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Toolbox: Limited Purpose Banking

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ACTION MEMORANDUM

TO: Secretary of the Treasury Timothy Geithner

CC: Sheila Bair, Chair, FDIC

Senator Christopher Dodd, Chairman, Senate Banking Committee

FROM: Christophe Chamley & Laurence J. Kotlikoff

DATE: April 1, 2009

SUBJECT: Limited-Purpose Banking

Despite nine months of intense intervention by two Administrations, U.S. financial markets and the overall economy have melted down. As you know, more than ten million Americans are now unemployed and our GDP is falling. Everyone realizes that we need the right financial fix, and need it right now. The President is on task, and there is no question that you and your colleagues are working day and night to solve this terrible crisis. Your efforts merit our deepest respect and admiration. Unfortunately, you appear to be misdiagnosing the problem and, consequently, applying medicine that won't work.

Trust, Not Liquidity

The fundamental problem facing our financial system is not insufficient liquidity, a shortage of credit or capital inadequacy. The fundamental problem is a well-deserved lack of trust between borrowers and lenders at nearly all levels. To be blunt, the financial sector played the big con and lost big time. No one is going to trust insider raters, banks that borrow to gamble, hedge funds that fake returns and insurers that concentrate rather than spread, risk. No one is going to trust assets that can't be disclosed, are self-custodied, are valued by models calibrated with limited

data that ignore systemic risk—and that are parked in secrecy jurisdictions like Antigua. Above all, no one in his or her right mind is going to trust bankers with me-first business plans—people who have seemingly lost the capacity to distinguish between conscience and greed.