

Dear Distinguished Members of the Independent Banking Commission,

I was very pleased to see Limited Purpose Banking (LPB) included in the list of financial reform proposals you are considering in your Call For Evidence. I'm happy to come to London to discuss LPB and other reforms with you. But for now, let me provide a quick reaction to what you wrote about LPB and also respond to your specific queries.

I realize you feel LPB has real merit, so I focus here just on your concerns and hope not to sound overly defensive.

You state in paragraph 4.13 that under LPB "There would be a reduction in the economic value added of intermediation." I have two reactions. First, the financial collapse has shown that there are states of nature in which the current intermediation system generates very significant negative value added. Its combination of proprietary information and leverage provides, as we've seen, fertile ground for fraud runs. By fraud runs I mean attempts by creditors to be the first to get their money out of banks, which they suspect are misstating the values of their assets or liabilities.

LPB, with its full and real time, web-based disclosure, independent verification (e.g., current and past employment status and income histories of would-be borrowers), independent collateral appraisals, multiple independent ratings of the securities held by mutual funds, and 100 percent equity requirements will greatly diminish the potential for fraud runs. Certainly in those states of nature in which the current system would collapse, the value added of LPB with respect to intermediation services will be vastly larger.

In comparing LPB and other reforms with the current system, it's important, then, to focus on the tail risk and not simply how different systems would operate under normal conditions.

Second, under LPB, mutual funds bid for securities in a centralized auction run by the Federal Financial Authority. This provides, I believe, a much more efficient form of intermediation than does the current system and ensures that those floating new paper get the best prices.

Third, intermediation is about matching lenders and borrowers and investors and savers. These parties are matched via mutual funds no less than via traditional banks. The mutual fund managers will have significant financial incentive to make those matches as good as possible because their fees will depend on it.

In the U.S., one third of financial assets are held by mutual funds, so the mutual fund industry may be said to be doing one third of the financial intermediation. Your statement would suggest that the quality of the financial intermediation now being done by the U.S. mutual fund industry is less than that of the traditional U.S. banking system. Are there careful studies that support that position?

In sum, I don't think your statement about intermediation can be justified when you really get into the plumbing and potential for fraud under the two systems.

You also state in 4.13 that under LPB, "Bank loans -- normally regarded as illiquid assets prone to problems of asymmetric information -- would be packaged into mutual fund units held directly by households." This is true, but the problem of asymmetric information would, in large part, be eliminated by having the Federal Financial Authority hire non-conflicted companies to verify, rate, appraise, and fully disclose the collateral and income prospects of the companies and households whose I.O.U.s will be purchased by the mutual funds. Again, please bear in mind that mutual fund companies are already making "bank loans." Among the 8,000 different U.S. mutual funds, there are junk bond funds, commercial paper funds, corporate bond funds, home mortgage funds, etc.

You refer to LPB as "radical." This seems to me a very strong term to use given the size and importance of the mutual fund industry, at least in the U.S., and the fact that mutual fund industry is the major banking system for most Americans because most Americans have most of their financial assets in mutual funds via their holding of retirement account assets.

I.e., calling LPB radical suggests that you think the U.S. mutual fund industry is a radical/rogue part of the existing financial system as opposed to the most stable part of that system. On the whole, the U.S. mutual fund industry weathered the financial crisis with no problem. The only area where it ran into trouble was with respect to money market funds that were effectively leveraged in so far as they provided a fraudulent guarantee to be able to back their bucks. Under LPB no mutual fund except cash mutual funds (which hold only cash) would be backed to the buck. The first page of each non-cash mutual fund prospectus would contain a single sentence in huge bold letters and require purchasers to sign that they had read and agreed to that statement. This statement would be: This fund is risky and can break the buck, leading you to lose some or all of your investment.

You also suggest that mutual fund holdings would be less liquid than bank deposits. Yes and no. First, cash mutual funds would be as liquid as today's demand deposits because they would be backed to the buck. Second, although non-cash mutual funds would not be backed to the buck, they would float on the market. In that sense, they would be highly liquid.

But you define liquidity as being able to exchange one's assets for real goods and services at a stable price; i.e., at stable terms of trade. You suggest that the current system delivers more liquidity than LPB because it provides more guarantees of terms of trade. But, as we've seen, these guarantees are not absolute and are often conveyed dishonestly. There are, thus, states of nature in which the current system's liquidity, as you define it, evaporates. Government guarantees are also not necessarily effective because governments, in the end, can only make nominal guarantees, not real (purchasing power) guarantees. A massive run on U.S. banks would necessitate the Federal Reserve's printing of many trillions of dollars virtually overnight. The resulting hyperinflation would ensure that anyone who left her deposit in a bank would end up wiped out in real terms. I.e., her deposit would not be able to swapped for real goods and services at the pre-crisis terms of trade.

To summarize, it's critical to compare reform proposals under adverse as well as normal circumstances and also ask whether some proposals are better than others in limiting the probabilities of adverse circumstances. Your mandate, after all, is not to care for the system

just in normal times, but to devise a system that will work when economic times are tough and to ensure that the financial system does not, itself, cause economic panic and collapse.

Thank you for considering these remarks and, again, I am at your service.

Sincerely yours,

Laurence J. Kotlikoff