Limiting Global Financial Instability with Limited Purpose Banking

Laurence J. Kotlikoff

Professor of Economics, Boston University

Wall Street Has Become Very Dangerous for Main Street

Two Global Financial Crises

With Devastating, Ongoing Impacts on Hundreds of Millions of Workers and Retirees

One Centered in the U.S.

One Centered In Europe

Will the Next One Be Centered in China?

What’s Going on?

Is It Bad Assets?

Subprime/Real Estate

Sovereign Debt

Or Bad Banks?

Bear Stearns, Country Wide, Lehman Brothers, Northern Rock, Royal Bank of Scotland, HBOS, BNP Paribas, UBS, Anglo-Irish Bank, MBIA, Citigroup, Merrill Lynch, Fannie Mae, Freddie Mac, Washington Mutual, Glitnir, Allied Irish, Bank of Ireland, Dexia, Landsbanki, AIG, Lloyds, Barclays, Bradford and Bingley, ING, ABN AMRO, Fortis, …

Or

Bad Regulators?

Bad Financial Rules?

Bad Governance?

Bad Politicians?

Bad Bankers?

Bad Disclosure?

Bad Leverage?

Bad Luck?

Regardless of Precise Cause,

Asset Prices Plunged and Banks Failed

Do Banks Always Fail When Asset Prices Plunge?

No!

Example: Bursting of Dot Com Bubble

Nasdaq Fell 70 Percent

S&P Fell 50 Percent

No Major Bank Failures

Why Didn’t Banks Fail When the Dot Com Bubble Burst?

They Weren’t Holding Dot Com Stocks – the “Bad” Asset of the Day

“So Maybe the Answer Is to Make Banks Hold Only Good Assets?”

“But That Will Kill the Market for Bad Assets!”

“So Maybe the Answer is to Have Good Banks that Hold Only Good Assets, and Have Bad Banks that Hold Bad Assets”

Good Banks Are Commercial Banks and
Have Retail Customers, Issue Insured Deposits,
and Run the Payment System

Bad Banks Are Investment Banks, Hedge Funds, SIVs,
Mortgage Companies, etc. and their Customers are
Corporations, Rich Foreigners, and Other Bad Banks

This Answer Can Be Refined:

1. “Good” Banks Hold Only “Good” Assets
2. “Good” Banks Behave – No Trading and No Derivatives
3. All Banks Hold More Capital Against Risky Assets
4. Stress Test Banks and Adjust Asset Mix as Needed
5. Let “Bad” Banks Fail, But Arrange Quick Funerals
6. Let All Banks Operate with Up to 33 to 1 Leverage

This is the “New” Financial Architecture

It’s the Basel III/Paul Volcker/ Dodd-Frank/Vickers Commission Answer.

It’s the Wrong Answer.

The Answer's Four Fatal Flaws

1. "Good" Assets Do Bad Things
2. "Bad" Banks are Too Big To Fail
3. The Stress Tests are Jokes
4. Macro Problem Is Funerals, Not Funeral Arrangements

Examples of Good Assets That Went Bad

U.S. Mortgages

Top-Tranched CDOs

Italian Government Debt

Lehman Brothers Bonds

AIG Stock

Which Are the Next “Good” Assets to Go Bad?

Chinese Mortgages and Real Estate?

U.S. Treasuries?

Will We Let Big “Bad” Banks Fail?

No

We ran this Experiment With Lehman and It Initiated the Great Recession.

No-Stress Stress Tests

Many Banks that Pass Stress Test

Have Less or Much

Capital than Lehman Had Three Days

Before It Declared Bankruptcy.

When the Panic of 2008 Hit,

Trust Took a Holiday

No One Trusted Lehman's Books –

Not the Treasury, Not the Fed,

Not the SEC, Not the Banks, Not the Public

And No One Trusted That Others

Would Trust Lehman's Books

The Funeral Arrangements Weren't the Problem

Of 28 Major Bank Failures in 2007 - 2009,
Only One Was Really Messy – Lehman's

The Rest Were Quick and Smooth, if
Ad Hoc, Shot-Gun Weddings or
Nationalizations or Federal Bailouts

The Spector of Widespread Financial Failure Produced a Massive Coordination Failure

Overnight, Households and Firms Coordinated on Bad Times and Took Individually Optimal Steps that Ensured that Collective Outcome

The 28 Financial Funerals Killed the Global Economy, Not the Flower Arrangements

What’s the Real Problem With the Banking System?

Answer:

Opacity and Leverage

Markets Don’t Operate Well in the Dark

If You Can’t See What You are Buying, You are Buying a Promise – a Promise that May Be Fraudulent

1982 Tylenol Scare

4 Bottles of Tylenol Laced with Cyanide Killed 7 People in Chicago

Overnight, 30 Million Bottles of Tylenol Became “Toxic Assets”

Price Dropped to Zero. This Was a Run on Tylenol.

Johnson & Johnson Recalled Old Tylenol and Distributed New Tylenol in Safety-Sealed Containers

This Was an Act of Disclosure Eliminating Concern about Tylenol Fraud

Fraud, Suspicions of Fraud, or Suspicions of Suspicions of Fraud Can Trigger Financial Runs

Governments Try to Prevent Runs By Promising to Keep the Banks' Promises.

In So Doing, Governments Make Promises They Can’t Keep

This Can Lead to Runs on the Governments Triggering Runs on the Banks that are Being Backstopped by the Governments.

Case In Point: Today's Eurozone Crisis

Bottom Lines –

- Our “Trust Me” Banking System Is Inherently Unstable
- “Managing” Systemic Risk Can Produce Systemic Collapse
- Urgent Need to Eliminate Promises that Can’t Be Kept
- Must Move From “Trust Me “to “Show Me” Banking

Limited Purpose Banking

Moves from “Trust Me” to “Show Me” Banking

Limits Banks to their True Purpose – Intermediation

Full Transparency and Disclosure and Zero Leverage

Households and Firms Borrow, But Not Banks

Prominent Economists and Policymakers Endorsing Serious Consideration of Limited Purpose Banking

- Mervyn King, Governor of the Bank of England
- Seven Nobel Laureates in Economics (Ackerlof, Lucas, Prescott, Phelps, Fogel, Merton, Sharpe)
- Former U.S. Secretary of Treasury (George Shultz)
- Former U.S. Secretary of Labor (Robert Reich)
- Former U.S. Senator (Bill Bradley)
- Two Past Chairs, Council of Economic Advisers (Michael Boskin and Murray Weidenbaum)
- Two Former Chief Economists of the IMF (Harvard's Ken Rogoff and MIT's Simon Johnson)
- Former Chief Economist of the SEC (Susan Woodward)
- Former Deputy Comptroller of the Currency (Robert Bench)
- Former Vice Chairman of Joint Chiefs of Staff (Admiral Williams Owens)
- Jeff Sachs (Renown Macro Economist and Head of Columbia's Earth Institute)
- Jagadish Bhagwati (Renown International Economist)
- Martin Wolf (Senior Economics Columnist for the Financial Times)
- Steve Ross (MIT's Premier Financial Economist and Father of Arbitrage Pricing Theory)
- Niall Ferguson (Harvard's Distinguished Economic Historian)
- Kevin Hassett (Distinguished Economist at AEI and McCain's Former Chief Economic Adviser)
- Paul Romer (Stanford's Distinguished Growth Theorist)
- Domingo Cavalo (Former Economic Minister of Argentina)
- Wiliam Niskanen (Chairman Emeritus, The Cato Institute)
- Preston McAfee (Chief Economist, Yahoo)
- Other Very Prominent U.S. Economists

Limited Purpose Banking

- Mutual Fund Banking
- Federal Financial Authority
- Auction Market

Limited Purpose Banking

Draws Line Based on Limited Liability,

Not Whether Banks Call Themselves Commercial

or Investment Banks as in Glass-Steagall

I.e., Regulation Based on Function, Not Form

Limited Purpose Banking

All Financial Companies Operating with Limited Liability Must Operate Solely as Mutual Fund Holding Companies Issuing 100% Equity-Financed Open and Closed End Mutual Funds

Limited Purpose Banking

Cash Mutual Funds Used for the Payment System and Hold Just One Thing – Cash.

Cash Mutual Funds Are Naturally Backed to Buck.

All Other Mutual Funds, Including Money Market Mutual Funds, Float at NAV.

M1 = Cash in Pockets and Cash Mutual Funds = MB

M1 Money Multiplier Equals 1.

Limited Purpose Banking

How Do Insurance Companies Fit In?

Tontines Allocate Idiosyncratic Risk

Pari-mutuels Allocate Aggregate Risk

Pari-Mutuel Funds Permit Safe Derivatives

The Federal Financial Authority (FFA)

- Verifies All Securities Purchased by Mutual Funds
- Private Verification Companies, Working Exclusively for the FFA, Verify Income, Employment, Tax Returns, Credit History, Collateral Appraisals, Etc.
- No More “Liar Loans,” “No-Doc Loans,” “Ninja Loans”
- Real-Time, Ongoing, Web-Based, Micro-Level Disclosure
- Mutual Fund Investors Know What they Are Buying

Mutual Fund Securities Auction Markets

Mutual Funds Buy and Sell All Securities at Auction

Borrowers/Equity Issuers Get Best Price for Paper

Auction Market => Fewer, Less Complex Assets

Much Easier for Small Business to Float their Paper

Transition To Limited Purpose Banking Is Simple

- Financial Corps. Re-Chartered as Mutual Fund Holding Co.s
- Convert Investment Banking Operations into Consulting Service
- Convert Trading to a Matching Business with No Open Positions
- Convert Checking Accounts to Cash Mutual Funds
- Convert Other Short-Term Bank Liabilities to Money Mkt Funds
- Convert Long-Term Bank Liabilities to Closed End Funds
- Insurance Companies Issue Only Tontines and Pari-Mutuels
- Establish the Federal Financial Authority

A System Built For Hucksters Disappears

- Fraud
- Insider Rating
- Director Sweetheart Deals
- Corporate Governance Problems
- Political Bribes
- Regulatory Capture
- Moral Hazard
- Non-Disclosure
- Off-Balance-Sheet Bookkeeping
- Government Bailouts
- Failure to Mark to Market