A framework for Guarantee Schemes in the EU:

A discussion paper

October 2005

HM TREASURY

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EXECUTIVE SUMMARY

Guarantee schemes provide consumers of financial services with some measure of protection in the event of failure of an institution in the financial sector. They therefore help maintain consumer confidence in financial markets. However, in judging the extent of protection to be provided, financial authorities need to consider the moral hazard that protection can generate. Guarantee scheme design is an important component of financial services policy: through their effect on consumer confidence, schemes can help to reduce the likelihood of crises. However, schemes should not be designed to prevent or manage financial crises: their most important role is to mitigate the effects of an institution's failure by providing compensation. Guarantee scheme design can also affect market efficiency and competitiveness.

The EU framework for guarantee schemes has three elements:

- the provisions of relevant **EU directives** on guarantees schemes;
- **guarantee schemes in individual Member States**; and
- **networks of cooperation and information sharing** between Member States' guarantee schemes and with relevant supervisory authorities.

The European Commission is currently examining guarantee schemes in the banking, investment and insurance sectors. This discussion paper is in response to the European Commission's consultation on the Deposit Guarantees Directive and call for response to the OXERA research on the Investor Compensation Directive. It also identifies and discusses the major policy challenges in Europe surrounding guarantee schemes more broadly.

To respond successfully to these challenges, the UK authorities have proposed a framework for action towards guarantee schemes at Community and Member State level:

- **strengthening financial services supervision**: strengthening the supervisory framework, improving cooperation between financial supervisors in different countries and enhancing the crisis management framework;
- **designing appropriate guarantee schemes**: providing adequate sectoral coverage, determining the scope of protection, determining adequate levels of protection and balancing the objective of ensuring appropriate consumer compensation while maintaining efficient and competitive markets; and
- **effective operation of guarantee schemes**: ensuring effective governance of schemes, delivering compensation quickly and enhancing consumer awareness.

Adopting this framework will help to ensure effective, efficient consumer protection throughout the EU. Common core standards of protection for all EU consumers have provided an important contribution to the future integration of financial markets in the EU. But beyond these, Member States should be free to determine issues such as additional levels of consumer protection and the funding of their guarantee schemes. It is vital that the outcome is fully consistent with the EU's future strategy on financial services policy and work on enhancing supervisory cooperation.

As Europe's financial markets become more integrated, the success of the guarantee scheme framework will depend upon proportionate regulation, improved cooperation and improved awareness of their impact on market efficiency and competitiveness.

1 Introduction

1.1 Developing a Single Market in financial services lies at the core of EU Member States' commitment to economic reform in Europe. An effective, integrated financial services market would reduce the cost of accessing capital and improve the allocation of capital across the EU; give institutions increased opportunities to access markets in other Member States and carry out business effectively on a cross-border basis; and give consumers access to a wider range of more competitively priced financial services products.

The FSAP and the UK's five priorities

1.2 Over the past five years the EU Financial Services Action Plan (FSAP) has been the legislative framework for developing a Single Market in Financial Services. Between its endorsement by the European Council in Lisbon in March 2000 and the end of September 2005, 40 out of the 42 FSAP measures have been adopted in the EU.

1.3 The UK authorities set out five priorities that they believe should guide further action in developing a Single Market in financial services[1] (see box 1.1). These priorities were also highlighted in the European Commission's Green Paper on Financial Services Policy[2].

Guarantee Schemes

1.4 Guarantee schemes provide consumers of financial services with some measure of protection in the event of failure of an institution in the financial sector. They therefore help maintain consumer confidence in financial markets. Policy on guarantee schemes should remain consistent with the EU's future strategy on financial services and work on enhancing supervisory cooperation and be consistent with the EU's commitment to follow better regulation principles.

An emerging debate

1.5 Recently, a debate has emerged about the response of financial supervisors to increasingly integrated financial markets. This debate has been triggered by a combination of factors, such as:

- the **availability of the EU corporate form**[3], allowing institutions to operate branches across borders. This has raised important questions:
  - how to manage risks when the supervisor and guarantee schemes are in different Member States;
  - how home state guarantee schemes are affected if a large amount of an institution's business is based in branches within other Member States; and
- the **need for consumers** to have recourse to clear redress mechanisms if they are to have the confidence to purchase financial products cross-border.

1.6 Against the background of this debate, it is important to design guarantee schemes in such a way that they can deliver effective protection for consumers against financial loss, while maintaining efficient and competitive markets.

[1] *After the EU Financial Services Action Plan: A new strategic approach, HM Treasury, Financial Services Authority and Bank of England, May 2004.*

[2] Green Paper on Financial Services Policy (2005 - 2010), COM (2005)177.

[3] Council Regulation 2001/2157/EC of 8 October 2001.

WORK ON GUARANTEE SCHEMES

1.7 The European Commission has initiated a public consultation on the Deposit Guarantees Schemes Directive[4] and, separately, has called for reaction to research by OXERA on the Investor Compensation Directive[5]. There is also an ongoing programme of work to consider whether or not it is appropriate to introduce a directive on insurance guarantee schemes.

1.8 There is a strong case for greater dialogue and coordination across work on banking, insurance and investor compensation schemes to ensure the coherent and consistent application of principles across the EU guarantee scheme framework.

1.9 This discussion paper – prepared jointly by the Treasury, Financial Services Authority (FSA) and the Bank of England – is in response to the European Commission's consultation on the Deposit Guarantee Schemes Directive and call for reaction to OXERA's research on the Investor Compensation Directive. This paper aims to answer the questions raised by the Commission and considers the role and purpose of guarantee schemes as part of the wider supervisory and consumer protection framework. Finally, it sets out the combined UK authorities' view on the future direction of guarantee schemes for the financial services sector.

TIMETABLE

1.10 At the EU level, the European Commission is reviewing the legislative framework for guarantee schemes. There are three strands to this work:

- **deposits**: in response to banking market integration in the EU, the Commission is currently reviewing the Deposit Guarantee Schemes Directive. It has launched a public consultation, which closed on 14 October 2005. This workstream is the most advanced of the three;
- **investments**: the Commission asked OXERA to prepare an extensive study of Member States' investor compensation schemes. This was published in September 2005. The Commission has issued a call for Member States to provide their opinion on the issues the study has raised; and
- **insurance**: technical work began in 2001 and continues on a draft directive proposal. The scope and timing of this work remain unclear.

1.11 The UK authorities would welcome comments on the ideas expressed in this discussion paper. These can be sent to: efs@hm-treasury.x.gsi.gov.uk.

[4] *Commission Services (DG Internal Market) Consultative Working Paper on Deposit Guarantee Schemes*, Ref.: DGS 001/2005, European Commission, July 2005. Available at: http://europa.eu.int/comm/internal_market/bank/guarantee/index_en.htm

[5] Description and assessment of the national investor compensation schemes established in accordance with Directive 97/9/EC, OXERA, January 2005. Available at: http://europa.eu.int/comm/dgs/internal_market/docs/evaluation/inv-comp-schem-directive_en.pdf

Box 1.1: The UK's five priorities

The UK authorities' five priorities for further financial services integration in the EU are:

- **better implementation and enforcement of EU measures affecting the financial sector**. A significant number of the FSAP measures that have been adopted have still to be implemented nationally. That should be a top priority, together with their subsequent enforcement;
- **alternatives to EU regulation**. In general, EU legislation should be a last resort and alternative approaches to policy making, such as more use of EU competition policy, market-based solutions and initiatives at national level, should be considered first;
- **better regulation**. In some specific cases, market failure analysis may demonstrate that further new EU legislation in financial services could be necessary. When new EU legislation on financial services is being considered a proper assessment of the costs and benefits should be undertaken and financial market participants should be fully consulted;
- **making the Lamfalussy arrangements work well**. These new regulatory arrangements are now in place to supervise financial services across the EU. They have been shown to work for securities markets and have recently been extended to banking and insurance, where the initial experience has been positive; and
- **recognising the global nature of financial services.** It is important to remember that financial markets are global. A global perspective is needed when considering the impact of EU financial services regulation on the competitiveness of EU-based institutions and financial centres. International action will sometimes be needed to tackle global issues.

2 GUARANTEE SCHEMES IN THE EU

2.1 Chapter one outlined work currently underway by the European Commission to review existing legislation on guarantee schemes. This chapter sets out the rationale for guarantee schemes and discusses the pressures currently facing the existing EU guarantee framework.

PURPOSE OF GUARANTEE SCHEMES

2.2 Guarantee schemes[1] help ensure effective protection for consumers when financial institutions fail and are an important part of financial services regulatory architecture. They are the last line of defence for consumers and encourage confidence by mitigating the consequences of a financial institution's failure. By underpinning confidence they can help to maintain financial stability.

2.3 Guarantee schemes are typically set up by governments, often as private companies (as in the case of the UK's FSCS[2]), to provide compensation to consumers when an institution is declared unable, or likely to be unable, to meet its financial obligations. Guarantee schemes are mostly funded by the private sector through a levy on financial institutions within the scope of the scheme. The scope of schemes varies across countries, but typically covers banking, insurance and investment services.

Reducing consumers' risk aversion

2.4 Many consumers will be unable to make a full assessment of the risks attached to dealing with specific financial institutions. In the absence of guarantee schemes, consumers may take an excessively cautious approach, leading to an economically inefficient allocation of savings. By offering protection, guarantee schemes can lessen the distortions arising from information asymmetry.

2.5 However, one adverse consequence of offering protection is moral hazard – the incentive for consumers to engage in transactions with higher risks in some circumstances because they believe any downside risk will be covered by the guarantee scheme. It is therefore important to balance the objectives of delivering consumer protection and maintaining efficient and competitive markets. Guarantee schemes must be designed in ways that seek to minimise moral hazard, while still providing enough protection for consumers to have confidence in financial institutions.

Mitigating the effects of financial crises

2.6 Guarantee schemes provide consumers with compensation in the event of a failure of a financial institution[3]. This can help to mitigate the effects of financial crises by providing consumer protection where losses are incurred. This protection can promote consumer confidence in financial institutions. Guarantee schemes also play a role in reducing the likelihood of financial crises, as at the systemic level, guarantee schemes can lessen the possibility of problems with one financial institution causing contagious loss of confidence in the financial system as a whole.

2.7 The ability of guarantee schemes to support financial stability, as well as consumer confidence and protection, will ultimately depend upon their effectiveness in paying out compensation in the event of an institution's failure.

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[1] The term 'guarantee scheme' is used throughout this document. In the case of the banking sector, this can be read as interchangeable with terms such as 'deposit insurance'.

[2] The Financial Services Compensation Scheme (FSCS) is described in Annex 1.

[3] This is known as the 'pay-box' function.

EU FRAMEWORK FOR GUARANTEE SCHEMES

2.8 The framework for guarantee schemes in the EU has three elements:

- the provisions of directives for EU guarantee schemes;
- national guarantee schemes' governing legislation and rules; and
- networks of cooperation and information sharing between guarantee schemes and with the relevant supervisory authorities.

EU directives

2.9 The EU currently has directives covering guarantee schemes in two sectors:

- **banking**: Directive 94/19/EC requires Member States to have in place a guarantee scheme covering deposit-taking activity, which is mainly conducted by retail banks. The Directive has several basic provisions[4], including an appropriate minimum threshold for 100 per cent protection of €20,000, and an insistence on the 'home state' principle[5]; and
- **investments**: Directive 97/9/EC requires Member States to have in place a guarantee scheme covering investments held by institutions providing investment services. The Directive's basic provisions are similar to the deposit guarantee scheme.

2.10 The European Commission is currently working on a draft directive on insurance guarantee schemes. A timetable has not yet been set out for this work and the scope of the directive is yet to be clearly specified.

Common core standards

2.11 The Directives on deposits and investments enshrine common core standards in consumer protection throughout the Single Market. The stated objectives of the Deposit Guarantee Schemes Directive are to:

- promote the integration of the Single Market through the elimination of all restrictions on the right of establishment, while increasing financial stability and consumer protection;
- ensure a harmonised minimum level of consumer protection wherever deposits are located in the Community; and
- ensure that, in the event of an institution's insolvency, the depositors at branches situated in a Member State other than that in which the credit institution has its head office must be protected by the same guarantee scheme as the institutions' other depositors.

National guarantee schemes

2.12 The scope of guarantee schemes in Member States is often wider than the common core standards established by EU directives. Member States often have schemes in sectors where no EU law is in place. Member States also operate schemes offering higher levels of compensation, specify how guarantee schemes should be funded and set out clear rules for the governance and institutional framework of guarantee schemes.

[4] The Deposit Guarantee Schemes Directive covers, among other issues: exclusions, definitions (deposits, credit institutions), scope of guarantee schemes, the home state principle of operation, provision of information and timing of payment.

[5] This principle stipulates that all consumers across the EEA who bank with an institution domiciled in one Member State are compensated according to the provisions of the domicile (home) state guarantee scheme. For example, UK consumers depositing money in a UK account operated by a UK registered bank would be covered by the UK's guarantee scheme. However, UK consumers depositing money in a UK branch of a German bank would be covered by the German guarantee scheme.

Networks of cooperation

2.13 Networks of cooperation and information sharing among supervisors and guarantee schemes are a critical third element of the EU framework. National guarantee schemes in the EU have mechanisms of cooperation such as, in the case of deposits, the European Forum of Deposit Insurers. Separately, financial supervisory authorities in the EU have fora for cooperation and information exchange, such as the Lamfalussy 'Level 3' Committees: the Committee of European Banking Supervisors (CEBS); the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS); and the Committee of European Securities Regulators (CESR)[6]. Outside these formal structures, there are ongoing networks of discussion and information sharing among supervisors on a day-to-day basis.

2.14 Taken together, these three sets of arrangements – EU directives, national laws and rules, and networks of cooperation – provide the institutional framework for guarantee schemes in the Single Market.

PRESSURES ON THE CURRENT EU ARRANGEMENTS

2.15 Financial markets are becoming increasingly global. There is increasing financial integration across the EU and many financial conglomerates work within the banking, investments and insurance sectors in many of the EU Member States. The changing landscape of financial services in the EU has created pressures for institutions and for the authorities. These pressures include:

- **possible increases in the number and importance of potentially systemic (mainly bank) branches**. This is partly an aspect of broader EU integration but the concern is heightened by the accession of new Member States to the EU[7]. Most of the foreign banks in the accession countries are currently constituted as subsidiaries, but there is scope for these to be changed into branches in the future. There are also examples of financial institutions contemplating moving to a branch structure;
- **the availability of the EU corporate form**, which may facilitate the transformation of subsidiaries into branches;
- **much market infrastructure is now part of larger cross-border groupings**, operating in a number of countries. Where these groups operate in Member States through a branch or remote access, concerns about loss of national supervisory control of potentially systemically important operations might be raised; and
- **EU legislative initiatives** to produce more streamlined arrangements for supervising cross-border groups, resulting from a growing number of calls for the removal of inconsistencies and duplication. Such initiatives are being introduced through the Capital Requirements Directive (CRD), and, in due course, for insurers through the planned Solvency II Directive.

[6] Supervising financial services in an integrated European Single market: A discussion paper, HM Treasury, Financial Services Authority and Bank of England, January 2005.

[7] Cross-border ownership already exceeds 70 per cent in the banking systems of Slovakia, Poland and Hungary, compared with the EU15 average of 30 per cent.

Challenges

2.16 These pressures in a changing economic environment raise two challenges for policy-makers:

- to continue to ensure that the framework for guarantee schemes can provide consumer confidence, protection and crisis mitigation; and
- to balance these goals against maintaining efficient and competitive markets.

2.17 This in turn requires:

- effective financial services supervision in the EU;
- guarantee schemes to be designed appropriately; and
- guarantee schemes to operate effectively.

3 POLICY CHALLENGES

3.1 Chapter 2 set out the rationale for guarantee schemes and discussed the pressures currently facing the existing EU guarantee framework. It went on to set out three requirements for future action:

- **achieving effective financial services supervision in the EU**;
- **designing appropriate guarantee schemes**; and
- **ensuring that guarantee schemes operate effectively**.

3.2 This Chapter considers the major policy challenges surrounding guarantee schemes and identifies responses to these challenges that deliver an appropriate balance between effective consumer protection and maintaining efficient and competitive markets.

ACHIEVING EFFECTIVE FINANCIAL SERVICES SUPERVISION IN THE EU

3.3 As EU financial markets become more integrated, so the question of how to supervise them becomes more complex. The challenges that this creates are numerous and relevant for guarantee scheme providers.

3.4 In *Supervising Financial Services in an integrated European Single Market: A discussion paper*[1], published in January 2005, the UK authorities considered how the EU supervisory framework might be developed. An important conclusion was that the appropriate policy response did not require new EU legislation, but rather practical solutions to enhance the supervisory framework. The paper set out some priorities for action, of which three are directly applicable to guarantee schemes:

- **measures to strengthen the supervisory framework**;
- **action to improve home-host supervisory cooperation**; and
- **enhancing the crisis management framework**.

Measures to strengthen the supervisory framework

3.5 No supervisory framework can provide a zero failure regime (i.e. prevent all and every potential failure). Rather, an effective supervisory framework should be targeted at minimising the possibility of a failure, in a manner which is proportionate to the risk of that failure occurring and its potential economic cost.

CRD & Solvency II

3.6 Measures to improve financial stability and prevent the frequency and severity of financial crises will be enshrined in two principal EU prudential directives:

- the **Capital Requirements Directive** (**CRD**) is designed to protect depositors or clients against risks taken by the financial institution which could potentially result in financial crises. It seeks to do so by ensuring that the financial resources held by an institution are commensurate with the risks

[1] Available at: http://www.hm-treasury.gov.uk/media/A50/DB/Supervising_Financial_Services_integrated_Eu_Single_Mk_Jan05_.pdf

associated with that institution. To achieve this, the EU's capital adequacy framework has been improved, in particular, in three respects:

  - first, there will be a substantial increase in the risk sensitivity of the minimum regulatory capital requirements;
  - second, the rules on minimum capital regulatory requirements will be reinforced by a supervisory review process that ensures that banks have appropriate systems in place to ensure good monitoring and management of their risks; and
  - third, by ensuring publication of information on risk exposures, risk assessment processes and levels of capital adequacy, markets will be able to make comparisons across institutions.

- a future **Solvency II Directive** will strengthen the EU's supervisory framework for insurance along similar lines.

3.7 These measures to strengthen the supervisory framework should be sufficient to give institutions strong incentives for sound risk management. Guarantee schemes will still be necessary to provide compensation if failure happens. However, guarantee schemes should not attempt to replicate the supervisory regime. The Solvency II project provides clear and helpful guidance on the relationship between the two. The European Commission's Amended Framework for Consultation on Solvency II[2] states:

> "Guarantee schemes are a last resort for policyholders and beneficiaries to be indemnified for their loss. The calibration of the new solvency system should not take into consideration the existence of a guarantee scheme. The new solvency system should provide enough safety and confidence in the insurance industry without relying on guarantee schemes."

Action to improve home-host cooperation

Examining the home state model

3.8 The basic EU approach to the division of legal responsibilities for cross-border financial supervision is enshrined in the Markets in Financial Instruments Directive (MiFID), the CRD and the Life and Non-life Insurance Directives:

- branches are authorised and prudentially supervised by the home[3] supervisor[4]; and
- subsidiaries are, in general, treated as domestic institutions, and thus are authorised and prudentially supervised by the host supervisor.

3.9 Nevertheless, in an attempt to accommodate some of the challenges described in the previous Chapter, two trends are emerging:

- the development of arrangements that give host supervisors a clearer role in supervising branches (for example, the provision for proportionate cooperation agreements in MiFID); and

[2] Amended Framework for Consultation on Solvency II, European Commission, July 2005, paragraph 13. Available at: http://europa.eu.int/comm/internal_market/insurance/docs/markt-2506-04/framework-cons_en.pdf

[3] For the purposes of this discussion paper, the "home" supervisor is taken to be the supervisor in the jurisdiction in which the parent institution is licensed, authorised or incorporated. The "host" supervisor is taken to be the supervisor in the jurisdiction in which a branch or a locally incorporated subsidiary is located.

[4] The exception to this rule is the liquidity regulation which, in line with the Basel Concordat, remains the responsibility of the host, although in practice it may be delegated to the home supervisor.

- the development of streamlined arrangements to give home supervisors more responsibility for supervising subsidiaries (for example, the arrangements for group risk model approval in the CRD).

3.10 To some extent, these two opposing trends might be expected to eventually lead to a degree of convergence in the current branch and supervisory models, in which there would be a "lead" supervisor (the current home supervisor), with host supervisors having well defined and definite, but secondary, roles.

Using existing structures

3.11 The UK authorities have argued that there is a need for an effective framework for promoting and enhancing cooperation between supervisors[5]. In summary, this framework would need to include:

- a set (or sets) of impact criteria;
- a set of models of cooperation (delegation, mediation, collegiate discussion, coordination);
- the provisions in existing EU directives; and
- the existing Lamfalussy structures (Levels 1, 2 and 3).

3.12 The continuing development of the framework for supervisory cooperation will create opportunities to evaluate the way in which the EU framework for guarantee schemes operates. However, it will be important to ensure that greater scope for interaction between supervisors and between guarantee schemes does not mean greater supervisory burdens for institutions. Policymakers and supervisory authorities should continue to look for ways to reduce such burdens and increase efficiency, without compromising the effectiveness of cross-border prudential supervision.

Enhancing the crisis management framework

3.13 As well as ensuring that an effective supervisory framework is in place, the most appropriate way to promote financial stability is through establishing robust crisis management arrangements.

3.14 This is being progressed through the Memorandum of Understanding on cooperation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations[6]. This puts in place a non-legally binding instrument for setting forth practical arrangements for national authorities to cooperate in crisis or potential crisis situations.

3.15 However, even though the existence of guarantee schemes can affect financial stability, financial stability should not be the principal determinant of guarantees scheme design. Financial stability is best dealt with through ensuring effective supervision and robust crisis management arrangements, leaving guarantee schemes to focus on financial redress following a failure or crisis.

3.16 The EU guarantee scheme framework should have in place effective and robust procedures for mitigating the effects of the failure of an institution. The guarantee scheme framework needs to be able to:

- respond quickly to minimise the costs and instability arising from crises;

[5] For a full examination, see *Supervising Financial Services in an integrated European Single Market: A discussion paper.*

[6] The press release is available at: http://www.ecb.int/press/pr/date/2005/html/pr050518_1.en.html

- specify clear procedures and responsibilities for all relevant authorities;
- ensure effective coordination and exchange of information among authorities; and
- withstand a wide range of stresses and pressures.

DESIGNING APPROPRIATE GUARANTEE SCHEMES

3.17 The design of guarantee schemes must deliver an appropriate balance between delivering consumer protection and maintaining efficient and competitive markets. There are three aspects to meeting this challenge:

- **determining the scope of consumer protection**;
- **determining the levels of consumer protection**; and
- examining **whether funding models affect consumer protection and market efficiency**.

Determining the scope of consumer protection

Scope of protection

3.18 The traditional role of guarantee schemes has been to provide compensation for deposits or investments lost as a result of a financial institution's failure. As we have seen, this function serves to provide consumer protection, thereby reinforcing confidence.

3.19 However, poor advice can cause widespread consumer detriment and this in turn can undermine consumer confidence in the financial services industry. For this reason, customers transacting business in the UK can appeal to the Financial Ombudsman Service (FOS)[7], which provides a mediation service and may require institutions to pay compensation for any loss suffered as a result of negligent advice for investments, mortgage advice and insurance. Compensation claims for negligent advice made against an insolvent institution in the UK are met by the Financial Services Compensation Scheme (FSCS)[8]. The UK is the only Member State in which the guarantee scheme provides such compensation.

MiFID

3.20 The Markets in Financial Instruments Directive (MiFID)[9] brings investment advice into the scope of EU legislation for the first time. In order to give investment advice, an entity will have to be authorised, and in seeking authorisation, it will have to meet its obligations under the Investor Compensation Directive. However, at present, the Investor Compensation Directive does not require compensation for entities that fail to meet the MiFID advice requirements and subsequently become insolvent.

3.21 The UK authorities welcome the recent OXERA report, produced for the European Commission[10]. The OXERA report raises the question of whether the Investor Compensation Directive should be widened to cover negligent financial advice. As a minimum, the Directive should continue to permit Member States to continue to provide compensation for negligent advice.

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[7] Information on the FOS is available at http://www.financial-ombudsman.org.uk

[8] See Annex A.

[9] http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_145/l_14520040430en00010044.pdf

[10] Description and assessment of the national investor compensation schemes established in accordance with directive 97/9/EC, January 2005.

Definition of eligibility

3.22 The core group of eligible consumers who are protected through guarantee schemes are private individuals, as they are typically least able to assess financial risk. Beyond this core group, there is an important policy question about whether, and how far, businesses should be protected. In general, the UK compensation scheme protects small businesses but not large companies. In the case of deposits and investments[11], a large company is a company which does not satisfy two or more of the following requirements: turnover of not more than £5.6 million; balance sheet total of not more than £2.8 million; and not more than 50 employees[12]. As eligibility remains a matter of consumer protection, on balance the UK authorities believe that decisions on the eligibility requirements for small institutions should be at the discretion of Member States.

Definition of products

3.23 Common definitions of financial services products and their coverage are clearly helpful to form the basis of an effective guarantee framework, and thus act to build consumer confidence. In view of the diversity of Member States' legal systems, definitions in Directives should be as universal as possible, while ensuring that any definition is flexible enough to capture the development of new financial services products and methods[13].

Determining the level of consumer protection

3.24 Determining the appropriate minimum level of consumer protection across all Member States requires finding an effective balance between the following objectives:

- providing all EU consumers with adequate protection;
- enabling Member States to set a higher level of consumer protection where they choose; and
- enhancing consumers' choice of financial institutions.

Reducing moral hazard

3.25 An open-ended commitment to fully compensate consumers for any losses can create moral hazard and weaken incentives for prudent investment choices. So, national authorities must remain conscious of the need to balance effective consumer protection with their responsibility not to undermine consumers' consideration of risk and reward. A number of policy options are available for mitigating this problem:

- imposing **maximum limits on compensation.** This should limit consumers' ability to protect their investment on amounts over the limit, thereby increasing the incentives for prudent investment choices. For some insurance products however, limiting compensation may not be the best option. Policy makers may deem it necessary for a very high coverage to be set, for example in the areas of professional indemnity or life insurance; and
- imposing **co-insurance**. Here, the consumer shares some of the cost responsibility with the guarantee scheme, and this liability of the consumer provides an incentive for a more considered analysis of the risks of the transaction. The current Deposits Guarantee Schemes Directive allows up to 10 per cent of the compensation claim to be met by the consumer (for claims that exceed the €20,000 limit, this percentage can increase).

[11] Required by the Deposit Guarantee Schemes Directive and the Investor Compensation Directive.

[12] There are some differences in eligibility rules across the schemes. More information is set out at http://www.fscs.org.uk

[13] One example of product development can be seen in the UK deposits scheme, where the introduction of Sharia banking showed the benefits of the current, flexible definition of a deposit.

3.26 The UK authorities believe that EU directives on guarantee schemes should continue to allow Member States to limit the amount of compensation payable and maintain some element of 'co-insurance'. The UK authorities believe that allowing consumers to bear an acceptable level of the cost should an institution fail, represents a proportionate way to address moral hazard.

Common core levels of consumer protection

3.27 On the basis of the current evidence, the UK authorities believe that the current level of consumer protection in the Deposit Guarantees Schemes Directive is adequate. The minimum level for 100 per cent protection of €20,000[14] has provided increased levels of protection across many Member States. As in practice, the current provisions in the Deposit Guarantees Schemes Directive ensure almost comprehensive cover for the vast majority of EU consumers[15], the UK authorities believe that this provides an adequate level of protection. Beyond this level, Member States are able to decide whether higher compensation is necessary.

Topping-up

3.28 Consumer's choice of financial institutions can, in theory, be enhanced by enabling institutions to 'top-up' into the scheme of the host country. This allows branches of incoming institutions to offer the same level of compensation as domestic institutions. However, there are relatively few topping-up agreements in place, largely due to the low levels of cross-border branches. As a result, there is insufficient evidence to assess the impact of different levels of consumer protection in different national schemes.

Examining whether funding models affect consumer protection and market efficiency

3.29 The UK authorities believe that the method of funding guarantee schemes should not be driven by trying to meet objectives that should legitimately fall to supervisory policy.

Supervisory objectives

3.30 The policy objectives for supervision that guarantee schemes should not be specifically designed to meet are:

- **crisis management**. Effective financial stability arrangements are of critical importance to the architecture of the financial system. The most appropriate way to promote financial stability is through ensuring an effective supervisory framework and robust crisis management arrangements are in place. The UK authorities set out a number of practical proposals to enhance these in *Supervising Financial Services in an integrated European Single Market: A discussion paper*. As discussed above[16], the proper role of guarantee schemes is not to manage crises, but to help to mitigate the effects of crises;

- **capital adequacy**. The EU is putting in place a new prudential regime to ensure minimum standards of capital adequacy in banking and insurance[17]. Risk-based funding models can be used by guarantee schemes to levy a higher premium on institutions that engage in higher risk activities, or

[14] This minimum level of protection can be subject to co-insurance of up to 10 per cent.

[15] According to a BSC survey, *Deposit Guarantee Arrangements*, the current minimum level of €20,000 in the Deposit Guarantee Directive corresponds roughly to 60-70 per cent of household deposits. In terms of deposit accounts, the figure is likely to be much closer to 100 per cent coverage.

[16] Paragraphs 3.13 – 3.16.

[17] Paragraphs 3.5 – 3.7.

operate from a weaker capital base, in order that 'riskier' institutions can be seen to have contributed to compensation payments that may be required should they fail. However, it is not appropriate to legislate for risk-based funding levies within the objectives of guarantee schemes at the EU level where the purpose of this is to minimise overall financial stability risk. To do so would duplicate the provisions already in, or foreseen to be in, EU legislation; and

- **financial market integration**. It is sometimes argued that harmonisation of guarantee scheme funding models is necessary to respond to integration in Europe's financial markets, particularly to the growing number of large institutions conducting significant cross-border business. However, as discussed below, no single EU funding model can address the separate demands created by the diverse pressures, or ensure greater certainty of provision.

Funding models for guarantee schemes

3.31 Guarantee schemes should be specifically designed to meet two main criteria:

- **raising adequate resources to provide an appropriate level of compensation for consumer loss**; and
- **ensure consistency with fair competition**.

Raising resources to provide appropriate compensation

3.32 Where consumers have bought a financial service or product that is covered by a guarantee scheme and are eligible for compensation, it is essential that the scheme is able to pay out that compensation. Without certainty of payout, consumer protection is substantially weakened. It is therefore vital that guarantee schemes are able to raise resources in a range of circumstances to compensate consumers effectively.

3.33 In order to achieve certainty of payout, guarantee schemes normally:

- recognise the vital importance of having **contingency funds** in place; and
- choose an appropriate **funding model**.

Contingency funds

3.34 No type of funding model will ensure certainty of payout from accrued funds. This means that all guarantee schemes must have adequate contingency funding in place. Any arrangements must be adequate to meet a range of payout circumstances, from a major failure, to a succession of small failures, to a failure that will lead to ongoing payments over many years. In the absence of comprehensive contingency plans, there is a risk of uncertainty and instability and of implying a potential reliance on state intervention and backing[18].

Funding models

3.35 Funding schemes for guarantee schemes across the EU are either 'ex-ante', 'ex-post', or 'mixed/hybrid' (a combination between ex-ante and ex-post). As, in practice, none of the models could meet the potential costs of all financial failures, all – at least implicitly – rely on ex-post funding to cover any potential shortfall in the fund.

3.36 All funding models therefore share the common objective of providing adequate compensation for consumer loss, while seeking to maintain efficient and competitive financial markets. Member States reconcile this balance differently, with the most

[18] In the UK the FSCS deposits sub-scheme can borrow from the other sub-schemes within the FSCS (money must be repaid), and it also has a commercial borrowing arrangement and the capability to raise a further industry levy within 3 months.

obvious distinction coming in the form of the size of standing fund maintained by their guarantee schemes.

3.37 The decision on what size of standing fund to maintain is influenced by many factors, such as supervisory policy, perceived financial stability, anticipated liabilities or liabilities already accrued, the availability of contingency funds, or other factors including social and historic attitudes.

3.38 On this basis, no single EU funding model can address the separate demands created by these diverse pressures or ensure greater certainty of provision**. The UK authorities believe that the current diversity in funding arrangements in the EU should continue**.

Fund size **3.39** The advantages and disadvantages of maintaining different levels of standing funds are discussed below.

Maintaining a large standing fund

3.40 The advantages of maintaining a large standing fund are that:

- the extent of contribution that potential defaulters make to the fund can be determined by the use of risk based premiums, if this proves desirable;
- the defaulting institution pays, to some extent, as it would have previously made contributions to the fund out of which compensation payments are awarded; and
- non-significant or one-off payments can be met, if these are lower than the accumulation of funds invested by the guarantee scheme. This can have the beneficial effect of allowing payments to be 'smoothed' over time.

3.41 The disadvantages of maintaining a large standing fund are that:

- assets retained by a guarantee scheme are not available for use by institutions and are likely to earn a lower rate of return than they would if held by institutions. The guarantee scheme would also have to employ administrators and investment professionals to manage the fund. Thus, contributions that are retained in the scheme will exert a 'deadweight' cost of capital on institutions' potential profitability. There is a strong rationale on these grounds for minimising the value of the standing fund in guarantee schemes; and
- joining or leaving a scheme may be difficult due to entry or exit payment requirements. Alternatively, institutions that have made substantial contributions to schemes may be dissuaded from moving their company seat as this may mean a 'loss' of those contributions.

Maintaining a small standing fund

3.42 The advantages of maintaining a small standing fund are that:

- the deadweight cost of capital is minimised: assets are retained by institutions, who – in a competitive market – are best placed to invest these with maximum efficiency. Additionally, the administrative costs associated with maintaining a large standing fund are minimised; and

- there are less perceived restrictions on an institution moving company seat, as these institutions will not have made substantial contributions to a scheme that remain unallocated to compensation and there is less likelihood of entry or exit payments (when moving between schemes with small standing funds).

3.43 The disadvantages of maintaining a small standing fund are that:

- surviving institutions pay, to some extent, as a failure may place the institutions still participating in the guarantee scheme in the position where they have to make payments to cover the losses of the defaulter (however, in the long term, these costs may be reduced insofar as the guarantee scheme has a claim on the defaulter's residual assets); and

- arbitrage opportunities exist, as the level of contributions required by the scheme are likely to be lower than those required by schemes operating large standing funds. These opportunities are limited, as they are unlikely to be a significant factor in an institution's choice of location.

Funding in the UK

3.44 The UK's FSCS maintains a low standing fund. A low standing fund is achieved by issuing an ex-ante call for funds from institutions for the amount of compensation that analysis has predicted is necessary to cover the likely liabilities for the year ahead. As the fund is not invested for future use, there are very limited costs of deadweight capital and no administration costs for investing the fund are incurred.

Ensuring consistency with fair competition

3.45 It is important when designing policy on guarantee schemes to consider any potential impacts on competition. There are two issues which may need to be addressed in order to ensure that the design of guarantee schemes is consistent with fair competition:

- **state funding**; and

- **cross-subsidisation** between sectoral guarantee schemes.

State funding

3.46 Many guarantee schemes have arrangements in place for the state, rather than the private sector, to provide loan facilities in the event of a crisis. While this arrangement may offer greater certainty, it is important that the loan facility is offered in such a way that national schemes do not place contributing institutions at a competitive advantage.

3.47 Although it is perfectly acceptable for Member States to approach the funding of their guarantee schemes in different ways, there is a need to ensure that funding does not amount to illegal state aid. If a state's government were to make payments into a guarantee scheme, or assist undertakings in making those payments, then there is an obvious risk of illegal government subsidies. The government would be relieving the undertakings governed by the scheme of the burden of making those contributions and thereby enabling them to trade forward with fewer liabilities.

3.48 However, there are likely to be situations when it may be permissible for a government to meet some of the liabilities of a financial institution being liquidated, or to pay on an ex-gratia basis the claims of consumers who have lost investments or entitlements as a result of an undertaking becoming insolvent. In this case, it is crucial

that Member States seek permission from the European Commission if they are in any doubt about the legality of payments that they wish to make.

Cross-subsidies

3.49 Cross subsidies across different financial service sectors should be minimised, so that institutions should not be expected to meet the cost of claims arising from areas of business in which they do not participate, although equally any levy class needs to be sustainable in the event of a failure. Under the Financial Services and Markets Act (FSMA), there is a requirement for the FSCS to have regard to the desirability of levies to reflect, as far as practicable, the amount of claims made, or likely to be made, in respect of that class of person. The rules of the scheme establish separate funds for distinct types of activities and require FSCS to allocate levies to these funds in proportion to the compensation costs arising from claims in respect of these activities.

ENSURING THAT GUARANTEE SCHEMES OPERATE EFFECTIVELY

3.50 In order for guarantee schemes to deliver effective consumer protection, it is important that, once the scheme has been designed, it can operate effectively. There are three aspects to this challenge:

- **ensuring effective governance of guarantee schemes**;
- **delivering compensation quickly**; and
- **improving consumer awareness**.

Ensuring effective governance of guarantee schemes

3.51 Guarantee schemes have responsibilities to consumers and financial institutions which fund their activities. Guarantee schemes must have the confidence of both consumers and institutions and they should be accountable for the effective and efficient discharge of their functions.

Governance

3.52 This suggests that, in addition to the traditional operational aspects of guarantee schemes and subject to relevant national laws, guarantee schemes should operate under appropriate governance rules and disclose how they comply with them. These rules should provide for recruitment, management, and reporting arrangements to:

- govern their relationship with national supervisors and others;
- ensure that those charged with oversight of the scheme are seen, collectively, to have appropriate competence, backgrounds and independence;
- require schemes to report publicly on their stewardship of the funds entrusted to them, including the outcome of any independent audit that may be required; and
- require schemes to report publicly on the principal features of their operations, including the numbers and types of claims dealt with and redress paid.

Delivering compensation quickly

Deadlines **3.53** Making sure that consumers receive compensation payments in time is essential for the maintenance of consumer confidence in guarantee schemes. The current Deposit Guarantee Schemes Directive sets a three-month deadline for compensation payments to be made, with limited options for extension.

3.54 More work is necessary to determine whether it is appropriate and practicable to propose any changes to the timing of compensation payments. Speed of payment may be especially important in the case of insurance, where the consequences of receiving late payment may be the loss of income stream (in the case of life insurance), or related contracts (in the case of payment protection insurance).

Tackling barriers **3.55** As cross-border activity increases, it will be necessary to ensure that there are no cross-border barriers to payment of compensation to consumers across the EU.

3.56 Some attempt has been made to link the possible speed of compensation payments to the funding model of individual guarantee schemes, with the argument that ex-ante funding is needed to ensure resources are immediately available. However, a scheme with contingency arrangements in place should be able to meet an appropriate deadline for compensation payments just as effectively. It is a matter for individual guarantee schemes to determine how this target is achieved.

Improving consumer awareness

3.57 Guarantee schemes cannot perform all of their functions effectively without consumer awareness of their existence and function. For, although compensation payments can still be made, schemes cannot promote consumer confidence in financial services if consumers do not know that they exist. Therefore, there needs to be easy access to readily digestible information about compensation and processes, such as through the operation of a single gateway that gives consumers information, access to compensation and access to the pan-European financial services guarantee scheme network.

3.58 Consumer awareness can be raised by guarantee schemes, for example by generating press attention, or by regulators. However, it is the 'front line' action of institutions that is likely to have the greatest impact. Regulators can play a role here by ensuring that institutions disclose the existence of schemes.

4 Conclusions

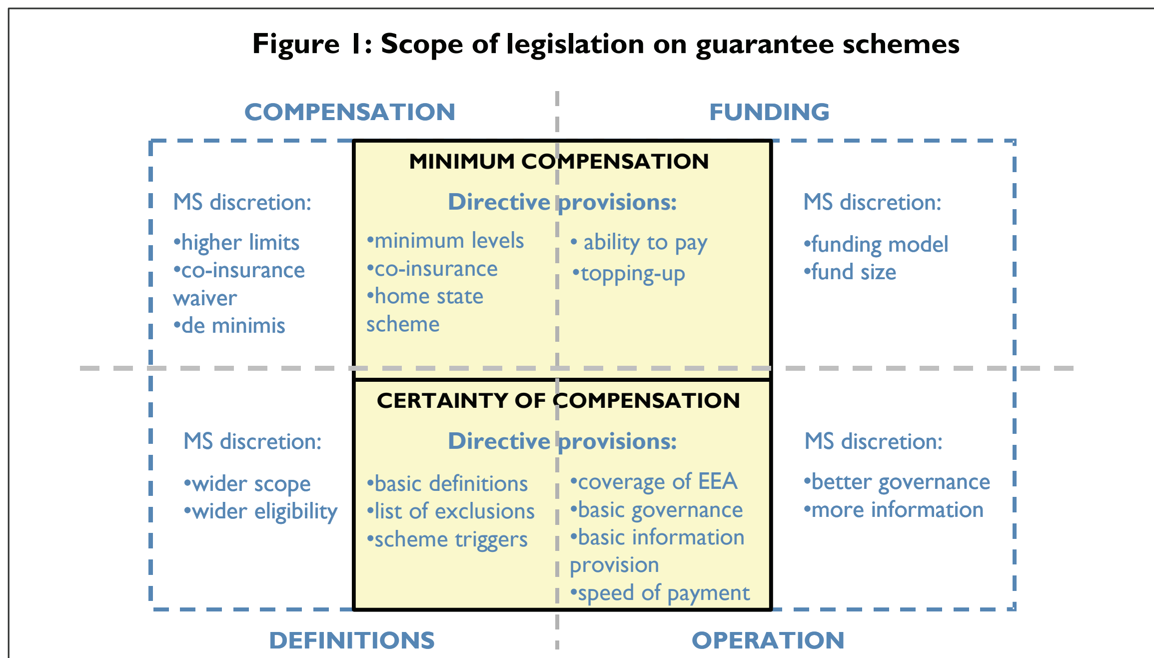
4.1 Chapter 3 considered the major policy challenges surrounding guarantee schemes and identified responses to these challenges to ensure effective consumer protection, while seeking to minimise moral hazard for consumers and maintain efficient and competitive markets. The policy responses outlined are fully consistent with the EU's future strategy on financial services policy and work on enhancing supervisory cooperation in Europe.

Legislative and non-legislative action

4.2 Meeting these challenges will require both legislative and non-legislative responses. In many cases, necessary legislation is already in place. Figure 1 below sets out the UK authorities' view of the appropriate scope of legislation on guarantee schemes.

4.3 In order for the EU framework for guarantee schemes to work effectively it is necessary for measures to ensure some common core standards and certainty of compensation. Figure 1 makes clear where common core objectives are required to meet the two basic objectives of guarantee schemes (hence the scope of European law) and where it is appropriate to leave policy decisions to the Member States. On the issue of funding for example, it is essential that common core standards ensure all schemes are able to make payments (for example by having adequate contingency provisions in place), while Member States should be free to determine funding models.

Figure 1: Scope of legislation on guarantee schemes



Consistency with future strategy

4.4 The response to the challenges set out in Chapter 3 needs to be fully consistent with the EU's future strategy on financial services policy and work on enhancing supervisory cooperation. Greater dialogue and coordination across work on banking, insurance and investor compensation schemes is necessary to ensure the coherent and consistent application of principles across the EU guarantee scheme framework.

4.5 Any future work to establish common core standards should only proceed if it is subject to the principles of better regulation. Policy should be formed on sound evidence. Proposals should follow an open and transparent public consultation process

and be subject to a rigorous cost benefit analysis that assesses the impact on both consumer protection and market efficiency.

The importance of implementation

4.6 To deliver effective consumer protection and maintain efficient and competitive markets, effective, proportionate and consistent implementation of EU measures on financial services is crucial. Effective implementation should be a priority for Member States and the European Commission.

ACHIEVING EFFECTIVE FINANCIAL SERVICES SUPERVISION

Financial stability

4.7 Guarantee schemes should not be designed to prevent or manage financial crises, as their most important role is to mitigate the effects of an institution's failure by providing compensation. Measures to achieve financial stability should be delivered mainly through ensuring effective supervision. Robust crisis management procedures are also essential, as, unless planned for, normal working arrangements tend to come under severe strain and collapse altogether in crises, just when decisions are needed most urgently.

Supervisory cooperation

4.8 However, the design of guarantee schemes does interact with the supervisory framework. It is therefore appropriate for each Member State's guarantee scheme to be designed in accordance with the individual structure of their supervisory framework. While EU supervisory cooperation has improved over time, there is still scope for further cooperation between guarantee schemes. Practical measures such as staff exchanges would assist in enhancing effective cooperation across the EU.

DESIGNING APPROPRIATE GUARANTEE SCHEMES

4.9 Guarantee schemes help ensure effective protection for consumers when financial institutions fail and are an important part of financial services regulatory architecture. They are the last line of defence for consumers and encourage confidence by mitigating the consequences of a financial institution's failure. By underpinning confidence they can help to maintain financial stability. The design of guarantee schemes needs to take into account:

- **moral hazard**. Guarantee schemes should be designed in ways that seek to minimise moral hazard and achieve the right balance between delivering consumer protection and maintaining efficient and competitive markets;
- **funding**. Member States should be free to determine the funding model of their guarantee schemes, as this must fit within that Member State's supervisory framework. The main distinction between different approaches to funding guarantee schemes is the level of the operational standing fund. While no funding model, or size of standing fund has overall advantages over the other, the key factors that need to be taken into account are:
    - guarantee schemes should have the ability to pay, for example by having adequate contingency funding arrangements in place;
    - state backed loans or payments need to be examined carefully;
    - controls on cross-subsidies need to be in place; and
    - funding models should not unduly restrict competition;

- **sectoral coverage**. Although guarantee schemes do not fully cover the entire financial services sector, there is presently not enough evidence to prove the case for further EU legislation;
- **definitions**. Consumers across the EU should benefit from the same minimum level of compensation. To ensure this, it is important to achieve universal definitions of the main features of guarantee scheme coverage;
- **compensation levels**. The provisions on compensation specified in the Deposit Guarantee Scheme and Investor Compensation Directives ensure comprehensive cover for the vast majority of EU consumers. Beyond this level, Member States should be able to decide whether higher compensation is necessary;
- **topping-up** and **co-insurance**. It is essential that topping-up and the principle of co-insurance be retained as they fulfil important competition and market efficiency functions; and
- **compensating for advice**. In a post-MiFID regulatory environment, there could be a case for examining whether negligent advice should form part of the EU guarantee scheme framework.

EFFECTIVE OPERATION OF GUARANTEE SCHEMES

4.10 In order for guarantee schemes to deliver effective consumer protection, it is important that, once the scheme has been designed, it can operate effectively. The effective operation of guarantee schemes requires:

- **effective governance**. Guarantee schemes should be subject to basic requirements for transparency and governance, in order to gain the confidence of consumers and institutions;
- **compensation** should be available to be paid quickly and any barriers to making cross-border payments should be identified and addressed. More work is necessary to determine whether it is appropriate or practicable to propose any changes to the current time limits on making payments; and
- **consumer awareness**. There should be greater consumer awareness of guarantee schemes in order to promote consumer confidence in financial services.

A GUARANTEE SCHEMES IN THE UK

The UK's guarantee schemes are operated by the Financial Services Compensation Scheme (FSCS). Box A1 below provides a summary of the FSCS arrangements.

Box A1: Guarantee schemes in the UK: the Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) was established by the Financial Services Authority under powers set out in the Financial Services and Markets Act 2000 (FSMA). The scheme replaced various compensation bodies that operated prior to the establishment of the FSMA, including the Deposit Protection Board (established 1979), the Investors Compensation Scheme (established 1988) and the Policyholders' Protection Board (established 1975).

The Scheme operates financially separate guarantee sub-schemes in the following areas:

- deposits;
- insurance (life and non-life);
- investment institutions;
- mortgage advice and arranging (with effect from 31 October 2004); and
- general insurance mediation (with effect from 14 January 2005).

Membership of the relevant FSCS sub-scheme (or of a home state scheme if applicable) is a condition of FSA authorisation.

The FSCS pays compensation to eligible consumers in cases where authorised institutions are unable, or likely to be unable, to satisfy claims made against them. The FSCS has the power to impose levies on authorised persons, or any class of authorised persons, for the purpose, amongst other matters, of paying such compensation.

The FSCS may include in its annual levy anticipated compensation costs for the 12 month period following the date of the levy. If necessary, the FSCS may levy more than once a year, but there is an overall cap, for example in the accepting deposits sub-scheme the maximum compensation levy that can be raised is 0.3 per cent of a participant institution's protected deposits, cumulative.

The UK's framework for guarantee schemes is well established and has a good track record, the scheme having met all of the eligible claims that have been received.

At the UK level, the FSA, is reviewing the compensation and eligibility limits for the FSCS and the Financial Ombudsman Service (FOS). This review meets the FSA's commitment to review the limits three years after FSMA came into force.

At the same time the FSA is conducting a review of funding of the FSA, FOS, and FSCS, with the main focus on the FSCS. The FSA is coordinating its work on these reviews.