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"In the bank or under the bed: Should the law protect your money?"

Money under the bed benefits no-one. The economy suffers because the funds are not available for investment. The saver suffers because inflation will diminish its value inexorably. However, an exaggerated view of risk combined with herd instinct can easily lead to the stuffing of money in mattresses. How might governments counter this, and is legislation an appropriate response?

It is helpful to leaven the argument with some facts. One in four Britons has less than £1,000 in savings[1]. The average level of savings is well below £20,000[2]. Therefore, most Britons are likely to be significantly protected by the Financial Services Compensation Scheme (FSCS), which guarantees £2,000 and 90% of the next £33,000 in an account. It has been argued that the FSCS guarantee should be increased to £100,000 or more. However, this surely misses the main point of the FSCS. It is first and foremost a tool to maintain consumer confidence and keep funds in circulation, not an insurance scheme. The UK scheme already compares favourably with those in most other European Union countries[3]. It should be set at the minimum level required to fulfil its policy objective.

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[1] Research by Alliance and Leicester, reported November 2007
[2] National Savings, Autumn Savings Survey 2006
[3] Report on the minimum guarantee level of Deposit Guarantee Schemes Directive 94/19/EC, Table 1, p10.

It is not entirely unreasonable for those with savings above the FSCS level of £35,000 to have assumed that their money is safe in banks. The demise of Overend, Gurney & Co. in the last run on a British bank occurred as long ago as 1866. However, the risk of bank failure has been ever-present. Investors who have chosen to place their savings in, say, Northern Rock as opposed to National Savings have acknowledged that risk by accepting a higher rate of interest in return. For those fortunate enough to have savings above £35,000, financial education appears to be required. Where inertia or risk aversion rules, there is a choice. National Savings are, after all, quite literally as safe as the Bank of England.

Active management of savings risk is a matter for insurance and not for law. For most financial instruments, this insurance is achieved through diversification. The problem arises where citizens choose to hold large amounts of cash in savings accounts on the assumption it is risk-free to do so. This is aberrant when behaviour in relation to other assets is considered. For the majority of the population, life, house and car are the three most valuable assets they possess and most will have insured them for that reason. Why then do so many people assume that savings assets require no insurance?

Perhaps some might say that this is too hard a position. Why not guarantee savings up to £100,000 or more? Economists would argue that it creates ‘moral hazard’. If funds are underwritten by government then investment behaviour by consumers and banks can become imprudent. There are, I submit, two more telling reasons why this should not happen. Firstly, it would be inequitable. Government has been unable to protect often low-income citizens from pension fund fraud or indeed from the demise of the Farepak Christmas club. Why then should it insure the wealthy against avoidable

risk? Secondly, moral hazard is primarily a risk in relation to bank behaviour. A stronger regulatory framework, preferably at European level now that the Markets in Financial Instruments Directive is in force, would offset this risk. Dare one suggest that banks might be encouraged to loan no more than they have on deposit?

The principles seem clear. Legislation is appropriate on the supply-side of the savings equation. Some banks have behaved irresponsibly in the rush for profits and their behaviour requires regulation. On the demand-side, savers have choices which are risk-free and should pursue them if they are risk averse. However, savings practicality is about perception not principle. Savers must have confidence that the majority of savings options are safe if a rush to the mattress is to be avoided. Government underwriting is unacceptable. Therefore, a new savings insurance scheme is required.

It might take several forms. Perhaps most radically, a market might develop in insurance policies against loss of savings which could be sold alongside life and house insurance. This would require careful thought given the scale of risk being insured. More simply, banks might be compelled to contribute to an insurance fund along the lines of the ATOL scheme operates in the package holiday industry. Costs could be passed on to savers through marginally lower rates of return. Alternatively, government might introduce a savings tax by adding a fractional percentage to the income tax on savings above a certain value (e.g. the level of FSCS). All of these approaches have one thing in common - the cost of insurance is borne by the savers themselves and not by taxpayers.

In conclusion, it is clear that the law has a role. It is needed to protect against fraud. It is needed to regulate bank behaviour. It is needed to maintain consumer confidence. However, the law must not be used to manage investment risk for the

wealthy, however politically tempting that appears to be. It is education and not law that will prevent UK savings from disappearing under the bed.

References

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