

The Financial Times

The Economists' Forum January 27, 2009

Limited Purpose Banking – Putting An End to Financial Crises

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It was the year the country stood still. Not a car, truck, or bus rode the roads. No one drove to work, no one drove to shop, no one drove to visit. No one drove anywhere.

The reason was simple. No one could buy gas. Gas stations had gone broke.

Their owners had tired of netting pennies on the gallon. They wanted to surge their earnings. The big money, they learned from a Harvard MBA, was in securitising their services. So they started selling GODs - gas options for drivers.

Each GOD gave the driver the option to fill her tank for \$3 per gallon. Drivers bought GODs religiously. And with gas selling for \$2 a gallon, station owners didn't worry.

Then the unthinkable happened. Gas prices sky-rocketed to \$6 a gallon, and drivers began invoking their GODs. Each GOD could save \$3 per gallon per tank, and if you didn't need gas, you held up a sign - "Gods for Cash!"

Station owners began cursing the GODs. They now had to buy gas at \$6 a gallon and sell it for \$3.

In short order, the owners went bust. They closed their stations and started looking for jobs in financial services. GODs became worthless, and the economy ground to a halt.

The economic moral is simple. If you want markets to function, don't let critical market makers - those who connect suppliers and demanders (e.g., refineries and motorists) of essential products - gamble with their businesses.

Apply the moral to banks and the regulatory prescription is clear. Don't let banks take risky positions. Make banks stick to their two critical functions - mediating the payments system and connecting lenders to borrowers.

To safeguard the payment system, banks must hold 100 per cent reserves against their deposits either in cash or short-term US treasuries. With 100 per cent reserves, banks runs will be history.

This is not true of the current system, notwithstanding Federal Deposit Insurance Corp insurance. The FDIC's potential liability exceeds \$4 tn; its assets are less than \$50 bn. A run on the banks would require massive money creation and engender greater economic panic.

To ensure their second function - the uninterrupted connection of suppliers of and demanders for funds - banks should be limited to a) packaging conforming mortgages and conforming business loans (commercial paper) within mutual funds and b) marketing these mutual funds to the public. The model here is Fidelity, not [Lehman Brothers](#).

Yes, this proposed banking system is not your father's Oldsmobile. But Jimmy Stewart is not your banker. Some overpaid chief executive thousands of miles away is deciding whether to foreclose your home and shutter your business. The clerk running your branch isn't applying personal knowledge in deciding to lend you money or call your loan. He's plugging your credit rating, collateral, and loan amounts in a computer and conveying the answer.

With the government ready to absorb losses, banks are talking outrageous risks knowing that Uncle Sam will cover them if things go south. Raising the trivially low capital requirements of banks, as Paul Volker's Group of Thirty Commission just proposed, won't change this behaviour.

What will change this behaviour is to not let it happen. Banks should be allowed to initiate only conforming, i.e., government-approved, AAA-rated mortgages and business loans. These would be long-term, fixed-rate loans with 20 per cent-down and payments below 25 per cent of income.

The government, via the Federal Financial Authority, would use tax records to verify loan payment-to-income ratios. It would also spot check collateral. Once approved, the banks would bundle and sell "their" loans within mutual funds.

Again, traditional bank runs wouldn't arise. And today's bank runs, which entail lenders and equity investors avoiding risky banks, wouldn't either. Why? Because banks would bear zero risk. Mutual fund owners would bear risk, but not the banks. And these lenders would know they were buying government-approved AAA-rated loans, not [Bear Stearns'](#) CDOs.

This limited purpose banking is a modern version of narrow banking proposed by Frank Knight, Henry Simons, and Irving Fisher. Banks would hold deposits, cash checks, wire money, originate loans, and market mutual funds, including money market funds with no guarantee of par value redemption.

With limited purpose banking, financial crises would largely disappear. Banks would never fail, never stop originating loans, never expose the public to massive liabilities, and never see their stock values evaporate. Banks would be stable, boring economic cogs - like gas stations.

The Fed would also gain full control of the money supply. To expand the money supply, the Fed would continue buying treasuries from the public and supplying cash. But banks wouldn't be multiplying and contracting M1 (cash plus demand deposits) based on their ever changing decisions about lending deposited funds.

Milton Friedman, who also advocated narrow banking, blamed the Depression on the Fed's failure to offset the M1 money multiplier's collapse. In the past year the M1 multiplier has contracted by over 40 per cent, forcing the Fed to double base money. If the multiplier shoots back up, we could see the money supply and prices explode.

What about investment banks, brokerage firms, hedge funds, and insurance companies? What's their right financial order?

Again, regulate to purpose. Investment banks take companies public and assist in mergers and acquisitions. They shouldn't be permitted to invest in their clients' companies. Brokerage firms are here to help us buy and sell assets, not to gamble on spreads. Hedge funds are here to help limit risk exposure. They aren't here to insure these risks themselves. Finally, insurance companies are here to diversify risk, not write insurance against aggregate shocks.

The FFA and "less is more" limited purpose banking won't prevent asset markets from occasionally going nuts. But the functioning of financial markets will no longer be in question. Nor will con artists, parading as "financial engineers," ever again be free to wreak havoc on the nation's finances and its citizenry.

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