

23 April 2008

FINANCIAL STABILITY & DEPOSITOR PROTECTION: STRENGTHENING THE FRAMEWORK

INTRODUCTION

HSBC is supportive of the five key objectives set out in the document '*Financial stability and depositor protection: strengthening the framework*' published in January 2008 and agrees with the Tripartite Authorities that we have a real opportunity to adapt the UK regime to respond to the rapidly changing financial markets. The collective, comprehensive, industry response submitted by the British Bankers' Association carries our support. Therefore, rather than answer each question within the consultation document, we are restricting our comments to areas we wish to emphasize or elaborate.

HSBC is one of the largest banking and financial services organisations in the world. We have 10,000 offices in 83 countries and territories in Europe, the Asia-Pacific region, the Americas, the Middle East and Africa. We interface with in excess of 500 regulators globally.

This review is fundamental not only to banks that provide services to retail customers in the UK and consumer confidence but also to the competitiveness of London. We continue to see sustained turbulence in global financial markets which requires action on a global basis. It is imperative that the UK and EU authorities do not take steps that could place global or international financial institutions headquartered in the UK, or indeed purely domestic players, at a competitive disadvantage.

OVERVIEW OF THE PROPOSALS IN THE CONSULTATION PAPER – Chapter 1

The key objectives outlined in the consultation paper namely:

- strengthening the Bank of England and improving co-ordination between authorities;
- strengthening the financial system;
- reducing the likelihood of banks failing;
- reducing the impact of failing banks;
- ensuring effective compensation arrangements in which consumers can have confidence;

while not mutually exclusive, are in fact a continuum. We consider that it is important to continually evaluate the proposals in this context as we seek to build upon the lessons of recent months.

We are concerned that disproportionate emphasis is being placed on what happens in the event of a bank or building society failure (i.e. the end of the continuum), for example faster payout to eligible depositors. The primary focus and priority must be on strengthening the system and reducing the likelihood of banks failing. Clearly there were regulatory failings in relation to Northern Rock, as identified in the FSA's Internal Review audit, and these must be addressed.

Timetable

The timeframe laid out in this consultation paper is extremely ambitious and we do not believe it leaves enough time for all stakeholders to consider in the depth required the impact of these proposals, and the practical implications of applying them. It is essential that unintended consequences are avoided and the competitiveness of the UK financial system and London as a financial centre is maintained. We strongly recommend taking more time before legislating to ensure that the eventual measures are appropriate, proportionate and effective. In addition we advocate continuous consultation with the banking sector, via the BBA, during the drafting of any legislation.

We believe that the Banking (Special Provisions) Act 2008 provides adequate short-term legislation, allowing Government and the Authorities more time to consult and work with industry to build a useful framework that is appropriate in rapidly changing markets.

STABILITY AND RESILIENCE ON THE FINANCIAL SYSTEM – Chapter 2

Liquidity management

We are broadly supportive of the intentions for liquidity management set out by the FSA in DP07. The main proposal of the DP is for the FSA to adopt a more principles based approach to their review of liquidity risk requirements by relying to a greater extent on banks' internal models to measure and manage liquidity and funding risks. This approach recognises that a standardised quantitative approach alone is not suitable in a marketplace where there will be differing levels of inherent liquidity risk between banks and for a risk type that is multi-dimensional.

The proposal to apply a more principles based approach will lead to a greater interaction between individual banks and the FSA as the FSA aim to get a detailed understanding of the models and overall liquidity risk management framework used by these banks. We would encourage this increased interaction. Liquidity risk management is the responsibility of banks' senior management; they should therefore be in the best position to develop appropriate models and measures to fully and adequately manage this risk. The FSA should then ensure that these models and measures are suitable, all encompassing and in line with best market practice observed across the industry.

A certain amount of quantitative reporting will always be necessary to aid at least a high level comparison across banks and to highlight trends. This is also accommodated in the DP.

We welcome the Bank of England's Special Liquidity Scheme announced on 21 April 2008.

Credit Rating Agencies (CRA)

It is worth noting that the Asset Backed Securities (ABS) market has become illiquid since this consultation paper was written and the remit of the CRAs is wider than structured products. They also rate bonds issued by both listed and private companies. Following the problems of last summer, some larger investors have lost confidence in CRAs and have therefore resorted to employing their own rating

analysts. We think this provides important context to the questions raised in the consultation paper and a possible indicator of the way forward.

The consultation paper recognises that there would be significant reputational damage to any CRA that was perceived to favour the issuer. As a result there is a very strong disincentive to over rate transactions. The entire CRA business model is built upon this premise and as a result there is very strong internal monitoring to ensure the quality of ratings. However, we would suggest that the appropriate Authorities consider the incentives created by the charging structure for new ratings and for the ongoing monitoring of ratings.

HSBC concurs with the view that regulation would not be the most effective way forward and it would be difficult to impose a European-style regulation on a global activity of this nature. However, CRAs should be encouraged to be more transparent in respect of their objectivity when rating names/structured products and also be bound by the same Conflicts policies as financial institutions.

REDUCING THE LIKELIHOOD OF A BANK FAILING – Chapter 3

Strengthening the regulatory framework

The key priority must be to ensure proper management of financial institutions and appropriate supervisory intervention to reduce the likelihood of a bank failing.

We consider that the FSA has the range of tools necessary to reduce the likelihood of a bank failing. The key issue for the FSA going forward will be the calibre, experience and size of the supervisory teams. The focus should not be predominantly on the larger groups and a balance must be achieved between capital, liquidity and consumer protection.

We look forward to the FSA's consultation on new rules to require banks to be in a position to provide additional evidence at short notice. Until we have seen the detail it is not possible to comment on proportionality and effectiveness. We would emphasize the need to avoid knee jerk reactions or taking steps that would put UK domiciled institutions at a competitive disadvantage.

Payment systems

We feel strongly that oversight of both wholesale and retail systems should be the responsibility of the Bank of England. It is not possible to draw clear dividing lines between systems and we believe it would add an unnecessary layer of complexity to split oversight responsibility.

REDUCING THE IMPACT OF A FAILING BANK – Chapter 4

Special Resolution Regime (SRR)

We support the principle of an SRR however:

- We believe that the specific proposals should be subject to full consultation in advance of legislation being introduced into Parliament.

- We do not support proposals for using the FSCS to fund SRR costs in advance of insolvency. The function of the FSCS is to insulate depositors from loss up to a pre-defined limit.
- The linkage between an SRR and the objective of 'faster payouts' in the event of a failure needs to be explored to minimise consumer uncertainty and panic, as well as facilitating an orderly migration from a failed institution to an alternative provider.
- We are concerned that an SRR could assign preferred credit status to depositors thereby disturbing the property rights of other stakeholders. This would potentially reduce the attractiveness of London compared to other financial centres.
- If business was to be transferred out of a troubled bank, we believe this should be the entire institutions business, rather than just a portion of it. Failing this, care needs to be taken to ensure that parties dealing with the residual presence of the bank are not severely disadvantaged.
- It is important that the triggers for intervention are a combination of both objective criteria and principles-based measures. A pre-requisite for entry into the SRR should be failure against objective criteria, such as the meeting of minimum regulatory ratios.
- In designing the regime it is important that thought is given to the circumstances in which it may need to be invoked and the processes that would be followed. Invoking the SRR should be the responsibility of the FSA after which responsibility for the institution should pass to the Bank of England. Any prior involvement of the Bank of England should be limited strictly to its assessment of the way in which the SRR should be applied.

Bank-specific insolvency procedure

A new bank-specific insolvency procedure would be a major departure and we believe that there are many issues that need resolving before proceeding with this proposal. The special resolution tools for pre- and post-insolvency are blurred and need to be more clearly defined.

As with other elements of the SRR, substantial issues arise which need reviewing in detail before the appropriateness of establishing this procedure can be evaluated. This includes the effect on contractual rights benefiting non-depositor creditors of UK banks which may be impacted by these proposals. As with the SRR, it is essential that set-off and netting rights, as well as the ability to realise collateral or enforce security interests be preserved. If this were not to be the case, the capital and economic cost of transactions would rise.

We agree that the Government should pass early legislation to provide the Bank of England with statutory immunity for acts and omissions relating to its role in providing financial stability and central banking functions.

The Treasury Select Committee report 'Financial Stability and Transparency' recommends that a mechanism is established to warn of diminishing market conditions from the Bank of England or the FSA that would need to be formally acknowledged by financial institutions and discussed at Board level. We agree that this is a practical and helpful suggestion and we support it.

CONSUMER CONFIDENCE & COMPENSATION ARRANGEMENTS – Chapter 5

Pre-funded model of compensation

The consultation paper recognises the significant disadvantages of a pre-funded model of compensation; we do not believe that this model is appropriate in the UK market. It would take a considerable length of time, or high pay-in rates, to build up a sufficient pool of money to cover the compensation costs for a bank the size of Northern Rock. We question whether having a small (and certainly not large enough to cover customers' claims) pre-funded account available would offer reassurance to consumers or change their behaviour. Requiring UK banks to pre-fund compensation seems like a token gesture, rather than a helpful solution to the current problem, given the concentration of banks in the UK market.

There is much comparison with the US system. However if the authorities believe that further consideration should be given to a pre-funded scheme we would like to see a thorough review of the Canadian risk-based scheme.

Higher compensation limit

We do not believe that a higher compensation limit would have a significant effect on consumer confidence. BBA research shows that £35k is sufficient as 96% of individual deposit and savings accounts are fully covered at this level. We recognise the political expedient of increasing the limit but stress that this should not be looked at in isolation.

The issues of gross versus net payments and FSA license versus brand are complex. We believe that the scheme should be simplified to make it clearer to consumers and to support the Government's policy of encouraging savings.

We would support a simplification to gross payments on a brand basis. To ensure that calls upon the FSCS, and the institutions that fund it, are minimised we would expect the FSA to look carefully at the proliferation of brands per license and ensure that the board of the relevant bank takes remedial action where necessary.

The consultation paper proposes a single customer view to make the transfer of information from a failed bank to the FSCS easier. There are significant costs and resource implications in this proposal if the current system of net settlement by FSA license is maintained. However, a simplification of the scheme as outlined above would minimise such costs.

A culture of 'responsible saving' needs to be encouraged which not only includes the level of deposits with an institution but also a portfolio approach across savings/investment products. We would encourage the FSA to examine the limits of the different claims categories within the FSCS to ensure compatibility with a 'responsible savings' culture. Charts 5.4 and 5.5 in the Consultation Document clearly demonstrate the lack of consumer awareness about the current scheme despite the high profile it has attracted in the media since last summer. Irrespective of any changes to the FSCS, we recommend that the FSA, as part of its financial capability programme and its *Money made clear* initiative, undertake an ongoing programme to raise awareness.

Ambition for speed of payments

We agree that compensation payments should be fast and efficient. However we do not believe that this would affect consumer behaviour in the event of rumours that an institution is in difficulty.

For a compensation payout to be received by a consumer within one week a number of major activities have to take place:

- the failed bank needs to pass the relevant information to the FSCS;
- the FSCS has to obtain funding even if there is an element of pre-funding;
- the FSCS has to be resourced to operate the scheme;
- the customers of the failed bank need to arrange new accounts. Consumers will need assistance throughout this process to maintain and rebuild confidence. We believe it is important that they are allowed to select their new bank and oppose any notion of indiscriminate allocation to another financial institution on the grounds of potential fraud and money laundering risks and likelihood of accounts being opened and not activated.
- employers, utility companies, public authorities will need to update their systems.

Whilst understanding the rationale for payout within 7 days, we do not consider that this is practical. We would be happy to work with the FSA to look at how an orderly transition could be achieved in the context of the SRR.

STRENGTHENING THE BANK OF ENGLAND AND EFFECTIVE COORDINATION – Chapters 6 & 7

We support the proposal to formalise in statute the Bank of England's role in the area of financial stability and to give its Court responsibility for overseeing its performance in this area, subject to amending the size and composition of the latter to comply with corporate governance best practice.

We would agree that fundamental changes to the responsibilities of the members of the tripartite are not required. However, clarification of the arrangements together with enhanced co-ordination, whilst avoiding regulatory overlap, in both 'business as usual' and 'crisis' circumstances are essential.

Yours sincerely