Financial stability and depositor protection:
Strengthening the framework

Response by the Royal Bank of Scotland Group plc

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.

In principle support

The Royal Bank of Scotland Group plc ('RBS') believes that there are important lessons to be learnt from recent market events which need to be addressed in order to strengthen UK financial stability. It therefore supports the purpose of this consultation, as well as the 5 key objectives set out at the start of the document. RBS also supports a number of the specific proposals made, including:

- strengthening the tripartite arrangements;
- promoting greater consumer awareness of the FSCS; and
- improving the provision of emergency liquidity assistance.

But several major concerns

However, RBS also has major concerns about certain aspects of the consultation, as follows:

(1) Focus of proposals:

In our view, excessive attention has been placed on seeking additional regulatory powers (relative to how existing powers might have been better used), and on ways of mitigating the consequences of failure (rather than on preventing failure in the first instance).

In particular, we believe three areas warranted much greater attention in the consultation:

- the effectiveness of the Financial Services Authority's ('FSA') prudential supervision - including why extensive existing powers were not used to the fullest extent in the case of Northern Rock;
- the Bank of England's ('BoE') money market operations, and the extent to which different outcomes might have been achieved with an approach more aligned with that of other key central banks; and

- the need to strengthen practical supervisory cooperation internationally (not just domestically within the tripartite), where cross-border cooperation apparently fell short even in the limited case of Northern Rock.

(2) The risk of unintended consequences:

The scope of the consultation covers a wide range of complex issues, many of a technical nature. These require careful consideration if the risk of unintended, adverse consequences is to be avoided. We have significant concerns that the desire to introduce legislation in May means that fundamental issues – notably the potential impact on property and creditor rights of the proposals for a Special Resolution Regime and a new banking insolvency regime – will not be adequately considered, with possible damaging effects on the City of London as an international financial services centre.

(3) An undifferentiated approach:

Whilst supportive of the need to seek improvements in the existing operations of the Financial Services Compensation Scheme ('FSCS'), and consumer awareness of deposit protection arrangements, we are concerned that the proposals envisage building a costly infrastructure for effecting early payouts in the case of all bank failures, regardless of size. The reality is that liquidating systemically important banks and protecting depositors affected through FSCS payouts is neither a sensible nor a practical policy option (for reasons explained elsewhere in this response). In such instances, other tools for managing the failure of such banks need to be considered.

Some suggested improvements

In light of the above, RBS would suggest the following high-level improvements to the consultation proposals; the rest of our response expands on these suggestions, as well as addresses other specific points in more detail:

(1) Re-balance the proposals to focus much more on prevention, and on a better utilisation of existing powers rather than building in additional regulatory costs. In particular, the authorities should consider:

- Strengthening FSA's prudential supervision, to match its responsibilities for supervising the world's largest international financial centre. Building on the FSA's recent internal audit report on Northern Rock, this should strengthen the quality and quantity of prudential supervisory resources, improve resolute decision-making, processes and IT, and achieve a more even balance between prudential and conduct of business regulation. Additional powers and regulatory requirements should only be sought where these clearly fall short. If necessary, RBS would be prepared to support such enhancements, e.g. through secondments or even higher levies (the costs of which are minor relative to the costs of financial instability).

- Enhancing practical international supervisory cooperation, both with respect to day-to-day supervision as well as crisis situations, through the promotion of supervisory colleges and the concept of a lead supervisor. Whilst recognising the need to tailor colleges to suit different groups, we believe the FSA should be less reluctant to consider minimum standards of prescription for colleges and supervisory cooperation, in order to achieve more efficient and effective supervision of cross-border institutions, where some

of the greatest systemic risks lie. We note and support the Chancellor's recent initiative on supervisory colleges, which we believe to be a welcome first step in this regard.

- Further developing the BoE's approach to money-market operations. We believe the recent announcement of the BoE's Special Liquidity Scheme to be a very positive and major step in this direction, whilst noting the scope for further international convergence of rules on acceptable collateral and related matters (such as haircuts and policies on lending rates).

(2) Phase in planned reforms, to allow proper consideration of complex issues. In particular, given the recent passage of the Banking (Special Provisions) Act 2008, further time should be allowed for a detailed consideration of the proposed Special Resolution Regime, whilst progressing on other aspects of the consultation. Failing that, government should at the very least involve industry and other expert opinion as early as possible in the development of new draft legislation.

(3) Adopt a more differentiated approach, which recognises that different types of bank failure will require different responses, and that in the case of larger institutions, tools other than an immediate liquidation and relying on deposit protection payments would have to be used. Some suggestions in this respect, and alternatives as to how the FSCS might be improved, are set out below.

Finally, as a general suggestion underpinning all of the above, RBS would also emphasise the need to observe fully 'better regulation' principles, by only resorting to legislation or regulation where absolutely necessary; by allowing sufficient time for such measures to be fully consulted and developed; and in ensuring that comprehensive cost-benefit analysis is undertaken with respect to proposals.

Chapter 2: Stability and resilience of the financial system

Stress Testing

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?

RBS broadly agrees with the comments made in this section of the consultation and the areas identified for further work in terms of stress testing and risk management. In taking forward further work on stress testing, however, the authorities should:

- be transparent as regards their risk appetite and avoid any over-reaction (since anything can be stress-tested to destruction, the more difficult assessment is what an acceptable level of failure is);
- avoid an excessive focus on recent market events (the next crisis may well be different), and sole reliance on standardised stress tests (these may miss the particular vulnerabilities of a bank's balance sheet); and
- distinguish clearly between stress events that require more liquidity as opposed to those which might lead to the need for more capital. The latter may take time to emerge and will not necessarily result in a firm being unable to continue trading, at least in the near term. On the other hand, no amount of capital will in itself cover a liquidity crisis.

It should also be recognised that firms are already responding to market developments and strengthening where necessary their risk management, as well as adjusting their risk appetite. Moreover, firms have been affected by recent market events to varying degrees – not all firms operated weak business models and poor risk management practices.

Liquidity Requirements

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

RBS has responded separately in detail to the FSA on its liquidity discussion paper (DP 07/7).

In summary, RBS believes the status-quo is unsatisfactory, for the following reasons:

- the multiplicity of quite different national regimes increases inefficiencies for international banks and adds to systemic risks (for instance by trapping local pools of surplus liquidity);
- many quantitative regimes represent poor measures of liquidity risk, are over-prescriptive and/or are over-conservative;
- all regimes have a national (not international) focus, and restrict the ability of international banking groups to operate their liquidity risk management in an integrated manner.

RBS further believes that FSA, in revisiting its own liquidity regime, should:

- coordinate its response internationally, to avoid further divergence in national regimes;
- adopt a principles-based approach, setting out core requirements focused on risk management principles and internal-based measures of liquidity, rather than prescriptive 'one-size fits all' quantitative measures;
- ensure a holistic review of relevant regulatory requirements, that takes into account the impact of large exposure and capital rules (as well as liquidity regulations), in restricting the ability of groups to operate an integrated approach to liquidity risk management.

In short, RBS welcomes the FSA's review of its liquidity rules, but considers that this does not go far enough in updating the existing regime, nor addresses all relevant issues.

Accounting and valuation of structured products

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

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

RBS is broadly supportive of the actions specified, aimed at ensuring consistent valuations in line with accounting and regulatory standards, and adequate disclosure of valuation methodologies and uncertainties. In taking forward this work, however, the authorities should:

- ensure that such measures are coordinated internationally, to avoid competitive distortions being introduced – in particular, care should be taken to ensure that measures are not introduced in the EU that might act as a disincentive for structured finance issuance to take place, relative to other markets such as in the US;

- recognise the economic and risk management benefits of securitisations, and not seek to restrict such markets – inadvertently or otherwise – through limiting innovation; and
- avoid an undifferentiated approach with regards to structured finance, which fails to recognise that there is already a significant degree of transparency and disclosure with respect to major parts of the market.

Credit Ratings Agencies

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

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

2.8) Do you agree with the Authorities that the preferred approach to restoring confidence in ratings of structured products is through market action and, where appropriate, changes to the IOSCO Code of Conduct on Credit Rating Agencies?

We believe that the authorities have correctly identified the main issues: the independence of credit rating agencies ('CRA'), the quality and transparency of methodologies and ratings, and investor use of ratings. Nevertheless, it is important that we avoid a disproportionate response that has the unintended consequence of undermining investor confidence and the recovery of the market, or indeed deterring new rating agencies from entering the market.

In our view, the transparency of methodologies and ratings is the critical issue. It should be noted that there is already quite a high degree of transparency of rating models. In recent years, the CRAs have taken significant steps to improve the transparency of their ratings, through issuing more papers on methodology, showing the detailed calculation of key ratios and by making their own in-house models more accessible to users. We would support further steps to improve transparency, but any such steps should apply to ratings for all products.

It would be unwise to adopt different ratings for structured products. Likewise, we believe that any sort of "health warning" for all structured products would represent a generalisation inconsistent with the proven historical performance of the majority of structured finance ratings. Indeed, structured finance has historically exhibited a relatively stable performance. Moody's January 2007 publication "Structured Finance Rating Transitions: 1983-2006" identified that over a 22 year period (1984-2006) Global Structured Finance ratings exhibited greater stability (91.95%) compared with the Global Corporate Finance ratings (77.86%).

It would be misguided, in our opinion, to base proposals for the rating of structured products solely on an eight month period of increased volatility in a narrow area of structured finance without having recourse to the historical performance of the wider market. In addition, any distinction between structured finance ratings and corporate ratings, either through the use of a different rating scale or the addition of a modifier, would cast doubt on the validity of historical ratings or further undermine market and investor confidence.

Nevertheless, we accept that steps should be taken to ensure greater transparency of ratings generally and support the majority of the proposals of the BoE to improve the information content of credit ratings. We agree that CRAs should publish information on the expected loss distributions of structured products, to illustrate the tail risks around them. However, consideration should be given to how this is performed. In particular, this proposal would only seem to make sense if done on a deal by deal basis. Equally, we support the suggestion that CRAs should provide a summary of the information provided by originators

of structured products, as long as any such summary does not result in the publication of non-public information.

We have some reservations regarding the suggestion that CRAs should produce explicit probability ranges for their scores on probability default: ratings are a relative scale rather than a straight assignment of a probability of default. In any event, the CRAs already produce historical statistical studies of default experience which illustrates a historical range for each rating category. We would support the development of separate measurements for products on dimensions other than credit risk, especially volatility, but once again, we are strongly of the opinion that this would only be constructive if it was applied across all ratings and not limited to structured finance.

As regards "scoring definitions" we understand that Fitch and S&P use the same rating scales, which is logical given that both rating agencies rate to *probability of default*. Moody's use a different rating scale because they rate to *loss given default*. Ultimately, this matter relates to investor awareness. We support efforts to ensure that market participants are well informed in order to prevent over-reliance on credit ratings. It is vital that investors understand the meaning and purpose of ratings and undertake sufficient due diligence in order to understand risk.

Regardless of whether a regulatory or self regulatory approach is adopted, there is a need for careful analysis of the appropriate response to recent market volatility. Premature conclusions and proposals should be avoided. In any event, we believe that the self regulatory model, which has been in operation for only a relatively short period of time, should be given sufficient time to bed down and be further developed.

Transparency of banks and exposure to off-balance sheet vehicles

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

No. Having identified in paragraph 2.66 the need for both capital and liquidity to be considered in looking at prudential measures, the paper has then focused in this section on capital needed to support the credit risk of off-balance sheet vehicles. However, it is the liquidity commitment provided by certain banks to their vehicles which has proved to be the key issue in recent months. The ability of such vehicles to issue paper to fund themselves relies on the liquidity line and/or perceived liquidity support from their sponsoring bank. Any such review needs to recognise that capital cover is no substitute for liquidity cover.

Furthermore, when considering off-balance sheet vehicles, the authorities need to distinguish between different types of securitisation structures, off-balance sheet vehicles and, indeed, variations in the quality of risk management by banks. The analysis in this section of the paper makes too many generalisations in this respect. For instance, ABCP vehicles sponsored by RBS are already consolidated under IFRS and disclosed, and all conduit liquidity commitments are an integral part of the Group's liquidity planning. The Group is also fully cognisant of the FSA's 'implicit support' rules.

Moreover, any review of regulation in this area should also recognise that securitisation has operated for many years and has brought with it significant economic benefits in terms of diversification of funding sources and greater flexibility in risk management and retention. A carefully calibrated response will be needed, if inadvertent damage is to be avoided.

Finally, we would also note that although the introduction of Basel II was intended to provide consistent rules and guidance throughout, the difficulties of introducing a consistent regime within securitisation have not yet provided convergence, neither with regard to detailed rules, nor with regard to principles for originators.

Chapter 3: Reducing the likelihood of a bank failing

Regulatory interventions
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?

RBS does not believe that a convincing case is made in the consultation that the FSA's supervisory powers are deficient, as far as preventing bank failures is concerned. (Powers to deal with a failing bank are a separate matter and dealt with below, in response to the questions dealing with the Special Resolution Regime.)

As the consultation itself acknowledges, the FSA already has extensive supervisory powers, including the power to remove directors and senior management, and to direct firms to undertake specified courses of action. The consultation does refer to practical problems in implementing OIVOP powers, but without clearly stating what these might be, or examining more widely the extent to which the FSA truly lacks sufficient powers.

A more pertinent issue in RBS' view is the effectiveness with which existing powers are used. This aspect is not given sufficient attention in the consultation, although the FSA's own review into the events surrounding Northern Rock is briefly mentioned. A key question in this respect is why existing powers weren't used more forcibly, in addressing concerns over the business model of the bank.

As regards proposals for new rules requiring banks to provide additional information at short notice, the consultation provides no evidence to back the need for such powers, and RBS is not convinced that these are necessary. Nor have we seen anything to suggest that a lack of such rules was a relevant lesson to be learnt from recent events.

FSA already has wide powers to request information from firms (including statutory powers contained in Part XI of the Financial Services and Markets Act 2000), and firms are required to be open and cooperative with the FSA under the Principles for Businesses (ref. PRIN 2.1.1R). Moreover, there is already an existing mechanism for requesting information in cases of market disturbances, through the 'Factbooks' mechanism (which currently applies to a sub-set of banks).

A more relevant issue to be examined in this area, in our view, is the extent to which information is fully utilised by FSA and acted upon (a point identified in the FSA's own internal audit report on Northern Rock); and the need to review reporting requirements and processes, in order to make it easier for institutions to report to FSA and reduce duplicative reporting obligations.

If new rules are brought forward, and additional reporting imposed, then we would suggest that these make use to the extent possible of banks' own internal reports. This will help minimise additional costs to institutions. Where internal reports are not used and standardised information across banks is requested on an ad-hoc basis, then it has to be recognised that there will be a trade-off in terms of how soon information can be provided and its conformance with the specific requirements of the request.

In the absence of any detail on the proposals, it is impossible to answer the cost impacts of the proposed new rules, nor how effective they would be in identifying a sudden deterioration in a firm's finances. The latter, of course, will depend not only on the type of information collected and its timeliness, but also how quickly and effectively it is analysed and acted upon within FSA.

RBS believes the FSA should be able to share information across the tripartite authorities. However, it is likely to be of a commercially sensitive nature, and will therefore need to be protected from being released into the public domain, under Freedom of Information legislation.

Oversight of payment systems

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?

Although RBS has no fundamental objection to the principle of a new regulatory framework, we are keen to understand how a move to "formal powers" would impact on the current arrangements which - notwithstanding the commentary in Paragraph 3.31 – we believe works well. RBS is certainly not aware of any significant concerns having been raised in this respect, and there has been no suggestion that payment problems were a factor in the Northern Rock crisis.

RBS would wish a new framework to introduce as few changes as possible in terms of new rules, to minimise the potential for disruptive change. Consideration would also need to be given to the basis of regulation, i.e. would payment schemes (of which there are many - some handling very small volumes) be dealt with on an individual basis, or will it be those organisations that run schemes (e.g. BPSL, CHAPS Company) that are regulated?

RBS would also not wish the role of the Payments Council to be undermined in any way as a result of these changes.

Finally, we would caution against splitting regulatory responsibility between the FSA and the BoE, because of the potential for regulatory duplication/confusion that this might entail. If, on balance, it is decided to give responsibility to a single regulator, we would recommend that the BoE retains this role - both as a reflection of its existing experience in this respect,

and a recognition that payment systems oversight is widely viewed as a central bank responsibility (i.e. potentially making it difficult for the BoE to disengage completely).

Liquidity assistance and disclosure

3.8) To what extent is the current provision to register charges at Companies House relevant to banks? Do you agree that it is appropriate to amend it?
3.9) Should any exemption for banks only apply to receipt of ELA, or should there be a more general exemption for all types of lending?
3.10) Would extending the 21-day period be a viable, alternative proposition?
3.11) What would be the effect of removing the 'weekly return' reporting requirement? What other statutory reporting requirements disclose ELA?

Whilst the questions raised in this section are relevant, the wider question which this section fails to address is the need for more generalised access to liquidity in times of systemic stress, such as those currently being experienced. As emphasised in our introductory remarks above, RBS believes that much greater attention needs to be focused on the issue of the BoE's money market operations, including recognition of the need for term lending under certain circumstances, policy on acceptable collateral, and aligning these with the approaches of other key central banks.

Re-labelling 'Lender of Last Resort' as an 'Emergency Liquidity Facility' will not by itself address the problem of stigma, whilst there are limits – as discussed in the consultation – on the extent to which disclosure of ELA may be delayed. In contrast, the more liquidity provision is made available, the less stigma would be attached to institutions availing themselves of central bank facilities. The issue of moral hazard can be addressed through a system of applying progressively penal rates for lower quality collateral.

Although the Companies House registration regime has only limited relevance to the inter-bank or capital markets, we would nonetheless support its dis-application as a means of reducing any deterrent to the lodging of a wider range of collateral with the BoE. The dis-application should apply to the granting of all collateral to the BoE, not just with respect to the receipt of Emergency Liquidity Assistance.

Protection for the Bank of England

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?

RBS believes the statutory immunity proposed would be appropriate, subject to the usual safeguards (such as acting in good faith). Such immunity would bring the BoE into line with that enjoyed by FSA and FSCS in relation to their responsibilities under FSMA.

As regards enhancing provisions that insulate collateral provided to the BoE from the effects of insolvency, RBS also believes this would be appropriate. Where the BoE provides

emergency funding as part of its responsibilities to ensure the continuing stability of the financial system in the UK, any collateral that the BoE obtains from a financial institution in consideration of that emergency funding should as a matter of public policy be fully effective, up to the market value of that collateral, if the BoE is ever required to rely on that collateral. This should not however discharge the BoE from its responsibilities to take all proper steps to ensure that its security is effective under all applicable laws.

Access by building societies to liquidity assistance
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?

RBS has no specific comment to make on these questions, beyond accepting the need for building societies to be also able to access BoE funding, as a means of limiting systemic risks in a crisis situation.

Chapter 4: Reducing the impact of a failing bank

Special Resolution Regime
Trigger and process for the special resolution regime
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?
4.5) Do you agree that the potential abridgement of property rights in the special resolution regime can, in principle, be justified with a suitable public interest test?
4.6) What safeguards and appeal processes would be needed to support a public interest test for the special resolution regime?

RBS supports the principle of a Special Resolution Regime ('SRR'), as a set of additional tools available to the authorities for dealing with a failing bank in a more orderly manner than might be possible under an early liquidation. However, we would stress that the issues involved are highly complex: proposed legislation will need to be very carefully thought out with due regard to the balance of interest between different stakeholders, notably creditors and shareholders, and interaction with existing legislation.

For this reason, our strong preference would be to allow time to develop new legislation, rather than rush to introduce a bill in the early summer: mistakes in legislation could have serious consequences for the reputation of the UK as an international financial centre. Failing that, RBS would encourage the government to consider ways in which industry and other expert opinion could be involved as early as possible in the development of draft legislation.

As also pointed out in our introductory remarks, RBS further believes the consultation should have placed greater weight on preventing bank failures (as opposed to dealing with the consequences of a bank failure through the SRR or Financial Services Compensation Scheme). The FSA currently has far reaching supervisory and enforcement powers, yet no consideration has been given as to how these could be used more effectively.

The consultation is unclear as to exactly when use of SRR powers would be envisaged, and this uncertainty fuels many of the concerns expressed around shareholder rights. In our view, SRR powers should only be used when a bank is judged to be about to fail, as a means of ensuring a more orderly resolution of a failed bank than would be possible by the triggering of insolvency proceedings. SRR powers should not, in our view, be used to intervene at an earlier stage, as a way of turning around a failing bank. (Besides the heightened concerns over shareholder rights that early intervention poses, knowledge that a bank was being subject to the SRR would of course increase pressures on the failing bank, probably making such a turn-around impossible in any event.)

RBS therefore believes that the trigger for a bank entering a SRR should be based on a judgement exercised by the Tripartite Authorities, namely that the bank is about to fail and that use of the SRR would be preferable to the alternative of insolvency proceedings. This judgment should be supported by a clear set of necessary but not sufficient conditions as trigger points (such as liquidity and capital) – the authorities should always have the option not to invoke SRR powers.

Given the practical impossibility of unwinding SRR tools once triggered, their exercise should be based on stringent internal governance processes (whilst allowing for rapid action when needed). For instance, a recommendation for use of SRR tools might be made by the tripartite authorities, upon recommendation by the Board of the FSA.

New SRR tools – directed transfers

4.7) Do you agree that the Authorities should have the power to direct a sale of a bank possibly against the wishes of the directors or shareholders?

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

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

The recent legislation which enabled the government to place the Northern Rock Building Society into public ownership largely supersedes question 4.7; however, we accept that there may be limited circumstances where it is necessary to direct the sale of a bank, possibly against the wishes of directors or shareholders, and that the authorities therefore should have such powers.

However, such powers should be carefully framed, notably to facilitate the take-over of a failing bank by a healthy entity, rather than the partial sale of a bank's business. Partial transfers would raise questions about preference, and existing creditor rankings being disturbed (to the possible detriment of the City as an international financial centre).

We would support judicial review as one means of challenging decisions to instigate directed transfer. However, given its inherent limitations in terms of scope, other avenues should be available to challenge the substance of a decision, and not just the way a decision has been

reached. As mentioned above, strong governance arrangements should also be put in place to control the exercise of SRR tools.

We have various reservations about the Financial Services Market Tribunal (FSMT) being the right forum to resolve transactional issues. This body was put in place under FSMA to provide governance and accountability around FSA decisions, and has no locus vis-à-vis the Bank of England or the Treasury.

New SRR tools – bridge bank

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?

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

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

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

RBS supports the principle of the authorities having bridge bank powers – as noted in the consultation, there is precedent internationally for such powers. RBS agrees that some flexibility in the description of the circumstances is also desirable - the decision to invoke a bridge bank arrangement will require careful judgement by the authorities in the light of prevailing market conditions and the exact circumstances of the bank or building society in question. A bridge bank may well work for a predominantly UK-based institution, but not for a global organisation with international banking licences and brands.

We agree with the removal of shareholders' and directors' rights, and temporary suspension of creditors' rights, providing these powers are used just prior to a bank failing (as discussed above), and providing creditor rankings are not disturbed.

New SRR tools – bank insolvency procedure

4.14) Should a new bank insolvency procedure be introduced for banks and building societies as an option for the Authorities instead of normal insolvency procedures?

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

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

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

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

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

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

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?

RBS is not convinced of the need for a specific bank insolvency procedure as outlined in the consultation document. The proposals are unclear as to what weaknesses in existing procedures they are trying to address (beyond the absence of an explicit obligation on the insolvency practitioner to work with the FSCS), nor do they analyse the extent to which there are genuine problems requiring a change to established insolvency law and practice.

The concern is that any new regime would introduce uncertainty, which could act as a deterrent to investment in the UK banking system and discourage creditors from entering into contracts with UK banks. Of particular concern is the suggestion (paragraph 4.37) that the statutory objective of the insolvency practitioner to manage a bank resolution in a way that best satisfies the interests of creditors as a whole, should be subordinate to the 'principal objective' of facilitating rapid payments to depositors.

Any changes should neither prejudice non-depositors nor alter creditor rankings. Nor do we see how a failed bank could continue trading, post-insolvency, without changing relative outcomes for creditors. (On the other hand, as discussed below under Chapter 5, it ought to be possible for early compensation payouts to depositors to be effected by the failed bank, though in such instances the FSCS should make good any shortfall in future recoveries, so as not to prejudice other creditors.)

We have significant concerns over the practicality of a 14-day notice period for invoking insolvency procedures. It is doubtful whether this could be made to work in overseas jurisdictions, and there would always be the risk of certain creditors being adversely affected (e.g. through depositors withdrawing funds during the 14-day period).

Finally, we do not believe that the level of protection afforded by the FSCS should be diluted by making it pay for any additional costs associated with the insolvency regime, as suggested. The costs of the insolvency proceedings should be met through the assets of the failed bank.

Governance and operation of the special resolution regime

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

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

4.24) Do you have any comments on the specific implications for shareholders, creditors or directors from the appointment of the restructuring officer over and above those already raised by the other resolution tools?

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?

Subject to the comments already raised above regarding implications of the SRR for creditor and shareholder rights, RBS supports the idea of a restructuring officer, as part of the range of tools available under the SRR. This would provide the authorities with greater control,

provide leadership for the financial institution in question and, if sufficiently independent, provide an objective view of the best resolution for the firm.

RBS also supports the government having the power to take temporary ownership of a failing bank, as there may be circumstances (e.g. the failure of one of the largest banks) when this would be the least bad option available. These powers should be exercisable based on a judgment of the authorities supported by quantifiable triggers, as outlined above in response to Question 4.2.

Resolution of Building Societies and Mutuals
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 along 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 liabilities are applied equally to creditors and members?

RBS has no specific comment to make on these questions, beyond accepting the need for the special resolution regime to be extended to building societies (but not other mutuals), as the failure of one or more of these might potentially have wider systemic implications that require use of SRR tools, as opposed to immediate liquidation.

Funding the special resolution regime
4.31) Should the industry contribute to the costs of a SRR?
4.32) Would mechanisms other than the FSCS be appropriate for addressing such cost issues? How might such mechanisms work?

Where the SRR, in whichever format is most appropriate for the circumstances, has been deployed to assist an ailing bank, then the cost of this should be borne by the bank and its shareholders to the extent possible. In certain circumstances (e.g. temporary nationalisation of a failed bank, requiring liquidity or capital), then additional costs might need to be borne by the taxpayer. The level of protection afforded by the FSCS should not be diluted by loading SRR costs onto it.

Agency banks

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 organization and structure are compatible with the tools proposed in the special resolution regime

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The key to this question lies in the industry sorting code process, which enables payments to be directed to the correct branch of the receiving bank. This involves maintaining a comprehensive database of payments-related information for UK banks and building societies, which contains information about all bank offices or branches involved in any of the UK clearing systems: Bacs, the Faster Payments Service, CHAPS, and Cheque and Credit Clearings. The Industry Sorting Code Directory (ISCD) holds details such as sorting code, BIC, branch title, postal addresses, telephone number and notes which clearings each bank office participates in. The ISCD is maintained centrally on behalf of the payments industry by VocaLink.

Whilst it takes only a few days to update the ISCD (i.e. if Agency Bank A was sponsored into a particular clearing by Sponsoring Bank B, and the latter was to fail, the ISCD could be updated to recognise a new sponsor relatively quickly), the underlying clearing processes can take considerably longer to amend. This is particularly the case if the agency bank in question participates in the Cheque and Credit Clearing, where the physical clearing process is undertaken on the basis of the first two digits of the Sort Code. Whether it would be possible to put in place some form of robust "emergency" arrangement would need to be the subject of further work - probably via a Working Group comprised of banks and the various clearing companies.

Agency banks should have contingency plans to switch payment providers and systems. These plans should be reviewed by FSA as part of its normal prudential supervision.

Financial collateral arrangements

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?

The consultation is not clear what the authorities' concerns are regarding the existing financial collateral regime, and what it might propose legislating.

Chapter 5: Consumer confidence and compensation arrangements

Introductory Comments

Whilst supportive of efforts aimed at improving confidence in deposit protection arrangements, RBS believes it important to acknowledge that:

(i) deposit protection schemes cannot prevent by themselves a troubled bank failing – at best they can only slow the withdrawal of its funding; and
(ii) deposit protection schemes do not provide policymakers with a realistic option of liquidating a medium or large-sized bank – in such cases, other ways of resolving a failing bank must be sought.

It is impossible of course to guarantee all deposits, at reasonable cost and without inducing unacceptable levels of moral hazard. It is also debatable whether insured depositors would react with equanimity to news that their bank was about to fail, instead of trying to pre-empt any potential costs – however remote – by trying to withdraw their funds.

Consequently, deposit schemes might instil a certain level of general confidence in a banking system, and prevent insured depositors from over-reacting to negative news affecting their bank. But once the perception sets in that a bank might indeed fail, insured as well as uninsured depositors are likely to seek to withdraw their funds from the institution concerned.

Furthermore, RBS is sceptical that the Northern Rock crisis demonstrated weaknesses in the Financial Services Compensation Scheme ('FSCS') arrangements in force at the time. Rather, survey evidence suggests that there was actually a very low level of awareness of the FSCS. Given this evidence, the only thing that can be deduced with certainty is that concerns over the actual scheme in place were not the primary cause of the bank run.

Regarding point (ii) above, the consultation paper places a great deal of emphasis on speeding up compensation payments, for instance through speeding up the provision of customer data and simplifying the definition of insured deposits. It does not, however, consider the operational capacities of the FSCS or of the banking system relevant to this objective, and their ability to cope with different sizes of failure; nor does it consider the systemic consequences of liquidating a bank.

In fact, RBS believes that even if customer data could be quickly extracted from a failed bank, promptly processed and compensation payments issued, that capacity constraints in the banking system would prevent affected depositors being able to open new accounts in the time frame contemplated, in the case of anything other than a small bank failure. Moreover, simply liquidating a medium or large scale bank failure would clearly have major ramifications, in terms of market confidence and its wider economic impact.

Consequently, given the above, we are very concerned that the consultation:

(i) focuses disproportionate attention on deposit protection, relative to the notion of preventing bank failures in the first place – particularly given the structure of the UK's banking sector, where the top 10-15 institutions account for the bulk of the deposit market;

(ii) gives insufficient recognition to the limits on what can reasonably be achieved in this area, and hence the likely benefits, whilst it under-estimates the likely costs of some of the mooted changes; and

(iii) fails to acknowledge that in some circumstances, other solutions (such as utilisation of the tools identified under the Special Resolution Regime proposals), are the only realistic mechanisms for dealing with a failed bank.

Specifically, we do not believe that the stated objective of guaranteeing compensation payments within a week is achievable as a general objective, applicable in all cases. Nor do we believe that it would be reasonable to impose significant costs on the industry (such as a single customer view and pre-funding) in order to develop capacities that would still fail to achieve the stated objective of faster payouts in the case of a failure of any significant scale, and would in any case prove irrelevant as an option for the systemic and other reasons mentioned above.

We do support, however, the principle of simplifying existing arrangements, in order to improve current pay-out times, and suggest some alternative ways in which this might be done (through a possible move to gross payments and providing depositors of a failed bank continued access to funds, notably through ATMs). We also support the idea of promoting greater awareness of the FSCS, providing this is done in a sensitive manner, i.e. in a way which doesn't fuel concerns about the financial stability of deposit takers (given current market uncertainties).

Finally, we would suggest that a differentiated approach is required, with the tripartite authorities planning confidential contingency arrangements for each bank, or group of similar banks, identifying how each might be dealt with in case of failure. These plans should identify when allowing a liquidation to occur might be sensible, and when alternative mechanisms (such as use of the Special Resolution Regime tools) would be more appropriate.

Compensation limit and coverage

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?

RBS does not believe that there is a strong case for increasing the existing compensation limit of £35,000, given that this already covers some 96% of retail depositors, and places the UK in the top third of developed economies in terms of level of protection. Raising the limit would increase the potential liabilities of the FSCS, with only a limited impact in terms of increasing the number of depositors covered (a £50,000 limit, for instance, would only increase the coverage of depositors to an estimated 98%).

Furthermore, raising the limit may:

(i) distort competition between deposits and other products (unless protection limits on other products are also raised);

(ii) reduce incentives for qualifying depositors with large amounts of money to spread those funds across different institutions, and thus increase depositors' concentration of risk to individual institutions; and

(iii) increase the number of depositors seeking higher deposit interest rates, regardless of the risk of the deposit-taker (i.e. moral hazard risk).

In addition, the dropping of co-insurance last autumn already represents a significant increase in the level of protection offered since the run on Northern Rock. On balance RBS supports this move (notwithstanding the increase in potential FSCS funding liabilities for financial institutions), as a means of bolstering depositor confidence. But moral hazard considerations cannot be ignored - co-insurance was introduced in the UK, after all, in response to an earlier supervisory incident (i.e. BCCI) – and the authorities should reflect carefully before further increasing the protection offered.

Coverage of balances above the compensation limit

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

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

5.6) Are there other circumstances, apart from client accounts, where consumers have little influence on where accounts are opened? What are your views on how the issue of client accounts might be addressed in relation to compensation payments?

RBS does not believe that it should be the responsibility of the FSCS to provide protection for the type of transactions referred to; rather, the purpose of the FSCS is to provide a base level of protection for individual depositors. RBS believes that better consumer education regarding FSCS coverage should be the approach here, so as to encourage depositors to manage their affairs in a prudent manner, by spreading their deposits.

In terms of the options presented, given the occasional and temporary nature of the transactions referred to, and thus the limited risks posed to consumers, we do not believe they warrant the additional costs and complications of special FSCS limits to accommodate them. The additional complexity this would require would have significant systems and operational consequences for banks, in terms of identifying these amounts and communicating FSCS coverage to customers. The additional complexity would also hinder the objective of facilitating greater consumer understanding of the FSCS and achieving faster payouts.

The option of getting depositors to spread such balances around several accounts at point of receipt is not realistic either, given the short-term nature of most of these balances, and the operational complications for life insurance companies and law firms to arrange multiple payments with respect to a single transaction such as a pension lump sum.

If the authorities nonetheless wish to pursue one of their options, RBS' preference would therefore be to investigate a private sector insurance solution for the types of balances mentioned, with depositors offered temporary insurance to cover 'life event' amounts ending up in deposit accounts. (Other large balances that might be considered include compensation and redundancy payments.)

Such cover does not, as far as we are aware, exist in the market at present and we are unsure if the market would have the capacity, or the will, to offer it – particularly given current market uncertainties. Technically, though, cover could be constructed, with premiums

dependent on the amount of protection offered and the credit quality of the bank concerned. Deductibles could be applied to limit moral hazard (thus reducing incentives to deposit with banks offering the highest rates, irrespective of credit quality). Insurers would, for obvious reasons, not be allowed to insure deposits held by banks within the same financial services group.

There would be challenges in pricing, given the nature of the risk (low frequency but high severity events), and thought would need to be given as to how such arrangements could be structured such that problems in the banking sector would not in turn spill-over to the insurance sector.

Faster compensation payment
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?

RBS does not believe that the one-week target is a realistic objective in all cases. Even if the problems associated with early access to information could be resolved (see below), the consultation ignores the issue of the FSCS's capacity to process that information and issue payment. It also ignores the capacity of other banks in the system to open new accounts for depositors of the failed bank.

As outlined in our introductory remarks to Chapter 5 above, a significant weakness in this part of the consultation is its failure to recognise the consequences of scale in any banking failure. The consultation proposals assume that objectives such as a one week payout should be achievable in all cases, even in the case of a large bank (paragraph 5.52 explicitly refers to facilitating rapid payments with respect to a 'medium or large bank'). Yet there are massive differences between the operational and other implications of liquidating a small bank and triggering the FSCS, and contemplating the same in the case of a medium or large scale institution.

The liquidation of a medium or large scale bank would in fact imply the opening of anything between 3 million to 20 million or more new accounts.[1] This is many times the potential capacity of the banking system to open new accounts during the 1-week time scale proposed in the consultation, and it would be patently unreasonable to expect commercial organisations to build up such a level of surplus capacity. A separate confidential annex to this submission explores these operational constraints in detail by summarising RBS group's capacity to open new accounts.

Besides the banking system, there are also likely to be constraints of a similar nature with respect to other key parties, which may be more or less relevant depending on the precise arrangements contemplated, but which in any event cannot be ignored (as seems to have been done in the consultation). These parties include the Post Office, and its capacity to deal with a sudden spike in mail volumes; the ability of utility and other companies to update

[1] The smaller number represents accounts held with the UK's 13th largest bank by market capitalisation. RBS Group has some 19.6 million accounts.

their Direct Debit records sufficiently quickly; and, as mentioned already, the FSCS, and its ability to process insured depositors' details and effect payment in the compressed time-scales suggested.

Besides these major operational constraints, liquidating a larger institution would of course incur wider systemic and economic costs. Such a failure would almost certainly add to any existing panic, which would vividly be illustrated with potentially several million customers queuing in streets trying to open new accounts in other banks in the space of a few days. Other financial institutions would be threatened, as a result of inter-bank exposures and the further undermining of general confidence in the banking system. And there would be some direct short-term economic consequences through the sudden curtailment of credit and termination of employment of a large workforce.

Given the above, RBS strongly believes that the initial starting point must be implicit recognition that the quick transfer of a large customer base to new accounts and early payouts to depositors is not a realistic possibility in the case of larger institutions, and that in these instances other solutions must be sought.

This is not the same as saying that certain institutions are 'too large to fail': we clearly recognise the need to limit moral hazard risk with respect to banks (just as we argue for the need to consider moral hazard with respect to the level of depositor protection offered). The other solutions contemplated would be use of the special resolution tools, which effectively allow a bank to fail in a more controlled manner, and under which shareholders and managers would in any event suffer.

In deciding where to draw the line (between smaller and larger institutions), a bank's customer base, relative to the remaining capacity within the banking system to open new accounts within a certain time-frame (e.g. 1 month), should be a key consideration.

Notwithstanding the above, RBS does support exploring ways of improving the FSCS, for cases when letting a bank fail <u>is</u> a reasonable option – the slowness of the current payout process and the inability to access funds once a bank fails both undermine the credibility of the existing scheme. As well as supporting ways of improving pay-out speeds, RBS also supports exploration of how interim payments might be paid, to minimise depositor hardship.

Operationally, processing speeds would be greatly facilitated by using the failed bank's existing infrastructure, to access data and effect payments. This would minimise the FSCS' operational constraints; it would also reduce the difficulties of extracting data from the failed bank's system and transmitting it to the FSCS (or other third party).

In using the failed bank's existing infrastructure, however, it is critically important in our view (as argued in the context of Chapter 4 above), that creditor priorities are not disturbed. This should be done by ensuring that the FSCS would owe the failed bank's estate any amounts paid out by the bank to depositors, out of its own funds, on behalf of the FSCS (either as partial interim or full compensation payments).

If it is accepted that a bank failure/payouts would only be triggered in the case of a smaller bank, i.e. within the capacity of rest of the system to open new accounts, then it would be possible to envisage basic bank accounts (e.g. with no overdraft facility, pending more detailed KYC and credit checks to be undertaken later), being opened within a relatively short period of time. Regulation would need to be amended to allow banks to open such accounts pending later completion of such checks. (Many banks, RBS included, would not wish to rely permanently on any checks undertaken by the failed bank, for risk management reasons.)

Pending the opening of new accounts by depositors of the failed institution, RBS would suggest focusing on how continued access to depositors' funds could be maintained through the banking system's existing networks and systems, rather than through new processes. This is likely to the most efficient way of ensuring such access.

One possibility might be to allow depositors of the failed institution to be able to continue accessing their funds through ATM machines for a specified period of time (e.g. one month). Withdrawals would be limited to positive balances held on accounts, subject to daily limits, and capped in aggregate at the maximum level of protection set by the FSCS. Amounts paid out in such a way would be reimbursable by the FSCS (even if withdrawn from ATMs operated by the failed bank, so that withdrawals do not impact creditor rankings in a liquidation); they would also be set off against any final amounts owing to depositors by the FSCS.

Such a system would ensure continued access to cash whilst depositors opened accounts with new providers in an orderly manner, thereby reducing the risk of panic and addressing the emergency liquidity needs of depositors. It would also give more time for the FSCS to process compensation claims and make any remaining compensation payments owing.

Consideration would need to be given as to whether and how depositors without plastic cards might access cash during this transition window – one solution here might be to enable over the counter withdrawals from the failed bank's branches, where staff have access to a customer's details and balances (again, with payments made being reimbursable by the FSCS).

Such an approach would require a shift to gross rather than net payouts under the FSCS - this is addressed further below.

Early access to information

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?

Although hard to quantify exactly – given the lack of detailed specifications in the consultation - RBS believes that the cost of achieving the sort of 'single customer view' that seems to be envisaged would be significant. We estimate that it would require systems work that would run into the many millions of pounds and take between 1-2 years to implement. Such work would also imply opportunity costs, in terms of other systems developments being postponed.

Although RBS currently pulls together a certain amount of data relevant to 'single customer view', this is done by brand (rather than by legal entity, or across the group as a whole), and is designed to provide information in a sales and servicing context, on a customer by customer basis, rather than a mass download of information for exporting into other databases.

RBS would question the value of imposing such costs on the industry to deal with low probability events, when a single customer view capacity (as argued above) would in any

event be irrelevant in the case of a significant bank failure, and when other solutions (such as the ATM access referred to above) would address the objective of minimising disruption to customers.

Eligibility
5.14) How would banks place a flag on accounts that are not eligible for FSCS payments?
5.15) Are there other classes of depositor that should be ineligible for FSCS compensation payments, and, if so, why?

In principle, placing flags on accounts that are not eligible for FSCS payments should be possible, providing these exclusions remain relatively straightforward – i.e. they allow data bases to be searched by certain objective criteria (e.g. names of a bank's own directors, deposits placed by other banks), without requiring significant human intervention. Flagging these accounts would allow the automatic access to funds suggested above (p. 21). There may be practical difficulties to overcome, e.g. in terms of maintaining these flags.

Regarding the proposed revisions to eligibility, RBS does not believe it appropriate that FSCS coverage be extended to protect deposits of large corporates, governments and the like. Any coverage provided would in any event be practically irrelevant, when compared to the size of deposits likely to be held by such entities. Moreover, such an extension would not necessarily simplify the process of FSCS reviewing eligibility, as there would need to be a process of aggregating multiple accounts held by corporate groups, governments etc, in order to compare against the FSCS limit.

Gross Payments
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?

RBS would potentially support a move to gross payments, as a means of encouraging greater depositor confidence in the FSCS – this would, as mentioned, help people's comprehension of the level of protection offered, avoid people facing a loss of liquidity through the application of set off, and facilitate speedier payouts. It would also allow – as discussed on p. 21 above – continued access to funds through, e.g., the ATM network.

Moving to gross payments would however represent an effective increase in the level of protection offered, as well as increase the rate at which FSCS resources would be drawn down – both additional reasons for not raising the £35,000 cap. Any payments working their way through the settlement system (e.g. cheques drawn by a depositor on their account), at the point of the bank's failure, would either need to be taken into account when calculating the gross amount payable, or else be refused (such that depositors would not effectively be preferred).

Moreover, any move to gross payments would need to be on the basis that depositors' obligations to the failed bank (e.g. amounts owing under mortgages) would not be affected, such that other creditors' rights would not be impacted. RBS believes the linkage made between FSCS payments with a proposed new insolvency regime for banks is confusing, and potentially counter-productive. FSCS payments should be viewed primarily as compensation payments, funded by the FSCS, rather than the outcome of a liquidation process representing the distribution of the net assets of the failed bank. As discussed above, with respect to Chapter 4 of the consultation, the two processes need to work to different time-scales, and the liquidation process needs to respect all creditor rights, without prioritising depositors.

De-coupling FSCS payments and the liquidation of the bank would allow faster payments to be made, and reduce pressures for the bank's assets to be quickly realised, with potentially harmful effects on their value. Clearly, once the liquidation process is eventually completed, then FSCS would receive any amounts owed to depositors, up to the amount of the compensation payments it had already made to depositors.

Streamlined claims process

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?

RBS would caution against complete removal of a formal claims process, given the risks of payments being misdirected. However, consideration should be given as to how the claims process should be modified to be made to work with new processes, such as the suggestion of maintaining a certain level of access to funds through ATMs (see p. 21 above) to work.

The mass use of cheques to effect payments increases risks of payments being mislaid or intercepted by criminals. These could be mitigated by allowing ATM withdrawals as suggested above, leaving cheques to be used for settlement of larger amounts / compensation payments due on non-ATM linked accounts.

FSCS funding and liquidity

5.21) What are your views on the introduction of an element of pre-funding into the FSCS?
5.22) What steps would need to be taken to ensure that pre-funding would be compatible with other elements of the FSCS funding arrangements?
5.23) What are your views on whether the FSCS should be permitted to borrow from the Government or the Bank of England?

In RBS' view, pre-funding would be costly and would bring no real advantages. It would tie up bank funds that could be used more productively elsewhere (for instance through the provision of credit to the private sector), with a consequent welfare loss. Indeed, building up a pot of sufficient size to deal with a major failure in a UK context would effectively require such a large amount of pre-funding as to represent a significant tax on the UK banking system. (In this regard, we would note that the CBA in the consultation underestimates the opportunity costs to banks, in our view, of pre-funding; whilst the £13bn pot suggested, even though it represents a massive increase in the FSCS' current funding, would still not have covered the deposit base of Northern Rock, for instance.)

Set against these costs, a pre-funded pot would in all probability never be of sufficient size to cope with all potential calls on the FSCS, and thus would never completely achieve its objective of strengthening consumer confidence in the ability of the scheme to meet its obligations. Indeed, it might weaken consumer confidence by making more apparent the discrepancy between the amount of any pre-funding and the amount of insured deposits. It is interesting to note here that confidence in the FDIC is not derived from its pre-funding (the size of its pot is tiny relatively to the quantum of insured deposits), but from the fact that it is guaranteed by the US government.

A better solution, in RBS' view, would be for the FSCS to be able to borrow funds (as suggested), pending payment of levies by the industry and the repayment of amounts owed to FSCS out of the estate of the failed bank, as part of the liquidation process.

Opening new accounts

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?

As discussed above, there are very real operational constraints on the number of accounts that can be opened across the banking system during a 1-week window, irrespective of whether streamlined procedures are applied. The 1-week standard is not a realistic target in anything other than the smallest of failures. Instead, RBS would suggest focusing on maintaining access to funds, e.g. through ATMs, which would allow a longer window for new accounts to be opened. In deciding whether a failed bank should be immediately liquidated or else subject to the special resolution regime, regard should be had to the capacity of the banking system to open new accounts.

Consumer awareness

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?

RBS supports the principle of improving consumer awareness of the FSCS. However, messaging should be carefully framed so as not to provoke concerns about the stability of the banking system.

A variety of channels should be considered (e.g. FSCS and FSA), as well as banks. As regards communications by banks, FSCS approved messaging could be included with statements, distributed through leaflets and included on websites. Non-static notification requirements, such as an obligation to notify individually a customer every time a deposit went above the FSCS limit, would however be burdensome, because of systems and process costs.

Protecting vulnerable consumers

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?

RBS would suggest investigation of pre-paid cards as an alternative, although distributing these could pose major operational challenges, depending on the scale of the failure concerned. (Again, as argued above, the use of special resolution regime tools – rather than immediate liquidation - would be the only realistic option for dealing with the failure of any significant scale, in our view.)

Increasing FCSC management flexibility

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?

Whilst supportive in principle of the need to allow FSCS flexibility to manage its operations effectively, safeguards will need to be retained to ensure that administration costs remain reasonable. Attempting to achieve full processing and payout of claims within a week of a failure may in fact prove extremely costly (and operationally impossible in the event of a failure of any significant scale).

Risk-based levies

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?

Whilst in principle in favour of the idea of risk-based levies, RBS would not wish this to lead to a parallel oversight regime, doubling up on FSA's supervision. Risk-based levies are more relevant, furthermore, in the context of a pre-funded scheme, which RBS does not support (as argued above).

Banknote issuance

The consultation document also proposes changes to the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland. These resurrect the proposals contained in a 2005 consultation paper, the results of which have never been formally published. We note that the current consultation paper does not provide any update on current Treasury thinking regarding a new regulatory framework, about which we have a number of concerns.

Nonetheless, we support the principal of protection for all of the notes in the hands of the public in the unlikely event that a note-issuing bank might fail. The industry is therefore currently in discussions with the Treasury and the Bank of England, and hopes to be able to develop a suitable and sustainable revised framework. This is on the basis that such a new framework remains proportionate, and that any changes are in pursuit of the principle of improving consumer protection, as set out in the consultation paper, rather than for any other unrelated, purposes.

Chapters 6 & 7: Strengthening the Bank of England & Effective coordination

Bank of England's objectives

6.1) What are the benefits of formalizing 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?

RBS supports the suggestion of formalising in statute the Bank's role in relation to financial stability, and giving the Court a formal role in overseeing the Bank's performance in this area. This would help clarify the extent of its responsibilities in this area, strengthen accountability, and encourage management focus and more resources to be devoted to stability issues. That said, RBS believes that leadership across the tripartite authorities with respect to dealing with a crisis impacting financial stability should rest with the Treasury (and specifically the Chancellor of the Exchequer), given the potential need for government funds in any bail out.

Governance of the Bank of England

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?

Whilst generally we welcome the proposals to clarify responsibilities and coordination between the tripartite authorities, there is no evidence that we are aware of as to how the Court was used in the Northern Rock crisis by the Governor. Before moving to a 'smaller, more effective Court', we would suggest that perhaps some reflection needs to be undertaken as to what the Court would be used for and whether it would serve any real purpose in another crisis situation.

Operational arrangements and the MoU

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

RBS does not believe that recent events demonstrated fundamental flaws in the design of the tripartite arrangements. Rather, they suggest potential weaknesses in execution and operational processes. Clarity around roles and responsibilities is essential in a crisis situation, as is effective information sharing. RBS therefore supports these proposals.

An early warning system for global financial risks
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?

RBS agrees that the efforts of the IMF and FSF should be coordinated, so as to enhance their effectiveness. Whilst this could lead to better identification of risks, the more difficult issue will obviously be to get sovereign countries and their authorities to act on issues, when identified. RBS would support the development of mechanisms for increasing interaction between the FSF and the financial services industry, and believes that this could be effected through existing groupings such as the European Financial Services Roundtable and the Institute for International Finance.

Managing cross-border crisis
7.4) To what extent will these proposals aid authorities in managing international financial crises?

RBS believes that practical, effective international supervisory cooperation – covering both 'business as usual' and stress situations – is essential. RBS supports these proposals, but believes that greater focus could be paid on developing these ideas further: they are given relatively little space in the consultation, yet potentially have a major role to play in the prevention of failures of cross-border institutions. RBS therefore notes and supports, in this respect, the Chancellor's subsequent initiative regarding supervisory colleges, which we believe to be a very positive first step in this context. Whilst the global dimension needs to be addressed, in addition to the EU context, this should not prevent supervisory cooperation and efficiencies from being taken further forward in Europe, where possible. In particular, we would emphasise the need to push forward on developing the lead supervisor model, as a means of driving effective regulatory coordination and efficiencies.