Banking on Failure

Fixing the Fiasco of Junk Banks, Government Bailouts, and Fiat Money

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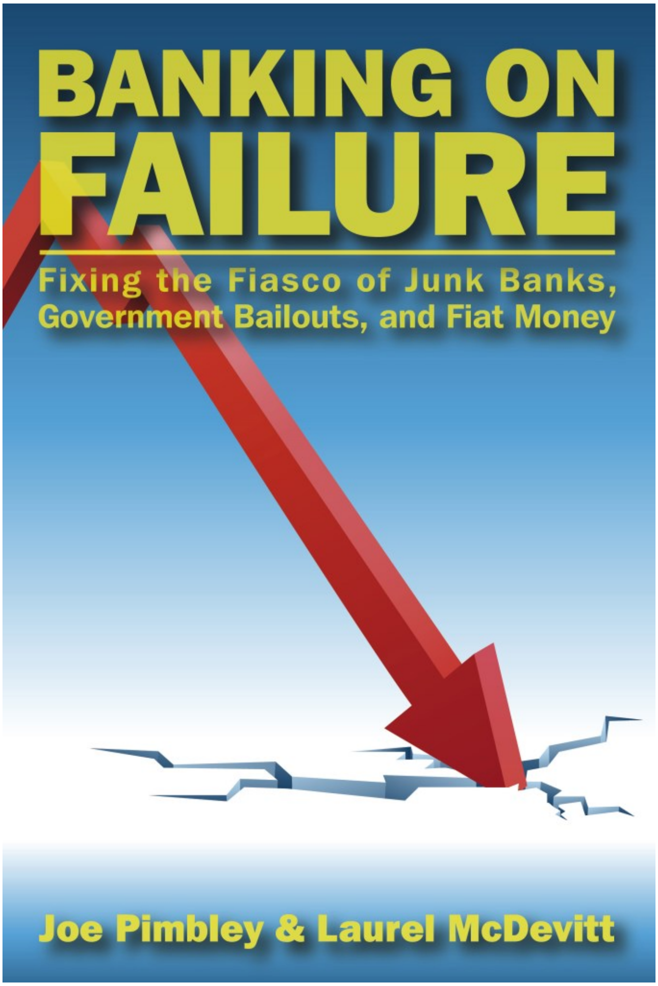

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INTRODUCTION

What's with banking? The news since 2008 has been full of failures and near-failures of firms such as *Bear Stearns*, *Lehman Brothers*, *Fannie Mae*, *Freddie Mac*, *Washington Mutual*, *IndyMac*, *Dexia*, *Royal Bank of Scotland*, *Lloyd's Banking Group*, *Northern Rock*, three Icelandic banks, and *Banco Espirito Santo*. The U.S. Treasury Secretary and the Chairman of the Federal Reserve rocked the world in late 2008 with a $700 billion "Troubled Asset Relief Program" (TARP) to bail out U.S. banks that hadn't yet failed. Still in panic mode, the government guaranteed everything with a financial pulse: *Fannie* and *Freddie* mortgages; money market mutual funds; larger deposits in the banks; the insurance company *AIG*; and bonds of banks and companies like *GE Capital*. *General Motors* and *Chrysler* even drove into this bailout frenzy somehow. Europe and others suffered similar convulsions.

Was all of this expensive chaos necessary? Will it happen again? The governments warned that all banks might fail without "taxpayer assistance." Why is it we never worry that all farms will fail? Or that all electricity providers will fail? Or all retail stores? *Why are banks different?*

We've never heard a President or comparable political leader of any country explain why banks are different. We've never heard such an explanation from a Treasury secretary or central bank chairman. All these people *seem* to dislike bailing out and otherwise supporting banks and bankers. At times these politicians will make brave statements or even propose and pass legislation to say the bailouts *will never happen again*. Unfortunately, the people and statements are not credible on Main Street or on Wall Street.

But why? Why bail out the banks? Why not just let banks fail – like "ordinary companies" – if they cannot honor their obligations? There's a reason … and it's surprising. By virtue of history, political bargains, and past government actions, *banks are part of government*. We demonstrate this point in a later chapter but we don't dwell on it. Rather, our focus is the discovery of what banking is now and the proposal for effective banking reform.

The most fascinating aspect of this entire study is that one cannot simply investigate banking in its current form, find problems, and suggest improvements. Much as we hate to say it, banking is complex. To ponder banks, one must also delve into corporations, governments, central banks, bank regulators, the nature of money, the commodities gold and silver, borrowing and lending, inflation and deflation, and the relationships and histories among all these subjects. It's work and it's fun. What we find in the end is a plan to make both banking and the government management of the money supply simpler, fairer, and far safer than what we have in the current world.

Chapters 2-11 lay the groundwork in gradually increasing level of content. Chapter 12 pulls all this background together to discuss various proposals to reform banking: current legislation in the United States and Europe (including the *Basel Committee on Banking Supervision*); innovative proposals of A. Admati, M. Hellwig, C. Calomiris, S. Haber, L. Kotlikoff, and others; and our specific recommendation. In addition to banking reform, we propose a larger monetary system reform in this chapter 12 that fits and accommodates the simultaneous banking reform.

We begin in chapter 2 with the topic of "business failure." Just as the civil engineer who designs bridges must be an expert in bridge *failure*, we seek expertise in business failure in order to understand healthy businesses. Banking is, or at least should be, just one type of business. Chapter 3 discusses the "business of banking."

Chapter 4 broaches the critically important question of why banks seem different from non-bank businesses. Are banks really different? If so, why? It is in this discussion that we find, among other observations, that *banks are part of government*. Chapter 5 provides a deeper analysis of banks at the level of financial experts. We use the word "expert" somewhat loosely since one conclusion (from an expert!) is that "nobody really understands banks."

At this point we digress somewhat to tackle history. If we were writing here about the business models of *Facebook* or *Twitter*, then there would be no chapters on "history." The only comment to make about history for some subjects is that "history doesn't matter." With banking, however, history is (almost) everything. Chapters 6, 7, and 8, then, cover the histories of banking, money and gold, and central banks.

Chapter 9 speaks to the (government) regulation of banks to convey the "standard thoughts," conventions, and operating guidelines of the banking world as well as to flesh out the relationships among banks, bank regulators, and governments. Chapter 10 is critically important to banking and monetary reform proposals since it defines the nexus of money, lending, and inflation. Borrowing from an earlier discussion, chapter 11 emphasizes the observation that banks are "junk" (have high risk of failure) in the absence of government guarantees. We raise the question again of why society cannot simply "let banks fail" and conclude with conventional and new thoughts on "systemic risk."

Chapter 12 is the culmination in which we review both mainstream and innovative bank reform proposals of others. We also propose our plan of *full reserve banking*. This concept of full reserve banking is not at all novel … and that's an advantage! We cite prior proposals and explain our variant. Given earlier discussion of the link between money supply and inflation, we realize that *full reserve banking* will produce *deflation* without further action. We discuss alternative techniques to manage such deflation. Our strong preference is to marry *full reserve banking* with a *full reserve gold standard* to produce stable monetary policy. We explain in some detail how this would work.

The reform is striking! Life in the financial world will change tremendously for the better. There will be no more "bank runs." Banks that encounter difficulty can fail, just like "ordinary companies," with no necessity of government bailout. Banks will no longer be *part of government*. Governments adopting these reforms will be unable to impose "the inflation tax" – a levy that harms the financially unsophisticated citizens most.

GLOSSARY

Asset

On a balance sheet, all financial items and broadly defined property of positive value of a business entity

Asset-Backed Security (ABS)

Financial security, usually a debt obligation, in which payments are collateralized (or “backed”) by a pool of consumer loans, leases, or other payment obligations

Balance sheet

One of the primary financial statements, it lists the assets, liabilities, and equity of a business entity

Bank of Canada

Central bank of Canada

Bank of England

Also known as the BoE, the central bank of the United Kingdom

Bank of Japan

Also known as the BoJ, the central bank of Japan

Bank of Mexico

Central bank of the United Mexican States

Bankruptcy

A legal proceeding involving a person or business as debtor that is unable to make payment obligations to one or more creditors

BCBS

Basel Committee on Banking Supervision, primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters

BIS

Bank for International Settlements, called "the central bank for the world's central banks," mission is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation, and to act as a bank for central banks

Board of Directors

A group of individuals that are elected to act as representatives of the stockholders of a public corporation to supervise company management and to make decisions on major company issues

Book value

For an asset, the value at which the asset is carried on a balance sheet; for a company's equity, the book value of assets minus the liabilities at par

Broker

An individual or a firm that charges a fee or commission and acts as intermediary for buy and sell orders submitted by an investor

Capital

Funds invested in a business, broadly includes common equity, preferred stock, and debt

Capital adequacy

In the context of banking, a judgment generally of bank regulators that a bank's common equity and other forms of capital are sufficient to absorb losses that may occur and thereby protect senior debt investors such as depositors

Capital structure

Amounts and descriptions of a firm's capital with emphasis on the relative seniority of each capital element

Cash flow statement

One of the primary financial statements, its purpose is to document the change of cash position and uses of cash from one period to the next for a business entity

CCAR

Comprehensive Capital Analysis and Review, stress testing regime for U.S. banks created by the *Fed* in 2011

Checking account

An account with a bank in which a customer deposits cash and pays bills to others by writing checks, sending wires, or presenting a debit card all of which draw funds from the account

Credit crisis

Period that began (roughly) in mid-2007 with the failures of two *Bear Stearns* hedge funds due to poor performance of U.S. mortgage-backed securities and began toppling or severely impairing large financial institutions in 2008 including *Bear Stearns*, *IndyMac*, *Lehman Brothers*, *Fannie Mae*, *Freddie Mac*, *Washington Mutual*, and others

Creditor

An entity to which a borrower (or "debtor") owes money, includes bond investors and lenders

Debt maturity

Period of time (months or years, for example) until a borrower must repay a debt obligation

Debtor

An entity that owes money to a lender (or "creditor"), includes bond issuers and borrowers

Deflation

General fall in price levels within an economy, equivalent to an increase in the purchasing power of a fixed amount of currency

Demand deposit

Liability of a bank for which the lender (depositor) may request payment on any business day

Deposit

Liability of a bank for which the lender (depositor) may request payment at any time, distinction from "demand deposit" is that the bank has some limited flexibility regarding day of repayment

Deposit insurance

Insurance provided by a government entity to protect bank depositors against loss to a specified threshold due to bank failure, there is often a "deposit insurance fund" generated by bank-paid insurance premiums but the government guarantees payments to depositors if the insurance fund is insufficient

Discount rate

Interest rate at which a country's central bank lends to the banks, banks must pledge collateral to secure the loan

Discount window

Financial industry term "borrowing at the discount window" denotes a bank's request to borrow from the central bank at the discount rate

Disinflation

Reduction in price inflation

DSCR

Debt Service Coverage Ratio, useful performance metric employing information from a firm's income statement (EBITDA divided by scheduled interest on debt)

EBITDA

Earnings Before Interest, Taxes, Depreciation, and Amortization, useful performance metric employing information from a firm's income statement

ECB

European Central Bank, the central bank for the 18 countries (as of 2014) of the *Eurozone* that share the Euro (€) as its common currency

Equity

On a balance sheet, the difference between assets (A) and liabilities (L): $E = A - L$; incorporated firms have no obligation to repay equity as they do liabilities, equity holders are the owners of the firms

Excess reserves

Reserve deposits a bank holds with its central bank in excess of its reserve requirement

Fannie Mae

Federal National Mortgage Association, also FNMA, created by the U.S. government by legislation in 1934 to provide government-backed residential mortgages, later legislation in 1968 converted this entity to full private ownership with the term "government-sponsored enterprise" (GSE)

FCA

Financial Conduct Authority, part of the UK Treasury that regulates financial services firms, advisors, and individuals primarily for purposes of consumer protection

FDIC

Federal Deposit Insurance Corporation, agency of the U.S. government that administers deposit insurance and regulates banks, created by legislation in 1933

Federal Reserve System

Also known as the *Fed*, U.S. central bank created by legislation in 1913, regulates bank holding companies, state bank members, U.S. branches of foreign banks, and foreign branches of U.S. banks

Fiat money

Currency of a country in which there exist legal tender laws compelling the citizens to make and accept payments with the currency *and* for which there is no right to convert the currency to any substance of intrinsic value (such as precious metal)

Fractional reserve banking

Centuries-old practice in which a bank accepts deposit liabilities with the bank promise of immediate repayment on demand but then lends much of the deposit funds with no matching ability to demand repayment from the borrowers

Freddie Mac

Federal Home Loan Mortgage Corporation, also FHLMC, created by the U.S. government by legislation in 1970 to facilitate secondary market trading of conventional residential mortgages for savings and loan associations, later legislation in 1989 converted this entity to full private ownership (GSE) and modified its mission to be identical to that of Fannie Mae

FSCS

Financial Services Compensation Scheme, government program of bank deposit insurance in the UK

Full reserve banking

Proposal to require banks to hold in cash the proceeds of all deposit liabilities which promise immediate repayment on demand (i.e., demand deposits)

GDP

Gross Domestic Product, monetary value of a country’s total production of finished goods and services over a defined period such as one year

Ginnie Mae

Government National Mortgage Association, also GNMA, unit divested from Fannie Mae by legislation in 1968, its obligations are backed by the U.S. government

Gold standard

Deliberate monetary policy that defines the country's money as convertible to a specified weight of gold

Income statement

One of the primary financial statements, it lists the revenue, expenses, and net income of a business entity

Inflation

General rise in price levels within an economy, equivalent to a decrease in the purchasing power of a fixed amount of currency

Inflation tax

Deliberate reduction in value of citizens' assets and income through inflation that enables government spending and other government goals

Insolvency

Situation in which a firm's assets are worth less than its liabilities, alternatively any condition that prevents a firm from paying debt as it comes due

Lender of last resort

Generally refers to one function of the central bank in which the nation's banks may borrow at the "discount window" from the central bank as long as such banks have sufficient quantity and quality of collateral to pledge to the central bank

Leverage

Financial term to measure the ratio of an entity's debt (or assets) to equity, numerous variants exist all of which share the feature that a high numerical value ("high leverage") implies higher risk of default on debt obligations

Liability

On a balance sheet, all payment obligations of a business entity

Limited purpose banking

Proposal that transforms banking such that banks would market and sell mutual fund products to customers that transfer all risk away from banks, for example, traditional depositors would become investors in a specific all-cash mutual fund

M1

Measure of money supply in the U.S.: "currency in the hands of the public; travelers checks; demand deposits; and other deposits against which checks can be written"

M2

Measure of money supply in the U.S.: "all of M1 plus savings accounts, time deposits of under $100,000, and balances in retail money market mutual funds"

Monetary base

Sum of all coins and paper currency in circulation and the total bank reserves placed with the central bank

Monetary policy

Actions and stated goals of a government and/or its central bank regarding the country's money

Monetizing debt

Central bank creation of money to purchase the government's debt obligations

Money supply

Broadly the entire stock of coins and paper currency and highly liquid instruments in an economy, may be defined more precisely as M1 or M2

Moral hazard

Situation in which a person, group, or business entity has an immediate and local incentive to make decisions that are potentially harmful on a larger scale to other parties that do not participate in the decisions

Mortgage

Debt obligation in which the borrower uses the proceeds to purchase property and pledges the property as collateral for the loan

Mortgage-Backed Security (MBS)

Type of Asset-Backed Security in which the collateral "backing" the MBS payments are residential or commercial mortgage loans

NCUA

National Credit Union Administration, established in the U.S. by an act of Congress in 1934, responsible for oversight of Federally chartered or insured credit unions

OCC

Office of the Comptroller of the Currency, bureau within the U.S. Department of Treasury (Executive Branch of the U.S. government), regulator for national banks and Federally chartered thrift institutions

OECD

Organization for Economic Cooperation and Development, alliance of more than 30 countries with stated mission to promote global economic and social well-being

Open Market Operations (OMO)

Central bank purchases and sales of government debt securities in which the central bank creates money to buy such debt and destroys money it receives upon the sale of government debt, one of the principal tools of monetary policy

Payment system

Large, critically important network of banks and associated firms that enables individuals, businesses, government, and all other entities to transmit and receive payments in non-cash form (*i.e.*, wires, checks, debit cards, credit cards)

People's Bank of China

Also known as the PBOC, the central bank of the People's Republic of China

PRA

Prudential Regulatory Authority, UK entity owned by the BoE that supervises and regulates banks, building societies, credit unions, insurers, and major investment firms

Quantitative easing

Central bank purchases and sales of financial assets other than government debt securities, relatively new tool of monetary policy born of lack of effectiveness of central bank purchases of government debt securities, also "QE"

Repurchase (“Repo”) agreement

In effect, a form of collateralized borrowing in which the “borrower” sells a financial asset to the “lender” today and simultaneously commits to repurchase the asset at a fixed future time at a fixed, higher price

Reserve Bank of India

Also known as the RBI, the central bank of the Republic of India

Reserve deposits

Deposits that a nation’s banks place with the central bank

Reserve requirement

Minimum amount of reserves a bank must place with its central bank expressed as a fraction of the bank’s deposit liabilities

Return on Equity (ROE)

Return on equity, useful performance metric employing information from a firm’s income statement and balance sheet, typical form is the annual return of an investment or business divided by balance sheet equity

Reverse repurchase (“repo”) agreement

When a borrower executes a repurchase agreement, the lender to this borrower calls the transaction a *reverse* repurchase agreement – the *Fed* employs the opposite label scheme by declaring a repurchase agreement when it is lender and a *reverse* repurchase agreement when it is borrower

SCAP

Supervisory Capital Assessment Program, stress testing regime for U.S. banks created by the *Fed* in 2009

SEC

Securities and Exchange Commission, established in the U.S. by the Securities Act of 1933

Seigniorage

Government profit from issuing currency, for example, the difference between the value of money and the cost to produce the money

Trustee

A person or firm that holds or administers property or assets or legal rights for the benefit of a third party, for example, corporate bond offerings have Trustees that monitor the payment of interest and principal to the investors as well as other legal obligations of the borrower, if the borrower violates any obligation, the Trustee will act on behalf of investors to enforce their legal rights

Vault cash

Literally the coins and paper currency immediately available to pay to depositors that a bank holds in its vaults or anywhere on premises

Velocity of money

GDP of a country divided by its money supply (generally M2 in the United States)

ABOUT THE AUTHORS

Joe Pimbley has more than twenty years of financial experience with Wall Street firms following an early career in theoretical physics, semiconductor device engineering, and applied mathematics.

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