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Banking Reform discussion response
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Our ref: Banking Reform

Dear Sirs

Banking reform – protecting depositors: a discussion paper

This is the Financial Services Consumer Panel response to HM Treasury's discussion paper on Banking reform. Recent market events have demonstrated that consumers must have confidence in the compensation scheme in order for it to be effective. The Panel has previously stated its belief that there should be no limits imposed on payments by the Ombudsman and Compensation Schemes. We believe that no limits on compensation would maintain consumer confidence during a crisis and may have prevented consumers' reaction to events at Northern Rock.

Question 2.1: Do you agree that these are the right objectives? Are any of these objectives more important than others?

The Panel agrees with the objectives given for banking reform. The Panel believes that critical banking services must maintain all transactional functionality on accounts.

Question 2.2: What other issues should the Government consider when reviewing the framework for depositor protection?

The Panel believes that the Government should recognise that a tripartite system of regulatory responsibility may result in lacunas, failure to take responsibility and prolonged inquests, possibly delaying recovery. As a result, the Panel suggests that in their opinion it may be better from a liquidity perspective to have a single body responsible for monitoring businesses that take deposits, identifying risks, and also possessing the ability to combat those risks.

Question 3.1: Should the level of coverage for deposits be increased from £35,000? If so, to what level and what are the benefits and costs of doing so? Should the bank deposit limits be related to those for other sectors, e.g. investment business and insurance?

In the Panel's response to the FSA's consultation paper CP05/15*** Review of Compensation Scheme and Ombudsman Limits and Miscellaneous Amendments to

the Compensation Sourcebook we suggested that there should be no limits imposed on payments by the Ombudsman and Compensation Schemes. We are aware that some will argue that there is a moral hazard in allowing unlimited compensation for consumers; however we believe that this is a mis-conception. In reality consumers do not have access to information nor have the ability to make a judgement on the financial soundness of a firm – that is the job of the FSA.

The Panel is aware that its view that the compensation limit should be removed is unlikely to be supported by other stakeholders. As such we believe that the current figure of £35,000 is too low. We believe that there is a strong argument that the limit should be set at the price of an average house¹. As the cost of a house is the largest spending that most families will ever undertake, the consequences of what might happen if a bank failed while house sale proceeds were passing through an account, prior to being used to buy another property would be severe. We are aware that there is likely to be resistance to such a large increase from the current limit, and as a result we suggest that the figure of £100,000, or at a bare minimum £50,000, should be used. The Panel strongly believes that this figure should rise automatically in line with the Retail Price Index or increases in housing costs.

Before establishing a compensation limit, the Panel suggests that research is conducted to establish the coverage of banking compensation schemes operated by other countries and to measure the amounts presently held by UK consumers on deposit. This information should be included in any consultation paper to enable respondents to make informed decisions on possible options. We also suggest that if limits are introduced, there should be temporary exceptions to the limits for defined groups, for example those selling or purchasing a house, lottery winners and those who have recently inherited.

We would also like information provided on the number of consumers protected at different levels of compensation.

The Panel believes that the benefits of a change of limits would be an increase in consumer confidence. The Panel is firmly of the view that bank deposit coverage should be the same as, or even better than, other sector limits. There is no logic that currently higher compensation is available to consumers who buy shares and are therefore willing to take risks than to consumers who select the safety of a bank deposit account.

Question 3.2: Would it be desirable to put in place arrangements to better ensure that depositors are repaid in a more timely fashion? What issues would need to be considered in assessing any new arrangements?

The Panel agrees that it would be desirable to put arrangements in place to ensure that depositors are repaid in a timely fashion. However we are aware that there are two issues - the mechanics and how this would be funded. There are also practical issues such as whether bank staff would continue to work and whether cash machines would continue to function and be refilled. The Panel suggests that state funding would be the solution to these issues. As the FSCS is not pre-funded, it

¹ £230,474 source bbc website

http://news.bbc.co.uk/1/shared/spl/hi/in_depth/uk_house_prices/html/houses.stm

would be unable to assist with short-term funding although it might be able to replace some or all of the funds in the long term. The Panel believes that the primary focus should be on maintaining liquidity and transactional functionality.

Question 3.4: What issues should the Government take into account in any further review of the funding mechanisms for the FSCS?

The Panel is aware that valid objections can be made to a pre-funded scheme. The Panel is aware that the primary concern of consumers is that any compensation scheme works quickly and effectively.

Question 3.5: Should the role of the FSCS be extended to promote access to banking services for depositors with failed banks?

The FSCS currently has powers to guarantee continuity of insurance cover when an insurer is in difficulties; however the Panel does not think it would be logical to involve the FSCS in guaranteeing continuity of banking services. As banking services are not confined to handling deposits such a move would require either the FSCS to have specialised staff ready and able to step in or the banking sector could consider providing this service.

Question 3.6: The Government would be interested in views on the best way to help consumers understand how banking deposit guarantees affect them?

The Panel believes that whatever limits are set should be displayed in bank branches and in appropriate literature including bank statements. The Panel believes that the limit should be prominently displayed on bank statements and rules should specify the font size and positioning of this information. In the case of deposit - taking institutions which are covered by their parent company's authorisation (for example, different brand names within a group) it needs to be clear that the FSCS will only pay compensation up to the limit once irrespective of how many of the institutions they hold accounts with. This information will enable consumers to make informed choices about where they deposit their money.

Question 3.7: Do you agree with the concept of critical banking functions? If so, what banking services might be properly regarded as so critical to the modern economy that they should continue to be provided in the event of a bank failure?

All transactional banking services are critical to some degree or another. The services essential to the typical consumer include provision of a current account into which salaries can be paid, paying bills by direct debit, the provision of overdraft facilities and the ability to make withdrawals from cash machines. The impact of a bank failure would be accentuated if these facilities disappeared; correspondingly, the impact of a bank failure would be markedly reduced if the same facilities could be taken over or in some way guaranteed.

Question 3.8: For what period of time should any critical banking functions be maintained and how this might vary in different circumstances?

Critical banking functions should be maintained for as long as it takes to allow the institution in difficulties to be rescued, taken over or to allow consumers to move elsewhere.

Question 3.9: What issues should the Government consider in assessing possible arrangements, in addition to the FSCS already available, to deliver continuity of any critical banking functions in the event of a banking failure?

The FSCS provides reassurance and currently guarantees to a certain level consumers' money. The FSCS does not guarantee continuity of services and its structure and in-house expertise is not designed to allow it to exercise a supervisory role in this area.

Question 3.10: What, if any, lessons can the Government learn from other sectors and other economies? For example, from special administration regimes and pre-funded insurance type schemes such as the Federal Deposit Insurance Corporation in the United States?

The Panel does not think there is much to be gained from studying protection schemes in other sectors. The most obvious schemes for comparison are the CAA ATOL and the ABTA package holiday schemes. However, both schemes have loopholes and shortcomings and the ATOL has required a back up scheme to maintain its stability. The Panel suggests that a comparison with UK energy providers would be more appropriate. The Energy Act 2004 safeguards the supply of gas or electricity if the commercial supplier gets into difficulties, and this could provide a useful template for any similar provision for the banking industry.

The Panel is aware that pre-funding would be enormously expensive and place a huge one-off strain on the financial services industry in its introductory year, when both pre-funding and post-funding levies would be needed. As a result the Panel is of the view that post-funding, backed by emergency state-funded liquidity to bridge the immediate gap, would be appropriate.

Question 3.11: How do the needs of different groups of customers differ? How should the Government take this into account in drawing up the new framework?

The Panel strongly believes that the Government should not attempt to distinguish between different classes of bank customer. In practice it would be inappropriate to ensure that consumers could pay their mortgage instalments, while failing to ensure that employers could use the system to pay salaries. As a result the Panel suggest that the only real differences are the following:

- The difference between the ordinary individual (or small businesses which might just involve one or two people) and the large corporate customer when it comes to setting the scope of the compensation scheme and to setting the compensation ceiling.
- The difference between depositors and unsecured creditors, whose commercial transactions with an institution in difficulties need not be covered by any compensation scheme but should be dealt with under conventional insolvency law.
- The difference between the bank's customers and the bank's shareholders, since shareholders share the risks in return for a share of the profits. Interfering with this basic principle would invite a reconsideration of the whole concept of limited liability, unchanged for

about 110 years, and such reconsideration might not be to the benefit of shareholders as a whole.

Yours sincerely,

A handwritten signature in black ink, appearing to be the name 'John Howard'. The signature is stylized, with a large, looped initial 'J' and a horizontal stroke extending to the right.

John Howard
Chairman