Back to Basics

The only way Obama can fix the economy is by changing the way banks do business.

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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.

There is a better way to restore trust in our financial system and get our economy rolling: Limited Purpose Banking. It's a simple and essentially costless change in our financial system that limits banks to their legitimate purpose: 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 who sell safe as well as risky collections of securities (mutual funds) to the public. They would never, themselves, own financial assets. Thus, they would never be in a position to fail because of ill-advised financial bets. No-risk banking? Exactly. It means making banks--meaning all financial corporations--be the disinterested intermediaries 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, too, is making promises it can't keep. Take the Federal Deposit Insurance Corporation's (FDIC) insurance. A bank run today would cost the FDIC $4.8 trillion--far beyond its $19 billion reserve. Or consider federal promises to cover AIG's bills. The government has already committed AIG $173 billion, but the 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's GM, Ford, GE, and many other companies the government has deemed or might deem "too big to fail." And let's not forget the government's guarantees of private pension funds; the liability there 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? It can't. Yes, it can print even more money--it's already on track to triple the monetary base--to pay people and companies what they were owed. But it can't guarantee that by the time they're paid, they'll be able to buy anything with their money; opening up the printing press to the extent needed to make everyone whole spells hyperinflation. The fact that the government's promises are about dollars, not purchasing power, makes the aforementioned bank and insurance runs quite plausible. Those who get and spend their money first on something real come out ahead.
Which leads us to the better way: Limited Purpose Banking (LPB). To understand it, think about trucking companies. Were trucking companies to sell rights to future shipping at a guaranteed price, they’d make a bundle in the short run. But were gas and other trucking costs to soar, the companies and the economy would shut down. One such episode would suffice for the government to outlaw this kind of gambling by trucking companies, limiting them to their legitimate and critical purpose.

To keep banks from shutting down the economy, we propose a new regime. Under Limited Purpose Banking, banks would let people gamble, but they would not themselves gamble. Banks would operate exclusively as pass-through mutual funds. Specifically, they would be permitted to one and only one set of activities: create mutual funds, sell shares to these funds to the public, and use the proceeds to purchase assets. These mutual funds would provide as much credit as the economy needs, allow us to engage in as much risk-taking as we want, and provide maximum liquidity.

There are already some 8,000 or so mutual funds on the market. Under LPB, there’d be more, including cash mutual funds that hold only cash, pay no interest, and never break the buck. Holders of cash funds could access their dollars at ATMs, via writing checks, or by using debit cards. Thus, cash funds represent the checking accounts in the new financial system.

Under LPB, people who seek to lend money to home buyers would simply purchase shares in a mutual fund investing in mortgages, with the money going directly to the mutual fund (not to the bank sponsoring the fund) and from there to the home buyer 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 investing in those assets. Credit is ultimately supplied by people, not via some magical financial machine. And every dollar people want to lend would be provided to borrowers via mutual funds.

To ensure the security of all these mutual funds, banks would be required to engage third party custodians, and a new federal regulatory authority--let’s call it the Federal Financial Authority (FFA)--would oversee these arrangements and ensure that no Bernie Madoff could ever again self-custody his clients’ assets and spend their money illegally.

The FFA would have other roles as well. For one, it would establish, like the Food and Drug Administration does, the safety of various securities: Every security sold on the market--be it an individual mortgage, a commercial loan, a foreign security, or a share of stock--would be rated and fully disclosed by the FFA, with no exception. Thus, we’d no longer have to rely solely on private rating companies that are paid by those they rate.

A new mortgage, commercial loan, credit card, issuance of stock, new real estate trust, etc. would be initiated by a bank, 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 markets 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 hold just cash, LPB effectively provides for 100-percent reserve requirements on checking accounts. This eliminates any need for FDIC insurance and any possibility of future 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 (apart from the mortgages on its property and any loans used to finance its operations), there would be no need for capital requirements.
One-hundred-percent reserve requirements on checking accounts was, by the way, advocated under the heading "Narrow Banking" by Henry Simons, Irving Fisher, and Frank Knight in the 1930s--three of the worlds' leading economists of their day. The world listened to John Maynard Keynes' many deep insights, but, unfortunately, entirely ignored Simons, Fisher, and Knight.

Given that today's insurance companies are fundamentally engaging in the same business as today's banks--insuring us against illness or our home burning down the way financial securities insure us against the stock market crashing, the dollar falling, the price of oil rising--insurance companies would be considered banks under Limited Purpose Banking. And like all banks under Limited Purpose Banking, 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 lets 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 (FBH). Purchasers of this fund would buy their shares, let's say, by September 1, 2010, but collect on August 31, 2011, only if they experience incidents like a fire, flood, or a robbery. On that last day of the policy, the FBH would divvy up all the monies 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, Limited Purpose Banking permits people to buy as much insurance coverage as they'd like. Another key feature of this system is that each insurance policy is, in effect, subject to separate reserving; the money contributed to each insurance mutual fund is used exclusively to pay off its own shareholder claimants.

The most important feature, though, is that the insurance mutual funds pay off based not just on diversifiable risk, but also based on aggregate risk. That is, if lots of the buyers of the FBH fund lose their house to fire, the recovery per shareholder with a loss will be smaller. This isn't the case under our current system: Life insurance companies, for example, tell their policyholders that they'll 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 they'll pay in full even if there's 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 would not be able to cover in the event of systemic risk. Moreover, AIG felt no compulsion to reserve against redemptions on these contracts.

The final point is that insurance mutual funds can be set up to bet exclusively on aggregate outcomes, like a particular company going bankrupt or the nation's mortality rate exceeding a given level. Shareholders in such closed-end funds would specify whether they were betting on the event occurring or not. If the event occurs, those betting on occurrence take the pot (the holdings of the mutual fund) in proportion to their shares. If the event doesn't occur, those betting against the occurrence share the pot based on shares. If such a system sounds familiar, it is: It's pari-mutuel betting, which has been used at race tracks around the world since 1867.

Leverage is also fully compatible with Limited Purpose Banking. Mutual funds could, as some already do, sell preferred and common shares. The preferred shares entail less downside risk and the common
shares more upside opportunity. This is leverage that all can see—particularly Uncle Sam, who may want to keep a close eye on who's gambling with the potential expectation of a government bailout.

Implementing Limited Purpose Banking is straightforward. All financial corporations, if they aren't already, would register with the SEC 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 would immediately 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 will 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, would, over time, 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 is gradual with respect to unwinding existing bank assets and debts, but immediate with respect to issuing new mutual funds. Banks 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, which puts a definitive end to financial crises and public bailouts. Bankers will likely fight this reform tooth and nail. They'll claim it is naïve, too radical, a non-starter, that it relies too much on the government, that it's going to limit financial sector returns. But the bankers' party is over; even the politicians are disgusted by what they've seen.

The beauty of the reform is that it's already pretty much in place. The mutual fund industry has been operating exceptionally well for 60 years. There are over 8,000 mutual funds operating in the country holding over $12 trillion in assets. And this industry is the only part of the financial sector that is still standing very tall.

Our financial system is in terrible shape and needs a fundamental overhaul. Limited Purpose Banking is the answer. This simple system would preclude financial crises of the type we're now experiencing. The system would rely on independent rating 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 is ultimately born by people, not companies, and that people need and have a right to know what risks they are facing. Finally, it would make clear what risks are and are not diversifiable. It would not pretend to insure the uninsurable or guarantee returns that can'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.

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