In the Bank or Under the bed: Should the law protect your money?

Runs on the bank are nothing new. In the eighteenth century there were eleven worldwide. By the twentieth the figure was thirty-three. In terms of crises of confidence, nothing changes. What has changed, however, is the business of banking itself. No longer can a bank be defined as an institution which, as Lord Denning MR put it: collects cheques for its customers, honours cheques drawn on it, and keeps current accounts in which the credits and debits are entered.[1] Ours is an era of multifunctional banking behemoths. It is also the era of banks which, like Northern Rock, rely heavily on securitisation to offer better rates to their savers. In this context it is morally and economically imperative for the law (by which is meant black letter law) to prioritise the stakeholder in the business of banking with most to lose, i.e. the depositor. This essay argues that the law should protect your money: more of it, differently, and better.

Why does a change in the business of banking mean the law should change? The answer lies in the globalization of the financial services industry. In the Summer of 2007, as the scale of the sub-prime mortgage crisis in the US became apparent, world markets reacted to the possible existence of 'opaque' debt somewhere in the system. By August inter-bank lending had all but dried up, leaving Northern Rock, whose business model was heavily reliant on access to the money markets, in the sticky position of being solvent but illiquid.

[1] *United Dominions Trust Ltd. v Kirkwood* [1966] 2 QB 431 at 447.

In a world where if America sneezes, Europe catches an economic cold, there is an ever-greater need for protection of vulnerable stakeholders who may be staking everything but who have neither access to risk assessments, nor the expertise to decipher them. The burden of a global credit crunch should properly be born instead by those who knowingly take calculated risks, i.e. (primarily) the shareholders. Society expects shareholders to be aware of the risks they are taking and to go in with their eyes open. Unlike depositors, shareholders in banks have access to the annual report and accounts: and rightly so, for they are the risk-takers and they should be properly informed of the nature of those risks.

By contrast bank deposits are, and are perceived to be, quite different. Rightly or wrongly, cash in the bank is (or was until recently) regarded as risk-free. In particular, the understanding is that the value of your investment will not fall. And notwithstanding the legal analysis of the banker/customer relationship, the Northern Rock customers did not think they were queuing to call in their debts: they were queuing for *their* money, to which, they would have thought, they were entitled as of right, and not merely as of law. Foolhardy perhaps. But the law should not be too quick to demand of people whose bank deposit is their primary or sole investment the same financial literacy it expects of other types of investor. Banks have changed, but Lord Denning's definition of banking still has currency in society at large. There is for example, even post-Northern Rock, no widespread public appreciation of the use by banks of securitisation. When tinkering with something as fundamental as life-savings, the law should be responsive to societal attitudes, not prescriptive of them.

One of the arguments against (only) protecting cash is the so-called 'moral hazard' argument: by protecting depositors, banks will feel impervious to risk and

will lend and borrow with abandon, whilst other investments will suffer because cash will be seen as risk-free. There is force in this argument when the only form of protection in a bank failure is a deposit guarantee. The Chancellor of the Exchequer, Alistair Darling, proposes to increase that guarantee from the current maximum of around £30,000 to £100,000. This is a welcome, if cosmetic, proposal. However the moral hazard argument could be addressed head-on by establishing a separate regime for bank insolvency under which the depositors rank first. This would bring English law into line with American law, and is the approach favoured by Mervyn King, Governor of the Bank of England.[2] It would simultaneously go some way to addressing another concern regarding guarantees, namely the cost to the tax-payer.

Depositor protection is also economically imperative. The shockwaves from the Northern Rock crisis have extended far beyond the City. Doubt has been cast on the stability of the UK's financial services industry, and on the credibility of those whose job it is to police it. And without a willing bidder to take over the stricken bank (as of 21 November 2007), there is also the prospect of taxpayers losing billions of pounds should the emergency loans fail to be repaid. If the law fails to protect your money, the cost will eventually be born by taxpayers and the wider economy. That should be reason enough for legislative protection.

But perhaps the most pressing reason why the law should protect your money is that, apparently, the Bank of England/Financial Services Authority/Treasury will not. Or at least none of them will do so until political pressure is applied. And regardless of which of the regulatory triumvirate was most to blame for the Northern Rock crisis,

[2] Speech by Mervyn King at the Northern Ireland Chamber of Commerce and Industry, Belfast on Tuesday 9th October 2007.

the episode starkly illustrated the need for legislative provisions specific to a banking crisis: to establish who should take responsibility, and to protect investors at an acceptable cost to the taxpayer.

The concept 'depositor comes first' will undoubtedly be regarded by many in the financial services as unpalatable, and by others as naïve. Any legislative change would of course have to balance the need for depositor protection on the one hand with the maintenance of the competitiveness of the financial services on the other. Yet on the basis of recent evidence, our soft-touch regulatory environment is not up to the task of managing a banking crisis. Given the uncertain future of the global economy, that is not an acceptable state to be in.

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