

Fractional Reserve Banking

An Insight into Coercive and
Legitimate Aspects while Peeking into
the Future of Financial Stability

MIGUEL MALLIA

This article was originally submitted as a seminar paper as part of the CVL1024 and is being reproduced on the Online Law Journal with the author's permission. In it, **Miguel Mallia** advocates for a novel and ethically driven banking framework, proposing a theoretical alternative to Fractional Reserve Banking.

TAGS: Banking Law; Philosophy of Law

Miguel Mallia is currently in his second year of the Bachelor or Law (Honours) course at the University of Malta.

1. Introduction

Fractional Reserve Banking is a term given to a banking system implemented globally, a system that uses ‘high powered money as only a fraction of its total assets rather than one hundred per cent reserve banking.’¹ The elaboration of this definition opens up into a world of contradictions on aspects of morality, legitimacy, contractual obligations, transparency, and more, all of which are a central subject of past financial crises leading into the debate of future financial certainty. Finding its roots in the 1800s, the Fractional Reserve Banking system allows banks worldwide to pool a large fraction of the deposits made by their customers to be used for profit-making in the form of lending and investments, with the deposits that are not utilised for profit-making left as reserves for immediate customer withdrawal. This procedure is done all while at the same time guaranteeing that the money is withdrawable upon immediate request, creating a contractual obligation between the customer and the bank upon the depositing of funds. The system within itself was a central topic of the Great Depression of the 1930s and the financial crisis of 2008 while giving argumentative rise to inflation.

Throughout the course of this paper, research was carried out to explore legitimate and coercive aspects of Fractional Reserve Banking in relation to the system’s adherence to the letter of the law. The research presented ranges from historical to present perspectives of a wide range of jurisdictions but primarily based in Europe. The paper also presents arguments by various philosophers and economists arguing the mentioned coercive aspects and the legitimacy of the present system at hand. The arguments focus on an ethical and moral perspective while discussing bank-customer obligations and the system’s actual adherence to the law. With banks losing the trust of customers² and with inflation drastically on the rise resulting in a risk of another financial crisis, it was determined that the system within itself demands a reform. This paper explores further transparency options on an individual account holder basis as a preliminary remedy in relation to legitimacy and as a summarisation of the research presented to promote future financial stability and the elimination of the extreme fungibility of money.

¹ D Rutherford, *Routledge Dictionary of Economics* (Taylor & Francis Group 2012).

² Katie Feehan, ‘Nearly a third of people aged 25-34 stash cash at home as they no longer trust banks, study finds’, (*Daily Mail Online*, 5 October 2021) <<https://www.dailymail.co.uk/news/article-10060647/Nearly-people-aged-25-34-stash-cash-home-no-longer-trust-banks-study-finds.html>> accessed 12 May 2023.

2. Coercing the Public into a Banking System

With coercion relying solely on the compulsion of someone to do something for someone else forcefully or manipulatively, central arguments on how banks coerced customers revolve around trust. Trust was initially found in various contradicting judgments,³ until a precedent in the year 1848 was established in *Foley v Hill and Others*,⁴ where it was determined that the bank was a full owner and in full control of the deposits of its customers.

The full ownership of banks on the money deposited in the bank gave rise to new risks associated with the system and a possibility to profit immensely from the money deposited due to the huge amount of capital gained. However, for the bank to build profit, it needs to build long term trust from its customers. Philosophers, like Rothbard in the *Mystery of Banking*,⁵ argue that there is coercion imposed by the banks on their customers since money is created out of thin air by creating two titles on the same property, which in turn results in using money for loans while still being available upon the immediate demand of the depositor. Two titles on the same property could lead to inflation and negative economic outcomes as seen in the Great Depression between 1930 and 1932⁶ and the horrendous investments made by banks in the financial crisis of 2008. Rothbard argues that the business of banking presently coerces customers into its use by masking the system with cash deposit bonuses, interests on deposits, and prizes upon depositing, making the business inherently coercive while rendering it as the current social norm. Gorton, in *Slapped by the Invisible Hand: The Panic of 2007*⁷ argues that it was in fact the government that coerced the banks into accepting higher risk investments by incentivising those investments, which eventually led to a crash and the financial crisis of 2008, an argument supporting Rothbard's studies on coercion in the business of banking.

Antithetical arguments that do not believe that coercion has a part to play in the Fractional Reserve Banking system tend to lean towards a more positivistic approach in supporting current legislation at hand, like the Directive 2013/36/EU of the European Union,⁸ stipulating that deposits are subject to an agreement of mutual consensus and a customer may choose alternative financial systems, as was the stance of Rozeff⁹ in his critique of

³ D Rutherford (n 1) 91.

⁴ *Foley v Hill and Others* [1848] 9 ER 1002.

⁵ Murray N Rothbard, *Mystery of Banking* (Blurb Incorporated 2018).

⁶ Brian Duignan, 'Causes of the Great Depression' (Encyclopedia Britannica, 29 June 2018)

<<https://www.britannica.com/story/causes-of-the-great-depression>> accessed 11 May 2023.

⁷ Gary B Gorton, *Slapped by the Invisible Hand: The Panic of 2007* (OUP 2010).

⁸ European Parliament and Council Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338.

⁹ Michael S Rozeff, 'Rothbard on Fractional Reserve Banking: A Critique' (2010) 14(4) *The Independent Review* 497

<<https://www.proquest.com/docview/211222362?parentSessionId=Lkh8GarT5Vx36u4eDjfCkSHotOJLby8eT9Pa>

Rothbard's research.

Both are justified arguments which can be amalgamated into a need for further transparency. Coercion cannot be induced into a system of full trust and open books from both the depositor and the bank. Since the banks do technically create two titles on the same property, an establishment of co-ownership needs to be taken in consideration despite past jurisprudential decisions and reverberations, leading to a path of financial stability while enhancing the Mutual Consensus Directive stipulated by the EU.

3. Main Regulations on Fractional Reserve Banking: An Insight into the Legitimacy of the System

To understand the legitimacy of Fractional Reserve Banking, a definition of 'legitimacy' must be outlined and delved into to truly perceive the systematic logic of the mentioned system objectively. The Collins English Dictionary defines legitimacy as 'something that is acceptable according to law'¹⁰ which is quite self-explanatory. Hence, in this part of the paper a concise summarisation of the main legislation concerning this banking system in Malta and the EU in comparison with other jurisdictions will be established, and ethical dimensions and banking alternatives relating to transparency will be delved into.

The main Maltese legislative enactments concerning fractional reserve banking and the business of banking in general are the Banking Act¹¹ and the Central Bank of Malta Act.¹² European Directives and a brief overview of the terms and conditions of three major banks in Malta will also be mentioned as a direct contributor to the regulation of the subject matter. The term 'fractional reserve banking' is not seen in any of these Acts, however its definition is implied in the definition of the 'business of banking' in the Banking Act where it is stated that the business involves accepting

*deposits of money from the public withdrawable or repayable on demand or after a fixed period or after notice or who borrows or raises money from the public (including the borrowing or raising of money by the issue of debentures or debenture stock or other instruments creating or acknowledging indebtedness), in either case for the purpose of employing such money in whole or in part by lending to others or otherwise investing for the account and at the risk of the person accepting such money.*¹³

A question that is immediately raised upon understanding the definition of the 'business of banking' is the question of whether a depositor is an investor.

kmwm9m8%3D&pq-origsite=primo&accountid=27934> accessed 11 May 2023.

¹⁰ Collins Dictionary <<https://www.collinsdictionary.com/dictionary/english/legitimate>>.

¹¹ Banking Act, Chapter 371 of the Laws of Malta.

¹² Central Bank of Malta Act, Chapter 204 of the Laws of Malta.

¹³ Banking Act (n 11) Article 2.

With a ‘depositor’ being a ‘person who keeps money in the bank,’¹⁴ and an ‘investor’ being a ‘person who puts money into something in order to make a profit or get an advantage,’¹⁵ the distinction between the two becomes ambiguous in nature when juxtaposed in comparison to the definition of the business of banking. It is publicly known that a depositor receives interest on the amount of money deposited in the bank, hence most depositors know that they will be receiving a profit or advantage for the money deposited, making it an investment by technical nature. Why is this distinction imperative in this study? The legislation highlights the importance between the two, providing much more protection and transparency to investors particularly in European Union Directives.¹⁶ It is a fact that investors invest on a high-risk, high-reward basis, hence the necessary protection needs to be provided, but a counter-argument in favour of enforcing and calling out for enhancement in depositor protection is that there is no information on the percentage of the depositor’s assets that are being invested, since they are kept confidential by privatised banks due to business competition. There is no information on how and where, on a personal portfolio basis, these assets are being invested, creating a high-risk situation for the individual out of which several financial crises have been born. As argued by several accredited authors, such as Gary Gorton,¹⁷ depositors should be protected as much as investors due to the fact that capital is still being raised for profit-generation by the bank, regardless of the risk factor involved in such entrustment of funds.

Another question that arises from this definition is the question whether the bank can fulfil its contractual obligations to its depositors. According to the definition in the Banking Act, deposits are to be ‘*withdrawable or repayable on demand or after a fixed period or after notice*,’¹⁸ creating an obligation to be followed by the bank to do as such. Rothbard argues that by implementing a fractional reserve banking system, a deposit bank becomes a loan bank with the difference of taking money from the depositor’s account for profit-generation while the depositor is still thinking that it is available on demand.¹⁹ The economist and philosopher Rothbard argued that the system was inherently fraudulent and a Ponzi scheme in its very nature, supported by fake receipts called ‘cash’ which are circulated and used for trade.²⁰ Rothbard’s critique on the system goes on to mention that naturally, in support of the previously presented arguments, fractional reserve banking ‘creates money out of thin air’,²¹ rendering a bank inherently bankrupt with the money that

¹⁴ Cambridge Dictionary <<https://dictionary.cambridge.org/dictionary/english/depositor>>.

¹⁵ Cambridge Dictionary <<https://dictionary.cambridge.org/dictionary/english/investor>>.

¹⁶ European Parliament and Council Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38; European Parliament and Council Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1.

¹⁷ Gary B Gorton (n 7).

¹⁸ Banking Act (n 11) Article 2.

¹⁹ Murray N Rothbard (n 5) 94.

²⁰ *ibid.*

²¹ *ibid* 98.

should be available on demand and informed as such by the bank not actually there.²² Several financial crises evolved over time due to these issues discussed by the philosopher, as the argument on the banking system presents a system of inherent fraudulency since the bank cannot meet its legal obligations to all its depositors simultaneously. This could be seen in the Great Depression between 1930 and 1932, where customers were fearful of the bank's solvency due to the stock market crash of 1929, and withdrew all their money.²³ Throughout the mentioned crises, banks were in a particularly strong economic position, yet it still resulted in a fifth of the all the banks in existence to fail,²⁴ displaying a prime historical example supporting Rothbard's arguments. Another very recent and local example which supports Rothbard's arguments and the flawed system of fractional reserve banking is the recent case of Kenneth Gauci,²⁵ where Gauci was a bank manager who was employed by a local bank for 32 years, in which a discovery of €1 million in fraud was only recently discovered.

A counter-argument to Rothbard's analysis is that banks do inform their customers of the risks involved in opening an account, even locally the largest banks in Malta have a page on their website²⁶ highlighting risk factors while showing a form of transparency on investments by showing their annual reports and accounts.²⁷ Therefore, as highlighted in the list of activities subject to mutual recognition under Directive 2013/36/EU of the European Union²⁸ the risk of the agreement is mutually recognised by both the depositor and the bank. Michael S. Rozeff also counter-argues the inherent fraudulency presented by Rothbard by basing his argument on the promotion of the principles of liberty and the free market.²⁹ The philosopher and finance professor emphasises the importance of these principles in relation to the reciprocal will of trade of the depositor and the bank.³⁰ The author goes on to criticise Rothbard and his systematic believers while emphasising the lack of criminality from fractional reserve banking by going into depositor property rights. He argued that "Rothbardians" cannot prove their case due to a

²² *ibid* 99.

²³ Brian Duignan (n 6).

²⁴ *ibid*.

²⁵ Jacob Borg, 'How an HSBC Manager Perpetrated a Modern-day "€1 million" bank heist' (*Times of Malta*, 30 April 2023) <<https://timesofmalta.com/article/hsbc-manager-perpetrated-modernday-1-million-bank-heist.1028594>> accessed 12 May 2023.

²⁶ 'Managing Risk' (HSBC) <<https://www.hsbc.com/who-we-are/esg-and-responsible-business/managing-risk>> accessed 12 May 2023; 'Deriving Value out of Managing Operational Risk' (BOV Group) <<https://www.bov.com/News/deriving-value-out-of-managing-operational-risk>> accessed 12 May 2023; 'APS Bank Chairman Panellist at IFS Seminar' (APS Bank 2022) <<https://www.apsbank.com.mt/news/aps-bank-chairman-panelist-at-ifs-seminar/>> accessed 10 April 2023.

²⁷ 'Annual Report' (HSBC 2023) <<https://www.hsbc.com/investors/results-and-announcements/annual-report>> accessed 12 May 2023; 'Financial Reports' (BOV) <<https://www.bov.com/Content/financial-reports>> accessed 23 May 2023; 'Financial Information' (APS Bank 2023) <<https://www.apsbank.com.mt/financial-information/>> accessed 12 May 2023.

²⁸ European Parliament and Council Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338.

²⁹ Michael S Rozeff (n 9) 497-498.

³⁰ *ibid*.

transitioning of depositor assets to a depositor account where its property rights do not necessarily include the storage of depositor assets in relation to the free market and liberty.³¹ Rozeff proposes a full-consensus system where the depositor has the final word hence eliminating the fraudulency of the creation of money or money under two titles presented by Rothbard.³² Yet there is another step – a step which should be implemented globally to mitigate financial crime and even the simple temptation to do so – transparency on an individual portfolio basis.

4. Transparency on an Individual Portfolio Basis: A Peek into the Future of Financial Stability³³

Transparency on an individual portfolio basis and actual legislation relating to the issue could bring a borderline illicit and inflationary system tempting financial crime into a legitimate and practical system in which a possibility that the antithetical arguments presented by Rothbard and Rozeff could find common ground from a philosophical, economic, and legal perspective. This system could even justify the depositor compensation scheme,³⁴ a borderline unethical legislation providing untaxable compensation of up to €100,000 from taxpayer money if a bank system fails, while not forgiving customer debts. By implementing ‘Individual Portfolio Transparency’, the bank can still pool deposits but in a way where each customer deposit account is informed where the money is being pooled for the individual investment to be made, obliging mutual recognition to a further extent and reaching a common ground while fortifying the principle of mutual consensus. This would justify Rozeff’s, Rothbard’s and all other contrasting philosophers’ arguments on the subject.

Counter-arguments include the amount of extra work administratively involved in ensuring full compliance with the transparency guaranteed and regulating business competition with other banks. The former counter-argument is justified to a certain extent and an enormous backlog is at risk, yet how is this system not even being discussed upon the recent implementation of AI technology? And for the latter, if regulations and legislation are all the same for all banks, then business competition is eliminated by default on the subject matter, basing bank competition on investment results and incentives provided. This systematic transparency can eliminate any grey areas relating to fractional reserve banking which arose throughout history and promote financial stability in a reciprocal and mutual

³¹ *ibid* 498-499.

³² *ibid* 499-500.

³³ An implementation discussed with Dr Neville Gatt upon which the professor immediately approved yet stated that it was ahead of the present time. The proposal for the formula necessary to maintain the operation of this system not to mention the heavy bureaucratic process involved were deemed by Dr Gatt to be ahead of our present time, yet if implemented, a common ground between the antithetical argumentations of the philosophers mentioned is argumentatively attainable.

³⁴ Depositor Compensation Scheme Regulations, S.L. 371.09.

agreement where there is complete adherence to the law while resulting in minimal temptation of embezzlement due to immediate detection. The system in a way shares property rights, a sort of co-operative on individually deposited money. It is a justified way for the ownership rights to be established since the money needs to be available on demand contractually upon request while being invested.

From the information presented in this paper, one can see how this alternative presented can lead to financial stability and a banking system shifting away from its grey and daunting past, with all its initial reverberations and repulsions on implementation.

5. Conclusion

By the research provided in this paper, it has been determined that banks have not necessarily used coercive tactics to gain trust from customers to deposit their money but arguments on coercion have arisen due to an illegitimate system, both in adherence to law in its written nature and from a legitimate perspective. Banks are unable to fulfil their full contractual obligations in the present system as seen throughout history, hence determining the business illegitimate from this paper's perspective. Yet with the theoretical proposal of individual portfolio transparency, a glimmer of hope is presented in a market which has no alternatives for the customer, the fungibility of money is mitigated and a balance of the law is reached with the doctrine of proportionality being implemented directly. With individual portfolio transparency being the bridge between obedience and legitimacy and also cutting out completely arguments on coercion in banking, contractual obligations will be fulfilled completely while financial stability will be at its peak upon implementation. The implementation of individual portfolio transparency provides a differentiation from several critics of fractional reserve banking whereby, instead of providing an alternative, critics tend to choose between a 100% reserve system or a fractional reserve one, which was not done throughout this study. The rationale for this being that a 100% reserve system is never going to be implemented completely as a deposit method with the vast majority of the public being used to the current banking system and the 'guaranteed safety' that it provides.



OLJ

GHSI ONLINE LAW JOURNAL