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by Valerio Carnovale

## McMillan J. The End of Banking

A financial system without banking is both desirable and possible. Banking - the function of creation of money out of credit, not confined to the banks - slipped out of control because in a world with fast-paced innovation, financial institutions can move banking anywhere where banking regulation does not apply. The boundary problem of financial regulation has become insurmountable with information technology. It offers new possibilities that make banking redundant. How well the financial system fulfills its purpose of supporting a decentralized and capital-intensive economy depends on the organization of money and credit. The banking system turned into a dysfunctional public-private project. Banking institutions make tremendous profits by taking excessive risks in good times, while the government absorbs the losses in bad times. The boundary problems of financial regulation call for a holistic approach: We have to address banking at the fundamental level of accounting and we have to redefine the role of the public sector in the organization of money and credit.

The digital revolution mobilized credit: Banks could now slice, dice, and redistribute credit over a chain of balance sheets (shadow banking) at negligible costs; Money Market Mutual Funds are an attractive alternative to banks without being subject to banking regulation. No legal commitment (reserves or capital requirements) restricts inside money creation. Credit risk perception by market participants determines how large both equity share in securitization and the haircut in repo transactions have to be. The most disturbing regulatory development is the expansion of government guarantees to financial institutions in the shadow banking, without accompanying effective regulation, and became all-encompassing for large banks (too big to fail). It exacerbated the moral hazard problem. Capital requirements no longer work in the digital age. Institutions that have their liabilities guaranteed by the government will always find ways to circumvent regulation (tail risk strategies) because it is just too profitable to take excessive risks when your downside is capped. The central banking conventional tools have not direct impact on the determinant of creation of inside money (haircut, asset price volatility, etc.). They had to resort unconventional tools to increase the amount of outside money beyond banking system and expanded their balance sheet at unprecedented levels, affecting asset prices and distribution of wealth in the economy. The central banks increased their political power and endangered their independence.

An intermediating balance sheet does not necessarily lead to banking, that is creation of money out of credit. Mutual Funds issue only equity share and do not constitute inside money; lending can take place without financial intermediation if lenders and borrowers establish direct-credit relationships. Without intermediating balance sheet, pooling and risk diversification require both borrowers and lenders to enter into a large number of relationship. In the digital age, credit contracts can be issued with very small denominations. Disintermediation doesn't require households to become financial expert: Financial institutions will offer financial advice. Peer-to-peer lending platform can split the saving of the household into tiny amounts and lend it across a large number of borrowers. At the same time, small businesses and individual can pool funds from thousands of lenders. It implies that the lending platforms have to efficiently collect the data on individual borrower and use statistical methods to calculate credit ratings; They have to act as delegated monitor of the borrowers; third parties and lenders will be in position to assess monitoring standards. Through social networks this is a reality in other sectors (restaurant, hotel, car rentals, etc.). Contractual liquidity for the lenders can be substituted by market liquidity as for corporate bonds. Transparency of credit scoring result and other price relevant informations reduces information asymmetry on secondary credit markets. To prevent insider trading peer-to-peer platforms can impose position limit on one single borrower and inhibit lenders from selling specific loans but only allowing placement of orders for loans with a certain credit risk and maturity profile. Everyone all over the world can participate in the same marketplace at negligible costs (see market for Exchange Trading Funds). Information technology has brought to another form of payments services, digital currency, a virtual outside money. Invest money according to own investment needs can be done automatically with trading algorithms.

The proposal of “narrow banking” doesn't allow banks to lend deposited money. It splits the business of lending from that of safekeeping. The idea of “limited purpose banking” regulates al financial institution as a mutual fund, fully funded with equity. The Authority monopolizes monitoring of every borrower. But these proposals are ideas of the industrial age. Banking is not confined to certain set of institutions, it origins from a double-entry bookkeeping. Ending bank should start at this fundamental level. We need an accounting rule, a solvency rule for all the companies that prevent a company to fund financial assets with someone else's credit, that doesn't permit a financial institution to undertake excessive risks and solve the boundary

problem: ”The value of the real assets of a company has to be greater than or equal to the value of the company’s liabilities in the worst financial state” (the worst financial state is that in which all the financial events that are relevant for determining the nominal obligation arising from a contingent financial contracts turn out in the most detrimental value of the company’s equity). The rule doesn’t affect nonfinancial companies, prevents daisy chains of balance sheets and the systemic risk, but allows to support decentralized and capital-intensive economy in the digital age. Peer-to peer lending, mutual funding are not restricted. The rule allows flexibility within clear-cut boundaries, cancels a lot of existing costly regulation and dissolves regulatory agencies. A financial system without banking would no longer have Government guarantees of the liabilities of the banks and feature banking panics; rationale for banking regulation would fall away. Government would assume a new role for monetary policy and in the organization of credit. The new financial system separate the function of money and credit and sets clear boundaries between the public and the private spheres. In the digital age there is no room for physical money and central banking will have no sense in providing price stability. Inflation incentives people to spend and invest money. A liquidity fee will have a similar effect without uncertainty and high costs of inflation. A simple and effective way to inject money is an unconditional income transferred to all the citizens: everyone receives the same amount. It is not a basic income because it is too low to enable a standard living but it is immediately and broadly into effect without distorting prices. It is egalitarian and not a political tool. The solvency rule prevents systemic effect emanating from Government and private defaults. Credit no longer need a special treatment, it belongs to private sphere and becomes an industry just like any other industry.

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