

# Financial Stability and depositor protection: Strengthening the framework

## Consultation response

DATE: 30 April 2008

Which? welcomes the opportunity to respond to this consultation paper.

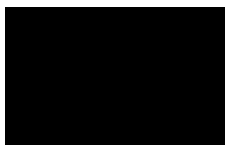
The recent Northern Rock crisis has shown up a worrying lack of knowledge among consumers about the compensation arrangements applicable to their financial investments. It has also high-lighted the shortcomings of the rather complicated compensation arrangements which currently apply in the UK. These include:

- > An array of limits depending on product and sales channel,
- > Co-insurance elements which were not always realistically attached to a consumer's opportunity to actually assess the risk of the product
- > Very low levels of consumer awareness
- > Slow payment for consumers
- > Coverage for a consumer's net rather than gross position with a bank which could lead to a loss of liquidity for an individual

Our response focuses on the proposals in Chapter 5 consumer confidence and compensation arrangements. In particular we believe that:

Any changes to the compensation scheme need to deal with the following issues:

- > Consumer understanding of the compensation arrangements
- > Improved information requirements and disclosure
- > Confidence in the speed of repayment
- > Consumer protection both in terms of the sum covered and the continued access to funds.
- > A full review of the compensation limits across all the sub-schemes and if a limit has to be imposed - an increase in the £35,000 limit for deposits
- > The limit to apply for each brand, not each financial institution
- > A move to gross, rather than net payments





We believe that more consumer research should be carried out before making a decision on information requirements and the limits. The research should look at consumer understanding and the sums covered per consumer/per banking licence to give a better view of consumer exposure.

We welcome the impending FSA consultation which we hope will look at some other aspects of the compensation arrangements in more detail. We also believe that other sub-groups of the scheme should be looked at before coming to a conclusion, as a part-amendment of the scheme could lead to ever greater consumer confusion.

**Question 4.1) Do you agree that there should be a special resolution regime for banks?**

As an organisation we have done no economic modelling around the Special Resolution Regime and we will judge the suggestion of a SRR on the basis of whether it will provide appropriate protection for consumers in a cost-effective and proportionate way. We believe that the principles that should be adhered to in considering these proposals are to:

- 1) Protect consumer deposits
- 2) Facilitate the continuation of critical banking facilities in the event of a bank failure
- 3) Any decision to place a bank in the SRR should be communicated quickly and clearly to consumers so that they are fully aware of the implications and the action they should take

We agree that there needs to be better mechanisms in place to guarantee the continuation of critical banking functions for customers of a failing bank. We believe that the application of regulatory triggers will guarantee that property rights of those involved are not unnecessarily infringed.

Ideally, consumers should be treated above non-statutory creditors.

**Question 4.2) Do you agree that the trigger for a bank entering a special resolution regime should be based on a regulatory judgement exercised by the FSA after consultation with the Bank of England and HM Treasury?**



Yes. This would appear to be a sensible procedure.

**Question 4.4) Do you agree with the special resolution regime process as outlined?**

Please see our answer to question 4.1

**Question 4.5) Do you agree that the potential abridgement of property rights in the special resolution regime can, in principle be justified with a suitable public interest test?**

Please see our answer to question 4.1

**Question 4.20 Should further consideration be given to the introduction of depositor preference?**

The issue of depositor preference will only become relevant if the Authorities decide to impose a limit on compensation for consumers. Should this be the case we would like to see further investigation of the potential benefits and consequences for consumers of any changes to depositor preference.

**Question 4.26-29)**

We agree that any special resolutions regime should apply to building societies on a similar model to banks.

**Question 5.1) How would a higher compensation limit affect consumer confidence?**

Consumer confidence has been severely damaged by the Northern Rock crisis. Consumers do not associate depositing money in a current account with risk as most people are lending their money to their bank for free or for a nominal interest rate for the bank to use as it sees fit without any restrictions. What consumers expected to receive in return was the original deposit. For savings accounts we believe most consumers do not expect to trade off a higher interest rate for the possibility of the bank failure. Indeed banks which offer higher interest rates on savings accounts do not mention that this is because they are taking greater risk with a consumer's money. It is unrealistic to expect the overwhelming majority of consumers to conduct 'due diligence' when making cash deposits.



If there was no limit on compensation then consumers would have complete confidence in banks as a place to deposit their money and there would be no repeat of the Northern Rock crisis. However, if there has to be a limit then it is essential that its level is based on a reasonable analysis of what is required to ensure consumer confidence and prevent a future occurrence of the situation at Northern Rock. At this stage we believe that if there has to be a limit it should be higher than £35,000, for example - £50,000 and that its level should be assessed in conjunction with a review of the compensation limits across all the sub-schemes in the FSCS.

We also believe that the limit should apply for each brand and not each financial institution. Given the plethora of different brands it is unrealistic for consumers to have to understand the corporate structure of a bank to determine if they are covered.

**Question 5.2) How would a higher compensation limit affect the responsibility consumers have for their financial choices?**

As discussed above, products covered by the deposit taking category of the FSCS are not generally associated with a high level of risk, they are not sold with advice and consumers do not “buy” a current account but are required to have one if they want to participate in the UK’s economic life. It is therefore very difficult to argue that consumers have a responsibility to check a firm’s financial viability when taking out such a product as they do not have access to the necessary financial information from the provider and are not in a position to evaluate the economic viability of its business model. The product features are also unlikely to reveal any significant variations in risk between current accounts offered by different providers. For savings accounts, very few consumers would undertake a detailed analysis of a firm’s prudential or liquidity position before depositing their money. Indeed, many may consider this to be the job of the regulator, with an appropriate guarantee applying if the regulator gets it wrong or fails to exercise its functions effectively.

We therefore cannot see how a higher compensation level would have any noticeable effect on the way consumers make their financial choices.

**Question 5.3) How would a higher compensation limit for deposits affect consumer perception of other financial products?**

Some industry representatives have raised concerns that consumers would be enticed away from products covered under the investment sub-scheme if the



limit for the deposit sub-scheme was increased or removed. However, current accounts do not have any competing product in any of the other sub-schemes. Savings accounts also have specific features, most importantly liquidity, and protection from the risk of poor stock-market performance which are not offered by products in the investment sub-scheme. There is no evidence that consumers will choose to deposit their money in bank accounts over other products if the limits are raised.

However, we do believe that there is a necessity to review compensation limits across the board and not only for the deposit taking sub-scheme. The industry's argument that this is too costly is not a sufficient reason to leave limits where they are. The limits applicable across the compensation scheme should accurately reflect potential consumer detriment.

The government is expecting UK consumers to take responsibility for their financial future and the minimum consumers can expect is that the government creates an environment where consumers are protected against firms' financial mismanagement, fraudulent behaviour by firms and regulatory and supervisory failures. Large financial institutions are unlikely to go bankrupt without any of the above behaviours being involved and it cannot be consumers' responsibility to directly or indirectly take responsibility for this type of behaviour. The government also needs to take into account the significant information imbalances that exist in the financial services industry between firms and consumers.

**Question 5.4) Which of the solutions to cover balances above the compensation limit is the most practicable, desirable and or proportionate, and why?**

We believe that it is not feasible for consumers to cover themselves during lifetime events by spreading the balance between different bank accounts e.g. a consumer selling a property at the current average house price of just under £200,000 would need to spread the sum between 6 different bank accounts offered by institutions covered by different banking licences. If the limit is not removed then the best possible solution would be some form of temporary 100% guarantee. The option of low-interest bearing accounts that offer 100% limitless cover should be explored further and we believe that a further study of such accounts should also look at ways of making them a permanent long-term product offering. An insurance based solution should be paid for by the bank that will be earning interest from the large sum placed with it and would need to be automatically triggered.



**Question 5.5) What type of large balance should be subject to additional protection, and in what circumstances?**

There are quite a large number of potential balances that could require additional protection and further detailed work is required to identify and mitigate these eventualities. Some of the types of balances that should be covered are proceeds from property sales, the sale or liquidation of investments, sale of a business, inheritance, pension tax-free lump sum payments, redundancy payments, insurance payouts.

**Question 5.6) Are there other circumstances, apart from client accounts, where consumers have little influence on where accounts are opened? What are your views on how the issue of client accounts might be addressed in relation to compensation payments?**

We believe that consumers should be entitled to separate cover for their individual account and any of their funds held in a client account.

**Question 5.7) What are your views on a one-week target for FSCS payment?**

We welcome the Authorities intention to speed up the payout process. However, a one-week waiting period could already cause major financial distress for consumers who hold all their funds with one financial institution and do not have access to other forms of credit. The most severely affected consumers are also likely to be the most vulnerable, people with basic bank accounts without any other financial products and elderly people who often do not have credit cards. The latest figures show that there are 7.3 million basic bank accounts in operation<sup>1</sup>, although it is not known how many people solely have access to a basic bank account.

We believe that the aim has to be to provide a continuation of normal banking functions for affected consumers. Any other solution risks the potential of another run on the bank as the Northern Rock experience has shown.

**Question 5.8) How feasible would it be for banks to provide instant access to the funds provided by FSCS cheques as soon as they are deposited?**

We believe that it is essential for banks to provide instant access to the funds provided by FSCS cheques as soon as they are deposited.

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<sup>1</sup> BBA, Basic bank accounts and financial inclusion, Q4 2007, 2<sup>nd</sup> March 2008



**Question 5.9) Are there other means to ensure consumers have access to funds within one week, alternative payment methods to cheques?**

Electronic payments would be faster and safer for consumers as they would deal with the issues of mis-delivery, delays in the postal system and incorrect address details. However, this would require consumers to provide details of all their bank accounts to an FSCS database and also raises the issue of consumers who only have one bank account or only bank with one financial institution.

There have been discussions around encouraging consumers to have a second bank account with another financial institution to deal with such situations. If the Authorities decide to pursue this route then we would expect them to look at the issue of charges for current accounts. Consumers cannot be expected to run two current accounts for which they potentially will be charged by their bank.

There would also be the possibility of allowing consumers to withdraw a limited amount of cash with their existing debit card or cash card from the failed bank. This would be deducted from any payment from the FSCS.

**Question 5.10) How effective would interim payments be in mitigating consumer detriment when a full payout is not possible within a week.**

An Interim payment could mitigate some of the problems for some consumers depending at which point in their own financial cycle they are when they lose access to their funds i.e. pre/post mortgage/rent payment, how long until the next salary payment etc. However, overall there may be too many consumers for which interim payments will not be a viable solution and we would therefore urge the Authorities to focus their attention on achieving full payout for all consumers within less than a week.

**Question 5.13) What information should be included in a single customer view and what would be the implications for firms of different information requirements?**

The development of a single customer view is an essential tool in speeding up the payout process for depositors. The view should contain contact details and lists of all accounts held with institutions covered by the same banking license.

**Question 5.14 How would banks place a flag on accounts that are not eligible for FSCS payments?**



We do not have the necessary expertise to propose solutions to this issue but any method chosen to place such flags has to ensure that legitimate claimants are not accidentally excluded from compensation.

**Question 5.15) Are there other classes of depositor that should be ineligible for FSCS payments, and, if so, why?**

We are not aware of any other class of depositors that should be excluded from FSCS payments.

**Question 5.16) To what extent would gross payments help maintain depositor confidence and speed up payment?**

The current FSCS is confusing for consumers and depositors are under significant misunderstanding on what they will be entitled to receive should their bank fail. The concept of net payouts contributes to this confusion as consumers cannot understand how the terms on their long-term loan agreements can suddenly be changed in such a way that their liquidity is completely wiped out.

**Question 5.17) To what extent are gross payments justified by maintaining depositors' access to liquidity as well as by accelerating payments by the FSCS?**

Gross payments would certainly significantly speed up the payout process. However, the main argument for gross payments is ensuring consumers' continued access to liquidity. Anybody who has their deposit accounts with their mortgage provider would have wiped out their liquidity completely and be left in a highly precarious financial position.

We would also like to point to the particular difficulties surrounding certain types of financial products which do not fit into the current way the compensation scheme is operated:

- > **Offset mortgages:** the product incentivises consumers to have their deposit accounts and mortgage with the same financial services provider and savings levels above £35,000 are not unusual in this product. Consumers choose this product to maintain financial flexibility and often for good reasons and the current operation of the FSCS would therefore be highly detrimental to them.



- > **Tiered savings accounts:** there are still a significant number of tiered savings accounts available which reward consumers for exceeding the current £35,000 compensation limit.
- > **Cash ISAs:** Many savers who took out an ISA when it was first offered and made full contributions will by now have reached the £35,000 limit. Under the current FSCS limit consumers would be required to regularly move around part of their ISA balance and would potentially be required to move their money out of a better paying product to achieve full protection of their balance.

Consumers who are offered such products should receive special warning in addition to any other general information provided about the compensation arrangements. Alternatively banks should consider offering special guarantees for such products.

**Question 5.18) What are your views on the link between FSCS gross payment and set-off?**

We believe that a move to gross payments is necessary to ensure that consumers who hold a mortgage or personal loan from the same bank where they have deposited their savings do not have their liquidity eliminated by a bank failure.

**Question 5.20) What are your views on the removal of the formal claims process? What risks would be involved in the FSCS automatically sending out cheques and how can they be mitigated?**

The risks for consumers are related to incorrect personal information held by banks. Cheques could therefore be sent to the wrong address and not reach the intended recipient. There must be adequate resources dedicated to a consumer contact centre to ensure that these risks are mitigated.

**Question 5.21) What are your views on including an element of pre-funding in the FSCS?**

It is questionable if part-pre-funding will make a significant difference to consumer confidence or consumer protection. This would only be possible if the scheme was completely pre-funded with the guarantee that enough funds are available to cover even the bankruptcy of one of the big high-street banks. However, pre-funding on such scale is economically unviable and it is questionable if it could be justified to keep such a large amount of capital virtually inactive. We believe that the only satisfactory solution for the consumer is that the government will have to act as a lender of last resort to the FSCS.



**Question 5.22) What steps would need to be taken to ensure that pre-funding would be compatible with other elements of the FSCS funding arrangements?**

N/A

**Question 5.23) What are your views on whether the FSCS should be permitted to borrow from the Government of the Bank of England?**

As discussed in question 5.21, we believe that this is necessary to guarantee consumer confidence in the scheme.

**Question 5.24) How soon could streamlined procedures for opening accounts be introduced so that the one-week target for opening a new account can be met?**

We anticipate that the Treasury will have discussions with the banking industry about ensuring that there will be sufficient capacity within the bank industry to ensure that all bank accounts could be opened within one week. Even if banks are required to establish a bank account within a week of a request for one being set up, it seems unrealistic to expect all of the customers from the failed bank to go to an alternative bank branch on Monday morning to open an account. It is easy to envisage a situation where existing branches lack the capacity to deal with the number of consumers involved. This could lead to queues and frustration for a number of consumers. Arrangements would also need to be made for those who were unable to visit a branch due to disability, lack of access to transport or work commitments.

There would also be significant administrative action needed by employers, utility companies, banks and other businesses to ensure that direct debits and standing orders are correctly established and payment of salary can commence into the new account.

**Question 5.25) Are there additional risks which need to be considered with this faster account opening method?**

There would need to be safeguards in place to prevent identity fraud. There are potential risks surrounding money laundering which would need to be taken into account.

**Question 5.26) How else could the account opening process be sped up?**

We believe that the Treasury should commission some research to evaluate the feasibility of portable account numbers which could simplify the process of switching bank accounts and the account opening process. Previous research by the Payments Council only looked at a very limited aspect of portable account numbers and did not take into account the possible advantages for the retail banking sector.

Alternatively, a system could be established for the consumer to retain the same bank account number and sort code in the event of a bank failure and for information about direct debits and standing orders to be seamlessly transferred to their new bank. If it was thought necessary a new account number could be issued after an appropriate period.

**Question 5.28) What notification requirements on compensation should apply to banks, and how can they be made less burdensome? Would these have an effect on market stability or depositor confidence?**

Industry has raised concerns that providing consumers with too much information about the scheme would be detrimental as it would give the impression that banks are an unsafe place to put ones money. At the same time, industry is expecting consumers to take more responsibility for ensuring that their deposits do not breach any compensation limits if they are unwilling to take on the associated risk. Unfortunately, there has to be some trade-off between the two competing goals and we believe that consumer protection needs to take priority. Given the low level of awareness of the limit we suggest that a comprehensive programme of improved information and disclosure is necessary. The information therefore needs to be prominently displayed on the front page of monthly statements, internet sites and in branches. The information should cover the limit that applies to their particular account, whether the customer has any other accounts with the same institution that are included in the limit and notification when the customer has exceeded the limit.

**Question 5.29) How should disclosure requirements be imposed?**

Under the current regulatory regime such requirements would have to become part of the banking code. However, we believe that the requirements are unsuitable to be left to industry agreement and we would therefore suggest that the FSA's and BCSB's Memorandum of understanding is amended in such a way



that the FSA can take responsibility for the enforcement of this particular aspect of banking regulation by including it in the FSA Handbook.

**Question 5.30) What would be the best way for DWP and HMRC to make payments in the event that consumers did not have access to their bank accounts?**

Post offices and Town Halls which already have payment facilities incorporated could be used to make payments to such groups. However, the logistical reasons posed by this are another argument why it should be a priority for the Authorities to maintain critical banking functions.

**Question 5.31) What are your views on the proposed changes to increase FSCS management flexibility?**

We are supportive of the proposed changes as we believe that they are necessary to ensure the smooth operation of the Scheme in the event of the failure of a major bank.

**Question 5.33) What are your views on the use of risk-based levies or on the introduction of behavioural factors into the calculation of the levies?**

We are supportive of risk-based levies and behavioural factors as this would introduce an element of the polluter pays principle into the financing of the scheme. Currently the vast amount of the compensation bill when a financial institution goes into administration is picked up by the remaining firms in the sub-scheme which have complied with rules and regulations. This issue can be studied in more detail by looking at the investment sub-scheme which has experienced the largest number of defaults since the start of the FSCS. A number of IFAs have managed to dump their liabilities onto the scheme and their fellow firms and some of them then “phoenixed” and continued in business.

A risk-based levy would also put a greater onus on the supervisory regime to provide relevant information and data and could potentially prevent further regulatory oversights as those connected with Northern Rock.