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Commentary

A Banking System We Can Trust

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Before throwing more money at Wall Street, let's understand what our financial system was supposed to deliver, what it did deliver and what price it charged.

The system was supposed to channel our hard-earned savings into the best real investments: new homes, offices, factories, equipment and research. And it was supposed to correctly price our assets.

It did neither. Instead, Wall Street morphed into a vast gambling enterprise, generating massive trades of existing securities without, in fact, raising the investment rate or growing the economy.

During the dot-com bubble, Wall Street funded all manner of silly businesses, and during the housing bubble, it put millions of people in homes they couldn't afford. This "expertise," which cost one-tenth of our output, was delivered by the best and brightest, with half of Harvard's graduating classes becoming high-class croupiers.

As for pricing assets, the stock market's been on a five-decade roller coaster, notwithstanding a relatively stable real economy. The market rose dramatically from 1950 through the mid-1960s. It then spent the next decade and a half falling through the floor. Then it rose like crazy in the late '90s, crashed, soared and crashed again.

We need a financial sector but not one like this. Nor do we need Wall Street hitting us up for its gambling debts. What we need is Limited Purpose Banking (LPB), which would transform all financial corporations, including insurance companies and hedge funds, into mutual funds. They would, henceforth, be called banks.

Under this system, banks would never fail for a simple reason. They'd never hold any financial assets and they'd never borrow except to finance their mutual fund operations. Instead, they'd be limited to their legitimate purpose--financial intermediation. Under LPB, people, not companies, bear risk as their mutual funds do well or poorly.

A new Federal Financial Authority (FFA)--would rate, verify, supervise custody, disclose and clear all securities purchased, held and sold by LPB mutual funds. Private rating companies could stay in business, but no one would need to trust them ever again.

Banks would initiate personal and business loans (including mortgages), send them to the FFA for processing and then sell them to mutual funds, including their own. Loans would activate when sold, so no bank would ever have an open position.

All mutual funds would break the buck with one exception: cash mutual funds. These funds would strictly hold cash and be valued at \$1 per share. Owners of these funds would write checks against their balances and never have to worry about a bank run. Fractional reserve banking and the FDIC would be history.

LPB would include insurance mutual funds. These funds would pay off based on the losses experienced by contributors. If losses are larger than expected, less is paid out per loss. Hence, LPB prevents insurance companies from insuring the uninsurable, e.g., claiming they'll pay the same life insurance claims even if there's a plague.

All risk allocation arrangements can be run through mutual funds, including credit default swaps. Take a bank that markets the GE-Defaults-On-Its-Bonds-In-2010 fund. Under this closed-end fund, shareholders specify in advance if they want to get paid off if GE does default on its bonds in 2010 or paid off if GE doesn't default. All money put into the fund, less the mutual fund's fee, would be held in one-year Treasuries and paid out at the end of the year to the winning shareholders in proportion to their holdings.

Hence, Limited Purpose Banking can accommodate credit default swaps (CDS) as well as any other risk product. But what Limited Purpose Banking won't do is leave any bank exposed to CDS risk since people, not banks, would own the CDS mutual funds.

If such mutual funds sound revolutionary, they're not. Funds of this kind have been around for centuries. They go by the name "tontines," or systems of "pari-mutuel betting."

Limited Purpose Banking would enhance liquidity, since all funds would trade in the market even if their underlying assets are illiquid. It would permit the extension of as much credit as the public--which is the ultimate source of credit--wishes to provide by buying mutual funds that purchase household and business loans. And it would force banks to charge fees and pay their employees based on their mutual fund performances as determined by the market.

What LPB will eliminate is insider rating, free riding on FDIC insurance, self-custody arrangements, no-doc loans, institutionalized gambling, me-now compensation plans, financial malfeasance and the possibility of future financial collapse. In other words, it would be a system we can trust.

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