LAW AND PRACTICE RELATING TO BANKING

FIFTH EDITION

F. E. PERRY

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Preface to Fifth Edition

Whilst he was in the course of writing his last revised fourth edition of this book, Fred Perry asked me if I would undertake the task on the next occasion. Shortly afterwards Fred died and it has therefore been a sad but valued privilege to fulfil my promise to him, albeit that much of this text remains as he wrote it, witnessing to the fact that authors live on through their writings.

In the intervening four years there has been an increasing pace of change in the financial world, and in addition to important new case law, bankers have had to adapt to a new Companies Act and the Insolvency Act 1986, the latter statute comprising the first major review of this important area of commerce for seventy years. All these changes have been brought into this new edition.

Additionally, the Consumer Credit Act, originally enacted in 1974, became wholly operational and bankers have needed to adapt to statutory requirements governing regulated lending, although whether the public is any better protected by the volume of paper and cumbersome procedures involved is very much open to doubt. Is it too much to hope that a future edition of this book will have a need to include amendments passed by Parliament or exemptions from the Act for recognized banks?

J. E. Kelly
January 1987

Preface to Fourth Edition

Each preface to previous editions has started with the words 'This is a book for the student. I have tried to set out the matters relating to banking law as simply and as clearly as possible.' This is still true, but little else of those past words can now apply. In the last few years there has been a substantial accumulation of statute law affecting bankers, including the Banking Act 1979, the Estate Agents Act 1979, the Companies Acts of 1980 and 1981, the Limitation Act 1980, the Supreme Court Act 1981, and many others. Various Finance Acts have added to the duties of the banker to disclose confidential information from the customer's account, as the authorities have progressively sought to close the gap in existing law with regard to taxation returns and to guard against downright fraud. The Sex Discrimination Act 1975 has had its repercussions, notably in connection with references and guarantees. Case law, too, has increased considerably its impact on banks' procedures and has added very much to the burdens which bankers carry in their efforts to supervise their customers' accounts and to conduct their business with due care. Some of the decisions have called in question principles which generations of bankers have taken for granted throughout their lifetimes, notably, perhaps, the 'Boland' case. The 'Mareva Injunction' has also come into prominence.

One result of this proliferation of new law has been the decision, very reluctantly taken, that it is no longer possible to provide an appendix of case reports and another of statutory sections important to the banker. However, the statutory law to date affecting bankers has been incorporated in the text and some thirty or so new legal decisions, some of the highest importance, mentioned and, in selected cases, summarized under the appropriate chapter headings.

It is hoped that this book will also give banking students a valuable introduction to Practice of Banking II, to which the questions on balance sheet appreciation have been transferred since the reorganization of the Institute's examinations. The chapters on the subject in this volume will, it is hoped, lead the student step by step into the knowledge of what to look for. Any names used in the examples of balance sheets given are fictitious and are not intended to refer to any existing person or company.

As well as acquiring the ability to read his customers' balance sheets, however, the management trainee should take an intelligent interest in the balance sheet of his own bank. For this reason one chapter in this book has been devoted to the balance sheet of National Westminster Bank. I acknowledge with gratitude the bank's kind permission to reproduce these figures.

Banking is both an interesting and an honourable occupation. Young people intending to make it their career will find it well worth their while to spend a few years studying to gain their technical qualifications: this general review of banking law and principles will, it is hoped, assist them in this task.

F. E. Perry
London, 1983

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I

The banking relationship with the customer

In this commercial world almost everything is governed by the law of contract. Buying a new suit or a packet of cigarettes, going on holiday – all come under the rules of contract law. The opening and maintenance of a banking account is primarily a matter for the application of the law of contract, but because the needs of customers change as time passes the services offered by banks change accordingly. The banks themselves are constantly seeking to perform their banking functions more quickly and efficiently (and, if possible, more cheaply), and therefore change is the order of the day. Handwritten passbooks and ledgers have given way to mechanized systems, which in turn have been replaced by computer accounting. While all this has been taking place, the law relating to banking has naturally undergone considerable modification also. Only the banker and the customer – the parties to the banking contract – remain unchanged.

What is a banker?

A number of Acts of Parliament have purported to define a banker – none very successfully. The Bills of Exchange Act says, in section 2, 'banker' includes a body of persons whether incorporated or not who carry on the business of banking. Other Acts have tended to make rules with special reference to the purpose of the particular Act.

Over the years this legislative background became very complex. Fortunately it is no longer necessary to examine this as the Banking Act 1979 made a clear distinction between institutions which are banks in the full sense and other deposit-takers. Before we go on to discuss this, however, we must note the generally agreed criteria for bankers, which are that a genuine banker must receive money on current or deposit account, collect the proceeds of cheques for his customers, and pay cheques drawn by his customer on himself. Nowadays, of course, bankers offer many other services, but those three are basic.

Supervision

The failures of the fringe banks and the resulting rescue operation by the Bank of England and the clearing banks, which came to be known as the 'lifeboat', raised from 1973 onwards the question of a stricter supervision of banks, in a much more acute form. Another factor was the need to bring this country into line with the systems of the other countries in the EEC, who have suggested that banks should be defined by law, licensed, and ought to be made to secure official approval for management and for existing and future plans. This question of supervision (by the central bank) brought up again the need for a definition of a bank. (Before anyone can supervise a bank he has to know what a bank is.)

The Banking Act took effect from 1 January 1979. Protection is given to bank depositors under the Act by the formation of a deposit protection fund which is managed by a board under the chairmanship of the Governor of the Bank of England. All recognized banks and licensed institutions have had to make contributions.

The fund will be used to pay a depositor an amount equal to three-quarters of his deposit if the institution which received his deposit becomes insolvent. This protection will apply for sums up to £10,000 for any depositor. The board may decline to pay any depositor who may have profited, directly or indirectly, from circumstances giving rise to the institution's difficulties. The 75 per cent limit leaves the investor some responsibility for deciding where he places his money. If he is tempted by a high interest rate he must expect to take some risk.

As far as the banks themselves are concerned, the Act divides deposit-taking institutions into two groups.

The first group are the major banking companies – the clearing banks, the merchant banks, and discount houses. Exacting criteria for such recognition, covering such matters as minimum capital and reserves, the type or range of banking services provided, and the reputation or status needed, is determined by the Bank with the agreement of the Treasury. A certificate is given to the bank, but it needs no licence. It is granted statutory recognition as 'a bank for the purposes of this Act' (Banking Act 1979).

The second group need a licence from the Bank of England. Criteria for obtaining the licence embrace a minimum figure for capital and reserves, trustworthy and qualified management, and a good past trading record. In assessing the business of a deposit-taking institution, the Bank will examine appropriate balance sheet relationships and ratios relating to the capital adequacy and the liquidity of the institution, the degree of risk attaching to various assets, the matching of liabilities and assets in both sterling and other currencies, the reliance placed on deposits from connected companies and the institution's lending to connected organizations, the distribution of its lending among economic sectors, and the provisions and profits that have been made. It may provide a range of banking services or one specialized service.

If, after all this, a licence is granted, the institution still will not be able to call itself a 'bank'. It will be a 'licensed deposit-taking institution'.

For this second group the Bank has the power to demand management changes or the injection of additional capital as a condition for the granting or renewal of licences. In both cases there is a right of appeal against an unfavourable decision by the Bank, to the Treasury, with the ultimate decision being made by the Chancellor of the Exchequer, or to the courts on the grounds of a denial of natural justice.

The Bank reports annually on the exercise of its supervisory responsibilities, and these reports are laid before Parliament.

The Act has cleared some of the confusion concerning the kind of institutions that are able to advertise themselves as a 'bank'. There is no doubt that some people have been misled in the past in assuming that the word 'bank' in the title of an institution necessarily implied integrity and prudence.

Another benefit of the Act is that it gives us an improved definition of a bank, which may be stated as 'a deposit-taking institution which is recognized as a bank by the Bank of England under the provisions of, and for the purpose of, the Banking Act 1979'. These institutions will be the only ones allowed to describe themselves as 'banks' with the exceptions of the National Girobank, the trustee savings banks, and the Bank of England itself.

The definition is in one sense little improvement on those which have gone before, in that again the definition is only for the purposes of the Act which gave birth to it. This, the last in the long line of statutory definitions, could be contrasted with the traditional view as expressed in Halsbury's *Laws of England* and Paget's *Law of Banking*, where the three criteria of the genuine banker, as stated above, are considered true hallmarks. These were discussed in *United Dominions Trust Ltd* v. *Kirkwood* (1966) where a majority of judges found in favour of the plaintiffs being a bank. It was stressed however, that there is nothing fixed and immutable about the criteria for deciding what a bank is, and indeed the plaintiffs only just gained the decision on the grounds that although their current accounts were relatively small in number and included very few trading customers who used them for payment or collection in the usual sense, they were in fact considered bankers by four of the then 'Big Five' clearing banks, who paid crossed cheques presented by the plaintiff company and gave it clearing house facilities; and by the Inland Revenue, which allowed it to account for stamp duty on cheques by a composition fee.

Incidentally, we must also remember, when talking about licences, that under the Consumer Credit Act 1974, all institutions which are concerned with consumer credit services, including recognized banks, licensed deposit takers, finance houses, credit rating organizations and debt-collecting agencies, require another licence – one issued by the Director General of Fair Trading. This licence will normally be renewed every three years, but can be cancelled or varied if the licensee does not comply with its terms.

What is a customer?

There is no statutory definition of a customer. The matter is particularly important because the statutory protection of the collecting banker against an action for conversion brought by the true owner of a cheque is given only on conditions; and one of these is that the cheque was collected by the banker 'for a customer'.

As a result, such definitions as we have of a customer come from cases of this type.

Thus in *Great Western Railway* v. *London and County Banking Co.* (1901) it was said that to make a person a customer of a bank there must be either a current or a deposit account or some similar relation.

Some people keep items of value with a bank, but leave no money in any sort of account. Sometimes the person concerned is connected with another person who is in account, and perhaps no charge is made for the service. In other cases a charge may be made periodically which is settled in cash or by postal order or cheque on another bank. It would seem that this is a banker–customer relationship also. Certainly the banks regard such people as customers.

An example of a short-lived relationship is afforded by *Ladbroke & Co.* v. *Todd* (1914). In this case the plaintiff drew a cheque and posted it to the payee. It was stolen, and the thief opened an account with it with the banker Todd. The endorsement was forged. A special clearance was asked for, the money was at once drawn out, and the customer was never seen again. The banker failed here because he had made no reference inquiries and was therefore held to be negligent. But he was successful in claiming that he had collected for a customer, Bailhache J. holding that the relationship of banker and customer begins as soon as money or a cheque is paid in and the bank accepts it and is prepared to open an account.

The same point was made in *Commissioners of Taxation* v. *English, Scottish and Australian Bank Ltd* (1920). It was held in this case that the word 'customer' signifies a relationship in which duration is not of the essence. A person whose money has been accepted by the banker on the footing that he undertakes to honour cheques up to the amount standing to his credit is a customer of the bank irrespective of whether his connection is short or long.

These judgments ignore the question of the status of the would-be account holder during the period when the reference inquiries are being made. Originally, when banking was a much smaller and more personal business than it now is, a new customer was introduced almost always by an existing customer, who brought him to see the bank manager and introduced him personally, giving his reference at the same time.

But it is exceptional nowadays to find matters arranging themselves so quickly and easily. In most cases now the new customer records his personal details and signature and is then asked for either one or two references. Each reference usually requires two letters out and two back. The first letter is addressed to the referee and asks his confidential opinion of the new customer who has given his name. (This letter should include a specimen signature of the prospective customer – *Marfani & Co. Ltd* v. *Midland Bank Ltd* (1967).) It also asks the referee to include in his reply a note of the name and address of his own banker. When the reply is received, a letter is sent to that banker requesting his opinion of his customer as a suitable person to act as a referee for the opening of a new account (see *Guardians of St Johns, Hampstead* v. *Barclays Bank Ltd* (1923)). Only when the reply from this second letter is received can the reference be said to be complete. Occasionally the referee may refuse to name his bank. There is nothing which can be done about this, except to ask the new customer for the name of another referee. Where the referee is the employer of the new customer, it may not always be necessary to ask for a note of his bank's address. In the case of a customer newly arrived from overseas, the bank should ask to see his passport (*Lumsden & Co.* v. *London Trustee Savings Bank* (1971)). However on grounds of cost saving when the relatively small losses which have arisen from fraud and conversion over the years are borne in mind, many banks have dispensed with the taking of references in recent years. Some now merely call for a means of identity and/or take up a credit-reference bureau opinion.

While all this has been going on, the banker opening a new account has very often been collecting the first cheque for his new customer. If the reference is satisfactory the person is a customer and probably has been since the first contact with the banker. On the other hand, if the reference is unsatisfactory, and no other suitable reference can be offered, the banker will be wise to close the account at once. In this case the person is not a customer and probably never has been.

Thus the formation of the banking contract, from which moment the legal status of 'customer' exists, is made subject to an implied condition subsequent, that the reference given proves acceptable to the banker.

On the other hand, the formation of the contract may be before the actual opening of the account. In *Woods* v. *Martins Bank Ltd* (1959) a person consulted the bank manager for advice as to the investment of certain money. As a result of the advice which he received he authorized the banker to make a certain investment with most of it, and to retain the balance to be dealt with as he should later direct. The bank account was actually opened three weeks after the date of the letter. It was held that the relationship of banker and customer arose at the date of the authority to collect the money from the building society where it had previously been kept.

Obligations under the banking contract

Any contract raises rights and duties, and the terms of the banking contract have been gradually clarified over the years as one case after another has been decided. These terms impose obligations on both customer and banker, but mostly on the banker. The contract is not usually evidenced in writing, and therefore remains flexible and capable of alteration with fresh terms being judicially defined from time to time.

If we go back in our history before the advent of banks we shall find that the chief problem for people with money was to find somewhere safe to keep it. The unassailably respectable position of the big banks now, with their reputation as safe keepers of other people's money, has not been achieved by accident. As the banks learned the basic principles of their business, so the law decided the legal relationship between the banker and his customer. There were on the face of it a number of possible choices. Fundamentally we had, and still have, one person who has money belonging to another. This money has sooner or later to be paid back. There is an element of keeping safe, and an element of obligation to repay.

The courts have in the past been asked to say that the banker was a trustee for his customer, or a bailee of his customer's property, or an agent. All of these, as part of their duty, hold in their possession money or property belonging to another. But so does an ordinary debtor. He holds the money of the creditor, and must repay it. And it was this simplest of all relationships which prevailed. The basic, fundamental relationship between banker and customer is that of debtor and creditor. Where a banking account is in credit, the banker is the debtor.

But he is not an ordinary debtor, whose duty it is to seek out the creditor and repay his debt. If that obligation were to be applied to banks they would have to close all their credit accounts immediately, forwarding remittances for the balances to all their customers. So it is easy to see that the banker is a debtor who is under a duty to repay but only when his customer instructs him to do so. What happens is, of course, that the customer issues a number of these instructions from time to time, each one being for a part, large or small, of the money owing to him. Furthermore, he may instruct the banker to pay the money, not to himself, but to some third person. The instructions are called 'cheques', and the vital part of the cheque is the signature of the customer. This is the authentication of the order to repay. Until such a demand is made, the banker is free to make what use he pleases of the customer's money.

(The comparatively modern invention of the direct debit signifies a direct claim made by a creditor on the customer's account, to be paid (or not) by the bank on each occasion. The consent of the customer is still obtained, however, although this time his signature authorizing this procedure is found only on the single form originally authorizing this use of his money.)