Tripartite Authorities July 2008 Consultation: Financial Stability and Depositor Protection

Annex 1 – Detailed Comments

We welcome the intention to strengthen the framework of financial regulation and the supervision of banks. Change is clearly needed – as demonstrated by Northern Rock – and it is important to get it right. Nevertheless we still have concerns about the speed with which the proposed changes are being pushed through. In our response to the January consultation we cited the number and variety of different proposals on the table, which have implications for a whole host of disparate audiences and will, accordingly, continue to evoke a range of diverse responses. Therefore, the danger of pursuing reform too quickly remains high.

We would urge the Authorities to consider whether the proposals set out in the consultation will, by themselves, be adequate to ensure that the UK delivers an "effective world class regime" (as the consultation's foreword asserts), or whether there is a need to take a more holistic review of factors which may provoke financial instability. The latter would include, for example, the role of current remuneration and/or bonus arrangements; whether banks focus unduly on short-term profitability and share price value (and if so, the reasons why); and how these factors might contribute to financial instability by providing incentives for banks to take unwise and inappropriate risks.

Our own major concerns are with the compensation arrangements.

Compensation Arrangements

We note that most of the detail with regards to the proposed compensation arrangements will be in the FSA's forthcoming consultation this autumn. However, we still think it is appropriate to raise our continued concern with some of the Authorities' thinking on compensation at this juncture. Credible, effective, understandable and well publicised compensation arrangements are essential if consumers are to have any confidence in the system.

Compensation limit – We note the intention to fix the limit for deposits at £50,000. The Panel has previously expressed its opinion that insufficient research has been conducted to ascertain the impact of a 100% guarantee on all deposits and we still very much maintain that a 100% guarantee would be by far the most favourable outcome for consumers. Although £50,000 may cover 98% of all accounts, in the absence of any available data on multiple account holding it is impossible to calculate what proportion of account holders this equates to. Moreover, the proportion of funds held in accounts where the limit has not been exceeded is likely to be closer to 70% of the total. The movement of the remainder which are in accounts with amounts in excess of the compensation limit might significantly destabilise those banks where those monies are deposited and potentially the system as a whole. It is our view that not enough consideration has been given to this potential eventuality.

If there is a genuine concern that no limit could see the influx of significant monies from overseas then this could be met by the formula of 100% up to £1 million. The latter limit would at least operate as a 100% guarantee for all but the most affluent of savers.

In addition, whilst the consultation process is squarely aimed at compensation reform for banks there needs to be a co-ordinated approach to compensation issues across the financial services industry as a whole. Otherwise the Authorities run the risk of fresh gaps appearing in the system. How will revised compensation arrangements apply to stock market investors or holders of self-invested personal pensions (SIPPs), for instance? We await the FSA consultation process where we hope that all these additional issues will be taken into account.

Moral hazard – we take issue with the perceived Tripartite thinking on moral hazard on two fronts in particular. Firstly, with regards to consumers, even if most consumers had the expertise necessary to assess a financial institution's long term solvency, much of the information that they would need to do so is not in the public domain. When the FSA itself had much of the relevant information it failed to identify the problem with Northern Rock at an early stage, so how is the average consumer expected to do so without those benefits?

Secondly, with regards to the banks, a 100% guarantee on deposits for consumers would surely have the effect of increasing moral hazard for banks. One of the, seemingly unstated, reasons that the banks oppose 100% compensation for investors is that, with it, it would be politically much easier for the Government to allow them to fail, at least in the case of smaller banks than Northern Rock. There should be other ways of controlling moral hazard and not just compensation. No one measure will control for moral hazard by itself, but acting together they may well do. We are intending to commission research on the international picture to indicate the extent to which the experiences of other countries can be used to support or oppose the arguments on moral hazard. We hope that this research will be able to feed into our response to the FSA's consultation on compensation later this year.

Transactional amounts – Of course there would be no issue with regards to transactional amounts, for example from property sales, were there to be a 100% guarantee on all deposits. Given the possibility that there will be a limit, however, we are still concerned that arrangements to cover temporarily high balances must be adequate. We believe that there are so many such examples of large balances, which require additional protection in the event of a limit being imposed, that the options for coverage would have to be very carefully thought out.

At this stage we do not think enough consideration has been given to this range of different transactional amounts which could theoretically qualify for any revised arrangements. As well as the obvious example of property proceeds, there are numerous others: inheritances, lottery winnings, sales of investments, pension tax-free lump sums, redundancy payments and insurance claims are just several of them, not to mention longer-term high balances such as those in a SIPP. Without a robust and comprehensive set of arrangements the risk will be of introducing a further set of anomalies. A 100% guarantee on all deposits would cancel out that possibility.

Responses to the FSA's consultations suggest that there will not be a market solution and that no firm is likely to introduce insurance unilaterally. It is therefore important that a way is found to ensure banks provide security for a limited period of time for clients who have significant transactional amounts, if there is to be a limit on cover.

At the same time whether the proposals are for insurance cover or the provision of particular types of asset-backed accounts it is important to ensure that compensation can be paid speedily, without involving, for example, lengthy claims to an insurance company. One option could be to offer a 100% guarantee, if not on all deposits then on all transactional amounts.

Application of limits per brand or per authorised firm – At the moment the deposit compensation limit is applied on a per bank (authorised firm) basis. Some banking groups have more than one authorised firm (eg Royal Bank of Scotland and NatWest) whereas others operate several brands within a single authorised firm (eg Halifax, Bank of Scotland, Birmingham Midshires etc... all operate under one licence). Some also provide banking services to completely separate companies. As an example if someone opens an account with Saga in response to its marketing campaign they naturally believe that is their counterparty not HBOS, where they may be up to their compensation limit. Another example where the situation is not obvious to consumers is the Post Office. In this case the banking service is provided by Bank of Ireland and customers are subject initially to the Irish compensation scheme. There is no requirement for firms to operate in one way or another, but this means that the picture with regard to compensation is confused and will continue to be so should the present system persist. It is absolutely essential that the name of the institution that will be holding their money is clearly communicated to consumers; the country in which that business is based; which compensation scheme would apply; and any limit on compensation, **before** any payment is made.

We support the application of compensation on a per brand basis and, as we understand it, the banks are also willing to support such a change in the treatment of limits. There therefore seems little justification to us in maintaining the current practice. Questions have been raised about the consequences, under such a model, should two distinct brands merge, therefore reducing their combined compensation coverage. However, a requirement could feasibly be made of the firms in question, in such a scenario, to inform their customers accordingly so they would have the option of spreading their deposits as appropriate once that merger has taken place. Otherwise, consumers cannot be expected to understand the details of their banks' legal relationships and how that translates in terms of their compensation position.

Method of compensation calculation – the consultation notes that the FSA will be proposing changes to the compensation payout above any limit under the compensation scheme. At present if someone has £100,000 on deposit and their bank fails they would, in due course, receive £35,000 from the FSCS. However, they may also be eligible for a further payout depending on the rate of recoveries from the estate of the failed bank. A 60% recovery rate would mean a return of £60,000 from the estate plus the £35,000 already received from the FSCS and a total of £95,000. The proposals on the table for a 'rateable' option would still see the FSCS pay out

the compensation limit, currently the £35,000, but would split the recovered amount from the failed estate's bank between the depositor and the FSCS levy payers – the banks.

This appears at first sight to be a means of appeasing the banks for the prospect of an increased compensation limit. One of the only redeeming features to consumers of having a limit is that they still stand a reasonable chance of recovering a significant proportion of their funds from the liquidation of the failed institution's assets. If that 'recovery' is to be shared between consumers and levy payers then consumers could forseeably be worse off than they are at present in the event of a failed bank, even with an increased limit, which seems entirely unsatisfactory. If banks are appeased in this way it will reduce their incentive to monitor each other.

Depositors with UK branches of overseas banks – the consultation very briefly raises the position of depositors with funds in UK branches of overseas banks. Depositors in this position may be entitled to compensation from the deposit guarantee scheme of the bank's home Member State up to its limit and, if the bank in question has 'topped up' with the FSCS, additional compensation up to the FSCS limit.

This raises a number of issues. It potentially exposes customers of these banks to the compensation systems used by other States for one thing, which they are even less likely to understand than the UK equivalent. Whether or not those compensation systems are funded well enough to cope with a failed bank is another question.

There are other issues, with regards to the speed of payout for instance. The UK system may be slow but, in comparison, other EEA Member States' systems are much slower. We recognise that the Government has made representations on the latter to the Economic and Financial Affairs Council (ECOFIN) but this is just one piece of the jigsaw. Consumers are largely uninformed about the pitfalls of depositing with a foreign bank and without this type of information overseas institutions offering attractive interest rates hold an unfair advantage over their UK-based competitors in attracting potential custom. It is essential that ways of better informing consumers are explored.

Gross payout – the consultation confirms the intention to move to a system of gross payments of FSCS compensation and the Panel very much supports that objective. The introduction of gross payments would help to speed up pay out and to ensure that depositors with loans or mortgages outstanding would still have access to liquid funds. In terms of how best to manage this change in order to ensure that depositors do not receive unwarranted benefits we consider the option which has most traction is the one which is the most transparent and offers the fairest deal to consumers. If insolvency law can be changed to ensure set-off is applied in a way which is compatible with gross payments then we would be in support. This may mean making insolvency rules that provide for the breaking of mutuality of debt for depositors' claims assigned to the FSCS after the commencement of the banking insolvency procedure, as the consultation suggests.

Continuity of service – we made the point in our response to the January consultation that any break in the continuity of banking services brought on by a

bank failure is likely to have significant implications for consumers. Consumers increasingly treat access to banking services as they do access to any other utility. If they are unable to access those services because of a bank failure then, however short that gap in access, it is likely to lead to difficulties.

Therefore, we are concerned that, because of the banks' anxieties at the technical difficulties they may have in ensuring prompt payout, even the proposal for a 7 day turnaround in payments is becoming highly contentious. We would therefore re-iterate our concern at the likely consequences of any delay in payout. Customers of failed banks need certainty over how long compensation payments will take to reach them. Electronic payments would be a faster and safer method than cheques of dealing with those consumers who have another bank account but the most severely affected consumers are likely to be the most vulnerable – those with basic bank accounts who have no other means of accessing their monies and who do not have credit cards.

British Bankers' Association (BBA) figures indicate that there are upwards of 7 million basic bank accounts in operation which gives some idea of the scale of the potential problem in this regard. One option for basic bank account holders would be for an automatic facility to transfer these customers into a default account, so they can still access any benefit payments for instance. The new Post Office Card Account, would appear to offer an appropriate solution here. The tender for this new account is being agreed by the Department for Work and Pensions (DWP) so there is incentive for the Government to work together on this potential solution.

There must also be the choice of a new bank/building society account for customers with just a single facility, to ensure that they can easily access their funds in the future. The current Banking Code provides the guideline of 10-13 working days for a new bank account to be opened. However, in practice this is often much longer so there may conceivably need to be some relaxation of the regulations in these extenuating circumstances. To this end bank staff would require the appropriate training.

Lack of capacity is another potential pitfall here so appropriate arrangements need to be in place to ensure that bank accounts can be opened quickly and without difficulty, and certainly avoiding the possibility of huge queues of people waiting outside their branch to open a new account.

Clearly this is a difficult area and one which requires further thought. The Payments Council are probably best equipped to conduct further research into the portability of banking services and we would encourage the Authorities to liaise with them to ensure that all possibilities for prompt payment have been explored before settling on the final arrangements.

Consumer communications – we expect the forthcoming FSA consultation to put concrete proposals forward in this regard but we believe that a comprehensive programme of improved information provision is necessary. This should commence with a public awareness campaign extolling the benefits of a streamlined scheme. Communications then need to cover all channels and levels of financial capability accordingly. Information should be prominently displayed on websites and in

branches and also on statements, covering all relevant aspects of the new scheme – limits, the application across different brands, the situation with regards to overseas banks, and the method of claiming should a bank fail. Clear information should also be provided about the institution with which monies are to be held, as in the examples of Saga and The Post Office given earlier in this Annex. There should also be a personalised communication when someone's balance exceeds the compensation limit, whatever that may be.

The requirements for adequate communications should be formalised either in the Banking Code, or, if the FSA were to take on conduct of business regulation of retail banking as we would prefer, in the FSA handbook. It should also form part of the FSA consumer communications strategy through its Moneymadeclear website and its Money guidance pathfinder project. This is an opportunity to raise confidence in the scheme and enhance the reputation of the banking industry at a time when it has come in for a great deal of criticism in a number of spheres.

Pre-funding – the consultation proposes to include in the legislation the powers to allow the Authorities to introduce pre-funding at a future stage if considered appropriate. We take a pragmatic view on this. Whilst we acknowledge that pre-funding would be a helpful means of introducing risk-based levies we are aware that it 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. Any additional strain on liquidity levels in particular, especially at a time when pressures in this regard are heightened, could have significant implications.

As a result the Panel is of the view that post-funding, backed by emergency Government- or Bank of England-funded liquidity to bridge the immediate gap, is still the most appropriate solution. However, we would be interested to learn what role the Authorities think pre-funding might have in reducing the risk of bank failure, and under what conditions would it be implemented. Our primary concern for consumers as ever is that, whatever the means of funding, any compensation scheme works quickly and effectively.

Special Resolution Regime – we were pleased to see that the Special Resolution Regime will be subject to regulatory trigger by the FSA. However, we are not persuaded that the proposed arrangements incorporate the 'coercive element' we called for in our earlier response. Nor are we convinced that the division of roles and responsibilities between the three authorities is sufficiently concise and structured to facilitate the kind of rapid and effective action that is so clearly lacking in the current arrangements.