Discussion of:

Limiting Global Financial Instability with Limited Purpose Banking

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Conference hosted by Tsinghua University
March 26, 2012

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Limited Purpose Banking (LPB)

- Recent events have highlighted the need for financial reform
  - Many “incremental” approaches have been suggested/debated
- LPB is an ambitious proposal that aims to prevent the failure of financial institutions by requiring either:
  - 100% cash reserves (for a deposit-taking institution), or
  - 100% capital (all other intermediaries are mutual funds)
- Also aims to promote transparency
  - A Federal Financial Authority (FFA) will vet all lending activity
  - Assets held by any limited-liability financial institution will be fully disclosed

- Would it be better to adopt LPB or an “incremental” proposal?
  - For example: tighter capital requirements and leverage ratios
- A strong case is made in favor of LPB, but ….
  - LPB is a big change; involves substantial uncertainty
  - I would like to see a systematic evaluation of costs and benefits
  - This is difficult to do (more so than for an incremental proposal)
  - I think some subtle issues arise; requires careful thinking
- My discussion: focus on some of these issues

- One way to frame the issue:

$$E[W] = (1\text{-}q)W(\text{no crisis}) + qW(\text{crisis})$$

- Ask how LPB would likely affect each of the 3 terms

  1) q

  2) W(crisis)

  3) W(no crisis)

- Would LPB improve welfare in all thee dimensions?
  - That is, is it win-win-win? Or are there tradeoffs?

$$E[W] = (1-q)\,W(\text{no crisis}) + q\,W(\text{crisis})$$

(1) Effect on the likelihood of a crisis (q)

- Financial crises are a hardy perennial
  - Difficult to imagine eliminating them altogether
- LPB would clearly have some stabilizing effects
  - Removes some factors that are common contributors
  - Leverage, maturity transformation in financial intermediaries, failure of (limited-liability) financial intermediaries
- However, crises can occur in the absence of these features
  - Consider the following example …

Auction Rate Securities (ARS): An instructive episode

- Long-term debt whose interest rate was reset regularly via an auction process
  - Current investors decide how many shares to redeem
  - New investors place bids for these shares
- Role of the auction process: maturity transformation
  - Issuer is borrowing long term, but ….
  - Investors can sell at any auction (like a short-term investment)
  - Issuer pays a short-term rate
- The Auction Rate Securities market was over $300b in 2007

- An auction *fails* is there are fewer bids than investors seeking to redeem shares
  - Interest rate resets to a prespecified rate until next auction
  - Sponsoring bank could step in and purchase shares, but was under no obligation to do so
- ARS seems to be entirely consistent with LPB
  - No debt or explicit backstop is issued by a financial firm
  - Example of the type of arrangement that may arise under LPB
- What happened during the crisis?

- Some auctions related to CDOs began to fail in August 2007
- By February 2008, most auctions were failing
  - Even for high-quality debt
  - New issuance of ARS stopped entirely
- Outcome resembled a bank run
  - Investors feared future auctions would fail, “ran” from current ones
  - Investors lost liquidity (some faced real financial distress)
  - Some issuers ended up paying high penalty rates (~20%)
  - New issuance stopped $\rightarrow$ a credit crunch

q

- Point: Financial panics are possible without banks or debt
  - The hardy perennial seems likely to appear in some form
- LPB would generate a strong incentive for financial innovation
  - Crises often follow periods of strong financial innovation
- Conclusion:
  - Would LPB decrease the likelihood of a crisis?
    Maybe, but … it is difficult to be sure
  - Conservative approach: treat q as being equal across regimes; ask how they compare in the two W terms

$$E[W] = (1\text{-}q)\,W(\text{no crisis}) + q\,W(\text{crisis})$$

(2) Effects on W(crisis)

- What would a financial crisis under LPB look like?
- Thinking of the ARS example, it could involve:
  - Falling asset prices, "frozen" markets in which selling is costly
  - A credit crunch (sharp decline in new issuance, rollover)
- But not:
  - Uncertainty about the solvency of financial intermediaries
  - Uncertainty about who will bear the losses
  - Debt overhang for financial intermediaries
- Suggests W(crisis) may be lower under LPB

- But … are there other concerns?
  - Ex: would household/firm bankruptcy increase substantially?
  - Suddenly holding illiquid assets; have to pay mortgage or other obligations
- Conclusion:
  - LBP has some real benefits – seems likely to raise W(crisis)
  - Quantitatively this effect seems likely to be large
  - But I would like to have a better picture of what a crisis under LPB might look like

$$E[W] = (1\text{-}q)\,W(\text{no crisis}) + q\,W(\text{crisis})$$

(3) Effects on W(no crisis)

- This may actually be the most difficult of the three terms
- There are many ways in which LPB *might* lower efficiency in normal times
  - 100% reserve requirement → fewer funds available for lending
  - Fully funding credit lines → more expensive credit lines
  - No debt → market-making more expensive → higher transaction costs
- Financial innovation and general equilibrium effects may offset many of these potential costs
  - But I worry that some efficiencies may nevertheless be lost
  - An example …

Ways to buy a 20-year, fixed premium, life insurance policy

(1) Buy shares in a 20-year life insurance fund

- Pay the entire premium in advance
- Wait until the end of the 20-year period for payouts

(2) Buy shares in two short-term (say, 3 month) funds

- One for life insurance during the 3-month period
- Another for changes in *insurability* during the period
- Verify both outcomes at the end of the period

W(no crisis)

- Relative to the current situation:
  - Approach (1) increases the credit burden on households
  - Approach (2) increases information-gathering costs
- Both seem to entail a non-trivial loss of efficiency
- This is one example; is it representative in any way?
  - I wonder what other costs may arise
- Conclusion:
  - LBP may lower W(no crisis), but is this effect large or small?

Conclusion

- Adding things up:

$$E[W] = (1\text{-}q)W(\text{no crisis}) + qW(\text{crisis})$$

- Preliminary, very rough guess is that LPB would be:
  - Costly in the no-crisis state
  - Beneficial in the crisis state
- Desirability depends on the sizes of these costs/benefits…
  - **and** on the value of *q*, *w*hich is difficult to pin down
- How can we get quantitative estimates of these effects?

Summing up

- LPB is an interesting proposal worthy of serious study
  - Offers some real benefits … but brings significant uncertainty
- I am skeptical of eliminating financial crises altogether
  - Therefore, a thorough cost-benefit analysis is needed
- I would like to see some issues fleshed out in more detail
  - What would the financial system look like under LPB? What innovation would arise? What would a crisis look like?
  - How large are the efficiency costs in normal times?
- Doing so is very difficult, but …
  - Otherwise … I might prefer to focus on taming the devil we know