

Financial stability and depositor protection: strengthening the framework

As with the discussion paper that preceded this consultation paper, “Banking reform - Protecting Depositors”, I welcome the opportunity to comment on what is proposed in this important area.

As before, these comments are made in a personal capacity, based on my experience of drafting and advising on the compensation arrangements under the Financial Services and Markets Act 2000, and are not made on behalf of my employer.

My comments are confined to the questions in chapter 5, “Consumer confidence and compensation arrangements”.

Question 5.1. Logically, if 100% deposit protection is given to a particular size of deposit (currently £35,000), increasing the amount that receives 100% protection should make no difference to consumer confidence - particularly if (as chart 5.2 shows) the vast majority of deposit accounts are below £35,000 and increasing the limit would not have a significant impact on the number of depositors covered.

That said, if the limit were raised this would probably have a beneficial effect. Though I disagree with it, the prevailing view (fostered by the comments of the Governor of the Bank of England) is that the current limit is inadequate. An increase would therefore serve, albeit illogically in my opinion, to foster consumer confidence.

Question 5.2. It needs to be emphasised (as this point is often lost in the discussion) that for the vast majority of consumers a higher compensation limit makes no difference: they do not have sufficient savings to make the size of deposit that would not be covered in full by the compensation scheme.

Those few consumers who can make a deposit in excess of the compensation limit currently have a choice. They can deposit the entire amount in one institution, possibly attracted by the higher rate a larger deposit would attract. Or they could split the deposit amount among a variety of institutions so as to ensure that the deposit would be 100% protected in each institution, and get a lesser sum by way of interest. They might also take into account whether the depositor was “too big to fail” in making a single deposit, where part of that deposit was unprotected by the compensation scheme.

Anecdotal evidence on the basis of the Northern Rock case suggests that for the most part consumers who deposit more than £35,000 with a bank simply assume that all will be well (on the basis that the bank is authorised) and do not address questions such as the risk to their deposits at all. In other words, they regard any responsibility in this process as that of the regulator, to ensure that the bank is fit and proper, and properly capitalised.

If that is right, then increasing the compensation limit will not affect the responsibility consumers have for their choices, since consumers do not believe in this situation that they have any responsibility. In their opinion, responsibility lies with the FSA.

If the view of the Authorities is that the general perception of consumers is wrong and that they need to accept responsibility for choosing whether to place all their deposit with one institution, or to split the deposit among a variety of institutions (and that the FSA, deposit-takers or both need to provide the information enabling consumers to make an informed choice), an increase in the compensation limit would simply make the issue irrelevant for a larger number of consumers.

Question 5.3. Given that the vast majority of consumers would be unaffected by an increase in deposit compensation limits, consumer perception of other financial products should be unaffected. An increase would, however, inevitably raise questions as to whether the compensation limits for other types of product were at an appropriate level.

Question 5.4. If the aim is to try to cover every eventuality, it seems to me that the third option (increased compensation for certain types of deposit) is the only plausible option.

Question 5.5. I cannot think of any other large balance a consumer is likely to receive.

Question 5.6. No other circumstances occur to me.

As the text implies, it would be reasonable to treat the amount held for a client in a client account as a separate deposit, for compensation purposes, from any amount held by that client directly with the same institution.

Question 5.7. This is really a question for the FSCS. It sounds an ambitious target to me, and would almost certainly involve the FSCS taking on a large number of temporary staff to process such payments, or outsourcing the task to a third party or parties. Staff of the right calibre and in the required quantity may not be available when required. Furthermore, if the bank is in difficulties, it is likely that its records will not be accurate, which will further complicate matters.

Question 5.8. If the banks think that the credit of the FSCS is good - as it should be - there seems no reason why the cheques could not be treated in the same way as a bank draft and instant access provided.

Question 5.9. Direct credit transfer might be possible, though this would either require FSCS to choose a bank or the customer making a choice of bank within a day or so of the bank failing and informing FSCS of his/her choice. It might be particularly attractive for customers that already had bank accounts with other institutions, though these are likely to be a small percentage of the affected depositors.

Question 5.10. This is obviously a sensible option and could be vital in cases where the consumer's entire savings are in the failing institution, but for one reason or another full payment cannot be made within a week.

Question 5.11. This is a question for the banks concerned.

Question 5.12. A common data standard or format would obviously be desirable, if it can be achieved without disproportionate cost. I cannot comment on whether that is possible.

Question 5.13. Name, address, and total amount on deposit, with joint accounts and trustee accounts being separately identified.

Question 5.14. This is a question for banks.

Question 5.15. For my part, I am not convinced that corporate customers regardless of size should be covered, or governments and international bodies. Depending on the level of compensation that the FSA eventually chooses, this will either make little difference (on the grounds that it provides a fraction of what they hold on deposit) or a significant difference (which raises questions as to the viability of the scheme to cover extremely large deposits). It would also raise the question as to why such customers' deposits should be protected when, in general, the regulatory system gives them little protection on the grounds that they are professional clients or eligible counterparties deemed to be able to appropriately assess the risks involved. Further, as 5.41 notes, there is the wider issue as to whether they should be covered for compensation payments in respect of other types of investment. And if the FSA does go down this path, it is unlikely that any firm will be able to take advantage of the current exemption from the compensation levy on the grounds that it does not deal with persons who could claim compensation. In short, this is a difficult issue which is likely to generate considerable comment when the FSA consults.

Question 5.16. This would be likely to maintain depositor confidence: as 5.43 implies, it seems unfair that on a default of a bank illiquid long term loans are crystallised and set off against short term deposits, with the likely result that the short-term deposit disappears. It seems unlikely, however, to do much to increase speed of payment.

Question 5.17. Gross payments are justified, for the reason given in the answer to 5.16 above: they preserve investor liquidity.

Question 5.18. These seem to be alternatives, rather than linked.

Question 5.19. I have no comment on this question.

Question 5.20. The obvious risk is that FSCS sends out cheques in accordance with the records, but the records are inaccurate (which could well be the case if the bank's systems and controls became less effective in the lead up to failure). It is hard to see how this

aspect could be ameliorated: either FSCS relies on the records, or it does not. But provided that FSCS has the power to pay a different amount to that shown by the records if the depositor can demonstrate that the records are inaccurate, this problem should be capable of mitigation.

Question 5.21. In my view, given the (rare) incidence of potential bank failure, the difficulty of establishing how great a level of pre-funding there should be and the objections that are likely to be made, pre-funding is politically a non-starter. It would also seem that, logically, pre-funding should extend across the entire range of investments covered by the FSCS - which makes it even less likely to be a starter.

Question 5.22. Given my answer to 5.21, this falls away.

Question 5.23. Subject to the points made in 5.57, this seems a sensible suggestion.

Questions 5.24 - 5.27. These are administrative banking questions on which I cannot comment.

Question 5.28. Since banks currently provide a great deal of marketing information to their customers, it does not seem to me to be particularly burdensome to require them to send a leaflet with each statement of deposit that sets out the current compensation limit and the information highlighted in 5.68 and 5.69. Another possibility might be to integrate this with the statement itself, perhaps at the head or foot of the statement.

Question 5.29. Disclosure requirements should be imposed via FSA rules.

Question 5.30. The example given in 5.72 seems a sensible solution to a difficult issue. It would obviously be even more helpful if the money stored on the card could be turned into cash, rather than being used only for goods in kind.

Question 5.31. Increasing management flexibility seems a sensible suggestion. However, it will be necessary to reassure contributors that the limit on management expenses (which is there for a reason) is not lightly set aside - that is, that the pre-set limit is only exceeded in rare circumstances, such as the default or likely default of a major institution.

Question 5.32. This is really a question for FSCS. It already has the power to engage additional staff on a temporary basis if required, or to contract out some part of its claims-handling process, so it would appear to have all the powers that it needs, provided that it can also access the money that it might need to pay the costs.

Question 5.33. This seems a very difficult and controversial area, which appears likely to give rise to legal challenge from those who would feel that their levy was too high. Given that it would also duplicate FSA prudential requirements, as 5.82 notes, I think there is little to be gained by going down this path.