Commentary by Laurence Kotlikoff

April 16 (Bloomberg) -- The crisis persists. Our 17-month-old recession is deepening by the month. The unemployment rate rose to 8.5 percent in March, with 12.5 million Americans unemployed while millions more have stopped looking for work.

In the U.S., since peaking in 2007 stock indexes have dropped about 45 percent, the housing market has declined 30 percent and $11 trillion of household wealth has evaporated. Bank lending is down, and so are output and exports. Consumer confidence is at rock bottom, and saving is now chic.

Uncle Sam is administering open heart surgery by expanding deposit insurance, nationalizing financial companies, bailing out automakers, lowering mortgage rates and financing acquisition of toxic assets.

All this is helping, but also scaring us to death. With luck and pluck, we’ll recover later this year. But big dangers are lurking.

The potential for a national bank run is real. The Federal Deposit Insurance Corp. has $35 billion in reserves to cover some $4 trillion in potential liabilities. A massive run would require the Fed to print the difference. This would trigger hyperinflation and justify running to spend one’s money before prices rise.

The Federal Reserve has been printing money like crazy, adding more than $800 billion in the past year, doubling the monetary base. It’s printing another $1.2 trillion to buy long-term bonds. If banks start lending again, and the Fed doesn’t contract the monetary base quickly enough, our money supply will triple. If this doesn’t spell inflation, nothing does.

U.S. Vulnerabilities

Life insurance companies also might face a run. If American International Group Inc. or some other big player goes under, the public might start withdrawing the $3 trillion or so of cash surrender value in whole and universal life polices, deferred annuities and guaranteed investment contracts.

The Pension Benefit Guaranty Corp., which insures private pension funds, has a reserve of roughly $40 billion to cover about $500 billion in unfunded pension plans.
Don’t forget China, which is getting increasingly antsy about holding more than $744 billion in U.S. Treasuries, whose real return could be wiped out by inflation. If the Chinese start selling Treasuries, watch out.

The key is to fix our financial system. Our economy has failed due to malfeasance -- financial, corporate, regulatory and political. We need a new financial system we can trust, not a new wig on our old pig.

The right reform is Limited Purpose Banking (LPB), which limits banks to their legitimate purpose, namely intermediating between borrowers and lenders, and savers and investors.

Banks as Intermediaries

Under LPB, all banks -- shorthand for commercial banks, investment banks, insurance companies, hedge funds, brokers and all other financial companies with limited liability -- operate as mutual fund companies that sell safe as well as risky securities to the public. In so doing, banks let us take the risks we want while they never gamble.

Banks simply act as middlemen. They never own financial assets, never borrow short to lend long and are never in a position to fail.

A new government agency -- call it the Federal Financial Authority (FFA) -- would rate, verify, supervise custody, disclose and clear all securities purchased, held and sold by LPB mutual funds. Thus, ABC Bank would initiate, say, a mortgage, send it to the FFA for processing and then sell it to its own or some other bank’s mutual fund. The mortgage would activate when purchased by the mutual fund, so ABC Bank is never exposed.

Insider Trading

The FFA would eliminate insider rating, a key cause of our financial mess. Standard & Poor’s, Moody’s Corp. and other rating companies could still operate but the public would have an independent assessment of financial products. Think Food and Drug Administration for financial products, and you’ll get the picture.

Limited purpose banks would market cash mutual funds, which would only hold cash and be valued at $1 per share. All other LPB funds -- whether invested in stocks, bonds, real estate investment trusts, commercial loans, or mortgages -- would break or exceed the buck based on market fluctuations. Owners of cash mutual funds would be free to write checks against their holdings. These cash mutual funds would represent the demand deposits under LPB and, since every dollar of deposits would be backed by one dollar of cash, there would be no need for FDIC insurance and no chance of bank runs.

Moreover, since no bank holds any assets apart from its furniture, buildings and land, and holds no debts -- apart from the mortgages on its property and loans used to finance its operations -- there’s no need for capital requirements.
LPBs would include insurance mutual funds. These funds would pay off based on the losses experienced by contributors. Take a homeowners fund sold by ABC Bank. This fund’s purchasers would buy shares by, say, Sept. 1, 2010, but collect at a specified future date (say, Dec. 31, 2010) only if they experience a fire, flood, robbery, etc. All money in the fund would be divided among those experiencing a loss, with the amount depending on the size of one’s loss (assessed by an adjuster) and the number of shares one originally purchased.

Note that an LPB pays off based on individual as well as aggregate risk. If lots of the buyers of the fund have a fire, the recovery per shareholder with a loss is smaller. Thus, banks selling life insurance mutual funds wouldn’t be at risk if there were a plague.

Thousands of mutual funds are on the market. Under LPB new funds would be established to buy or sell risks not handled by these funds. Take a credit default swap sold by XYZ Bank via its IBM-Defaults-in-2010 mutual fund.

Purchasers would specify in advance if they want to get paid off if IBM defaults or the opposite. All money put into the fund by, say, Jan. 1, 2010, would be invested in 1-year T-bills and, at the end of the year, paid out to one of the winners in proportion to their share holdings.

LPB accommodates leverage. Consider an equity mutual fund where the asset held by the fund yields a zero return half the time and a 100 percent return the other half. Suppose that 30 people invest in the fund on the basis of receiving $1,033 no matter what, while one person (Sue) invests understanding she’ll receive zero when the return is zero and $31,010 if the return is 100 percent. Sue is leveraged 30 to 1.

LPB doesn’t limit credit. People with money to lend (the ultimate providers of credit) will simply do so by buying mutual funds investing in credit instruments. LPB, via the FFA, also deals with banks “initiating to distribute.”

The problem here is with initiation (verification, disclosure, and rating), not with distribution (i.e., securitization). Another worry is that banks won’t exercise due diligence in overseeing investments by fund managers. But banks market their funds, so they’ll have strong oversight incentives. Finally, if the FFA lacks expertise, it could hire private contractors with no conflicts of interest for assistance.

Our financial system needs a new engine, not an oil change. Limited-purpose banking would eliminate financial crises. It would provide maximum transparency. It would make clear that risks are born by people, not companies. LPB would neither insure the uninsurable nor guarantee returns that can’t be delivered. In short, limited-purpose banking would be honest, which is absolutely essentially for getting our economy rolling again.