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Limited Purpose Banking

By Scott Burns and Laurence J. Kotlikoff

In case you hadn't noticed, the foxes are still guarding the banking henhouse. The only change: President Obama is reducing how many hens the foxes can kill while on guard duty.

The foxes, of course, are the financial wizards whose leadership almost entirely wiped out the capital of the banking system.

The old system relied on trusting [people who lied and cheated](#). They are still running the show. They will lie and cheat again. We will be called upon to pay the bill, again.

We need a new financial system. We need *limited purpose banking*. It should be transparent, trustworthy and unsinkable. The key is to limit banks to their legitimate purpose. Not gambling, but financial intermediation, connecting savers to investors and lenders to borrowers.

Is this possible? Yes, it already exists in the only part of old system still above water – the mutual fund industry. Mutual fund companies like Fidelity, Vanguard, and TIAA-CREF stuck to their knitting. They didn't leverage themselves 30 to 1 and promise things they could never deliver. These companies didn't gamble with their own fortunes or the nation's future. Instead, they bought mortgages, stock, real estate, and other securities. They packaged these assets in mutual funds. And they sold the mutual funds to the public.

The public, not the mutual fund companies, held the securities and took the risk. In so doing, the fund companies ensured *their* solvency and prevented runs on their funds. They avoided the double jeopardy of conventional banking--- financial shipwrecks that drown both the ships and the public. The one revealing exception was money market funds. There the mutual fund companies promised something they couldn't deliver – that their money market funds would never lose money.

Mutual fund companies also have other safeguards. They use third-party custodians to hold the securities purchased by their mutual funds. This precludes a Bernie Madoff or an Allen Stanford from selling claims to securities they neither owned nor purchased. Mutual fund companies divulge their investments. Whether the assets in their mutual funds are toxic or nutritional, the mutual fund companies say what they hold.

The two things mutual funds can't guarantee are the prices of the securities they purchase or the quality of the securities themselves. This can be improved (but not guaranteed) by compelling disclosure.

The compulsion must come from Uncle Sam. Sam needs to do [what we proposed a year ago](#)--- set up a Federal Financial Authority (FFA) to verify, fully disclose, and rate securities, as well as audit the Fortune 500 companies. As we've seen, our private, insider-rating agencies are not to be trusted. Neither is insider-accounting.

The FFA should also appoint and pay independent directors to the Fortune 500 companies to determine compensation for top management. This is the only way to stop top management from bribing their directors to let them steal from shareholders. The FFA would also supervise all custodial arrangements.

With an FFA in place, here's how the new mutual fund-based banking system would work. Banks (our shorthand for all financial companies) would initiate mortgage, commercial, auto, credit card, and other loans. They would send them to the FFA for rating, package them in mutual funds, and sell them to the public.

Banks would not hold their loans. They would never be exposed to default risk. They'd provide no guarantee on their money market funds. Banks would also sell equity and real estate mutual funds. There would still be risk, but it wouldn't be in the financial institutions that put our money to work.

Finally, banks would accept checking account deposits. To ensure they have zero exposure to a bank run, the banks would be required to hold 100 percent reserves (in cash and short-term Treasuries) against these deposits. Incidentally, this aspect of the plan – moving from the current 10 percent to 100 percent reserve requirements – is called *Narrow Banking*. It was proposed by Irving Fisher, Frank Knight, and other leading economists during the 1930s. It was also advocated by Nobel Laureate Milton Friedman.

By requiring banks to stick to their fundamental purpose – financial intermediation – and to proscribe their taking risk of any kind, we will never again have either bank runs or the specter of major financial companies going under.

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