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What we've forgotten

On Oct. 14, the editor of *Grant's* addressed the Fixed-Income Management Conference, sponsored by the CFA Institute, in Boston. Following is an amended transcript of his remarks:

"Fixed income" are the words in the conference agenda, but "no income" might be more descriptive. Does anyone even bother to read the weekly report on certificate-of-deposit yields in Wednesday's *Wall Street Journal*? This week's installment reported that the national average of yields on money-market accounts at major U.S. banks stood, or rather crouched, slouched or crawled, at 14 basis points, the 12-month rate at 34 basis points. When compounded annually, money invested at 34 basis points doubles in 204 years, money invested at 14 basis points in 496 years—before tax. You've got to be patient.

My talk comes in three parts—past, present and future. By way of illuminating our present-day monetary and banking difficulties, I want to tell you how the banks of New England and New Orleans managed to remain solvent and profitable before the coming of the Federal Reserve and federal deposit insurance. In the telling, I hope to inspire you.

Next, I will put in a bullish word for so-called leveraged loans, a kind of debt obligation that delivers some modicum of income and some element of safety. Many an investor these days needs income, but the *federales*, not content with miniaturizing the Treasury yield curve, have also—via Operation Twist—undertaken to flatten it. The mortgage real estate investment trusts, those once-reliable yield machines, are going to have a hard time generating income. Tradable bank debt is one of the least bad income-producing options, we think. Also on the subject of present-day finance, I will simply observe that the People's Republic of China is larger than the economies of Greece and Portugal combined. Our preoccupation with the drama of the euro is understandable, but it too easily distracts us from the clear and present danger of China.

Finally, I'll venture some guesses about the future of interest rates. In fact, I'll do that right now. They're going up. If this forecast happens to pay off, you should ascribe it to persistence rather than genius. I've been saying "up" for many a profitless moon.

I ask your patience as I begin to tell you about the Suffolk Bank of Boston, circa 1818, and the New Orleans banking community, circa 1842. We investors live in the present and try to imagine the future, but we'd be wiser and richer if we had a better grounding in the past. In science, progress is cumulative; we stand on the shoulders of giants. In finance, however, progress is cyclical; we take one step forward, another back. Some of the best ideas about money and banking are the ones we've forgotten. I mean to revive them.

The more I read about the "Volcker Rule" and the rest of the Dodd-Frank legislative tsunami, the more I'm drawn to the monetary and regulatory systems of long ago. And may I here enter an emphatic anticipatory denial? Much as I would like to see the Dodgers return to Brooklyn, or the original Count Basie band to Birdland, these things are impossible. What is not impossible is to imagine a constructive alternative to our not wholly successful 21st century monetary and banking institutions. I am not talking about nostalgia. I am talking about progress.

Under the alternative I favor (and one that long and successfully existed), the dollar was defined as a weight of gold. Stockholders and directors bore personal financial responsibility for the banks they owned and managed. The states chartered banks, and the banks issued their own paper money, which was redeemable in gold. There was no national currency. With the exception of the Bank of the United States, a forerunner to the Federal Reserve, the U.S. government stayed mainly in the banking shadows.

No need to dwell for long on the contrast with the arrangements in place today. The paper dollar is, of course, unredeemable in anything except small change—this despite a quarter century of agitation by *Grant's* to restore the classical gold standard. You'd think they'd listen. Interest rates are under the governmental thumb. Credit risk is heavily socialized. The mortgage market has become a federal protectorate.

There's no better window on the way we live now than the Volcker Rule, which would restrict the freedom of big banks to trade securities and invest in hedge funds. Just this week, the FDIC circulated a document seeking comment on the proposed rule. It ran on for 298 pages and posed 383 questions to interested members of the public. The original idea had occupied just 11 pages.

The great American who conceived the not-great Volcker Rule once quipped that the only substantive advance in financial technique in the past 50 years was the automatic teller machine. In fact, the more you know about the canons of money and banking in the gold-standard era, the more you're inclined to wonder if we haven't actually gone backward.

Leveraged financial institutions are inherently fragile. It was true in the 19th century; it is true today in the 21st. What distinguishes one epoch from another is society's approach to mitigating the risk. In our day, the government has largely assumed the job. In the time of the Suffolk Bank—and, indeed, for many decades thereafter—it was largely, although not entirely, the bankers' lookout.

Grant's makes its offices at the corner of Broadway and Wall Street in lower Manhattan. We are therefore, as they say, "occupied." The protesters, many of them, are so young and earnest that nobody has the heart to tell them that Wall Street—the financial place—moved uptown or to Greenwich, Conn., about 40 years ago. But the occupying forces are not without grounds for complaint. Very largely, under the heavily regulated and subsidized system in place, the bankers get the upside while we, the people, bear the cost of the downside.

It was different with the Suffolk Bank—and, in fact, with most American banks right up until the 1930s. To the stockholders went the upside—and, justly, to the stockholders went the downside. If the bank in which they invested went broke, they got a capital call, the proceeds being earmarked for the depositors, among other senior creditors. As for the directors, the Commonwealth of Massachusetts held their feet, too, to the fire. The Suffolk's charter restricted loans to twice the sum of the paid-in capital. For losses on loans above that limit, the state held the directors personally liable.

The essential and defining change in bank regulatory policy over the past several generations has been the substitution of collective responsibility for individual responsibility. Not since 1935 have the stockholders of an insolvent national bank had to worry about the sheriff dropping by to demand their compliance with a court-ordered capital call. You bank-stock investors in the audience may cheer the removal of this sword of Damocles. You may also celebrate the advent of federal deposit insurance, too-big-to-fail, the Greenspan put, the Bernanke put, QE, the TARP and the whole array of government initiatives that postpone cyclical days of reckoning. But nothing's for free. Only witness—just try to pick up and carry across the room—the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Look no further for a quintessential legislative expression of the doctrine of statism in money and banking. Here it is in 2,323 pages. As President Obama signed it into law in July 2010, the law firm of Davis, Polk & Wardwell reckoned that 67 new studies would be necessary before the 11 relevant federal agencies could draft the requisite 243 new rules. Of course, the rule makers are still at it.

The polar opposite of Dodd-Frank is the Louisiana Banking Act of Feb. 5, 1842. Like Dodd-Frank, the Louisiana law was passed in the politically and financially charged aftermath of a financial panic. Unlike Dodd-Frank, the Louisiana law was concise, unambiguous and devoid of legalisms. Though it forced the state's bankers into narrowly prescribed channels of business conduct, it allowed freedom of action within those boundaries. Bray Hammond, author of "Banks and Politics in America: From the Revolution to the Civil War," summarizes the law's intent this way: "The Louisiana act rested the value of money on gold and its volume on the volume of consumable products moving through the markets; it sought to make the value of money independent of the state or of political action."

What did the law say? Most importantly, it delineated two basic types of assets. The quick kind, it called "the movement," the slow kind, the "dead weight."

"The movement" meant business movement. The ultimate in movement-type assets were 90-day commercial bills that paid off when a consignment of merchandise, against which the loans were secured, changed hands. The natural flow of commerce turned them into money. Like "the movement," the phrase "dead weight" is wonderfully descriptive. A mortgage, for instance, may pay off, but it doesn't turn itself into money. It may be sold, but only if there's a buyer (easy to find in good times, next to impossible in a panic). It is marketable, but not, by its nature, liquid.

Under the Louisiana law, a bank could invest its own capital in dead-weight assets, including mortgages and long-dated commercial loans. Its depositors' funds, however, being liquid, had to be placed in gold and silver (at least one-third) and self-liquidating commercial loans and discounts (the remaining two-thirds).

And again to quote Hammond, "If any borrower or other obligor failed to pay a short-term obligation at its maturity, his account would be closed and the other banks in the city would be informed of what had happened." State examiners saw weekly statements of condition and stockholders a monthly one. On the available evidence, according to Hammond, the Louisiana system operated with "distinguished success" until the Civil War.

The story of the Suffolk Bank of Boston is another variation on the theme of self-governance under the gold standard. I mentioned that, in this period of America's financial history, there was no national currency. Banks issued their own. The notes of strong banks traded at par, those of weaker banks at a discount. Sound and otherwise, the paper emissions of the innumerable country banks of greater New England (as Red Sox Nation was then known) accumulated in Boston. To redeem them for gold at the counter of an issuing bank in the backwoods of Maine was no welcome prospect for a Boston creditor. In these circumstances, the Suffolk perceived an opportunity. It built a profitable business in making markets in country bank notes. And in building this business, the directors of the bank enunciated a principle. Said they, "the right to demand [gold and silver] of a bank for its promise to pay cannot be given up without destroying the efficacy of the system."

Let nobody think that our forebears were anything more than flesh and blood. Some of them chafed, as some of us would surely chafe, under the discipline of a convertible currency. How much sweeter it would be, a certain number of New England bankers sighed, if there were no golden constraint on the growth in their lending. The Suffolk Bank was the sometimes scolding voice of conscience and sound practice for almost 50 years. In 1842, the record shows an officer of the Suffolk writing to correct a Vermont correspondent. It seems that the Bank

of Woodstock was getting out over its skis on other than short-dated, self-liquidating commercial loans. Probably, the Suffolk officer chided his country cousin, you are anticipating a prosperous harvest, or banking your hopes on "the wisdom of our country collected in Washington." Better, urged the Boston big brother, that you put your faith in gold and silver and/or "good mercantile paper." The banking orthodoxy of Boston and New Orleans was identical in the all-important fundamentals. Only the most liquid assets were suitable to support deposit (or bank note) liabilities.

The Suffolk Bank—and the Suffolk system—did yeoman's service in regulating New England's banking and monetary affairs—and on a voluntary, laissez-faire basis, mind you. I commend it as a topic for study by Elizabeth Warren and Barney Frank, whom Boston has so generously contributed as their loudest civic voices in the national debate on money and credit. Give me, rather, Nathan "Bullionite" Appleton, an original Suffolk director who wrote thousands of words in the 1830s and 1840s extolling the virtues of a sound currency. By "sound," he meant money circulating at par and redeemable in gold on demand. Anything else, as he was successfully able to demonstrate, was "merely a broken promise."

Compared to the illiquid, subsidized, undercapitalized and crisis-prone banks of the 21st century, the institutions of 19th century New Orleans and Boston seem as if they were the products of an advanced civilization. Still more do they shine in comparison with the scarily chaotic credit arrangements in place (either formally or informally) today in the People's Republic of China.

I heard it said this morning that the tone of the conference was unrelievedly pessimistic. Count me an optimist. Some assets are overvalued, others are undervalued. At either extreme, there are opportunities for thoughtful investors. Some banking and monetary systems are trustworthy and elegant, others not. If the latter, there are opportunities for thoughtful citizens to effect improvements.

My words to you in conclusion are simple and heartfelt: Let us go forth and make money—sound money, preferably.

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