

23 April 2008

Dear Sir/Madam

## **Tripartite Authorities Consultation: Financial Stability and Depositor Protection**

This is the Financial Services Consumer Panel response to the Tripartite Authorities Consultation on Financial Stability and Depositor Protection. We have concentrated our response on those areas where we feel the outcomes will have direct and significant impact on consumers.

### **Overview**

As the events of last year demonstrated consumers must have confidence in the compensation scheme in order for it to be effective. Therefore, we have concentrated much of our response on Chapter 5: Consumer Confidence and Compensation Arrangements, but have answered those other questions where we have sufficient knowledge and expertise. We have not answered questions where we do not consider our knowledge to be appropriate.

We have previously stated our belief that there should be no limit imposed on payments by the Compensation Scheme and we are still unaware of any research that has been done to establish what the actual cost would be of such a change. Any limit, whatever it may be, if communicated effectively would lead to considerable movements of money by those who have deposits above the limit with any one provider. We believe that not enough consideration has been given to the consequences of these movements or, indeed, what a limit will mean for transactional amounts such as would pass through a consumer's account very quickly when purchasing a property. Thus, as things stand a further bank failure could potentially lead to a relatively small number of consumers suffering a very high degree of detriment.

If, once the appropriate calculations have been done, the idea of a 100% guarantee is not considered to be cost-effective then the setting of an appropriate compensation limit should make sure it enhances consumer confidence through adequate coverage. A split system where current accounts and low level deposits

are treated differently for compensation purposes to transactional amounts may need to be considered.

Our other major concerns are to ensure that communications with consumers about the parameters of the scheme are effective, and that in the event of any failing bank the continuity of service to consumers should be maintained. Consumers increasingly treat access to banking services as they do access to any other utility. If they are unable to access those services because of a bank failure then, however short that gap in access, it is likely to lead to problems. These concerns run through our responses to the individual questions as highlighted below:

## **Questions and Answers (where appropriate)**

### **General**

**1.1) Please provide detail if you think that any of the proposals in this document:**

- **are necessary and proportionate;**
- **raise significant concerns; or**
- **could be improved?**

We have concerns about the speed in which the proposed changes are to be implemented. The consultation raises a number of different and varied issues which have implications for a large group of diverse stakeholders. It will therefore undoubtedly provoke a set of very disparate responses. However, there is a danger that the speed in which this reform is being pursued means that important considerations will be missed or overlooked. We would urge the Tripartite not to pursue expediency at the expense of a workable end solution.

As indicated in our introduction our main concerns relate to the proposals in Chapter 5 on Consumer Confidence and Compensation Arrangements. We consider that the current compensation arrangements are inadequate in terms of the eligibility arrangements, limits and the level of engagement with consumers. The consultation does not go into detail on these elements but our fear is that the current limit on deposits will be seen as sufficient and consumers will still not receive the information they need to make informed decisions on where to put their savings.

We are also uneasy about the proposal to make compensation payments within one week of a bank failing. Any cessation of banking services would have considerable consequences for often the most vulnerable groups of consumers so we favour a seamless change in regime or an immediate payout.

**1.2) To what extent are the proposals in this document mutually reinforcing?**

The extent in which the proposals detailed in the consultation are mutually reinforcing depends on the level in which each of the regulatory authorities takes forward their own agenda and understands their own remit. The Tripartite Authorities were roundly criticised for the way in which responsibility for Northern Rock was passed around. It is hoped that the lessons of that particular instance have been

learned and that the current proposals are mutually reinforced by a more effective Tripartite working relationship.

**1.3) The proposals in this consultation document, unless specified, are intended to be implemented for banks, building societies and other deposit-taking firms. Please provide details where this is not appropriate.**

We consider it appropriate for the proposals in the consultation to be implemented for banks, building societies and other deposit-taking firms.

## **Chapter 2 – Stability and resilience of the financial system**

**2.1) Do you agree with the actions being taken by the Authorities in the UK to improve stress testing by banks?**

The Panel agrees that firms should be required to take a much more thoughtful and thorough approach towards stress-testing, which should incorporate a number of potential extreme scenarios. Those scenarios should reflect the size, nature and complexity of each bank and the markets in which it operates.

**2.6) Have the authorities correctly identified the issues on which international work on credit rating agencies should focus?**

There is both need and scope for considerable improvement in the functioning of the credit rating agencies. The measures proposed by the Bank of England would go some way to providing investors with a fuller picture of the risks to which they are exposed with structured products. The Panel agrees that regulators, as well as investors, have a strong interest in ensuring that ratings are reliable and that the information content is sufficient (para 2.61). For this reason, the Panel believes that the rating agencies themselves need to be regulated.

**2.7) Do you agree with the Authorities' proposals to improve the information content of credit ratings?**

See the response to 2.6.

**2.8) Do you agree with the Authorities that the preferred approach to restoring confidence in ratings of structured products is through market action and, where appropriate, changes to the IOSCO Code of Conduct on Credit Rating Agencies?**

See the response to 2.6.

## **Chapter 3 – Reducing the likelihood of a bank failing**

### **3.1) To what extent do the FSA's range of existing powers reduce the likelihood of failure of a bank, and under what circumstances would they not be effective?**

The FSA's range of existing powers was tested in the case of Northern Rock. In that event the FSA did not identify the implications of a complete withdrawal of the bank's main source of funding. However, even had it done so the options open to the FSA were limited. The FSA could and should have instructed Northern Rock to carry out more stress-testing on possible eventualities, including the complete withdrawal of funding from that source. In particular the FSA could have discussed with the Northern Rock Board broadening their funding sources i.e., to increase customer deposits/back-up credit lines. This would, in our view, have reduced the likelihood of Northern Rock failing.

However, Northern Rock could still have potentially ignored those representations and therefore deemed those powers ineffective. The FSA's powers at that time lacked a coercive element and still do. Some form of resolution mechanism, whether that is the imposition of a special resolution regime or bridge bank, would seem to us to offer more to the FSA in terms of influence.

### **3.5) Are there circumstances in which it would not be appropriate for the FSA to collect and share the information that the Bank of England or HM Treasury require?**

We are unable to identify any circumstances where sharing of information in this manner would not be appropriate.

## **Chapter 4 - Reducing the impact of a failing bank**

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

The Panel supports the introduction of a Special Resolution Regime (SRR) for banks should this be necessary to enable continued access to banking functions or rapid and orderly payments to depositors.

### **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 in close consultation with the Bank of England and HM Treasury?**

If such a regime were to be introduced we believe that the FSA should be the body which makes the regulatory judgement on whether or not it should be applied to a particular bank. The FSA supervises the banks and is therefore closest to the detail of their operations. It is therefore best-placed to be in possession of the necessary information required to make the decision as to whether the SRR would be the most appropriate option for a failing bank.

**4.3) Do you agree that the trigger should be linked to regulatory guidance material?**

Without suitable guidance material it would be extremely difficult to determine whether or not it would be appropriate to apply an SRR. Therefore, detailed circumstances for initiating the tools of the SRR would need to be laid out in the FSA Handbook. Such guidance material would thus give the decision as to whether or not the SRR should apply greater clarity and transparency for all concerned.

**4.7) Do you agree that the Authorities should have the power to direct a sale of a bank possibly against the wishes of the directors or shareholders?**

We agree that legislation should be introduced to give the Authorities power to direct and accelerate transfers of banking business to a third party, should this be deemed absolutely necessary. With appropriate regulatory guidance as to when such a situation should apply the Panel is satisfied that the transfer process should be made as quick as possible, in order to maintain consumer access to the banking system and, if necessary, overriding the rights of directors in this process.

**4.10) Do you agree that, in tightly defined circumstances, the Authorities should be able to take control of a failing bank through effecting a transfer of some or all of its assets and liabilities to a bridge bank? Do you agree that that some flexibility in the description of these circumstances is also desirable?**

In our view the most important element to bear in mind when considering whether or not a bridge bank facility should be implemented is that consumers have continued access to banking services. It would appear that this, although possible, is slightly more problematic with the introduction of a bridge bank. However, if it could be achieved then we would be prepared to support the introduction of such a facility if it became required.

In terms of the circumstances of when such a facility was to be introduced we agree that this would need to be sufficiently flexible to encompass a range of different eventualities.

**4.11) Do you agree with the removal of shareholders' and directors' rights and temporary suspension of creditors' rights under this bridge bank proposal?**

We believe that the removal of these rights can only be justifiable in the interests of maintaining banking services to consumers. If there is no viable alternative mechanism then we would support this proposal.

**4.14) Should a new bank insolvency procedure be introduced for banks and building societies as an option for the Authorities instead of normal insolvency procedures?**

This is not an area that the Panel thinks it has sufficient expertise to answer in any detail but, given the important social and economic roles of banks, we think it appropriate that consideration should be given to improving the position of unsecured creditors such as ordinary depositors in any insolvency situation.

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

This would depend how the Authorities decide to treat compensation limits. As we mention elsewhere in our response we do not believe that all ways and means of trying to ensure 100% payout on all deposits have yet been sought out. If all deposits were guaranteed then depositor preference would not be necessary. However, under a scheme when 100% payouts are not assured we consider that depositor preference should be given further consideration as it places depositors on a heightened footing.

**4.24) Do you have any comments on the specific implications for shareholders, creditors or directors from the appointment of the restructuring officer over and above those already raised by the other resolution tools?**

No.

**4.25) Should the Government have the power to take temporary ownership of a failing bank, in order to facilitate a more orderly resolution? Under what circumstances would it be appropriate for this power to be exercised?**

We consider that such an option would need to be available as a last resort or the end result for consumers could be considerable detriment. However, this would very much be the Panel's least preferred option as it would be much more satisfactory if a suitable market solution were to be found which would have no direct impact on the tax payer.

**4.27) Do you agree with the proposals for a new accelerated directed transfer procedure for building societies, similar to that proposed for banks?**

Yes we consider that the building societies, in particular the larger ones, should be treated no differently to the banks in this regard.

**4.28) Do you believe a form of temporary public sector control through a bridge bank should be provided for building societies?**

As indicated at Q4.10 our view is that the most important element to bear in mind when considering the merits of a bridge bank facility is that consumers have continued access to banking services. It is our belief that this applies whether the firm is a bank or building society. If a sufficiently flexible model can be achieved then we would support it.

**4.29) Do you agree that a building society insolvency procedure should exist for building societies alongside a similar model for banks?**

Yes.

**4.30) Do you agree that the Treasury should make an Order under the 2007 Act to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members?**

Yes as this would put both groups on an equal footing.

**Chapter 5 - Consumer confidence and compensation arrangements**

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

We stated publicly when the Treasury increased the compensation limit on deposits to 100% of the first £35,000 held that it was a sensible first step in giving consumers more confidence in the safety of their savings. However, we feel that the current limits are still not high enough and that there is scope to do further research into the different options. As it had been such a long time since there had been a 'run' on a bank prior to Northern Rock consumers had grown to expect their savings to be guaranteed to 100%. It was not until Treasury took the decision to guarantee all Northern Rock deposits in this instance that the 'run' halted. Although, according to the figures from the BBA, the current limit of £35,000 would cover approximately half of all deposits, in the case of Northern Rock if customers with the remaining half had withdrawn their funds this would still have been enough to put the bank in an extremely perilous position.

Increasing numbers of consumers, particularly older consumers, are moving out of equity based products into what are perceived as 'safer' deposit accounts. The current maximum limit of £35,000 is far too low to accommodate such a change in consumer behaviour. Therefore, as a first step the Panel would like to understand what the costs are if all deposits, irrespective of value, were guaranteed. We do not feel that, at this stage, this particular option has been explored in sufficient detail.

Tables 5.2 and 5.3 in the Paper indicate the current spread of deposits in the UK by value, and appear to indicate that increasing the limit from the present £35,000 would not have a significant impact on the number of depositors covered. However, this does not appear to take into account the situation which many consumers find themselves in – holding multiple accounts with different institutions that only have one banking license between them. So depositors with accounts at Birmingham Midshires and Halifax, for instance, will only be covered up to a combined account total of £35,000. The Panel would like to see the current data broken down to take account of this issue as well as further work to be done in calculating the cost of a limitless option.

We are also firmly of the view that bank deposit coverage should also be the same as, or even better than, other sector limits. There is no logic that currently higher compensation is available to consumers who buy investments and are therefore willing to take risks than to consumers who select the safety of a bank deposit account.

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

A justified change in the compensation limits would not have any detrimental impact on the level of responsibility consumers have for their financial choices. It is too simplistic to say that an increase in the limit would discourage consumers from being more responsible. At present how are consumers to know that a particular firm may be in difficulty? They are highly unlikely to know whether the firm they are considering doing business with is not well capitalised, well run or has an unacceptable risk profile or business model. This is the job of the regulator.

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

Changes to the upper limit for deposits would only serve to make the savings and investments market as a whole more competitive. If consumers feel confident their deposits will be guaranteed to a significant level then investment product providers will have to ensure their own products are competitive enough to offer attractive alternatives. We would not wish to see compensation levels used as a marketing tool aimed at changing the perception of alternative products and in any event we understand that comparison of levels of compensation available within different EU Member States is prohibited. Deposit coverage should be the same as, or even better than, other sector limits. In our opinion at the moment the balance appears wrong.

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

If there has to be an upper limit – and as we explain above we do not believe that the option for a 100% guarantee has yet been explored in enough detail – then there is obviously a real danger to those people temporarily holding large balances. Consumers who sell their homes and wait before buying another are one group likely to have large sums of money on deposit with banks and building societies. One way of dealing with this would be to allow those individuals to place these amounts in certain special accounts and National Savings products may offer a part-solution in this regard. However, this would still not cover all scenarios. Consumers in the process of buying a property would have money passing through their accounts for a very brief period and therefore would not have the opportunity to move that money to another product for compensation purposes. In this event a 100% guarantee would offer far more appropriate coverage.

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

We believe that there are many such examples of large balances which require additional protection in the event of a limit being imposed, so many in fact that the options for coverage need to be very carefully thought out. There appears no obvious means, for example, of covering the scenario indicated above where an individual is buying a house and a large sum is passing through their account very quickly, other than by offering a 100% guarantee across the board..

**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?**

If somebody is the executor of a will they may have little influence over where the relevant account is opened. Bank employees too may be required as part of their employment contract to have their salary paid into an account with that bank. Similarly, small firms may have to open their account with a particular bank if they have also borrowed money from that firm. In circumstances where a consumer has one of these types of account and their own individual account held with the same institution we believe that the two should be treated independently for compensation purposes should there be a need for a limit. As we have mentioned earlier should there not be a limit imposed this particular situation would not need to be problematic.

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

We believe any changes to the system should ensure that normal banking functions continue to operate without any cessation at all. This is what consumers would expect to happen. In this regard any wait to access funds would be too long, even for one day. What about those consumers who are paid weekly and rely on those funds to cover basic living expenses? How would they cope in a situation where they are unable to access their money for a week? The longer the wait before payment the greater the difficulties the most vulnerable groups would inevitably find themselves in.

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

Electronic transfers, where possible, could potentially be one alternative to issuing cheques and would perhaps be more efficient in terms of ensuring that payment is prompt and accurate. Issuing cheques could potentially lead to distribution difficulties.

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

As we have commented throughout our response we believe that it is imperative for any regime to ensure continued consumer access to basic banking functions. Interim payments would only come into play if this could not be assured and, in our opinion, should be seen very much as a last resort. It would be very difficult to guarantee the effectiveness of interim payments as decisions would have to be made as to who would be entitled to them, how they would receive them, etc...We would certainly not support such payments if they were unable to be significant enough in value to mitigate the delay that the consumer may have to face in receiving full payment. Communication with the consumer would also need to be clear and give defined timings or risk leading to widespread consumer distress.

**5.12) Should banks follow a common data standard or format, and, if so, what would this entail?**

As we have said earlier one of our primary concerns is that basic consumer banking services are maintained throughout any crisis. Therefore, in our view, it makes sense for the banks to follow a common data standard to better cope with any such eventuality. We do not have the technical expertise to answer the second part of this 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?**

We believe that it is highly important that a single customer view is developed. Information should include basic contact details, lists of accounts (including those held at different institutions operating under the same banking license), and the capacity in which those accounts are held.

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

Under the current eligibility criteria we have concerns about how systems would be able to indicate the relevant information to 'flag' accounts. How would systems indicate that someone was exempted from payment because he or she was a relative of a bank employee for instance? If there is to be such a system then we consider it important to make the point known to consumers that they are ineligible for compensation before they take out an account in these circumstances.

However, if changes are implemented to remove the current complexity of eligibility criteria and ensure that the only exceptions to payment are those in para 5.37 of the consultation then a 'flag' system would surely work more effectively.

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

We do not consider that there are any other classes of depositor that should be made ineligible for compensation.

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

Consumers need a straightforward system that explains how their savings are protected in the event that a firm goes under. At the moment, the net payment system is confusing and it is difficult to see how even an informed consumer can find out how it applies. This can only have a detrimental effect on consumer confidence. A gross payment system would be far easier to understand and therefore give rise to greater consumer confidence.

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

The Panel believes that depositors' access to liquidity is a very important aspect of the consideration on gross payments. As well as net payments being more difficult for consumers to understand, customers who hold short-term deposits and long-term illiquid loans at the same bank would currently suffer a potential loss of liquidity in the event of a bank failure. It would be much clearer for all concerned under a system of gross payments.

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

The Panel believe the option which has most traction is the one which is the most transparent and offers the fairest deal to consumers. That would appear to be a system of gross payments. Inconsistencies with insolvency law would seem to be a very minor concern when weighted against the needs of vulnerable consumers who would face potentially insurmountable financial demands if a system of net payments were maintained. Furthermore, if the current system of net payments is not amended there may well follow a significant movement of money by those consumers who currently hold deposits with their mortgage bank. If insolvency law can be changed to ensure set-off is applied in a way which is compatible with gross payments then we would be in support.

**5.19) Are any other measures necessary to better align FSCS rules and the provisions of the proposed bank insolvency procedure?**

We are unaware of any such measures.

**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?**

This move would certainly have a resource impact on the FSCS. It would require either the FSCS to have specialised staff ready and able to step in or the banking sector could consider providing this service. There is also the risk of cheques going astray.

**5.21) What are your views on the introduction of an element of pre-funding into the FSCS?**

The Panel is aware that pre-funding would be enormously expensive and place a huge one-off strain on the financial services industry in its introductory year, when both pre-funding and post-funding levies would be needed. As a result the Panel is of the view that post-funding, backed by emergency Government- or Bank of England-funded liquidity to bridge the immediate gap, would be appropriate. The Panel is aware that the primary concern of consumers is that any compensation scheme works quickly and effectively.

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

The Panel believes that accessing other forms of liquidity through borrowing from the Government or the Bank of England would be the most sensible solution to the problems faced in introducing pre-funding. We believe that the primary focus should be on maintaining liquidity and transactional functionality.

**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?**

From a consumer perspective we believe that all efforts should be made to maintain continued consumer access to the banking system. The one week may actually be too long for large numbers of consumers.

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

There are obvious risks of fraud and money laundering that need to be taken into account for any fast-track process of account opening. Therefore, it is important that any such system should be considered in detail and piloted as appropriate before any situation where it may have to be rolled out.

**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?**

The Panel believes that whatever the parameters of the new compensation scheme are should be displayed in bank branches and in appropriate literature including bank statements. The Panel believes that the limit, should there be one, should be prominently displayed on bank statements and rules should specify the font size and positioning of this information. Information requirements should also address consumers' concerns about access to their funds in the event of a bank failure, indicating whether or not they could expect to have continued access to those funds. The low consumer awareness of the previous limits was one of the primary reasons behind the 'run' on Northern Rock, so providing consumers with the relevant information will enable them to make informed choices about where they deposit their money and increase their confidence in the system.

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

Our preference would be for the disclosure requirements to become part of the FSA Handbook.

**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?**

We believe that this problem offers another reason why every effort should be made to maintain consumers' continued access to basic banking services. Any break in that access, however short, will be liable to lead to all manner of problems for often

the most vulnerable groups reliant on such payments. Pre-paid electronic cards would not be practical for all, and for those consumers without close access to a Post Office it would be very inconvenient to have to use one to cash in a benefit or tax credit payment.

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

The Panel supports the need to make changes to the structure and flexibility of the FSCS to greater facilitate the operation of the compensation scheme should there be a significant bank failure.

Yours faithfully