Views of Banking Ethics

Development of Modern Banking

Much of the current financial structure can be traced to three innovations in the 17th century. The first of these was the establishment of a system of bank transfers that has survived to this day in the form of cheque issuance and inter-bank transfers. The second was the foundation of fractional reserve banking that enabled banks to lend substantially more than the amount of deposits they carried on their books. The third was the creation of the Bank of England as the official issuer of bank notes, which were initially backed by gold bullion, and the keeper of bank reserves. The modus operandi of banking was twofold: on the one hand, a bank had to be able to guarantee its depositors that they could withdraw their money whenever they wanted; on the other hand, the same bank had to lend the funds out so it could generate income in order to be able to pay interest to encourage the depositors to place their funds. The three innovations were the original measures that made possible the institution of modern banking.\(^1\) Essentially reserve banking means that, if the reserve requirement is, for example, 10 per cent, a bank can lend out 90 per cent of say $100, that is $90, to another person who may deposit that amount at another bank, which in turn can lend out $81 to a third person, and this goes on to the next bank and borrower. The initial deposit of $100 has created loans of $171 and is capable of creating even further loans, so this is called the ‘multiplier effect’ in money creation, and this allows banks to greatly expand lending.

The institution of reserve banking did not completely eliminate the possibility that most depositors in any given bank might want to withdraw their funds at the same time and, if the affected bank had insufficient cash on hand because it had loaned out most of its deposits or if the bank had uncollectible loans, then the bank suffered a bank run.\(^2\) The introduction of deposit insurance in certain countries has protected depositors in affected banks in those countries and given peace of mind.
to others. Banking regulators have sought to prevent such eventualities through close supervision to ensure a stable banking system and adherence of banks to prudent practices.

**Necessity for Banks in Contemporary Period**

It is crucial to have a robust and sound banking structure because of the central role of banks in every society. Economic growth has witnessed the constant flow of money through banks, and a breakdown of the financial system as witnessed in the contemporary period 2007–09 creates havoc throughout society because everyone is reliant on banks.

Workers in many service and manufacturing entities receive their salaries or wages from their employers through direct credit transfers to their respective bank accounts. While there are some instances of cash payment, compensation for employment is normally effected through banks. At a minimum, employers would probably maintain accounts at banks out of which they pay salaries, rent and utilities, as well as taxes. Employees would likely have at least savings accounts and possibly current accounts in order to facilitate their own regular payments to others.

More importantly, people in most countries have also relied on banks for issuance of credit cards, housing mortgage loans to acquire homes and personal loans to purchase consumer durables such as motorcars, boats and household appliances. Once individuals have assumed a debtor relationship with banks, as a rule they are obliged to establish deposit accounts with the same banks.

Companies, which may range from sole proprietorships to partnerships to corporations, avail of bank services to ensure they earn competitive interest rates on deposits and also receive financing to meet standard operating requirements and further needs such as trade finance to support imports of raw materials and exports of finished goods as well as foreign exchange transactions to shield them from the potential losses of unfavourable currency fluctuation. The large companies are especially reliant on corporate finance to support new capital expenditures.

It is therefore indisputable that all members of society are dependent on banks, which are expected to serve the function of intermediation. It is equally important to stress that banks require customers, if they are to earn any income and attain profits, so the question is how ethically banks deliver their services. The argument is that banks are indispensable members of their respective communities and therefore have moral obligations towards their constituents and customers.