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

This question focuses on a compelling conflict in financial policy making. Parliament has sought to achieve a degree of equilibrium between the competing needs for liberal markets, public awareness and consumer protection. These last two concerns are the second and third statutory aims respectively of the FSA as set out in the Financial Services and Markets Act 2000[1]. However, turbulent times in the global and domestic banking sectors have thrown the debate into sharper relief. Parliamentary committees, consumers and some economists are clamouring for greater protection. It is the submission of this essay that an imperfect status quo should be maintained.

To an extent, this question is based on the false premise that the law does not protect consumer's money. In fact, there has been a scheme for guaranteeing such deposits since the Banking Act 1979. As of 2006, £150m had been paid out under the UK scheme.[2] Indeed, since the 1994 Deposit Guarantee Directive (94/19/EEC) this has become a European obligation although the UK scheme is considerably more generous than the €20,000 minimum guarantee threshold required. Since 1 December 2001, the Financial Services Compensation Scheme has been the statutory fund of last resort for customers of authorised financial services firms. Where a bank or building society becomes insolvent, the scheme will pay compensation for financial loss up to £35,000 if the institution is unable to pay back deposits it owes to its members.[3]

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[1] At s.2(2) FSMA 2000 (c 8)

[2] EP Ellinger, E Lomnicka and R Hooley, *Ellinger's Modern Banking Law* (Oxford, 2005)

[3] http://www.fscs.org.uk/consumer/How_to_Claim/Deposits Note that the rules were changed by the FSA on 1 October 2007 and the old rules will continue to apply for deposit-taking firms declared insolvent before that date.

The rationale for protecting deposits is essentially twofold. Firstly, the scheme is justified on the basis that unsophisticated investors are unable to access or interpret the complex financial information necessary to coming to a decision about the reliability of banks. Therefore savers should not lose their savings where a bank fails.

Secondly, the scheme acts as a mechanism to prevent instability in the banking system through the mass withdrawal of funds. The spectre of long queues of Northern Rock plc savers waiting to remove their funds had an immediate impact on market confidence in similar institutions.[4] Alan Greenspan offers a version of events in the worst case scenario: 'there will always exist a remote possibility of a chain reaction, a cascading sequence of unchecked defaults that will culminate in financial implosion if allowed to proceed unchecked.'[5] A practical example was provided by the secondary banking crisis in the UK between 1973 and 1976 where the collapse of London and County Securities Limited contributed to the protracted period of instability and volatility in world financial markets.

However, the argument for a total guarantee of consumer deposits needs to be balanced by the so-called moral hazard. This theory, which originated in relation to insurance, refers to the danger that market participants take excessive risks if they believe someone will bail them out if things go wrong. It has several facets. Firstly, consumers may be less discerning in their choice of institution. Indeed, they may actively seek high-risk institutions in pursuit of more attractive interest rates in the knowledge that their money is guaranteed. Second, the financial firm may be induced to operate a riskier policy. Finally, a total guarantee of

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[4] In particular, the share prices of Alliance & Leicester and Bradford & Bingley fell by 7% and 8% respectively on 14 September 2007.

[5] A Greenspan, *Remarks at the Eighth Frankfurt International Banking Evening* (1996)

deposits may encourage banks to hold a lower level of capital. The effects of illiquidity, and its contingent instability, are well illustrated in the Northern Rock plc crisis of August and September this year. The moral hazard argument is one which is weighs heavily with UK central bankers. Before the Treasury Select Committee on 20 September the Governor of the Bank of England, Mervyn King, declared that: 'the balance between [providing] liquidity and moral hazard is a judgment we are making almost daily.'[6]

While a total guarantee of consumer deposits could have significant detrimental effects, no guarantee at all would disregard both the informational disadvantage of consumers and the risk of systemic crisis. It is argued that the current scheme offers a via media through these competing concerns.

Yet guarantees merely form a constituent part of the way that the law protects consumers. Regulation of banks – traditionally a self-regulating sector – was not introduced until the Banking Act 1979 gave it a statutory footing. Since that time, subsequent domestic legislation, the FSA rules, European law and international banking organisations such as the Basel Committee have all impacted upon the sector. Prudential regulation requires financial institutions to maintain capital resources proportionate to their risks and make adequate provision for bad and doubtful debts.[7] Where, as with Northern Rock plc, an institution has a high ratio of long term loans to short term deposits, there is a particular need for adequate capital resources. Regulation also has an important role to play by requiring

[6] http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article2497870.ece
[7] The introduction of the second Basel Accord in January 2008 will make further requirements in this regard.

reasonable disclosure for the market and for consumers to make an informed analysis of the institution's position.[8]

This essay does not contend that the current system should be ossified. Governments, central bankers and regulators should use the legal and economic tools at their disposal where they see fit to do so. They should be able to step in to rescue banks – as happened with Johnson Matthey Bank in 1984 – or let them fail as they did in 1992 with the closure of BCCI. The strength of the UK system is in its flexibility. The law should not require governments directly or indirectly to protect 'our' money. In a system where markets are not perfect and consumers not always rational, it is unsurprising that the remedy, too, should be an imperfect one.

[8] Article 6 of the EU Market Abuse Directive 2003/6/EC provides for disclosure and also for conditions where disclosure could reasonably be delayed. It is interesting to note that the European Commissioner Charlie McCreevy has accused the FSA of gold plating the requirements of the Directive.