The Cobden Centre

For honest money and social progress

PUBLIC ATTITUDES TO BANKING

A student consultancy project by ESCP Europe for The Cobden Centre*
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The main objective of this report is to provide new evidence that helps to assess the strength of the current UK banking system. We have two main findings:

1. **The general population is highly uninformed about the banking system**, misunderstanding the legal status of their deposits and unaware of what banks do with them. According to our survey:
    - 74% of people think that they are the legal owner of the money in their current account, as opposed to the bank
    - 66% of respondents answered “don’t know” when asked what proportion of their current account was used in various ways by their bank
    - Only 33% of the general public favour the existing policy of government backed deposits and a lender of last resort

2. **UK high street banks are virtually insolvent** according to the common use of the term; their legal privilege allows them to continue to trade.
    - By leveraging an average of 34 times its reserves, banks are behaving in a way that would not be considered legal in any other business
    - A healthy solvency ratio is typically seen as about 20%. Of the 6 high street banks that we analysed the average is just 0.18%
    - Although these banks have a positive asset/liability ratio, 20-40% of the assets comes from derivatives and possible “toxic” assets

The crisis in context

The current financial crisis has provided an opportunity for central banks to present themselves as guardians on the monetary system. Journalists and policymakers take for granted the role of the Bank to stabilise the economy and provide a platform for future growth. However some economists pinpoint the nationalisation of the money supply as a *cause* of business cycles. Indeed there are two main schools of thought that oppose the modern practice of central banking.

100% reserve banking mandates that the full amount of each depositor's funds is available in reserve (as cash or other highly liquid assets), whenever the depositor had the legal right to withdraw them on demand (e.g. a current account)[1]. This would eliminate (or at least greatly reduce) the financial risks associated with bank runs, as the bank would have all the money in reserve needed to pay depositors at all times. This form of banking would also eliminate the need for a lender of last resort (such as a central bank), which is normally needed to support the banking system in times of systemic risk or financial contagion.

Free banking asserts that it is the monopolisation and politicisation of the money supply that create economic instability, and there is nothing unethical or erratic per se if banks issue their own currencies subject to competition and the threat of bankruptcy.[2]

Why public perceptions matter

Much of the debate between these two positions rests on an empirical assertion about the degree to which the general public realise that commercial banks lend out demand deposits as loans. According to the 100% reserve view the evolution towards fractional-reserve lending has occurred through

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[1] A classic statement of this position can be found in Rothbard, Murray N., 2005*, What has government done to our money?* Mises Institute, 5th Edition

[2] White, L. 1995., *Free Banking in Britain*. Institute of Economic Affairs

fraud and legal plunder. According to the “free banking” view it is because banks have responded to the desires of customers for instant access money that have a positive interest rate. Up until now, however, this has been based mostly on assertions. The objective of this survey is to gain some preliminary empirical evidence about the general public’s attitudes towards fractional reserve banking.

The British public has little understanding of how their banking system operates

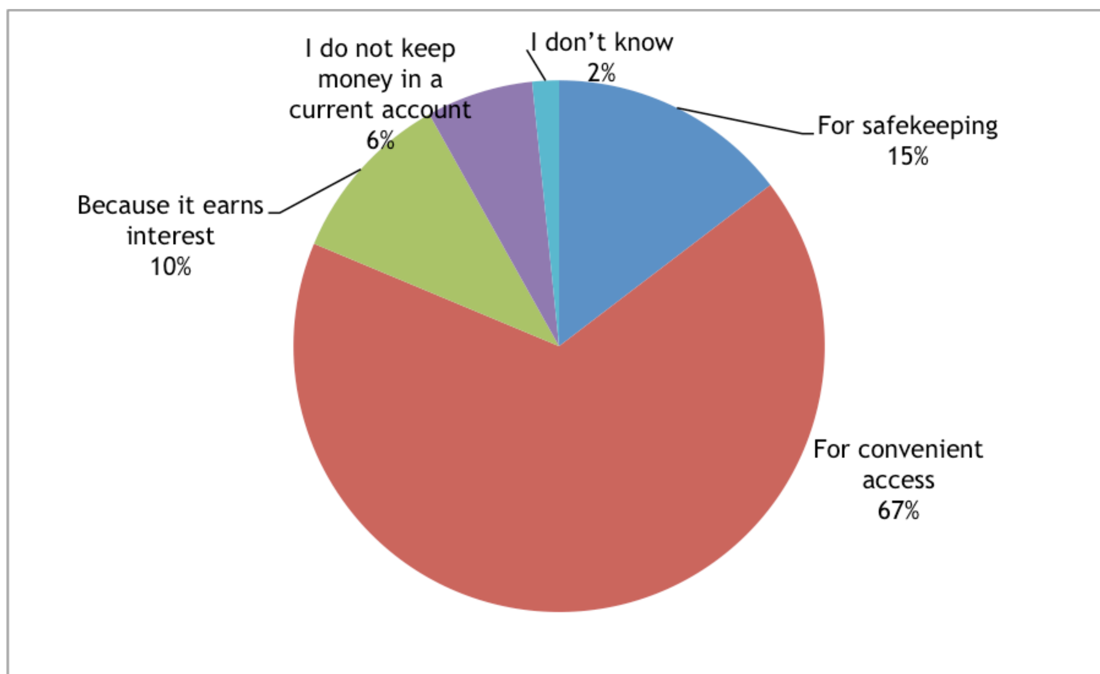
We hired the pollster ICM to conduct a nationwide survey of 2,000 members of the British public. Our questions were modified based on feedback from a number of prominent economists and professional advice received from ICM[3]. The survey was conducted 7th-9th August 2009. The key findings are outlined below.

[3] We are grateful to Philip Booth, David Howden, Jeffrey Rogers Hummel, Steven Horwitz, and John Meadowcroft for providing feedback on early drafts of the proposed questions. Their constructive advice should not be viewed as endorsements of the final survey

1) Most people use current accounts because they provide convenient access

A majority of the British population deposit their money into the bank for convenient access. This may show that people trust banks and think that they can access their money in the bank easily. In addition people believe that their money is protected in banks as 'safe keeping' comes as the second most popular choice.

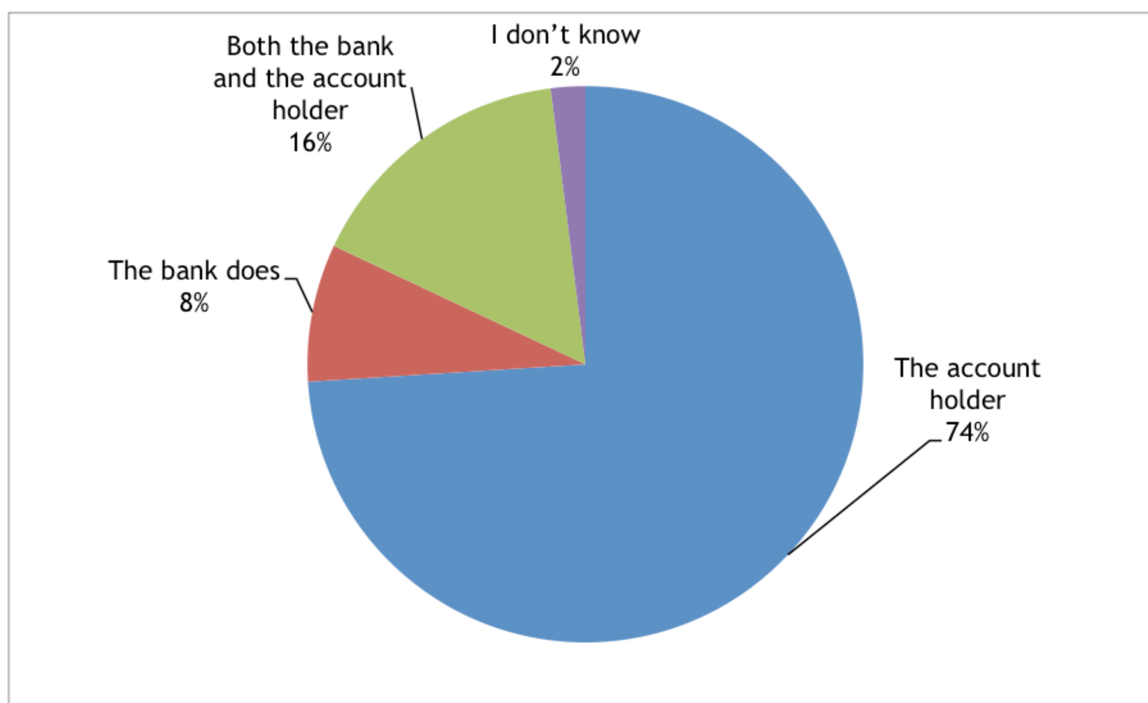
Question 1. Why do you keep some of your money in a current account?



2) 74% of people think that they are the legal owner of the money in their current account, as opposed to the bank

Almost three quarters of the public believe that they still own the money they deposit in the bank, however, under British law the customer has no specific claim of ownership of these assets, as they become the property of the bank and are treated as loans from the depositor. The famous legal case of Carr vs Carr (1811) established that putting money in a bank was not an act of bailment, but rather was a generalized debt (from bank to customer). This seemingly innocuous change opened the doors for fractional reserve banking. Suddenly, the bank was not responsible for the specific asset the customer entrusted them with, only the generalized debt. This allowed them to take a portion of the deposit and loan it or invest it. Consequently, banks became responsible only to repay the customer the amount of the deposit, while the depositor had no specific claim of ownership of the assets deposited. Only 8% of the public understood this point, whilst 16% believe that both the account holder and the bank share ownership of the same resources.

Question 2. Who do you think owns the money in your current account(s)?



3) 66% of respondents answered “don’t know” when asked what proportion of their current account was used in various ways by their bank

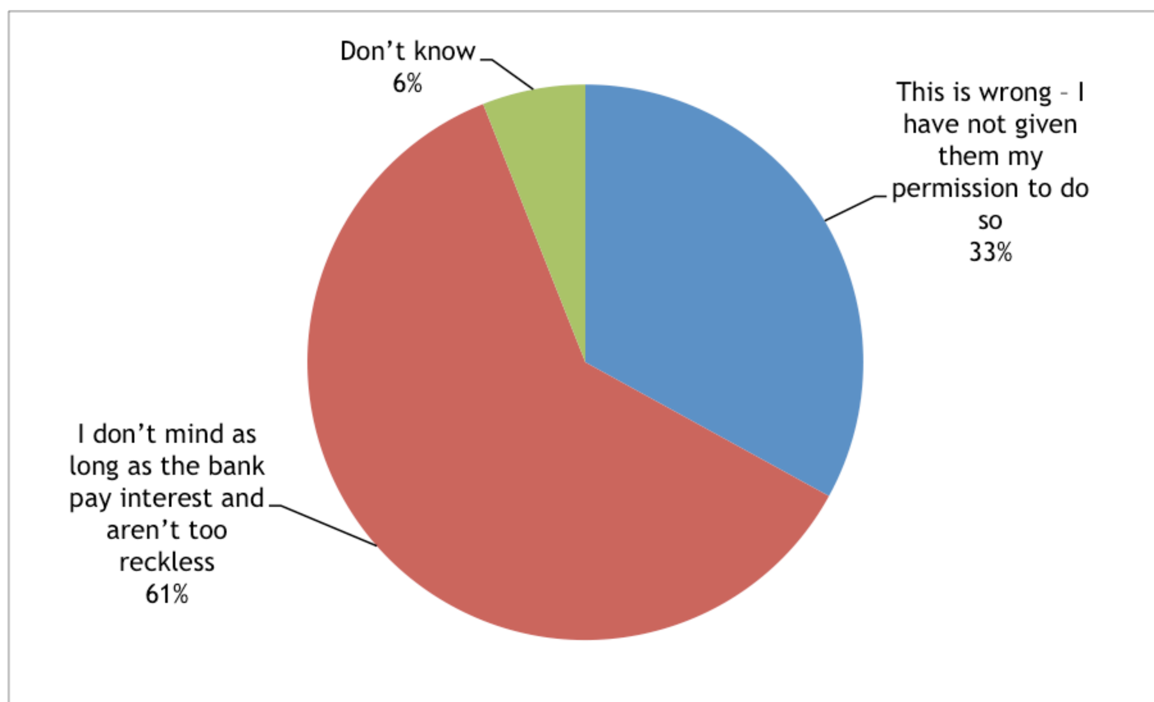
On average, 66% of the population answered “I do not know” to each of the following questions, suggesting a widespread unawareness of what banks do with their customers’ deposits:

> *Question 3. Thinking about the money that banks hold on their customer’s behalf via their current accounts, what percentage of that money do you think is:*
>
> a. *Held as reserves in their vaults to meet immediate withdrawals*
> b. *Held as reserves at the Bank of England*
> c. *Lent out as commercial loans*
> d. *Used to speculate on financial derivatives (i.e. investments, stock market etc)*

4) 33% of the population oppose the fact that banks lend out some of the money in their current account as loans

A majority of the population do not mind about their bank lending out some of the money in their current account as loans, however 33% believe that they have not given this permission to the bank. Given the fact that banks do these transactions all the time, one may conclude that they are simply not aware of this reality. As the Foley vs Hill case (1848) showed, demand deposits become the property of the bank given that the bank has borrowed the money from its customer. It was found that when a customer pays money into his account, the bank becomes a debtor to the customer. The money becomes the property of the bank.

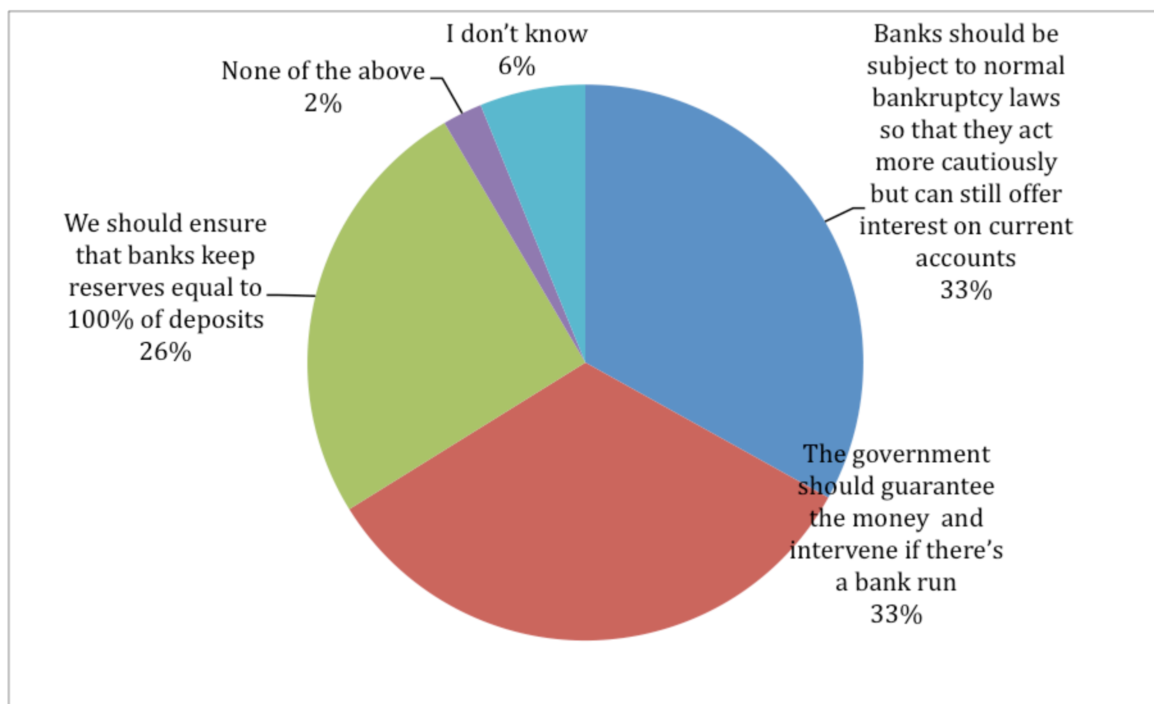
Question 4. You may or may not have been previously aware that banks lend out some of the money deposited within current accounts by their customers to fund loans. Which of the following best describes how do you feel about the fact that your bank lends out some of the money in your current account as loans?



5) Only 33% of the general public favour the existing policy of government backed deposits and a lender of last resort

When asked about what policies should be applied to banking, a third of the general public believe that if banks were subjected to normal bankruptcy regulations, they would act more cautiously. Anther third of the public supported the current practice of government guarantees and the support of the central bank if there is a bank run. Around a quarter of the public supported the idea of mandating 100% reserves.

Question 5. Given that banks only keep a fraction of the money their customers deposit with them in reserve, if more than 1 in 34 people wish to withdraw all their money at the same time they would not have enough to pay out. Which of the following apply to what you think about this:



Conclusion

The main findings are that there is diverse opinion about the banking system, with widespread support for fairly radical measures. However this is underpinned by a general ignorance about the legal status of demand deposits and what banks actually do with people's current accounts. And by general standards of accounting, this ignorance is even more concerning.

By reasonable auditing standards, high street banks are insolvent

We took a selection of six of the biggest banks with a presence on the UK high streets: RBS, HSBC, Barclays, Lloyds TSB, Abbey, and Standard Chartered, and performed a basic test of solvency and liquidity. We found that banks have financial statements that in other businesses would lead to bankruptcy

Solvency is the extent to which businesses can meet its liabilities on an ongoing basis. When a company is insolvent, it means that it can no longer operate and is undergoing bankruptcy. High street banks claim to be solvent but under GAAP regulation it is far from obvious. The typical tool used by accounting firms to check the solvency of a business is to run a basic solvency test,[4] which shows the following ratios:

[4] Solvency ratio = After tax net profit + depreciation/ Long term liabilities + short term liabilities

Bank	2008	2007
RBS	-1.48%	0.44%
HSBC	0.90%	0.20%
Barclays	0.26%	0.43%
Standard Chartered	0.85%	0.97%
Lloyds	0.20%	0.97%
Abbey	0.33%	0.41%
Average of 6 banks	0.18%	0.57%

Note that usually a company is considered healthy with an average solvency ratio of around 20%, whereas the average of the banks studied is just 0.18%. For the sake of comparison we also looked at some leading companies from other industries, and found that in 2008 Tesco had a solvency ratio of 11.7%, Unilever 20.5% and Pfizer 15.2%. Moreover, even though high street banks have a slightly positive asset/liabilities ratio this is misleading since 20% to 40 % of the bank's assets come from derivatives (many of which we would assume to be "toxic" assets).

The **liquidity** of a company typically means how able the company is at paying its debt as it falls due.[5] The average liquidity ratio of the banks studied is 7.1% while in the three other sectors studied, the companies liquidity ratios go from 61% (Tesco) to almost 160%. (Pfizer)

Solvency and liquidity both describe two different cash-flow related characteristics of a business. Solvency means that a business can pay its bills. Liquidity is a measure of a business's ability to have cash ready (as opposed to cash tied up in investments and inventory). A liquid business is more likely to be solvent than a non-liquid business. However, not all

[5] Liquidity ratio = Net credit Facilities / Tot. Deposits

businesses with liquid assets are solvent, and not all solvent businesses have strong liquidity.

A liquidity crisis is a negative financial situation characterized by a lack of cash flow. For a single business, a liquidity crisis occurs when the otherwise solvent business does not have the liquid assets (i.e., cash) necessary to meet its short-term obligations, such as repaying its loans, paying its bills and paying its employees. If the liquidity crisis is not solved, the company must declare bankruptcy. An insolvent business can also have a liquidity crisis, but in this case, restoring cash flow will not prevent the business's ultimate bankruptcy. That means that a solvency crisis bring a liquidity crisis because banks could not more lend money to the companies. Furthermore, while they are paying their liabilities they loose “cash” (liquidity) and if there is a slow down in the circulation of money in the market a liquidity crisis becomes more likely.

To summarise**,** the current banking system is at the root of the current financial crisis. Banks claim their solvency but it is only thanks to legal privilege that they are not already bankrupt. Moreover, the British population seems to be largely unaware of how the system actually operates. Overall there is widespread public support for bringing the legal status of banks into line with other businesses.

The Cobden Centre *is an independent educational charity founded formally to undertake research into economic and political science, to disseminate the results thereof, and to advance the education of the public in economic and political science.*

Our vision is of a ***peaceful, open*** *and* ***free society*** *based on a stable, sustainable economy in which everyone has the opportunity to participate in constantly growing real prosperity.*

Based on sound scholarship, we argue that such a society must be built on ***honest money****.*

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