# Safety First? The Deceptive Allure of Full Reserve Banking

A Response to Adam J. Levitin,
*Safe Banking: Finance and Democracy*,
83 U Chi L Rev 357 (2016).

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## INTRODUCTION

In *Safe Banking*, Professor Adam Levitin joins a venerable tradition in the money and banking literature. That tradition, called full reserve banking, has claimed a number of illustrious supporters over the years, including Professors Irving Fisher, Henry Simons, and Milton Friedman.[1] The basic idea of full reserve banking is seductive in its simplicity: "banks" should own nothing but physical cash. Because a full reserve bank has no investments, it can suffer no investment losses. A run on such a bank would be harmless, because the bank would never fail to meet redemptions (barring any loss or theft of cash). The process of bank money creation, familiar to any student of Economics 101, would go away. Money creation would be exclusively a government affair; "banks" would be pass-through vehicles, true depositories of currency. Our elaborate system of prudential bank regulation and supervision would be needless.

If it seems too good to be true, that's because it is. Proponents of full reserve banking have long run up against two principal objections—one of them surmountable, the other fatal. The surmountable objection has to do with "regulatory arbitrage," or avoidance. Once "deposits" must be backed by physical currency, the argument goes, nonbank financial institutions will create close substitutes for deposits and thereby evade the full reserve requirement. Levitin treats this issue in some detail, and he offers

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1 See generally Irving Fisher, *100% Money* (City Printing 3d ed 1945). See also Henry C. Simons, *Economic Policy for a Free Society* 62–65 (Chicago 1948); Milton Friedman, *A Program for Monetary Stability* 65–76 (Fordham 1960). While Friedman became more laissez-faire over time, he reiterated his support for full reserve banking in his preface to the 1992 reprint. Milton Friedman, *A Program for Monetary Stability* vii–xii (Fordham 1992).

a rather optimistic answer: He thinks that deposit substitutes can emerge on a large scale only with various forms of government "facilitation."[2] Remove such facilitation, he says, and the problem is basically solved.[3] For reasons described below in Part I, I do not find this answer wholly convincing. The good news is that regulatory arbitrage can be dealt with through well-designed entry restriction laws, which have been a staple of banking law (not to mention public utility law) for centuries. Levitin's full reserve banking plan therefore can't be rejected on this score.

It is the second objection—what I will call fiscal-monetary entanglement—that poses the real problem for full reserve banking proposals, including Levitin's. As I show below in Part II, full reserve banking would present daunting challenges for both fiscal management and the administration of monetary policy. Unfortunately, Levitin's article has little to say about this topic. Others before him have addressed the issue, but their answers are unsatisfying. While noble in intent—and despite their continuing allure—full reserve banking proposals do not offer a workable blueprint for financial reform.

## I. REGULATORY ARBITRAGE AND "SHADOW" BANKING

Among the novelties of Professor Levitin's proposal is his treatment of "shadow banking," by which he means the creation of deposit substitutes "outside the bank regulatory system."[4] "Existing 100% reserve proposals universally fail to address the problem of shadow banking," he writes.[5] "[A]ll previous 100% reserve–banking proposals have focused solely on regulation of depositaries."[6]

This is a bit of an overstatement. Professors Simons and Friedman each wrestled with the problem of deposit substitutes under full reserve banking.[7] Simons was particularly troubled by the issue. He worried that the development of deposit substitutes

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2 Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U Chi L Rev 357, 388–90 (2016).

3 Id at 389–90.

4 Id at 359.

5 Id at 365.

6 Levitin, 83 U Chi L Rev at 416 (cited in note 2).

7 Professor Fisher recognized the problem but dismissed it. See William R. Allen, *Irving Fisher and the 100 Percent Reserve Proposal*, 36 J L & Econ 703, 708–09 & n 21 (1993).

"might render our drastic reform quite empty, nominal, and unsubstantial."[8] Simons remarked that "[t]he whole problem which we now associate with commercial banking might easily reappear in other forms of financial arrangements."[9] That such deposit substitutes "cannot serve as circulating medium is not decisively important," he wrote, "for they are an effective substitute medium for purposes of cash balances."[10] Hence, "the problem of runs would still be with us."[11] By 1936, Simons had concluded that the full reserve plan, standing on its own, "would promise little but evasion."[12] Friedman saw the problem, too, though he thought he had a solution. Under his proposal, the government would pay interest on the cash reserves held by full reserve banks, thereby enabling them to offer superior terms to depositors.[13] Nonbanks offering deposit substitutes would be unable to effectively compete.

While Levitin isn't the first full reserve banking proponent to grapple with deposit substitutes, he does offer an intriguing strategy for addressing the issue. In Levitin's view, deposit substitutes owe their existence to government *facilitation*. Rather than being an "organic development," he writes, "various shadow-banking products, like all financial instruments, are legally constituted."[14] Levitin's point here is something more than the familiar notion that markets depend on the legal infrastructure of property, contract, tort, and so on. The mechanisms for creating deposit substitutes (or "safe assets") are "qualitatively different" from these background rules, he notes, "because of the product- and institution-specific nature of the regulations" that go into safe asset production.[15] Levitin supplies an extensive catalogue of these interventions—risk-based capital requirements, bankruptcy safe harbors for repos and swaps, implicit government backstops for various types of institutions and markets, special regulatory treatment of asset-backed securities, regulatory exemptions for

8 Ronnie J. Phillips, *The Chicago Plan & New Deal Banking Reform* 68 (Sharpe 1995) (quoting a letter from Simons to Fisher dated January 19, 1934).

9 Id at 90 (quoting a letter from Simons to Fisher dated July 4, 1934).

10 Id (quoting a letter from Simons to Fisher dated July 4, 1934).

11 Id (quoting a letter from Simons to Fisher dated July 4, 1934).

12 Simons, *Economic Policy for a Free Society* at 173 n 17 (cited in note 1).

13 Friedman, *A Program for Monetary Stability* at 73–74 (cited in note 1).

14 Levitin, 83 U Chi L Rev at 389 (cited in note 2).

15 Id. Levitin draws here on Katharina Pistor, *A Legal Theory of Finance*, 41 J Comp Econ 315 (2013), and Anna Gelpern and Erik F. Gerding, *Inside Safe Assets* (unpublished manuscript, Oct 5, 2015) (on file with author). See also generally Robert C. Hockett and Saule T. Omarova, *The Finance Franchise*, 102 Cornell L Rev (forthcoming 2017), archived at http://perma.cc/L6ZH-KAW9.

money market mutual funds that allow them to maintain stable net asset values, and so forth—and notes that their existence "is essential to the vitality and size of the shadow-banking system."[16] Without them, "the shadow-banking market would assuredly be substantially smaller."[17]

But how *much* smaller? It is one thing to say that the government, through various "product- and institution-specific" mechanisms, facilitates the creation of deposit substitutes.[18] It is quite another to say that, absent those mechanisms, deposit substitutes would wither away or at least shrink to the point of no longer posing a threat to financial stability.

There seems to be no reason in principle to think that the business model in question—funding financial asset portfolios with lots of short-term debt, continuously rolled over—can't be established using just the basic tools of property, contract, business organizations, and commercial law. Historical experience seems to indicate otherwise. It is clear, for example, that the distinctive funding model of banking (or shadow banking) can exist and even thrive without a public liquidity backstop. The United States didn't have a lender of last resort until the creation of the Federal Reserve in 1913, but banks have been around since the earliest days of the republic. Similarly, it is far from obvious that the "bill brokers" of nineteenth-century England—colorfully described by Walter Bagehot in his masterpiece, *Lombard Street*[19]—were the beneficiaries of any special government favoritism or facilitation. But these proto–shadow banks created deposit substitutes on a very large scale.

Fortunately, the case for full reserve banking does not stand or fall on the question of affirmative governmental facilitation. If the creation of deposit substitutes by nonbank entities is dangerous, why not just prohibit it outright? This strategy—restricting entry into "money" creation—has been a core feature of bank regulation for centuries. Soon after the founding of the Bank of England in 1694, Parliament forbade any other corporate entity or large partnership in England from issuing bank notes.[20] In the United States, analogous restrictions—called "restraining acts"—

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16 Levitin, 83 U Chi L Rev at 389, 391–411 (cited in note 2).

17 Id at 390.

18 Id at 389.

19 Walter Bagehot, *Lombard Street: A Description of the Money Market* 281–300 (Scribner, Armstrong 1873).

20 Bank of England Act, 7 Anne, ch 30, § 66 (1708), in 9 Statutes of the Realm 113, 130.

were established at the state level around the turn of the nineteenth century.[21] When Congress later sought to federalize money creation by making national banks the exclusive issuers of bank notes, it imposed a prohibitive tax on the issuance of bank notes by state banks.[22] Today, entry restriction remains at the core of US bank regulation: it is axiomatic that no person or entity may maintain "deposit" liabilities without a bank charter.[23]

Note that these prohibitions apply not to chartered banks, *but to everyone else*. Entry restriction laws define the privilege that a banking charter conveys. I have argued elsewhere that the creation of deposit substitutes—shadow banking—stems from banking law's failure to define, in functional terms, what constitutes a monetary instrument.[24] Restricting entry into money creation means establishing a workable legal-institutional definition of what types of instruments constitute "money." I see no reason to think that this is any less feasible than defining "security" for securities regulation purposes, or "swap" for derivatives regulation purposes, or "investment company" for investment company regulation purposes, or "proprietary trading" for Volcker Rule purposes, or . . . the list could go on and on. These kinds of threshold definitional questions arise in pretty much every area of financial and economic regulation. There will always be some degree of regulatory arbitrage, but you don't need zero arbitrage to be effective.

Of course, these two strategies—ending facilitation and establishing entry restriction—aren't mutually exclusive. It may make sense to do both: a kind of belt-and-suspenders approach. In any case, the crucial point here is that regulatory arbitrage shouldn't be viewed as an insuperable obstacle to the effective regulation of bank money creation. Unfortunately, full reserve banking has another, deeper problem.

## II. Fiscal-Monetary Entanglement

In a fractional reserve system, commercial banks create money (deposit balances) to a multiple of their holdings of government-issued base money. Suppose the government outlawed fractional reserve banking—thereby transitioning to a full

21 See Bray Hammond, *Banks and Politics in America: From the Revolution to the Civil War* 184–85 (Princeton 1962).

22 See Act of March 3, 1865 § 6, 13 Stat 469, 484.

23 See 12 USC § 378(a)(2).

24 Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* 230–37 (Chicago 2016).

reserve system of the type Professor Levitin contemplates—while holding constant the quantity of government-issued money. With commercial banks no longer augmenting the money supply, the total quantity of money would shrink drastically. The macroeconomic consequences could be severe.

The government (or an agency or instrumentality thereof) might choose to offset this contraction with a corresponding expansion in government-issued money. Presumably it would get this new base money into circulation by buying up government debt securities, the traditional central banking practice. But what if there isn't enough government debt outstanding to accommodate the desired increase in the money supply? As Professor Fisher asked in his discussion of objections to full reserve banking: "If it should come to pass, some fine day, that the whole national debt had been paid off, what then?"[25]

Naturally, the government could produce more debt to accommodate monetary expansion. This would mean cutting taxes and/or increasing spending. Here the problem of fiscal-monetary entanglement under full reserve banking begins to come into view. In this world, fiscal expansion must precede monetary expansion. Monetary stimulus therefore becomes contingent upon the resolution of contentious political questions. Who gets a tax cut? What additional expenditures should the government undertake? For obvious reasons, such questions belong to political processes and are ill-suited to administrative delegation. Further, it is not hard to imagine how political gamesmanship and gridlock might come into play, frustrating monetary stabilization. Even well-meaning legislators may not see eye to eye on the relative merits of new "shovel ready" spending projects or on the incentive effects of increased social welfare expenditure. And a policy of adjusting tax rates based on monetary policy considerations would incentivize private actors to adjust their behavior so as to realize taxable income in low-tax periods. There are ample reasons to question whether this is a sensible way of doing money.

To be clear, the question here is *not* one of political *accountability* for monetary policy—an entirely separate issue. Rather, it is a basic matter of policy execution. Is it wise to condition monetary expansion on fiscal adjustments? Some proponents of full reserve banking (and its close cousin, narrow banking) have recognized this problem. Professor Friedman favored 100 percent reserve banking, but he had concerns about "the close connection

25 Fisher, *100% Money* at 207 (cited in note 1).

between the 100% reserve plan and debt management."[26] If the supply of government debt were exhausted, he wrote, then "[s]ubsequent increases in the stock of money" may require "the creation of additional debt to finance deficits"—an outcome he did not find "particularly appealing."[27] Along similar lines, Professor Hyman Minsky noted that among the "institutional prerequisites" for a narrow banking system are "[a] large government debt that can be monetized" and "[a] Federal Government fiscal posture which can readily be adapted" to accommodate the economy's need for growing transaction account balances.[28]

I should emphasize that fiscal-monetary entanglement is not merely hypothetical. In fact, it is a recurring theme of US monetary history, stretching back to colonial times. Colonial governments that relied on public expenditures to put new money into circulation ran into problems when public expenses declined. Some of them experimented with *lending* (rather than spending) money into circulation through the device of "land banks"—thereby sidestepping fiscal-monetary entanglement.[29] In the next century, the National Bank Acts of 1863[30] and 1864[31] forced national banks (which were bestowed with a monopoly on bank note issuance) to collateralize their bank notes with US government bonds.[32] In the decades that followed, the supply of government bonds proved insufficient to support an adequate supply of bank notes.[33] Fiscal-monetary entanglement thus precluded monetary elasticity; this difficulty turned out to be a major impetus behind the Federal Reserve's creation in 1913.[34] As recently as the turn of the twenty-first century, with the federal government running surpluses and paying down debt, the Federal Reserve was scrambling to figure out what to do if the supply of Treasuries could no

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26 Friedman, *A Program for Monetary Stability* at 71 (cited in note 1).

27 Id at 71 & n 11.

28 Hyman P. Minsky, *Foreword*, in Phillips, *The Chicago Plan* at xiii (cited in note 8). See also Robert E. Litan, *What Should Banks Do?* 169 (Brookings 1987) (suggesting that narrow bank portfolios would ideally be limited to T-bills but acknowledging that "the total supply of privately held short-term Treasury securities (with maturities up to one year) is limited").

29 Christine Desan, *From Blood to Profit: Making Money in the Practice and Imagery of Early America*, 20 J Pol Hist 26, 28–29 (2008).

30 National Bank Act of 1863, 12 Stat 665, superseded by the National Bank Act of 1864 § 62, 13 Stat 99, 118.

31 13 Stat 99, codified as amended at 12 USC § 21 et seq.

32 National Bank Act of 1863 § 15, 12 Stat at 669; National Bank Act of 1864 § 16, 13 Stat at 104.

33 See Alexander Dana Noyes, *History of the National-Bank Currency* 12 (GPO 1910).

34 Allan H. Meltzer, *A History of the Federal Reserve: Volume I, 1931–1951* 66 (Chicago 2003).

longer support even the *base* money supply.[35] A full reserve system would obviously magnify this problem severalfold—particularly once "shadow" monies (deposit substitutes) are suppressed.

Perhaps we should aim to design a monetary framework that is compatible with a variety of fiscal environments. "There's something wrong with any monetary system that only works well if the government acts as borrower of last resort," monetary economist Professor Nick Rowe wrote recently.[36] I am inclined to agree.

Fractional reserve banking offers an appealing escape from fiscal-monetary entanglement. Banks create money (deposit balances) in the process of investing in not just government credit but also consumer and business credit. The supply of private credit investment opportunities is vast, far exceeding any conceivable desired money supply. In such a system, satisfying money demand never depends upon fiscal adjustment. The system is compatible with any fiscal environment, including a long-term balanced budget. The advantages of decoupling monetary and fiscal affairs are substantial. Viewed through this lens, the deposit banking system can be understood as a joint venture with the state: a public-private partnership for the issuance and circulation of the money supply.

Fractional reserve banking need not be equated with the creation of private, defaultable, runnable "money." We know that these things are logically separable. The establishment of US federal deposit insurance in 1933[37] put an end to the recurring panics that had previously beset the chartered banking industry. This was a revolutionary monetary transformation. In one fell swoop, the bulk of the US money supply went from private to sovereign. And this development inaugurated an unprecedented seventy-five-year period of panic-free conditions in the United States.[38] Only with the emergence of shadow banking—the large-scale creation of deposit substitutes *outside* the insured banking system—did instability return.[39] Whether the monetary liabilities of chartered banks are "private" or "sovereign," then, is a policy choice.

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35 See generally Marvin Goodfriend, *Policy Debates at the Federal Open Market Committee: 1993–2002*, in Michael D. Bordo and William Roberds, eds, *The Origins, History, and Future of the Federal Reserve: A Return to Jekyll Island* 332, 356 (Cambridge 2013).

36 Nick Rowe (Twitter, Apr 27, 2016), archived at http://perma.cc/R6UM-9CW4.

37 See Banking Act of 1933 § 8, 48 Stat 162, 168–80.

38 Professor Gary Gorton refers to this as the "Quiet Period" in US banking. Gary B. Gorton, *Slapped by the Invisible Hand: The Panic of 2007* 11 (Oxford 2010).

39 See generally id.

Deposit insurance has plenty of critics, and its history is not unblemished. The savings and loan debacle of the 1980s and early 1990s resulted in a $124 billion taxpayer bailout of the deposit insurance system.[40] While costly, this failure needs to be kept in perspective. First, it amounts to less than one-third of US military expenditures in 1990.[41] This is hardly an exorbitant fiscal price to pay for seventy-five years of run-proof financial conditions. Second, much of this fiscal cost was avoidable, because regulation of insured banking in the 1980s was awful. Among other things, Congress relaxed bank and thrift portfolio constraints in the early 1980s, allowing insured institutions to dramatically increase their exposures to risky asset classes like junk bonds and construction loans.[42] Insured institutions then "gambl[ed] for resurrection," compounding the debacle.[43] Third, and most important, the savings and loan debacle was *not* accompanied by a severe macroeconomic disaster. The United States entered a mild and brief recession in July 1990. It is reasonable to conclude that, by preventing a banking panic, deposit insurance forestalled a macroeconomic catastrophe. I concur with Warren Buffett, who recently opined, "I think the FDIC and Social Security were the two most important things that came out of the '30s. I mean the system [ ] needed an FDIC."[44]

Levitin approvingly cites Professor James Tobin's view that fractional reserve banking—the combination of monetary (deposit) liabilities and investment portfolios—is an "accident of history."[45] The implicit claim is that the combination lacks a respectable justification. An alternative view would hold that existing institutions of money and banking *do* embody an intelligible economic logic, and that the paramount task of monetary-financial

40 See Timothy Curry and Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13:2 FDIC Banking Rev 26, 33 (2000).

41 See *1990 United States Budget* (InsideGov.com), archived at http://perma.cc/L26W-J3F5.

42 See Depository Institutions Deregulation and Monetary Control Act of 1980 §§ 401–02, Pub L No 96-221, 94 Stat 132, 151–56; Garn-St Germain Depository Institutions Act of 1982 §§ 321–30, 403, Pub L No 97-320, 96 Stat 1469, 1499–1502, 1510–11.

43 Jean-Charles Rochet, *Why Are There So Many Banking Crises? The Politics and Policy of Bank Regulation* 86 (Princeton 2008).

44 *FCIC Staff Audiotape of Interview with Warren Buffett, Berkshire Hathaway* 1:46:22–1:46:32, online at http://fcic.law.stanford.edu/interviews/view/19 (visited Aug 26, 2016) (Perma archive unavailable).

45 Levitin, 83 U Chi L Rev at 369 (cited in note 2), quoting James Tobin, *A Case for Preserving Regulatory Distinctions*, 30 Challenge 10, 14 (Nov/Dec 1987).

reform is, or should be, to follow through on that logic.[46] The principle of Chesterton's fence—don't dismantle a fence (or other institution) without a clear understanding of why it was erected in the first place—is apposite here.[47]

## CONCLUSION

Legal scholarship has been somewhat neglectful of money, which is after all a legal institution. Payment law—one facet of the law of money—has become something of a scholarly backwater, even in the eyes of its leading thinkers.[48] Banking law scholarship has tended to focus on the "intermediation" function of banking rather than its monetary function.[49] The classic treatise on the law of money, F.A. Mann's *The Legal Aspect of Money,* pursues by its own admission "a strictly legal approach" and is useful primarily as a reference work.[50] The international monetary order has received attention from internationalist legal scholars, but monetary systems are first and foremost domestic institutions. Professor Rosa María Lastra's *International Financial and Monetary Law*[51] is a formidable work of exposition and synthesis, but it has few theoretical pretensions apart from the topic of monetary sovereignty.

There is room for deeper thinking in this field. Other legal institutions of capitalism—property, contract, business organizations, securities, bankruptcy, antitrust, labor, and so forth—are the subjects of vast legal literatures; each of these topics can claim landmark contributions that give us ways to understand, impose structure upon, and organize our thinking about these diverse fields. By comparison, legal scholarship on monetary systems is sparse.

This is starting to change. Professor Levitin's *Safe Banking* joins a nascent surge in legal scholarship on monetary

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46 I have argued as much at some length. See generally Ricks, *The Money Problem* (cited in note 24).

47 G.K. Chesterton, *The Thing* 35 (S & W 1929).

48 See, for example, Joseph H. Sommer, *Commentary: Where Is the Economic Analysis of Payment Law?*, 83 Chi Kent L Rev 751, 766–67 (2008).

49 There are notable exceptions. See generally, for example, Hockett and Omarova, *The Finance Franchise* (cited in note 15); Kathryn Judge, *Information Gaps and Shadow Banking*, 103 Va L Rev (forthcoming 2017), archived at http://perma.cc/W8YC-ZZCY.

50 F.A. Mann, *The Legal Aspect of Money: With Special Reference to Comparative Private and Public International Law* ix (Oxford 5th ed 1992).

51 See generally Rosa María Lastra, *International Financial and Monetary Law* (Oxford 2d ed 2015).

institutions—a surge that was largely, but by no means exclusively, precipitated by the global financial crisis of 2007 to 2009. Some of that work, such as Professor Peter Conti-Brown's illuminating *The Power and Independence of the Federal Reserve,* zooms in on the central bank.[52] Others have treated monetary institutions in a broader context. A major entry in this new literature is Professor Christine Desan's astounding *Making Money: Coin, Currency, and the Coming of Capitalism*, which traces the emergence and evolution of monetary institutions in medieval and early modern England.[53] Desan reveals monetary system design to be an essential aspect of statecraft—a project of constitutional dimensions, an act of institutional engineering with profound distributional implications. How monetary institutions are structured matters a great deal, and the *choices* that are inherent in this project are often obscured from view. Levitin has done his readers a service by inviting us to reexamine those choices.

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52 See generally Peter Conti-Brown, *The Power and Independence of the Federal Reserve* (Princeton 2016).

53 See generally Christine Desan, *Making Money: Coin, Currency, and the Coming of Capitalism* (Oxford 2014).