Fixing Banking – Part III

Banks are junk. How do we fix that? A simple yet sweeping revision to banking solves all problems connected to weak banks and government guarantees. (Suggested sub-title / deck)

In Part I and Part II of this Series, we divide proposals for "fixing banking" into three categories: "Nibble the Edges;" "Dramatic Change Inside the Box;" and "Banking Re-Boot into Safe Mode." The first option is easiest to implement and is the current course of global governments and regulators. Unlike this first option, the second proposal would be highly effective but is not the most elegant and complete solution. Our option #3, though simple, is a stark reinvention of modern banking.

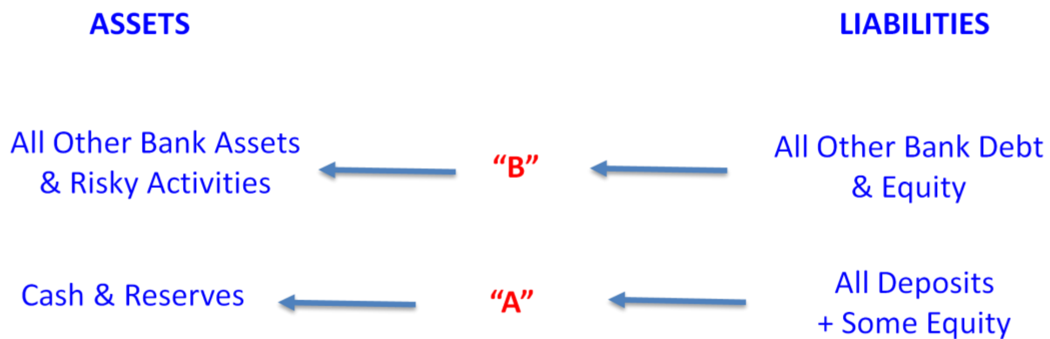
Option #3: Banking Re-Boot into Safe Mode

We announce here a revised structure for banking that: (i) is simpler; (ii) preserves the payment system; (iii) reduces or eliminates government lending to banks and guarantees of banks; (iv) permits banks to fail without detriment to the economy; (v) breaks the link between sovereign and bank credit quality; (vi) eliminates banks' role in expanding and contracting the money supply; (vii) greatly reduces complexity of bank regulation; (viii) removes banks as *part of government*; (ix) virtually eliminates bank runs; (x) eliminates systemic risk as we now know it; and (xi) costs nothing (other than requiring a determination of new management of the country's money supply). We get all these benefits and the concept is not new! Labels of the past and present for this and similar proposals are "full reserve banking," "100% reserve banking," "narrow banking," and "limited purpose banking."

Tale of Two Banks: "Bank A" and "Bank B"

Explaining this prescription is straightforward. Divide every bank into two components – call them Bank A and Bank B. Bank A holds all the demand deposit liabilities. Thus, Bank A holds "money" for people and businesses. We restrict the assets of Bank A to cash (coins and paper currency also known as "vault cash") and reserve deposits with the central bank. That's it. Bank A cannot purchase or own any other type of asset.

When a deposit customer puts funds into her account, the Bank A segment of the bank holds the entire customer deposit as cash and/or reserves. It's simple and (almost) foolproof. Just as bank regulators now conduct audits to determine that banks meet current minimum reserve requirements, the same regulators will audit each Bank A to determine compliance with this full 100% reserve stipulation.



Split Each Bank into "Bank A" and "Bank B"

No More "Lender of Last Resort"

Bank A will always have immediately available funds to pay all depositors on any day. Government deposit insurance is not necessary though governments may choose to keep the insurance in place for the sake of public appearance. For the same reason, central banks will have no need to lend to Bank A against illiquid collateral to help meet deposit withdrawals. Bank A will need essentially zero equity since its assets (cash and central bank reserves) have almost zero risk. Dominant risks are embezzlement, other types of fraud, and operating expenses in excess of projection. Thus, Bank A should have insurance policies covering fraud and negligible capital to mitigate these potential losses.

Bank A and all the similar "Bank A entities" of all other banks constitute the payment system. Just as in the current system, depositors will use their accounts to make and receive payments. Individuals, for example, will receive employer checks and wires for their salaries and all other regular payments and compensation. Through wires, on-line instructions, checks, or

ATM and debit cards the account holders will *make* payments to the extent their balances permit.

The limited purpose banking proposal of Chamley, Kotlikoff, and Polemarchakis designates this Bank A as a “cash mutual fund.” (See also L. J. Kotlikoff, *Jimmy Stewart is Dead: Ending the World’s Ongoing Financial Plague with Limited Purpose Banking*, John Wiley & Sons, 2010.) These authors describe the cash mutual fund as “permitted to hold only cash.” We construe central bank reserves to be a form of “cash” in a fiat currency framework. We and Chamley, Kotlikoff, and Polemarchakis specifically *exclude* sovereign debt such as Treasury bills, notes, and bonds in the U.S. from the definition of “cash.”

The *Bank B* of every bank in this proposal holds all activities other than the Bank A tasks of deposit-taking, safekeeping of deposits, and the operation of the payment system. Bank B will have “all the risk” such as lending to individual, corporate, and sovereign borrowers who may default. Bank B will have no obligation to redeem demand deposits since it will have no demand deposits.

No Guarantees for Bank B

Governments provide no guarantee, implicit or otherwise, of Bank B because failure of Bank B has no more consequence to the economy than failure of non-bank corporations. Individual depositors will take no losses since their money resides in Bank A. Default of Bank B does not harm *borrowers* (such as mortgage, auto loan, and credit card holders) since another entity will simply acquire their loans from the estate of the bankrupt Bank B. The shareholders and lenders to Bank B will take losses, but there is no free market imperative for a government to insure losses of typical bank investors such as mutual funds, hedge funds, insurance companies, endowments, pension plans, *et cetera*. While Bank A and Bank B form parts of the same bank, the assets of Bank A are legally separated from Bank B. Hence, the Bank A assets and deposit liabilities are immune to the failure of Bank B.

Absent government guarantees and central bank lending for Bank B and recognizing the minimal impact to the economy of a Bank B's failure, the need for extensive bank regulation vanishes. Instead of regulators setting minimal standards for capital and liquidity, decisions of market investors and trading counterparties will drive banks' leverage and liquidity choices. Risk to the taxpayers will fall dramatically in this "no-bailout regime."

Unlike our proposal, Kotlikoff *et. al.* limited purpose banking (LPB) does not permit a Bank B that will purchase risky assets such as loans. Rather, LPB replaces the borrowing and lending of Bank B with mutual funds that the banking entity merely sells to investor clients. Clearly, investors already have the ability to purchase mutual funds for banking instruments such as bonds and loans. Thus, Kotlikoff LPB would ramp up mutual fund volume in lieu of bank lending.

CLOs Contribute to Banking Reform

A critically important investment of recent years is the *collateralized loan obligation* (CLO). The CLO is not a mutual fund, but it fits the LPB framework exceedingly well. As a securitization of bank loans, the CLO also suits precisely an early full reserve banking desire for "investment trusts:"

> "The original [Chicago Plan of the 1930s] advocated the replacement of traditional banks with investment trusts that issue equity, and that in addition sell their own private non-monetary interest-bearing securities to fund lending." (See J. Benes and M. Kumhof, "The Chicago Plan Revisited," *IMF Working Paper* WP/12/202, August 2012.)

Contemporary commentators often speak of CLOs as "bank disintermediation" and/or "shadow banking." We view CLOs as a natural evolution of banking in light of the accommodation to full reserve banking and matching of maturity of assets and liabilities.

Under our full reserve banking proposal, the broad view of banking remains unchanged *except for two crucial elements*: the government role in banking declines tremendously and banks no longer create and destroy money. Yet there are nuances and consequences that merit discussion. First, the Bank A assets do not include government debt or any other interest

bearing securities. Hence, banks are no longer a conduit to convert citizens' deposits into loans to government. This aspect helps to break the link between banks and government and also diminishes the political and moral hazard of governments' covert influence and abuse of banks. Banks will no longer be *part of government*. Further, unless the central bank pays interest on bank reserves, it is likely that Bank A deposit liabilities will pay zero or negative interest. (See J. M. Pimbley, "True Reform for the Financial Industry," *Maxwell Consulting Archives*, September 2010, for further discussion of this point.)

Second, banks no longer create and destroy money because they do not employ deposits (a form of money) to create "new money" through lending. Proponents of full reserve banking applaud this complete separation of the money supply from the activities of the banking world. (See, for example, J. Benes and M. Kumhof, "The Chicago Plan Revisited," *IMF Working Paper* WP/12/202, August 2012, and M. Wolf, "Strip private banks of their power to create money," *Financial Times*, April 24, 2014.)

Minding the Money Supply

An immediate consequence, though, is that the money supply will fall significantly after a shift to this new policy. By way of example, the U.S. M2 money supply measure of January 2015 is $11.7 trillion while the monetary base is $4.07 trillion. A reasonable expectation, then, is that the full reserve requirement could push the money supply in the U.S. from nearly $12 trillion down to roughly $4 trillion absent government or central bank intervention.

We acknowledge that a full plan must manage this steep drop in the money supply that would otherwise be highly deflationary. We propose that the central bank create money in the form of new reserves in open market operations (OMO) and quantitative easing (QE) transactions to offset diminished Bank A lending during the 5-10 year phase-in period. As Martin Wolf of the *Financial Times* noted in supporting full reserve banking, "the central bank would create new money as needed to promote non-inflationary growth."

This one-time transition from fractional reserve to full reserve banking provides a great, one-time opportunity to adopt a monetary standard. If the central bank chooses to buy gold (or silver, or bitcoin, or barrels of oil, or any other monetary candidate) with the QE operation, then it may later define the country's currency in terms of gold (or silver, or bitcoin, or barrels of oil, *et cetera*). If instead the central bank merely transfers the QE proceeds to the government Treasury, the resulting central bank asset will be more government debt signalling a continuation of *fiat money*.

Fixing Banking

To "fix banking," we need not join the celebrated debate of the best monetary standard. Banks are agnostic to whatever standard the government and central bank impose. Thus, it is deeply ironic that banks in today's fractional reserve world control the money supply. Banks do not desire this control. Having such monetary control gives no competitive advantage over other banks and yet exposes them to scorn and punishment when the economy falters. Let's move to a *full reserve* system for our banks!

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