

Testimony of John H. Cochrane

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Chairman Frank, Ranking Member Bachus, and members of the committee: I am grateful for the opportunity to talk to you today. My name is John Cochrane, and I am a professor of finance at the University of Chicago Booth School of Business. I am here only in that capacity. I represent no firm, industry, organization, or party.

I salute you for taking on these difficult issues, which are vital to the economic health of our nation.

### **The big picture.**

We are in a cycle of ever larger risk-taking, punctuated by ever larger failures and ever larger bailouts. This cycle cannot go on.

First, we cannot afford it. This crisis strained our government's borrowing ability. There remains worry of a flight from the dollar, and default through inflation. We will probably escape that fate, but the next, bigger crisis may be beyond even our government's prodigious resources. That would be a calamity.

Second, the bailout cycle is making the financial system much more fragile. In a crisis, it is forgivable to stem the tide today and worry about moral hazard tomorrow. But now it is tomorrow, and unless we deal aggressively with moral hazard, the next tide will be a tsunami.

Financial market participants expect what they have seen and been told: no large institution will be allowed to fail. They are reacting predictably. Banks are becoming bigger, more global, more integrated, more "systemic," more "interconnected" and more opaque. They want regulators to fear bankruptcy as much as possible, and they will succeed. These actions will make the system less stable, not more so.

We need the exact opposite. We need Wall Street to reconstruct the financial system so that as much of it as possible can fail, with pain to the interested parties, but not to the system. Our task is to write the rules so they do it.

### **Policy**

There are two competing visions of policy to achieve this goal. In the first, large integrated financial institutions will be allowed to continue pretty much as they are, with the implicit or explicit guarantee that they will not fail, but with the hope that higher capital standards and more aggressive supervision will contain their risks and forestall failure.

In the second, we think carefully about the minimal set of activities that cannot be allowed to fail and must be guaranteed. We commit *not* to bail out the rest. Private parties need to prepare for their failure, and monitor and discipline their counterparties to avoid it. We fix, where possible, whatever problems with bankruptcy law cause regulators to fear it.

I think the second approach is more likely to work. The financial and legal engineering used to avoid regulation and capital controls last time were child's play.

Powerful authority is attractive ex-post to mop up. Alas, it sets up incentives which makes the system more fragile in the first place.

Too large to fail must become too large to exist.

### **Resolution authority.**

The issue of a "resolution authority" is on your minds so let me make a few comments.

A "resolution authority" offers some advantages. Currently regulators feel they must bail out creditors to keep them from exercising their claims in bankruptcy court. A resolution authority allows the government to impose some of the economic effects of failure -- shareholders lose their equity, debt holders lose value and become the new equity holders -- without actual bankruptcy.

However, nothing comes without a price. First, much of the "systemic effect" regulators seem to fear is *exactly* that counterparties will lose money, or that subsidiary contractual claims (such as CDS contracts) will be triggered. So, it's not obvious that regulators will use this most important provision. Second, the reason people buy debt in the first place is that they know they can seize assets in the event of default. If the authority is tough with creditors, firms will substitute to short term debt and other "runnable" liabilities, making the system less stable.

The FDIC is a useful model, for its *limitations* as well as the *rights*. A successful resolution authority, which does not just morph into a huge piggybank for Wall Street losses, needs similar strong and clear limitations.

- The FDIC applies only to banks. We know who they are – and that the FDIC cannot "resolve" anything else.

A "resolution authority" must come with a similar clear-cut statement of who is subject to its authority – and most importantly who is not, and therefore *must be allowed to fail*, yes, we really mean it this time! If, as in the Administration's proposal, resolution authority applies to bank holding companies, we must all clearly understand that does *not* mean investment banks, hedge funds, insurance companies, and automobile manufacturers -- and no last-minute change of legal status either, please.

- Deposit insurance and FDIC resolution comes with serious restriction of activities. An FDIC insured bank can't run an internal hedge fund.

Institutions, or parts of them, that are eligible for “resolution” and consequent government resources must be limited to their “systemic” activities as much as possible.

- Deposit insurance and FDIC resolution address a clearly defined “systemic” problem.

Bank deposits are prone to runs, because they have a fixed value (unlike, say, mutual fund shares), and they are redeemed on a first-come first-served basis. Deposit insurance stops runs but puts the government at risk. FDIC supervision and resolution is the sensible covenant of the most senior debt-holder.

A “resolution authority” must similarly be clearly aimed at specific, defined, and understood “systemic” problems.

In the Administration’s proposal, the *legality* of a systemic determination is admirably clear, but not the *grounds*. All the Secretary and President have to do is announce their opinion that “the failure of the bank holding company would have serious adverse effects on financial stability or economic conditions in the United States.” This is an invitation to panic, frantic lobbying, and gamesmanship to make one’s failure as costly as possible.

Of course, this obscurity is not a new problem. As an ardent observer of events in the last tumultuous year, I have heard many declarations of imminent systemic risk, but never any clear explanations.

### **Fix bankruptcy**

This last point is the most important. Before designing a regulatory regime, we have to ask, *what problem is it that we are trying to fix, anyway?* Once stated, what is the best way to fix this problem?

Regulators fear “systemic” effects of bankruptcy, but if you ask what they are, you typically find technical problems that are readily solved. Some examples:

- Lehman and Bear Stearns both experienced runs on their brokerage businesses. If you own stocks in a brokerage account, there is no more reason you should have to go to bankruptcy court to get them – or pull them out in a panic ahead of time -- than you should need to go to court to get your car out of the repair shop if the auto dealer fails. Putting a “ring fence” around brokerage accounts in bankruptcy, or otherwise separating “systemic” brokerage from risk-taking, solves this problem, removing the incentive to run.
- Many investors found collateral tied up in foreign bankruptcy courts. Others, knowing this problem, “ran,” refusing to renew short term debt even against good collateral. This is easy to fix. Collateral is collateral, it’s yours if the other side defaults!

- Money market funds holding Lehman debt suffered a run, since they promise steady \$1 value. There is no reason money market funds can't seamlessly trade at net asset value any time the value falls below \$1, removing entirely the incentive to run. Money market funds are not mom-and-pop bank accounts.

In fact, one healthy effect of Lehman's failure is that financial market participants are already addressing these problems, demanding greater soundness of prime-broker relationships, clearer treatment of collateral, and rewriting money-market fund accounting rules. I don't mean to make light of the substantial legal problems. But fixing them will cost a lot less than the hundreds of billions of dollars we are throwing around in bailouts.

Perhaps then the fear is that losses in bankruptcy will lead to the failure of other "systemic" institutions down the chain. But losses in credit markets are small compared to the losses that the financial system absorbs easily in stock markets every day. In any case, the right answer is to protect the systemically important activity downstream, not to bail out losers to restore the appearance of solvency.

Why then is Lehman's failure perceived to be such a problem? The major complaint, and the only persuasive argument, is psychological, not technical: Markets expected the government to bail everybody out. Lehman's failure made them reconsider whether the government would bail out Citigroup. If everyone expects the government to bail out, it has to do so to avoid a panic.

Needless to say, the right answer to this problem is to limit and clearly define, rather than expand and leave vague, the presumption that everyone will be bailed out.

### **Bottom line**

The major systemic problem last fall was the freezing of short-term debt markets. There are many classic remedies to this problem, including limits on how much systemic activity can be supported by rolling over short-term debt, (the FDIC won't let a bank finance a loan portfolio with overnight debt!) intervention by the Fed as lender of last resort, and removing uncertainty about government action.

We should focus on this question. A broad guarantee that no financial institution can fail is not the answer.