Equity-financed banking and a run-free financial system

John H. Cochrane
Hoover Institution, Stanford University
**Principle**
• Name, diagnose, and limit the problem before you start fixing

**Premises**
• Goal: End financial crises. Period.
• Not: End to big to fail per se.
• Financial crisis = systemic run.
• Not: Dominoes. Outsized losses. Dark ATMs. Holes in ground.
• Stock crashes = good. (Or at least not our problem.)

**Vision before regulation**
• Central problem: run-prone liabilities
• Answer: no more large-scale funding by run-prone liabilities!
• “Banks” finance their risky asset holdings with equity, (+long-term debt).
• Fixed-value “deposits”-> reserves, treasuries.
But how will banks make loans?

(1) $100 Assets (complex)  
Bank  
$10 Equity (stock)  
$90 Debt (deposits, bonds)  
$100 People

(2) $100 Assets (complex)  
Bank  
$100 Equity (very safe!)  
$100 People (diversified)

(3) $100 Assets (complex)  
Bank  
$100 Equity  
Mutual fund, Holding co. (diversified)  
$10 Equity  
$90 Debt  
$100 People

- Eliminating financial crises with 100% equity financed banking does not require any new money, any less credit or any additional risk taking
A more realistic structure

$30 Securitized debt

$40 Assets (complex)

Bank

$40 Equity (safe!)

Mutual fund, ETF

$100 People

Mutual fund, ETF

Transactions Provider

fixed value debt

$14T Treasury debt (Floaters?)

$30 Reserves
Getting there

Remove disincentives/bad regs first!
• Tax distortion
• Debt guarantees
• Regulations that encourage holding debt
• Capital gains tax
• Short term debt is poison in the well!
• *Regulatory safe harbor*

Finally, a bit of stick:
• Not ratios, risk weights, etc.
• Pigouian tax on debt, say 5 cents/ dollar
• Higher for high debt / market value of equity
Before you complain

- Costs and dysfunction of the current system.
- Current regulation lost in the woods.
- High hurdle for whining!