

Banking reform consultation responses
Banking Reform Team
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Dear Banking Reform Team

Financial stability and depositor protection: further consultation

INTRODUCTION

Ernst & Young LLP welcomes the opportunity to review and comment on the joint consultation paper entitled *Financial stability and depositor protection: further consultation* ("the Consultation Paper").

Our interest

Ernst & Young is one of the largest global professional services organisations. We provide a wide range of audit, accounting, tax, corporate finance and other business advisory services. All of our UK activities are supervised by the Institute of Chartered Accountants in England & Wales, with further supervision over certain parts of our business by the Financial Reporting Council, the Financial Services Authority ("FSA") and other regulators.

Our interests in the Consultation Paper are twofold:

- ▶ Our client base is diverse representing most sectors and industries, including banking. As business advisers, particularly in the areas of auditing, advisory and restructuring, we have seen the wide-ranging effects of the recent "credit crunch" on most sectors and industries including those effects which form the subject matter of the Consultation Paper.
- ▶ We are a large business in the UK with over 9,500 partners and employees. Not only do all of our people have a personal interest in the specific issue of depositor protection but, as individuals and as a business, we are dependent on a fully functioning banking system in the UK.

We have a number of overall observations to make on the Consultation Paper that we outline below before commenting on its specific questions.



OVERALL OBSERVATIONS

Maintaining the competitiveness of the UK

As we have said throughout the consultation process, the increased protections proposed in this Consultation Paper and the two preceding papers will invariably mean extra cost. This will ultimately be borne by business and the public, both as taxpayers and as banking customers, through increased bank charges. If the Government identifies a particular case for change or a limited number of options then they need to be supported by a comprehensive cost/benefit analysis. As the Impact Assessment attached to the Consultation Paper shows, the costs of many of the proposals are still largely unquantifiable.

In considering the Consultation Paper, it is still not clear whether and to what extent the proposals have been benchmarked against reforms which may be planned by other countries. We welcome a strong leadership position by the UK Government on banking reform. However, it would be regrettable if the proposals threatened the competitiveness of the UK unnecessarily jeopardising its position as a global leader in the financial services industry.

We would recommend that the Authorities continuously consider the competitiveness question as they move to finalise their reforms in this area.

RESPONSE TO SPECIFIC QUESTIONS

Our answers to the Consultation Paper's specific questions are set out in the Appendix.

CONCLUSION

We are grateful to the Authorities for publishing the Consultation Paper. We hope that you have found our comments helpful. If you would find it useful, relevant members of our firm are available to discuss any of the points we have raised.

We wish you every success with the rest of the consultation process and encourage you to publish all non-confidential responses to the Consultation Paper in early course. We look forward to reading the results.

For the avoidance of doubt, none of the comments set out in this letter are intended to be confidential.

Yours sincerely



Robin Heath
Managing Partner, Regulatory & Public Policy

APPENDIX

RESPONSE TO SPECIFIC QUESTIONS

Chapter 3: Reducing the likelihood of bank failure

3.1 The Authorities are seeking views from respondents on the extent that contractual provisions, such as those set out above may prevent the Authorities from taking appropriate action; and the merits of the two approaches set out above.

Our preferred approach would be for a regulator like the FSA to prohibit financial institutions from entering into contractual provisions such as these. The FSA would then follow up through inspections to check that banks had not entered into them.

If the Authorities are intent on pursuing one of the two approaches set out in the Consultation Paper, we would favour the second approach; namely the use of regulatory guidance or rules discouraging banks from entering into certain agreements.

We are wholly against the first approach. It has the potential to cause chaos in the financial markets after the event. The unintended consequences arising could include less liquidity or a loss of confidence in the market *bona fides* of certain financial instruments, in a similar way as was seen more recently with local authority swaps.

3.2 Are the criteria as set out, the right criteria and will they provide sufficient flexibility as payment systems evolve overtime?

The draft criteria as set out seem to us to be suitably flexible. We believe that the following should also be considered:

- ▶ Any criteria should be aligned with the criteria for recognising “Payments Institutions” as defined in the Payment Services Directive (PSD). The PSD allows for the specific creation/recognition of Payments Institutions that have a capital requirement.
- ▶ The position and role of a system within the payments processing and value chain needs to be clarified. Although the proposed criteria cover the need to recognise “the relationship between the system and other systems”, it might sometimes be ambiguous about whether a system is a payment system or not. For example, SWIFTNet is critical to CHAPS payments but is only a messaging system. Whereas under the proposed criteria it is unclear whether SWIFTNet would be recognised, if practically SWIFTNet were to fail this would cause payment systems like CHAPS to fail.
- ▶ The development of the Pan-European payment model through the Single Euro Payments Area and the PSD is removing regional boundaries between EU member states. This raises the question of the Bank of England’s jurisdiction over payment systems and institutions that reside within the UK but provide services overseas.

3.3 Is there a preferred method for recognising payment systems?

Payment systems come in many different forms which makes it difficult in some cases to recognise them. In view of this, it would be challenging to create prescriptive rules for recognition. However we believe that payments systems can loosely be classified as follows:

- ▶ **Payment system:** This would cover all systems that provide payment for goods and/or services. It would cover cash, cheques, electronic payments (e.g. BACS or CHAPS), etc. These systems can be both domestic and international schemes.
- ▶ **Money transfer system:** This is a system which transfers funds from one account to another. Money transfer systems are not tied to any provision of goods or services (even though some of the systems are common) but on the movement of funds. The systems themselves have tended to be domestic (e.g. BACS or CHAPS) even though moves are being made to extend across other geographies by some service providers. Money transfer systems include remittance service providers such as Moneygram, Western Union and the like as well as the newer breed of mobile phone-based systems. ATM networks should also be included as one of their principal roles is transferring funds from an account into cash.

We recognise that the classifications above are not perfect and both have the potential to extend the Bank of England's oversight remit into systems whose failure of themselves will have a limited impact on the core banking infrastructure. Having said that, the failure of any system mentioned above could lead to a loss of customer confidence which could itself contribute to further loss of consumer confidence and subsequent financial instability through contagion.

In view of the above, we believe that all payment service providers who wish to be considered as a Payments Institution, and who will need to be licensed for the first time from November 2009 should be recognised as payments systems for oversight purposes. Any other payment service providers should fall under the oversight of the FSA and/or OFT as appropriate.

3.4 Do you agree that the indicative list in paragraph 3.48 includes all the relevant payment systems which are of systemic or system-wide importance?

In principle, the payment systems listed are those that have systemic or system-wide importance. We believe that consideration also needs to be given to capturing the following specific payments systems:

- ▶ **Outsourced service providers:** Around 70% of cheques are cleared by iPSL and a large proportion of the residual amount cleared by EDS. In effect these organisations are providing and operating the strategic payment systems for cheque clearing.
- ▶ **Real Time Gross Payment (RTGS) systems:** Both TARGET and CLS should be included.

We repeat the points we make in response to Question 3.3 above.

3.5 Are the powers, as set out above, necessary and appropriately graduated?

Yes, particularly given the critical importance of payment systems to our economic infrastructure.

Chapter 4: Reducing the impact of a failing bank

4.1 The Authorities would welcome views on the most appropriate ways to deal with other relevant entities in investment banking groups with the aim of helping to maintain financial stability.

This question seems to confuse two separate points; namely (i) what are the most appropriate ways to deal with group companies; and (ii) what role do investment banks play in helping maintain financial stability? We have therefore commented on each of these points separately:

Group companies

Different companies within a banking group are likely to hold different data often about the same customer. In circumstances where the failing bank is only one company within a banking group structure, the Authorities need to consider and address how a bridge bank could obtain relevant customer data from other parts of the company group while complying with data protection requirements and without removing value in terms of valuable customer information from the other group companies.

Consideration also needs to be given to how services provided to a bank by other companies its group (or third companies) might either continue in the event of failure or be transferred to a bridge bank.

Investment banks

Investment banks are crucial to the wholesale banking markets and to financial stability. In our view, it is important that the Authorities consider the potential issues which may arise where an investment bank fails and how it might threaten financial stability. However, we believe a separate exercise and discussion is necessary because the issues arising are likely to be very different to those encountered where a retail bank fails.

It seems to us that other issues such as state aid, competition and human rights may also need to be considered in the context of these proposals. Other respondents are better placed than us to comment on these issues.

4.2 Do you agree with the roles for the Authorities for the triggering and operation of the special resolution regime?

Yes, subject to our comments in response to Question 4.3 below.

4.3 Respondents' views are sought on the practical considerations involved in developing an SRR.

Primarily because the SRR is designed to achieve a swift outcome, many of the practical considerations will centre on a need for readiness and the ability to respond quickly when a bank looks like it is going to fail. We believe that the following matters are among those practical issues which will need to be considered:

- ▶ **Market sensitivity to the different SRR options:** There will be different levels of market sensitivity with different results depending on which tool(s) the SRR might use. In making their decision the Authorities will need to assess the possible effects and identify the most preferable option and the desired outcome taking into account the particular complexities

of the failed bank's financing arrangements. For example, the best solution might be the sale of the whole to a private purchaser. In that case, it would be preferable to identify a potential purchaser before entering the SRR. This could enable a quick sale rather than entering the SRR and then attempting to find a buyer which could of itself exacerbate a commercial or retail run or otherwise cause financial instability. Using partial transfers might be even worse for the same reasons.

To get a clearer picture of the possible effects, we recommend that the Authorities and the banking industry work together through different hypothetical scenarios to identify what a likely market response might be.

- ▶ **Preservation of existing agreements/services for the bank:** Consideration should be given to how agreements, such as those referred to in Chapter 3 above, might be preserved between any bridge bank or failed bank and payment systems to allow the SRR to continue effectively.
- ▶ **Standard precedent documentation for use in an SRR:** This would need to be maintained reviewed regularly and updated where appropriate. This might include:
 - ▶ Sale and purchase agreements
 - ▶ Funding agreements (on emergency stability basis) including agreements granting security
 - ▶ Shelf companies
 - ▶ Transitional service agreements between the bridge bank and the residual bank, another company in its group or third companies where appropriate. This could include agreements for continued access to payment systems and other critical banking services
- ▶ **Contingency planning:** it is important that the Authorities review and update their own contingency plans for dealing with a banking failure and the SRR. This would include running regular scenarios and stress testing. The plan should be reviewed regularly and updated where necessary.

As well as key contact lists, the contingency plan should identify a committee or group comprising representatives of the Authorities who can be called upon at short notice to make decisions.

- ▶ **Communications:** to mitigate the risk of contagion and to help maintain financial stability, a detailed communications plan needs to be in place so that it may be executed quickly and effectively in the event of a banking failure. It would cover communications to all stakeholders such as bank employees, suppliers/service providers, customers, investors and the general public. Even before a banking failure, it would also be useful to educate the general public about the SRR and how it works. Any plan would include the possibility of engaging specialist public relations advisers.
- ▶ **Legal challenges:** consideration needs to be given to the SRR's legal framework and an individual SRR's susceptibility to legal challenge. The SRR aims to be a rapid process and so any legal challenges will likely require an expedited hearing. There would also need to be safeguards against frivolous claims and some comfort potentially as to costs for both

applicants and respondents.

The SRR process also needs to guard against the aggrieved party attempting to stymie the SRR in circumstances where the Authorities will invariably need to act quickly. Accordingly, as for injunctions, where liquidated damages are seen to be an adequate remedy for the aggrieved party, it would be possible to preserve the *status quo* and allow the SRR to continue.

- ▶ **Advisors panel:** the Authorities could look to appoint a standing panel of advisors who may be called in to assist the Authorities in triggering and implementing the SRR.

4.4 What would be the best way to calculate the hypothetical net cost of depositor compensation payments, including the estimation of the recovery rate?

The calculation of the level of protected deposits in the failed bank should be able to be estimated with reasonable accuracy if the data is being maintained by firms as under the proposals for fast payout. There is likely to be a wide range of recoveries in insolvency dependent upon the position of the bank when it enters the SRR.

On this basis, any formula-driven approach is likely to be inaccurate in most circumstances. An estimate at the time of entering into the SRR on a case-by-case basis, while it may prove more accurate than a formula, is also likely to be inaccurate and will be heavily dependent upon assumptions as to recovery and realisations. A revision to update the figures will be invariably necessary at a later stage.

Simplicity of approach for all stakeholders suggests that a formula-driven approach would be cheaper and easier to implement. A case-by-case assessment would take longer and may result in a better overall accuracy. However, this would be by no means certain.

Chapter 5: Effective compensation arrangements for depositors

5.1 The Authorities would welcome further views on the best way of introducing gross payout when there are mutual debts.

We believe that gross payouts, up to the amount guaranteed by the FSCS, represent the most practical way to achieve the Authorities' proposal to move to a fast payout scenario for depositors. Added to that, we believe that they represent the most equitable arrangement for depositors in circumstances where it is reasonable for depositors to expect that their mortgage, loan or other credit arrangements will continue on their original terms as medium to long term commitments.

Clearly it is important that depositors continue to make repayments and to otherwise meet those existing commitments. Accordingly, where depositors receive FSCS-backed repayments, it will be important for those repayments to be accompanied by clear communications which explain that they should continue to meet existing commitments to the failed institution on the original terms. Ideally these communications should be able to identify the categories of debt and ideally the amounts. However, even if this is not possible at that point, the communications should still be specific about actions to take in respect of particular types of debt. For example, for a mortgage, the depositor would be asked to continue making payments by direct debit and for a credit card the depositor would be informed that the card can no longer be used and asked to continue making at least the minimum payment. The

communications might also suggest they transfer the balance to another card and/or apply for a card with another provider.

There are three suggestions made in paragraph 5.37 the Consultation Paper of introducing gross payouts when there are mutual debts. We prefer the third suggestion of making insolvency rules provide for the breaking of mutuality of debt for depositors' claims assigned to the FSCS after the commencement of the banking insolvency procedure. We are not clear how the first suggestion would work and we do not understand how non-FSCS protected depositors would be covered by the second proposal.

In any event, we agree that any changes will need to be subject to full and proper consultation to bring out all the issues and to seek to avoid unintended consequences.

5.2 The Authorities would welcome further views on a possible move to pre-funding and on the proposed legal framework for pre-funding and FSCS borrowing from the National Loans Fund.

Even though the existing levels of FSCS funding in the wake of Northern Rock did not meet market expectations, we believe that pre-funding is undesirable and potentially impractical. That said, we do not see how an element of pre-funding can be avoided if the proposed reforms set out in the Consultation Paper are to work. In circumstances where the Government looks likely to introduce an element of pre-funding at some stage, we welcome the Authorities' intention to delay its introduction until the economic conditions are right to do so.

Even in a benign economic climate pre-funding will have a substantial impact on the operating capital of banks. It is therefore extremely important that the right balance for pre and post-funding is achieved and that a full cost benefit analysis is carried out. However, with or without pre-funding, a facility from the National Loans Fund is always likely to be required because of the potential amounts involved and the desire for fast payout.

We believe that the proposal to use risk-based levies, where pre-funding is required, is sensible. As we have said before though, a discrete risk assessment will be extremely complex and may run counter to other similar assessments. Therefore, if risk-based levies are proposed they could be calculated by reference to existing risk assessments used in prudential regulation such as Basel II.

We believe other respondents are better placed than us to make comments in relation to the proposed legal framework.

Annex A – Impact Assessment

A.1 Do you have information that would improve the analysis of this impact assessment?

The impact assessment acknowledges that in many instances there will be direct costs attributable to implementation of the proposals not only for the Authorities but for others stakeholders and acknowledges that those direct costs are presently unquantifiable. Having said that, the wording of the impact assessment seems to underestimate the amount of costs that will be incurred by all parties in order to move to a state of readiness which will permit a fast payout close to the Government's stated aim of seven days.

In our view, costs will be incurred not only setting up the new framework and in the event of a banking failure but also in maintaining a state of readiness during the good times. As we have highlighted in our previous consultation responses, this heightened state of readiness and new fast payout regime will mean a new dynamic for banks and the Authorities with an associated need for larger quantities of data of greater integrity than was necessary under the old individual claims-based system. This will bring significant costs which should not be underestimated.

We would also add that in respect of paragraph A.130 there will also be costs associated in deciding which of the SRR tools to use before the failing bank enters the SRR regime.

A.2 Do you think that there are any significant indirect costs associated with this proposal?

We refer to our response to Question 3.1 above. Although we cannot at present quantify them, we believe that the pursuit of Option One would have the potential to increase significantly the costs of banks' borrowing. However, even more concerning than that would be the significant wider costs of a loss of confidence in the market *bona fides* in different instruments. Again, this should not be underestimated.