

## Reassessing the Ethicality of Some Common Financial Practices

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**Abstract:** Depositors have perceived banks as acting unethically during the most recent recession. One area of consternation is the ambiguity of the legal obligations entailed by the deposit contract when it is backed with only fractional reserves. In this article we apply an existing analysis of the legitimacy and ethicality of banking practices to a wider range of financial transactions, including insurance policies, securities lending, perpetual bonds and callable loans. Securities lending in particular creates rights violations analogous to those in fractional-reserve banking. Both callable loans and perpetual bonds have clear legal obligations which are not inherently problematic, though we herein clarify what these obligations are. Finally, we apply our ethical framework to demonstrate that insurance products are distinct from banking deposit contracts, and that perceived parallels between the two products underestimate these differences.

**Keywords:** insurance, banking, fractional reserves, callable loans, perpetual bonds, callable loans

## **Reassessing the Ethicality of Some Common Financial Practices**

### **1. Introduction**

Bagus and Howden (2013: 235) ask “[h]ow ethical have recent banking practices been?” Before we can answer the question of “should” a certain financial contract be issued we must first answer the question of “can” a contract be created. “Can” in this sense refers to its legal legitimacy, while the answer to “should” requires assessing the resulting contract’s ethicality.

All contracts must adhere to certain criteria. The purposes and intents of the contractors must be aligned (e.g., there must be a “meeting of the minds”), the rights and obligations must be clearly defined and consistent with the contract’s intent, and there should be no logical inconsistencies in the contractual terms. The first two criteria ensure that there is no misrepresentation or confusion concerning the contract’s purpose or effects. The final criterion ensures that it is possible to fulfill all contractual terms and obligations.

One method to assess the ethical implications of financial contracts is to make use of an economic-legal framework which outlines contractual duties (Huerta de Soto 2009; Bagus and Howden 2013). Heretofore this framework has only been applied to the banking system. As the past few years have made clear, there are other important players in the financial arena besides banks whose practices have been seen as less than unsavory. In particular, several high-profile bailouts and lawsuits have forced innocent third parties to be involved when investment firms, brokerage houses and insurance companies sold or facilitated the sale of financial products that lost invested funds.

Herein we broaden the analysis to look at several other questionable financial contracts. Section 2 overviews the role of “good” laws in promoting ethical behavior. Section 3 develops a framework for analyzing the legal obligations and subsequent ethicality of a financial product. In section 4 we demonstrate that a brokerage violates key obligations when lending securities, and as such infringes on the rights of the original owner of the financial product. In sections 5 and 6 we show that the common financial practices of issuing callable loans and perpetual bonds do not break any legal obligations and as such do not expose either borrowers or lenders to ethically dubious results. In section 7 we outline that although functionally quite similar to fractional-reserve banks, insurance companies serve a fundamentally different purpose: risk reduction instead of uncertainty mitigation. As such the legal obligations are distinct and there is no reason to group well-intentioned insurance policies into the same ethically questionable category as fractional-reserve demand deposits. Section 8 concludes.

## **2. Ethics in Finance**

While not everything that is legal need be ethical, they share a common link. Laws exist to separate those actions that are permissible from those that are not. Illegal actions are not allowed because they either violate someone’s rights or they do not fulfill an obligation beset on another. These two criteria are opposite sides of the same coin, as any right to do something entails that another has an obligation to not hinder performance of the same.

While ethical frameworks need not be ingrained in law, good laws will be structured in light of ethical considerations of the relevant jurisdiction. In this way, the law reflects society’s prevailing values and beliefs, and creates compliance by way of a system of punishments for

violations. Naturally, good laws coincide with good ethics. Nowhere is this more true than in the financial world. The recent opprobrium directed at the financial sector creates a case to reassess where the disconnect between laws and ethics has stemmed from. Writing about the ethics of banking in the wake of the crisis of 2008, Koslowski (2012: 6) notes that:

The principle that the obligation arises out of the nature and the purpose of the institutional domain applies both to law and to ethics. For law, the content of the statutes derives from the purpose and the nature of the matter at issue; for ethics, the ethical personal norm derives from the purpose and the nature of the matter at hand. The principle that the obligation derives from the nature and purpose of the subject domain breaks down into three further sub-principles: a duty or an obligation is derived firstly from the purpose or the teleology of the institution or the operational domain at issue, secondly from the idea of justice as equality under the law, and thirdly from the demands of legal certainty.

Thus, in order to clarify whether a decision or action is ethical in the domain of finance, it is necessary to establish what the norms of the domain are, whether they are well founded, and whether the action is aligned with the purpose of the norm. Likewise, since market actors in finance are ethically prohibited from acting in a way that harms or violates the rights of another, ethical matters become practical issues for contract law (Boatright 2014: 36).

Despite being broadly charged with acting unethically over the past few years, there have been relatively few instances where legal actions have been successfully brought against financial

institutions. This is troublesome, not least because good laws evolve to promote ethical behavior given the accepted norms of society. The fiduciary duty of a bank to prudently lend client funds has long been cited as one ambiguous area giving rise to potentially ethically dubious behavior (Green 1989). Banks in particular have high levels of responsibility within the field of finance, and must be held to a high standard regarding their lending practices as a result (Cowton 2002). Due to their central role in the crisis, Paulet (2011) recommends resolving the disconnect between the unethical practices of banks and their legal responsibilities by expanding the regulatory regime to curtail certain financial activities.

Paulet is correct in choosing the legal regime as the area to be changed in conformance to ethical principles, but the reconciliation has a simpler test than the one she proposes. By looking at the original intents of financial activities, we can assess them according to their rights and obligations. Infractions to these matters are what give rise to those actions commonly termed as “unethical”. At the same time both rights and duties are the central subject matter the law is designed to enforce. A framework to test for ethicality can be derived from rights and obligations implicit (or explicit) in the intent of the original action. Fortunately there is a well-established framework for testing the legality of such terms as they apply to banking contracts, and which we can extend to test the ethicality of other financial products.

### **3. A simple framework for the ethicality of financial contracts**

Many financial contracts can be analyzed using an economic-legal framework defining and differentiating between deposits and loans (Huerta de Soto 2006, Bagus and Howden 2009; 2013). This framework recognizes three economic distinctions between deposits and loans,

which result in three separate legal obligations. These obligations allow for one to make statements concerning the ethicality of financial products.

The first economic difference is that a loan represents an exchange of a present good for a claim to a future good. A financial lender may loan money to a borrower today (a present good) in exchange for a claim to a set of money payments in the future (future goods). This *intertemporal exchange* is absent in the deposit contract (Mises 1971: 269). The depositor does not renunciate his claim but instead retains the full availability and use of the deposited good. The depository does not gain the use of the deposited good, but instead must make the good continually available to the depositor, who may withdraw it at a moment's notice. **The exchange for a future good in a loan contract creates an additional element of uncertainty for the lender that does not occur for depositors as they deal exclusively with present goods.**

As a consequence of the intertemporal exchange in a loan contract, there is also a shift in the *availability* of the good being lent. By lending a good, e.g., money, the lender gives up both the availability and use of the lent sum for the duration of the contract. The borrower is at liberty to use the money until its maturity when the future good promised becomes due. The loan contract thus terminates with the original lender gaining a present good (which serves to cancel the future good originally promised) and the borrower renouncing his claim over a present good (and in doing so canceling the original liability to repay the future good). **The loss of availability of the present good creates additional uncertainty for the lender as repayment will depend on an as yet unknown future event. Since the depositor's good is maintained by the depositor, he does not bear this type of uncertainty as reclaiming the deposit is a matter of requesting the return of the**

present good.<sup>1</sup> The mitigation of uncertainty in a deposit contrasts with a loan contract where uncertainty is willingly introduced into the contract.

A deposit contract does not involve an intertemporal exchange of the good's use. As the intent of a depositor is to retain full availability of the deposited good, the depository is never in a position to make use of it. Because the deposit can be redeemed at any time by the depositor, there can be no transfer in its availability. The depositor retains full availability (Mises 1971: 268) while the depository must ensure this is possible, a promise which implies that it cannot use the deposit for its own purposes. While constraining opening hours or clearing times may seem to remove the full availability of a deposit, they are more apparent than real examples. Some degree of physical or institutional limitation will always exist on transferring a deposit to another or on withdrawing it (Bagus and Howden 2012b). The question is one of whether this is in the depository's control (e.g., security checks, opening hours or clearing times do not negate the depositor's control). If the depository were to lend out the deposit, it creates uncertainty not only for the depositor but for the depository as he is no longer in control of money – its return is now in the hands of the borrower.

The third economic difference is the occurrence of an *interest payment*. As a deposit entails no intertemporal exchange there can be no corresponding interest payment. (Indeed it is commonly the depositor who must pay the depository for services rendered, although this payment can be

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<sup>1</sup> The depositor is exposed to other uncertainties and risks as there are any number of events that could prevent the return of the good in question, e.g., fraud, theft, flood, fire, etc. Some of the events involve, however, risk and are insurable, such as flood and fire catastrophes. The probability of a fire and flood prohibiting the return of a deposit are independent of the depository's actions and therefore represent insurable risks (although a depository can take precautions to minimize the effects of these catastrophes). Losses incurred with borrowed money that prohibit repayment of a loan, by contrast, are very much related to the borrower's actions, and thus uninsurable.

waived at the depository's will). Since a loan contract necessarily creates an intertemporal spread between when the present good is lent and the future good is returned, there will be an at least implicit interest payment created. The borrower will have to remunerate the lender for the availability and use of his lent good over the duration of the loan's contract.

<b>Economic Differences of Contract</b>	
Deposit	Loan
1 No intertemporal exchange; depositor retains the present good deposited	Exchange of present good for claim on a future good
2 No transfer of availability; deposit remains available to depositor at all times	Availability of good transferred from lender to borrower
3 No interest as no intertemporal exchange; depositor must remunerate depository for services rendered	Intertemporal valuation spread between present and future good creates interest; borrower remunerates lender for use of good

Table 1: Economic Differences in Financial Contracts

These economic differences, as summarized in table 1, lead to three important legal differences between deposit and loan contracts. These legal differences are important to the extent that they create different obligations for each party and define the types of use allowed with the goods contracted. Note that the characterization of "allowed" is not something created *ex nihilo*; these legal obligations are the necessary implications *ipso facto* of the economic distinctions in each case. By not adhering to the obligations entailed by the legal requirements of the contract, one party will be violating the rights of the other. These rights violations form the grounds for legal action, either creating a tort *ex post* or leading the legal system to make the contract illegal *ex ante*. It also leads one party to feel as though the other has acted unethically. By not following through with the original intent of the agreement, either one of the parties will be deceived into a



loss (e.g., through an act of fraud), or will not receive the terms as originally agreed.

First, the legal *purposes* of each contract are radically distinct. Any valid contract must be predicated on a “meeting of the minds”: all parties must have a common understanding at the formation of the contract. Common understanding in this case can refer to knowledge of and agreement to the purpose behind the contract.

A loan contract is motivated by a desire to transfer property from one party (the lender) to another (the borrower) for a finite period. Entailed in this transfer is a loss in the availability and use of the lent good over the contract’s duration, with the borrower gaining both of these attributes. In distinction, the purpose or intent of a deposit contract is to keep a good safe for a period. The intent is not to renunciate a claim on the use and availability of the deposited good over the period, but rather to retain these attributes.

The second legal distinction is the *time horizon* that each contract will be enforceable for. Any loan cannot be for an indefinite period of time, lest it become a gift (Bagus and Howden 2012b: 296; 2013: 237fn4). Any loan must contain in its terms an at least implicit contractual duration (Huerta de Soto 2009: 1-6).

The final legal distinction entails the *obligations* of each party. These obligations not only differ depending on the type of contract entered into, but also depending on the type of good contracted for, whether specific or fungible (Huerta de Soto 2009: 2-4).

A loan contract drafted for a specific good – such as a car, apartment or book – represents a *commodatum* contract. The borrower gains the use of the good in question for the contract's duration. At the contract's termination the lender is remunerated with the return of the good in some predefined condition as well as payment for the use of the good over the period. In contrast, a loan for a fungible good – such as money, oil or wheat – results in a *mutuum* contract. The primary distinction here is that the loan is terminated by returning a *tantundem* – a predefined quality and quantity of the lent good. This distinction arises because units of a fungible good are indistinct of one another (e.g., all one dollar bills are equal) so that they can be mixed with each other when stored or used.

The only distinction between deposits of specific versus fungible goods is in the good that the depository must return to settle the contract. The same specific good must be returned as was originally deposited. A woman placing her engagement ring in a safety deposit box whilst on vacation represents a deposit for a specific good. Provided that she keeps paying the service fee to the depository it must keep her ring safe until she requests it. At that time the same ring must be returned as was originally deposited. Fungible goods create a somewhat less restrictive requirement for the depository as the legal obligation is only to return the *tantundem* upon request. Thus a grain elevator storing wheat for a farmer does not need to return the same units of wheat that the farmer deposited, but only an equivalent quantity and quality. Likewise, the bank need only return the same quantity of money requested by the depositor, not necessarily the same money units previously entrusted with the bank.

Deposits of specific goods are known as regular deposits, while those of fungible goods are

termed irregular deposits. Table 2 summarizes the distinction between these deposits and loans.

		Purpose	
		Transfer of ownership	Safekeeping
Type of Good	Specific	<i>Commodatum</i> Loan	Regular Deposit
	Fungible	<i>Mutuum</i> Loan	Irregular Deposit

Table 2: Typography of financial contracts  
Source: Bagus and Howden (2013: 238)

This third legal distinction of the obligations constraining the borrower or depository is where the largest contractual difference occurs. Since the borrower only needs to return a predefined good at the contract's maturity, he may also make full use of the good over that period; this was the original purpose of the contract. Nothing is implied by this legal requirement in regards to what he may or may not do with the borrowed good over the contract's duration. In distinction, since the depository must return the deposited good on demand, the depositor does not transfer the right to use the deposit for the depository's purposes. **The depository may "use" the deposit only in such a way that it guarantees the original intent of the depositor, viz. complete availability, e.g., by moving it around in its vault to ensure full availability. As a result, the depository may do what it wishes with the irregular deposit, provided that it holds a tantundem safely and completely available for the depositor.**

These three legal contractual distinctions between deposits and loans are summarized in table 3.

Legal Differences of Contract	
Deposit	Loan

1	Legal purpose of safekeeping and availability	Legal purpose of transferring property for pecuniary gain
2	No duration of contract; depositor can request deposit to be returned at any moment	Finite duration of contract; lender can only request return of lent good after some period
3	Return the deposited good (or <i>tantundem</i> ) upon request; <i>tantundem</i> must be kept safe and available to the depositor	Return lent good after specific period; borrower may use lent good for duration of contract for his own purposes

Table 3: Legal Differences in Financial Contracts

For financial transactions, these distinct legal obligations imply that deposited goods such as money or stocks must be treated separately from similar lent goods. This separation of legal obligations is tenuous in modern-day banking, where sums deposited into a bank are treated as loans to be lent to other customers by the bank. The bifurcation of deposits and loans creates at best confusion and at worst fraudulent activity among the banking establishment (Huerta de Soto 2009; Bagus and Howden 2009, 2013).

The common demand deposit exists as a mixture of some attributes of a deposit (the depositor thinks he has full use and availability of the deposited money) while it also has attributes of a loan (the bank makes use of the deposit to fund its investment portfolio, e.g., by selling mortgages, and in this way negates the full availability of the deposit to the depositor). **Notably, this practice is often approved of *de jure* by a country's legal authority (as is the case in the United States and United Kingdom), or the legal system *de facto* chooses not to enforce laws against the practice, as arguably is the case in Germany (Köhler 2013: 916-20).<sup>2</sup>** While this *de jure* or *de facto* legitimacy of the fractional-reserve demand deposit is certainly problematic, the

<sup>2</sup> Additional legal confusion exists in those countries where the illegality of the practice of lending out deposits is only partially enforced, as in Spain (Huerta de Soto 2009: 125-29; Bagus *et al.* forthcoming).

contract is not the only financial product to suffer from this affliction. We could well note, as others have (Evans 2014), that there are other financial products very similar to this contract which are viewed as legitimate by the financial community.

From a practical point of view, the apparent problem with the fractional-reserve demand deposit is that it cannot be honored if all depositors redeem their funds at the same time. Since banks use the deposits to invest in longer-dated projects, e.g., mortgages, they require time to liquidate these investments and return the proceeds to depositors. This is often not an issue, as banks keep sufficient reserves on hand to honor the day-to-day redemption requests of depositors. The problem is more apparent during liquidity crises or banking runs, where a bank is caught in an illiquid situation requiring a bailout from its regulator (as was the case with Northern Rock in 2008). If no such regulator is available the bank must close its doors and refuse to allow depositors to claim their funds. Such an outcome was widespread in Scotland during its free-banking period of 1716–1845 (Checkland 1975) and in the United States during its own free-banking experience from 1837-64 (Bagus and Howden 2012a; Howden 2014).

Other financial companies make similar promises that they would not be able to honor in practice should circumstances turn against them. Insurance policies, for example, promise to make a future payout based on the expected returns of the present premiums, but should many policy holders pass away earlier than expected the insurer would not be able to make good on the policy (or would have to pay out less than it promised). Other financial products do not appear to abide by the criteria that exist for deposits or loans. Take the perpetual bond, for example, first issued by the British government in 1751 under the guise of “consols” (Mills and Wood 2011).

The perpetual bond represents, at least at first blush, a loan of infinite or undefined maturity. Yet, the second legal criterion of the loan contract states that a finite maturity must be specified, at least implicitly. Should perpetuities be banned as they do not abide by this criterion? Do perpetual bond contracts create a legal contradiction? Are the rights of the lenders to perpetual borrowers infringed in some sense?

A more common financial product that does not function as either a deposit or loan is a callable loan, commonly used in margin trading. In margin trading, investors borrow money from their brokers to purchase stocks. The brokers can call the loan when the value of the purchased stock falls abruptly in order to retrieve their lent money. Does this represent a case of a loan of potentially zero maturity, in which case it would more correctly be considered a deposit according to the economic and legal criteria governing such contracts? Or, if it does not fit the criteria established should the practice be deemed illegal?

Finally, a spate of financial turmoil surfaced when it was uncovered that the commodities broker MF Global was practicing securities lending which led to its bankruptcy in 2011. By using client accounts for its own proprietary trading operations, MF Global was doing nothing different than what thousands of banks do on a daily basis. Yet, MF Global collapsed and brought forth the disdain of its clients when they realized they would lose their financial assets. Did MF Global do something wrong, or can we blame the ire directed at the company on financial illiteracy on the part of its clientèle?

While similar in many ways, these aforementioned contracts substantially differ from demand

deposits in regards to their purposes, rights and obligations. It is with these financial products in mind that we now assess the legal obligations of each contract to uncover whether they are ethically dubious.

#### **4. Securities Lending**

The failure of the commodities brokerage MF Global in late 2011 was in many respects similar to a fractional-reserve bank entering insolvency because of a loss on its assets (Bagus and Howden 2013). The similarities are in the way both types of financial intermediaries – banks and brokerages – treat their clients’ assets.

When you purchase a financial asset through your brokerage, you become the owner of the asset and your broker acts as custodian. Despite retaining legal ownership of the security, the client is potentially not the only party who “owns” the asset. On almost all of the world’s major securities markets the brokerage is permitted to lend a client’s securities for specific purposes, e.g., to facilitate a trade settlement, to deliver on a short sale, to finance the security or, commonly, to facilitate a loan to another borrower motivated by one of these aforementioned purposes.

When the security is loaned the title transfers to a new borrower, who then becomes its full legal owner. The brokerage is paid for this lending activity, and must also shoulder the risk should the borrowing party default and fail to repay the security. (Alternatively, the brokerage must purchase the security on the open market if the original owner redeems the asset prior to the borrower returning it.) In this way, securities lending is completely analogous to fractional-reserve banking. The security is equivalent to the demand deposit, and the brokerage loans out a

portion of the assets its clients hold, just as the bank lends out a fraction of its depositors' funds. Furthermore, both the security and the deposit can be redeemed at any time, thus exposing both the bank and brokerage to liquidity risk. The only difference between the two cases is that the equity is redeemed at its market price while the deposit is redeemable at par value.

Similar to the case with fractional-reserve banking we can see the two legal, economic and ultimately ethical problems inherent in this practice. The first is the wealth illusion created by multiple claims to the same asset (Hoppe *et al.* 1998). Only one security exists, as purchased by the original owner, but multiple parties have legal claim to it through the broker's security lending operations. There is an "over-ownership" as two individuals simultaneously believe they own the same asset.

Perhaps more important is a consideration of the economic, legal and ethical ramifications of such a practice. The broker is earning interest by lending a security that it does not have legal title to. As is the case with banking, this practice is not apparently problematic as the brokerage retains some liquid assets to cover redemption requests by the owner of the lent security. This possibility does not rectify the contradiction that arises should the brokerage not be able to honor a redemption request by a client. Indeed, as brokers are not covered by deposit insurance they are more at risk of such an eventuality than is a fractional-reserve bank.

The original owner of the security has entrusted the broker to act as a custodian (i.e., depository) and to keep his investment safe. Note that safety in this case does not refer to the expected *return* on the security, but merely to the safe return of *the security* when demanded. By lending the



security the brokerage breaks an important term of the deposit contract and places the security's owner at risk of not having his funds available on demand when requested. Lending out deposited securities violates the purpose of the contract from the point of view of the depositor. Note that even if the depositor is aware of the possible lending, the contract is invalid as long as the depositor wants to maintain the full availability of the securities. In fact, if the depositor did not want to maintain full availability he could remove the intermediary and lend the security directly, as is the case in repurchase agreements.

## **5. Callable Loans**

Fractional-reserve demand deposits are often compared favorably with “callable loans” (Evans 2014; White 2007). A brokerage or bank will lend money to an investor but the loan is callable, meaning that the lender can demand repayment at any moment. The parties and terms to a callable loan are thus the mirror image of those involved in the fractional-reserve demand deposit. If callable loans are such a widespread and accepted part of the financial system, should not fractional-reserve demand deposits also be?

There are several important differences between these two financial products. The first is the purpose behind the callable loan and the demand deposit. A deposit represents a perfect money substitute. “Perfect” in this sense refers to the two distinct qualities of money *qua* financial asset: on-demand availability and par value. Any deposit must necessarily preserve these two qualities.<sup>3</sup> Since holding a deposit creates a cost for the depositor (e.g., lost purchasing power,

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<sup>3</sup> In distinction, money could be held in an equity investment or a money market mutual fund, both products which offer on demand redemption at market value. Holding money in the form of a time deposit or bond allows for par value redemption, but only after some waiting period. The act of holding money is motivated to hold the unique asset that is both on demand and at par value.

service fees) with no offsetting pecuniary benefit (e.g., there is no return on the deposit since there is no intertemporal value spread), the individual's motivation for holding the deposit *qua* money must be unique: he wants to retain the availability in order to use it as a perfect money substitute.

The purpose of the callable loan, in distinction, has nothing to do with keeping a funding source available. It is an investment by the brokerage undertaken to earn pecuniary gain through interest charges or service fees.<sup>4</sup> The callable loan is *not* an attempt by the brokerage to construct a perfect money substitute. The borrower, in turn, takes out the loan in order to leverage his investments. If treated as a deposit there could be no "meeting of the minds" as the end sought is distinct for each side of the transaction. With deposit accounts it is understood that the goal is to have a deposit ready to be withdrawn at a moment's notice while in the callable loan the motivation is to create a source of investable funds for a period, the use of which will be repaid to the lender through service fees or interest charges.

The second distinction is that there is an implicit minimum duration to the loan *de facto*, even if it is callable *de jure* by right of its legal terms. If the investor thought the loan would be called the moment he used the proceeds to purchase another financial asset he would have nothing to gain from the transaction. Not only would his investment not have time to mature into an expected gain, but the investor would be forced to pay the brokerage for this "service" through the interest expense or service fee of the loan. The borrower must expect that he will be allowed to use the loan unhampered for some minimum period before (or if) the loan gets called. In

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<sup>4</sup> If the purpose of a "callable loan" was to maintain the availability of the "lent" money, it would be a genuine deposit with all corresponding legal obligations applying.

distinction, the depository has no problem with a depositor making a deposit and then withdrawing it instantly; this is the service that the depositor pays for.

The third distinction is that a “callable” loan is a misnomer. It is not that the brokerage may call it at a moment’s notice, but rather that it may fail to renew it at any point. It is actually a short-term loan with an embedded extension option at the discretion of the lender.

The fourth and final point demonstrates the most striking economic difference between a deposit and a callable loan. In a deposit the depositor is the party that pays for the services rendered by the depository. This is an economic necessity – the depositor cannot gain as there is no intertemporal value spread between the good deposited and when it is available to the depositor. He will remunerate the depository for its safekeeping services. In the callable loan it is commonly claimed that the borrower is acting as a “depository” while the broker functions as the “depositor.” Yet in this financial transaction it is then the “depository” who is paying the “depositor” for the services rendered by the deposit.

The reason why this confusion arises is because the borrower of the callable loan is in no way a depository – he makes use of the money which is available to him. As a result of this use he is forced to pay an interest charge to the lender because of the intertemporal value spread between when he borrowed the money (in the present) and when it will be returned (in the future).<sup>5</sup>

Although by some appearances a callable loan looks and functions as a deposit, it is a distinct

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<sup>5</sup> It is true that fractional-reserve banks sometimes also pay interest on deposits. This does not show, *ipso facto*, that depositors wanted to loan the money to the bank. The undefined term and desire to maintain full availability of the deposit indicate that the depositors did, in fact, intend to make a deposit.

financial transaction with differing motivations, terms, obligations and service charges between its parties. As such, any argument supporting the legal and ethical nature of callable loans cannot be sustained *pari passu* with fractional-reserve demand deposits.

## **6. Perpetual Bonds**

A perpetual bond is commonly marketed as an infinitely-lived debt instrument. The bonds are issued at some face value (e.g., \$1,000) and in theory have no maturity date. Over the perpetual bond's life it will pay a fixed interest payment. Most recently, in 2010 HSBC issued \$3.4 billion of perpetual bonds (though they are callable after 5½ years).

Although commonly called a perpetual “bond”, the financial product has nothing to do with a bond. As a matter of historical fact, all issuances of perpetual bonds have been callable at the issuer's discretion. Furthermore, all except for the most recent issuances have been called early.

As a theoretical matter, some authors (Evans 2014) have likened a perpetual bond during its callable period to a deposit. One defining feature of a deposit is that it has a potential maturity of zero – it is “callable” at the depositor's discretion. As the lent amount of the perpetual bond is callable after the call protection period, it becomes economically equivalent to a deposit. The service fee on the deposit is the “interest rate” paid on the bond. Since perpetual bonds are a more-or-less normal feature of financial markets, and since they are in some ways equivalent to fractional-reserve demand deposit contracts, authors like Evans make the claim that fractional-reserve demand deposits should also remain a normal feature of the financial world.

There are important distinctions between perpetual bonds during their callable period and a deposit. Since a loan must necessarily result in the return of the principal at its par value, a key contractual component is missing in the terms of the perpetual bond, which in theory never repays its principal. Furthermore if one were to say that the principal will be returned, but only at some future date infinitely far away, there would be a lack of certainty which is apparent in all loan contracts. The cumulative probability of an event occurring over an infinite timeline tends to unity. Thus it is a certainty that a perpetual bond will at some future point default. Since the return of principal at par value is missing from the perpetual bond, it is better thought of as an equity investment (Brealey and Meyers 2003: chap. 2).

The payment of “interest” on a perpetual bond creates the appearance that the one who borrowed money is remunerating the lender for the use of the money over the contract’s duration. Yet this interest payment can only exist on a lent sum of money where there is a differential between the present value of the sum lent and the expected future value of the principal to be returned. Since the perpetual bond entails no return of the principal, the expected future value is zero. As a consequence, no interest can result from this economic distinction between the values of present and future goods.

What appears to be an interest payment akin to a fixed dividend. The original transfer of the principal amount gives one party the availability and control over the “lent” sum. To remunerate the “lender” the party in possession of the proceeds transfers a payment in the form of a dividend. Just as a dividend on an equity is a payment from the company to the investor for the use of his funds, so too does a payment made on a perpetual bond represent a dividend

remuneration for the same purpose.

Indeed, as a practical matter, the pricing formula for a perpetual bond is that of a no-growth stock paying a fixed dividend (Bodie *et al.* 1992: chap. 13).<sup>6</sup> A firm that retires its perpetual bond offering early is exercising a share repurchase option at a fixed price tender. Such a transaction is common in cases of equity, and the only distinction between such a repurchase of perpetual bonds and equities is the terminological confusion of an equity masquerading as a loan. To the company selling a perpetual bond we can thus more accurately state that it has sold a stock with a fixed dividend while simultaneously purchasing a call option to repurchase the principal at some future date. As this call option has value to the issuer, the price paid for perpetual bond will either be 1) lower than bonds of comparable yield and quality, or 2) the yield will be higher than on bonds of comparable quality and present value. If there is anything ethically dubious about perpetual bonds, it is limited to the mislabeled nature of a fixed dividend equity

## 7. Insurance

In many important respects the basic life insurance contract entails the same contractual promises as the fractional-reserve demand deposit. It also suffers a similar deficiency, namely, a potential over-subscription of property rights (Evans 2014). Life insurance companies manage risk in much the same way as it is commonly thought that modern fractional-reserve banks do. By taking premiums today, the insurer makes an estimate of when the expected policy payout will occur (e.g., the life expectancy of the policy holder) and the expected rate of return this policy will earn until the policy is expected to be paid. Life insurance is a specific example of

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<sup>6</sup> The present value of a no-growth stock,  $P_0$ , is equal to the future stream of dividends ( $D_n$ ) discounted at the appropriate rate ( $r$ ), which simplifies to  $D_1/r$ .

what Mises (1949: 107-10) refers to as “class probability.” In these probabilities we know or assume to know about everything concerning a whole class of events but we know nothing about individual cases within such a class except that they are part of the larger set. Death is a prime example of such a case. We may know that the probability of death within a given year for a certain class of men, e.g., 40-year old non-smokers, is 3 out of 1,000. Although we have knowledge of how the greater class behaves we do not know anything of the individual members of such class, i.e., we do not know which three individuals out of the 1,000 will die within a year.<sup>7</sup>

Because the date of death falls into such a well-defined category an insurer can take the knowledge of the behavior of the larger class and couple it with the law of large numbers to offer a risk-dilution policy to individuals. The insurer will overestimate the date of death for some individuals and earn profits on them. This will be offset by an under-estimation on others which will cost the insurer profits. The successful insurer will estimate correctly as this implies the lowest premium for policy holders without incurring losses.

It is true that an insurer may not be able to pay out all policies if, by some freak event, a sufficiently large number of policy holders passes away over a short period of time.<sup>8</sup> In this case the insurer may find himself with insufficient current assets from the premiums to pay out the policies owing. It is in this manner that the life insurer is compared favorably with the common fractional-reserve bank: the potential though not assured impossibility to pay out all clients when

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<sup>7</sup> For a group of individuals, the cause of death for any sub-group can be estimated as it involves categorizable risks (e.g., 2.18% of all people die of lung cancer, 1.73% of diabetes, etc.). This distinction is brought about by the class that exists with groups but not individuals from which common causes can be probabilistically ascertained.

<sup>8</sup> Many of these freak events, however, are excluded in life insurance policies as “Acts of God.”

necessary.

This similarity is very superficial as the basic operation of each business is fundamentally distinct. Insurers are in the business of offering *risk-reduction* services by aggregating the probability of death over a broad range of individuals. Insurance on death is possible because, 1) the probability of one person's death is not affected by any other's death, 2) all people die eventually, and 3) all people who die of their own accord are purposefully excluded from the class of insured.

Banks are in the business of offering a service to mitigate people's *uncertainty*. The defining characteristic of a bank is depository services.<sup>9</sup> Clients deposit money into a bank account, thus splitting their demand for cash balances between currency held physically and claims to currency via deposits. Money is held to mitigate felt uncertainty (Mises 1949: 249). If an individual was certain as to the extent and time of his monetary needs, he would never need to hold a cash balance. In its place he could invest the money in some interest-earning asset that matures at that exact moment when the demand for money becomes real. Money is a unique financial asset as it is the only one that sells at par value and on demand. These features are demanded by an individual to reduce his felt uncertainty by providing a hedge to settle future unknown expenses. Since the future demand for money is fundamentally uncertain, so too are the redemption demands for money in the present. The bank does not know when or how much money the depositor will withdraw from his deposit account. Indeed, even the depositor knows not these pieces of information (Bagus and Howden 2013).

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<sup>9</sup> Some might claim that banks are agents that provide liquidity services by "borrowing" short term through the deposit base and lending long term through their loan portfolio. Note that even this basic *raison d'être* for the bank is predicated on a bank acting first and foremost as a depository to obtain funds.



Despite the fact that many individuals hold money balances in a deposit account, this fact alone does not group them into a type of insurable class. The factors governing the redemption demands of depositors behave in a fundamentally distinct way from those of insurable classes. In fact, the factors governing redemptions are correlated with each other as a long line in front of a bank may induce others to demand their deposits. The case is different for insurable events such as death, where a line up at the cemetery does not induce others to die off *en masse*.

The main difference is the purpose of the contracts. The life insurance policy holder gives up the availability of his premium he is paying until he dies. He wants the insurance company to invest his money wisely in the meantime. The depositor, in contrast, wants to maintain full availability of his money to mitigate uncertainty.

Since insurance products are not related to deposit products, ethical doubts concerning the latter are unrelated to the former. Indeed, cases of insolvent insurers not meeting the obligations of their clients are quite rare. That such cases occur frequently in fractional-reserve banking should allude to the legal differences and ethical implications of each financial product.

## **8. Conclusion**

Never in recent history has the financial services industry been viewed with such opprobrium as it is today. This article has shed light on why this is the case. Both parties in many of the most common financial contracts – notably demand deposits and securities lending – are at odds with one another. Both parties' purposes behind such contracts are quite distinct and irreconcilable.

Other similar financial products, such as callable loans, have distinct obligations when viewed in light of the economic-legal framework employed herein. Unfortunately, confusion has been created by equating such illegitimate but common place financial products with wholly legitimate practices, such as perpetual “bonds” and insurance. We have clarified the confusions and errors created in assessing the legitimacy of certain financial products by demonstrating the unique economic and legal characteristics of each.

While the framework outlined in this article is a step in the correct theoretical direction to outline which financial practices the legal system should reassess, there is much need for practical work to be done to realign the rights and obligations of each party of these financial transactions (as in Huerta de Soto 2009: chap. 9; Bagus and Howden 2013: 242-43). As always, financial products evolve and the laws constraining their use must likewise develop. Our framework herein outlines how laws can be restructured concerning some specific and problematic financial contracts to avoid the ethical conflicts that have plagued the industry over the past few years.

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