Maturity Mismatch and Financial Stability

When banks use short-term deposits to fund longer-term loans, it's known as "maturity transformation." In recent decades, a significant amount of maturity transformation has occurred outside traditional banking in the shadow banking sector, via financial products such as asset-backed commercial paper and repurchase agreements, or repos. Economic models generally assume that maturity transformation is socially valuable, a way to bring together savers and borrowers in order to fund useful economic activity. But maturity transformation can be risky: During the 2007-2008 financial crisis, the firms that were most stressed were those that relied on short-term, wholesale funding to finance portfolios of longer-term assets such as mortgage-backed securities. When lenders got nervous about the value of those securities they pulled their funding, and the shadow bankers struggled to repay their investors.

The distress of the firms engaged in shadow banking highlighted the tension regulators face between the systemic consequences of allowing a firm to fail and the moral hazard of providing government support. For that reason, regulators have been working to strengthen the process for resolving failing financial firms, with the goal of reducing — or better yet, eliminating — the need for government bailouts.

But resolving a large, complex financial firm is no easy task, and the more maturity transformation a firm is engaged in — that is, the more it relies on short-term funding — the more likely it is to need sources of funding during bankruptcy to continue operations and pay off creditors. That created major challenges during the crisis, when the stresses in short-term markets caused funding to evaporate. The Dodd-Frank Act's most prominent approach to reforming resolution, the Orderly Liquidation Authority (OLA), thus provides access to public sector lending in order to avoid the disruptions of a retreat of private short-term funding.

The logic behind this reliance on government credit seems to assume that the amount of maturity mismatch and short-term funding we see in the markets is optimal, not to mention fixed and independent of policy choices. But another explanation — the more compelling explanation, in my view — is that the current funding structure of financial firms is the *result* of government policies that have induced a socially excessive amount of maturity transformation.

One such policy is the exemption some financial products receive from the "automatic stay" in bankruptcy. Typically, creditors are prohibited from rushing in to seize a failing firm's assets, in an effort to ensure that those assets are sold in a way that generates the most value for all the creditors. But many short-term financial contracts, such as those common in shadow banking, are exempt from this stay, under the rationale that short-term creditors need access to their funds in order to pay off their own creditors and prevent a failure from spreading to other firms. It's possible that the preferential treatment given to these contracts, although intended to reduce systemic risk, has instead encouraged a greater reliance on less-stable sources of funding.

Numerous instances of government support over the past several decades also have led the creditors of some financial institutions to feel protected by an implicit government safety net should those institutions become troubled. This expectation of protection dampens incentives to contain risk-taking, encouraging greater leverage and more reliance on highly liquid short-term funding.

I believe there are better options for resolving financial firms than those that rely on taxpayer-funded support. One option, for example, is to look for ways to better adapt the bankruptcy code to the business of large financial firms, such as limiting the automatic-stay exemption for certain financial instruments. Another option is to vigorously implement the provision in the Dodd-Frank Act that requires large, complex firms to create resolution plans, or "living wills." These are detailed plans that explain how a troubled financial institution could be wound down under U.S. bankruptcy laws without threatening the rest of the financial system or requiring a public bailout. If these plans indicate that bankruptcy would pose a risk to the system as a whole, regulators can order changes in the structure and operations of a firm in order to make it resolvable in bankruptcy without government assistance. That might mean a change in the firm's funding structure — and a reduction in maturity transformation to a level that is compatible with an unassisted failure.

The intent is not for regulators to decide how much maturity transformation is too much — that is ultimately a question for markets to decide. Instead, our goal should be to make credible changes in policy that properly align the incentives of financial market participants to monitor and control risk. That, I believe, is the best approach to achieving financial stability. **EF**

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