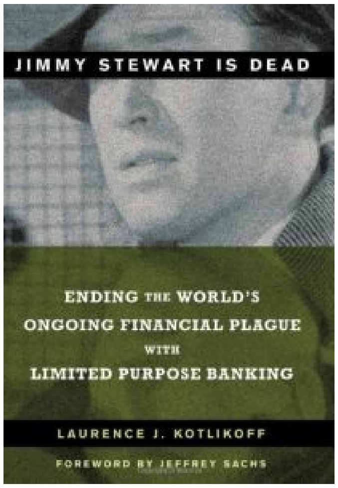

Book Jimmy Stewart is Dead

Ending the World's Ongoing Financial Plague with Limited Purpose Banking

Laurence J. Kotlikoff
Wiley, 2010
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Recommendation

There's no use pining for the good old days – *It's a Wonderful Life* was just a Hollywood movie, the town of Bedford Falls doesn't really exist and Jimmy Stewart is long gone. But earth-shattering economic tumult has a way of evoking nostalgia for the return of (what you think were) simpler, more honest fiscal times. Economist Laurence J. Kotlikoff delivers a salty, sometimes irreverent, but ultimately convincing remedy to cure you of the erroneous belief that banking should return to the past to make up for the sins of the present. He competently lays out his concept of how "limited purpose banking" would work while hoisting on their own petard the crafty bankers, sinister lenders and obfuscating bureaucrats who nearly crashed the economy. *BooksInShort* recommends Kotlikoff's original interpretation of events resulting from the 2008 crisis and his exposition of the far-reaching solution he offers, but quibbles over just one point: George Bailey ran the Bailey Building and Loan, not the Bailey Savings and Loan.

Take-Aways

- Your friendly banker, like Jimmy Stewart in *It's a Wonderful Life*, no longer exists.
- A computer decides your creditworthiness, and you don't know what the bank does with your money.
- The US government effectively became the lender of last resort for the American financial system during the 2008 panic.
- With more than $12 trillion pledged to the economy, the US is severely overstretched.
- Uncle Sam may guarantee bank deposits, but he can't warrant their purchasing power.
- Wall Street operates like a Ponzi scheme: Investors place their trust in bank CEOs.
- The only way to ensure depositors' safety and security is reform that separates economic risk taking from financial intermediation.
- A "Federal Financial Authority" (FFA) should rate banks and protect depositors, just as US government agencies test and approve drugs.
- "Limited purpose banking" (LPB) would convert all banks into mutual fund companies, thus ensuring integrity, safety and full disclosure to investors, borrowers and savers.
- With no ability to borrow or invest, banks would become financial "middlemen."

Summary

So Long, Bedford Falls

In the classic 1946 film *It's a Wonderful Life*, actor Jimmy Stewart plays George Bailey, a beleaguered banker in the town of Bedford Falls. When panic forces a run on his bank, Stewart assures his frightened depositors that their money is safe, because it's tied up in their neighbors' mortgages and loans.

> "Our financial system is in terrible shape and needs a fundamental overhaul, not an oil change."

So much for Hollywood. The time when your local banker knew you personally is long gone. Now, your corner bank is a branch of a megabank whose service representatives score your credit and determine your creditworthiness by computer. And you don't know where your money goes, or what assets it has funded, or even if the bank is still holding those assets on its books. Fractional reserve banking, in which banks need to keep on hand only 10% of "potential immediate withdrawal" requirements, is just one of the many problems with today's financial system, along with "off-balance-sheet bookkeeping...kick-back accounting, sales-driven bonuses, nondisclosure, director sweetheart deals...and government bailouts." This system nearly collapsed in 2008, and bankers and politicians still are trying to put it back together. But the only way to ensure depositors' safety and security is to enact reform that separates economic risk taking from financial intermediation.

"Who's Backstopping the Backstop?"

In responding to the 2008 financial crisis, the US government effectively became the lender of last resort for the American financial system, either directly buying assets or promising to pay contingencies of more than $12 trillion. How? By guaranteeing money market accounts, corporate commercial paper, Citigroup's and Bank of America's "poison securities," and Fannie Mae and Freddie Mac's obligations. All those pledges are in addition to actual expenditures on the Troubled Asset Relief Program (TARP), the Public-Private Investment Program (PPIP), AIG, Bear Stearns, and the list goes on. The US already has laid out $2.5 trillion for the financial crisis, more than it spent throughout World War II.

> "We were broke before the financial crisis hit, and we are now in much worse shape given the vast sums we've spent trying to save Main Street from Wall Street."

From January 1, 2008 through June 1, 2009, "Uncle Sam printed more money (just shy of $1 trillion)...than was printed in the entire history of the republic." But simply issuing money doesn't mean the nation can make good on its commitments: "Uncle Sam has no backstop for his backstop." While government guarantees may assure citizens that their deposits are safe, those commitments don't extend to the purchasing power of those deposits, should inflation return.

> "There was no Jimmy Stewart...around to calm everyone down...There was George Bush in a daze, Hank Paulson and Ben Bernanke pulling out their remaining hairs, and Jimmy Cayne playing bridge."

The US crisis spread panic throughout the global financial system. No "firewalls" existed to keep the fear from swelling around the world. Lack of transparency about the types and amounts of toxic assets that financial institutions held led directly to the seizing up of credit markets. If you didn't know how deeply your bank invested in crumbling mortgages or collapsing derivatives, you wouldn't wait to find out – and neither did any other credit provider, putting the entire financial system into a state of suspended animation. Timely information is the critical linchpin of a free-flowing economy. Disclosure of bank portfolios' exact holdings might have averted the broadening of the crisis. Yet none of the CEOs caught in the crisis – among them, Stan O'Neal at Merrill Lynch, Jimmy Cayne at Bear Stearns or Richard Fuld at Lehman Brothers – had the technical expertise to grasp the complexity of the transactions their banks were conducting. Squelched or intimidated by their own ignorance, the executives deferred to their subordinates more than they should have.

"Is the US Banking System a Ponzi Scheme?"

Ironically, Bernard Madoff's $65 billion Ponzi scheme came undone not because of toxic mortgages or bad derivatives but due to his investors' concerns as the panic spread in late 2008. Accepting new money to pay off current investors is not a crime; money market funds do it as a matter of course. And incorrectly or inadequately assessing the worth of assets is commonplace and legal; *The New York Times* wrote of a major bank that valued its mortgage securities at 98%, while the market placed a 38% estimate on the same assets. Madoff succeeded in his scam for so many years because he "engaged in massive nondisclosure." Currently, Wall Street investors are placing their trust in bank CEOs, who theoretically know everything about their companies' portfolios and investment practices, but in practice, do not. Does this sound familiar?

"Limited Purpose Banking"

Channeling savers' funds to meet borrowers' needs is a basic, but vitally important, "utility" that keeps markets working properly. But complex securities, manipulative bankers, mendacious mortgage lenders, biased rating agencies, inept regulators, bonus-driven executives, irresponsible directors and "the naïveté of investors" led to a "casino" economy, in which the public lets "Wall Street play craps with our financial system" and taxpayers are the losers. The financial community prefers the status quo. Bankers can "socialize risk and privatize profits," since banks' place in financial intermediation and their interconnectedness command government assistance whenever one or more of them gets into trouble.

> "No one really trusts the banks, least of all the banks themselves, which remain reluctant to lend to one another."

Resegregating banking into two separate functions – highly regulated financial intermediation and unregulated risk taking – as existed from the 1930s to the 1990s isn't realistic today. The financial sector comprises 20% of the US's GDP, and innovative financial products and structures fuel the economic engine, so outlawing derivatives or risky investments is a nonstarter. Protecting depositors and ensuring that the intermediation utility operates smoothly, while allowing transparent risk taking, demands a rethinking of the entire system.

> "Is Wall Street running a Ponzi scheme? Yes. Insofar as any financial company does not fully disclose the current market value of its holdings, it's fundamentally playing the same game as Madoff."

Even with complete information about their banks' financial holdings, "Joe Six Pack" investors and depositors lack the skills to judge financial creditworthiness. In the US, the Food and Drug Administration (FDA) performs as a pharmaceutical watchdog; it tests medicines, assures the public of their safety and warns Americans about – but doesn't prevent the sale of – items that are untested. Similarly, the US needs a "Federal Financial Authority" (FFA) to rate banks and their offerings, and to protect depositors from "predatory financial companies."

"There is a better way to restore trust in our financial system and get our economy rolling...[it] is not to let the mess happen to begin with."

Limited purpose banking (LPB) would convert all financial intermediaries, including commercial and investment banks, insurance companies and hedge funds into "pass-through mutual fund companies." This would cost little to implement – it could use the existing mutual fund infrastructure – and would keep government out of the financial industry. Banks would operate strictly as "middlemen," only intermediating deposits and investments; they would neither own assets nor borrow to acquire any, and thus remain immune to failure. No restrictions would keep individuals or companies from taking on as much risk as they like; banks could offer investment vehicles, but not hold ownership positions in those assets. Financially innovative products like securitizations and derivatives would continue to thrive and expand, offering higher returns and risk management, as they do now. What would change is the availability and clarity of information and background data on these vehicles; the FFA would have to evaluate and supervise these investments.

Cash and Insurance

While LPB banks could offer any number and type of mutual funds, the most common might be the "cash mutual fund" and the "insurance mutual fund." The former would hold only cash and act like current demand-deposit accounts: You could add to and withdraw funds using ATMs, checks or debit cards. Because cash mutual funds must contain only the cash deposited, banks no longer would need reserve or capital requirements, or deposit insurance. Bank runs will become irrelevant, because the mutual fund will hold every dollar you deposit and you'll always have access to your money.

"I'm going to ask you to jump out of the car with me with respect to radically restructuring our financial system."

Because the concept of insurance has blurred with financial innovation – derivatives are a form of insurance – all insurance companies would become banks under the LPB protocol. But insurance mutual funds would differ from cash mutual funds in two important ways:

1. "Their purchasers would collect payment contingent on personal outcomes and decisions as well as economy-wide conditions."
2. They "would be closed-end mutual funds, with no new issues (claims to the funds) to be sold once the fund has launched."

"The goal of LPB is not to rebut the market system, but to save it."

The second point pertains to establishing firewalls. Suppose a bank sold "a three-month, closed-end insurance mutual fund" that would accept investments only from men aged 50 to 55. At the end of three months, the estates of any deceased purchasers would collect their proportionate share of "the pot." The payout is limited to what's in the pot. Contrast this with current insurance policies, which promise to pay all policyholders when they die; that's only possible if relatively few people die at any one time. If an epidemic or catastrophe took place, insurance companies would be hard-pressed to honor all claims. Similarly, in marketing annuities, insurance companies count on enough young people buying policies to cover claims by the elderly. But if a disease (like swine flu) targeted youngsters while a cancer cure kept oldsters alive and collecting benefits, annuity issuers would go bankrupt. Large firms like AIG would beg for government bailouts. A closed-end insurance mutual fund would eliminate this possibility.

"Getting from Here to There"

Limited purpose banking is not an unfamiliar concept: Before the 2008 crisis, more than one-third of Americans' financial holdings were in mutual funds. So implementing LPB is straightforward, but restructuring the banking system would take some doing. First, all financial institutions would become mutual fund companies subject to Securities and Exchange Commission (SEC) supervision. Next, banks would devolve their investment banking and trading operations into "no-risk, no-leverage" entities, offering only consulting and brokering services, respectively. They no longer would take positions in companies' stocks or trades, thereby eliminating conflicts of interest and "rogue traders." Then, the current 115 US government "bureaucratic regulatory agencies" would merge into one FFA that would "verify the accuracy of our credit scores and hire private, independent companies to rate our loans." Other questions regarding LPB include:

- **"Will LPB reduce liquidity?"** – Because all LPB mutual funds would trade freely and their holdings would be known to everyone, liquidity should increase.
- **"Will LPB reduce credit?"** – Mutual funds will lend as banks do today, but with better data about their borrowers, thanks to the FFA's assessment.
- **"Who will lend to business?"** – Firms needing funds will apply to a bank, which will ask the FFA to rate the application. The bank will auction the loan via the Internet to mutual funds; this will ensure low rates for borrowers.
- **"Will LPB reduce leverage?"** – While banks are not allowed to leverage, no such restrictions apply to "consenting adults" who still could borrow for investment purposes.
- **"What about venture capital, private equity firms and hedge funds?" –** Such firms could convert into mutual funds specializing in private investments, or they could remain outside the LPB structure, with "unlimited liability" for the risks they take.
- **"Will LPB prevent financial panics?**" – Markets rise and fall on human sentiment, so "irrational exuberance and pessimism" will endure, but under LPB these waves won't threaten the entire financial system.

"We are at a turning point for our nation and our children, and we need [to] set our sights on their future, not our own."

While popular opinion likely would welcome the transparency and security LPB would bring to daily financial decisions, the banking industry would mount a strong resistance. But Wall Street could become LPB's greatest supporter, once financiers understand the threat of Washington micromanagement in response to current calls for extensive reregulation of the industry. Certainly the fate of the world's economic future should not rest in the hands of Wall Street or government bureaucrats. Limited purpose banking would ensure integrity, safety and full disclosure to investors, borrowers and savers.

About the Author

Laurence J. Kotlikoff is an economics professor at Boston University and has worked with the World Bank and the IMF.