

## Paul McCulley's Design for Financial Regulation

By Robert Huebscher

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Paul McCulley parents his 20-year-old son with an overarching principle: If you want access to the “Bank of Dad,” then you must comply with the regulations of the “Bank of Dad.” Wall Street abandoned similar tenets with in the run-up to the credit crisis, and now McCulley says that core principle – to play the game, you must accept regulation – needs to be restored before another crisis unfolds.

McCulley is a managing director of PIMCO, where he runs the California-based firm's short-term bond desk. He spoke at last week's Strategic Investment Conference, held in San Diego and hosted by Altergis Investments and Millennium Wave Investments.

“Regulatory reform is going to happen,” McCulley said. “This crisis will not be wasted.”

Over the last 40 years, a segment of the investment industry – the shadow banking system – evolved in such a way as to avoid conventional banking regulations. It raised capital and invested in assets, including much of the worst “toxic” debt of the past decade, but it sidestepped all regulatory requirements.

McCulley discussed the rise and fall the shadow banking system, its flaws that contributed to the financial crisis, and how it should be regulated to avoid future crises.

### **The rise of the shadow banking system**

The essence of banking is the transformation of maturity, liquidity and quality, McCulley said. Banks take in short-term, low-quality deposits from individuals, and they represent that those liabilities can be claimed by the depositors at any time at the price they were issued (i.e., at par). In doing so, banks extend the maturity of the deposits, decrease their liquidity and reduce their quality.

Banks make a very attractive profit for providing this service, based on the prevailing interest margin – the difference between the interest rate they pay depositors and the rate at which they can invest their capital.



For their business to be stable, McCulley said, banks issuing deposits must have access to two public goods: deposit insurance and a lender of last resort. That latter is necessary to provide liquidity and to avoid a potential run on the bank, and both of those goods mean conventional banking today amounts to a joint venture between the private sector and the public sector.

When those two critical ingredients are lacking, as was the case in the 19<sup>th</sup> century, the banking system is inherently prone to face panics – which is what happens when the public’s demand for liquidity exceeds the bank’s cash on hand.

The last banking panic occurred in 1907, when J.P. Morgan acted as the lender of last resort. It led to the creation of the Federal Reserve Bank in 1913.

From the Great Depression to 2007, banking was characterized by a “quiet period,” without systemic runs on the banking system (aside from S&L crisis, which McCulley said did not fit the classic definition of a run). For this quiet period, bankers could thank the fact that the joint venture between government and private bankers was an accepted and followed principle – banking was regulated and it was simple business. Bankers, McCulley said, could take in a deposit at 3%, lend it at 6%, and be on the golf course by 3 p.m. – the highly profitable 3-6-3 business model. If bankers did stupid things, the regulators shut them down.

Bankers, however, eventually sought higher profitability without the constraints of regulation, so they could run their businesses with less capital and buy riskier assets. The shadow banking system, McCulley said, came about as a means to that end, and it allowed banks to fund their operations with something just as good as a demand deposit, but without deposit insurance or a lender of last resort.

The first shadow banking innovation was the invention of the money market mutual fund in the 1970s. Its shares always traded at par, unlike a conventional mutual fund whose net asset values (NAVs) fluctuate. Money market mutual funds lacked capital – share values were equal to asset values – and there was no buffer to absorb losses from bad assets. The public, nonetheless, believed the shares they owned were just as good as a bank deposit.

Money market mutual funds bought asset-backed commercial paper (CP) and repurchase transactions (repos), in order to offer higher returns to investors. Repos and asset-backed CP, in turn, were a primary source of funding for investment banks before those banks became commercial bank holding companies.



Thus, McCulley said, the assets of the money market mutual funds were the liabilities of the investment banks and also of the structured investment vehicles (SIVs). SIVs were highly leveraged, off-balance-sheet entities, created by the investment banks, as mechanisms to issue collateralized debt obligations (CDOs) and other instruments that were among the worst “toxic” debt.

### **The collapse of the shadow banking system**

The shadow banking system, in fact, was regulated, McCulley said. Its regulator was the rating agencies – Moody’s, Standard & Poors and Fitch. In order to take funding in the form of asset-backed CP and repos and to create CDOs with them, it needed the rating agencies to provide AAA ratings. Since the fees to the rating agencies were five times the fees they could earn for rating corporate bonds, they were happy to do so.

And so, from 2003-2007, the shadow bankers held the equivalent – in McCulley’s analogy – of an under-aged drinking party, with the rating agencies passing out fake IDs, he said.

The jig was up on August 9, 2007, when the French bank BNP said the liability holders in three of its off-balance-sheet conduits (SIVs) couldn’t get out, because the assets it held were too illiquid. They couldn’t let one of those holders out, because it would have put the remaining holders in a worse situation. All assets were frozen.

In the ensuing months, approximately \$500 billion of asset-backed securities couldn’t be rolled over, ultimately leading to the failures of Bear Stearns and Lehman Brothers.

The shadow banking system did not abide by the rules of the “Bank of Dad,” McCulley said. When Bear Stearns had to be bailed out, it was as if a shotgun was put in Dad’s ear, with the bankers demanding more money. The government, acting as the “Bank of Dad,” provided sufficient liquidity to avoid a reoccurrence of the Great Depression, he said, but it did not do so from a position of strength or authority.

### **The right path for reform**

Very simply, McCulley said, regulations should go back to “fundamental first principles:” Banking cannot be a solely private sector venture, because it requires a lender of last resort, he said.



“If you are going to do what is called banking generically, you are going to be regulated and you cannot arbitrage around the rules,” he said. “If you are engaged in maturity, liquidity and quality transformation, you are a banker, regardless of what you call yourself.”

Entities operating as banks will have capital and liquidity requirements, and they will have supervisors looking over their banks, he said, noting that this is the essence of the regulatory reform bills proposed by Senator Chris Dodd (D-CT) and Representative Barney Frank (D-MA).

Money market mutual funds are a “peculiar beast” in their current form, McCulley said, since they lack capital, yet trade at par. “Either they will be banks and have capital requirements, or they are not banks and they will have floating NAVs,” he said. The way they are now is a “walking prescription for a run,” he said, which was what happened with the Reserve Fund.

“Money market mutual funds are going to change,” McCulley said, and they should have floating NAVs because their structure is not conducive to capital requirements.

The overall goal of regulation is to recreate the quiet period, which McCulley said will stifle innovation and creativity in financial services at the margin. “That is not a bad thing, on balance, for society,” he said.

When he plays “Bank of Dad” to his son, McCulley admitted that he too stifles creativity at the margin. He wants his son to be “all that he can be,” but he doesn’t want his 20-year old mind to be an “unshackled rocket of creativity.”

“Nor should that be the case with the banking system,” he added.

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