ASSET MANAGEMENT

market notes: Make Banking Boring Again

Make banks boring again – that's the promise of banks built on digital rails. Digital currencies are a disruptor to antiquated business models, not a threat to sovereigns. An unintended consequence of today's banking crisis? Proving the case for narrow digital banking.

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Bottom Line: Make banks boring again – that's the promise of banks built on digital rails. Digital currencies are a disruptor to antiquated business models, not a threat to sovereigns. An unintended consequence of today's banking crisis? Proving the case for narrow digital banking.

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1. An audience will only care about your idea if presented with compelling context. It took me years to understand this point. I was determined to escape a small town and academics was the only road out. I wrote an undergraduate thesis on the non-linearities between stock market prices and takeover rumors with data collected by the WSJ Heard on the Street column…by microfiche. It was crazy enough in ambition that I got interviews.

2. Interviews? I bombed. It's not that I didn't have a story; I wasn't proud of it. I worked two jobs to buy a car as a kid, ran a microbrewery to pay for college, and grew up in Fruitland. Despite no pedigree, I got a "real" job. I wrote things nearly thirty years ago that I couldn't hope to replicate today. What stuck? Work with a great story. Credit crunches, monetary inflation, pointless FX intervention, and especially crises. "Crisis" and "shock" are used interchangeably in policy circles. Oddly. It's not a shock if it keeps happening.

3. So why is it always a "shock?" Balance sheets. It's the blind spot of most analysts, economists, and even risk officers. Mistakes on balance sheets build gradually without a sense of urgency. Mistakes can be glossed over – as they have. Every crisis in the past thirty years has been met with lower lows in policy rates and central bank balance sheet expansion when rate cuts weren't enough. Markets demand deleveraging in crises. But deleveraging has been suppressed. Instead, leverage has been redirected to sovereign balance sheets.

4. That's not a solution. It plants the seeds of the next "shock". Welcome to the 2023 banking crisis. This is not an individual bank problem. Somebody had to be first, and Silicon Valley Bank (SVB) drew the weakest-link straw. Unmarked losses on US bank balance sheets nearly equal core capital of the bank system. But the challenge is not complex. Banks can't pay market rates on deposits without large losses. So, deposit rates are kept low, and deposits leave banks for more attractive alternatives.

5. How will this crisis proceed? Hope for a whimper, prepare for a bang. The IMF built a database covering over 100 countries and five decades (Figures 1 & 2). Of the 16 macro factors, the most common during banking crises are deposit runs (62%), currency crisis (55%), and large current account deficits (4% of GDP). What doesn't matter is notable. Inflation is generally low at 1.4% on average, only 30% of crises are preceded by a credit

boom, and government debt-to-GDP ratios are low at 46%. The macro message is never to let your guard down.

6. The micro side is where the value of the data really shines. Large-scale government intervention occurs in 86% of the cases and at a substantial fiscal cost of 13% of GDP on average. Bank recapitalizations (76% of the time), emergency liquidity support (71%), regulatory forbearance like letting delinquent banks operate (67%), and nationalization (57%) are the most customary micro features of a banking crisis. The distinction between rich and poor countries is only notable in the need for IMF support, which occurs with 52% of countries.

7. US banks are a special case given USD is the epicenter of global finance. Stakes are higher. Cross-border US dollar banking claims are measured in the tens of trillions. The coincidence of banking crisis, deposit runs, and a currency crisis is a global systemic risk. Failure is not an option. If there were a US currency crisis, global policy would have to coordinate. And there are always weekend interventions. In the 1970s, for instance, the IMF and New York Fed had coordinated tools sharpened to smooth any disorder in the US dollar – they weren't needed.

8. Today, policy is stuck. Financial and price stability are competing objectives. Inflation is high and instability in the banking system can be immediately cured by a sharp decline in bank funding costs – rate cuts. Policy tools built for zero interest rate policy are exacerbating the problem. Money is leaving banks in favor of money market funds, and those money funds are lending money back to the Fed through the reverse-repo facility. The dynamic stops when cash isn't king – real rates will be lower through rate cuts or higher inflation or both.

9. Markets don't wait for permission to adjust. They get the joke – and so do asset allocators. Barry Eichengreen and friends evaluated a new megatrend – rising gold reserves, the reversal of a four-decade downturn. Allocations to the barbarous golden relic inflected higher after the 2008 financial crisis. Their empirical work shows emerging market countries are actively diversifying into gold reserves for two purposes: a safe haven from economic risks and protection against financial sanctions on US dollar reserves.

10. "How did you go bankrupt?" Hemingway wrote playfully. "Gradually, and then suddenly." Change is always gradual, giving plenty of time to adapt. Gold is performing in this banking crisis, and digital assets are aligned with their commodity cousins. The correlation of gold and bitcoin returns is 1.7x greater than stocks and bitcoin this year versus; the ratio was 0.9x last year (Figure 3). Digital gold? It's more about digital banking. The best ideas identify a need not being met. Confident, narrow banking is that need, and digital infrastructure fills the gap.

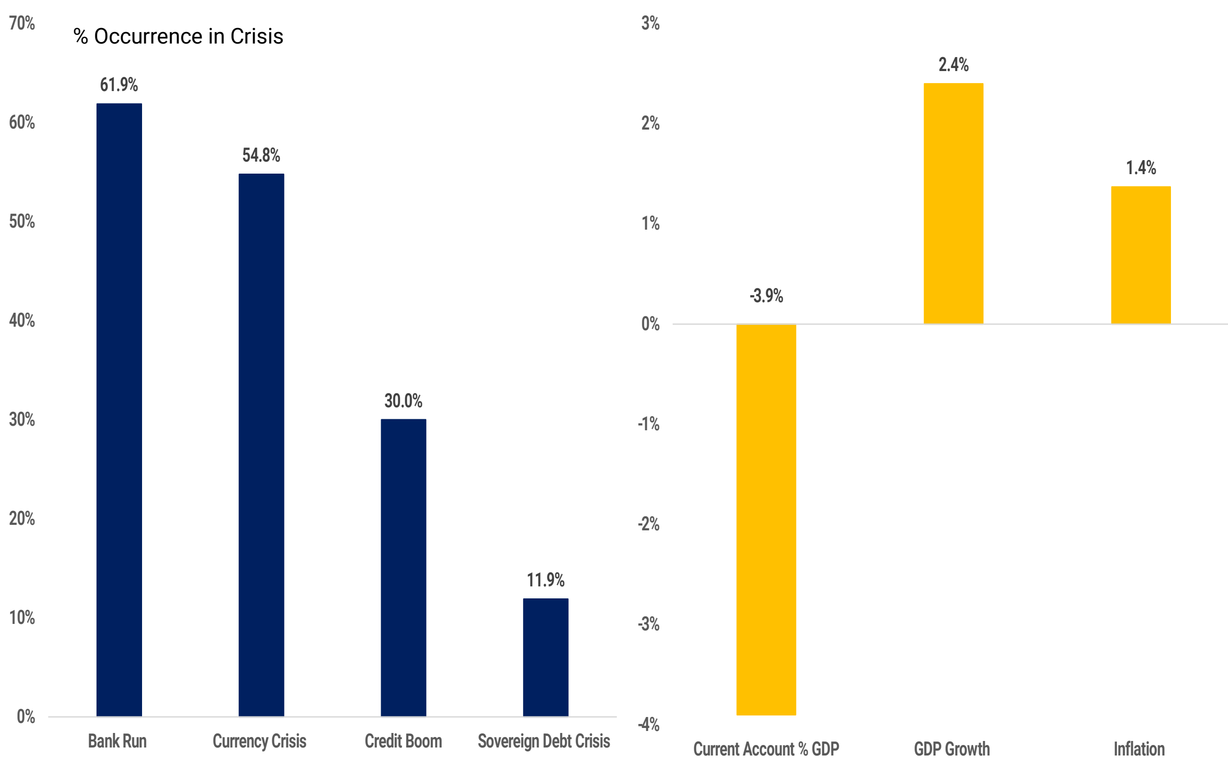
11. "Make banking boring again," is the ask of Senator Warren. A 100% reserved bank is about as boring as it gets. It starts gradually. And it requires technological efficiencies of scale and security – precisely what the Bitcoin and Ethereum base layers provide. Digital banking is already delivering on this promise with models like Xapo bank. It can live in

harmony with the fiat system, not as an antagonist to sovereigns or regulators. The technology is antagonistic to antiquated banking business models.

12. Separate banking into two simple functions: narrow banking for cash management and broad banking for lending. Today, those are comingled. Customers want them separated. Customers in lending banks should earn a higher return and be subject to credit-like market risk. Banks with 100% reserve requirements would be the place for cash management. The probability of loss on cash would be as close to zero as possible.

13. Bitcoin up, down. Ethereum, a commodity, a security. Warning: cryptocurrencies are volatile! These are entertainment vectors. It's tempting to evaluate young technology by its price volatility. But if Ethereum and Bitcoin were in private markets, we would only focus on their technological potential for a better user experience. Boring banking is coming to a phone in your pocket soon. The next generation won't know why it works – only that it does. And boring banking will live on decentralized digital rails.

Figure 1: Banking Crisis – Macro Features



Source: Systemic Banking Crisis – A New Database (IMF Working Paper).

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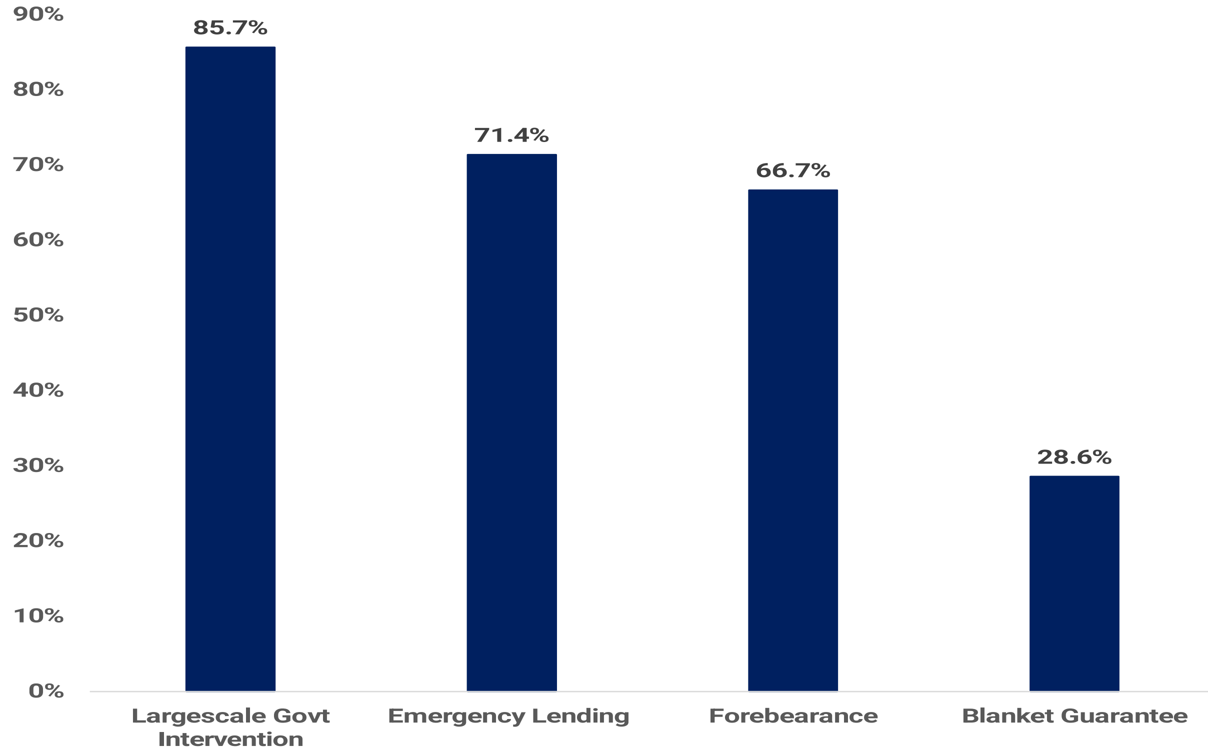
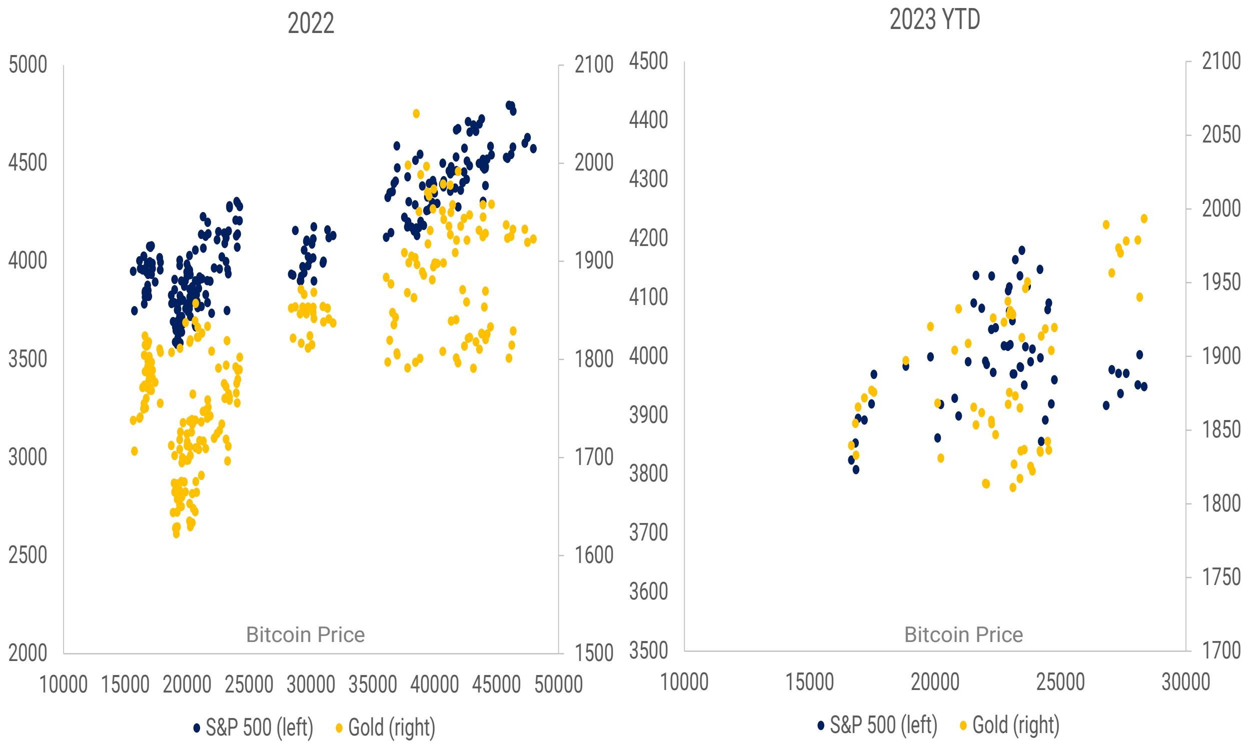
Figure 2: Banking Crisis – Micro Features (% Occurrence)



Source: Systemic Banking Crisis – A New Database ([IMF Working Paper]).

Figure 3 – Bitcoin Tethered Gold, Not Stocks



Source: Coinbase Asset Management Calculations. Bloomberg LP.

Disclaimer

One River Digital Asset Management has been acquired by Coinbase and is now Coinbase Asset Management. Additional details on the transaction may be found on the Coinbase blog. References to One River Asset Management and One River Digital Asset Management may be contained herein during the transition period but are subject to change.

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