BANKING CERTIFICATE SERIES

# Banking: the Legal Environment

David Palfreman

The Chartered Institute of Bankers

Second Edition

# BANKING:
# THE LEGAL ENVIRONMENT

SECOND EDITION

**David Palfreman**

Pitman

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**For my father, a remarkable man, sadly missed; also Rula Maria, who never knew him, Chris and Hellen.**

# Preface

The Banking Certificate requires students to combine and use relevant skills, knowledge and understanding. Skills are best acquired at work and in the classroom; this book is thus not a substitute for them. Knowledge and understanding it promotes by providing a comprehensive and definitive interpretation of the legal environment of banking. I very much hope that *Banking: the Legal Environment* will enable teachers and students to spend more class time on skills development and less on acquiring information and explanation.

The first edition was a new book for a new course. I endeavoured to write something relevant to bankers and not just another 'general principles of English law book'. Feedback from teachers and students would indicate that I at least partially succeeded. Hence, there are no major changes to the academic structure in this second edition, although it has been completely updated and expanded where extra depth should prove useful. I have resisted two specific temptations: the first to include considerable extra material on the legal system, the second to cover electronic banking. The legal system is covered in sufficient depth for the syllabus and, more importantly, examination questions; electronic banking is not on the syllabus. I hope my book thereby provides more than enough information for the Banking Certificate Course and a firm foundation of legal knowledge for those students who will progress from the Banking Certificate to the Chartered Institute of Bankers' Associateship examination in *Law Relating to Banking Services.*

Those of you familiar with the first edition will notice two obvious changes in this edition: a new layout and the inclusion of numerous 'activities'. I hope the former will make the book more accessible and that the latter will provide the basis for discussion, class and project work.

As with the first edition I have written for bankers, not lawyers, but tried to balance a banking perspective with the traditions of law teaching – where these seemed appropriate. I have attempted to make the book as readable as possible.

I would like to thank Phil Ford, (former Chartered Institute of Bankers' Chief Examiner for this subject) and John Beardshaw. Much of the original text and some of the ideas were based on my long-standing writing partnerships with them. Thanks also to the Chartered Institute of Bankers for permission to reproduce their examination papers.

David Palfreman
1991

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# 1 The legal environment: an introduction

**OBJECTIVES**

**After studying this chapter you should be able to:**

1. **Appreciate some basic ideas about the nature and purpose of law;**
2. **Be aware of the different types of law;**
3. **Understand what is meant by the terms 'legislation', 'common law' and 'equity';**
4. **Appreciate the different forms of legal liability;**
5. **Explain the role of law in the business of banking.**

## ■ INTRODUCTION

There will be few occasions (if any!) when bankers will sit and discuss the nature of the legal environment. Bankers are practical people and while they may seek to influence the legal environment they will do so in respect to specific aspects which directly affect them; payment systems, securities, consumer credit and insolvency law, for example. They are most unlikely to spend time considering the nature of law itself; the law exists, they have specialists who know all about it and they therefore tend to view the law purely as a framework, albeit important, within which to work. They understand that the law regulates their activities and they know how to use it – a straightforward pragmatic approach.

This is a perfectly acceptable and proper view, one which you no doubt share. However, you have begun a course of legal studies, albeit of law applied to banking, which will inevitably involve some theoretical considerations. For this reason we begin this chapter with a simple discussion of the 'idea of law'. This is something to understand and think about, not something to try to remember. Indeed, much of this chapter is not strictly required by the syllabus but we hope, having read it, that you will find it a useful and interesting background to the rest of your studies.

## ■ THE IDEA OF LAW

Any attempt to define and explain the 'idea of law' in a book of this nature can do no more than give a very limited introduction to an important philosophical subject. Unlike scientific laws, *law* cannot be objectively defined, let alone proved. It is the product of society, not of nature, and it means different things to different people according to their time, culture and the social structure in which they live.

The greatest of the world's philosophers have considered the 'idea of law',

but no one definition has been universally accepted. There are, however, three main kinds of *jurisprudence* (legal theory):

- *historical*, which studies the growth of law, particularly in connection with the development of the state;
- *analytical*, which studies the concepts and structures of the law as they actually are (an approach bankers would most likely take);
- *sociological*, which considers how the workings of the law affect society.

To a greater or lesser extent, all jurisprudence attempts to answer the following questions:

- What is law?
- Why is law necessary?
- What is the purpose of law?
- How just is the law?

We will attempt to answer these questions, but you should always remember that different theories attempt to answer different questions. Some are concerned with the *form* of law, some with its *concept* and others with law's *function.*

Similarly, methods of enquiry differ. An *inductive* approach produces definitions and answers from the observations of actual situations and legal phenomena, while a *deductive* approach involves formulating definitions and answers based on initial assumptions about the nature of law. In our own legal system the *common law* (judge-made law) follows an inductive approach but *legislation* is often the result of a deductive process of law-making. Of greatest importance, perhaps, is the fact that all definitions of law are to a greater or lesser extent, consciously or subconsciously coloured by *value systems* and ideological factors – social, economic and political.

### What is law?

Although there is no universally accepted definition of 'law', we can usefully begin our discussion by quoting three well-known jurists (legal writers).

> The body of principles recognised and applied by the State in the administration of justice ... In other words the law consists of rules recognised and acted upon by courts of justice. (Salmond)
>
> A law is a general rule of external human action enforced by a sovereign political authority. (Holland)
>
> A social process for settling disputes and securing an ordered existence in the community. (Paton)

We can also put forward our own definition of law: *a set of rules administered and enforced by the state.* This definition is perfectly adequate for our present purposes. We might add that most people would accept that the broad function of law is to regulate conduct within a society.

In all three quotations and our definition, two ideas are either expressly or impliedly involved:

- that law is a *set of rules* by which human conduct within society is ordered and controlled;
- reference to the *state* or other sovereign power within society.

The first of these is largely self-explanatory and non-contentious but reference to the state raises fundamental issues about the nature of the law.

Laws are certainly enforced by the state but does the state impose its own corporate will on its members or is law essentially the will of the people recognised and adopted by the state? Clearly, an individual or bank is unlikely to give money voluntarily to the state to finance its activities, and taxation by law is therefore a necessary imposition. On the other hand the enforcement of the basic criminal law, which protects us all from the anti-social behaviour of the few, is equally clearly the wish of the people. So, the nature of law comes from a combination of factors. Governments use the law to fulfil their policies and serve their political philosophy; banks and other powerful organisations seek to influence the development of law to best serve their own interests, while most ordinary individuals accept the law for what it is, using it when necessary, complaining about what seems 'unfair' and generally knowing little about it.

The concepts of morality and law are closely linked. Virtually all serious crimes are immoral acts, e.g. murder and theft, and some essentially immoral acts are crimes, e.g. perjury (lying on oath) and libel may both be the subject of criminal proceedings; but a vast number of criminal acts committed each year, minor motoring offences in particular, are not usually considered immoral acts but are nevertheless punished. Conversely, many moral offences, adultery for example, go unpunished by the criminal law – at least in this country! (Under some legal systems adultery is a crime, for example, under some Islamic-based codes and, perhaps surprisingly, under the laws of some American states.) The difference between them in legal terms is that laws are enforced by the state while morals are not, *except* when law and morality coincide. In this context, is paying by cheque when you know you have no money in your account and no agreed overdraft facility an immoral act, a criminal act, neither, or both? Does the position differ if you use a cheque guarantee card? What is the position when you knowingly exceed your limit on a credit card or obtain a second mortgage for home improvements and then spend most of the loan on a new car? The legal distinction between law and morality raises an important issue about the purpose of law: should law be used to enforce morals? (This is something you might like to think about – but it would never be an exam question.)

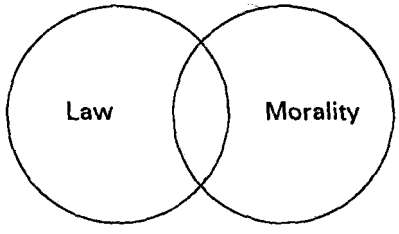


**Fig 1.1 Law and morality**

**ACTIVITY 1.1**

The relationship between law and morality is often illustrated using the simple diagram on the previous page. Name other acts or omissions which are (a) exclusively 'illegal', (b) exclusively 'immoral', and (c) both illegal and immoral.

### Why do we need law?

Law is central to society. All except anarchists would agree that the existence of law is necessary. Every community has found a need to regulate the rights and duties of individuals in relation to each other and to the state.

A society presupposes order and it would seem that the natural order usually to be found in small primitive communities breaks down as the society becomes larger and more complex. It is clear that controls on powerful bodies and individuals are necessary if the interests of the majority are to be protected. For example, detailed regulation of the consumer credit industry is necessary to protect consumers from the less reputable elements within it, while the Banking Act 1979 (now replaced by the Banking Act 1987) was enacted largely to regulate deposit taking. In a wider context, experience has shown that the absence of health and safety, employment protection and monopoly legislation can have harmful social and economic effects on a society.

**ACTIVITY 1.2**

There are numerous specific legal rules which regulate the business of banking and many of them are found in Acts of Parliament (statutes). One such statute is the Consumer Credit Act 1974. This and other statutes you will study in Chapter 2. However, think about the regulation of your industry now and list below as many statutes – and legal decisions if you know any – as you can which have such a regulatory function. (Don't forget about statutes which regulate employment and health and safety at work.)

### What is the purpose of law?

Law's purpose is usually considered to be the general regulation and control of society, the *criminal law* in particular providing and enforcing minimum standards of social behaviour. The legal system provides means for resolving conflicts and dealing with those who infringe legally enforced *social norms*. However, on the assumption that it is only a small minority of individuals and organisations in society that the law has to positively control, law can equally well be considered as an *enabling medium* for the majority. For example, individuals are able to use and enjoy their land because the *torts* of nuisance and trespass to land restrain the few who would interfere with it. Similarly, banks could not exist or function as they do without the concept of *juristic personality* – that a company (or other *corporation*) exists at law independently from its members – and the framework of commercial law in general. (Incidentally, a company's independent legal existence accounts for the rule that cheques made payable to a company must only be collected for that company's account and cannot, for example, be collected for the account of the only major shareholder/owner.)

**ACTIVITY 1.3**

**Think about this idea of law as an enabling medium and write down as many examples as you can of how the law enables banks to pursue their business activities.**

It is not within the scope of this book to argue the validity of different legal theories but one well-known example will illustrate how economic and political ideology can determine theories of the nature and purpose of law. In classic Marxist philosophy, law is viewed as the institutionalisation of the prevailing ideology which the socio-economic elite of a society uses to coerce the masses into obedience in order to preserve its privileged position. Thus, law's purpose is here seen in terms of achieving social, economic and political objectives. This may be a rather too unsophisticated view of law's nature and purpose and extreme, but many of you may often have considered that the government uses law to impose its will upon the individual and that large organisations of all kinds are able to use the law to further their commercial (or other) interests at your expense. It also makes a good contrast with the rather 'cosy' view of law's purpose with which we began this section!

It is clear from just this one example that it is difficult to discuss the ultimate purpose of law without asking fundamental questions about the nature of society as it is and as we might wish it to be. This of course involves questions of political philosophy and the nature of the economic society in which we would choose to live. Such issues merit a book to themselves but we shall examine the specific functions and uses of law in relation to banks and forms of legal liability in general later in this chapter.

### Law and justice

The ultimate aim of all law should surely be to promote justice but any attempt to define law in these terms meets two serious obstacles:

- 'justice' is a vague concept, meaning different things to different people;
- law must be considered within its socio-political context and, assuming that law exists to serve society, what may be justice with regard to one individual may not be useful to society.

Theft, for example, is a serious crime. What, however, of people who steal food from supermarkets or milk from doorsteps because they cannot afford to feed themselves or their families? Is justice served by their punishment? Alternatively, a person who is made redundant has a legal right to compensation under the Employment Protection (Consolidation) Act 1978. This is no doubt 'just' but it must be remembered that the rest of us have to contribute towards the compensation through taxation. Is this 'fair' to the rest of us?

You might like to consider the argument that law may always produce injustice unless it is the product of a socially and economically just society. But social and economic justice is, in turn, a matter of personal judgment!

It is possible, however, to talk in more objective terms about the distinction between *procedural justice* and *substantive justice*. The former is concerned with the legal process and the latter, justice in particular cases. At one time the common



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