

## **IMA's detailed response to the paper on financial stability and depositor protection**

### **Stability and resilience of the banking system**

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

No specific comment; though clearly these are important priorities for the UK.

#### **2.2) Have the Authorities correctly identified the issues on which international work on stress testing and risk management should focus?**

The practice of supervision at high-risk firms should display a high regard for areas of risk identified also by the Bank for International Settlements (which has raised issues about credit markets at least in their 2005 and 2007 Annual Reports).

#### **2.3) Have the Authorities correctly identified the issues on which the work on liquidity regulation should focus?**

#### **2.4) Do you agree with the actions being taken by the Authorities to encourage full and consistent valuation and disclosure by banks?**

Recent credit market conditions pose a greater risk to corporate reporting than has been experienced for some years and require additional diligence on the part of preparers of accounts, audit committees and auditors. Market confidence is low and, as can be seen from pricing and activity levels, the markets are in a poor state. Nor is it clear when they will recover. In such circumstances IMA believes that banks, their audit committees and their auditors need to ensure that assets are properly valued and that this is best achieved through a system of fair value accounting, mark to market or mark to model. Thus we support its use and the Authorities' actions to encourage full and consistent valuation and disclosure by banks.

In particular, the current crisis originated in the collapse of the leveraged loan and bank loan markets - banks still originate loans but no longer carry them to maturity. Only by exposing the "bad news" by marking such assets down to realistic prices can confidence in those markets be restored, trading resume and valuations recover. In any event, the absence of realistic and transparent information is likely to mean that the markets apply their own more exaggerated discounts. In this respect the principles of fair value accounting have received much criticism in the media due to the write-downs made – this forgets, however, that even under the historical cost convention, assets were required to be recorded at the lower of cost or net realisable value which, of itself, would have necessitated write downs in the current economic climate.

In conclusion, to operate effectively markets need to be transparent and where, due to illiquid markets, instruments that were previously marked to market are marked to model, the changes to valuation methods, the judgments made and key assumptions need to be disclosed. Furthermore, just as FSA does not regulate on a zero-failure regime, it must be not be forgotten that valuation models are approximations and

can fail. There may be correlations and risks that cannot be captured by just improving existing approaches and boards of banks should keep this well in mind.

There is a further dimension to disclosure for several of the banks; they are listed companies. The IMA has noted elsewhere that there are concerns that the transparency obligations which apply to companies whose shares are admitted to trading on UK regulated markets appear at times to be considered subordinate to a bank's own needs to maintain confidence in its business. It is essential that legislation and policy changes take care not to excuse failures to inform shareholders on a timely basis of relevant events. Comments have been made to us that over the New Year information was brought to the market in a manner and with a timing that would not have been thought acceptable had the disclosure been coming from Shell about its reserves or (hypothetically) Vodafone about a loss of, say, a £1bn contract.

**2.5) Have the Authorities correctly identified the issues on which international work on accounting and valuation of structured products should focus?**

We believe so.

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

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

**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?**

We have responded to IOSCO and CESR on CRAs. We believe IOSCO is the appropriate venue for such global issues to be addressed, and CESR should ensure a convergent approach across the EEA.

**2.9) Have the Authorities correctly identified the issues on which international work on banks' exposures to off-balance sheet vehicles should focus?**

A key lesson of recent events is the need for regulators to focus on the degree of leverage taken on by individual institutions and the system as a whole. The very high degree of leverage within many vehicles and institutions exposed them to risks of calamitous losses in the event of quite modest falls in the value of the underlying assets. With hindsight it is clear that this posed a major systemic risk and future regulation of the banking system needs to address this issue more explicitly. Our comments about the threshold conditions under 4.2 relate to this.

**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?**

**3.2) Are the FSA's existing powers, and in particular the application of them, clear, and how could they be further clarified?**

The OIVOP powers should be supplemented by the special resolution regime, including for the reasons identified at para 3.10. See as well the discussions below about the SRR powers.

**3.3) To what extent are the annual and one-off costs of the new information requirement on banks proportionate? Can they be quantified?**

**3.4) How effective would the new information requirement be in identifying and addressing a sudden deterioration in a bank's financial soundness?**

**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?**

No comment.

**3.6) Do you agree with the proposal for a new and flexible regime for payment systems oversight and, if so, how should its scope be defined?**

**3.7) Which elements of such a payment systems regime should be effected through statutory powers?**

We support addressing oversight of payment systems. It is perhaps surprising that it needs consultation.

**3.8) To what extent is the current provision to register charges at Companies House relevant to banks? Do you agree that it is appropriate to amend it?**

**3.9) Should any exemption for banks only apply to receipt of ELA, or should there be a more general exemption for all types of lending?**

**3.10) Would extending the 21-day period be a viable, alternative proposition?**

As the paper notes, not all charges created by a bank need registration. However, for certain assets registration is an important part of priority notice and title completion. We think rather than alter the Companies Act's requirement for registration, extending the 21-day period would be a better alternative. Taking the time out to say, 35 days, would provide a longer breathing space for banks in receipt of ELA. Ultimately, however, registration should be mandatory and the market should be able to receive after 35 days the notice that ELA had been received (it does not need always to specify the amount of course). If it were felt that even such late notice might endanger a bank's standing, that is an issue which is not improved by suggesting even lower (or zero) transparency or altering long-established methods for protecting creditors' rights and priorities.

**3.11) What would be the effect of removing the 'weekly return' reporting requirement? What other statutory reporting requirements disclose ELA?**

No comment.

**3.12) Do you agree that the Bank of England should be provided with statutory immunity for any acts or omissions which relate to its role in providing financial stability and central banking functions?**

Yes.

**3.13) Do you agree that it is appropriate for the Bank of England to be able to rely upon its security in all such circumstances?**

It is unclear from your papers what the issue is. Is it that the SFD applies only to participants' collateral "in systems" and so may not cover all circumstances of collateral provision? If so, it would seem acceptable to protect any collateral that had been taken against ELA.

**3.14) Do you agree that funds provided by the Bank of England should be exempted from calculation of building societies' wholesale funding?**

**3.15) What risks are there to building societies granting floating charges over their assets to the Bank of England?**

Yes, and generally as regards building societies there should not be legislative barriers to ELA when compared with banks. We support the intent of the Building Societies (Financial Assistance) Order 2008, for example.

### **Reducing the impact of a failing bank**

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

**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?**

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

Given what is said in the paper and comparison with the US treatment of Bear Stearns (an example which weighs more with us than Northern Rock in relation to these issues), we support the introduction of the SRR. It is right that the powers exist and that their use is given to FSA, even if more work needs to be done in some areas. It would be a mistake for the UK to decide not to legislate soon because of a view that the SRR will never be appropriate. We have in mind as well the importance of having any new regime in place before the sunset clause on the current Act of 20 February 2009.

We have sought to answer several questions: What should the trigger be, who decides any trigger exists, and what should happen next. The answers to these questions necessarily intertwine.

First we have approached this issue from the point of view that sees the SRR as part of the toolkit available to those who oversee banks (and without thereby concluding it must be for the FSA as opposed to the Bank of England).

We also consider that should it be concluded that the circumstances which would justify entry into the SRR were wholly different from the circumstances under which

action could be taken today for breach of the threshold conditions, then this would need addressing. In fact, we consider the threshold conditions relating to suitability and adequate resources should form the foundation of the trigger. The paper states that:

*“The decision would be based on consideration of some or all of the following factors:*

- *that there was a significant risk that the bank concerned would fail the relevant threshold conditions in future (in particular, the conditions of adequate resources or suitability);*
- *that the available regulatory powers to manage that risk had been exhausted; and,*
- *that further options were needed to protect the stability of the financial system or the interests of depositors.”*

It follows that we agree with the approach of the first bulleted condition. We think that the conditions of adequate resources or suitability will fit the needs of a trigger; however, if it were felt for example that COND 2.4.2G (2) needed expanding then that should be done<sup>1</sup>. In particular the threshold conditions might be assisted with an explicit statement that adequacy and materiality can be assessed by reference:

- (a) to both expected and unexpected alterations or developments in the wider economy and particular markets (this would include depositor and counterparty confidence); and
- (b) to the particular sensitivities (including due to leverage) that a firm's resources or business model may have to such external factors.

Our intent is to ensure, among others, that low-risk high-impact external events, including irrational but destructive losses of confidence can always be taken into account by the FSA.

However we do not think the second bullet point should be a condition. It may capture the aspiration of the Government, in that the SRR would be the final tool to use. But it may as well be the only tool or the timing may be such that other powers are inadequate.

Setting a standard that alternatives had been exhausted is inappropriate. Perhaps the notion could be better expressed if were said that the alternatives were impracticable or inapposite, or there were no alternatives; since in our view FSA will not lightly use the SRR powers and as a matter of practice they are likely to be used when FSA has no alternative.

We think the trigger should reflect the purposive nature of the power in two ways: first that the operator of the power considers something should be done to protect stability or depositors (i.e that the SRR toolbox needs to be considered), and secondly that the *specific* SRR tool to be used is likely to achieve one of the public interest purposes identified by the paper at para. 4.17.

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<sup>1</sup> COND 2.4.2G(2) states: In this context, the *FSA* will interpret the term 'adequate' as meaning sufficient in terms of quantity, quality and availability, and 'resources' as including all financial resources, non-financial resources and means of managing its resources; for example, capital, provisions against liabilities, holdings of or access to cash and other liquid assets, human resources and effective means by which to manage risks.

“Likely to achieve” one of the public interest tests is an important discipline that will oppose any risk that FSA felt they had to do “something” were there to be political pressure not to have a bank failure (we do not suggest such pressure would be improper).

As for the trigger, guidance material is entirely appropriate. If the trigger is defined by ‘hard’ conditions, it will permit default clauses and other contractual conditions to be designed to pre-empt them (and notwithstanding discussion later about interfering with property rights).

It follows that we consider FSA is the appropriate body to reach the decision overall, since the FSA will be best positioned to have the information to make a judgement about a particular bank **but** that judgements relating to financial stability must be informed by the Bank of England.

We would propose a requirement that:

“It should appear to the FSA

- that there was a significant risk that the bank concerned would fail the relevant threshold conditions in the foreseeable future;
- that there are steps that should be taken to protect the stability of the financial system or the interests of depositors; and
- that the use of any SRR power proposed to be used would be likely to achieve one or more of the purposes mentioned below:
  - the prevention of damage to financial stability;
  - the continuity of banking arrangements;
  - the protection of the interests of depositors.

In reaching a decision as to whether there are steps that should be taken to protect the stability of the financial system or that the use of any SRR power would be likely to prevent of damage to financial stability, the FSA shall have regard to the opinion of the Bank of England.”

Having made the above points, it remains to make one more – if it were felt that these powers could not have been used in the case of Northern Rock or in a Bear Sterns equivalent, then that needs saying by the Tripartite Authorities before legislation is passed.

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

**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?**

**4.6) What safeguards and appeal processes would be needed to support a public interest test for the special resolution regime?**

For the IMA one of the potentially most complex issues in the paper is within the last sentence of 4.16. It must not be forgotten that provisions under Part VII of the Companies Act 1989 alter contractual rights and a variety of self-help and other remedies.

Policy needs to distinguish between situations that practically can be (broadly) compensated by monetary payment after the fact and those which cannot. In the

latter, we would place the role of some banks in clearing and settlement activities ancillary to an exchange, that is to say situations where disruption of operation cannot be adequately compensated after the fact.

In our view this brings into stark relief comments we have made before about the existing default arrangements in the OTC space. The proliferation of trading outside the default rules of organised exchanges and clearing houses, gives rise to serious questions about the existing regimes. As we have posed before – what was the counterfactual to Northern Rock’s “nationalisation”? Had Northern Rock or a settlement bank gone into administration on a creditor application, or a winding-up petition been presented, would the existing regime of property rights and contractual arrangements operate to reduce or increase damage to financial stability? We are unconvinced that the existing regime could cope in the absence of an SRR (unless Government supports every potential failure so rendering the issues around default clauses and cross-border insolvency moot). This issue should be addressed.

**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?**

**4.8) Is judicial review the correct mechanism for challenging a decision to institute the directed transfer?**

**4.9) Is the Financial Services Markets Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?**

Yes, the SRR powers must include a power of directed transfer. Banks will fail and the priorities are clear – depositor protection and financial stability. This will mean sometimes that shareholders’ interests must be subordinated. The key issue is ensuring that shareholders are financially compensated by a purchaser and/or the State. The mechanism introduced for Northern Rock goes some way to this. So we agree with judicial review as the route for objections and the Financial Services and Markets Tribunal for resolutions. Independence from the executive and FSA are determinations and review should be a given. To that end, whilst we are making no comment upon the appropriateness of the valuation rules that were introduced for Northern Rock, IMA is of the view that at least for market confidence purposes, the valuation approach in any further legislation must be left open to allow for the specific circumstances to be properly reflected in compensation provided to shareholders. Contrast may be made to the Bear Sterns situation and the increase in purchase price from (broadly) \$2 to \$10.

**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 some flexibility in the description of these circumstances is also desirable?**

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

**4.12) Is judicial review the correct mechanism for challenging a decision to transfer to a bridge bank?**

**4.13) Is the Financial Services Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?**

Our answer about bridge banks is as for directed transfers, and it follows that we think this should be an SRR power.

**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?**

**4.15) Do you think that there ought to be provision in the bank insolvency procedure for continued trading of some of the bank's business in the interests of depositors or other creditors? If so, how do you think this might work?**

**4.21) Do you agree that commencement into insolvency should be controlled by the Authorities, for example through requiring 14 days prior notice be given to the FSA? Should normal insolvency proceedings be retained alongside the bank insolvency procedure?**

No, we do not see a case for a changed bank insolvency procedure – at least as described:

- We do not agree with the assertion at 4.34 about the 'significant weaknesses' of existing regimes (in contrast to there being a need for the other SRR tools to complement them). Existing regimes can deal with these issues – they are mainly untested by regulators but have been tested in many other situations.
- We agree with some minor changes to existing regimes, but we propose one significant change in an attempt to avoid the introduction of a new regime. As now notice of proceedings should be given to the FSA, and if FSA notify the court that it considers there are grounds for operating the SRR powers then the proceedings should be stayed for some period. As with the Part VII default rule processes, steps could be taken free from insolvency effects both by the FSA and any transferee of the whole or part of the bank.
- In short, directors of banks should not be released from fear of creditor action; and the FSA should not be seen as guardian of creditors (which could occur if everything was postponed to an FSA decision in every case).
- Also insolvencies will commence overseas anyway and more so if UK places too great a block on creditor action – one assumes (at worst) Bear Sterns might have sought protection from the US courts first, and more widely than within the banking field, there are numerous examples of international insolvencies where the UK is a secondary proceeding. If the SRR powers are spent because of another jurisdiction's insolvency proceeding, then it would be preferable to stick with the existing insolvency regimes (which are internationally understood).

**4.16) Should the objectives of a bank liquidator be limited to assisting a rapid FSCS payout to eligible depositors and then winding up the affairs of a failed bank? Should the proceedings have any other statutory objectives?**

**4.17) Should a bank insolvency procedure be subject to the overall supervision of the Authorities?**

**4.18) Should a bank insolvency procedure be a stand-alone regime in which the bank liquidator has the combined powers of an administrator and liquidator? Are any other powers required?**

The IMA would support an additional explicit duty to be imposed upon office-holders (as the insolvency regimes describe them) to assist FSCS (indeed this could have

application generally and not just within the ambit of the paper). Analogies are in s.160 Companies Act 1989 where officeholders have to assist default proceedings.

The rights of creditors should be retained and control of the insolvency should stay with the Courts. There is no need for the suggestion at para 4.38. Under the Insolvency Rules, FSCS should be recognised as a creditor prospectively (but at full value) for all the protected deposits. Any creditors wishing to propose an alternative liquidator will wish to secure FSCS support in all likelihood.

The proposal at para 4.41 (to allow cash in the insolvency to be used to repay the FSCS) could apply in any existing insolvency regime and provision could be made within the officeholders' powers and duties. As the paper mentions insolvency set-off and claims rules will need to ensure the FSCS is not put in a better position ultimately than other creditors (see qns 5.16 et seq).

**4.19) Should the FSCS cover any additional costs that a new bank insolvency procedure may incur?**

No, if this means the costs of the liquidator in assisting the FSCS. These should form an expense of the insolvency as now. FSCS should still have power to fund an officeholder if cash or assets were insufficient and that sum can be recovered (as now) as an indemnity ahead of liquidation expenses (which of course themselves always rank ahead of creditors).

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

No, depositor preference is unworkable and unnecessary and could distort retail investment markets given deposit products that are sold as investments.

**4.22) What should the governance arrangements for the SRR be?**

**4.23) Do you consider that introducing the office of the restructuring officer as part of the SRR would be a helpful and necessary development?**

**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?**

There appears to the IMA to be two, probably distinct, roles that could be described as a restructuring officer (though we note the impact assessment only addresses the second).

The first is a role that seeks to implement (action) the decisions of the FSA as regards the use of the SRR tools. The directors of a bank will clearly need to comply and co-operate, and they will need to effect some decisions that only a board can. In this sense the restructuring officer may direct and inform; and if discretionary decisions need to be made then the officer should be empowered or if need be the officer will ensure FSA formalises that in an instruction to the board. Critically in this role the directors are still in place, but protected insofar as they comply with the SRR powers, including directions from the restructuring officer. Once the transfer to a bridge bank for example had occurred this role would largely come to an end.

The restructuring officer should therefore be appointed by (and possibly from within) the FSA. The person, who may have delegates and advisors including outside appointees, should be covered by the same immunity as the FSA (and indeed for decision review purposes would be the FSA).

Analogies would be as with the chair of the RDC, whose role is to implement FSA policy ultimately, or with an administrator under the Insolvency Acts (where the directors are technically still in office).

In the second role, the term restructuring officer would cover the role, for example, of Mr Sandler at Northern Rock. That is, it would commence as the FSA restructuring officer role largely ends. In this second role generally (and making no comment about the specific case of Northern Rock), IMA recognises that there are protections that need to be given to the officer from unintended effects of company and insolvency law. Essentially these would be provisions that would render them liable for wrongful trading and preference or undervalue in their dealings with the Bank as provider of ELA. Equally however, we do not consider the role should have the immunities that the FSA restructuring officer should be given. It is important that the officers of a bank that is operating in the market and in competition with other banks should not be lightly relieved of any usual liability or director's duty, due to the usual moral hazard reasons.

**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?**

The Government should have power to take a bank into temporary public ownership. This ought to be a last resort, but it should not be by any means the only last resort. In a regime with SRR powers, complementing existing insolvency regimes, IMA would expect "failed" banks to be allowed to fail. To do otherwise introduces the possibility of real damage to the standing of the UK.

**4.26) Do you agree that the special resolution regime should be extended to building societies but not other mutuals?**

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

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

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

Building societies, but not other mutuals, should be treated equivalently to banks in these respects.

**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.

**4.31) Should the industry contribute to the costs of an SRR?**

**4.32) Would mechanisms other than the FSCS be appropriate for addressing such cost issues? How might such mechanisms work?**

We consider the failing bank should pay for the costs of the SRR. It is akin to a supervision cost, and commonly will be occasioned by failing for which the bank's board is ultimately responsible. It is inappropriate to socialise the costs of a failing bank more widely. If powers are exercised in the public interest then the cost should fall on the bank or the public purse.

**4.33) Are there any other mechanisms available to secure access to payment systems for agency banks in the event of a settlement bank failure?**

**4.34) Are there contingency measures that banks could adopt to ensure that their organisation and structure are compatible with the tools proposed in the special resolution regime**

No comment

**4.35) Do you agree that the Government should take a power to enable it to make secondary legislation in relation to financial collateral arrangements, and with the proposed definitional scope? If not, why, and what would you suggest?**

**4.36) Do you have any suggestions as to future revisions to the financial collateral regime that should be considered?**

Yes, Government should be empowered to address concerns over financial collateral, particularly given the speed of innovation and market developments globally (and see our answer to 4.4-4.6 about the risks of not doing so).

### **Consumer confidence and compensation arrangements**

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

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

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

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

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

**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?**

**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?**

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

It is vital that the existence and nature of compensation arrangements is far better communicated to the public. By better, we do not criticise how the FSCS does what it does presently, for example. But by better, IMA would envisage that the arrangements should be simple to understand, that what compensation is available for which products should be clear, and that the likelihood of payment should be credible. It may be appropriate for the FSCS to publicise their scheme more widely and through mass media channels. Whatever the level of compensation at the time, we doubt many depositors at Northern Rock knew what protection they had; and trying to explain the co-insurance component possibly off-set any comfort that could have been given.

Publicity and labelling should also make clear when compensation was not provided by the UK, as regards for example could be the case with branches of foreign banks.

We note the debates about compensation affecting the choices of individuals as to where to put their money. Perhaps it will, though one assumes the extent to which someone holds cash will also reflect levels of confidence in the general economic outlook, confidence in investment advisers and other parts of the industry given miss-selling and a host of other issues. It would be good to see evidence one way or another. As FSA stated in CP24 (of 1998) at 4.14:

*However, initial research suggests that consumers' general awareness of compensation arrangements is very low and that it is not a factor to which consumers attach much significance when making savings or investment decisions or decisions about purchasing insurance cover, which might suggest that the incentive effect of the co-insurance element in the existing schemes is limited.*

The Handbook of Central Banking series No.9, Deposit Insurance (author Ronald MacDonald issued by the Centre for Central Banking Studies, Bank of England 1996) also touched upon this moral hazard issue. The assumption in that paper behind a claim of such moral hazard is that depositors in the absence of deposit insurance feel obliged to assess the credit risk associated with depositing money with a particular bank and choose banks with reference to their relative financial condition, rather than solely in accordance with the attractiveness of the interest rates they offer. We consider such an assumption is not evidenced in the UK market.

If the level is to differ between products that are similar, such as deposits, insurance products and CFDs all linked to a FTSE return then the compensation level ought not to differ dependent upon the manufacturer/distributor chain, as it does presently.

As to the level, we have suggested £50,000 and have noted the US level of \$100,000. We acknowledge there must be some upper limit. This should be informed by an evidence-based approach; to that end we notice that statistics based upon the data in charts 5.2 and 5.3 are quoted by others as axioms when considering who and what would be covered at any particular level. First, those statistics show that if the top 3% of depositors took out their deposits, then banks would lose 50% of their total deposits. That should not be lightly dismissed in claims that most people are covered at £35,000, if the argument is that it will stop a run. Secondly, we note that only two banks have contributed data to the paper. We would welcome publication of data showing coverage across say the top five banks at least before too much further weight is put on these numbers.

Additionally, the comments at 5.14 cannot be ignored. Depositors who on any given day have house proceeds in their own account or a client account of their adviser will be little comforted by a £35,000 limit. Depositors should be offered a low or zero interest account that is protected above the, say, £50,000 limit. This should apply to individuals and to client accounts.

The IMA considers that increasing the limit to £50,000 would not have a material effect upon the competitive position of deposits and investment products. The purpose and role of deposit protection is clearly distinguishable from compensation under the FSCS for investment products, because of the overriding need to inject confidence in the banking system.

The funding of the FSCS has recently been the subject of a comprehensive review by the FSA, which has now announced how it intends to proceed. In common with a number of other groups, the IMA opposed the introduction of the general compensation pool, under which one sector could be liable for defaults in other, unrelated areas. The FSA has decided to proceed with this proposal. However, the decision to increase the level of compensation for bank depositors to at least 100% of the first £35,000 changes the arithmetic of the scheme. The size of the retail banking pool should therefore be reviewed and increased to reflect the higher compensation that will be available to depositors under the scheme.

- 5.7) What are your views on a one-week target for FSCS payment?**
- 5.8) How feasible would be it for banks to provide instant access to the funds provided by FSCS cheques as soon as they are deposited?**
- 5.9) Are there other means to ensure consumers have access to funds within one week, including alternative payment methods to cheques?**
- 5.10) How effective would interim payments be in mitigating consumer detriment when a full payout is not possible within a week?**
- 5.11) How quickly could banks make the changes to have the necessary information readily available on account balances of FSCS-eligible depositors, and what would be the cost to them?**
- 5.12) Should banks follow a common data standard or format, and, if so, what would this entail?**
- 5.13) What information should be included in a single customer view and what would be the implications for firms of different information requirements?**
- 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 ultimate aim of changes to compensation arrangements should be to give depositors continuous, or virtually continuous, access to their funds, perhaps within some limits, irrespective of what happens to the bank itself. There are precedents in other jurisdictions which could be examined, for example the Federal Deposit Insurance system in the United States.

As we said in our oral evidence to the Treasury Select Committee, the IMA considers that undue focus is being placed upon the ultimate recovery for depositors. Revising only what is the limit that the banks ought to pay for, will not be sufficient.

Efforts should be made to ensure those self-same depositors can access their funds without interruption in the event of some interposing insolvency event. The SRR regime will go some way (perhaps a long way) to this aim.

We are however not advocating the single customer view as such. Having set out what IMA considers should be the aspirations of a regime, it is properly an issue for the banks and Government and FSA to consider whether it is workable at any economic scale to do what is suggested. We have not ignored either the fact that competition and innovation in information services and technology solutions are the new battlegrounds for businesses. Forcing all UK banks into a single model seems counter-intuitive to reducing risk and increasing competition. Nevertheless if it were considered by the banks to be achievable, it would seem almost the perfect solution.

We doubt however it would ever be so neat and we remain of the view that higher compensation, and further consideration of how the ATM system could be kept in operation for some period along with faster FSCS payout through eligibility simplification (as mentioned at para 5.35) may be far more rewarding.

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

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

No comment

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

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

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

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

We support consideration of gross payments with adapted set-off arrangements.

#### **Pre-Funding and opening new accounts**

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

**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?**

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

**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?**

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

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

**5.27) What else would be needed to enable banks to provide instant access to funds following the deposit of a FSCS compensation payment?**

The IMA is concerned to ensure there is a credible, easily explained and well communicated compensation scheme. These objectives can be met in our view whether the scheme is funded as now or if some measure of pre-funding is introduced. This matter should be determined by considering the efficient application of capital by banks; and we think banks and their shareholders are the relevant parties to comment upon this. The IMA would oppose pre-funding were it proposed for asset managers, for example.

The speed of payout is important but even now FSCS are not slow in making payment to depositors. Reducing eligibility criteria and the requirements for formal claim forms will only speed this up. Again account opening being simplified would be helpful, but issues of cost and the effort against financial crime will need to impose some realistic limits. If ATMs could be operated and scheme money made available to it (even notionally in the name of the failed bank at first) we consider this might ease many individuals concerns over a delay of 7 or 10 days.

**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?**

No comment.

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

**5.32) Are there other possible changes which could increase management flexibility for the FSCS or enable it to process a large volume of claims quickly in the most cost-effective way?**

We support the proposals at 5.80 subject to seeing the detail.

**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?**

No comment.

**Strengthening the Bank of England and international co-ordination**

No specific comment; though clearly these are important priorities for the UK.