SUBMISSION TO
THE INDEPENDENT COMMISSION ON BANKING

RESPONSE TO THE INTERIM REPORT

Ben Dyson, Tony Greenham, Josh Ryan-Collins and Richard A Werner

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Positive Money

Ben Dyson

nef (the new economics foundation)

Tony Greenham & Josh Ryan-Collins

University of Southampton, School of Management

Centre for Banking, Finance and Sustainable Development

Professor Richard A. Werner

1 Introduction

This submission is in response to the ICB Interim Report dated 14 April 2011 ("Interim Report: Consultation on Reform Options"). It follows our submission dated 15 November 2010 ("Towards a Twenty-First Century Banking and Monetary System").

Section 2 argues that, based on the contents of the Interim Report, the Commission has not given sufficient weight to the importance of the credit creation process to financial and economic stability.

The key points are that the existing system has the following features:

- the quantity and quality of money supply is determined by the aggregate of banks' credit decisions, which are driven by confidence, short-term liquidity requirements, and often perverse financial incentives;
- it is therefore naturally pro-cyclical;
- new money will tend to be over-allocated to non-GDP transactions, leading to asset price inflation, followed by a credit contraction which prompts recession, and;
- this inherent instability in the money supply leads to greater general macro-economic instability than need be the case.

The Interim Report did not contain a full analysis of the credit creation process, or its implications, and so we call for the Final Report to contain this analysis in order to ensure a comprehensive and complete assessment of drivers of, and potential solutions for, financial instability. As such it may be seen as a response to the following questions:

Q2.2 We consider the analytical framework to be flawed.
Q3.1 We believe that reforms to the credit creation process should be properly examined.

Section 3 addresses factual inaccuracies in the description of Full-Reserve Banking included in the ICB Interim Report, and identifies invalid conclusions drawn about the potential impact of the proposal. As such it may be seen not as a response to questions raised in the Interim Report, but as seeking correction of serious shortcomings in the text of the Interim Report.

The key findings are:

- paragraph 4.119 is factually incorrect. Full-reserve banks do not have to retain sufficient funds in cash to cover all of their depositor liabilities;

- paragraph 4.120 draws an invalid conclusion. Full-reserve banking need not curtail lending nor prevent intermediation. It also makes a false statement – the shrinkage of credit has not been advanced as the reason for, or even an advantage of, adopting full-reserve banking, and;
- paragraph 4.121 misses the point. Full-reserve banking would make deposit insurance entirely unnecessary. However while this market distorting and taxpayer funded subsidy exists, it is unlikely that full-reserve banking, which would enjoy no such subsidy, could compete commercially with fractional reserve banks.

In conclusion, we call once more for a thorough and intellectually robust analysis of the credit creation process, and its implications for financial stability, to be included in the Final Report. If this is considered beyond the scope of the Commission, then we instead call for it to include among its final recommendations that such an analysis is carried out by the Government either directly or at arms-length without delay.

2 The Importance of the Credit Creation Process

The Interim Report (Section 4.7) describes five ways in which banks are different from most businesses. However, it neglects to mention the most significant difference between banks and all other businesses, which is that banks create virtually all the money, as credit, that all other businesses need in order to transact and invest.

We believe that the Commission's work completely neglects the fundamental fact that the quantity and quality of the money supply are currently determined by the confidence of banks (and senior bankers). The change in money supply is the aggregate result of many individual lending decisions. There is no compelling reason in theory, or evidence in practice, that the aggregation of these decisions should lead to favourable macroeconomic outcomes such as consumer price stability, asset price stability, or expansion (or at the very least stability) in employment and output. Indeed, there are compelling reasons in theory and in evidence to suppose that the current credit creation process is not only pro-cyclical but likely to drive credit bubbles, asset booms, under-investment in productive capital and to trigger recessions, apart from being likely more inflationary than is necessary.

For these reasons we believe that an investigation into financial stability cannot be considered complete without a thorough consideration of the credit creation process, and of proposals to improve this process.

2.1 How the Money Supply is Determined

Every loan that banks make increases the money supply in the hands of the public. When loans are repaid, the money supply contracts. Consequently, the money supply of the nation depends on the lending activity of the banks, which in turn depends on their confidence and willingness to lend.

Given that the Commission's remit is to make recommendations that would promote financial stability, perhaps it may be relevant to note that decisions over the money supply are currently taken by bank loan officers, who make decisions whether to lend to a borrower or not. These loan officers:

- have no understanding that their decisions to lend will increase the money supply of the nation and will therefore have a wider impact on the economy;
- are motivated by bonuses, commissions and the opportunity of promotion to lend as much as possible, within the confines of perceived levels of risk;
- have no incentives to favour allocating new money to transactions contributing to GDP (especially of the productive type, using money for investment or productivity enhancement) rather than speculative (non-GDP) transactions;
- have no feedback mechanisms to show them that the money supply is growing too quickly and that they should restrain lending. Conversely, in a recession all the opposite applies. There is considerable pressure on loan officers not to make certain types of loans, starving viable new projects investment capital and withdrawing working capital from profitable businesses to satisfy short-term balance sheet considerations at the expense of long-term macro-economic benefit.

It is unlikely that we could ever achieve economic or financial stability when we have delegated control of the money supply to people who are unaware of the impact of their actions, have asymmetric incentives and no mechanism to receive and act upon feedback from the wider economy.

2.2 The Impact of Credit Creation on the Crisis

Prior to the crisis, banks expanded the money supply by £497 billion between 2005 and 2007 alone[1]. Much of this newly-created money went into speculative mortgage lending, fuelling the house price bubble. The promise of house prices rising at 10% or more every year fuelled a self-fulfilling prophecy, with some entering the housing market to get rich, and others entering in fear of being permanently priced out of the market if they waited any longer. This rush to borrow was a positive feedback loop - the more banks lent, the faster house prices would rise, and the more house prices rose, the more people would want (and need) to borrow to buy houses. An equally destructive cycle was observed in the commercial property market, with lending to this sector exceeding lending to all productive sectors (including manufacturing, distribution, retail, telecoms, and construction) by 2007[2].

Had the money supply been stable - as it would be under a full-reserve system - property and other asset bubbles would have been much less severe as banks would have been constrained by the real level of savings before they could lend.

The credit crunch was also economically harmful. However, the reality is that our dependence on bank lending is artificially inflated by the fact that banks have a monopoly on supply of money to the public and real economy. If they do not lend, and if the public continues to service their existing debts, then the money supply of the economy will shrink, triggering a recession. In a full-reserve banking system where the money supply does not depend on bank lending, a 'credit crunch' will have an impact on businesses that are starting up or expanding, but should not affect the wider economy, as there would still be a persistent and stable money supply, regardless of bank lending behaviour.

2.3 How Do Banks Use the Credit they Create?

The ICB's Interim Report suggests that:

> *"2.8 ...[Banks] use funds that are deposited with them to provide loans to businesses to allow them to undertake productive economic activities, and also to consumers."*
>
> **This is not a useful description of reality.**

First, banks do not have to wait for funds to be deposited before making a loan. The making of a loan creates a new bank deposit. Second, banks frequently provide loans to business to allow them to undertake unproductive economic activities. This is an important observation. The last two decades of actual banking activity in the UK tells us that banks tend to prefer creating credit for either short term speculative returns (financial market trading) or longer term non-productive credit creation (mortgages and commercial property). As Lord Turner describes in the Future of Finance report, almost half of bank lending to businesses goes into commercial property. Only a small percentage of their total lending actually goes to increasing the productive capacity of the economy. This description in paragraph 2.8 of what banks do is simplistic to the point of being critically inaccurate.

2.4 Bank Credit is Money in any Meaningful Sense of the Word

It is argued by some that bank credit is not, in fact, money and is no different in status to credit granted by non-bank institutions or even by individuals. This completely ignores the fact that bank credit is special because it is fully underwritten by the state and universally accepted as payment including by the state in settlement of taxes.

While the credit of one individual or business has credit risk attached to it (as they may not repay), the credit that banks extend is effectively made as good and as safe as physical cash by the fact that government guarantees to reimburse the customers of any banks that are unable to pay out. Consequently, £10,000 of bank credit is as much money as £10,000 of paper notes printed by the Bank of England.

It is not clear from the Interim Report that this is properly understood by the authors, but neither is there any clear statement of an opposing argument: that bank credit does not fulfil the functions of money in the economy.

We strongly urge the ICB to address this gap in its analysis in the final report, and give a comprehensive account of the existing process of money creation and the implications of this system for financial and economic stability.

3 Addressing Inaccuracies in the Description of Full-Reserve Banking in the Interim Report

We suggest that instead of private banks making the key macroeconomic decisions about the quantity of money in the economy by default, this decision could be taken by an independent group of policy makers, in much the same way as the MPC decides upon changes to interest rates. This is, perhaps, a role that could be taken on by the new Financial Policy Committee, which was set up to take a 'macro-prudential' (ie, broad) overview of the economy as part of the Bank of England.

The creation of money would be separated from its allocation, instead of the current system where both are combined in the hands of private banks. Banks would continue to recycle savings into investment and provide the payment system. However, they would not play the role of creating new money via their lending, and therefore the money supply of the nation would not depend on their pro-cyclical lending behaviour.

This is described in detail in our original submission to the Commission.

We consider the description of full-reserve banking given in the Interim report is both factually inaccurate, and incorrect in its analysis of the implications of the proposal.

We address these inaccuracies and misapprehensions below:

> *"4.119 Full reserve banking goes further than narrow banking, requiring banks to retain sufficient funds in cash to cover all of their depositor liabilities."*
>
> **This statement is factually inaccurate.**

First, full-reserve banking does not require banks to retain **cash** to meet depositor liabilities, as stated here. It simply requires banks to hold electronic central bank reserves in custody on behalf of those customers who wish for their money to be available on demand. These central bank reserves would be held off the balance sheet, in custody, on behalf of depositors, and would therefore not constitute liabilities or appear on the balance sheet of the bank at all.

Secondly, this requirement does not apply to **all** depositor liabilities, as stated above. The requirement only applies to demand deposits - money that customers can withdraw without a notice period (approximating roughly to current accounts and no-notice savings accounts). There would be no requirement for banks to retain any funds to cover time deposit liabilities. (These time deposit liabilities are described as 'Investment Accounts' in our initial submission). Deposits in notice accounts would be available for lending to business and personal customers. In practice a fraction of these might be retained in liquid assets or cash, but as withdrawals would require notice of at least 30 days the bank has ample time to manage its liquidity requirements.

As a result, full-reserve banking draws a clear distinction between the payments system and the lending business of a bank. The payment system would consist of custodial instant-access accounts, backed up fully by central bank reserves. The lending business would involve banks actually intermediating existing money between savers and borrowers, rather than simply extending credit on the back of a small pool of real liquidity.

Sir Mervyn King has spoken at length about the need to separate the payment system and the lending business, and we believe the full-reserve banking proposal achieves this objective better than any proposals yet put forward by the Commission.

"4.120 Like narrow banking, a complete move from fractional to full reserve banking would drastically curtail the lending capacity of the UK banking system, reducing the amount of credit available to households and businesses and destroying intermediation synergies."

This conclusion does not follow logically from the facts.

This appears to be a statement of opinion and if any economic modeling has been undertaken to justify this statement we would be interested in testing it. We would also appreciate clarification on precisely what kind of percentage reduction should be understood from the word `drastic`.

Our own calculations imply that a switch to full-reserve banking only constrains bank lending to the extent that banks must bid for funds from depositors (or from the wholesale market) before they can actually lend, rather than simply extending credit and relying on inter-bank lending markets to replace the funds once the bank`s borrowers make payments . This would mean that lending would be correlated with saving, as economic models often assume is the case, rather than simply being dependent on whether a bank is confident both of chances of repayment ***and*** of being able to borrow funds on the inter-bank market .

"...To its proponents, this shrinkage of credit is a benefit, as it removes the current ability of banks to 'create money', a prerogative they consider should be reserved for the state."

This is a misrepresentation of the case for full-reserve banking, and does not follow logically from the proposal.

The removal of banks' ability to create money by extending credit is not a result of 'shrinkage of credit'. Neither is the reverse true. Removing the privilege of money creation from banks does not necessarily entail shrinkage of lending or total credit creation. The change in money supply would be determined by the Bank of England, which would have regard to the desired nominal GDP growth rate and the level of savings and lending in arriving at its judgments of how much to expand the money supply.

The key benefit of the proposal is not 'shrinkage of credit' but achieving financial and macro-economic stability by allowing better control of the quantity of money. Indeed, this would be more likely to prevent the drastic shrinkage of credit that actually did occur under the existing system during the financial crisis and which is still acting as a drag on recovery in investment, output and employment.

> *"4.121 Some have argued that full reserve banking should be mandated as an option for all deposits, so that depositors could choose whether or not their money was lent on. It is important to find safe deposit options and having these options might help to reduce the need for a government guarantee applicable to all deposits."*
>
> **Not "might" but "would". Furthermore, full-reserve banking completely removes the need for a government guarantee on any deposits.**

Customers are provided with a means of holding money and accessing the payments system that is fully risk-free.

> *"However, safer deposit options than bank deposits do already exist (such as National Savings & Investments or safety deposit boxes), although these do not offer the same transactional capabilities as a current account."*
>
> **That these do not offer the same transactional capabilities as a current account is precisely the point.**

The fact that these investment products do not offer any access to payment services is why there is a need for \`full reserve\` custodial accounts with transaction services.

> *"There is no prohibition on the establishment of a full reserve bank (or a narrow bank) which could provide such capabilities, though it would likely have to charge for them."*

Any bank that chose to operate on a full-reserve model now is immediately disadvantaged by the fact that the taxpayer-funded government guarantee on the first £85,000 in a person\`s account allows fractional-reserve banks to take risks with customers\` money whilst passing the entire risk onto taxpayers and simultaneously promising customers a risk-free financial return. Therefore it is difficult to have a genuine market-driven alternative to fractional-reserve banking whilst the UK government and the Commission sanctions and supports a banking sector structure that requires underwriting with taxpayer funds.
There may be no prohibition in law on the establishment of a full-reserve bank, but deposit insurance is an effective taxpayer funded subsidy that acts as a material market distortion. This places a significant commercial rather than legal barrier to introduction of the model

alongside the existing one. Furthermore, full-reserve banking is an alternative system that requires the return of the public privilege to create the money supply from the commercial banks to the government (or its agent, the central bank). Establishing individual full-reserve banks while leaving the privilege in the hands of the banking sector neither makes sense (as these banks will be disadvantaged) nor achieves any of the goals of the proposal.

> *"In light of deposit insurance, mandating that all depositors have such an option appears unnecessary."*

The point is rather that full-reserve banking makes deposit insurance unnecessary, rather than the other way round. The advantage of full-reserve banking is that deposit insurance, and all state-support for the UK banking sector, can be withdrawn. It is difficult to see why the Commission believes that the banking sector should benefit from taxpayer support that no other industry receives.

4 Conclusion

It appears that the Commission has given up on the hope of building a safe banking system, and instead chosen to focus on how to handle the post-crisis 'clean up'. We believe that it would be better to focus on treating the cause of the problem rather than merely addressing the symptoms, and we call once more for a thorough and intellectually robust analysis of the credit creation process, and its implications for financial stability, to be included in the Final Report. If this is considered beyond the scope of the Commission, then we instead call for it to include among its final recommendations that such an analysis is carried out by the Government either directly or at arms-length without delay.

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[1] Change in M4 deposits, Source: Bank of England.

[2] Simms A and Greenham T (2010) *Where did our money go?* (London: nef)