



23 April 2008

Dear Sir

Financial stability and depositor protection: strengthening the framework

We are pleased to respond to the above consultation. This letter summarises our view while the subsequent pages provide our detailed response to the appropriate questions.

Although Aviva is not involved in deposit taking activities, we have a specific interest in Chapter 5 – ‘Consumer confidence and compensation arrangements’ – as a contributor to the FSCS. Our response is confined to this chapter.

Aviva has previously responded to HM Treasury’s ‘banking reform – protecting depositors: a discussion paper’, the themes of which, to a large extent, overlap with this consultation. We have repeated our response to this previous paper where appropriate.

Aviva believes that the FSA’s new FSCS model is fundamentally flawed and recommends that the Government takes this opportunity to work with the financial services industry to devise a balanced scheme, providing a targeted approach to risk mitigation and consumer protection.

Following the FSA’s planned introduction of a general pool to the FSCS framework on 1 April 2008, the Government must recognise that any changes to depositor protection will have a direct impact on all firms authorised by the FSA.

Aviva has raised its concerns, directly with the FSA, with regard to the revised basis for the funding of the FSCS, in particular the general pool, and the detrimental impact it could ultimately have on the wider industry.

The current review is an opportunity for both the tripartite authorities and the industry to look at the root causes of business failures rather than simply revising the existing scheme to ‘plug gaps’. Analysis needs to focus on why firms fail, why certain sectors have higher failure rates, what options are available to address these issues and ultimately how the FSCS should be designed.

We would reemphasise that, whilst the FSCS has some clear benefits, the primary issue is that no matter how the scheme is designed it will almost certainly be inadequate to protect depositors, even with a medium sized failure. In the UK, firms reported approximately £812bn in protected funds for the 2006/07 levy period; this compares to the maximum payout under the new FSCS model of £4.03bn. The proposed maximum compensation limit is also put in context by Northern Rock, which has had to borrow in excess of £25bn from the Bank of England to cover its liquidity shortfall prior to its nationalisation. Consequently, we consider a fundamentally different approach is required to protect depositors, given the magnitude of the protection required.



Whilst we are not advocating a US style scheme in the UK, it should be noted that the US scheme holds \$49bn, insuring approximately \$3trillion of deposits. We do believe, however, that a system where depositor protection is managed independently, similar to the current UK scheme and the approach taken in the US, would reflect the individual nature and requirements of the banking sector.

Aviva believes that the compensation scheme should be based on the level of risk firms pose and equally encourage good risk management, by applying lower levies to those firms that can demonstrate they are securely capitalised, rather than the current FSCS proposal which simply penalises those firms with the 'deepest pockets'. Encouraging better risk management and risk mitigation should be at the core of any new proposals.

Yours sincerely



Detailed Response to Questions in Chapter 5

Q5.1 How would a higher compensation limit affect consumer confidence?

Aviva does not believe that compensation limits should be further increased.

Compensation limits were changed as recently as October 2007, at which point the element of coinsurance was removed, so, consumer protection and therefore confidence have already been enhanced.

Whilst a higher compensation limit might improve consumers' confidence still further, we believe that a balanced approach should be applied to any changes made to the compensation scheme, as improved consumer protection must not remove the need for consumers to be responsible for their own financial decisions; if the limit were to be further increased, so consumers' responsibilities would fall.

As a result of events surrounding Northern Rock, consumers may assume that should a similar situation arise in future, their deposits will be guaranteed without limit, so the compensation scheme may already have been irreparably undermined. We comment further on this under 'consumer awareness' below

Q5.2 How would a higher compensation limit affect the responsibility consumers have for their financial choices?

Aviva believes that consumers should be aware of the risks involved with any financial product and make an informed decision regarding which product suits their needs. Increasing the threshold for deposits would diminish the level of consumers' responsibilities.

Q5.3 How would a higher compensation limit for deposits affect consumer perception of other financial products?

Aviva believes that extending the compensation guarantee may distort the savings market, promoting a shift in consumer saving to 'guaranteed' bank savings accounts, to the detriment of longer-term savings and investments products offered by life insurers.

Q5.4 Which of the solutions to cover balances above the compensation limit is the most practical, desirable and/or proportionate and why?

Aviva does not believe that deposits above the compensation limit should be protected in any circumstances, and that it should be left to depositors to take a degree of responsibility and risk mitigation action as they see fit.

Well in excess of 90% of deposit accounts hold balances below £35,000, and are thus fully protected. So a relatively small proportion of depositors hold balances above the compensation limit.



Q5.5 What types of large balances should be subject to additional protection and in what circumstances?

See Q5.4 response.

Q5.6 Are there any 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?

Aviva is aware that the 'eligibility' section of the consultation acknowledges that compensation arrangements are already complex and we consider that defining circumstances justifying additional compensation would lead to significant problems – for example disputes as to what constitutes 'temporary' deposits – adding to the existing complexity.

In addition, firms' potential liabilities under the FSCS to fund a failed bank would become open-ended.

Q5.7 What are your views on a one-week target for FSCS payment?

Whilst it may appear desirable for depositors to be repaid in the shortest time possible, impact on the wider financial services market following the introduction of the FSCS 'general pool' must be considered.

In particular, the timing of payments made by each sector when settling their liabilities should be taken into account. For example, in the event of a failure by a bank, deposits are paid immediately, or as quickly as possible, whereas if a general insurance provider fails, the liabilities, i.e. claims, are paid out over a number of years.

In deciding whether there is a case for repaying depositors in a more timely fashion, there is a clear need to weigh up consumer benefit against cost and the potential detriment to industry.

Q5.8 How feasible would it be for banks to provide instant access to the funds provided by FSCS cheques as soon as they are deposited?

Aviva has no comment.

Q5.9 Are there other means to ensure consumers have access to funds within one week, including alternative payment methods to cheques?

Aviva has no comment.

Q5.10 How effective would interim payments be in mitigating consumer detriment when a full payout is not possible within a week?

Aviva has no comment.



Q5.11 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?

Aviva has no comment

Q5.12 Should banks follow a common data standard or format, and, if so, what would this entail?

Aviva has no comment

Q5.13 What information should be included in a single customer view and what would be the implications for firms of different information requirements?

Aviva has no comment

Q5.14 How would banks place a 'flag' on accounts that are not eligible for FSCS payments?

Aviva has no comment

Q5.15 Are there other classes of depositor that should be ineligible for FSCS compensation payments, and, if so, why?

Aviva has no comment

Q5.16 To what extent would gross payments help maintain depositor confidence and speed up payment?

Aviva has no comment

Q5.17 To what extent are gross payments justified by maintaining depositors' access to liquidity as well as by accelerating payments by the FSCS?

See Q5.18 below

Q5.18 What are your views on the link between FSCS gross payment and set-off?

Aviva recognises the potential hardship to consumers arising from netting of deposits and borrowings, particularly in cases where borrowings exceed deposits.

Conversely, netting would be of potential benefit in cases where the amounts are much larger; for instance, where borrowings and deposits are £1m each, netting of these might benefit the consumer who would receive only £35,000 under the gross arrangements whilst being left with a debt of £1m.

Furthermore, as the proposals would involve corporate customers being eligible under the FSCS, consideration needs to be given to cases where formal setoff arrangements exist across different legal entities, which is commonplace with larger corporates, and the extent to which these arrangements would take precedence over the FSCS.



Clearly there are many scenarios that could be developed, some arguing in favour of net and some gross, and some will conflict with existing insolvency rules.

This is a complex area which the FSA will need to consider carefully when consulting on a change to gross payment arrangements.

Q5.19 Are any other measures necessary to better align FSCS rules and the provisions of the proposed bank insolvency procedure?

Aviva has no comment.

Q5.20 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?

Aviva has no comment.

Q5.21 What are your views on the introduction of an element of pre-funding into the FSCS?

Aviva strongly opposes pre-funding:

- As the consultation acknowledges, it would potentially take many years to build up a fund of meaningful size, and contributing companies would be deprived of funds (and the return on those funds) which might never be needed by the FSCS.
- We have already objected to the 'general pool', which is to be introduced in April 2008. Pre-funding would introduce unfair constraints on firms outside the banking sector to forego funds, heightening the cross-contamination that is inherent in the general pool.

Q5.22 What steps would need to be taken to ensure that pre-funding would be compatible with other elements of the FSCS funding arrangements?

Aviva is strongly opposed to changes being made to one part of the FSCS arrangements (in this case, the banking sector) in isolation. We believe doing so potentially disadvantages firms outside that sector; in this instance, it might require all firms, irrespective of sector, to participate in pre-funding.

Q5.23 What are your views on whether the FSCS should be permitted to borrow from the Government or the Bank of England?

Aviva believes that borrowing from Government or the Bank of England, with subsequent recovery from contributing firms under the 'pay-as-you-go' principle, would be a far more pragmatic and fair solution.

Q5.24 How soon could streamlined procedures for opening accounts be introduced so that the one-week target for opening a new account can be met?

Aviva has no comment.



Q5.25 Are there additional risks which need to be considered with this faster account opening method?

Aviva has no comment.

Q5.26 How else could the account opening process be sped up?

Aviva has no comment.

Q5.27 What else would be needed to enable banks to provide instant access to funds following the deposit of a FSCS compensation payment?

Aviva has no comment.

Q5.28 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?

We agree that banks should be required to inform customers of the FSCS limits on a one-off basis; this exercise should be refreshed regularly (e.g. annually), and if the FSCS limits change.

However, as is noted in the consultation, consumer knowledge is generally poor – and even if this were to be improved, it seems entirely likely that consumers would withdraw funds from a bank were to be highlighted as having difficulties – because they would not wish to face the inconvenience of having to recover funds from the FSCS.

We are therefore doubtful as to whether sustained publicity would entirely avoid a further run-on-the-bank as consumers will respond to adverse press in ways that they believe will safeguard their money – and rapid access to their money.

Conversely, as stated previously, some consumers may believe that the way in which Northern Rock was handled sets a precedent for similar circumstances reoccurring, and that the Government will step in – despite limitations on compensation.

Q5.29 How should disclosure requirements be imposed?

Aviva believes that the suggestions made in our response to HMT's previous discussion paper that publicity can be managed through:

- Through the FSA's Financial Capability workstream.
- The role of the FSCS to be more transparent and advertised more widely to consumers.
- Deposit takers to provide more information on the FSCS in conjunction with other product information.
- Citizens Advice Bureau to provide information to consumers and explain the details of the scheme.

Q5.30 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?

Aviva has no comment.



Q5.31 What are your views on the proposed changes to increase FSCS management flexibility?

Aviva agrees that at times of stress the FSCS should be afforded a suitable degree of management flexibility. We believe that more detailed proposals should be presented for consideration by the industry.

Q5.32 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?

Aviva has no comment.

Q5.33 What are your views on the use of risk-based levies or on the introduction of behavioural factors into the calculation of the levies?

Aviva believes that the compensation scheme should be based on the level of risk firms pose and equally encourage good risk management, by applying lower levies to those firms that can demonstrate they are securely capitalised, rather than the current FSCS proposal which simply penalises those firms with the 'deepest pockets'. Encouraging better risk management and risk mitigation should be at the core of any new proposals.

Whilst Aviva does not advocate a wholesale increase in the FSCS compensation limits, it is hard to see how the Government could make material changes to one class without assessing the consistency and suitability of consumer protection provided by the other classes.