

Response to the Banking Reform Team from the Institute of Insurance Brokers (IIB)

Financial stability and depositor protection: strengthening the framework

The IIB fully supports the objectives¹ expressed by the Authorities in this paper. The stability and resilience of the financial system is essential to the future of the financial services industry and to the country as a whole.

As an association for UK insurance broking businesses we are responding to the consultation only in relation to those matters which most directly affect our members. In particular we wish to draw attention to the threat posed to insurance brokers and other small intermediaries as a result of their obligations under the Financial Services Compensation Scheme (FSCS). Our former Director General, Andrew Paddick, sadly now deceased, described the compensation arrangements as 'passing financially explosive parcels to total innocents, under the guise of consumer protection.'

In response to Treasury consultation, we have previously expressed the view that too much emphasis is placed on the FSCS as the safety net for the FSA's own regulatory failings. The Northern Rock debacle demonstrated that supervision by the FSA has been inadequate and ineffective. The regulated community already has picked up the tab in terms of distorted competition over time and the spiralling cost of continuing operations in a destabilised market. The prospect of prudent businesses having to pay further for the recklessness of others and the ineptitude of the regulator through FSCS levies seems iniquitous.

In a scenario where a sizeable bank were to default, total calls on the FSCS could far exceed the applicable annual levy limits for firms. We presume it would then have to use its borrowing powers to make good the shortfall which it might hope to recover in subsequent years by raising both caps and levies to draconian levels. Such unlimited funding arrangements could have disastrous consequences, not least for intermediary firms which, unlike product providers, would be unable to make point-of-sale recoveries.

This Institute has long held that the unlimited compensation available to customers of failed insurance intermediaries through the current FSCS arrangements is unsustainable and an absurdity, particularly when compared to the current £35,000 limit for bank customers. The revised funding model for the FSCS which came into force on 1 April 2008 has fuelled further discontent amongst our members with its measures for cross subsidy and the creation of the general retail pool; hence small retail firms are liable to contribute towards compensating victims of failed banks.

Clearly, increasing numbers of intermediary firms are getting out of the market in the face of the potential exposures - which has an adverse effect on consumers by reducing scope for those seeking advice.

It appears the previously independent compensation schemes were mingled without any structured thought or attempt to achieve consolidation and

harmony in the consumer interest. We make no apology for repeating the illustration we have previously used to show the current disparities in compensation limits, which simply cannot be justified from a consumer perspective (see below).

The prospect of further FSA consultation on changes to the FSCS limits and the compensation calculation suggests more tinkering at the edges of this issue rather than a radical overhaul of compensation arrangements. In our response to CP07/5 we strongly advocated product based levies as a sustainable and fair method of meeting FSCS compensation exposures. This may not have been properly understood by the FSA officials concerned and in any event they disregarded the proposal by stating it was not possible as, in their opinion, it would not meet the requirements of s213(5) FSMA.

In our view the FSCS should be radically reformed, if necessary, through changes in the relevant legislation. Should you require any clarification or further input at this stage we should be pleased to assist.

An illustration of how current FSCS compensation arrangements might apply to consumers

1. Your £500,000 house burns down, but the actual insurer has gone into liquidation. You will receive 100% of the first £2,000 plus 90% of the residue – total compensation £450,200, **a personal loss of £49,800.**
2. Your £500,000 house burns down, but your broker forgot to renew the policy. He also forgot to renew his own professional indemnity insurance (PII) and has no assets. You will receive 100% of the first £2,000 plus 90% of the residue – total compensation £450,200, **a personal loss of £49,800.**
3. You sold your house for £500,000 and put the money on deposit whilst taking a holiday and awaiting completion of your new house. In the meantime, the bank collapsed because of its exposures to sub-prime mortgages. You will receive 100% of £35,000 (under the new limit introduced on 1st October 2007), **a personal loss of £465,000.**
4. You effected a 100% interest only mortgage on your £500,000 house and were advised (as a higher rate tax payer) to link this to a personal pension plan, ultimately using the tax free lump sum to discharge the capital balance outstanding. The risk warnings were grossly inadequate, especially as the mortgage/investment adviser (now a departed firm) had utilised a derivative fund, which just weeks before the time needed crashed and was worthless. You will receive 100% of the first £30,000 and 90% of the next £20,000 – total compensation £48,000, **a personal loss of £452,000.**

¹Objectives described in the paper: reducing the likelihood of individual banks facing difficulties; reducing the impact if, nevertheless, a bank gets into difficulties; providing effective compensation arrangements in which consumers have confidence; and strengthening the Bank of England, and ensuring effective coordinated actions by authorities, both in the UK and internationally.