US Banking Reform 2010

An accounting solution with the added benefit of paying off the National Debt

By Michael Schemmann[1]

The Italian monk and scholar, Luca Pacioli (1445-1517), codified a double-entry bookkeeping system for commercial enterprises[2] that is still the foundation of modern accounting today, although much more complex than five hundred years ago. Present day accounting by depository financial institutions contains serious inconsistencies and misconceptions surrounding the recognition of assets and liabilities under the going concern principle and has not kept up with the times.

The accounting equation underlying the balance sheet of Assets - Liabilities = Owner's Equity lends itself to the creation of "assets" by banks by debiting "loans receivable" and crediting "customer deposits" that circulate as money through check-writing.[3], [4] "The process by which banks create money is so simple that the mind is repelled," wrote John Kenneth Galbraith (1975) in *Money. Whence It Came. Where It Went.*

The bank's treatment of "loans receivable" is that of an "asset", and the treatment of the corresponding deposits that of a "liability". The liabilities are extinguished when the accounting entries that gave rise to their creation are reversed (debiting deposits, crediting loans receivable), an act that effectively destroys the deposits' function as part of the nation's money supply reported as M1 in the case of a demand deposits, or as M2 in the case of a savings deposits.

Pursuant to the accounting principle of substance over form, an asset created out of nothing is also nothing. If Galbraith is right, and if cash in banks are not assets, the deposits booked to create the liabilities are also a nullity, tantamount to counterfeit.

Such sobering accounting thought has far reaching consequences. The Global Financial Crisis of 2007 which started as a "liquidity crunch" has effectively recognized the nullity of bank-created book-deposits, requiring the Federal Reserve to step in and save the payment system by lending trillions of dollars of its high-powered federal funds that alone are the nation's money.

If bank-created book-deposits are not liabilities, if they are a nothing and should be treated as such, perhaps the Global Financial Crisis, too, will go away by a stroke of genius if we only corrected the accounting treatment. Before we try, let us have a look at All US Banks' combined balance sheet at the time that the current crisis started to manifest itself – in 2007.[5]

All US Commercial Banks
Combined Balance Sheet
Year End 2007
(US dollar billions)

Assets				**Liabilities**			
Cash & due from investments		482	4%	Demand & savings deposits	7,309		65%
Investment securities		1,591	14%	Borrowed funds	1,880		17%
Loans & leases	6,626			Subordinated notes	175		2%
Allowance for loan & lease losses	-89			Other liabilities	668		6%
Net loans & leases		6,537	58%	**Total liabilities**		**10,032**	**90%**
Other earning assets		1,514	14%				
Total financial assets		**10,124**	**91%**				
				Shareholders' equity			
Bank premises & equipment	105			Perpetual preferred stock	5		0%
Other real estate	10			Common stock	36		0%
Total real estate		115	1%	Surplus	738		7%
Intangibles		424	4%	Undivided profits	365		3%
All other assets		513	5%	Other capital	0		0
Total nonfinancial assets		**1,052**	**9%**	**Total equity capital**		**1,144**	**10%**
Total assets		**11,176**	**100%**	**Total liabilities & equity**		**11,176**	**100%**

The above combined balance sheet shows that the banks' total financial assets of $10 trillion equal the banks' total liabilities of $10 trillion, and they are the banks' own creation, creating money out of nothing by double-entry bookkeeping, thereby circumventing Article 1 Section 8 of the US Constitution[6] which gives the money power to Congress, leaving only the relatively small amount of legal tender in circulation for the government to print while the banks' demand and savings deposits serve as the nation's money supply M2, used to transact its $14 trillion GDP, a measure for the size of the US economy.

Under TARP, Congress is bailing out the very system that has usurped the Congressional power to create the nation's money supply. As a result, the nation carries the massive burden of an $11.7 trillion national debt while its government's money creating power lies idle and unused.

While the nation's long practice of using bank deposits in lieu of money cannot be changed overnight, the accounting practice can to address the going concern issue, for example, by requiring banks to show all customer deposits as a deduction from their vault cash plus balances at the Federal Reserve on the asset side of the balance sheet instead of "broad" on the liability side, the net amount of which may not be negative[7] (a so called "100% Money Rule"[8]).

The problem is, however, that banks do not have the required federal funds and would all fail.

To prevent the massive failure, the $11.7 trillion national debt, or a good part of it, could be paid off by monetizing it and finding a way that channels the new federal funds to the banks, not to be accounted for as deposits redeemable in cash so as to keep the money supply stable and avoid price inflation, but an another form of a government-administered fund that invests in bank stock on a competitive basis and is listed for trading on the major stock exchanges to provide liquidity.

What would be required of Congress to make the transition?

1. Congress passes a law directing the Federal Reserve on the full faith and credit of the United States of America to make payment to the US Treasury by crediting its current account at the Fed with $9.3 trillion (using the 2007 figure from the above balance sheet. The National Debt has since risen to $11.7 trillion and continues to rise at the rate of $3.9 billion per day.)
2. Under further Act of Congress, the Treasury calls in the national debt for redemption, issuing "Redemption Receipts" to the owners but transferring the proceeds to a new government or privately administered "bank capital stock investment fund" which acts as a conduit passing on dividends tax free to its proportionate owners. The Redemptions Receipts are listed for trading on the NYSE and other exchanges to provide liquidity for their owners. Arrangements may be made with the IMF to lend to sovereigns against the Redemption Receipts in the IMF's own currency: Special Drawing Rights (SDRs).
3. The US depository institutions will compete by seeking the national debt redemption funds, which are high-powered federal funds at the Fed, to put on their balance sheets as backing for their present customer deposits in order to comply with the 100% Money Rule. Banks who fail to attract the "bank capital investment funds" cannot obtain a clean audit report and are closed down by the banking regulators. Many small or otherwise vulnerable banks may disappear as a welcome side-effect of the reform and taken over by stronger institutions.
4. The US National Debt ceases to exist, avoiding annual interest payments of about $600 billion to help balance the budget.

The new combined balance sheet of All US Commercial Banks – using the same 2007 figures – will look as follows:

All US Commercial Banks
Combined Balance Sheet
Accounting for US National Debt Redemption Deposit Receipts
Year End 2007
(US dollar billions)

Assets				**Liabilities**			
Cash & due from investments	482			Borrowed funds	1,880		14%
Cash at Federal Reserve Banks	9,300			Subordinated notes	175		1%
Less: Demand & savings deposits	-7,309			Other liabilities	668		5%
Net cash & federal funds	2,473	2,473	19%	**Total liabilities**		**2,723**	**20%**
Investment securities		1,591	12%				
Loans & leases	6,626			New capital from RDAs	9,300		71%
Allowance for loan & lease losses	-89			Perpetual preferred stock	5		0%
Net loans & leases		6,537	50%	Common stock	36		0%
Other earning assets		1,514	11%	Surplus	738		6%
Total financial assets		**12,115**	**92%**	Undivided profits	365		3%
				Total equity capital		**10,444**	**80%**
Bank premises & equipment	105						
Other real estate	10						
Total real estate		115	1%				
Intangibles		424	3%				
All other assets		513	4%				
Total nonfinancial assets		**1,052**	**8%**				
Total assets		**13,167**	**100%**	**Total liabilities & equity**		**13,167**	**100%**

As a result of the US National Debt Redemption, the banks have excess liquidity at the Fed of $2.5 trillion (using 2007 figures) that can be used to make fresh loans and help the economy out of recession. The capital ratio of total equity to total assets is a stunning 79% can easily absorb losses from loan defaults as a result of sub-prime lending.

The US-NDRP may at first sight trigger a flight from the US dollar and a devaluation of US Treasury bonds and bills, until the public begins to realize the underlying benefits of the US National Debt Redemption Plan for the purposes of the credit rating of the US government, the strength of the US dollar because of the inflation neutrality of the plan. The new competition for federal funds among banks will be a welcome novelty to replace the handouts the banks are perceived to have received at taxpayer expense effectively socializing their losses.

The US budget deficit is "expected to soar to almost $1.6 trillion in 2009, the highest on record, both the White House and Congress have warned. Fuelled by President Obama's $787bn stimulus package and reduced tax revenues due to the recession, it compares with a $455bn deficit in 2008. The White House says the deficit will grow further, predicting it will hit a cumulative $9tn from 2010-2019."[9] The U.S. is in the state of a "banana republic".[10]

The plan may serve as a model for industrialized nations with national debts at levels equal to or exceeding their GDP, that are beyond the points of no return, including Britain and Japan that cannot pay off their national debts relying on budget surpluses.

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[2] *Summa de arithmetica, geometria, proportioni et proportionalita* (Venice 1494), a textbook for use in the schools of Northern Italy. It was a synthesis of the mathematical knowledge of his time and contained the first printed work on algebra written in the vernacular (i.e. the spoken language of the day). It is also notable for including the first published description of the method of bookkeeping that Venetian merchants used during the Italian Renaissance, known as the double-entry accounting system. Although Pacioli codified rather than invented this system, he is widely regarded as the "Father of Accounting". The system he published included most of the accounting cycle as we know it today. He described the use of journals and ledgers, and warned that a person should not go to sleep at night until the debits equaled the credits. His ledger had accounts for assets (including receivables and inventories), liabilities, capital, income, and expenses — the account categories that are reported on an organization's balance sheet and income statement, respectively. He demonstrated year-end closing entries and proposed that a trial balance be used to prove a balanced ledger. Also, his treatise touches on a wide range of related topics from accounting ethics to cost accounting. (Wikipedia at http://en.wikipedia.org/wiki/Luca_Pacioli)

[3] In England, before the British Bank Act of 1844 was passed, regulating the issue of a paper circulation while ceding the monopoly to the Bank of England, the country banks sustained themselves on the interest on their private note issue which was used by merchants as the circulating medium. "In England, of course, bankers immediately set themselves to recover the economy of elasticity which the Act of 1844 banished from the English system by other means' and with the development of the cheque system to its present state of perfection they have magnificently succeed," writes John Maynard Keynes (1913) in *Indian Currency and Finance.*

[4] "All charges and credits to [demand deposit] accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made." [Financial Accounting Standards Board (2009), *Accounting Standards Codification* §305-10-20]

[5] The starting date may be August 9, 2007, when BNP Parisbas refused to redeem certain investment funds because the bank was unable to determine their value and the ECB pumped 95 billion euros into the system to stave off a liquidity crisis. BBC News Business at http://news.bbc.co.uk/2/hi/business/6938425.stm

[6] Historically, the coining or creation of money is the right of the sovereign, the King. Article 1 Section 8 of the US Constitution gave the power "To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures" to Congress. Federal Reserve notes carry the notice "This note is legal tender for the payment of all debt, public and private." The same cannot be said of bank created deposits which are not transferable except by offset in the clearing system.

[7] In conformity with Core Accounting Principle No. Core-05(a) of the IICPA at http://www.iicpa.com/standards/standards.HTML

> Core-05 Going concern principle
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> (a) An industrial or commercial entity is a going concern and presumed to continue to be operating for the foreseeable future, so that assets are valued at cost or fair value rather than liquidation or break-up value, reflecting the time-value of money and the risk associated with the future expected cash flows.
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> (b) A bank or other deposit-taking financial institution is a going concern if deposits in the nature of demand or checkable deposits by its customers are reported on the asset side of the balance sheet as a deduction from the bank's or other deposit-taking financial institution's vault cash plus current account deposits maintained at the nation's central bank, the net amount of which may not be negative.

[8] Adopted from Irving Fisher (1935). *100% Money. Designed to keep checking banks 100% liquid; to prevent inflation and deflation; and to wipe out much of the National Debt.* Boston: Houghton Mifflin.

[9] "US deficit to soar towards $1.6tn" - BBC News Business August 25, 2009 at http://news.bbc.co.uk/2/hi/business/8221207.stm

[10] David P. Goldman, associate editor at First Things magazine, on Bloomberg Surveillance 24 August 2009, talking to hosts Ken Prewitt and Tom Keene about banking, regulation and financial stocks. Surveillance is simulcast weekdays from 7 to 9 A.M. ET on Bloomberg Television. Retrieved at clipSRC=mms://media2.bloomberg.com/cache/vnoVbCL4bpHE.asf