

# Financial stability and depositor protection: Strengthening the framework

The National Consumer Council's response to the consultation by the  
Bank of England, HM Treasury and Financial Services Authority (FSA)  
January 2008

## About the National Consumer Council

The National Consumer Council (NCC) makes a practical difference to the lives of consumers around the UK.

With changes in provision of services by government and companies, there is apparently more choice, and more talk about meeting consumers' needs. Yet, the rhetoric does not always match people's experience: markets can operate in ways that act against consumer interests; and consumers who are disadvantaged or inarticulate can be ignored.

The NCC uses its insight into consumer needs to advocate change. We conduct rigorous research and policy analysis to investigate key consumer issues, and use this to influence organisations and people that make change happen. We don't just respond to policy discussions, but shape future debate through our groundbreaking thinking.

An open and collaborative organisation, we seek to work with public service providers, businesses and regulators. We hold regular policy forums which provide us with a unique opportunity to exchange views and test our thinking.

Our relationship with the Department for Business, Enterprise and Regulatory Reform – our main funder – gives us a strong connection within government. But we are ready to challenge any organisation, public or private, that does not give consumers a fair deal.

We have linked organisations in Scotland and Wales, and a close relationship with colleagues in Northern Ireland. We play a leading role within European and worldwide consumer groups, ensuring that cross-border consumer issues are tackled and the consumer voice is heard within global institutions.

Please check our website at [www.ncc.org.uk](http://www.ncc.org.uk) for our latest news.

We can often make our publications available in braille or large print, on audio tape or computer disk. Please contact us for details.

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# Summary

Overall, the National Consumer Council (NCC) welcomes the Authorities' (the FSA, Bank of England and HM Treasury) wide-ranging proposals to strengthen the framework for financial regulation and supervision of banks in the wake of the Northern Rock crisis. The objectives of strengthening the financial system; reducing the likelihood of banks failing, while minimising the impact of any failure; providing effective compensation arrangements in which consumers have confidence; and of strengthening the Bank of England and its co-ordination with the Treasury and FSA, are all desirable from the consumer perspective.

NCC's response to this consultation focuses on the proposals for consumer confidence and compensation arrangements (Chapter 5). It also makes broad comments on Chapters 3 and 4 in so far as they impact on compensation arrangements.

Compensation arrangements: NCC's key points

## *A higher compensation limit and consumer confidence*

- o FSCS (Financial Services Compensation Scheme) compensation scheme for bank deposits should be simplified to remove complexities and ambiguities to entitlement that potentially distort the market and undermine consumer understanding and confidence in the scheme - including co-insurance and restrictions on the application of the compensation limit.
- o The FSA should examine the feasibility of unlimited compensation (ie 100 per cent) for personal (as opposed to corporate) deposits of failed banks and building societies. If the financial system and the regulators' supervisory powers are strengthened appropriately and effectively, the risks of moral hazard associated with unlimited depositor compensation would be mitigated and the benefits of a no-limit compensation scheme could well outweigh the costs. A higher compensation limit for bank and building society deposits would do nothing to distort the market for other retail financial

products - including shares, unit trusts, life-  
assurance and pension products.

- o Multiple account holders with one bank/building society must be protected by the compensation scheme in the same way as single account holders.
- o The Authorities must address the unintended consequence of bank licensing for personal customers, and its potential impact on their FSCS compensation rights.

#### *Faster compensation payments and speedier opening of new accounts*

- o The Authorities must take an approach to payment of FSCS compensation and opening new accounts that focuses on minimising disruption for customers.
- o A multi-channelled support service for victims of failed banks/building societies to help them reorganise their banking arrangements and open new accounts will be necessary.
- o Consumers must be given a choice of new bank/building society to ensure they can easily access their funds.
- o Customers of failed banks need certainty over how long FSCS compensation payments will take to reach them. They also need their compensation payments as soon as practically possible. FSCS should commission an independent study of the options for introducing a fast-track compensation payments process with clear deadlines.
- o Any relaxation of the Money Laundering Regulations to ease the account-opening process for customers of failed banks must be clearly and effectively communicated to bank staff, and reinforced by training.

#### *Gross payments*

- o NCC supports the proposed move to gross payments for the FSCS compensation calculation.

#### *Streamlined claims process*

- o Potential problems associated with the proposals to streamline the claims process would be mitigated by the introduction of an FSCS complaints scheme and by consumer choice in payment methods for compensation - including direct transfer, by cheque, or in cash at a Post Office, bank/building society branch.

### *Protecting vulnerable consumers*

- A pre-paid card solution to ensure benefit and tax credit payments reach entitled consumers would not suit everyone. Many elderly people, for example, do not use cards. Alternative payment options will be needed.

### *Consumer awareness*

- A public information campaign is more likely to lead to better understanding of the scheme – and so to greater confidence in it – if the scheme is simplified as we suggest.
- Proposals for awareness-raising measures must be informed by research with consumers – across a range of locations and levels of financial capability – and in consultation with a wide range of stakeholders. Before they are implemented they must be piloted and assessed for effectiveness in terms of consumer understanding and behaviour.
- The FSA must ensure that the measures will raise public confidence in the scheme and reinforce the financial inclusion agenda; and that they are multi-channelled to meet the different needs of consumers – including the most disadvantaged and least financially capable.
- Any new requirements on banks and building societies to inform consumers about the FSCS compensation scheme should be incorporated into the Banking Code.

### *Other issues*

- Dormant accounts: reforms to the compensation scheme must include clarity about what happens to dormant accounts in a failed bank/building society.

# Introduction

Much of the National Consumer Council's advocacy work and expertise lies in helping make markets work for consumers and ensuring that disadvantaged and vulnerable consumers get a fair deal. These are two of our four strategic objectives.

We welcome the opportunity to respond to this consultation. Ensuring that the lessons of the Northern Rock crisis are learned to improve both the regulation of financial markets and the depositor compensation scheme is vital for maintaining consumer confidence in the financial system.

## 1. Reducing the likelihood of banks failing, and reducing the impact of failing banks

### **NCC's response to Chapters 3 and 4**

NCC generally welcomes the proposals aimed at reducing the likelihood of banks failing in the first place (Chapter 3) and those for reducing the impact of a failing bank (Chapter 4). Together they have the potential to form an essential cornerstone on which truly effective compensation scheme can rest.

The proposed new pre-solvency 'special resolution regime' (SRR) - allowing the Authorities to take greater control of a failing bank and, if necessary, transfer all or part of the business to a 'bridge bank' - are particularly welcome. They would ensure that customers of the at-risk bank could continue to access banking functions and, in the event of insolvency, ensure fast and orderly payment of bank customers' compensation claims.

However, it is important that putting a failing bank into the pre-solvency SRR process does not in itself damage consumer confidence and precipitate precisely what it is

designed to avoid - i.e a run on the at-risk bank. Speed and skilful public communications will be vital. For this reason, NCC recommends that the set of SRR tools at the authorities' disposal should be simple and readily understood by consumers.

The backstop last resort pre-insolvency position of the government taking a failing bank into temporary public ownership (as has already occurred in the case of Northern Rock) is also important reassurance for consumers.

The proposals in Chapter 4 aimed at aligning the framework for building societies with the proposals for banks are welcome. From the consumer perspective, banks and building societies offer much the same service - current and cheque accounts, a home for their savings as well as home loans and other forms of consumer credit. The de-mutualisation of many building societies over the last twenty years or so - and in some cases the retention of their brand names (as in the case of Northern Rock, for instance) - has also contributed to the blurring of the distinction between the two types of institutions in consumers' minds.

For these reasons if, in the event of a failure, building society cheque and savings account holders (members) were treated differently from holders of personal bank current and deposit accounts, the system could be seen as unfair and confusing - undermining confidence in the regulatory framework and the FSCS compensation scheme.

## **2. Consumer confidence and compensation arrangements**

### **NCC's detailed response to Chapter 5**

Consumers will have confidence in compensation arrangements only if they are credible, effective, understandable, and well-publicised.

These key criteria shape our response to the Authorities' proposals for changes to the Financial Services Compensation Scheme (FSCS) in the wake of the Northern Rock crisis. Within the financial sector, where the *caveat emptor* principle has been set aside by the regulator's duty, among other things, to secure the appropriate degree of protection for consumers, preventing a run on an at-risk bank depends on strong consumer confidence in the compensation scheme for bank deposits.

In common with the Treasury Select Committee Inquiry into the Northern Rock episode<sup>1</sup>, NCC believes that the risk of bank failure should be borne by a bank's shareholders and creditors, not by its ordinary retail customers. The framework for handling failing banks must insulate small depositors. And the framework for maintaining financial stability should not provide free insurance to banks.

After all, ordinary bank customers are not in control of, nor party to, their banks' finances and whether the bank is at risk of failing. Nor are they in a position to judge how well a bank is being run until - as we saw in the case of Northern Rock - it is too late. Such financial matters are the responsibility of the bank's directors, its shareholders and the regulators (in the form of the tripartite Authorities - the FSA, Bank of England and HM Treasury). Bank personal customers are in effect innocent bystanders and - in the event of failures in regulation and supervision that result in a bank failure - customers must be protected by a credible and effective compensation scheme in which they can have confidence.

The emphasis of our comments is therefore on what consumers need to have confidence in the compensation scheme.

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<sup>1</sup> *The run on the Rock* (Jan 2008) paras 182-183

## *A higher compensation limit and consumer confidence*

(consultation question 5.1)

It's quite clear from the behaviour of Northern Rock depositors in September 2007 that they were uncertain and confused about whether and to what extent compensation arrangements existed that would protect their money if the bank failed.

As the Treasury Select Committee pointed out in its inquiry into the Northern Rock episode<sup>2</sup>, 'the existence of a deposit protection scheme did not prevent the formation of long queues of depositors outside Northern Rock branches, a sure sign that bank customers lacked confidence that their deposits would be protected.'

The FSA's own Omnibus Survey in January 2008 into consumer awareness of the FSCS limits (published as part of this consultation) underlines how confused and badly informed consumers are about the FSCS - a perfect launch pad for rumour and panic.

According to the research, a clear majority (66%) didn't know what the FSCS compensation limit was for deposit accounts. However 9 per cent thought that the limit was 100% and another 7 per cent thought that compensation was unlimited - effectively an assumption by 16 per cent that depositors would be compensated in full. Only 1 per cent of those questioned correctly gave £35,000 as the current FSCS limit for deposit accounts. The scattered distribution of the answers given by the remaining 16 per cent of the sample suggests that their answers were little more than guesswork.

This lack of awareness is especially stark since the research was carried out in January 2008 when public awareness of the FSCS scheme is likely to have been greater in the wake of the massive media coverage of the

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<sup>2</sup> *The run on the Rock* (Jan 2008) para 217

Northern Rock crisis and its lessons for investors, than it was in September last year.

Poor knowledge of the FSCS scheme's limit is not the only explanation for the Northern Rock depositors' behaviour. Other complexities in the depositor protection scheme are likely to have been the architects of consumer confusion and lack of consumer confidence:

- o co-insurance;
- o restrictions on the application of the compensation limit.

NCC recommends that the FSCS compensation scheme for bank deposits should be simplified to remove complexities and ambiguities to entitlement that potentially distort the market and undermine consumer understanding and confidence in the scheme - including co-insurance and restrictions on the application of the compensation limit.

This will help consumers understand the level of protection the scheme will give them, and ensure they have confidence that this protection will be delivered when things go wrong.

So long as complexities in the FSCS exist - and many are specifically linked to the existence and application of a compensation limit - consumer understanding of the scheme and their confidence in it will be undermined. Even with a higher compensation limit, simplification of the scheme will be needed.

Our detailed reasoning and further recommendations on these issues are below.

### *Co-insurance*

Until 1 October 2007 (ie during the run on Northern Rock) the compensation scheme covered 100% of the first £2,000 of a claim, 90% of the rest between £2,000 and £33,000 - an effective maximum compensation of £31,700. This

sharing of risk by depositors (co-insurance) above £2,000 confuses consumers about the compensation limit. On the face of it, the limit may appear to be £35,000, but in reality anyone with a £35,000 deposit at a failed bank would have received only £31,700 from FSCS.

Co-insurance is also unfair to consumers who can't be expected to share the risk of their bank going bust, since they are not in a position to assess that risk. Assessing that risk is the responsibility of the regulators.

The Treasury select committee's report pointed out that co-insurance can '*create incentives for depositors to withdraw their funds at the first sign that a bank is in difficulties*'. Several witnesses also attested to the difficulties a co-insurance element introduces into explaining the scheme to consumers and raising public awareness<sup>3</sup>. It is important for public understanding of the compensation scheme that it is transparent and simple.

NCC welcomes the removal of the co-insurance element in the scheme from 1 October 2007. We also welcome the Authorities' intention not to revert to coinsurance for bank deposits. In its forthcoming consultation on the compensation scheme and the degree of co-insurance, the FSA must give sufficient weight to the consumer perspective that reverting to co-insurance would be counterproductive.

Removing the co-insurance element not only reduces the risk of depositors withdrawing their funds at the first sign of trouble, but it also helps to simplify the scheme, so increasing the chances of success for an FSCS awareness-raising campaign. (See further comments on raising awareness on p19.)

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<sup>3</sup> *The run on the Rock* (Jan 2008) para 226

## *Application of the compensation limit*

The FSCS compensation limit for bank deposits is currently set at £35,000 per person per bank. This means that depositors with more than one account with the same bank have their compensation calculated in relation to the total amount they have deposited with that bank – eg cheque account, deposit and savings accounts as well as other non-equity investment accounts such as cash ISAs and Tassas.

The consultation document argues that since the vast majority of retail deposit accounts (98%) hold less than £35,000, increasing the compensation limit would not have a significant impact on the number of depositors covered by the scheme. It goes on to assert that *'an increase to the [compensation] limit would therefore increase the value of deposits covered by significantly more than it increases the number of depositors protected'*.

NCC disagrees with this interpretation and with the conclusion reached: that the vast majority of depositors are covered by the scheme and that a higher compensation limit would not be a cost effective way of increasing the number of depositors protected.

Many consumers hold more than one account with the same bank or building society. To the extent that some of these consumers have individual accounts below £35,000, but aggregated deposits above £35,000, they would not be covered fully by the FSCS. This would reduce the proportion of customers totally protected by the current FSCS scheme.

And in the absence of any available data on the value and number of multiple accounts held by individual customers in each bank or building society (the so-called single customer view) it is impossible to judge by how much the proportion protected is below the 98% claimed in the consultation document. In turn, it is therefore impossible to conclude that raising the compensation

limit would not be cost effective in terms of the greater number of depositors so protected.

The application of the compensation limit across the aggregated accounts that each customer holds with each bank is, however, another complexity in the FSCS scheme. Even if very few consumers hold aggregate accounts with one bank valued above the compensation limit, it is another source of uncertainty that undermines consumer understanding and confidence in the scheme.

Aggregating the compensation limit across accounts held with one bank introduces a potential distortion into the market for savings and deposit accounts. Rational consumers would spread their saving across different banks up to the compensation limit to protect their deposits rather than seeking the best deals.

Multiple account holders with one bank/building society must be protected by the compensation scheme in the same way as single account holders or consumer confidence in the compensation scheme will be undermined.

The way that bank membership of the FSCS operates is another complication in the application of the scheme's compensation limits for consumers with more than one bank account. This has a bearing on depositors' entitlements under the FSCS which are on a per customer, per bank basis.

As revealed in the Treasury's stakeholder workshops during the consultation process, some banks hold one FSA authorisation licence for a range of different retail deposit-taking brands and subsidiaries. For instance, HBOS group comprises the Bank of Scotland and all its savings brands - including AA, Birmingham Midshires, Halifax, Intelligent Finance and Saga. Each of these are not separately authorised by the FSA. Other bank groups continue to operate with individual bank licences for each of their subsidiary retail operations. However, information enabling consumers to check whether the banks

in which they hold accounts are individually or collectively licensed is not readily available. Recent bank mergers and acquisitions are one possible reason for this inconsistent and confusing state of affairs.

Consumers cannot be expected to know the details of the legal relationship between their bank and its parent or holding company, and how that translates into the bank's FSA authorisation and its customers' FSCS compensation rights. Cautious consumers keen to spread their savings accounts across different banks might mistakenly assume that they have spread their accounts across different banking entities when they have not.

NCC recommends that the Authorities address the unintended consequence of bank licensing for personal customers, and its potential impact on their FSCS compensation rights. From the consumer perspective, any compensation limit should be applied per bank/brand per customer - regardless of the legal niceties of FSA authorisation.

### *A higher compensation limit*

NCC welcomes the FSA's intention to consult on changes to the FSCS limit for bank deposits and its coverage. There is a prima facie case for raising the limit - which has remained at £35,000 (with and without co-insurance) since 2001. Allowing for inflation in the intervening seven years, the £35,000 limit should now be at least £42,700<sup>4</sup>. Linking the limit to average earnings (on the grounds that consumers save out of their earnings) would bring to limit to £44,100<sup>5</sup>.

Linking the compensation limit in future to retail prices or earnings would at least ensure that its value would be preserved in real terms. However it could make the task of raising public awareness of the scheme and

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<sup>4</sup> Increase in RPI 2001 - Feb 2008 is 22%

<sup>5</sup> Increase in average earnings index 2001 - end 2007 is 26%.

its changing limit much more difficult (see Consumer Awareness p19).

The FSA should examine the feasibility of unlimited compensation (ie 100 per cent) for personal (as opposed to corporate) deposits of failed banks and building societies.

Unlimited FSCS compensation would not only inject simplicity into the compensation scheme, but also buoy consumer confidence in the scheme. And importantly - given the strengthened regulatory and supervisory framework envisaged by the Authorities - unlimited compensation would minimise the need for expensive extra data collection and data-sharing duties proposed in Chapter 5 to speed up FSCS compensation payments.

A 100 per cent compensation limit would not necessarily expose the financial system to the much-vaunted 'moral hazard' whereby some banks would throw caution to wind by offering excessively high savings rates for customers - possibly increasing the risk of that bank failing and of its customers claiming large sums from the FSCS. It is the role of the regulator - not the compensation scheme - to control banks that are offering irresponsible savings rates. The Treasury Select committee report also argued that moral hazard could be mitigated by prompt corrective action.

NCC is of the view if the financial system and the regulators' supervisory powers are strengthened appropriately and effectively, the risks of moral hazard associated with unlimited depositor compensation would be mitigated and the benefits of a no-limit compensation scheme could well outweigh the costs.

It is instructive to recall that it was only after the Chancellor, Alistair Darling, announced on 17 September 2007 that the government would guarantee the full

deposits of Northern Rock customers that the 3-day run on the bank was contained<sup>6</sup>. The co-insurance element of the FSCS for bank depositors (another contributor to the run on the bank) wasn't dropped until later - on 1 October 2007.

*As the consultation document points out, the knowledge that less than 100 per cent of a claim is covered can create incentives for depositors to withdraw their funds at the first sign that a bank is in difficulties.'*

*A higher compensation limit and consumer perceptions of and responsibility for financial choices* (consultation questions 5.2 & 5.3)

As already noted above, consumer knowledge and awareness of the FSCS limits for depositors are poor and confused. As such, they can have little bearing on consumers' choice of bank or their choice of account from the range of accounts offered by any particular bank.

Consumers' perceptions of a bank or building society and their choice of account are governed by a range of factors - principally the bank or building society brand image, branch proximity, how well an account's features meet the consumer's needs, account charges and rates of interest.

Indeed much of the banks' marketing efforts are focused on developing their brand image and devising accounts that they hope will attract affluent consumers. Often higher rates of interest are on offer the more a customer holds in a savings account or the longer their savings are tied up.

If the FSCS compensation limit were a factor in consumer choice between banks it would be irresponsible of banks and building societies to encourage above-limit savings balances in this way. (Even though the FSCS limit is not

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<sup>6</sup> *The run on the Rock* (Jan 2008) para 154

a factor in consumer choice, the fact that its existence is ignored in bank and building society promotions could, incidentally, be interpreted as not treating their customers fairly.)

The question of whether a higher compensation limit for bank and building society deposits would distort the market for financial products by discouraging consumers away from other savings products such as shares, life assurance and pension plans for instance - is easily answered.

Consumers use bank and building society current/cheque accounts because, uniquely, they offer the security and convenience of a comprehensive money transmission and monitoring service. There are no other financial products that compete for this purpose. A higher FSCS compensation limit therefore would have no distorting effect on the market for current accounts. As for savings accounts, consumers put their savings into banks and building societies because they consider them 'safe' - ie risk-free and reasonably liquid. Their initial stake is secure (more secure than if they kept their cash at home) and they can expect it to grow - albeit slowly - in line with the interest rate on offer. Shares and retail equity-linked investments, on the other hand, offer consumers no such risk-free security. The value of the consumer's original stake may well go down as well as up. That risk is the price they pay for the possibility of higher overall returns longer term.

Fixed-interest deposits with banks and building societies are not substitutes for risk-based retail financial products. A higher compensation limit for bank and building society deposits would do nothing to distort the market for other retail financial products - including shares, unit trusts, life-assurance and pension products. It would, however, help to uphold consumer confidence in banks and building societies as a safe haven for their funds - especially if NCC's other proposed reforms to the FSCS for deposits are implemented.

### *Compensation limits and additional protection for client accounts and other circumstances*

(Consultation questions 5.4), 5.5) and 5.6))

NCC welcomes the recognition that the deposits of consumers with funds in client accounts or with temporary large balances (from a house purchase or as the beneficiary of a will, say) should be protected if their bank fails before the funds have been transferred elsewhere for their intended purpose. However, designing additional protection over and above any compensation limit to cover such situations, that is also fair, clear and understandable to consumers, could prove challenging.

However, if the FSCS compensation limit for personal deposits were totally removed, as NCC suggests, there would be no need to make special provisions for additional protection of customer balances in these special short-term circumstances.

### *Faster compensation payments*

(Consultation questions 5.7 to 5.10)

NCC welcomes the Authorities' intention to find ways of speeding up FSCS compensation payments for bank and building society deposits.

Currently, FSCS aims to process all claims within six months, depending on the type of claim. Most credit union claims can be processed in four weeks for instance, but claims on larger institutions could take much longer depending on complexity and factors outside the FSCS' control.

Such uncertainty over when depositors in a failed bank will get their money back is not only unacceptable from the consumer point of view, it is also unacceptable from the Authorities' perspective as it increases the likelihood of a run on an at-risk bank.

Evidence to the Treasury Select Committee's Northern Rock Inquiry from the Governor of the Bank of England and expert witness Dr Hamalainen led to the same conclusion<sup>7</sup>:

*'The speed of release of funds is of critical importance. However generous a compensation scheme may be, and however much confidence consumers may have in eventually getting back their deposits, it would still be rational for a depositor to withdraw their funds from a failing bank if there were a prospect of them losing access for more than a few days.'*

The Authorities have therefore proposed a one-week deadline for payment of FSCS compensation to depositors of a failed bank. (It is not clear from the consultation document what is meant by one week, since references are made to 7 and 9 days, with no reference to working days.)

A 7-day (5 working days) deadline would be a welcome improvement on the current situation. But still be too long for many consumers - especially those on low incomes who are less likely to have other sources of funds to tide them over.

Even a week's delay in compensation could pitch significant numbers of bank customers into a complex and potentially expensive tangle over any automated payments due to be made from their account during the hiatus<sup>8</sup>. From the consumer and financial stability perspective we would suggest that anything more than a one-day delay to compensation payments would cause difficulty.

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<sup>7</sup> *The run on the Rock* (Jan 2008) para 240

<sup>8</sup> Default charges in the region of £30 are common for missed payments and unauthorized overdrafts. Customers who miss an automated payment because they have gone into unauthorised overdraft or exceeded their overdraft limit will incur both types of charge instantly – together with interest charges on the overdraft. According to 2006 NCC research a default charge of up to £39 for an unpaid direct debit or standing order can pitch low income consumers into a spiral of debt that is difficult to recover from.

The feasibility of achieving faster FSCS compensation payments should be tested in an independent study of the payouts from the scheme so far and from discussions with the FSCS in the light of the reforms coming out of this consultation and the review of FSCS funding.

Once they receive FSCS compensation, consumers must face the hassle and delay involved in opening a new account with a different bank or building society. The current (2005) Banking Code says that consumers can expect a bank/building society account switch to be fully effective within 10 - 13 *working days*<sup>9</sup>. This could translate into as long as three weeks depending on weekends and public holidays. However, as the consultation document points out (para 5.65), in practice, it takes even longer - an average of 8 to 12 weeks - by the time all direct debits and standing orders have been transferred.

NCC has mixed views on the desirability of interim compensation payments to help mitigate the detrimental impact on consumers of the structural delays in paying compensation and opening a new account.

On the one hand such interim/emergency payments could reduce the financial impact for some consumers - especially those on low-incomes. (They should, however, be given a wide choice of how interim payments are made - cash, cheque, or direct payment at a Post Office, or a bank or building society of the consumer's choice.) On the other hand, the knowledge that the system can't pay full entitlements in the early days after a bank failure, could be a cause for concern that further funds may not materialise, so undermining consumer confidence in the scheme.

Customers of failed banks need certainty over how long FSCS compensation payments will take to reach them. They also need their compensation payments as soon as

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<sup>9</sup> The Banking Code 2008 paras 7.2 and 7.3.

practically possible. FSCS should commission an independent study of the options for introducing a fast-track compensation payments process with clear deadlines.

### *Speedier opening of new accounts*

(Consultation questions 5.24 to 5.27)

The Authorities propose to mitigate the delaying effects of the Money Laundering Regulations on the account-opening process for customers of failed banks who need to open a new account elsewhere. The proposal is to allow banks to rely on verification of a new customer's identity from the checks already made by the failed bank. Additional proof of identity would be requested, where possible, by the new customer providing a letter or account statement from the failed bank.

NCC supports, in principle, the application of Regulation 17 of the Money Laundering Regulations to smooth the account-opening process for customers of a failed bank. However, it is vital that banks ensure their branch staff are made aware of this less onerous applications process for customers of a failed bank, and are trained to ensure that new applicants in this situation benefit in practice. Also, if additional proof of identity cannot readily be provided by the applicant, it is important that this does not become a bureaucratic barrier denying customers of failed banks access to the banking system.

Consumer experience of the process for opening a basic bank account – for which an exception to the Money Laundering Regulations has been agreed – is an example of how principle is not always translated into practice. The exception allows applicants for limited functionality 'basic' accounts – usually consumers on low incomes who have never before had a bank account – to produce less onerous ID documentation. But research has shown<sup>10</sup> that the reduced ID requirements are not always applied –

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<sup>10</sup> Banking Benefits, Citizens Advice 2006

leading to delays and difficulties for some of the most vulnerable consumers.

NCC welcomes recognition that speeding up the new account opening process is important for customers of failed banks who find themselves - through no fault of their own - denied access to their bank/building society account and urgently need to open replacement bank/building society accounts. But the Banking Code 10-day account-opening standard would provide very little help for customers of a failed bank who are in urgent need of banking facilities. A far shorter time period must be guaranteed in these circumstances.

Relaxation of the Money Laundering Regulations to ease the account-opening process for customers of failed banks must be clearly and effectively communicated to bank staff, and reinforced by training on the practical implications for the applications process.

Unless bank staff are confident they can apply the special rules correctly and appropriately they are likely to err on the side of caution - deferring to the full applications process to reduce the risk of incurring sanctions, and thereby exacerbating the problems of failed bank customers. The FSCS will need to spell out to bank and building society staff exactly what ID proof is acceptable - bank statement, passbook, cheque book, bank card etc.

### *Compensation and new account-opening arrangements that meet consumers' needs*

In an age when bank transactions can be implemented electronically and instantaneously, several weeks' delay in restoring bank account functionality is a serious enough shortcoming where the customer has initiated an account switch and is in control of the start of the process. But where the process is forced unexpectedly on a customer because a bank or building society has failed, it is unacceptable.

NCC therefore suggests that the question of how quickly compensation can be paid is the wrong question to ensure that customers of a failed bank get appropriate redress. (As it is, a one-week compensation target looks to be ambitious from the banks' perspective - not least because of information collection and checks necessary to apply any compensation limit.)

Whatever the target payout deadline for FSCS compensation, and however much the account opening process is speeded up, the fundamental needs of customers of a failed bank are no different from any other bank customer. They need an ongoing uninterrupted banking service from their current/cheque account and ongoing security for and access to their savings.

FSCS compensation may ensure customers of failed banks don't lose out financially. But it does nothing to ensure a continuous banking or building society service, nor avoid consumers paying the price of a bank failure in non-financial ways - eg disruption to insurance cover, fines or disconnection for non-payment of bills, enforcement action from landlords and creditors, inability to buy food.

Customers of a failed bank need their funds reimbursed in a way that ensures their use of the bank and building society system is uninterrupted. This is especially important for the government's policy of increasing financial inclusion among groups who have traditionally managed their money in cash. Without the reassurance that the banking system is always available for them, these groups, in particular, are unlikely to find maintaining a bank account attractive.

The Authorities must take an approach to payment of FSCS compensation that focuses on minimising disruption for customers. This could include the FSCS and/or the Authorities transferring the business of a failed bank/building society to another bank/building society, and automatically opening new immediately-accessible

accounts for customers with their compensation entitlements. Giving consumers a choice of the new bank/building society is vital to ensure they can easily access their funds. (Consumers could perhaps nominate their chosen alternative bank when they first open their account.)

Alternatively (or as first stage to transfer) the Authorities' proposed pre-solvency 'bridge bank' could perhaps also be an appropriate tool in post-insolvency situations - to ensure that customers of failed banks can continue running their accounts until a switch to another bank/building society can be arranged and completed. A bulk payment of FSCS compensation entitlements for customers of the failed bank could be paid into the bridge bank - from which consumers could continue to make payments etc.

A multi-channelled support service for victims of failed banks/building societies to help them reorganise their banking arrangements and open new accounts will be necessary. This could be a key part of contingency planning.

### *Gross payments*

(Consultation questions 5.16 and 5.17)

NCC welcomes the FSA's forthcoming consultation on moving to gross payments in calculating customer entitlements under the FSCS for deposits.

The current situation where customers' outstanding debts (such as loans, overdrafts and mortgages) to the failed bank/building society are netted off against their deposits with the same institution for the compensation calculation could disadvantage the many consumers who have both mortgages/loans/overdrafts and current/savings accounts with the same bank/building society. Together with the associated delays in the calculation and payment of compensation, netting off is likely to further undermine depositor confidence in the scheme.

Netting off is also potentially market-distorting. Customers who are aware of netting off in the event of a bank failure, will seek to separate their finances between banks/building societies, rather than seeking the best deal. Netting off also acts against industry interests in cross-selling to existing customers.

The average outstanding mortgage is currently just over £100,000<sup>11</sup>. According to the consultation paper's analysis of deposit accounts, most deposit and savings account balances are below £35,000. As a result, many consumers with both a mortgage and savings in the same bank/building society are likely to see their entitlement under the FSCS totally wiped out. FSCS compensation for many consumers with an overdraft associated with their current account, or with an offset mortgage, will also be severely reduced or wiped out by netting off.

It's not at all clear whether consumers are aware of the compensation scheme's current netting off rules. The public awareness research made available during this consultation did not explore this aspect. But consumers expect a 'deposit protection' scheme to be as described and fit for the purpose of *protecting deposits*. If consumers were to become aware that the deposit protection scheme is, in certain circumstances, only a net deposit protection scheme and unlikely to protect those with mortgages with the same bank at all, that would further confuse consumers and undermine their confidence in the scheme and the financial system.

What's more, consumers see their mortgage as a medium to long-term responsibility that must continue to be paid, but is totally distinct from any bank account balances, overdrafts, personal loans or savings they may have. Savings and deposit accounts, overdrafts and personal loans are often an important source of liquidity to smooth the ups and downs in consumers' short-term finances.

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<sup>11</sup> Council for Mortgage Lenders media note in advance of March 2008 Budget.

It's important that the compensation calculation respects such rational consumer choices and does not disrupt their financial arrangements and pitch them into financial difficulties.

NCC supports the proposed move to gross payments for the FSCS compensation calculation. Gross payments reflect consumers' own approach to their short and long-term finances, they will reduce distortions in the market and speed up compensation payments from the scheme, improving consumer confidence in the scheme.

### *Streamlined claims process*

(Consultation question 5.20)

NCC welcomes the FSA's intention to consult on new rules to remove the need for consumers to make a formal claim to the FSCS.

This would reduce form-filling for consumers and potentially reduce the delay in paying compensation by cutting out the FSCS notification and the depositor claim stages of the process. This would be especially helpful for consumers with poor financial literacy or who are away on holiday or other business when their bank or building society fails.

However, streamlining the claims process so the FSCS makes automatic compensation payments based on the records of the failed bank raises some potential problems. These include:

- o errors in bank/building society customer records - e.g value of accounts held; depositor contact details - which could result in inaccurate compensation payments;
- o no choice in how payments are made - consumers need some choice in payment method especially since they may need to repair their finances speedily;
- o no procedure for resolving disputed compensation payouts.

Potential problems associated with the proposals to streamline the claims process would be mitigated by the introduction of an FSCS complaints scheme and by consumer choice in payment methods for compensation - including direct transfer, by cheque, or in cash at a Post Office, bank/building society branch.

The complaints scheme would have to apply to all the compensation schemes under the FSCS umbrella. Unresolved complaints would be referred to the Financial Ombudsman Service (FOS), with special arrangements for speedy resolution.

### *Protecting vulnerable consumers*

(Consultation question 5.30)

NCC welcomes recognition by the government (Department of Work and Pensions and HM Revenue and Customs) that its policy of paying benefits and tax credits through bank accounts could, in the event of a bank/building society failure, prevent significant numbers of people from accessing their benefits and tax credits. We also welcome the government's plan to introduce contingency measures to ensure that benefits and tax credits reach these groups in other ways.

Since 60 per cent of the UK population is in receipt of at least one state benefit or tax credit (including state pension and pension credit) contingency measures must be appropriate for all groups - from people who rely totally on benefits/tax credits to better off recipients eg some pensioners in receipt of both state and occupational pensions and affluent families in receipt of child benefit.

On the face of it, people who are totally dependent on benefits and tax credits and who are among the poorest groups in society may appear to be most in need of speedy alternative ways of payment. However, a pensioner with both their state and occupational pension paid into the same bank, could equally be in need of a speedy

alternative state pension payment if that bank were to fail. To the extent that consumers across the income range channel their regular income from all sources (benefits, tax credits, pensions or earnings) through one bank account, they are vulnerable to the impact of that bank failing.

### *Pre-paid cards*

The Authorities' suggestion that benefits and tax credits could be paid via pre-paid electronic cards could work well if the card could be used to withdraw cash (free of charge at any bank/building society ATM) or to deposit the funds at a bank, Post Office or building society - either opening a new account (giving rise to delays in accessing their entitlement) or using an existing account. It's important that consumers have a choice over the means of payment in such crisis situations as PINs could be delayed.

A pre-paid card solution would not suit everyone. Many elderly people, for example, do not use cards. Alternative payment options will be needed.

To issue a pre-paid card, HMRC and DWP would first need to identify those recipients with accounts in the failed bank. This could delay the issue of the cards and therefore the recipients' access to funds out of which they may need to make essential payments such as rent or utility bills.

If instead, HMRC and DWP were to maintain an ongoing database for each bank/building society identifying current recipients of direct benefit payments, issuing pre-paid cards could be speeded up. However this may not be cost effective, since information on recipients across all bank and building societies would have to be collected and kept up-to-date, when in fact only the information on current recipients with the failed bank is relevant (but not predictable).

### *Automatic divert*

An alternative way of ensuring benefit and tax credit recipients continue to receive their entitlements if their bank or building society fails is for HMRC and DWP to **automatically divert** all payments that would otherwise go to the failed bank/building society to a special emergency account. The emergency account could be held centrally - by the Bank of England, or in a 'bridge bank' under SRR (where the DWP and HMRC business elements of the failed bank are transferred).

Benefit recipients would access their entitlements by presenting their NI number at a bank, building society or Post Office counter - choosing to receive their benefits in cash, by cheque or direct transfer into another account of their choice.

This solution could possibly speed up the time it takes for recipients to access their entitlements (because they themselves identify their entitlement through their NI number). However, because it involves recipients having to claim in person and rearrange their affairs it could further disadvantage already vulnerable consumers.

### *Consumer awareness*

It's clear from the FSA's January 2008 survey that consumer understanding and awareness of the FSCS is poor and that consumers generally don't remember being made aware of the compensation arrangements when they opened their account or purchased a financial product.

This lack of awareness - compounded by the schemes' complexities (see pages 7 - 9) - is likely to have contributed to the run on the Northern Rock bank last September.

NCC welcomes the FSA's intention to consult on how consumers can be better informed about the compensation scheme. A public information campaign is more likely to lead to better understanding of the scheme - and so to

greater confidence in it - if the scheme is simplified as we suggest.

Retaining the current confusing and complicated rules about how much the scheme protects different consumers in different situations is likely to undermine any public awareness raising campaign. Raising public awareness of the compensation scheme also needs to strike a delicate balance between information and reassurance, and alerting the public to its limitations.

The proposed awareness-raising measures must be informed by research with consumers - across a range of locations and levels of financial capability - in consultation with a wide range of stakeholders. Before they are implemented they must be piloted and assessed for effectiveness in terms of consumer understanding and behaviour.

The FSA must ensure that the measures will raise public confidence in the scheme and reinforce the financial inclusion agenda; and that they are multi-channelled to meet the different needs of consumers - including the most disadvantaged and least financially capable.

Any new requirements on banks and building societies to inform consumers about the FSCS compensation scheme should be incorporated into the Banking Code.