Banks cannot lend their depositors' funds

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Introduction

I keep getting comments from people who claim that my suggestion that banks do not use funds deposited with them to make loans is wrong.

They are adamant that this claim is wrong. They are usually quite rude about it, and when presenting their arguments, they claim that their argument must be right because banks pay interest on deposits, and if banks did not make money from those deposits by lending them out, they would not do so. Quite how that is proof, I do not know, but they say it, nonetheless.

At the same time, they also say that I do not understand how bank balance sheets work, because if I did, I would realise that when a bank makes a payment on behalf of a customer using funds that were created by loans in the way I have so often described, thereafter the bank balance sheet could not balance, so I must be wrong.

Let me try to address these issues.

Preamble – the nature of money as debt

Almost everyone who makes these claims to me appears to have made a fundamental error in understanding when making their claim.

It would seem as if they, without exception, think that there is something real, distinct, tangible, and possibly asset-backed which represents money. At the very least, it seems that they think that money is always made up of either banknotes or “funds” which somehow have a real, distinct, tangible, and identifiable existence. It seems that they believe it is one of these two, but most probably cash, that banks always deal with.

Let me set the record straight. Banknotes are a most unusual form of money, if not the most distinctive form. With that, I would agree. They are the only part of base money that is accessible to the public in the UK. And, if you do not know what base money is, please follow the link in the previous sentence for a detailed explanation, but in short, base money is the money created by the government to, in most cases, enable the banking system to work.

That said, the vast majority of base money is electronic, or entirely digital, like all other modern money, but banknotes are also a part of this base money supply and, at present, **there are about £85 billion of banknotes in circulation, although it would seem that a significant part of this total is essentially stashed out of use at any point in time. It is, in other words, the proverbial money under the mattress. As a result, it might be that just 1.5% of the active money supply in the UK is in the form of cash, despite which people persistently think that banknotes are what money is, when that is not the case.**

But, perhaps most importantly, banknotes conform to my description of money as debt for two reasons.

The first is that they say so on the note itself. They declare themselves to be an IOU by saying, "I promise to pay the bearer on demand the sum of [whatever]."

Secondly, the Bank of England confirms this by including them on its balance sheet as liabilities, a point I have previously proven, albeit that the method of demonstrating this is quite torturous due to the Bank of England's unusual presentation of its accounts.

The point is, however, clear: like all money, banknotes are just representations of debt and have no inherent worth in themselves. As a result, just like all other forms of money, including all that of the electronic variety that is created under licence by the UK commercial banks when undertaking their commercial activities through the making of loans, they are debt.

As for "funds", I will address this issue below, but first let me address another key foundational issue.

How banks create money

As I have said many times before, banks create loans by simply marking up a customer's current account with the amount that they borrow (a credit entry in the bank's books) and by marking up their loan account in a similar amount (a debit entry in the bank's books).

Bankers the world over have confirmed this case, as have all central banks that have commented on the issue. The Bank of England **confirmed this in 2014. The Bank of Canada did in 2015. Money creation is that simple. In fact, it is so obscenely simple that people recoil from the idea that this is all there is to bank**

lending, but that is what happens. It simply involves tapping a few entries on a computer keyboard and then charging a great deal for having done so. Money creation is an exercise in double-entry bookkeeping on a computer keyboard. There is no other way in which bank loans can be created.

I would also add that UK bank loans are now never made by advancing cash and, therefore, there is no reason to explain what the double entry of those transactions is: if you want a cash advance now, the transaction would be as I describe above, and you would then have to draw the cash out of your current account. We can, therefore, ignore this issue.

Do, then, let me summarise what the entries in the bank records it has created are:

*
The bank has recorded a debit, which creates an asset in its books, representing the sum that the person borrowing funds from it now owes it.

*
It has also created a credit entry in its books, representing the increased current account balance of the person who has borrowed money, to whom it now owes that borrowed money, which means that this balance is now available for them to spend.

That, quite literally, is all that happens.

Are other customers' funds involved in the creation of new bank money?

Note that there are no entries in what I suggest happens when banks create new money that in any way imply that the bank has depleted its cash reserves when providing a customer with a loan. That is because no cash was involved in these transactions. Everything I have explained relates to debt, and nothing else, because that is what a loan is, and that is what money is. The bank's cash reserves are not in any way altered by the creation of a new bank loan.

Similarly, no balance that anybody else might have with the bank that created the loan is in any way altered as a consequence of the creation of this new loan. In fact, it is not possible that any such balance could be in any way altered as a result of this new loan being made. In other words, other customers' funds (which are what commentators seem to think exist in a bank) are never involved in bank loan creation.

Testing the "loanable funds" model

To test this suggestion, suppose, as my critics claim, that funds deposited with the bank are used to make the new loan to a customer of the bank who asks for an advance to be made to them.

Firstly, note that this presumes that there is something in existence in the bank independent of the deposit that a person has made with it. In other words, there is an implicit claim that a depositor has something called “funds” which they have made available to the bank. This, quite specifically, is not true. Even if the depositor had, quite unusually, deposited cash, the transaction to record that deposit would be as follows:

*
A credit to the customer’s current account for the amount of cash deposited, representing an increased sum that the bank now owes back to the customer.

*
A debit of the amount of cash that the bank now owns in its cash account.

There are no other possible entries.

Importantly, though, and by definition, the cash now deposited with the bank does not now belong to the customer. It belongs to the bank.

If it belonged to the customer because, for example, it was placed in a deposit box, then the bank would not have a liability to repay it, but that liability to repay is what is reflected in the bank balance shown on the customer’s current account statement, which is in credit as far as the bank is concerned because it has a liability due back to the customer. That credit balance can only exist if the property previously belonging to the customer now belongs to the bank. If the cash were held in a deposit box at a bank, the transaction would only exist in the books of the customer, and the sole duty of the bank would be to physically protect that cash from being stolen, which is a quite different exercise from managing a bank account, not least because legal title to the money has not changed in the deposit-box case: it remains the property of the customer. If, instead, the customer wants to pay cash into their account, they necessarily give up ownership of that cash to the bank. This is the necessary corollary of obtaining an entry in the customer’s bank statement, which shows that they are now owed the sum they deposited in cash back from the bank.

In summary, and ignoring this use of safe deposit boxes (and I have never come across the actual practice of doing so in my whole career), in reality, the moment a person pays cash into their current account, that cash ceases to be their property, and in exchange for giving up that asset to the bank, they get an alternative asset, which is the liability that the bank owes to them as shown on their bank statement.

What this means is that if the bank did use those funds to make a loan (and I stress, banks do not make loans in cash these days), they would still not be using the funds of the customer who deposited cash with them to make that loan. That is because the funds in question ceased to belong to the customer the moment they were deposited, at which point they became the property of the bank.

The bank cannot use depositor funds to make loans in that case, even if cash is deposited, quite simply because there are, in fact, no depositor funds in a bank. There are only cash balances belonging to the bank, and assets and liabilities representing funds owed to or by the bank. Depositor funds, as such, do not in that case exist. Understanding this is vital to understanding how banks operate.

Let me also stress that this is also true, of course, if cash is not involved. To be clear, if someone has made a deposit in a bank, they must, first of all, have an account with it, and secondly, that account must have an increased credit balance (or at least a reduced debit balance) on it after the deposit because the deposit in question is always owed back to the customer. That means it either increases their credit balance or it reduces their liability to the bank if they were overdrawn both before and after the deposit was made. As such, deposits in something other than cash never create something distinct and separate from the depositor which might be called depositors' funds that are located and identifiable within a bank, which is what those who claim that depositors' funds are used to make loans suggest exists.

To reiterate: there are no such things as depositors' funds. All that a depositor has with the bank is an account balance, and that is it. In that case, of course, their funds cannot be lent, because there are no such funds.

Why one customer's account balance cannot be lent to another customer

The question that has to be asked in that case is: how can it be suggested that a bank can lend the account balance owed to one customer to another customer without their consent and without altering the balance in question? That question is, of course, impossible to answer, because it cannot be done.

So let me be clear what would have to happen if a bank was to lend what are supposedly called depositors' funds when there is quite literally no such identifiable item in existence in a bank because the only relationship that exists between a depositor, or a borrower, and a bank is the balance on their account as printed on a bank statement. Depositors are creditors of banks. Borrowers are debtors of banks, and that is it.

Despite that, if anybody wishes to suggest that a bank could lend something called depositors' funds to a person who wants to borrow from the bank, they would have to suggest that a bank could, without a customer's permission, reduce the balance on the deposit that they have with the bank to then supposedly advance what they describe as depositors’ funds to the new borrower, who they suggest is taking out a loan with the bank.

However, that is not how banks work. They are not peer-to-peer loan brokers. They operate discrete banking arrangements with each customer, respecting the right to privacy of each and every one of them, without ever giving one customer access to another person’s account, or the sums they might have saved with the bank. To do so would be a direct contravention of every established banking arrangement and banking regulation. In other words, to appear to alter one customer’s balance to then provide the funds removed from one customer’s account to another customer is simply not technically possible within the regulated structure of banking.

To be clear, it is not possible that the funds deposited by someone we might call Customer A might be reduced by, say, £5,000 so that an equivalent balance might be credited to the account of Customer B, who can now spend it. That is not only because the reduction in the balance of Customer A would amount to theft, but absolutely essentially, if this transaction did take place, no asset would be created in the bank’s books indicating the obligation of Customer B to make repayment to the bank of the loan that has been advanced to them. The debit entry in the bank’s books, to which I referred near the start of this note, that records the existence of that loan asset, could not exist because if Customer A’s funds were lent to Customer B then the debit representing the credit on Customer B’s current account, which they could spend as a consequence of being offered a loan by the bank, would in fact be in Customer A’s account, actually precluding the possibility of any record existing of a loan between Customer B and the bank. The bank would have simply been eliminated from the transaction, making it very difficult (if not impossible, I suggest) for them to charge any interest on the resulting outstanding balance, which I very strongly suspect is something that the bank would not want.

It would, of course, be possible to suggest a longer version of the double entry in question. For example, Customer A could have their bank balance seized, or otherwise be deemed to be the property of the bank, cancelling the bank’s liability to Customer A as a consequence, and in effect increasing the property owned by the bank through the recording of new income for it resulting from the sequestering of the property of that customer, which income could then be matched with an expense incurred by the bank of equal and opposite sum, which would be a debit, with its matching credit being in the account of Customer B. In this way, Customer A and Customer B might not know each other’s identity, but the effect is that Customer A has still, in effect, involuntarily lent their balance to Customer B, and there is still no asset balance in the bank’s books representing a loan from it to the customer. That essential debti balance representing the loan in the books of the bank can only be created if the balance in question is represented by the double entry that I explained right at the beginning of this post, where two entries are made, one being a debit of the sum borrowed to the customer’s loan account, and the other being an equal and opposite entry as a credit in the bank’s books representing the current account of the customer who has taken out the loan. Money does, in other words, have to be created out of thin air using double-entry bookkeeping. There is no other way in which it can be done.

Summary

In summary, there is no technical possibility of a bank making loans out of so-called customers' funds when undertaking banking transactions in the form in which they are regulated in the UK.

There is no way in which such transactions could be recorded in the double-entry system that represents their books of records, which they are required to maintain by law.

Perhaps quite importantly, if a bank did try to lend the balance on one customer's account to another customer, it is very likely that the theft of the property of the customer whose balance was loaned would be involved.

The consequence is that the loanable-funds myth of banking is just that: it is a myth, and that needs to be consigned to the bin.

Footnote: a note to bankers

Finally, let me add one last point to all the bankers who are going to read this, who say they think they do loan customers' funds.

You don't.

You are required to have deposits as part of your capital requirements as laid down by the Bank of England. I acknowledge this, but this does not mean you lend those funds.

It means these deposits must exist to provide security to ensure your bank's solvency before you are allowed to lend.

In fact, you are being told to keep customer deposits as part of your capital (as I have long contended), whether you are aware of it or not.

But you are not loaning those funds to customers because that is a technical impossibility for the reasons that I noted above.

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