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It's time to institute 'limited-purpose banking'

By **Laurence J. Kotiokoff and John C. Goodman**

The Obama administration's strategy to address the economic crisis may be making the problem worse. Its plan — bailing out one financial institution after another and rebuilding the old system pretty much as was — treats the symptoms, not the disease, and will leave us fiscally and financially weaker.

The disease is letting financial companies borrow in order to gamble, resting easy that Uncle Sam will cover their losses. The more the government enables this behavior, the more financial companies will gamble at public expense and the greater the chance of systemic collapse.

Creating a “limited-purpose-banking” structure is a better way to restore trust in our financial system and get our economy rolling.

It is a simple and essentially costless change that limits banks to their legitimate purpose, which is connecting, and intermediating between, borrowers and lenders, and savers and investors.

Under limited-purpose banking, all financial corporations engaged in financial intermediation, including all banks and insurance companies, would function exclusively as middlemen selling safe as well as risky collections of securities (mutual funds) to the public.

They would never own financial assets. Therefore, they would never be in a position to fail because of ill-advised financial bets.

No-risk banking? Exactly. It means making all financial corporations the disinterested intermediaries that they pretend to be.

The government has been going to extraordinary lengths to cover the financial sector's losses, running astronomical deficits and printing money like crazy. But the government also is making promises that it can't keep.

Take the Federal Deposit Insurance Corp.'s insurance. A bank run today would cost the FDIC of Washington $4.8 trillion — far beyond its $19 billion reserve.

Or consider federal promises to cover bills for American International Group Inc. The government has already committed $173 billion to AIG, but the New York company still has $1.6 trillion in credit default swap exposure.

Were AIG or some other large insurer to fail, we could see a run on the industry's roughly $3 trillion in cash surrender value, which the government would surely cover. Then there is Ford Motor Co., General Electric Co. and General Motors Corp., among many other companies, that the government has deemed or might deem “too big to fail.”

And let's not forget the government's guarantees of private-pension funds. That liability could run to $100 billion. How can the government cover all these promises, not to mention its enormous future Social Security, Medicare and Medicaid benefit obligations?

The answer is that it can't.

Yes, it can print even more money to pay people and companies what they are owed. But it can't guarantee that by the time that they are paid, people will be able to buy anything with their money.

The fact that the government's promises are about dollars, not purchasing power, makes bank and insurance runs quite plausible. Those who get and spend their money first on something real come out ahead.

That leads us to limited-purpose banking. Under LPB, banks would let people gamble, but they wouldn't themselves gamble.

Banks would operate exclusively as pass-through mutual funds.

Specifically, they would be permitted only one set of activities: create mutual funds, sell shares of these funds to the public and use the proceeds to purchase assets. These funds would provide as much credit as the economy needed, allow us to engage in as much risk taking as we wanted, and provide maximum liquidity.

There are already some 8,000 or so mutual funds on the market.

Under LPB, there would be more, including cash mutual funds that held only cash, paid no interest, and never broke the buck.

Holders of cash funds could access their dollars at ATMs, via writing checks or by using debit cards. Thus cash funds would represent the checking accounts in the new financial system.

Under LPB, people who sought to lend money to homebuyers would simply purchase shares in a mutual fund investing in mortgages, with the money going directly to the mutual fund and then to the homebuyer in return for his or her mortgage.

Those wanting to lend to companies would buy mutual funds investing in commercial paper. Those wishing to finance credit card balances would buy mutual funds in-vesting in those assets.

NO MAGIC

Credit is ultimately supplied by people, not via some magical financial machine. And every dollar people wanted to lend would be provided to borrowers via mutual funds.

To ensure the security of all these mutual funds, banks would be re-quired to engage third-party custodians, and a new federal regulatory authority — let's call it the Federal Financial Authority — would oversee these arrangements and prevent Bernard Madoff-type scams.

Every security sold on the market would be rated and fully disclosed by the FFA, with no exception. Thus we would no longer have to rely solely on private ratings companies that are paid by those they rate.

Once a new security were initiated by a bank, it would be sent to the FFA (and private parties, as desired) for rating, income verification and disclosure, and then sold by the bank to mutual funds, including mutual funds that the bank itself marketed to the public. Once funded, the new securities would be held by the owners of the mutual fund — in other words, by people.

In requiring that cash mutual funds held just cash, LPB would effectively provide for 100% reserve requirements on checking accounts. This would eliminate any need for FDIC insurance and any possibility of bank runs.

Moreover, since no bank would hold any risky assets apart from the value of its furniture, buildings and land, and would hold no debts, there would be no need for capital requirements.

The concept of 100% reserve requirements on checking accounts was, by the way, advocated in the 1930s under the heading “narrow banking” by Irving Fisher, Frank Knight and Henry Simons — three of the worlds' leading economists of their day.

Given that today's insurance companies are fundamentally engaging in the same hedging business as today's banks, insurance companies would be considered banks under limited-purpose banking. And like all banks under LPB, they would be free to market mutual funds of their choosing.

The mutual funds that insurers would issue, however, would differ somewhat from conventional mutual funds.

First, purchasers of such insurance mutual funds would collect payment contingent on personal outcomes and decisions, as well as economy-wide conditions. This would let people buying a fund share risk with one another.

Second, they would be closed-end mutual funds, with no new issues (claims to the fund) to be sold once the fund had launched.

Take, for example, a one-year homeowner's insurance policy sold by The First Bank of Homes. Purchasers of this fund would collect only if they experienced incidents such as a fire, flood or a robbery.

On the last day of the policy, the FBH would divvy up all the money in the fund between all those experiencing a loss, with the amount paid out depending on the size of one's loss and the number of shares one had originally purchased. Hence, LPB would permit people to buy as much insurance coverage as they wanted.

Another key feature of this system is that each insurance policy would in effect be subject to separate reserving; the money contributed to each insurance mutual fund would be used exclusively to pay off its own shareholder claimants.

The most important feature, though, is that the insurance mutual funds would pay off not based merely on diversifiable risk but also on aggregate risk. That is, if lots of the buyers of the FBH fund lost their house to fire, the recovery per shareholder with a loss would be smaller.

This isn't the case under our current system. Life insurance companies, for example, tell their policyholders that they will pay the face value of their policies if they die, regardless of how many other claimants the company faces.

Thus life insurance companies are saying that they will pay in full even if there is a plague — which they can't actually do. Neither can the paltry state life insurance reserves cover the losses.

This is really no different from AIG's writing some $1.6 trillion in credit default swaps that it knew it wouldn't be able to cover in the event of systemic risk — and not reserving a penny.

Implementing LPB would be straightforward. All financial corporations, if they hadn't done so already, would register with the Securities and Exchange Commission as investment companies and begin marketing cash and other mutual funds subject to the third-party custody and other regulatory provisions of the Investment Company Act.

Depository institutions immediately would transfer all their checking accounts into cash mutual fund shares and use their reserves to provide the cash to back these shares. These institutions have massive excess reserves and would have no problem covering this operation.

Since they would no longer be allowed to buy financial assets or borrow to invest in securities, banks, as broadly defined, over time would pay out their cash flow to their owners as dividend payments. The owners, in turn, would use these funds to purchase mutual funds issued by the banks.

So the transition to LPB would be gradual with respect to unwinding bank assets and debts but immediate with respect to issuing mutual funds. Banks would become zombies with respect to their old practices but gazelles in exercising their new purpose.

Politically, LPB should garner lots of support. The public is dying for a transparent, safe financial system that puts a definitive end to financial crises and public bailouts.

Bankers will likely fight this reform tooth and nail. But the bankers' party is over; even the politicians are disgusted by what they have seen.

Our financial system is in terrible shape and needs a fundamental overhaul. Limited-purpose banking is the answer.

This simple system would preclude the type of financial crisis that we are experiencing. The system would rely on independent ratings by the government but permit private ratings as well.

It would require maximum disclosure and provide maximum transparency.

Most important, it would make clear that risk ultimately is born by people, not companies, and that people need and have a right to know what risks they face.

Finally, it would make clear what risks were and were not diversifiable. It wouldn't pretend to insure the uninsurable or guarantee returns that couldn't be guaranteed, and it would keep other people from gambling with our money without our consent.

In short, the system would be honest, and because of that, it would be trustworthy.

Laurence J. Kotlikoff is a professor of economics at Boston University. John C. Goodman is president and chief executive of the Dallas-based National Center for Policy Analysis. This is an edited version of an article that originally appeared in The New Republic.