<u>EVIDENCE TO INDEPENDENT COMMISSION ON BANKING</u>

<u>by John Tomlinson</u>

<u>The Terms of Reference from HM Treasury to the Independent Commission on Banking state that it will formulate policy recommendations with a view to reducing systemic risk in the banking sector and mitigating moral hazard.</u>

Has the banking system now been fixed? Are your cash deposits now safe?

Although some reform has taken place in the banking system, the deep seated structural fault has still not been fixed, let alone addressed, and as a result the next crisis, which will inevitably come, will be worse than the one we have just gone through. To prevent a recurrence of another banking crisis we need first re-visit to understand more fully the root cause of the recent one.

Most critics attack the banks for having "invested" so much in bad loans, and/ or toxic assets, that it caused the banking crisis of 2007/2008. While certainly this was a trigger mechanism, the actual root cause was much more profound. In reality, it was a structural fault that has been central to every bank failure since the beginning of banking. It is ever present and it centres on the very modus operandi of the banking system itself. Simplistically, there isn't enough 'cash' in each bank to meet the simultaneous withdrawal of every deposit in the bank. (By 'cash' I of course mean actual physical notes and coins.)

This is not a new situation and regrettably has never changed. Nor has it ever been properly addressed and, until it is, depositors' money will always remain at risk. All the cures which have been suggested have been designed to **mitigate** the risk – not to remove it.

The risk itself flows from the court challenges to early behaviour of bankers in England during the early 19th Century and subsequent related court decisions. The Earl of Caithness stated the position very clearly in the House of Lords on the 5th of February, 2009:

"Prior to 1811 title to the money in depositors' accounts belonged to the depositor. Lending of depositors' money without their consent could then have been considered fraudulent. In that year in *Carr v. Carr [1811]*, Sir William Grant ruled that since money paid into a bank deposit had been 'paid in generally', and not earmarked in a sealed bag (i.e., as a 'specific deposit') the transaction had become a loan rather than a bailment. Following that, in *Foley vs. Hill [1848]*, in the High Court of Chancery, Lord Cottenham stated *'There is a fallacy in likening the dealings of a banker to the case of a deposit to which in legal effect they have no sort of resemblance, money paid into a banker's account becomes immediately a part of his general assets and he is merely a debtor for the amount'.*

These two judicial decisions gave legal status to the banking practice of removing depositors' money from their accounts and lending it to others. Since then, title to depositors' money is transferred from the depositor to the bank at the moment that the deposit is made.

(This *immediately* creates a moral hazard and it is essential that the banking system is restructured if we are to make our deposits safe. **It is because banks invest depositors' funds for their own interest and benefit that banks cannot meet all withdrawals simultaneously.)*** My comments.

Bankers have always seen it as their job to invest as much of their depositors' money as they "prudently can", in order to earn income for themselves, whilst at the same time maintaining sufficient cash flow to be able to honour depositors' cheques when presented and to meet withdrawals as and when demanded. If new deposits fail to materialize in sufficient strength or if borrowers fail to repay loans on time (or at all), banks need to be bailed out or they will fail. Historically, banks have failed, depositors have lost all of their deposits and bankers have lost all of their money. These failures then led to a demand for Central banks to act as lenders of last resort, ostensibly in order to save depositors from losing their deposits, but more importantly, in order to save the imprudent bankers, who had been caught short, from losing all of their money.

These judicial decisions in 1811 and 1848 have meant that, from then until now, money deposited belonged to the bank and not the depositor. This, in turn, has allowed bankers to use customers' deposits as they saw fit - always provided that they could manage cash flow so as to meet depositors' requirements. In good times this has enabled banks to take more serious risks.

Then, with the advent of Central Banks as lenders of last resort, the bankers soon learned they could take even greater risks with virtual impunity. When their lending became too aggressive and their reserves and deposit receipts were less than required to meet cash flow, they began to lend to each other. In order to balance their books each night, banks with excess reserves that day would lend on the 'overnight' market to those with a shortfall that day. The loan would be repaid the following day.

With all of these supposed safety mechanisms to protect them, bankers came to believe they could become even more aggressive in their lending, enabling them to make increased profits for themselves. The unintended consequences of the provision of these safety mechanisms had, in too many cases, merely been to encourage bankers to take excessive risks.

Further, those two judicial decisions overlooked or failed to consider the fact that when banks lend depositors' funds, more than one receipt for the same deposit is issued. This was not done intentionally by individual banks or it would immediately have been seen as fraudulent. Rather, it was done by the system as a whole.

Let me explain with this example. Suppose someone deposited £100 into his account at, say, Barclays who then gave him a receipt for it. Let us assume that Barclays then lent the £100 to another customer who spent it at a shop and the shopkeeper deposited the cash into his account at Natwest. The same £100 will be received by Natwest as a new deposit and a new receipt will be issued against it. Thus the banking system as a whole will have issued two receipts against the same money and the total of all deposits will increase by £100. The original person will still have his deposit in Barclays and the shopkeeper now has his in Natwest. Because the Money Supply is the total of deposits plus money in circulation, the total Money Supply will have increased.

This process will then continue when Natwest loans the shopkeeper's money to someone else who spent it and, as a result, more receipts are issued. This happens every day in retail banking. This is how the U.K. money supply has grown from £31 billion in 1971, when President Nixon closed the gold window, to in excess of £1700 billion today.

Let us consider the implications of those last two figures. They mean that every year since 1971 the banking system has created, on average - for its own use - in excess of £44 billion. That is more per year than the entire money supply which had, until 1971, sustained our economy since recorded history and through two world wars! Is it any wonder that we have suffered such serious inflation over that period? It is clear that the normal, everyday onward lending of depositors funds by retail banks has been the principal producer of inflation."

The Earl of Caithness's statement begs the question: who authorised the banks to create all this money? To my knowledge, there is no Act of Parliament which specifically authorised or now authorises banks to create money. It occurs as a direct result of transfer of title of depositors' funds to the banks and the banks then lending it onward. The creation of money by this mechanism has not yet been successfully challenged. It needs to be now.

Further, so too does the misleading information taught in basic economics need to be challenged. In basic economics we are taught that, when banks issue loans, the money supply increases by the size of the loan and, when the loan is repaid the money supply decreases by the size of the repayment. The two are meant to cancel each other out so that no net new money is created by the onward lending of depositors' funds.

However, because the money supply is calculated by adding total deposits to total cash in circulation, and banks do not have separate deposit accounts into which they place shareholders' funds, the money they receive for interest payments, for fee payments and for loan repayments, <u>any money paid directly to a bank is not included in the count.</u>

When banks issue loans they deposit the money into the borrower's account and thus the total deposits increase accordingly. When the loan is repaid, the borrower removes it from his/her account and pays it to the bank. The money then goes directly into the bank's balance sheet and **is not represented in either deposits or cash in circulation.** Hence the money supply appears to be reduced accordingly but, it is only the measurement of the money supply (as it is currently defined) that is reduced. The money does not go out of existence. The instant the bank uses it to pay a bill, to pay a salary or to make a loan, that money is restored to the money supply and the measurement once again returns to its previous size. The current definition of money supply is inaccurate. **Therefore, what is taught in basic economics is misleading and needs to be corrected.**

This misleading information has provided a smokescreen of misinformation and lack of understanding behind which bankers have created and continue to create new money according to demand. They create it solely for their own benefit. In doing so, they debase the currency and are the direct producers of inflation.

When we consider 'inflation', we must ensure that our understandings are very clear: inflation is a general level of price increases due to the loss of value [debasement] of money. Not all price increases are caused by inflation. Nor is inflation caused by all price changes. Price changes that arise from changes in supply and demand are particular price increases or decreases. They are not general price rises or decreases. Prices can change, both upward and downward, as a result of the forces of supply and demand. These changes are a normal function of the marketplace. Prices increases due to Inflation are not a normal function of market forces. They are a result of the loss of value of money which has already taken place. Too many bankers, economists, regulators and financial commentators have been and remain careless about how they use the term 'inflation'. They have helped to create much of the current misunderstandings.

With respect to our own understandings, we cannot ourselves fully understand or even begin to know how to correct the banking system unless and until we are each prepared to re-examine completely the very pre-suppositions upon which much of our own current understandings are based. From the moment we are born, at various times, our parents and others whom we love and respect have put aside a few pounds for our future in a savings account at a bank or a building society. These actions are well meant and seen as 'good'. So, from an early age, we are 'conditioned' to associate money in banks and building societies as both 'safe' and 'good'. It is a well-known human trait that we can – all of us – become accustomed to a bad habit as well as to a good habit. We should all, however, by now, know better!

Early bankers, themselves, were well aware that what they were doing was wrong. That is why they always tried to appear both frugal and circumspect. They didn't want anyone even to suspect what they were actually doing. They took risks – but very measured risks. They knew their own livelihood was at stake.

Since the court rulings in the 1800's, the very reason for their frugality and circumspection has been removed. The banks now own the money in their depositors' accounts. The money is now theirs to do with as they see fit. In fact, now - other than the money which is in circulation - **all of the money in the world belongs to bankers.** Governments may have placed some restrictions on them but, nevertheless, bankers control virtually all of the money in the world. It is legally theirs. Of course, they do owe money to depositors – but bankers control access to it. Power corrupts and absolute power corrupts absolutely! The situation in the U.K. is no different.

The decisions made by those two judges have allowed bankers to alter their behaviour radically. The need for circumspect and frugal outward behaviour has been removed. Today, too many bankers are arrogant, brash and ostentatious. As we all know, the CEO of Goldman Sachs in New York has even gone so far as to claim to be "doing God's work". He appears unaware that it is not God's work to operate a business whose fundamental 'modus operandi' is both dishonest and immoral. Too many bankers, themselves, no longer understand the fundamentals of the system they operate.

In some ways, this is not dissimilar to the position these days with cars. When I was young I, like most others, could buy a car, drive it well and fix it when it went wrong. Today, most of us can still buy and drive cars well but few of us can fix them. Cars have become too sophisticated and complex. Highly skilled technicians are required to read the electronics in modern cars before they can be fixed. But, many who cannot fix them can drive them very well indeed.

Similarly, some bankers can still operate banks very profitably but few – if any – know how to fix them. Most bankers, indeed economists, regulators and supervisors appear no longer to know or understand the fundamentals which underpin the very system they manage, teach about or comment upon. If they did, by now they would have fixed it. I understand that those with banking experience on this committee have been selected in part because they have already begun to question the structure of the system. Their appointments give me hope.

I am fortunate. I was blessed, more than 30 years ago, with the opportunity, the time and the will to re-examine the fundamentals upon which my own thinking had previously been based. In particular, I was able closely to examine the fundamentals of the banking system – not the developments that have since flowed from the fundamentals or the new technologies that have led to many of today's modern banking practices – but the very core 'modus operandi' that underpinned the entire system. Having been both a stockbroker and a banker since leaving university and, as a member of the 'Foundation for Economic Education', I had been quite confident that I already understood the basics.

Well, I didn't and I was shocked by what I found. So shocked that I had to re-examine and re-examine it until the overall picture became so very clear that I was certain. So certain that in my book, “Honest Money”, published in 1993, I was able - with clarity - to foresee what was coming. I wrote then:

“If history is an accurate guide to the future, we can confidently expect to see the number of claims, receipts or units of money in the world expand to a point of imprudence. From an historic perspective, first individual banks expanded their receipts and claims to the point of imprudence. Bank failures were experienced and the term bankruptcy was coined. Central Banks were then established as lenders of last resort to bailout individual banks which had reached their point of imprudence. The effect was, by giving them a safety net, to license all commercial banks to expand their operations to their individual points of imprudence. Central Banks then allowed their national money supply to be expanded in multiples, until the international banking and monetary system as a whole reached its point of imprudence. This brought the collapse of the gold standard system.

It follows logically that the international banking community will now expand the world's paper money supply to its point of imprudence. Thus we must each ask ourselves some very serious questions:

Will the entire system then collapse, destroying the savings and liquid assets of everyone, including our own?

Will the system's survival instinct produce yet another palliative which allows some parts of the banking system to survive and continue their current imprudent and destructive practices, while the remainder fails?

Will our savings and liquid assets be in the part that survives or the part that fails?

Would we not be wiser to take action now to correct the system and thus avoid the risk?”

Fourteen years later, the banking collapse of 2007/2008 fulfilled that prophecy. Indeed, the collapse of the banking system has been wonderful testimony to my own failure successfully to convince anyone of the faults in the system or the dangers inherent therein. I suppose I must also add that few wanted to know at that time. There was – and still is - too much money and power at stake. It is not in the interest of bankers that the system be changed. They still have too much influence.

However, the imprudence of the bankers has now gone too far. This round of bankers' imprudence has been so excessive that even the Reserve Banks could not handle it. The Bank of England didn't have enough money to bail out British banks from their reckless purchases of toxic assets. They have now had to pass the problem to the government and thus, ultimately to the taxpayers - who, ironically, are also the depositors. It has been the same all over the world. Even the Federal Reserve Bank in America didn't have the funds to bail out banks in America. So the imprudence of bankers has now led to the destruction of the entire system of Reserve Banks as lenders of last resort. <u>Where to</u> <u>next?</u>

It is also worth noting that, contrary to popular misconception, toxic assets in British banks did not arrive here like some virus from elsewhere in the world. They were purchased deliberately by British bankers to increase their own profits and thus to increase their own bonuses. The collapse of British banks was caused by British bankers under the supervision of British authorities. It is inaccurate to say that these failings were beyond our control. The fault lies here in the U.K*.,* not somewhere out there!

Will this Commission have the courage and the foresight to take the actions required to return the banking system to a safe place to store and from which to distribute one's own money and thus set an example for the rest of the world? I hope so. There was a time when Great Britain set the standards by which the rest of the world was happy to operate. We can still. You now have the opportunity, once again, to set the right example.

Certainly the existing situation is indefensible. Current or cheque accounts hold household and business budgets. Families and businesses put funds into their current accounts to meet current obligations. These are the funds with which families pay their bills and feed themselves. These are the funds with which businesses pay their bills and meet payrolls. These are not funds that should be put at risk or be paid to secured depositors of banks in the event that banks fail. Under no circumstances should these funds be put at risk for the profit of bank shareholders or to pay bankers bonuses.

Of course, bankers will claim that their banks hold sufficient cash and collateral to meet normal withdrawals as and when they arise. At first blush, that might make a modicum of sense - until one examines the nature of the collateral itself. Whatever the collateral might be, it is not notes and coins. Stocks and bonds were the collateral in 1929. Their value collapsed. Property was the collateral in the 1980's. Its value collapsed. Now, even sovereign debt is suspect. Whatever it is, collateral is not risk free and household and business budgets should not be put at **any** risk. Let banks and investors put their own shareholders' capital at risk – not family budgets and business budgets.

So, what has been the response by the governments to the banking collapse of 2007/2008? It has been three-fold. The first has been an immediate injection of cash into the system via quantitative easing and loan funds - at less than 1% - by the Bank of England, funded by the taxpayer. This action removed the immediacy of the threatened collapse.

This also helped banks to rebuild their balance sheets. Banks immediately reduced the rate they paid to depositors, yielding to banks even greater returns on existing loans. In addition, banks invested much of these newly borrowed funds into British ‘public sector’ securities. Thus, in essence, the British taxpayer is now lending money to banks at less than 1% per annum and borrowing it back at over 3% per annum, yielding a handsome profit to the banks as a gift from the taxpayer.

(In fact, ‘public sector securities’ held by banks and building societies increased by £265 billion between August of 2008 and June 30, 2010. That represents a gift of in excess of £5 billion per year to bankers from taxpayers.)

One of the unintended consequences of this arbitrary reduction of interest rates by the Bank of England is only now beginning to appear: the destruction of pension funds set aside by millions of people for their retirement. Those who are required to purchase annuities with interest rates at these very low levels will have a meagre existence indeed upon retirement. Others, whose investment earnings have been greatly diminished by this arbitrary reduction of interest rates by the Bank of England, will find their pensions produce far less than planned. Many are now growing quite concerned about their ability to survive on future incomes. They may all have a case in law against the Government and the Bank of England for damages resulting directly from their interference in the marketplace.

Even now, it is not too late for The Bank of England to let these damagingly low interest rates go and allow investments to find their own levels and again yield a more realistic rate of return. This could immediately improve the future for millions of pensioners.

In “Honest Money” I also addressed the use of interest rates as a tool for controlling inflation. I wrote then:

“Interest rates are often used as the principal tool to control the money supply. Interest is the amount of money charged by the lender for use of his money. The payment of interest transfers existing units of money from one person or business to another. A transfer does not create any new units of money and is not of itself inflationary.

Any increase in the amount of interest payable will simply cause more units to be transferred from the borrower to the lender. This, of course, will increase the income and profits of the lender which, in turn, <u>will encourage him to lend more</u>.

As we shall discover, net new lending increases the money supply. This is the real cause of inflation. If we increase interest rates we simply provide an incentive for lenders to lend more. (Witness: the most recent period of high interest rates in the United Kingdom. Throughout the period of the highest rates letter boxes were stuffed with enticements from banks and other money lenders to borrow, borrow, borrow.) In the short term this is counter-productive. In the longer term it is deadly.

Increased interest rates will add to a borrower's expenses and thus decrease the amount he will have available to spend. The same process will apply to his customers who will order less, and therefore the borrower's income will be reduced. His profits will be squeezed from both ends. From the wider perspective, the production of goods and services - the wealth of the community - will be reduced and the vitality of the market-place will be sapped.

Increases in interest rates sap the life force of the economic system. Increases in interest rates do not cure inflation: they destroy an economy. They are the wrong tool. Inflation can only be cured by stopping the production of new units of money.

We need to take a critical look at the basic mechanics of the monetary and banking system, to see exactly where the production of new units of money occurs. Then, we must remove the cause of their production. That is the minimum required to repair the fault and provide a more accurate and reliable system."

Now, 17 years after I published the above, we can see that arbitrarily reducing interest rates can be equally disastrous. **It should by now be clear that arbitrarily changing the rate of interest paid in the marketplace is not a proper action for authorities to use either to increase economic activity or to cure inflation. It is an action which destroys parts of the economy – if not the whole economy - and is certainly not curative.**

The second action taken by banking authorities has been to revisit the capital requirements of banks in order to strengthen their balance sheets. In essence, this has required shareholders in banks to purchase more shares, increasing the amount of money available to meet withdrawals.

These first two actions are meant to further reduce or mitigate the risk of systemic collapse. Yet, the expense to the taxpayer (who, we must continue to remember, is also the depositor and the pensioner) has been and will continue to be enormous.

The third action taken by banking authorities and endorsed by too many economists and commentators has been to urge banks to lend once again. This policy is utterly mad. The U.K. is up to its ears in debt. The Government is over-borrowed – loading future generations with an enormous burden of debt. Too many individuals are carrying unacceptable levels of debt. Businesses are failing because of excessive debt. Homeowners are losing their houses at the highest rates ever because of excessive debt. It is utterly beyond belief that governments and pundits continue to insist on banks making new loans.

In fact, a great many are wiser than these government planners and pundits. They are not only resisting these urgings to borrow, they are trimming their sails, living more prudently and repaying debt. Banks, investors and consumers have all become more cautious. <u>The economy will not settle and start to grow again until enough of them are</u>

<u>convinced that their own debt is sufficiently reduced and total national debt levels have been sufficiently reduced and enough of them feel confident about their own future and the future of both the economy and the banking system.</u>

Instead of more lending by banks, what we really need, and presumably what the government and commentators actually intend, is to increase the levels of investment spending and consumer spending. This can be better accomplished in other ways.

In looking to the right actions to take to return the banking system to a sound state, it is important to remember that banking imprudence has been central to all banking collapses from the outset of banking to the destruction of the gold standard and on to the recent failure of the Central Banking system and that the burden of securing bank deposits has now fallen to the taxpayer.

<u>Two important questions need to be asked:</u>

1) **Why should taxpayers guarantee the gambling instincts of bankers?**
2) **Is it not now the time to stop merely trying to mitigate the risk and, instead, to remove it altogether, make all current account deposits absolutely safe and lift this foolish and unnecessary burden from the taxpayer?**

The most direct way to remove the risk altogether is to reverse those judicial rulings of the 1800's and return the title to their deposits to depositors.

The 'Safety Deposit Current Accounts Bill', still in the House of Lords remains a sound template for proper reform of the Banking system. It was originally offered on January 30, 2008 immediately after the collapse of Northern Rock and was intended to give depositors a choice. It was our belief then that enough depositors would choose Safety Deposit Current Accounts to allow us to avoid the collapse. However, instead of seeing the Bill as an attempt to defuse the bomb ticking away within the system, the Earl of Caithness was himself accused of trying to plant a bomb into the system. It was an accusation that was then – and remains – a great injustice to the Earl of Caithness.

This Bill needs now to be amended so that <u>all</u> Current Accounts are changed to Safety Deposit Current Accounts – not merely the option offered in its present state. The Bill also needs to be amended for a technical reason: when the Bill was drafted, the supervising authority was the FSA. Under the Chancellor's revisions, the supervising authority is now the Bank of England. Then the amended Bill needs to be fully endorsed by this Commission and by the Government. Its passage through both Houses of Parliament and Royal Assent must be assured. **The return of title to their money to all Current Account depositors should be the first priority of this Commission.**

Once title is returned to depositors, the rest of the system will then need your attention. The money in current accounts will no longer be "the bank's money". Banks will not be able to invest or gamble with it in any way. Bank responsibility to depositors will then become a fiduciary responsibility wherein they must store and distribute the funds according to the wishes of their owners – the depositors.

Under the terms of the amended Bill, the Bank of England will be given the authority to audit these accounts regularly to ensure that all of the money on deposit in each account is held by the bank either in actual cash or on deposit with the Bank of England. (As a practical matter and for security reasons, banks may prefer to store some of their depositors' cash at the Bank of England.)

The Bank of England can then guarantee the safety of 100% of the sum on deposit in each account – no matter how much is in each – because they will merely be guaranteeing their own audit and funds that they, themselves, hold for each bank. They will not be guaranteeing the gambling instincts of bankers. Bank deposits will then be safe.

For the first time in centuries, bankers will no longer own all of the money in the UK which is not in circulation. They will no longer have power over it. A myriad of different depositors will have control over their own money once again and will each make different decisions about what to do with it. The banking system will be returned to what most people thought it was all along – a safe place to store and from which to distribute the hard earned money of individuals and businesses.

Of course, enactment of the amended Safety Deposit Current Accounts Bill will also mean that depositors will have to pay banks to store and distribute their money for them. Many depositors have become accustomed to receiving interest payments for the amounts on deposit in their current accounts or to having had 'free' banking. That will stop.

New storage fees will be introduced. Some depositors will then worry about the cost of storing their money. Although many may have thought previously that they had had "free" banking, as taxpayers they have just had the bill – billions of pounds to bail out a failed system – and the system still isn't fixed. The costs have been much higher than any storage fees could ever be and those costs will continue to mount.

At the end of May, 2010 the U.K. resident banks held £920 billion in sight deposits – all of which can be demanded for immediate cash. They held only £8.2 billion in cash. The shortfall is a gigantic £911.8 billion! Where's the fix?

The enactment of the amended Safety Deposit Current Accounts Bill will ensure that title to money deposited remains with the depositor. It will stop the automatic transfer of title to the banks and thus stop banks from lending Current Account deposits. It will also expose another difficulty: <u>at the time of the change, banks will not hold sufficient</u>

cash to honour all Current Accounts at the same time. Therefore, banks will fail the audit required by the Bank of England to ensure that the cash into all current Accounts is either physically stored in each bank or is held by each bank in a deposit with the Bank of England. **As we have seen above, there is now a gigantic £911.8 billion shortfall.**

To fix this shortfall, the Treasury must instruct the Royal Mint to issue new notes and coins to the full amount of this shortfall and then use that newly created cash to purchase real assets from the banks and building societies. (Please note that this 'printing of money' will not increase the money supply and cause any inflation. It will no longer be able to be loaned onward in multiples by the bank. It will merely replace existing collateral with real notes and coins.)

For instance, UK resident banks and building societies hold **£72.6 billion worth of government securities**. The Treasury can then use some of this new cash to buy these securities back at face value. This will substantially reduce total government debt and, as a result, substantially reduce the cost of servicing government debt. The shortfall will then be reduced to £839.2 billion.

Bank and Building Societies also hold £1,240 billion of lending secured by dwellings. The purchase by the Treasury of **£839.2 billion worth of good and performing loans secured on dwellings** from those banks and building societies, in exchange for cash, will then **clear the shortfall** and make all Banks and Building Societies 100% safe.

The Treasury will also gain an income of more than £29 billion in interest from mortgage payments. The total of savings and revenue to the Treasury would be in excess of £30 billion. The newly acquired mortgages can then be used to begin properly to fund and, perhaps even to increase state pensions. This new funding combined with the new savings can also be used to reduce taxes.

The cost to depositors of storing and distributing their funds through the banking system will also need to be monitored by the overseeing authority. Banks already charge fees for depositing funds, fees for withdrawing funds, fees for honouring cheques, fees for using debit cards, etc. What banks have not yet charged for is storage.

(When the existing fees are analysed - as the system now stands - they are outrageous: banks are actually charging depositors for the privilege of lending money to the banks and then charging depositors again for the privilege of having the money they loaned to the bank repaid. Try that on a bank!)

What might such storage charges look like? Some money managers have historically charged as little as ¼ of 1% or £2.50 per £1000 per annum for managing funds. Others, of course, have charged more. Nevertheless, storage requires much less management than producing returns for investors requires. Under the terms of the Bill, these charges will be monitored by the Bank of England to ensure that they are not excessive and are fully and freely competitive.

The cost of storage, therefore, need not be prohibitive. It should, however, be enough to discourage many from maintaining more than the necessary minimal amounts in storage. **<u>Striving to avoid storage costs will encourage the prompt payment of bills and drive any excess funds into investments which, in turn, will help to create the economic activity necessary to start to get the economy moving again.</u>**

Current Account depositors who wish to invest their excess funds will have a range of new choices. Certainly banks will establish investment vehicles specifically to meet the needs of their own depositors. Banks can then continue to earn returns by managing funds depositors wish to invest with them.

Each of these investment vehicles must have its own current account at the bank. When an investor buys shares in one of these investment vehicles, the money used to purchase the shares will be transferred from the depositor's current account into the current account of the investment vehicle. The funds in the investment vehicle's account may then be used buy shares in businesses or to make loans – depending upon what the vehicle is authorised to do by its shareholders. The amount invested or loaned, however, may not exceed the amount in the account of the vehicle. Any lending done this way will not create new money or cause inflation.

Having thus sorted out their Current Account holders, the banks will still hold **£400.8 billion in loans secured by dwellings plus all their other assets - both on and off balance sheet** – which can now be applied for the benefit of their time deposit holders and, where possible, also for the benefit of their shareholders. All of these remaining assets of each bank must then be placed into a specific investment vehicle or into specific investment vehicles created to hold them only. The shares in these vehicles must be then placed in a temporary Trust for the benefit of both time deposit holders and bank shareholders. The banks, with the approval of the Trust, can then manage these investments for the benefit of the former time depositors and savings account holders and their own shareholders.

Markets will then need to be made in which the shares in these new investment vehicles can be traded and the value of these shares determined. Only then will Trustees learn the real value of these savings. If the market value exceeds the face value of all time deposit holdings, the excess can be returned to the bank for the benefit of shareholders. The balance – or the full amount if the market value is less than the face value of all time deposits – must remain in the vehicle and the shares in the vehicle distributed pro-rata to the former holders of time deposits and savings accounts. Those who wish will then be free to sell their shares and to invest any funds received in other investment vehicles managed by the banks or elsewhere.

At the same time, a closer look at the legal structures that affect investment decisions will need to be taken. For instance, under existing tax law, interest payments are deductible from pre-tax profits whilst dividends have to be paid from after-tax profits. Therefore, businesses have to earn much more to pay dividends than they do to pay the same amount in interest. This legal preference favours lending as a form of investment and needs to be changed to put both types of investment on an even field. Then, businesses will be more willing to issue and investors will be more willing to invest in shares.

I believe, given the choice, both businesses and investors will prefer to put their savings into preference shares rather than into debt investments. Preference shares can pay fixed dividends as well as participating in growth. Preference shares can be voting or non-voting and they can be redeemable or not redeemable. The fixed dividends on preference shares must be paid before ordinary shareholders can draw any dividends for themselves. Businessmen who wish to raise capital and maintain control of their businesses can seek to issue non-voting preference shares. There is a wide choice of available options.

The use of non-redeemable preference shares can also free businesses from having to set aside money to repay the capital raised. They can then use the extra money themselves – as they see fit. Some will choose to invest it. A whole new flow of investment funds can become available whose direction of investment will be decided by a multitude of businessmen from a variety of backgrounds – not just bankers. The criteria will be different and more opportunities will become available. The merit of the investment will play a more important role than that of the collateral held by those receiving the investment. The merit of the investment will be being judged by people who have a more active and thus a greater understanding of the marketplace than bankers can possible have. This alone will stimulate parts of the economy not previously stimulated.

Markets will quickly adapt. New markets will arise nationally, regionally and locally so that investors can invest at any level. Local people are more likely to invest in local businesses and local projects run by local people - people about whom they have personal knowledge and whom they might know and trust.

With respect to replacing debt finance with equity finance, Eastern Europe ironically is already leading the way. In the Financial Times of Tuesday 15th, June 2010, Neil MacDonald wrote:

> "The debt market and banks are pretty well closed, so equity is the only viable way for companies to expand….
>
> Poland moved earlier than others to create modern pension funds, market analysts say. These have provided a steady source of capital for the stock market…..
>
> Elsewhere in Central and Eastern Europe, companies with growth potential have relied on private equity. Cash strapped firms have embraced new shareholders or made equity deals with their creditors…….."

Capitalism can and will work when allowed and encouraged to do so. Faith in capitalism was one of the underlying strengths of The Safety Deposit Current Accounts Bill presented by The Earl of Caithness and debated in the House of Lords in 2008 and which, if it had been accepted by the Government, would have gone a long way to mitigating the dreadful consequences of the present banking crisis!

Those who are sceptical and who did not and still do not support the Earl of Caithness's Bill in the House of Lords were and are, no doubt, worried about what will happen if banks stop lending. These are understandable, albeit ill informed, worries. They need to re-examine the fundamentals and restore their faith in both Capitalism and the initiative of individuals in need. There will still be a need for business finance and there will still be a need for housing finance. Let's all remind ourselves that the marketplace can and will provide cost effective responses to these needs.

With respect to consumer purchases, certainly there is no reason why banks should not continue to offer debit cards. Credit card issuers could form and fund specific vehicles which can continue to offer credit – but only to the extent that the total amount extended to all credit card holders does not exceed 100% of their shareholders' capital. Some retailers will offer their own lines of credit to known and acceptable clients. They, themselves, will then carry all of the risk. Others might return to the old fashioned system whereby someone wanting to purchase an item paid a deposit of 10%, then makes regular payments until the item is fully paid and only then takes delivery. There are many choices which retailers can and will make to increase turnover. But, it will be their risk alone.

On the housing front, there are now a number of investors offering shared ownership schemes to purchase homes jointly with those who cannot afford to buy their own home outright. The form and number of these schemes can and will grow.

These programmes, for consumers, for businesses and for housing can and will provide equity finance to replace debt and they will provide it at a sustainable level - not at the excessive levels previously provided by banks. Then you will actually have sustainable growth and not 'boom' and 'bust'.

The changes proposed will return the banking system to better health than it has enjoyed for centuries. They will:

1. **remove completely both systemic risk and moral hazard from the banking system,**

2. **restore the sanctity of family and business budgets by having completely removed the risk from current account deposits and resolving the moral hazard faced by bankers,**

3. **allow substantial budget reductions and make room for tax cuts,**

4. **allow meaningful increases in old age pensions and**
5. **create a substantial demand from depositors with excess funds for both consumption and investments to help restart economic growth.**

This is a better and wiser way forward than to continue with a system that demands more and more lending to get the economy working again. That discredited policy can only continue to build an increasing burden of debt for future generations and further weaken British banks and building societies.

Regrettably banks have not changed their ways. Bank imprudence has not been removed: banks continue to choose to pay disproportionate bonuses rather than to fully write down their non-performing loans. The banking system – as it now exists - is bound to fail once again and, this time, in the near future. Further bailouts will be required.

The opportunity before this Commission now is completely to remove the risk and the moral hazard, thus avoiding any further mess.

Conclusion

There is a fog of misunderstanding about the current banking system arising from years of inaccurate assertions and habitual patterns of actions by the banking system to maintain it which, for too long, has masked the inherent faults in the banking system. Well intentioned people will continue to assert: "We must get the banks lending again!" These are decent people, unwittingly arguing that 'the end justifies the means'. Sadly, we have all seen - to our great cost - that it doesn't.

The proposals advanced, based on common sense and practicality, correct the faults in the banking system and will put the economy back onto a path of sustainable improvement. Rather than reducing the current systematic risk in the banking sector, and mitigating the existing moral hazard, **THEY WILL REMOVE BOTH COMPLETELY.**

The Commission has a unique opportunity to advise the Government to legislate now to fix the system so that it can function properly and without further incident for centuries to come.

John Tomlinson

September 26, 2010

EVIDENCE TO INDEPENDENT COMMISSION ON BANKING

ADDENDUM

Although not specifically within the remit of this Commission, I believe it is also important to be aware of the most damaging, indeed the most insidious, of all of the unintended consequences of both the moneylending mechanism of the banking system and the judicial decisions of Sir William Grant in *Carr vs. Carr [1811]* and Lord Cottenham in *Foley vs. Hill [i848].* That is the continued shrinkage of the size of the unit of measurement of exchange value.

Imagine what would happen if the unit of measurement of time diminished continually. Suppose the clock on Big Ben set the official time. Suppose further that it had a mechanical fault so that it lost half a second a minute. Every 5 days we would lose an hour. Every 40 days we would lose 8 hours. Soon it would be dark at noon and light at midnight. Time would no longer be synchronized with nature. Farmers could not rely on the clock to feed their animals. Nights would get shorter and soon we would find that 8 hours sleep left us still tired. We wouldn't be able to get everything done during a normal day's work and would have to work later and later. What couldn't be completed today will need to be done tomorrow. We would have to squeeze more and more into our already busy schedules. Soon we will always be running out of time and craving more and more of it. Our levels of stress would increase. We would know we were not at fault and would seek someone else to blame.

It is no different with money. Measurements of exchange value taken at different times may use the same numbers of pounds, but those pounds will each represent a different amount of purchasing power. The budget we planned will no longer suffice. We find ourselves short of money and crave more. Soon we can only see the 'short term'. Long term planning is no longer an option. Our levels of stress increase and we seek someone else to blame. The results are both socially divisive and economically destructive.

Nevertheless, the effects have not always been that obvious. In our individual experience, one day we suddenly realize that the money we receive as income no longer provides what it did or that our savings are no longer sufficient. We need more money or we need to reduce our standard of living.

In the 1960’s an average manager earned £4,000 per year. On that income, he could provide for his family. He could put his children through private school. His wife could stay at home and look after the children and she could have help in the home 5 days a week. He could take his family on a holiday every year. It wasn’t until he retired that he noticed the change. By the mid to late 1970’s those who had retired on £2,000 or £3,000 per year discovered they could no longer afford the levels of comfort they had previously enjoyed and many had to alter their retirement plans radically. The calculations they had previously made did not produce the results predicted. Someone or something had stolen their purchasing power. They cannot see who or what did this to them. They begin to distrust everybody and the seeds of social unrest are sown. They see themselves as having failed and their self-worth is diminished.

Today, the average manager earns more than £50,000 per year and cannot provide for his family the same standard of living that his predecessor did 50 years ago. To achieve a decent standard of living, his wife also has to work. Children do not receive the same quality of home care. What will happen in the next 50 years?

Economists use money in much of their measurements. The calculations they then make are based on invalid comparisons. Their predictions continuously fail to come to pass and the entire field of economics has been brought into disrepute. Nevertheless, many try to ‘index’ the pound so that they can produce better results but, in real life, indexing does not work well. It is selective and less than complete. Most people are well aware that the increases in their own costs of living are well in excess of the official figures. As we saw in the ‘time’ example above, nature does not synchronize with an index.

The loss or ‘theft’ of purchasing power is destroying trust in the capitalist system throughout the world. Producers of raw materials will no longer willingly enter into fixed long term contracts. They have been robbed of purchasing power too often and now no longer trust the people with whom they wish or need to do business. The focus of too much human endeavour has become focused on the short term. Too many now believe they must earn as much money as possible in the short term. A culture of ‘greed’ has been fostered.

All of the above flows naturally from having allowed the mechanism of money-lending to have been superimposed onto a perfectly valid system for storing and distributing our money. Who can we blame today? Is it the fault of the government, the banker or the depositor? Yes and no to each. Yes, in that we have each allowed it to happen and we each continue to allow it to happen. No, in that we have each found ourselves born and raised within the system as it is. We have been conditioned to trust it and have each done our best to survive within it. Like those who for centuries believed and acted as if the world was flat, we have all merely failed adequately to question the system within which we have found ourselves. There is no point in now trying to apportion blame. Those who made the original mistakes died centuries ago. Those of us alive today, bankers, regulators or depositors should not feel responsible for their mistakes. However, having seen the faults within it, we must now concentrate our energy on properly fixing this failed banking system.

Some bank services remain a necessity in our economic system. We live in a mandatory exchange system - a system within which exchange is required to survive. A medium of exchange is required to measure the value and the fairness in each exchange. Money is that medium of exchange. Safely to store our money and to distribute it efficiently and conveniently is essential today. Banks can and should continue to provide those services.

This Commission now has the opportunity to restore genuine 'safety' to the system. The programme I outlined in my evidence above will stop further diminution of the size of the unit of measurement of exchange value. Each of us can then begin to make more accurate measurements of exchange value and that will allow us to make better decisions. Nevertheless, we must remember that much of the data already stored in our memories is distorted and inaccurate. We will each only be beginning the process of correcting our own thinking. The process will take a long time. In our own minds, we have each accumulated years of experiences, calculations and decisions – all based on inaccurate information. We each may well have used our energy pursuing courses we would not otherwise have pursued and much of it will have been wasted. Patience and understanding will be required. We are all in the same boat.

Yet, begin we must. I believe the future of civilization as we know it depends upon our actions now.

John Tomlinson September 26, 2010