

## **Proposals for the Treasury, the Federal Reserve, the FDIC, and the Banking System**

The purpose of this paper is to present proposals for the Treasury, the Fed, and the banking system. Government begins with an assumption that it exists for public purpose, and I use that as the guiding assumption of my proposals. I begin with my proposals for the banking system, as banking operations influence both Fed and Treasury operations.

### **Proposals for the Banking System**

U. S. banks are public/private partnerships, established for the public purpose of providing loans based on credit analysis. Supporting this type of lending on an ongoing, stable basis demands a source of funding that is not market dependent. Hence most of the world's banking systems include some form of government deposit insurance, as well as a central bank standing by to loan to its member banks.

Under a gold standard or other fixed exchange rate regime, bank funding can't be credibly guaranteed. In fact, fixed exchange rate regimes by design operate with an ongoing constraint on the supply side of the convertible currency. Banks are required to hold reserves of convertible currency, to be able to meet depositor's demands for withdrawals. Confidence is critical for banks working under a gold standard. No bank can operate with 100% reserves. They depend on depositors not panicking and trying to cash in their deposits for convertible currency. The U.S. experienced a series of severe depressions in the late 1800's, with the 'panic' of 1907 disturbing enough to result in the creation of the Federal Reserve in 1913. The Fed was to be the lender of last resort to insure the nation would never again go through another 1907. Unfortunately, that strategy failed. The depression of 1930 was even worse than the panic of 1907. The gold standard regime kept the Fed from being able to lend its banks the convertible currency they needed to meet withdrawal demands. After thousands of catastrophic bank failures, a bank holiday was declared and the remaining banks were closed by the government while the banking system was reorganized. When the banking system reopened in 1934, convertibility of the currency into gold was permanently suspended (domestically), and bank deposits were covered by federal deposit insurance. The Federal Reserve wasn't able to stop depressions. It was going off the gold standard that did the trick.

It has been 80 years since the great depression. It would now take exceptionally poor policy responses for even the current severe recession to deteriorate into a depression, though misguided and overly tight fiscal policies have unfortunately prolonged the restoration of output and employment.

The hard lesson of banking history is that the liability side of banking is not the place for market discipline. Therefore, with banks funded without limit by government insured deposits and loans from the central bank, discipline is entirely on the asset side. This includes being limited to assets deemed 'legal' by the regulators and minimum capital requirements also set by the regulators.

Given that the public purpose of banking is to provide for a payments system and to fund loans based on credit analysis, additional proposals and restrictions are in order:

1. Banks should only be allowed to lend directly to borrowers and then service and keep those loans on their own balance sheets. There is no further public purpose served by selling loans or other financial assets to third parties, but there are substantial real costs to government regarding the regulation and supervision of those activities. And there are severe consequences for failure to adequately regulate and supervise those secondary market activities as well. For that reason (no public purpose and geometrically growing regulatory burdens with severe social costs in the case of regulatory and supervisory lapses), banks should be prohibited from engaging in any secondary market activity. The argument that these areas might be profitable for the banks is not a reason to extend government sponsored enterprises into those areas.

2. US banks should not be allowed to contract in LIBOR. LIBOR is an interest rate set in a foreign country (the UK) with a large, subjective component that is out of the hands of the US government. Part of the current crisis was the Federal Reserve's inability to bring down the LIBOR settings to its target interest rate, as it tried to assist millions of US homeowners and other borrowers who had contracted with US banks to pay interest based on LIBOR settings. Desperate to bring \$US interest rates down for domestic borrowers, the Federal Reserve resorted to a very high risk policy of advancing unlimited, functionally unsecured, \$US lines of credit called 'swap lines' to several foreign central banks. These loans were advanced at the Fed's low target rate, with the hope that the foreign central banks would lend these funds to their member banks at the low rates, and thereby bring down the LIBOR settings and the cost of borrowing \$US for US households and businesses. The loans to the foreign central banks peaked at about \$600 billion and did eventually work to bring down the LIBOR settings. But the risks were substantial. There is no way for the Fed to collect a loan from a foreign central bank that elects not to pay it back. If, instead of contracting based on LIBOR settings, US banks had been linking their loan rates and lines of credit to the US fed funds rate, this problem would have been avoided. The rates paid by US borrowers, including homeowners and businesses, would have come down as the Fed intended when it cut the fed funds rate.

3. Banks should not be allowed to have subsidiaries of any kind. No public purpose is served by allowing bank to hold any assets 'off balance sheet.'

4. Banks should not be allowed to accept financial assets as collateral for loans. No public purpose is served by financial leverage.

5. US Banks should not be allowed to lend off shore. No public purpose is served by allowing US banks to lend for foreign purposes.

6. Banks should not be allowed to buy (or sell) credit default insurance. The public purpose of banking as a public/private partnership is to allow the private sector to price risk, rather than have the public sector pricing risk through publicly owned banks. If a bank instead relies on credit default insurance it is transferring that pricing of risk to a third party, which is counter to the public purpose of the current public/private banking system.

7. Banks should not be allowed to engage in proprietary trading or any profit making ventures beyond basic lending. If the public sector wants to venture out of banking for some presumed public purpose it can be done through other outlets.

8. My last proposal for the banks in this draft is to utilize FDIC approved credit models for evaluation of bank assets. I would not allow mark to market of bank assets. In fact, if there is a valid argument to marking a particular bank asset to market prices, that likely means that asset should not be a permissible bank asset in the first place. The public purpose of banking is to facilitate loans based on credit analysis rather, than market valuation. And the accompanying provision of government insured funding allows those loans to be held to maturity without liquidity issues, in support of that same public purpose. Therefore, marking to market rather than evaluation by credit analysis both serves no further public purpose and subverts the existing public purpose of providing a stable platform for lending.

### **Proposals for the FDIC (Federal Deposit Insurance Corporation)**

I have three proposals for the FDIC. The first is to remove the \$250,000 cap on deposit insurance. The public purpose behind the cap is to help small banks attract deposits, under the theory that if there were no cap large depositors would gravitate towards the larger banks. However, once the Fed is directed to trade in the fed funds markets with all member banks, in unlimited size, the issue of available funding is moot.

The second is to not tax banks in order to recover funds lost on bank failures. The FDIC should be entirely funded by the US Treasury. Taxes on solvent banks should not be on the basis of the funding needs of the FDIC. Taxes on banks have ramifications that can either serve or conflict with the larger public purposes presumably served by government participation in the banking system. These include sustaining the payments system and lending based on credit analysis. Any tax on banks should be judged entirely by how that tax serves or doesn't serve public purpose.

My third proposal for the FDIC is to do its job without any assistance by Treasury (apart from funding any FDIC expenditures). The FDIC is charged with taking over any bank it deems insolvent, and then either selling that bank, selling the bank's assets, reorganizing the bank, or any other similar action that serves the public purpose government participation in the banking system. The TARP program was at least partially established to allow the US Treasury to buy equity in specific banks to keep them from being declared insolvent by the FDIC, and to allow them to continue to have sufficient capital to continue to lend. What the TARP did, however, was reveal the total failure of both the Bush and Obama administrations to comprehend the essence of the workings of the banking system. Once a bank incurs losses in excess of its private capital, further losses are covered by the FDIC, an arm of the US government. If the Treasury 'injects capital' into a bank, all that happens is that once losses exceed the same amount of private capital, the US Treasury, also an arm of the US government is next in line for any losses to the extent of its capital contribution, with the FDIC covering any losses beyond that. So what is changed by Treasury purchases of bank equity? After the private capital is lost, the losses are taken by the US Treasury instead of the FDIC, which also gets its funding from the US Treasury. It makes no difference for the US government and the 'taxpayers' whether the Treasury covers the loss indirectly when funding the FDIC, or directly after 'injecting capital' into a bank. All that was needed to accomplish the same end as the TARP program- to allow banks to continue to

function and acquire FDIC insured deposits- was for the FDIC to directly reduce the private capital requirements. Instead, and as direct evidence of a costly ignorance of the dynamics of the banking model, both the Obama and Bush administrations burned through substantial quantities of political capital to get the legislative authority to allow the Treasury to buy equity positions in dozens of private banks. And, to make matters worse, it was all accounted for as additional federal deficit spending. While this would not matter if Congress and the administrations understood the monetary system, the fact is they don't, and so the TARP has therefore restricted their inclination to make further fiscal adjustments to restore employment and output. Ironically, the overly tight fiscal policy continues to contribute to the rising delinquency and default rate for bank loans, which continues to impede the desired growth of bank capital.

### **Proposals for the Federal Reserve**

1. The fed should lend unsecured to member banks, and in unlimited quantities at its target fed funds rate, by simply trading in the fed funds market. There is no reason to do otherwise. Currently the Fed will only loan to its banks on a fully collateralized basis. However, this is both redundant and disruptive. The Fed demanding collateral when it lends is redundant because all bank assets are already fully regulated by Federal regulators. It is the job of the regulators to make sure that all FDIC insured deposits are 'safe' and 'taxpayer money' is not at risk from losses that exceed the available private capital. Therefore, the FDIC has already determined that funds loaned by the Fed to a bank can only be invested in 'legal' assets and that the bank is adequately capitalized as required by law. There is no room for funding from the Fed to be 'misused' as banks already can obtain virtually unlimited funding by FDIC insured deposits. The only difference between banks funding with FDIC insured deposits and funding directly from the Fed might be the interest rate the bank may have to pay, however it's the further purpose of the Fed's monetary policy to target the fed funds rate. The Fed also tends to set quantity limits when it lends to its member banks, when there is every reason to instead lend in unlimited quantities. Bank lending is not reserve constrained, so constraining lending to the banks by quantity does not alter lending. What constraining reserves does is alter the fed funds rate, which is the rate banks pay for reserves as well as the Fed's target rate. So the only way the Fed can fully stabilize the fed funds rate at its target rate is to simply offer to provide unlimited funds at that rate as well as offer to accept fed funds deposits at that same target rate. And with no monetary risk or adverse economic consequences for lending unlimited quantities at its target rate there is no reason not to do this. Another benefit of this policy would be to entirely eliminate the interbank fed funds market. There is no public purpose served by banks trading fed funds with each other when they can do it with the Fed, and transactions costs are reduced as well. And to eliminate the interbank markets entirely the Fed has the further option to provide funding with an entire term structure of rates to its banks to both target those rates and also eliminate the need for any interbank trading.

2. I would limit the Fed to using banks as agents for monetary policy. I would not pursue the policy of attempting to establish additional public/private partnerships for the purpose of buying various financial assets. Instead, if I agreed with the need to purchase those assets, I would enable the banking system to do this along the same lines proposed for the new public/private partnerships. That might take the form of allowing banks to put these 'qualifying assets' in a segregated account, where losses to bank capital would be limited to, for example, 10% of the investment in those accounts. This would have the same result as the recently

proposed public/private partnerships but within the existing highly regulated and supervised banking system. Banks are the appropriate instrument of monetary policy for targeting the risk adjusted term structure of interest rates. Why go to the expense and risk of creating new public/private partnerships when there are already approximately 8,000 member banks already set up for that purpose?

3. I would make the current zero interest rate policy permanent. This minimizes cost pressures on output, including investment, and thereby helps to stabilize prices. It also minimizes rentier incomes, thereby encouraging higher labor force participation and increased real output. Additionally, because the non-government sectors are net savers of financial assets, this policy hurts savers more than it aids borrowers, so a fiscal adjustment such as a tax cut or spending increase would be appropriate to sustain output and employment.

4. I would instruct the Fed to offer credit default insurance on all Treasury securities through its banking system to any buyer. There is no default risk in US Treasury securities, but, if market participants do want to buy such credit default insurance, I would make it available through the Fed. This would keep the premiums and the perception of risk down to a level determined by the Fed. I would suggest they offer it freely at 5 basis points for any maturity.

### **Proposals for the Treasury**

1. I would cease all issuance of Treasury securities. Instead any deficit spending would accumulate as excess reserve balances at the Fed. No public purpose is served by the issuance of Treasury securities with a non-convertible currency and floating exchange rate policy. Issuing Treasury securities only serves to support the term structure of interest rates at higher levels than would be the case. And, as longer term rates are the realm of investment, higher term rates only serve to adversely distort the price structure of all goods and services.

2. I would not allow the Treasury to purchase financial assets. This should be done only by the Fed as has traditionally been the case. When the Treasury buys financial assets instead of the Fed all that changes is the reaction of the President, the Congress, the economists, and the media, as they misread the Treasury purchases of financial assets as federal ‘deficit spending’ that limits other fiscal options.

### **Conclusion**

I conclude with my proposals to support aggregate demand and restore output and employment.

1. A full payroll tax holiday where the Treasury makes all the contributions for employees and employers. This immediately restores the purchasing power of those still working and enables them to make their mortgage payments which also stabilizes the banking system.

2. I would distribute \$150 billion of revenue sharing to the State governments on a per capita basis. This would stabilize State governments currently cutting back on public services due to revenue short falls caused by the recession. Distribution on per capita basis makes it ‘fair’ and does not ‘reward bad behavior.’

3. I would have the Federal government fund \$8/hr full time jobs for anyone willing and able to work, that includes health care benefits. This provides an employed labor buffer stock that's a superior price anchor to our current unemployed buffer stock. This helps support an expansion in private sector employment as the economy improves. It's been demonstrated that the private sector prefers to hire those already working rather than those who are unemployed.

These three proposals, along with above proposals for the Fed, the Treasury, the FDIC, and banking system, will quickly restore the US economy to positive growth, full employment, and establish a banking system that will promote the intended public purpose and require less regulation while substantially reducing the systemic risk inherent in our current institutional arrangements.

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