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

Plus ça change. Both Northern Rock and Overend, Gurney & Co once inspired public confidence: the former sponsored Newcastle United, the latter was the Quaker-founded 'banker's bank' of the mid-nineteenth century. And both succumbed to the classic vice of hubristic bankers in periods of easy credit: borrowing short to lend long. Up North, a mortgage book was increasingly funded by short-term financial instruments and inter-bank borrowing. In Victorian London, diversification into railways and other investments was based on an existing trade in rapidly turned-over bills of exchange. When, in both cases, long-term liabilities exceeded supplies of ready cash, the result was widespread panic. Yet a comparison between the two most recent runs on British banks is important for more than journalistic *schadenfreude*. For policy-makers, the Overend Gurney crisis of 1866 and the Northern Rock debacle of 2007 should, together, demonstrate the eternal necessity of protecting ordinary bank depositors, while vindicating the law's reluctance to shield other categories of investor from the consequences of overenthusiastic speculation.

First, all can agree that bank runs are bad news – for savers, governments, a country's reputation, and broader confidence and stability in the financial markets. There is a simple way to avoid them: a solid government guarantee for all deposits at all regulated banks. Such a guarantee is important not only to prevent nervous savers fuelling the fires of future banking crises. It also safeguards the critical economic role of deposit-taking banks. This role is partly to provide a safe home for money before it is spent or otherwise put to work. But it also, significantly, underpins a model of responsible lending – particularly mortgage lending – departed from by Northern Rock. For this model to function, bank accounts cannot come with a health warning that they may at some point, without notice, become worthless. Whether officially prescribed or as a result of conventional wisdom, such a perception would reduce funds available to responsible banks while encouraging two dangerous approaches to personal finance. One is literal under-the-bed saving. In a land stalked by inflation, burglars and faulty electric blankets, this approach looks, and is, ridiculous. The other is favouring risky investments in the hope that greater rewards will compensate for inevitable insecurity.

This points us to the second lesson from history: the legitimate and necessary distinction between savings and investments. The financial markets may no longer be the sole preserve of the wealthy and the buccaneering. But even the humblest contemporary investor views – or should be encouraged to view – his stock portfolio differently from the savings account into which he pays his dividends. The account represents a sacrifice of potential gain in exchange for security. The portfolio, by contrast, is a gamble. Hopefully an informed punt, it nevertheless implies an awareness that companies both make and lose money. Yet today's investor already benefits from the phenomenon of limited liability. While there was no theoretical limit to how much shareholders could profit from their fractional ownership of Northern Rock plc, there was no corresponding risk that creditors, employees or even the taxman could ever seize their DVD collection to satisfy the bank's bad debts. This was not necessarily the case for Overend Gurney shareholders, many of whom had rushed to buy partly-paid shares. On the bank's collapse, they thus not only lost what they had paid, but were obliged to hand over substantial further sums. Today, the combination of limited liability and standard fully-paid shares puts shareholders in an enviable position: those with diversified portfolios, who avoid selling when the market has just crashed, are likely to prosper. But it is still a gamble, and the first rule of gambling applies whether dealing with the stockbroker or the croupier: put up no more than you can afford to lose. It would be a strange world indeed if this rule was also applied when paying wages into the bank.

On that note, a third historical lesson becomes relevant: that government and the law should combat commercial malpractice by regulation, but must at some point accept that markets (like race tracks and casinos) are able to provide some with large windfalls partly because others experience losses. A market regulated to the extent that no investor can lose is one which has had its life-blood of entrepreneurial risk-taking sucked dry. Companies must be allowed some leeway, and investors must accept some risk. Mervyn King was right to fear the 'moral hazard' in bailing out irresponsible banks; where he erred was in imagining that any government would tolerate queues of pensioners jostling to withdraw their life savings on the streets of Sunderland. A standing guarantee for deposits is a prudent compromise, providing certainty and a sufficient incentive for proper banking supervision, without establishing a general policy of insulating investors from losses. The sophisticated modelling techniques available to today's regulators enable a high level of rolling analysis and 'stress-testing' of bank investment policies. The focus of reform should be on enabling regulators to force banks to explain and adjust their strategies in light of this data. No bank, for example, should be so caught up with novel financial instruments that it is unable to evaluate its exposure to key potential market changes.

Far better to develop regulatory requirements reining in those bank directors in danger of having their heads turned by the prospect of easy profits, than to be put in the morally hazardous (in all senses) position of dealing with the consequences.

A fool and his money, sneered Gordon Gekko, are lucky enough to get together in the first place. Regulators and legislators – while of course free to reject the fictional financier's view that lunch is for wimps – should be slow in ignoring this dictum. A bank depositor is not foolish to expect that his money will be safe, and the law should not allow him to be made a fool by his bank manager. But speculators cannot complain when fantastic market gains are sometimes offset by spectacular losses. It would be folly for the law to pretend otherwise.