Financial stability and depositor protection: strengthening the framework

The ABI's Response to the Tripartite Authorities' consultation paper

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Introduction

1. The Association of British Insurers (ABI) represents the collective interests of the UK's insurance industry, including in the role of its members as major institutional investors. The ABI speaks out on issues of common interest; helps to inform and participate in debates on public policy issues; and also acts as an advocate for efficient capital markets and high standards of customer service in the insurance industry.

2. ABI members have a strong interest in the health of the City and the stability of the financial system. Insurers play a key role in the financial services sector generating employment for 324,000 people. As investors of funds totalling £1.3 trillion on behalf of policyholders and savers, insurance companies rely on the smooth operation of the markets. They are major providers of funds to banks both through their ownership of equity shares and their investment in bonds and other debt instruments issued by banks.

3. All of this gives the insurance industry a significant stake in financial stability, and we therefore welcome the opportunity to respond to this consultation.

Overall comments

4. We believe the government is right to draw lessons from the credit crunch and the failure of Northern Rock. This is a rare opportunity to strengthen our arrangements for financial stability and one that should not be squandered. There are three criteria against which the proposals should be judged. They should:

   - focus particularly on systemic risk
   - identify and address the relevant issues in a proportionate way, and
   - be carefully considered to avoid unintended consequences.

   Our members consider that the proposals set out in the consultation are deficient on all three counts. They are drawn too narrowly on the UK retail market experience of Northern Rock. They fail to take sufficient account of the reasons behind the paralysis of the money and asset-backed securities market, which is where systemic risk currently lies, and they are part of a legislative timetable

which allows inadequate time for proper analysis and the identification of downside risks.

5. We are particularly concerned about the proposals for a Special Resolution Regime (SRR), which are presented as the cornerstone of the consultation paper. As shareholders we clearly understand and accept that banks, like all businesses, will sometimes fail. Wherever possible, the market should be allowed to operate. Intervention by the authorities in a failing bank will mean overriding the rights of shareholders and wholesale lenders. It must always be a last resort and only be undertaken in response to genuine systemic risk.

6. Premature intervention that removes these rights, especially where there is no systemic risk, would lead to a general loss of confidence in London as a financial centre and make the market less willing to provide finance even to healthy banks. The risk of contagion and loss of confidence in the money markets is considerable if the intervention were poorly handled. Little or no regard appears to be paid to institutional investors whose confidence is vital to the UK economy and who could be part of a recapitalisation solution. The current proposals damage this prospect. Our members have been impressed by the speedy, decisive and coherent way the US authorities dealt with Bear Stearns and believe any proposals should draw lessons from this.

7. For these reasons, and based on our experience of Northern Rock, we do not support the consultation proposals. Were, nevertheless, an SRR regime to be introduced we believe it should be authorised and supervised by the courts and we are not currently confident of the rigour of a public interest test conducted by the government.

8. In contrast we support the proposal to give the Bank of England a statutory responsibility for financial stability. We believe this responsibility should specifically require it to ensure the smooth day-to-day operation of financial markets and of the payments system. Giving the Bank accountability in these areas should ensure better balance in the Tripartite arrangements, help identify looming problems and create a more rounded approach to systemic risk. This proposal should have priority.

9. All of these proposals require careful consideration, however. We remain concerned that rushing prematurely into legislation could result in arrangements that are not fit for purpose and end up damaging confidence in the City of London, making it less competitive internationally. It would be counter-productive, for example, to introduce arrangements that deterred sovereign wealth funds and other international investors from recapitalising banks thereby adding potentially to the burdens on the taxpayer. A more measured timetable would also allow time to take account of measures under way in the EU and in the international financial institutions.

10. We do not, therefore, believe that the case for a SRR is proven and urge the Tripartite Authorities to give deeper consideration to the issues involved and the best response to them before rushing into legislation

Regulatory regime

11. We do not believe that the Tripartite System is fundamentally broken, but it does need to work better. The necessary ingredients are: an approach that identifies emerging risks in a timely and robust way; improved communication between the authorities; a clear delineation of responsibilities; and better processes for crisis management. The regulators need to ensure that they have suitably qualified, high calibre staff to operate the system and need to ensure that they can retain these staff – the FSA should consider the extent to which it needs to improve remuneration of its supervisors in order to attract and retain the best staff.

12. We support the FSA's role as a single financial regulator. This makes particular sense to those of our members whose insurance business forms part of a larger banking group. However, the smooth operation of the money markets is also crucial to stability. Formal allocation of responsibility to the Bank of England in this area would ensure that this is recognised by all parties as one of the priorities of the Tripartite System

13. The objective of regulation should not be to prevent any bank from failing. Rather it should be to ensure the stability of the system and a level of consumer protection sufficient to ensure confidence without creating a situation where consumers are encouraged to ignore risks they are taking because they know they will be compensated.

14. The regulator's ability to identify and address looming problems before they become critical is vital to confidence. This is also the key to avoiding rescue operations which end up being a burden on the taxpayer. The document acknowledges the need for a period of heightened regulation before recourse to an SRR but fails to develop this theme fully. Nor does it focus sufficiently on the importance of ensuring that banks are adequately capitalised.

Deposit protection and the Financial Services Compensation Scheme

15. A robust system of retail depositor protection is important to confidence but we believe the current limit of £35,000 per customer should be retained. This covers the overwhelming majority of depositors in full and is sufficient to alleviate hardship. A larger amount would distort the savings market by deterring savers from considering other products that might be more suited to their needs. It would also compound the moral hazard problem. We agree in principle that payment of compensation to depositors should be done as quickly as possible. However, we are not convinced of the practicality of many of the proposals in the consultation paper for achieving this.

16. We believe that the events at Northern Rock have shown that the problems that can arise at even relatively small banks are different in kind and in scale from those likely to arise at other institutions and are best dealt with through special arrangements. However, the FSA has recently put in place reforms to the Financial Service Compensation Scheme (FSCS) introducing a considerable element of cross-subsidy between different sectors. Essentially the failure of a retail bank would quickly mean that life and general insurance companies as well

as asset managers and others would be levied to provide compensation for depositors.

17. We continue to see no grounds for one part of the industry to underwrite weakness in another, particularly when that underwriting would provide a commercial advantage, as well as increase the risk of contagion. Further, there is no real reciprocity to the proposed arrangements: in most cases problems with an insurance company take many years to unfold and the likely cost of claims can be met from regular annual levies by the FSCS on the insurance sector. We, therefore, continue to oppose the FSA's reforms and believe that any further changes to the FSCS should separate the deposit protection element of the scheme from the insurance and investment components.

Other points

18. More attention needs to be given to the way in which banks account for their off-balance sheet business and to the role of audit committees in ensuring that risks are understood, properly managed and that relevant disclosures are complete and timely. The IASB has now signalled it intends to consider what greater disclosure of off-balance sheet interests should be required. This seems the right approach to ensuring that, at least in the short term, accounts can be made to provide the necessary information to enable users to make properly informed judgments.

19. Much blame has been attached to credit rating agencies. As large investors our members do not rely heavily on ratings, regarding them as only one factor in a decision to invest. We do not currently consider regulation is appropriate as this might lead to standardisation and lack of choice, but the rating agencies' involvement in structured finance has raised a series of particular problems. We would prefer these to be addressed through a robust code of best practice, which addresses conflicts of interest and lack of transparency. This should be agreed at an international level. Regulation should follow only if it fails.

ANNEX

Questions for Consultation

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?*

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

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

To the extent that these issues are relevant to us they are covered either in our general comments or in response to specific questions.

Chapter 2

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

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

This is essentially a matter for the banks as insurers are subject to separate stress testing requirements which we believe remain appropriate and robust.

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

We agree that the Authorities have correctly identified the issues.

This is clearly an important issue for banks where sudden liquidity difficulties can cause significant problems and it is appropriate for the authorities to consider steps to improve regulation in this area. However, this is not a major issue for insurance companies (where any problems that arise will usually be due to a long-term mismatch between assets and liabilities, i.e. a solvency problem). We do not believe that there should be any read across from the work being proposed in banking regulation to insurance regulation.

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

We agree with the Authorities' general approach, being to work with their international counterparts. We note that, in the case of accounting standards, the

relevant body is the International Accounting Standards Board. We would not support any politicisation of the accounting standard setting process.

The overarching objective must be to ensure that disclosure under accounting standards is sufficient to provide a true and fair view that in turn enables users of accounts and regulators to form a proper and balanced understanding. We agree that valuation approaches should be prudent and conform to regulatory guidance and accounting standards. However, this should not be regarded as a substitute for adequate disclosure about uncertainties and risks.

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

We agree with the Authorities that the international work should focus on valuation and disclosure issues and should consider the specific risks set out in paragraph 2.51. As the International Accounting Standards Board itself acknowledges, there are important questions that need to be considered, particularly on the use of fair values where there are not deep and liquid markets. These include how fair value modeling should work and what factors should be included in valuations, for example ratings given by credit rating agencies; whether fair values can be assumed always to be reliable enough, how they are best presented and what extra disclosures may be required; and what form of disclosure should be given to highlight risks that relate to off-balance sheet assets, for example SIVs.

Accounting numbers need to reflect genuine underlying values and do so on a consistent basis over time. It can scarcely be overstressed that market confidence has been seriously impaired by what in practice have proved to be 'pro-cyclical' approaches to valuation. The proper remedy is not smoothing and concealment of valuation changes but a better and more rounded approach to fair valuation approaches and a recognition that there are limits to reliability and availability of both market and model prices.

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

We agree with many points in the analysis on pages 31-32 of the consultation paper. We note that a number of reports on the role of credit rating agencies (CRAs) are expected shortly. Events since mid-2007 have intensified the debate within the institutional investor community. This has raised questions about whether CRAs as commercial entities, can manage the conflicts of interest facing them and about whether their work encourages procyclicality.

However, institutional investors, certainly within the ABI membership, are fully aware of the limitations of the information content of ratings. Whilst for corporate credit, transparency on the part of CRAs has improved notably in recent years, there remains room for improvement in the area of structured credit and particularly in the area of key data inputs. However, ABI members welcome competition between CRAs and would therefore not approve of a standardised methodology.

We note (paragraph 2.55 bullet point 3) the assertion, often repeated elsewhere, that investors have over-relied on ratings. We find this troubling as the assertion is

frequently ill defined and the document offers no supporting evidence. We agree the Authorities have correctly identified the issues. CRAs activity in structured credit has exposed them to severe conflicts of interest and led some to question whether they retain the nature of “disinterested observers”

We note (paragraph 2.59) the suggestion made by the Bank of England in its October 2007 Financial Stability Report. We find market opinion divided as to whether the same scoring definitions should be used by different CRAs, so as to reduce this risk of misperception by investors (paragraph 2.60)

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

We would make the following points in respect of the issues raised in paragraph 2.59:

- “ Publish information on the expected loss distribution of structured products, to illustrate the tail risks around them.”

  The Bank of England recommendations were published in October 2007. Developments since then indicate that losses greatly exceed expectations. This suggests users of ratings would benefit from information on the sensitivity of inputs, e.g. in the case of a CDO the impact of a downward or upward notching of ratings.

- “ Provide a summary of the information provided by the originators of structured products”

  This would be valuable in allowing investors to assess how much of a rating is based upon assumption and how much on empirical evidence. Some types of structured finance, such as sub-prime, are essentially new products with little data history.

- “ Produce explicit probability ranges for their scores on probability of default”

  Such estimates are already available from the CRAs. If they prove incorrect, as in the case of sub-prime/CDOs, then their value is questionable.

- “Develop separate measurements for products on dimensions other than credit risk”

  Given the developments in the securitisation markets since mid 2007 it is difficult to see how CRAs could have measured these dimensions better than other market participants (save for their access to data). Measurement of liquidity is notoriously difficult and costly. It is difficult to see how they could expand the range of their services when the output may be perceived as having little value in relation to the cost. It is important, however, that everybody is aware of the limitations on what CRAs can provide.

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?

Yes, subject to our analysis of the several reports on CRAs that are to be published in the coming months.

We note that there are industry initiatives underway, in particular that led by the European Securitisation Forum, which will lead to greater transparency in the securitisation markets and new market practice.

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

We support the Authorities' proposed work looking at the CRD/Basel II prudential rules in relation to banks' exposure to off-balance sheet finance. However, we do not agree that the IASB should be invited to take reputational risks specifically into account in its accounting criteria for consolidations. We would, however, support a recommendation to the IASB that it should give due weight to substance over form in developing its consolidation criteria. This is necessary to ensure that financial statements reflect the economic reality of exposures to risks in presenting a true and fair view.

Chapter 3

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?

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?

We have no specific comments on this set of questions.

It is worth noting that regulators have extensive powers to monitor and intervene in insurers. These are currently being modernised as part of the Solvency II project. This introduces the concept of a 'ladder of intervention' between a Solvency Capital Requirement (SCR) and a Minimum Capital Requirement (MCR) – a breach of the MCR will normally result in the insurer being closed to new business. Solvency II will also introduce detailed requirements for both supervisory and public reporting. The ABI fully supports the introduction of a modern, risk-based approach to insurance regulation as proposed under Solvency II.

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 have no comments on these questions.

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?

The issue of whether and when liquidity assistance has to be disclosed has featured prominently in many of the discussions about Northern Rock. It is therefore important that any problems that may exist in the current legislation or how it is interpreted are addressed at this stage.

In general our members consider that significant corporate developments that are price-sensitive should be announced to the market immediately in most cases. However, particular issues of confidence apply to banks. As providers of capital to them we recognise that there is sometimes value in creating the scope for discreet assistance and for the conclusion of arrangements that enables their business to continue. Such occasions should be exceptional and limited in time.

In principle, we therefore do not object tot the FSA making a ‘limited clarification’ to the disclosure rules guidance. We assume this means guidance in the Handbook.

However, there are several issues we believe should be taken into account when deciding how and when to do this. First, Article 6.2 of the Market Abuse Directive (MAD) already provides for a delay, if certain conditions are met. It is effectively a cumulative test: a firm has to have a legitimate interest in delaying disclosure, the delay is not likely to mislead the public and confidentiality of information can be maintained.

In its guidance from July 2007, CESR touched upon the legitimate reasons an issuer could delay disclosure of inside information. It refrained from producing a full list of circumstances that may constitute such a reason and offered instead some examples. CESR believes it is the issuer’s responsibility to make a judgement about its particular case based on all the applicable conditions.

Second, the European Securities Markets Expert Group (ESME), in its evaluation of the market abuse EU legal framework, acknowledged that there are problems with the second leg of the test and we expect this issue will be addressed in the forthcoming review of the Directive undertaken by the European Commission. This is primarily because the definition of inside information *per se* implies that “a reasonable investor would use it as a basis for her decisions: thus, any delay in the dissemination is almost by definition misleading”. ESME therefore believes that the circumstances in which the public interest is better served by some delay are wider than those contemplated by the existing exception. As a solution, it proposes

amending the Directive, either at Level 1 (which may prove to be impossible) or Level 2.

It would appear to make sense for the FSA to wait for the outcomes of the Commission's review before producing any additional guidance, unless such guidance simply repeats the conditions in Article 6.2.

We would also like to draw attention to some other aspects of the process. Article 3.1 of MAD highlights some legitimate reasons for delay, stating it could be allowed for a limited period where a public disclosure would seriously *jeopardise the interest of existing and potential shareholders* (our emphasis) by undermining the conclusion of specific negotiations designed to ensure the long-term recovery of the issuer". These overriding principles of protecting shareholders and preserving value are fundamental to how any such cases are handled in the future. Any arrangements for long-term recovery that may be agreed during the delay period - for example, a decision to sell the bank - ought subsequently to be ratified by the existing shareholders in the usual manner. The opportunity to delay disclosure of liquidity assistance should not be used to disenfranchise existing owners of the company.

The question of whether charges should be registered at Companies House and whether the Bank of England should publish a weekly summary of its balance sheet cannot be considered in isolation from the Article 6.2 test and in particular the third leg: the confidentiality of any undisclosed ELA cannot be ensured if no changes are made to all the relevant parts of the legislative framework.

We would therefore support the suggestion that charges should be registered only after disclosure is made following a delay period.

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

We think it would be better to amend the Companies Act as simply extending the time period to more than 21 days would not address the problem directly. However, the benefit of any delay will always be counterbalanced by the costs to investors of not getting the information as soon as possible. It may therefore be necessary to stress that permissible delays should be as short as possible.

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

Our members believe that the Government should repeal the provisions of the Bank Charter Act 1844 so that weekly returns by the Bank of England are no longer a statutory requirement. Instead, the Bank would be in a position to exercise discretion about when to delay specific disclosure of support in its accounts.

We are not aware of any other statutory reporting requirements that disclose liquidity assistance.

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?

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?

We agree, in principle, with these proposals.

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?

We have no comments on these questions.

Chapter 4

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?

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

We do not consider that the case for a Special Resolution Regime (SRR) is proven. We are concerned that, were it to be introduced, it could set in train negative reactions in the wholesale money and investment markets. While one of the stated purposes of the SRR is to reduce the risk of contagion, we consider that the negative reaction in wholesale markets might actually increase the risk of such contagion with wholesale investors and lenders withdrawing support from other potentially affected banks. Our members have indicated that they would withdraw wholesale deposits in a bank that was subject to an SRR.

The lack of confidence could quickly offset any potential benefit to retail depositors and damage the standing of the City of London as a whole. It is important to remember that much investment activity in the wholesale markets is also undertaken for the benefit of individual savers, for example, through their pension funds. The cost of damage to confidence in wholesale markets would thus also ultimately be born by such individuals.

For this reason we believe that more emphasis should be placed on effective heightened regulation, which is described in the paper as the process that would precede any SRR. Were an SRR regime to be introduced, it should be a requirement on the FSA to report publicly within a reasonable time period on the steps it had taken during the period of heightened regulation and explain why these had not been sufficient to address the bank's problems.

Our strong preference also is that, even though it would be initiated by a regulatory decision, any SRR regime should be authorized and administered by the courts.

We believe that there are two key conditions which must be met in the design of any SRR regime:

- It should be clear that it can only be invoked for cases involving systemic risk; and
- Intervention can be justified on the basis of a clear set of triggers, which command widespread consensus in financial markets. Such consensus does not currently exist, and this is adding to anxieties about the proposal.

Meeting these conditions would be necessary but not sufficient to justify the imposition of a SRR - it would always be a matter of regulatory judgment whether to request the court to authorise a SRR in relation to a particular institution.

While the focus on retail depositor protection is understandable, there are other means of ensuring the interests of retail customers are looked after. The SRR regime as outlined seems intended to help small banks whose primary business is in the retail market. This is the case with the US system on which it appears to be modeled. Little consideration has been given to the fact that most UK banks are larger than those to which the US model applies and have wholesale and international business. UK banks would not necessarily be assisted by such a scheme. Indeed it is unlikely that any bank for which the scheme was suitable would be a systemic risk. This makes it extremely hard to justify the negation of shareholder and contractual rights.

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?

The potential abridgement of property rights is a very serious matter for financial markets whose confidence depends on the reasonable expectation that these rights will be respected. Our members have been concerned, both in relation to Railtrack and Northern Rock at the ease with which the government dismisses the rights of shareholders. It is fully understood across the financial markets that shareholders' capital is forfeit in the event of bankruptcy, but the government's repeated assertions on both these cases that shareholders do not deserve any recognition of their rights conveys an impression that the government believes that share ownership is in itself morally tainted. This is wholly inconsistent with its professed support for the City of London, which is a major employer, service exporter and generator of tax income. It is also not in line with the Government's policies to increase equity investment by retail investors.

Moreover the long period of limbo through which Northern Rock went from October to February has damaged confidence more generally in the approach of the regulators. While the markets were assured that the bank was solvent and the shares were permitted to continue trading, it was clear that the bank was not functioning normally. The chain of accountability to shareholders was effectively broken. There was limited public information and a great deal of selective off-the-record briefing of sensitive information in the newspapers. We remain of the view that it is likely that a false market existed in the shares for a long period, or at least that the FSA placed too low a priority on the risk of such a market existing. No SRR

regime should allow such a situation to recur. One way of limiting this is to ensure that any SRR regime is very short.

This concern is compounded by the government's failure to date to acknowledge unequivocally the importance of recognizing the hierarchy of seniority in the debt market, which is itself contractually based. We have been distressed by the refusal of officials over a long period to respond to queries on the handling of preference shares in Northern Rock, to which a number of our members are exposed through the Saphir securitization vehicle. A subsequent ministerial statement has failed to deliver certainty.

In law, preference shares rank senior to ordinary shares in any administration. If any compensation is paid to holders of ordinary shares, preference shareholders should be paid out in full. When they invest in market instruments our members rely on these norms being respected. The government's failure to do so has caused them financial losses and a more general loss of confidence in the debt markets.

Based on these recent experiences we currently have no confidence that a public interest test applied by the government would have sufficient rigour to be acceptable to the markets.

Moreover, one of the dangers of establishing a system that explicitly overrides these rights is that it will be harder to find investors willing to recapitalize banks that are facing trouble. Sovereign wealth funds have shown a willingness to do this in the case of certain European and US banks. Any SRR regime should not cut off this potential assistance because of the way it overrides the rights of shareholders.

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

As stated above, we have serious reservations about the introduction of a SRR. Were such a regime introduced, we consider that it is for the courts not the government to determine the public interest.

As to the criteria, we agree that the prevention of damage to financial stability, and the need for continuity of banking arrangements is within the public interest, but only where there is a real systemic threat from an institution failing. While we accept the need to protect retail depositors (see below), there are specific arrangements for this and we do not believe this should form part of a public interest test. By contrast the public interest definition should be explicitly balanced by a need to maintain confidence in the wholesale financial markets in which the public generally has an important economic stake.

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?

No. We consider that any such decision should be subject to authorisation by the courts.

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

Judicial review presumes that the authorities take the decision on their own authority. Since we consider that any SRR regime should be authorised and administered by the courts, the question of judicial review is it is not relevant. Even when the courts have authorized a directed transfer, those damaged by the decision should have a statutory right of appeal. Moreover our experience of judicial review with the Financial Ombudsman Service is that it is a weak process.

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

This must be a matter for the courts.

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?

No. We consider this should always be a matter for the courts. Moreover we have serious reservations about the transfer of part of a bank as this would create serious difficulties in deciding which assets were to be transferred alongside the liabilities. It is very doubtful that an equitable decision could be made in the short term.

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

Only if this is determined by the courts as overwhelmingly and urgently in the public interest based on a test involving consideration of the implications for wholesale financial markets and the presence of systemic risk.

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

No. See our answers to question 4.8-4.11 above.

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

No. See our answers to questions 4.8-4.11 above.

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?

It is not clear whether a new insolvency procedure is required – this would appear to depend on the scope and form of the SRR. If insolvency proceedings are only entered into once the SRR has been completed, or failed, then there seems little need for a special insolvency regime as all that will remain to be done is to liquidate the remnants of the bank. However, if insolvency proceedings begin at an earlier stage then there may be grounds for a special procedure to enable depositors to be paid out quickly and allow some parts of the bank to keep functioning for at least a short time in order to minimize disruption to customers.

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?

With regard to depositors this presumably will only be necessary where depositors have not been transferred to another institution or a bridge bank under a SRR. With respect to other parts of the business it would clearly be incumbent upon the insolvency practitioner to realize the greatest value possible for all stakeholders from the remaining assets of the failed institution.

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?

Once again this will depend on the scope of the SRR.

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

The procedure should be subject to the overall supervision of the Courts.

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?

We have no comment on this question.

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

No. The failed bank should meet all costs relating to the insolvency procedure.

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

Many of the proposals in the consultation document would appear to result in a de facto depositor preference. We would be concerned that any move to a formal depositor preference could weaken the rights of other creditors and shareholders in banks. This could result in UK banks facing problems with counterparties, particularly in a stressed situation. Clearly this could weaken the competitive position of UK banks and the attractiveness of London as a financial centre. It could also make it more likely that a UK bank facing financial difficulties could become insolvent which would work against the interests of depositors.

As mentioned above, a noticeable feature of the current financial crisis has been that sovereign wealth funds have emerged as providers of capital for a number of major banks which have suffered major losses. Depositor preference would make it less likely that such investors would be willing to provide capital support to UK banks in similar situations.

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?

The Courts should control insolvency procedures.

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

We consider that it should be governed by the courts.

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?

If an SRR is introduced we consider that a restructuring office could play a useful role. However, the courts should make the appointment. We are particularly concerned at the potential conflicts of interest facing a restructuring officer who is required to report to any political authority. The overarching objective of a restructuring officer should be to preserve value in the business for all its creditors and shareholders. This should be clearly set out in terms of reference approved by the courts which should determined the powers of the officer.

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?

We have no additional comments.

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?

If an SRR regime were to be introduced, it should only apply in cases where there is a clear prospect that it would lead to a market-based solution. It should not be a prelude to nationalization. Government ownership creates serious problems of competition because of the guarantees that immediately apply to its deposits and because of the issues around compensation for existing stakeholders.

Moreover, it is very hard to define the word temporary. What would happen if the bank were not ready for re-sale to the private sector at the end of a temporary period? At the point where nationalization is the likely option, the situation will almost have been reached where an orderly liquidation is the only realistic option.

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?

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?

We have no specific comments on the position in relation to building societies.

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

No. The costs should be born by the failing institution.

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

The process would be similar to that applying to administration or liquidation.

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?

We have no comments on these questions.

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?

This appears a sensible proposal to enable the Government to keep legislation in this area up to date and in line with market practices.

Chapter 5

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?

The ABI believes that the current limit of £35,000 is sufficient and, on the evidence of the consultation paper, provides complete cover for the overwhelming majority of depositors (research carried out last year for the ABI provided very similar results to those quoted in the consultation paper). The current limit should, therefore, be sufficient to maintain overall consumer confidence.

Chart 5.3 in the consultation paper suggests that a very considerable proportion of total deposits are held by a very small percentage of consumers. However, the limit needed to provide a high level of protection for these depositors would have to be £100,000 or more. In our view a limit in excess of the current £35,000 could give rise to issues of moral hazard as it would discourage depositors with larger amounts from taking due care and attention in making their choice of deposit taker. While there are strong arguments for providing compensation it is important that some responsibility remains with consumers for the investment choices they make.

We are also concerned that a higher limit for deposits could distort the wider market in savings and investments as it could encourage investors to retain money in deposit accounts rather than investing in other products. This would not be in the wider interests of investors as, historically, other investments have produced a higher return than bank and building society deposits. It may also call into question wider Government policy objectives such as encouraging individuals to make greater provision for retirement.

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

It is likely that where the amounts involved are being held as long-term savings the most practicable solution would be for customers to spread their deposits among a number of banks.
However, as the consultation document notes, this is unlikely to be a viable solution where the amount is being held only for a short time. Under these circumstances solutions along the lines of special accounts with a higher limit might be feasible. However, any such accounts would have to be relatively unattractive to depositors to prevent them being used for longer-term savings and so distorting the market.

It would be a commercial decision for our members whether they were willing to offer private deposit insurance as a product. However, it should be noted that our members have expressed concerns about how such a product would be priced, the potential capital requirements needed to support such a product and the circumstances for determining whether a valid claim had arisen. It is likely, therefore, that to be viable any such insurance would only provide cover under certain conditions and for limited amounts.

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

Where larger balances are simply being held as longer-term savings we do not believe that any additional protection above the general limit should be provided. However, in principle, the suggestion that large balances being held on a temporary basis as a result of 'life events' (such as house sales or the receipt of a legacy) should be given additional protection appears attractive.

However, it is unclear to us how such events could be adequately defined. For example how long could a balance be held on a 'temporary' basis? In the case of monies being held for house purchase there would probably be general agreement that amounts held for a few days or weeks following the sale of one house and pending completion of the purchase of another should be covered but it is less clear that such deposits should be given special treatment if the consumer had made a decision to delay purchase of a new property in the expectation that house prices would fall.

It is likely that the most practical approach is likely to be, as discussed in response to 5.4 above, that larger amounts held in special accounts could be given some additional protection. In order to prevent abuse these accounts would have to be designed in such a way as to make them unattractive as savings vehicles. Private deposit insurance may also develop to cover certain larger deposits.

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 have no comments on this question.

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?

In principle a one-week payout timetable for deposits is highly desirable. However, it remains unclear to us how practical this is likely to be. We believe that it is important that the FSCS retains proper controls and procedures in making payments so as to prevent fraud and minimize incorrect payments and accept that this could slow down the process.

In practice depositors will mainly need fast access to their current accounts. It may, therefore, be worth concentrating efforts on ensuring that amounts in these accounts are available quickly with compensation for amounts held in savings accounts being paid in slower time.

We believe that deposits, particularly those in current accounts, are a special case and that the proposed one-week timetable would not be necessary or appropriate for other parts of the FSCS. In the case of life insurance savings products many policies are long-term and so would not normally be available to policyholders at short-notice and claims arising from life assurance or general insurance will only be paid once the insurer is satisfied that the claim is valid. Therefore, time is not of the essence in making compensation payments in such circumstances.

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?

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

All of these appear to be technical questions for banks and we have no comments.

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

We have very severe reservations about the Authorities' proposals in this area. We believe that it is important that the current eligibility criteria for compensation (essentially limiting compensation to individuals and small businesses) are retained. Removing these criteria will substantially increase the cost of compensation and give rise to additional moral hazard problems.

More generally these proposals disregard the basic concept that the compensation arrangements are there to protect small customers and that larger businesses and public bodies should be presumed to have a sophisticated knowledge of the risks of their banking (or other financial service) arrangements and so should not need or be eligible for compensation.

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?

Making gross payments would be a significant change to current insolvency practice and could substantially increase the cost of compensation. However, it could be argued that would be fairer to ordinary depositors who maintain both mortgage and savings/deposit accounts at an institution. However, it is less clear that it makes sense if compensation is extended to larger corporates which may have substantial overdrafts overall but could have sufficient credit balances on some accounts to claim compensation.

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?

We accept that removing a formal claims process is needed if FSCS is going to pay out quickly. However, not requiring formal claims will almost certainly lead to a greater incidence of fraud and incorrect payments being made.

In order to alleviate this the FSCS will need to have powers to review payments and if necessary reclaim these where they have been made incorrectly.

We believe that these proposals should only apply in relation to deposits (and perhaps should be further limited to amounts held in current accounts). Claims relating to the insurance and investment schemes should continue to require formal claims to be made.

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?

We believe that a US style pre-funding model is not an appropriate basis for a UK scheme. In the UK, insolvencies among banks and insurers are rare, so the compensation scheme is rarely called upon. Indeed, it has not been called upon in the case of Northern Rock. However, in the US, failures of small, local banks are relatively common. These differences mean that the introduction of a pre-funded scheme will result in the transfer of substantial resources from industry to the compensation scheme.

More generally, the US model would require fundamental changes to UK legislation – to insolvency law and the Financial Services and Markets Act, as well as to the existing compensation scheme. In the US model the Federal Deposit Insurance Corporation has regulatory responsibilities to require struggling banks to take action to become recapitalised. If this fails, it has the power to declare the bank insolvent and assume the role of liquidator. In the UK such matters are the responsibility of the FSA, as the regulator (or a court appointed liquidator in the case of an insolvency), rather than the compensation scheme. We do not believe that such a radical change is needed to the current regulatory system, which, despite the events at Northern Rock, is generally seen as a model for other countries and has the support of the financial services industry.

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

This would appear necessary if the FSCS is to pay out within a week (it would take the FSCS several months to raise a levy).

In our view this proposal shows up starkly the significant differences between the deposit protection scheme and the other parts of the FSCS where the potential need for substantial liquidity at short notice will not arise and the current levy mechanisms are sufficient. The Authorities should, therefore, separate the deposit protection element of the FSCS from the other parts of the scheme. The FSA has recently introduced a 'general pool' for the FSCS specifically to provide additional liquidity – this clearly will become unnecessary if the Bank of England were to provide such liquidity.

However, if the 'general pool' arrangements were to be retained then we would have substantial concerns about this proposal. It would increase the cost to the industry generally because the Bank of England would presumably want its money back first from any recoveries so increasing the risk of losses being suffered by the levy payers and the Bank would also need to be paid interest on its loans.

It has always been implicit in the design of the FSCS that it was, at least in relation to banks, designed to meet small and medium sized failures and that alternative mechanisms would be needed in the event of the failure of a large bank. However, the implication of this proposal is that the Bank of England would, regardless of the size of the bank failure, simply be a provider of liquidity that would subsequently be

recovered from levies. We do not think it acceptable that insurers and other financial service firms could face levies for years on end in order to repay the Bank for loans made to provide compensation for a large bank failure. Such a drain on resources could have a substantial impact on the profitability and competitiveness of the UK financial services sector. It would also make the UK a less attractive place to do business if financial services firms seeking to set up operations in the UK become liable for substantial levy payments in respect of a failure many years previously.

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?

We have no comment on these proposals.

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?

Any notification requirements should seek to provide customers with a clear statement that the institution is a member of the compensation scheme. Such information could be made available (for example, in the form of leaflets) at the time of account opening. Reminders of the existence of the scheme could be made through a ‘quality mark’ on letterheads or displayed in branches.

However, there is a danger that an over emphasis on the existence of the compensation scheme could result in customers developing an overly cautious attitude to investment which would be to their long-term detriment. This would suggest that to be really effective this issue has to be dealt with in the wider context of increasing financial capability.

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 have no comments on this issue.

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 believe that the current system, introduced a few years ago, whereby the management expense limit for the FSCS contains a reserve amount that can be called upon to meet emergencies without the need for additional consultation works well.

We are not, therefore, clear why additional changes are needed and the description in the consultation paper of these proposals is not sufficient to allow us to form a clear view of what is being proposed. We would be concerned if they were to weaken budgetary controls at FSCS and allow overspends to be charged to levy payers without consultation. Even in an emergency we see no reason why proper controls and limits on expenditure should not be retained.

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?

The FSA looked at the possibility of introducing risk-based levies in its 2006 discussion paper on FSCS funding (DP 06/1) but concluded that it was not feasible to do this. In our view risk-based levies (or other mechanisms to take account of behavioural factors) are only feasible under a pre-funded regime. However, as explained in our response to question 5.21 we do not believe that a pre-funded regime is appropriate and do not believe that any advantages that might arise from introducing a risk-based levy would outweigh the disadvantages of such a regime.

Chapter 6

6.1) What are the benefits of formalising in statute the Bank of England's role in the area of financial stability, and giving its Court responsibility for overseeing its performance in this area?

The Bank of England's continuing role in respect of financial stability was specifically identified at the time of the reorganisation of regulatory responsibilities when independence in monetary policy setting was enacted and banking supervision powers were transferred to the FSA. This aspect of the changes was important to market participants, providing a useful element of balance within the regulatory framework, and it has been a matter of some surprise in retrospect that there was no reference made in statute to this role. This may have reflected, at least in part, the challenge in defining what is meant by 'financial stability'.

We suggest the remit of the Bank in this regard could usefully be specified in a way that gives it formal responsibility for the smooth day-to-day operation of the money markets and the payments system. Making the Bank responsible for outcomes in these areas will reinforce its role within the Tripartite Arrangements. It should link explicitly to its oversight of the money markets and the use of information it gleans in this role, such as of patterns of borrowing and of type of collateral being advanced, that may give early warning of trends or problems. The Bank should not be a shadow regulator of individual institutions in the financial services sector, but must

still be proactive in sharing relevant information with, and seeking such information from, the other regulatory bodies in order to fulfil its statutory obligations.

We therefore agree that formalisation in statute of the financial stability role would be beneficial and should be taken forward at this time. This enhanced standing of the role should give both greater power to the Bank as well as putting a clear obligation upon it to treat this dimension to its work with the importance it merits to the financial system as a whole.

6.2) To what extent would the proposals improve the ability of the Court of the Bank of England to oversee the Bank of England's performance including its enhanced role in the area of financial stability?

The allocation to the Bank of statutory responsibility for the operation of the money markets and the payments system will require organizational and governance changes, but we are not convinced that the Court should have a specific supervisory role. Currently its formal responsibility is administrative oversight, including overseeing the Bank's finances. It does not oversee the policy deliberations of the Monetary Policy Committee and, therefore, if it were only involved in one part of the Bank's policy responsibilities distortions could emerge. We, therefore, believe that having a separate expert committee responsible for the Bank's financial stability remit (along similar lines to the MPC) could be more effective. This would leave the Court to continue with its administrative role.

The Bank would need to ensure that it had the skills and the resources needed to meet its new statutory obligation. The remit of the Governor would also need to be changed.

Chapter 7

7.1) To what extent will the proposals enable an improved handling of a financial crisis?

7.2) To what extent would the proposals strengthen the operation of the IMF and FSF?

7.3) To what extent would the proposal for the IMF and FSF to work together to develop an early warning system be helpful in improving risk identification and financial sector resilience at the international level? How would this best be implemented?

7.4) To what extent will these proposals aid authorities in managing international financial crises?

It is important that the Authorities understand the risks to the financial system. Ensuring that policy makers have strong analysis at their disposal has clear benefits. Information on the risks to the financial system will also allow policy makers to run better stress tests and to understand the interlinkages between individual institutions' actions more clearly, leading to more effective crisis management.

However, it is important to understand that simply knowing about the risks will not be enough to prevent crises from occurring. The current crisis illustrates this clearly – many of the key risks to the financial system were understood well before the current crisis struck. For example the IMF noted that US sub prime lending and the related securitization posed risks in its December 14, 2006 Financial Market Update. Similarly the Bank of England July 2006 Financial Stability Report discussed three of the main components to the current crisis: the fact that risk premia had fallen to very low levels, and the risks associated with an abrupt correction; the fact that increased reliance on wholesale funding made banks more vulnerable to liquidity risk; the risks associated with the credit cycle and a possible impact of reassessment of creditworthiness; as well as the links between these 3 factors.
Part of the reason for this mismatch between knowledge and avoidance is that once a bubble starts to build it becomes rational for individuals to behave as if it will continue. This conflict between what is best for the individual and what is best for the system means that simply publicizing risks will not necessarily change outcomes – even if it can alert people to the need for contingency planning on how to handle a bubble's collapse. The key therefore will be to have a framework for sharing and exploring risk to the financial system that avoids the repeating the problem of the boy who cried wolf.

Giving the Bank statutory responsibility for the operation of the money markets will go some way towards mitigating this problem, since, if it believes its own warnings, it will be forced to take some steps to ensure that it fulfills its statutory obligation. This could be reinforced by more active monitoring of day-to-day strains in the money markets at the international level. What is needed is a process for exchanging information that is pro-active, continuously, informed and with the minimum of bureaucracy.

This analysis also suggests that a main focus of work to strengthen institutional arrangements should be around crisis management. Clarifying and strengthening the roles of the different players within the Tripartite Agreement will be an important element in improving the response to future crises. Similarly strengthening communications and coordination at an international level will help improve the speed of response.

Crisis prevention is much harder, in part because the international regulation of financial services does not provide a level playing field. Improved international coordination of the regulatory response to perceived bubbles might help prevent some future crises, as individual countries often face risks from tightening regulation on a unilateral basis. However, this needs to be balanced against the risks of moving to the lowest common denominator.

Impact assessment

A.1) Do you have information that would improve the analysis of this impact assessment?

A.2) Do you believe that the impact on building societies of the tools within the special resolution regime is different to that on other banks?

A.3) Do you agree that small businesses would not be affected by these proposals in a different way to other consumers?

We have no comments on these specific questions.

We do, however, believe that in developing its final impact assessment the Government should fully assess the potential cost to the UK (in terms of loss of competitiveness and making the UK a less attractive place to do business) of the proposals on the SRR and funding deposit protection.