




**Steve Lindo,**  
Principal,  
SRL Advisory Services



**Joe Pimbley,**  
Principal,  
Maxwell Consulting

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## **Safer Banks: Dream or Possibility?**

***Banks Which Don't Have the Power to Disrupt Economies,  
Need Government Subsidies or Taxpayer Bailouts***

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# Safer Banks: Dream or Possibility?



## AGENDA

- ✧ Current State of Banking
- ✧ Business Failures
- ✧ Banking Risk
- ✧ History of Banking
- ✧ Central Banks, Regulation of Banks,  
Lending & Inflation
- ✧ Fixing Banking

# **Quick Poll Question**

1. Which industry sector most accurately describes the one you work in?
  - a. Banking
  - b. Non-bank financial services
  - c. Government/Regulator
  - d. Academic
  - e. Other

## Current State of Banking

- ✧ Fail frequently and taxpayers “must” support
- ✧ Existence of regulation sensible due to the government liability (“moral hazard”)
- ✧ But regulation to “prevent” failures is intrusive, expensive, and ineffective (eg, former CEO BB&T)
- ✧ Failing, weak, or zombie banks reduce lending which decreases money supply => deflation



# Safer Banks: Dream or Possibility?



## Current State of Banking

### Observations of Several Sources:

- ✧ **Admati and Hellwig (*Bankers' New Clothes*)** claim banks need much more equity
- ✧ **Mismatch of assets and liabilities is historical mistake (risk management principle)**
- ✧ **Regulation has failed and will fail – see Sheila Bair *Bull by the Horns* – purported capital models are entirely wrong; regulators are “trapped”**
- ✧ **Calomiris and Haber (*Fragile by Design*)** argue that banks are “political bargains” between government and bankers

# Quick Poll Question

2. Which one of the following statements most accurately describes your opinion of the current state of banking?
- a. It is just a passing phase in the long history of a storied business sector
  - b. It is undergoing far-reaching changes in reaction to extraordinary events
  - c. It is carefully orchestrated by stakeholder groups in order to perpetuate their roles and influence

## Business Failures

- ✧ Hundreds of thousands of businesses fail annually in the U.S. (roughly 30 million total)
- ✧ “Ingenious” (?) aspect of capitalism: threat of failure prods companies to keep customers happy
- ✧ Gov’t does not save non-banks (GM and Chrysler aside), why try to prevent bank failures?
- ✧ Old J.P. Morgan version of capitalism quite different – competition ruinous to bondholders – form Trusts and monopolies

# Quick Poll Question

3. Which one of the following statements most accurately describes your opinion of banking failures?
- a. Banking failures are an essential component of a healthy banking system
  - b. Market forces should decide which banks fail or survive, regardless of size or ownership
  - c. For struggling banks, Government-led recovery and resolution is preferable to failure



# Safer Banks: Dream or Possibility?



## Banking Risk

**BANKS: Fail Frequently – RISKY !**

### *Lehman Consolidated Balance Sheet (May 2008)*

	<b>Assets</b>	<b>Liabilities</b>
\$307 billion "Low Risk"		
\$4 billion Goodwill/ Intangible	\$639 billion	\$613 billion
\$328 billion "Net Assets"		<b>Equity</b> \$26 billion

**Huge Leverage – Typical of Banks and  
Similar Financial Entities**

# Safer Banks: Dream or Possibility?



## Banking Risk

**BANKS: Fail Frequently – RISKY !**

Company/Bank	Total Liabilities (\$ billion)	Equity (\$ billion)	L/E	Date of 10-K
Citigroup	1,670	204	8.19	Dec-13
JP Morgan Chase	2,160	211	10.2	Dec-13
Goldman Sachs	833	78.5	10.6	Dec-13
Google	23.6	87.3	0.270	Dec-13
Intel	34.1	58.3	0.585	Dec-13
Procter & Gamble	70.6	68.1	1.04	Jun-13
Merck	53.3	49.8	1.07	Dec-13
Walmart	122	76.0	1.61	Jan-14
Target	28.3	16.2	1.75	Jan-14
JC Penney	8.71	3.09	2.82	Jan-14
Amazon	30.4	9.75	3.12	Dec-13
Kellogg Company	11.9	3.55	3.35	Dec-13
General Electric	520	131	3.97	Dec-13
United Parcel Service	29.7	6.47	4.59	Dec-13
Deere & Company	49.3	10.3	4.79	Oct-13
Campbell Soup	7.11	1.22	5.83	Jul-13
Clorox	4.17	0.146	28.6	Jun-13
American Airlines	45.0	(2.73)	NM	Dec-13
United Continental	33.8	2.98	11.3	Dec-13

**Bank Leverage is Much Higher Than That of  
Other Corporate Entities**

# Safer Banks: Dream or Possibility?

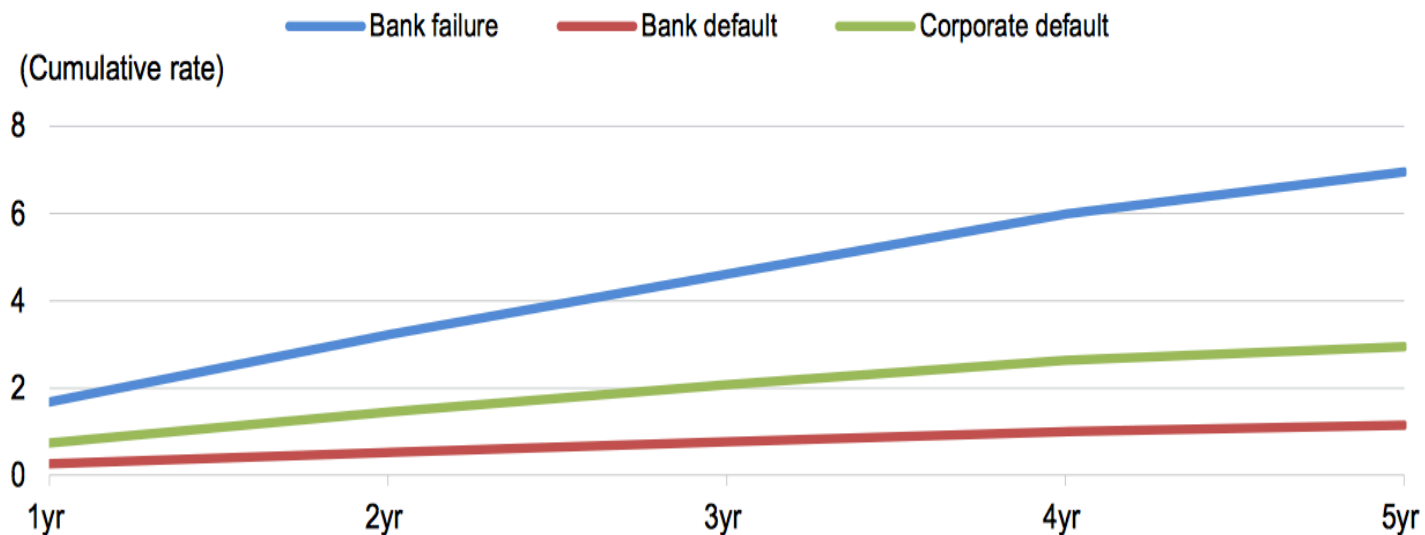


## Banking Risk

**BANKS: Fail Frequently – RISKY !**

### The Value of Support: Bank Failure vs. Default Rates (1990-2012)

Failure rates YE89-YE12



Source: Fitch

**Bank Failure Rate is DEFAULT Rate in the  
Absence of Government Rescue/Bailout**

# Safer Banks: Dream or Possibility?



## Banking Risk

**BANKS: Fail Frequently – RISKY !**

### Fitch Global Corporate Finance Average Cumulative Default Rates: 1990–2012

(%)	One-Year	Two-Year	Three-Year	Four-Year	Five-Year	10-Year
AAA	0.00	0.00	0.00	0.00	0.00	0.00
AA	0.03	0.03	0.07	0.13	0.19	0.19
A	0.08	0.24	0.41	0.57	0.76	1.93
BBB	0.20	0.68	1.23	1.84	2.45	4.73
BB	1.05	2.80	4.46	5.97	6.91	11.55
B	2.02	4.79	7.24	9.50	10.52	11.60
CCC to C	24.88	31.87	35.59	38.32	36.84	43.75
Investment Grade	0.12	0.36	0.64	0.92	1.22	2.29
Speculative Grade	2.99	5.53	7.66	9.51	10.25	14.14
All Corporates	0.74	1.45	2.08	2.63	2.95	4.14

Source: Fitch.

**(Bank “Failure Rating” is  
Below Investment Grade)**

# Quick Poll Question

4. Which one of the following statements most accurately describes your opinion of banking risk?
- a. Market forces should determine how much leverage banks have
  - b. Banks need high leverage in order to be efficient
  - c. Banking can safely operate with higher leverage than other industry sectors



# Safer Banks: Dream or Possibility?



## History of Banking



Deposits are Bank Debt with Daily Maturity  
Risky and Unstable !  
“Run on the Bank”

# Safer Banks: Dream or Possibility?



## History of Banking

- ✧ **Bank Deposits are Debt Obligations of the Bank**
- ✧ **Depositors May Withdraw Funds at ANY TIME with NO Advance Notice**
- ✧ **Yet Banks DO NOT HOLD CASH or Reserves to Pay Depositors**
- ✧ **“Reserve Requirement” is 10% in the U.S.**
- ✧ **Bank Failures Always Begin with “Runs”**

## History of Banking

- ✧ **Fractional Reserve Banking has Origins in 17<sup>th</sup> Century London (G. Selgin, *Those Dishonest Goldsmiths*)**
- ✧ **Depositors are Thus DEBT INVESTORS in the Bank and Have Risk to Bank Activities Yet Can Redeem at Par on Demand**
- ✧ **Walter Bagehot, *Lombard Street – a Description of the Money Market***
- ✧ **Government Deposit Insurance – Not a Solution**

# Quick Poll Question

5. Which one of the following core banking functions do you consider to be the most essential?
- a. Safekeeping deposits
  - b. Facilitating payments
  - c. Making loans
  - d. Transforming deposits into loans

# Safer Banks: Dream or Possibility?



## Central Banks, Regulation, Lending & Inflation

- ✧ **Swedish Riksbank ( 1668 ) / Bank of England ( 1694 )  
Formed as “Funding Arms” to Government**
- ✧ **Myth of “Central Bank Independence” – Which is  
a Good Idea! – History’s Theme is Government  
Destruction of the Country’s Money**
- ✧ **Central Banks “Control the Money” – Monetary Policy**
- ✧ **Central Banks Inspect and Regulate the “Private  
Banks” to Prevent Panics and Failures**



# Safer Banks: Dream or Possibility?



## Central Banks, Regulation, Lending & Inflation

- ✧ **Fractional Reserve Bank Lending Increases the Money Supply (Common in Textbooks but Puzzling!)**
- ✧ **“Money Supply” is Roughly “Currency + Bank Deposits” Held by Citizens and Companies**
- ✧ **Prices in the Economy – Inflation and Deflation – Depend Directly on Money Supply, so Change in the Level of Bank Lending Pushes Prices Up or Down**
- ✧ **Capital Adequacy Requirement Encourages De-leveraging after Losses with Resulting Deflation as (Fractional Reserve) Bank Lending Falls**

# Quick Poll Question

6. Which one of the following statements most accurately describes your opinion of the purpose of banking regulation?
- a. Manage the nation's money supply
  - b. Establish safe and sound banking practices
  - c. Ensure that market forces operate effectively in the banking sector
  - d. Prevent and punish bank mismanagement

# Safer Banks: Dream or Possibility?



## Fixing Banking

- ✧ **“Reserve Requirement” → 100%**
- ✧ **Drastic Change, but Easy to Implement !**
- ✧ **Split Each Bank into “Bank A” and “Bank B”**
- ✧ **Bank Deposits ”Completely Safe”**

# Safer Banks: Dream or Possibility?



## Fixing Banking

**FullReserveBanking.com**

### The Chicago Plan Revisited

**Author/Editor:** Benes, Jaromir ; Kumhof, Michael  
**Publication Date:** August 01, 2012  
**Electronic Access:** Free Full text (PDF file size is 1,110KB).  
Use the free [Adobe Acrobat Reader](#) to view this P

## Narrow Banking

George Pennacchi

IBE Professor of Finance, University of Illinois, Champaign, Illinois  
61820; email: [gpennacc@illinois.edu](mailto:gpennacc@illinois.edu)

### Abstract

This review discusses the history of narrow banks, reform proposals involving narrow banks, and theory and empirical evidence regarding whether narrow banks should play a more prominent role in the financial system. Prior to the early-twentieth century, US banks tended to be much narrower than they are today. Common modern banking practices, such as maturity transformation, arose only after the creation of the FDIC. My review of theory and empirical evidence is supportive of narrow bank reforms. A narrow banking system could have huge advantages, including reducing the overall risk in the financial system.

### Keywords

bank regulation, narrow banks, money  
companies, deposit insurance

JEL codes: G21, G28.

### The University of Chicago

Irving Fisher and the 100 Percent Reserve Proposal

Author(s): William R. Allen

Source: *Journal of Law and Economics*, Vol. 36, No. 2 (Oct., 1993), pp. 703-717

Published by: [The University of Chicago Press](#)

Stable URL: <http://www.jstor.org/stable/725805>

Accessed: 11/05/2011 08:22

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Full reserve banking is also known as 100% reserve banking

A collection of resources for anyone interested in this alternative monetary system.



Some people dismiss Full Reserve Banking (the opposite of Fractional Reserve Banking) as a crazy system not taken seriously by any leading economists. This is entirely false. As recently as 2010, Mervyn King, the governor of the Bank of England, said in a letter to a full reserve banking supporter...

*You might be aware that I have said publicly that I think ideas in this spirit - such as those articulated by John Kay - certainly merit serious consideration in the debate as*

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# Safer Banks: Dream or Possibility?



## Fixing Banking

### ASSETS

### LIABILITIES

All Other Bank Assets  
& Risky Activities

“B”

All Other Bank Debt  
& Equity

Cash & Reserves

“A”

All Deposits  
+ Some Equity

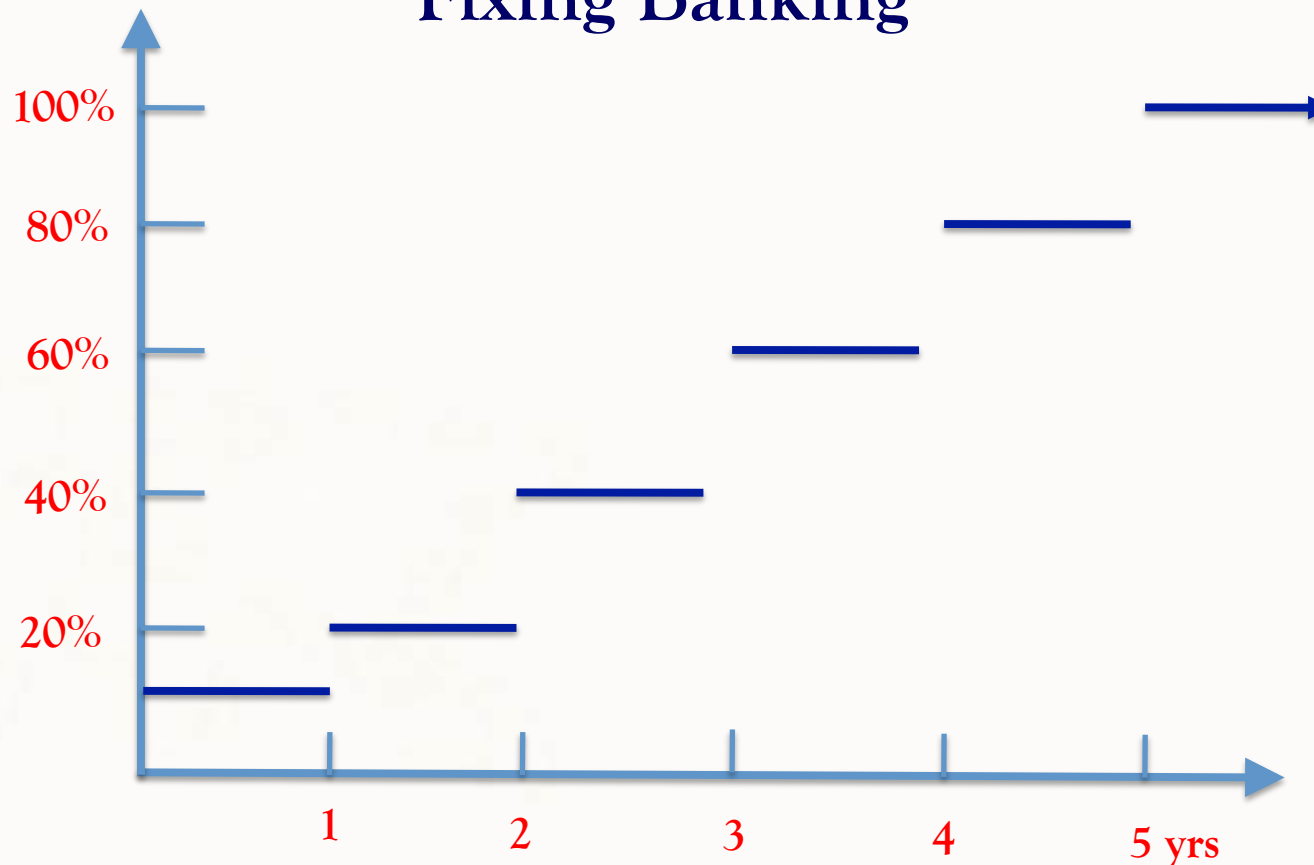
**Split Each Bank into “Bank A” and “Bank B”**



# for Banks: Dream or Possibility?



## Fixing Banking



**Transition to 100% Reserve over Five Years**  
**Banks Already Have Excess Reserves**

# Safer Banks: Dream or Possibility?



## Fixing Banking

### **DEFLATION PROBLEM !**

- ✧ **Full Reserve Banking Decreases Money Supply**
- ✧ **Deflation Would be “Confusing” and Detrimental to Debtors**
- ✧ **Solution: “Quantitative Easing” to Maintain Price Level During Transition Period ONLY**

# Safer Banks: Dream or Possibility?



## Fixing Banking

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## Strip private banks of their power to create money



By Martin Wolf

Author alerts ▾

The giant hole at the heart of our market economies needs to be plugged

Printing counterfeit banknotes is illegal, but creating private money is not. The interdependence between the state and the businesses that can do this is the source of much of the instability of our economies. It could – and should – be terminated.

I explained how this works [two weeks ago](#). Banks create deposits as a byproduct of their lending. In the UK, such deposits make up about 97 per cent of the money supply. Some people object that deposits are not money but only transferable private debts. Yet the public views the banks' imitation money as electronic cash: a safe source of purchasing power.

### VIDEOS

Small's getting ugly



Small's getting ugly



Bitcoin after the Bubble



Changes at the Tesco board

## What Would Central Bank Buy in its QE? More Government Debt?!

# Quick Poll Question

7. Which one of the following statements most accurately describes your opinion of fixing banking?
- a. Only radical reform can restore banking safety and economic usefulness to acceptable levels
  - b. The present wave of banking regulation will gradually restore banking safety and economic usefulness to acceptable levels
  - c. Market forces will ultimately dictate the future of banking

# Safer Banks: Dream or Possibility?



## RECAP

- ✧ Banks Fail Frequently
- ✧ Choice of High Leverage and A-L Mismatch
- ✧ Gov't Support Due to Fear of Bank Failures
- ✧ Fractional Reserve Banking Ties Bank Lending (and Solvency and Health) to Full Economy
- ✧ Solution: Eliminate Fractional Reserve Banking and Do Not Rescue "Bank B"



# Questions for the Presenter?



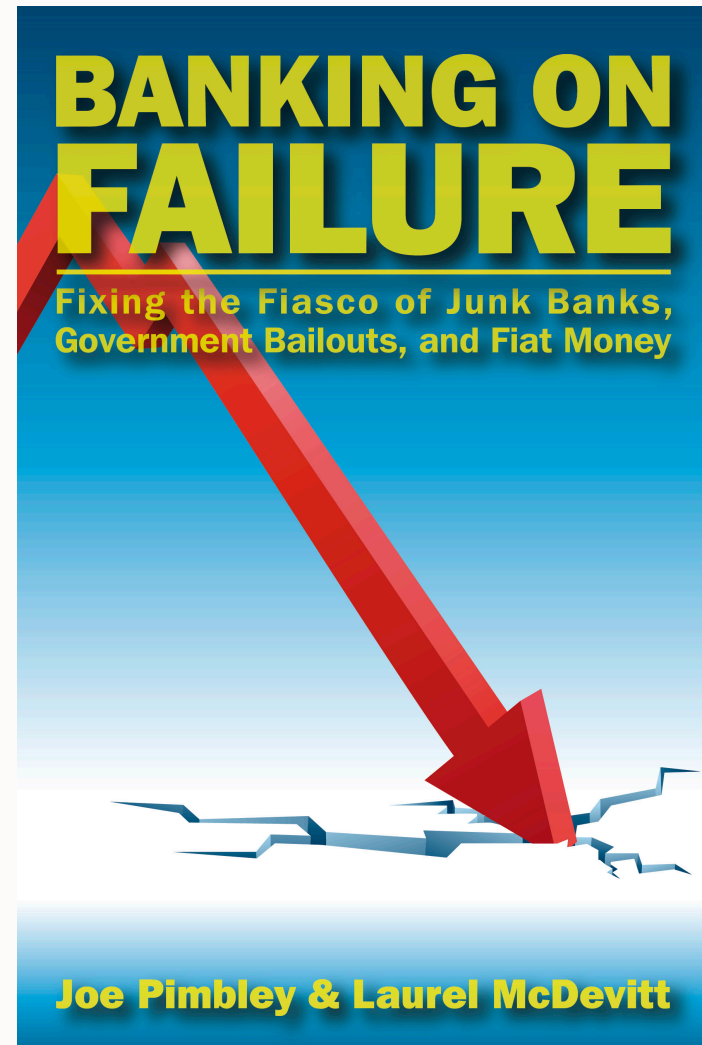
**Send them via the Question Pane in the webinar utility panel on the right hand side of your screen**

# Safer Banks: Dream or Possibility?



Kindle or print versions  
available  
at Amazon.com

<http://www.amazon.com/Banking-Failure-Fixing-Government-Bailouts/dp/069227426X>



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