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

"A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain"[1]. Recent events involving the Northern Rock bank may indicate that depositors have learned to reciprocate the favour.

This essay will draw on the recent crisis to advocate that it is manifestly right that the law should introduce further measures to ensure ordinary retail depositors are protected and it will make proposals for how this can be achieved. It will also outline why the recent crisis is indicative of a deeper malaise within financial services. A malaise that should be tackled by a package of improvements to regulation, leading to improved confidence bourn out of transparent markets and informed consumers.

Even before the current crisis, ordinary depositors were afforded protection by the Financial Services Compensation Scheme. However, the level of 100% protection was set at the low level of £2,000. Government clearly recognised that this was insufficient to protect most retail savers and the level of 100% protection was raised on 1st October to £35,000. This move should be welcomed. As well as providing an appropriate level of direct protection, the FSCS remains funded via levies imposed on the financial services industry, thereby ensuring that the burden for the additional protection is not borne by public funds. Unfortunately, this measure alone is insufficient to protect savers.

The Northern Rock crisis revealed deeper issues, which requires more fundamental change in order to protect depositors and the reputation of the financial markets. The government's strategy involved acting to issue a blanket protection on Northern Rock

[1] Mark Twain

deposits in order to calm the crisis. Whilst such a move may have been justifiable as an emergency response measure, it was a measure to deal with the symptom, not the cause. First, it created an inconsistency in government policy, by effectively underwriting bank held money with public funds; a position in sharp contrast to government refusal to offer full financial support to those affected by collapsed pension funds. Second, such action clearly created a risk of 'moral hazard', a risk acknowledged by the Governor of the Bank of England. Such a measure may distort the financial markets, protecting directors and shareholders from the consequences of risky investment strategies, penalising the prudent and providing incentive for the behaviour that underpinned the crisis.

The EU Market Abuse Directive has been cited as having exacerbated the crisis by preventing the Bank of England from undertaking covert measures to support Northern Rock[2]. Is it disputed that the Directive would have prevented such covert action by a central bank by the EU Commission[3], but in any case, such shadowy action is actually counter productive. Transparency should and can be an advantage in well ordered markets that protect investors if accompanied by depositor's confidence that banks are obliged and inclined to protect their interests. Under current law, the Northern Rock depositors were right to act as they did. In the highly unlikely event of the bank falling into receivership, the use of securitised investment vehicles by the bank would have put the return of their deposits as a low priority. Transparency brought about by the Directive has cast clear light on the precarious situation that depositors may find themselves. This must be compounded by regulation to place the

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[2] Mervyn King; Governor of the Bank of England; Commons Treasury Select Committee 20th September 2007

[3] The Times; 22nd September 2007; '*Europe say Directives on Disclosure did not mean King had to stay silent'*

interests of depositors at the heart of business decisions, enabling transparency to underpin consumer confidence rather than revealing their vulnerability.

The proper legal solution should introduce protection to depositors whilst continuing to ensure business owners reap the rewards and consequences of their chosen strategies. In practise, there was little chance of this underwriting ever actually being required to protect deposits. Existing laws on capital adequacy, establishing minimum limits of cash to be maintained by Northern Rock to meet liquidity were in place[4]. The risk assessment calculation model behind the requirements may have been tested and found wanting, but the key issue, the issue that turned a market adjustment into a full-blown crisis was one of consumer confidence. The real value of the government guarantee was in restoring confidence.

Changes in the FSCS levels or in Basel II capital adequacy calculations alone are insufficient. The crisis highlighted a mistrust held by the public towards major corporations, in the post Enron era, and one that had already been identified[5]. The use of increasingly complex derivatives products created financial implications that the average investor is unable to understand and therefore their responses were largely instinctive. The government has recognised that further action is required and is investigating various possibilities[6]. They appreciate that any further protection must involve a clear understanding by depositors that they are protected by an “appropriate, credible and reliable guarantee that can operate in a timely fashion”. Customer confidence was the driver in this crisis and in order for savers money to be protected

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[4] Basel II; EU Capital Requirements Directive (CRD)
[5] 2007 Unisys Trusted Enterprise research; 71% of UK consumers do not trust banks.
[6] Banking Reform – protecting depositors:
a discussion paper October 2007

that confidence must be restored. The government have outlined an intention to, "separate savers money from the rest of bank assets, so that savers money is as much protected as possible"[7]. Any such measures that strengthen the position of depositors in cases of insolvency are a welcome move.

A key further legal reform to restore confidence should involve amendments to the Companies Act 2006. Companies are legally obliged to be run primarily for the benefit of shareholders. Directors of the Board of Banks are therefore intrinsically inclined to adopt strategies to boost shareholder value and that the interests of depositors are subservient to this prime role. The Companies Act 2006 should be amended so that the interests of depositors become a core concern within corporate governance practise, including measures to allow depositors to have representation and appointment rights of Boards of Directors and to receive audit and company reports. Auditors do not currently owe a duty of care towards depositors[8]; such a duty of care should be laid out in statute.

There is little doubt that the dynamism and profitability of UK financial services has been boosted by a system of light touch regulation. The government has been quick to defend 'principles based regulation' and to calm those fearful of reactionary legislation[9]. Whilst they are right to refrain from an impulsive legal response, the case for regulatory reform is compelling. The recent crisis is a timely warning that reform is required, especially as the Bank of England has stated that further shocks are distinct possibilities[10].

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[7] Alistair Darling MP; Chancellor of the Exchequer Radio 4 Today Programme, Monday 1st October 2007

[8] *Caparo Industries v. Dickman* [1990] UKHL 2, [1990] 2 AC 605, [1990] 1 All ER 568

[9] Kitty Ussher MP; Economic Secretary to the Treasury; Speech to the Association of Private Client Investment Managers and Stakeholders (APCIMS) Annual Conference; 17th October 2007

[10] Bank of England Stability Report 22nd October 2007

By deploying public funds in the protection of private assets, at the behest of a major UK corporation, the City has opened the door to a more robust regulatory environment. As the champion of free market economics, Milton Freeman said, “there is no such thing as a free lunch”. For the sake of ordinary depositors, it is time for the banks to pay the bill.

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