

Banks, the Law, and Money – the root of all evil

Don Beal argues for urgent reform

To be exact, the quote is “The love of money is a root of all kinds of evil” (1 *Timothy* 6:10). Is this still true 2000 years later? Who loves money? Well, banks do. They have to love money because it’s what they do. Does that result in evil? In this article we look at some of the consequences of modern banking systems, how they came into being, and the structural change needed that only a change in law can bring about.

The Bank Charter Act 1844

Until 1844, every bank was free to create and issue its own banknotes. They loved to do this, and they issued far more banknotes (which were promises that the bank would replace them with gold (real money) upon request) than they had gold in their vaults. Why did they do this? Because they issued banknotes to borrowers who agreed to replay later **plus interest**. There was noticeable inflation in prices, many crises, bank insolvencies, and ruined depositors, due to depositors and holders of banknotes asking for gold simultaneously, when a bank was suspected of not having the gold to back all its banknotes. So the government passed the Bank Charter Act. After that only the Bank of England could issue new banknotes. Moreover, the Bank of England had to have 100% gold to back its banknotes.

Evils averted?

Not so fast. There was an exception to the new system of 100% backing by gold. “Demand deposits” were exempted. What is a demand deposit? “A very small part of the banking system, and not really money, but a form of credit that is not part of the money supply” – **according to the “British Currency School” at the time**. Oh Dear. This new form of credit – free from the restriction of 100% gold backing - became immediately popular. Today “demand deposits” are called “bank accounts”. Banks could create and issue “credit” instead of banknotes, not backed by anything. They loved it. There followed crises in 1847, 1857, 1866. Each time parliament suspended the 100% gold backing requirement for the Bank of England so that it could issue new banknotes to bail out the banks and prevent a wider banking collapse. Despite this backtracking, there was nevertheless a substantial fraction of money backed by gold. Until 1914, the new monetary regime served to approximately stabilise the monetary system, not only in the UK, but internationally.

International banking

As 1914 approached, banking was international, but dominated by the London banks. In the USA, the Federal Reserve Central Bank was created at the end of 1913 – despite its name, it is a private bank owned collectively by the largest US private banks.

In 1914, the war panic caused a freeze in international banking transactions. Again the UK parliament intervened, and this time the Treasury issued lower-denomination banknotes instead of coins, and the Bank of England paid merchant banks the money owed from companies abroad. (The bank of England eventually was paid back from overseas companies.) Effectively, the gold backing was suspended. It was restored by the Gold Standard Act of 1925 by Winston Churchill. Unfortunately that was a disaster. The pound was fixed at its pre-war value. The war had caused international trade to change and the pound was no longer worth as much internationally. The UK finally abandoned the gold standard in 1931 after losing most of its gold.

Later, partial gold standards for international transactions were established, lasting until 1971, but there was effectively no gold backing for UK money within the UK.

The fractional reserve system

However, what was called the “fractional reserve” system for UK bank accounts was established. Banks were required to keep 10% of deposits in vaults so that depositors who asked for their money back could

get it immediately. At first this meant depositors could get bank notes, but over time, this merely meant that they could transfer the money to another bank.

Note that the act of lending 90% of a deposit is effectively creating money. The original depositor believes they still own the full amount. The new borrower (with the new credit/money in their bank account) believes they now own the additional 90% to spend as they wish. The borrower has an obligation to repay but until that time, the borrower has new money to spend. The amount of money has just increased from 100 to 190.

The 90% is issued as a loan from the bank into a bank account. Because it is credit it does not actually come from any existing money. But it behaves as money from that point on, until the loan is repaid, when the credit is cancelled, and that money disappears.

The lure of issuing money that they didn't have, and the benefit to banks of the **interest** on the loan that they could **keep**, meant that banks sought to lend as much as possible. Bank owners loved this system. Effectively it meant that most of the money in existence was temporary, in the form of loan money sitting in bank accounts, and a steady stream of interest was fed into the banking system to enrich the bank owners (shareholders).

There are two consequences to this. **(1) the rest of the economy has to feed the banking system with resources that could have been used elsewhere (2) the amount of money has to increase for ever, because the interest can only come from further loans taken out by someone somewhere.**

Are these evils? I think the first answer depends on whether one owns bank shares (directly or indirectly). As for the second consequence, sooner or later the amount of money in existence exceeds the ability of borrowers to repay – and we suffer from financial crises and bank collapses.

Moreover, the 10% fraction only applied to individual banks. A loan made into a bank account would typically be spent by the borrower and paid into another bank. This second bank would regard this as a deposit, and could lend 90% of that. And so on. If one does the maths, it turns out that for the banking system *as a whole* the fraction of bank account money held as reserves is merely 1%, not 10%

Deregulation by Thatcher in 1986

The Restrictive Trade Practices Act of 1956 had been used by banks to challenge the wise London Stock Exchange rules separating brokers acting as agents for clients buying or selling stocks and shares, and “jobbers” who traded in stocks and shares. Another rule prevented brokers and jobbers being part of larger banking companies. Thatcher agreed with the challenge and settled with the LSE that these rules, and others, should go. The banks loved it. Among other things the combined banking entities could now use depositors money to trade on the financial markets. This greatly increased risks of financial loss, and led to the later term “casino banking”.

Fast forward to 2007-8

By then bank accounts were 97% of the money in existence. The fractional reserve system had failed to curb bank lending. Banks in the USA had been lending heavily to house mortgage borrowers who could not repay. Why, you might ask!? It was due to financial “engineering” devised in the wake of deregulation in the 1980s. Previously mortgage loans were made by the banks that collected the payments over the lifetime of the mortgage. Managers stood to lose their jobs if the loans they authorised went into default.

Now, large numbers of mortgage loans were collected and assembled into “securitised collateralised obligations”. These new financial instruments were then sold to banks and investment houses that had played no part in making the original loan. This meant that the banks making the loans were not the banks that collected the income over time. Banks loved it, because house prices rose during the process of more and more lending, but it was unsustainable. The standards for making loans grew lower and lower, while still being sold on as if they were sound investments.

Was it evil to lend other people's (investors) money to people unable to repay? Some people think so. Certainly the lenders were breaking the laws of the time.

By 2007 USA mortgage defaults were rampant and houses were being repossessed at ever lower prices. There was recognition that the packaged mortgages were not sound investments, and that financial companies were facing huge losses. By now the financial world had become highly interconnected. When Lehman brothers crashed, the USA's other major banks would have collapsed too, if the US government had not used taxpayer money to prevent a cascade of defaults from each bank through to the next.

Despite the US government bailouts, there was a global financial crisis. Banks in other countries also needed bailouts from their governments. In the UK Northern Rock failed – they had been making long-term loans (mortgages) at low interest rates, funding them with *short-term* borrowing from international banks that repeatedly had to be repaid and re-borrowed. Interest rates for international borrowing went up, and now they could no longer borrow at rates that matched their loans – they became insolvent. Nor could Northern Rock sell their securitised mortgage packages – the market now had no appetite for them. Bradford&Bingley, RBS, and HBOS also required Government bailouts or intervention.

Fast forward to 2018

Little that is fundamental has changed. The main change is that banks are now advised to hold more capital under the (voluntary!) Basel III regulations to protect against the pattern of the previous crisis. But banks that were “too big to be allowed to fail” are now bigger (due to mergers of the weakest banks into larger ones), and there is no genuinely effective limit on the amount of money they create. Banking is international. The money supply continues to expand and the amount of debt of governments, businesses and individuals, continues to grow at the same rate. It is clear that many debts are unpayable (just ask Yanis Varoufakis of Greece) – but it is not known exactly where and when the next wave of defaults will occur. The UK total debt (government plus businesses plus households) is now 5 times (500%) UK GDP (Source: McKinsey Global Institute).

*The system is **unsustainable** – what changes in law and by government are needed?*

The key issue is money creation. Underneath all of the financial system, underneath the banks, underneath the regulations, underneath the different forms of money, underneath central banks, money itself and the relentless growth in the amount of money drives banking behaviour.

Money creation *can* be controlled. We have to understand the issue and get politicians to understand the issue. The organisation Positive Money (positivemoney.org) has proposed to entirely remove the right to create money from banks – essentially closing the loophole in the 1844 Act – and hand money **creation** to an independent committee at the Bank of England. Then the new money can be limited to the growth in GDP, and be spent by government instead of the favoured borrowers of the banks. This particular proposal is too radical to be feasible, but is good for raising awareness of the problem.

I prefer a more gradual change, based on changing the taxation regime for banks so that banks pay tax in proportion to the amount of money they create, combined with government issue of sovereign money to ensure any reduction in bank lending does not shrink the money supply.

Government should ensure citizens have access to bank accounts which protect their right to **own** their deposits. Ever since *Foley v Hill 1848*, banks own the money that depositors place with them, and in the event of bank insolvency and liquidation, the depositors come in the last category of creditors for any resolution payments. Moreover, they are now vulnerable to “Bail-Ins” which could be worse.

It is also vital to enforce existing laws. Banks have paid fines for ~~fraud~~ mis-selling of insurance, the libor scandal, and other law-breaking, but the fines are often less than the bank's profit from the illegal activity. If public prosecutors won't prosecute bank executives, is there a role for private prosecutions?

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