International Institute of Certified Public Accountants

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An Open Letter to

Professor Simon Johnson
MIT Sloan School of Management
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Dispatched via email: sjohnson [at] mit.edu

Dear Professor Johnson:[1]

Your Article on Bloomberg.com "A Valuable U.S. Export: Banking Regulations" 18 February 2013

On October 1, 2012, I wrote you per email in response to an article written by you and published by Bloomberg. You wrote that "If equity is depleted, the bank is insolvent." I advised you as an accountant that "This is patently false." I added, albeit somewhat provocatively, "In fact, banks don't need capital," relying on one of my latest booklets: Michael Schemmann (2012), "Liquid Money. Liquid Money — The Final Thing. Federal Reserve and Central Bank Accounts for Everyone."[2] The commercial banks' activities take place primarily on the liability side. Liquidity is needed to redeem deposits and that is found on the banks' asset side, whereas capital is also on the liability side and therefore of no assistance in redeeming deposits. Bankruptcy does not result from losses impairing capital, but from a lack of liquidity to redeem deposits.

Take an example: A bank has 100 million cash in the vault or at the Federal Reserve and also 100 million in customer deposits. Say, the bank's premises are reported at 10 million and equal the bank's equity capital of 10 million. You say that if the bank incurs a 10 million loss (eg, on its premises or real property which wipes out its 10 million capital), then the bank is bankrupt, whereas in fact that bank is 100% liquid. Perhaps you see in this simple example your sad misconception.

Today, 18 February 2012, I find another article from you on Bloomberg.com entitled "A Valuable U.S. Export: Banking Regulations" in which you quote the FDIC's Jeremiah Norton's question "whether the U.S. should continue to rely heavily on sophisticated risk-based measures of assets to calculate the adequacy of what is known as 'regulatory capital ratios.' Or, instead, should greater emphasis be placed on the simpler, more straightforward measure of 'leverage' — meaning how much equity a bank has relative to its assets, without any risk adjustments (or, equivalently, how much debt versus equity the company has on the liabilities side of its balance sheet)?"

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[1] For the benefit of readers, you are Ronald A. Kurtz (1954) Professor of Entrepreneurship at the MIT Sloan School of Management. You are also a senior fellow at the Peterson Institute for International Economics in Washington, D.C., a co-founder of BaselineScenario.com (a much cited website on the global economy), a member of the Congressional Budget Office's Panel of Economic Advisers, and a member of the FDIC's Systemic Resolution Advisory Committee.

[2] http://www.iicpa.com/publications/publications.HTML

Your article continues to promote the idea of capital adequacy for internationally active commercial banks as promoted by the Basel Committee on Banking Supervision.

You are an economist, but capital is an accounting determination. I am an accountant, a licensed public accountant, a CPA. I am also a professional banker.

I must tell you again of the misconception in the Basel capital accords, in particular that capital however measured is NOT a protector of deposits, is NOT a safeguard against a bank's illiquidity also known as, or leading to, 'bankruptcy'.

Only liquidity protects a bank from 'bankruptcy', and that liquidity is not bank-created book-money also known as 'quasi money', but ONLY legal tender, namely in the United States where you teach 'federal funds' of the central bank, the Federal Reserve. Money center bank fund may be a good substitute, eg, held at JP Morgan Chase, Bank of America, and, yes, even Citibank. But equity capital? Not a chance.

The Federal Reserve through its so called 'Quantitative Easing,' or the European Central Bank through its so called Outright Monetary Transactions (OMTs), are pumping trillions into the banking system to provide them with their central bank money, and only that keeps the payment system going and banks from failing. It has finally sunk in with the central banks, and I wished you would join in sharing their wisdom because your are also an educator.

I believe the public who you address through the media would appreciate an explanation of your position why bank capital requirements should be enforced to save our banks from collapsing, so that the accountants among us may be able to follow your reasoning. Please explain your position without emphasizing your past experience at the IMF which did not prevent the Global Financial Crisis, or by citing the Basel I, II, or III capital adequacy standards which have also contributed nothing to prevent the recurring bank failures since 1988 when Basel I was announced.

By sheer coincidence, I happen to be a Basler, where I grew up, and was also a banker in my late twenties (I am now in my seventies). To the best of the City's knowledge, the academics in the Ivory Tower of the Bank for International Settlements, the BIS, that architectural masterpiece of copper (not gold or silver), don't really know what they are doing to get us out of the GFC, or to prevent another one… They are not really bankers either, or accountants, but economists.

With all best wishes,

Michael Schemmann, PhD, CPA, CMA
Professional Banker
Director of the IICPA