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

You could be forgiven for thinking that a snail found in a bottle of ginger-beer in 1930s Paisley has little to do with the recent Northern Rock crisis. But you would be wrong. Both go to heart of what the law is for, whom it should protect, when it should act and why.

When the now infamous Mrs Donoghue sued drinks-maker Mr Stevenson, her success marked one of the most important watersheds in British legal history. One of the reasons for the unprecedented verdict was that the bottle was made of a dark, opaque glass. Mrs Donoghue could not see the snail it contained. So the law stepped in to protect the ignorant and impotent, paving the way for modern consumer protection law.

By analogy, the loan book of a typical High Street bank is hardly 'transparent' enough to allow the average customer to see any potential 'snails' within. Economists like to talk about 'information asymmetries' – an imbalance in knowledge and hence power. But the underlying principle is the same: the law should protect the weaker, disadvantaged party.

Of course, it's not that simple. The tripartite authorities charged with banking regulation – the FSA, the Bank of England and the Treasury – frequently find themselves between a rock and a hard place. Do too little and risk leaving savers in the same position as customers of Barings or BCCI; do too much and tie the City's hands behind its back with red tape.

And 'in the bank or under the bed' is hardly a real choice. In modern society there is no realistic alternative to participation in the banking system; the finest goose-down will not facilitate electronic payments or pay interest. Of course, these benefits, which we obtain by putting our money in a bank, must necessarily come at a cost. We all know that profit entails risk: no pain, no gain. The question is to what extent the risks in the banking sector – in the worst case banks going bust – are proportional to what we stand to gain; whether we understand the risks and whether we subject ourselves voluntarily to them.

Stash your cash under the bed and the law will seek to protect your property rights. But were it stolen in a burglary or destroyed as your house burnt down, the law would not actually get your money back. The law expects people to take responsibility for their actions. No one who leads a normal life can avoid taking risks. To avoid risk you are expected to purchase contents insurance to protect your divan-deposited fortune.

Yet whilst a theft from one bedroom might leave another unscathed, not so in the banking sector where regulators must defend confidence in the wider financial system as much as the individual consumer. This systemic risk was understood by nineteenth century commentator Walter Bagehot, who explained that 'in wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them'.

These considerations shaped the approach which UK law attempted to take with the Financial Services and Markets Act 2000. Part XV of the act created the Financial Services Compensation Scheme to protect savers' money if a bank fails: no mere act of benevolence. The provisions implemented European Commission directive 94/19 on deposit guarantee schemes, facilitating the creation of a single market in financial services by ensuring that deposits in banks throughout the community were subject to the same basic level of protection.

One criticism of such schemes is that knowing they are there as a safety-net, both banks and their customers will then take greater risks with their money. Until 1 October 2007, the British approach was that such 'moral hazard' could be avoided by an element of so-called 'co-insurance', by only guaranteeing ninety percent of claims between £2,000 and £35,000. The idea was that risk could be shared with consumers and prudent decision-making encouraged.

But inadequate financial regulation is like a broken prophylactic. By the time you know that it has failed, it's already too late; you're likely to have a crisis on your hands. So the flaws in the co-insurance argument became apparent as the queues at Northern Rock branches grew. For one thing, it wrongly implied that the man in the street was aware of the scheme, its limitations and was capable of making informed decisions as to the precise financial risks he faced. More seriously, to lose ten percent of £33,000 is still, for those who work outside of the City, to lose a considerable sum of money: the incentive remained for depositors to withdraw their money when confidence in an institution faltered.

It is almost three decades since the establishment of a Deposit Protection Scheme under the Banking Act 1979. It has taken the anxiety and anguish of thousands of depositors, considerable political embarrassment for a new Prime Minister and it may yet cost a Chancellor of the Exchequer his job, but it seems that with the decision to fully protect deposits up to £35,000, the law is now closer to providing the protection it should to bank customers.

The role of the law now seems clear: to do everything possible to render the playing field level – no more, lest we fall foul of EU competition and market abuse law. It should protect the consumer, who has no alternative and cannot afford financial insurance. But it should leave the institutional investor, who can diversify, hedge and insure himself with credit default swaps, to his devices. And regulation must be accompanied by increased transparency and consumer education. One of the objectives of the FSA is 'promoting public understanding of the financial system' and it must be understood how fundamental this is to the related aims of consumer protection and market confidence. Ultimately, though protected, the man in the street must be equipped to understand one thing: there is no such thing as a (risk) free lunch. *Caveat depositor.*

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