with a mixture of long-and-medium term debt, insured short-term repo debt, and only an unthreatening amount of uninsured short-term debt.

CONCLUSION

I have tried in this paper to build upon the “panic-proofing” approach to financial regulation, as championed by Yale economist Gary Gorton and Vanderbilt law professor Morgan Ricks. Panics are the financial problem of our time. If policymakers fail to adopt a panic-proofing attitude to financial regulation, a repeat of 2008 seems to be not a matter of “if” but “when.”

I have proposed in this paper an original panic-proofing solution that is focused primarily on the short-term repo debt market. I envision the federal government becoming a fully secured repo backstop, guaranteeing to very-short-term repo creditors the moneyness of their deposits at the SIFIs while also limiting the SIFIs in their exposure to other forms of runnable short-term debt. The government would be fully and safely secured by the high-quality collateral under each insured repo agreement.

Creating another Quiet Period should be the goal of financial regulation. History begs of us to respond to the runnable short-term debt problem. These institutions are too big—too important—to fail. Panic-proofing—one way or another—can recreate the quiet.
REFERENCES


The Dodd–Frank Wall Street Reform and Consumer Protection Act, §§ 203, 210, 1104, and 1105.