

Financial stability and depositor protection: strengthening the framework

- BBA response to the tripartite consultation document -

The British Bankers' Association (BBA) welcomes the opportunity to respond to the consultation paper '*Financial stability and depositor protection: strengthening the framework*' published jointly by HM Treasury, the Financial Services Authority and the Bank of England (the tripartite authorities).

The BBA is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

The proposals for reform are aimed at five objectives summarised as follows:

- Strengthening the stability and resilience of the financial system – in the UK and internationally;
- Reducing the likelihood of individual banks facing difficulties – including regulatory interventions and liquidity assistance;
- Reducing the impact if, nevertheless, a bank gets in to difficulties – including a new 'special resolution regime';
- Providing effective compensation arrangements in which customers have confidence; and
- Strengthening the Bank of England, and ensuring effective coordinated actions by authorities, both in the UK – including through reforms to the tripartite arrangements – and internationally.

The pursuit of these objectives involves a comprehensive and wide-ranging set of initiatives that collectively represent the most significant banking reform in the past 30 years. They include:

- Plans to strengthen key aspects of regulatory arrangements placed on banks by international regulatory bodies and international cooperation by the Bank for International Settlements, the International Monetary Fund and the Financial Stability Forum.
- Improvements in the transparency with which markets operate through the provision of better information about complex transactions and improved best practice on the part of credit reference agencies and hedge funds.
- Plans to strengthen regulatory execution on the part of the FSA, including the introduction of a clearer path to heightened supervision on the part of the FSA in the event of the financial position of an institution giving serious cause for concern.

- Plans to develop the money market tools at the disposal of the Bank of England, within an approach that seeks greater convergence internationally in the money market operations of key central banks.
- The introduction of a special resolution regime (SRR) and bank-specific insolvency arrangements that would help resolve an ailing institution in the rare event that heightened supervision had not succeeded.
- Measures aimed at enhancing the terms of the Financial Services Compensation Scheme and the confidence in which consumers hold the scheme and the prospect of efficient and orderly payout in the event of bank failure.
- Improvements to the basis on which the tripartite arrangements work and further measures aimed at strengthening the Bank of England's role in overseeing financial stability.

The banking industry supports the reform package in concept and intends to work with the tripartite authorities and other interested parties to ensure that each of the measures is developed with the full engagement of the industry. But there are a number of concerns that we would want to highlight from the outset:

- We are not convinced that sufficient weight has been placed on the benefit of improving the FSA's execution of its existing regulatory powers and the proposed escalation of regulatory intervention on the basis of heightened supervision.
- We believe that conditions of market stress could be significantly calmed through improvements in the operation of tripartite arrangements and a more efficient application of the Bank of England's money market operations, though this would require the Bank to embrace more radical change as part of its Sterling Money Market review.
- While we can see the case for the development of the SRR and bank-specific insolvency arrangements unless appropriately designed we believe that placing these on the statute book could potentially damage the competitiveness of the UK financial markets and the financial standing of banks that operate within them.
- We are not persuaded by the case in favour of pre-funding the FSCS and see great impracticality in the approach set out in the consultation document for achieving faster payout and believe that there may be a better way of going about this.
- We have major concerns about proposals being pursued by the IASB on both the scope and application of fair value accounting.

We are particularly concerned about the aggressive legislative timetable that we understand is to be followed, especially in the case of the more complex arrangements such as the SRR and the bank-specific insolvency regime, where many are concerned about the potential for unforeseen consequences if further time is not provided to think through the highly technical issues involved. Great care should be taken in disturbing principles of English law, in particular property rights, that have been sacrosanct for many generations; our preference therefore would be for the SRR and insolvency arrangements not to be included in primary legislation until we have seen full and proper consultation on a well explained and clearly defined scheme.

Should however the Government be determined to press ahead with legislation setting out the framework across all aspects of its proposal, irrespective of the concern expressed by many within the business community, then we believe that at the very least it must:

- Ensure that the legislation is drawn up in such a way that the broad legal framework provides scope for time to be taken to get the detailed arrangements right.
- Engage openly with interested parties in the development of the Bill so as to ensure that there is an opportunity to take on board concerns; this should involve a further consultation on the draft legislation before it is introduced into Parliament.
- Commit in clear and unambiguous terms to a full consultative process in respect of the secondary legislation that will subsequently be brought forward; and ensure that Parliamentary debate on this also takes place.

Any changes need to be considered in the context of London as an international financial centre. A significant attraction of London has been our stable regulatory framework and there are proposals in the consultation document which would alter fundamentally some of these arrangements. These will have a significant bearing on both deposit takers and their counterparties and will impact differently depending on legal status. It is essential that the tripartite authorities adopt a more realistic timeframe for the more intricate measures falling within the consultation.

We have submitted this response to the consultation document in advance of the deadline in order to share with the tripartite authorities our thinking on all aspects of the proposals at the earliest possible stage. In addition, we have participated fully in the workshops arranged during the consultation period and have arranged for structured discussions to take place between industry representatives and the tripartite on ways in which the deposit protection scheme can be improved without pre-funding, including the facilitation of faster payout, and issues arising from the special resolution regime. We remain committed to working with the tripartite authorities with the aim of developing their proposals into workable solutions that can command the support of the banking industry and the markets in which it operates.

Our response to the specific questions raised in the seven chapters of the consultation document is attached.

Yours sincerely

BBA RESPONSE TO THE QUESTIONS FOR CONSULTATION

SUMMARY OF KEY POINTS RAISED BY CHAPTER

Chapter 1: Introduction and Overview

The banking industry supports the reform package in concept and can see why the tripartite authorities would want the various elements in their 'toolbox' for dealing with every eventuality. But we would wish to emphasise that:

- We are not convinced that sufficient weight has been placed on the benefit of improving the FSA's execution of its existing regulatory powers and the proposed escalation of regulatory intervention on the basis of heightened supervision.
- We believe that conditions of market stress could be significantly calmed through improvements in the operation of tripartite arrangements and a more efficient application of the Bank of England's money market operations, though this would require the Bank to embrace more radical change as part of its Sterling Money Market review. This is a matter on which the Bank is consulting separately.
- While we can see the case for the development of the SRR and bank-specific insolvency arrangements unless appropriately designed we believe that placing these on the statute book could potentially damage the competitiveness of the UK financial markets and the financial standing of banks that operate within them.
- We are not persuaded by the case in favour of pre-funding the FSCS and see great impracticality in the approach set out in the consultation document for achieving faster payout and believe that there may be a better way of going about this.
- We have major concerns about proposals being pursued by the IASB on both the scope and application of fair value accounting.

We are concerned about the aggressive legislative timetable planned and see a critical need for further consultation being built into the timetable in respect of both primary and secondary legislation.

Chapter 2: Stability and Resilience of the Financial System

We should not overlook market changes taking place nor underestimate the impact of these. Current market conditions are clearly generating a top down review of strategy and risk appetite and this in itself is likely to result in a greater emphasis on risk management and disclosure in forthcoming years. There are a variety of measures under discussion at an international and European level that would significantly strengthen regulation and market transparency. These include initiatives on stress testing and liquidity management and measures relating to the functioning of the securitisation markets, including valuation, accounting and information disclosure, aimed at improving market discipline and the regulatory underpinning; while in the case of accounting and valuation we would say that the need is more for the IASB and related parties to reappraise its position on fair value accounting. Issues concerning the structure and methodologies of credit rating agencies are also under discussion. This is in addition to the cross over into Basel II.

Chapter 3: Reducing the likelihood of a bank failing

It is important to recognise that past failings have not resulted from a lack of supervisory powers, but from poor execution. Any proposals to introduce additional regulatory powers should therefore be scrutinised critically in light of what can be achieved by applying existing

powers. Within this context, a process of heightened supervision could be instrumental in turning around an ailing institution. While this would need to be based on the breaching of regulatory thresholds based on key regulatory ratios, there should also be scope for the exercise of regulatory judgement. The aim of heightened supervision should be to return the bank or building society to a state of normality, with varying degrees of strategic refocusing, depending on need.

Chapter 4: Reducing the impact of a failing bank

We can see why the tripartite authorities would want to have a special resolution regime as part of its toolkit for dealing with an ailing institution but would stress the complexity of the issues involved. We therefore believe that the specific proposals should be subject to full consultation in advance of legislation being introduced to Parliament. There are issues, in particular, concerning the property rights of counterparties other than depositors that need to be resolved first, including set-off and netting rights and the effect on creditor rankings and the ability to obtain payment. In designing the regime it is important to give thought to the circumstances in which the SRR may be invoked and the processes that would be followed. The decision that heightened supervision will not work, and that there is no alternative to utilising the SRR arrangements, should be taken by the Chancellor of the Exchequer on the advice of the tripartite authorities and should involve responsibility passing from the FSA to the Bank of England.

Chapter 5: Consumer confidence and compensation arrangements

The banking industry has supported improvements in the terms of the FSCS and fully signs up to working with the tripartite authorities to find the means of achieving faster payout in the event of insolvency. The recent removal of the co-insurance element of the depositor compensation scheme within the £35,000 limit is a highly significant improvement in the terms of the scheme; we have also agreed to a revised funding structure for the FSCS involving ex-post levy contributions of up to £4 billion per year. We further believe that there may be a case for moving to gross payments.

But in the highly concentrated UK market we cannot see a role for pre-funding as such arrangements would be either punitive or tokenistic and neither is advisable. Pre-funding would also constitute a drag on bank liquidity and would tie up capital that could otherwise be better utilised. We also believe that the tripartite authorities have underestimated the practical difficulties in introducing the single customer view as proposed in the consultation document and payout through the FSCS. The emphasis needs to be on the preservation and use of existing accounts and bank infrastructures to the maximum extent possible and measures which help consumers appreciate that their money, up to any applicable limit, is truly 'safe'.

Chapter 6: Strengthening the Bank of England

We support the codification in statute of the Bank of England's responsibility for financial stability and the overhaul of its money market operations in support of liquidity and payment systems.

Chapter 7: Effective coordination

We support the proposed strengthening of the tripartite arrangements but see the answer as lying more in the assignment of clear roles and responsibilities for each of the three parties and view this as being the key to improving coordination.

The strengthening of cross-border cooperation under the aegis of the Financial Stability Forum and the International Monetary Fund is of central importance given the global marketplace and international transfer of risk. In a global banking market practical cross-border supervisory cooperation is also critical in terms of more effective supervision. This is arguably where the greatest systemic risks lie.

Impact assessment

There is a lack of appreciation of the scale of the IT changes that would be involved in delivering the single customer view as proposed in the consultation document and an unreal expectation of what could be achieved in terms of delivery through the FSCS.

CHAPTER 1: INTRODUCTION AND OVERVIEW

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?

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The banking industry supports the reform package in concept and intends to work with the tripartite authorities and other interested parties to ensure that each of the measures is developed with the full engagement of the industry. But there are a number of concerns that we would want to highlight from the outset:

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- We are not persuaded by the case in favour of pre-funding the FSCS and see great impracticality in the approach set out in the consultation document for achieving faster payment and believe that there may be a better way of going about this.

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

The proposals are all intended to strengthen different aspects of the regulatory and market arrangements that contribute to the framework intended to achieve financial stability and depositor protection. While elements are mutually enforcing, we believe more could be done to bring out the bright lines of the different stages involved so that they are more clearly identifiable in terms of delivering a continuum of measures that may be appropriate depending upon the outcome of preceding action.

We would underline in particular that the emphasis should be on using the tools in the hands of the regulatory authorities, including the better execution of the FSA's existing powers and the provision of liquidity assistance to the market – as refined post-Northern Rock – and that the SRR and insolvency arrangements will only be used in the exceptional circumstances that there is no prospect of reversing the fortunes of an ailing institution.

There also needs to be a better understanding of the interrelationship between the different stages and the point at which different authorities would be drawn towards fulfilling their functions. So, for example, there comes a point at which we believe that the FSA, in consultation with the Bank of England and HM Treasury, would determine that it should trigger the special resolution regime arrangements. At this point the Bank of England should assume lead responsibility for exercising powers under the SRR arrangements.

While this would necessarily involve some engagement on the part of the Bank of England in advance of the transfer of responsibility, we believe that any such engagement should be limited in scope to the Bank assessing the options open to it under the SRR and insolvency arrangements and not involve it duplicating the FSA's regulation of the institution.

Core to strengthening the financial framework will be improving the communication within the tripartite authorities and ensuring that each is clearer about the role it has to play.

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

All credit institutions with the ability to take deposits from the public should be subject to the same range of measures.

CHAPTER 2: STABILITY AND RESILIENCE OF THE FINANCIAL SYSTEM

We should not overlook market changes taking place nor underestimate the impact of these. Current conditions clearly bring with them a top down review of strategy and risk appetite and this in itself is likely to result in a greater emphasis on risk management and disclosure in forthcoming years.

There are a variety of measures under discussion at an international and European level that would significantly strengthen regulation and market transparency. These include initiatives on stress testing and liquidity management and measures relating to the functioning of the securitisation markets, including valuation, accounting and information disclosure, aimed at improving market discipline and the regulatory underpinning; while in the case of accounting and valuation we would say that the need is more for the IASB and related parties to reappraise its position on fair value accounting. Issues concerning the structure and methodologies of credit rating agencies are also under discussion.

It should also be borne in mind that the turmoil that started during the summer of 2007 took place against a prudential capital regime still based on Basel I¹. The Basel II requirements were not universally introduced in the EU until the beginning of 2008 and are unlikely to be required in the US until 2010. The assessment about whether changes to the Basel II regime are required should not be made until it has had a chance to bed down and demonstrate its efficacy.

Recent events, the international response and strengthening risk management by banks

Basel II and the Capital Requirements Directive & stress testing

The consultation document proposes that:

- The FSA will intensify its work with banks to improve stress testing in light of recent events.
- The tripartite authorities will work with international partners to encourage a stronger consensus on the importance of stress testing, in particular at group level and by multinational banks.
- The tripartite authorities will work to consider whether the stress-testing standards under Basel II are sufficiently robust.

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

Yes. Banks fully recognise that the stress testing of capital requirements and liquidity arrangements is a key component in their planning processes. The majority of our members undertake stress testing routinely as is required by the CRD, using it as a forward looking business tool, which informs senior management on changing risk profiles and facilitates the development of strategy and tactics for capital planning purposes as well as being a regulatory requirement.

¹ It should be recognised that Northern Rock was an early adopter of the foundation approach under Basel II so was subject to the new regime which the FSA has acknowledged it did not implement appropriately.

We support the proportionate application of regulatory standards by regulators based on the scale, nature and complexity of a bank. Such an approach recognises that different sizes of firm will have different requirements of their stress testing processes and the costs of mandating less complex firms to perform multi-factoral scenario tests are likely to outweigh the benefits.

Our members would not support the development of required stress testing scenarios by the FSA. We do not believe that there are any immediate plans to do so, but wish to emphasise that financial institutions' balance sheet and contingency funding profiles differ materially, giving them different susceptibilities to different types of stress. These should be identified by the bank's own senior management and this makes the application of any standardised approaches largely impractical.

Experience of the use of stress testing for regulatory purposes is likely to grow as ICAAP processes arising from the CRD have only become embedded in businesses and regulatory procedures relatively recently. We would urge the FSA not to become more conservative in its Pillar 2 assessments as a result of the current market turmoil - to do so might have damaging procyclical effects with flow through to the economy generally.

It is important that the FSA feels able to question robustly the stress scenarios employed by banks using sufficiently experienced supervisors who are fully familiar with a particular bank's business model. Our members recognise that ongoing dialogue with FSA's senior management and their own is the only way to achieve the level of challenge required and they are prepared to commit to ensuring this happens. It is critical to separate stress testing for capital purposes under Basel II, from liquidity stress testing. Capital is not a suitable mitigant for liquidity risk.

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

Our members believe that for the regulatory audience, group wide, top down stress tests will have the most relevance as they present the totality of the firm's view of its likely capital and liquidity requirements.

While stress tests are undertaken at various levels within a group and may focus on particular geographical sectors, business segments or risk types, they will be tailored for an internal audience and as such will vary in the time horizon covered and degree of severity applied. So we do not expect regulators to routinely review stress tests that are applied at a business unit or geographic sector level, as only by taking a holistic approach will an appropriate aggregate view of future capital and liquidity requirements be formed.

We therefore support the authorities focusing on persuading international partners to concentrate on the stress testing processes of multinational banks at a group level. It is important that the Authorities ensure that they coordinate with their overseas counterparts to ensure that work in this area does not place UK banks at an international disadvantage.

As we have emphasised in our recent response to the FSA's recent Discussion Paper 'Review of the liquidity requirements for banks and building societies' (DP 07/07) a major concern of our members is the risk that the FSA will introduce quantitative requirements ahead of the completion of the work that is currently being undertaken on liquidity by the Basel Committee on Banking Supervision and any consequent

CRD changes. This risks creating trapped pools of liquidity which would decrease the ability of a bank to move liquidity around their group and introduce a regulatory requirement that does not match the way banks run their businesses.

Until an agreement can emerge at G10 level, the FSA should refrain from introducing new quantitative requirements, and rather focus on the qualitative aspects of liquidity supervision.

Liquidity risk

It is proposed that the tripartite authorities will work with international partners to ensure that liquidity regulation standards are consistently high across banking groups and encourage more consistent approaches to liquidity regulation.

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

Yes. Stress testing and scenario analysis, contingency funding planning and a firm's documentation of how it intends to deal with any liquidity risks it identifies have been a requirement in the UK since the beginning of 2005. If institutions have not been meeting these requirements the FSA should robustly remind senior management of their obligation and use their regulatory toolkit appropriately on recalcitrant firms.

A key issue for the regulator and bank will be the assessment of their mutual risk appetites. Stochastic measures are unlikely to be the most effective in describing a risk appetite or determining at what level it should be pitched. How a bank assesses its risk appetite should be a matter for discussion between it and the FSA – there is no easy answer on this issue. Quantitative approaches should, we believe, permit banks to use their own liquidity models for regulatory purposes and be based on a mismatch approach.

Until an international consensus emerges on any quantitative requirements the focus should be on the qualitative aspects of liquidity regulation – notably stress testing and contingency planning.

Improving the operation of the securitisation markets

Accounting and valuation of structured products

It is proposed that the tripartite authorities will:

- Work with their international counterparts to ensure that firms' valuation approaches are consistent with the relevant accounting standards and the CRD/Basel II prudent valuation guidance.
- Work with their international counterparts to ensure accounting standards require adequate disclosure about the uncertainties around valuations, their significance for the entity and how these risks are being managed.
- Encourage markets to find ways to increase transparency of valuation methodologies and, to the extent appropriate, move towards greater standardisation of methodologies for valuation.

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

Banks were assisted in their 2007 reporting by the summary of key IFRS principles for valuation and risk disclosure produced from within the audit profession – the Global Public Policy Committee report ‘Determining fair value of financial instruments under IFRS in current market conditions’ – and the UK Financial Reporting Council’s questions for Audit Committees in reviewing draft accounts. As these initiatives illustrate, the fair valuation of the relevant instruments takes place within a pre-determined framework.

In any event, it should be borne in mind that structured products have provided a means by which funding sources can be diversified and investors permitted to participate directly in a wide range of asset classes. While there may be issues concerning credit assessment, these should be addressed in ways that support funding diversification and the contribution this makes to risk management. Care also needs to be taken to avoid stifling innovation, for instance, in determining additional disclosure requirements in respect of underlying assets there may be confidentiality issues where the underlying issuer or borrower is listed or where the underlying asset is a loan.

Regulatory capital requirements should be reasonable and not confer a competitive advantage on any particular set of market participants, or bias towards or away from certain products – for instance there should be a close link between securitisation and the underlying loan assets.

This will be helped by the expeditious implementation of Basel II which better aligns regulatory capital with risk. The UK authorities should encourage the regulators of other major banking systems to introduce Basel II as swiftly as is reasonably practicable.

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

We understand the desire to review the securitisation framework in Basel II to ensure it does not create the wrong incentives - either by drastically under-capitalising or over-capitalising certain activities - but believe that we are still in the process of identifying the critical issues on the accounting and valuation of structured products and for this reason agree that it is important not to rush into precipitous regulatory action. In our view there is a need first to objectively assess the extent to which the current accounting and valuation rules proved fit for purpose before devising new or refined requirements. In any event, any proposals should be made in light of the next stage of the IASB’s due process in determining how to take forward its proposed adoption of a modified form of US SFAS 157 ‘Fair Value Measurements’. This relates specifically to the mechanics of calculating fair values within the parameters of its current scope and should involve a review of the prescription with which the fair value hierarchy is applied on the basis of market prices for instruments, market prices for components of instruments or internal models. It is critical that in determining the way forward the IASB should pay heed to the application issues that arose in the US this year.

Most banks reported under IFRS 7 ‘Financial Instruments: Disclosures’ for the first time in their 2007 annual report and accounts and new disclosures concerning counterparty credit risk are in the process of being introduced under Pillar 3 of the

Basel II Capital Accord. These enhanced disclosures are intended to provide the market with greater information about risk exposure and management and we need to take into account the fuller disclosures that they involve in determining whether any additional measures are needed at this stage.

As set out in our response to question 2.4 above a good starting point will be to assess the disclosures made in the 2007 year-end accounts and the market transparency that will be achieved by the Pillar 3 disclosures.

We would also underline the need to build in an understanding of the current market conditions when assessing the merit of moving to full fair value accounting for financial instruments as advocated by the International Accounting Standards Board. This issue has returned to the agenda with the publication of the IASB's discussion paper 'Reducing Complexity in Reporting Financial Instruments'.

The banking industry globally is on the public record² as having expressed severe doubts about the appropriateness of the IASB's long term goal of moving towards full fair value and will use the consultation period for responses to the discussion paper to ensure that the industry's views are clear and widely understood. Quite simply, there are instances where a market value provides a true and fair reflection of banks' financial position and earnings generation process; but there are others where this is not the case, most notably in respect of instruments held to maturity within the banking book.

Credit rating agencies

It is proposed that the tripartite authorities will:

- Work with international counterparts in the FSF and the EU to look at the role of CRAs in structured finance. The tripartite authorities will also support the work of the International Organisation of Securities Commission taskforce on CRAs, which has recently been reviewing the applicability of its Code of Conduct for CRAs to structured finance business.
- Keep the development of investor practice in relation to structured products under review to determine if further measures are needed to assist markets to achieve an appropriate outcome. The authorities should consider the role CRAs have to play in investor education.
- Consider the implications for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large.

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

The consultation document proposes that the Authorities will work with their international partners in the FSF and the EU to identify whether there remain incentives under the CRD or Basel II framework for banks to minimise their regulatory

² See 'Accounting for Financial Instruments Conceptual Paper' published by the International Banking Federation, April 2008

capital requirements by holding assets in SIVs and other funding vehicles, and if so whether this might reduce the total amount of regulatory capital in the financial system below the level that the tripartite authorities consider desirable

As outlined in the consultation document there would be significant reputational damage to any CRA that was perceived to favour the issuer. As a result there is a very strong disincentive to over rate transactions. The entire CRA business model is built upon this premise and as result there is very strong internal monitoring to ensure the quality of ratings. But we would suggest that the appropriate Authorities consider the incentives created by the charging structure for new ratings and for the ongoing monitoring of ratings.

We support many of the provisions in CESR's Consultation Paper 'The role of credit rating agencies in structured finance' regarding transparency of: models utilised; conflicts of interests provisions; staffing arrangements and monitoring. CRAs operate in a global market, and any change to the regulatory environment should be in the global, rather than regional context.

Credit ratings are a vital tool for market participants, especially for AAA level investors who only have limited resources to spend on risk assessment. These investors are, for completely rational reasons, more likely to withdraw from markets they do not understand than to invest into an expensive due diligence process. Users of ratings should, however, be mindful of the limitations of the ratings and they should not be used as a complete substitute for judgement. All users of ratings (including AAA investors) should be expected to perform their own due diligence on the rating process for different asset classes.

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

We agree with the proposals to improve the information content and availability of ratings. Additional information will improve investor knowledge and modelling. We would not support credit ratings being expanded to offer an opinion on dimensions other than credit risk. If for instance ratings were to look at liquidity, this would be a massive shift and would require an entirely different kind of analysis. If such a liquidity measure were required we would suggest that it should be explained in a separate rating rather than confusing the purely credit aspects of the rating. We would strongly oppose the imposition of a differential ratings scale for structured finance products. Our members do not consider that this will add significant value or transparency, whilst it would impose technical change and concomitant costs.

CRAs could usefully increase the information available on the volatility of their ratings. That is, what the factors are could impact the quality of the rating and the likely quantum of that change. On-going and clear disclosure of CRAs' limitations on what they analyse for which purpose, and what they do not, in an easily understandable format for investors. Clear disclosure or explanation of assumptions and methodology used is useful for the investor to perform his own due diligence and to know what action to take when such assumptions are broken.

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

Yes. Our members consider that amending the IOSCO code of conduct within the context of a self regulatory regime is the appropriate way forward. It may be that IOSCO could examine more closely and regularly the implementation of the IOSCO code within CRAs. The regulatory authorities should however, consider that the CRA's operate within the context of market discipline. As a result, many of the issues outlined will already be addressed by changes in the market approach and value of credit ratings.

We are of the view that enhanced self regulation, built upon the amended IOSCO Code of Conduct and strengthened internal controls within CRAs, is more effective than formal regulation. Any putative regulatory regime would have to be funded from the CRAs. The fees and levies from regulated CRAs may not be sufficient due to the small number of CRAs applying to be regulated. It is not clear how supervision might be funded as supervision can be expensive and often difficult to perfect.

The tripartite authorities should bear in mind that it is competition between CRAs that has brought many benefits to issuers and the wider market. In the drive to improve the quality of ratings and the ratings process the Authorities should be careful not to crush any possible future competition. If the regulatory burden is made so heavy as to pull up the trap door behind the current big 3 then it will only serve to reinforce the CRAs' position.

We agree that there is an issue over investor education. It is likely there has been over-reliance on ratings and not enough independent due diligence by firms. While banks would support an increased focus on the responsibility of investors to carry out their own due diligence we would also observe that in the current market environment it is likely that this is a self correcting issue.

It may also be the case that more can be done to simplify the process of rating structured products so that their ratings are as clear and understandable as the ratings applying to non-structured products.

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?

Asset-backed securitisations (ABS) have a good track record and have been used for many years to issue notes within a structure that could be assigned the highest credit ratings. Securitisation generally has allowed wide risk diversification and this has enhanced financial risk management. It has also brought significant benefits to the global financial markets enabling issuers to diversify funding sources and investors to participate indirectly in a range of asset classes. This has brought different markets together and in the process has significantly lowered the cost of borrowing. It is therefore imperative that measures designed to add transparency are introduced against a backdrop of an appreciation of the contribution that these markets bring to the global economy. Additional requirements need to be designed on the basis of a full understanding of the disclosure requirements in place or in the process of being

put into place and need to be introduced in a way compatible with restoring market confidence.

As the consultation document observes there are already detailed rules in place within both the CRD/Basel II capital framework and international accounting standards in respect of the regulatory and accounting treatment of off-balance sheet vehicles – although, as they were only implemented at the beginning of 2008, the recent market disruption was largely played out under the older, less risk sensitive Basel I rules.

It is right therefore that the starting point will be to address any deficiencies by augmenting these regimes. A significant input to this review will be the lessons that the banks themselves have learnt from recent events. Before layering on additional regulatory requirements, we need to determine whether the then existing rules were deficient, whether the newer Basel II requirements would have resulted in a less cataclysmic out turn or whether difficulties arose through management strategy and risk appetite. This analysis will have a significant bearing in the determination of whether there are regulatory holes that need to be plugged.

In international discussions involving the Financial Stability Forum, the Basel Committee on Banking Supervision, IOSCO and the European Commission there is a growing understanding that there are a number of areas that merit inspection now that the year-end process is complete. These include:

- The consolidation rules for SPVs, conduits and money market funds.
- The valuation of funded leveraged credit commitments.
- The disclosure of exposures to off-balance sheet vehicles.

We agree with this analysis. In the first instance, we are of the view that the consolidation requirements of IAS 27 and SIC 12 are comprehensive; it may be, however, that disclosure requirements can be strengthened in support of transparency and market discipline.

It is important that the tripartite authorities take full account of the differences between the UK and US securitisation models. In the US, all risk is typically passed on to the investor in the securitised vehicle. In the UK, almost invariably, banks retain an element of risk, aligning their own interests with those of investors in the securitisation vehicle.

CHAPTER 3: REDUCING THE LIKELIHOOD OF A BANK FAILING

Strengthening the regulatory framework

The FSA's internal audit report on the supervision of Northern Rock and the supervisory enhancement programme outlined in the high level recommendations illustrate the extent to which the poor execution of existing regulatory powers contributed to the downfall of Northern Rock. The high level recommendations and the proposed supervisory enhancement programme will contribute significantly to the execution of the FSA's extensive regulatory powers and in themselves will greatly strengthen banking supervision in the UK. Any proposals to introduce additional regulatory powers should be scrutinised critically in light of what can be achieved by exercising existing powers.

We believe that heightened supervision can play a significant part in the turning around of an ailing institution and would propose to engage constructively in discussion with the FSA on this. We support such arrangements resting on banks or building societies breaching threshold conditions based on key regulatory ratios but would underline the need for there to be sufficient scope within the heightened supervision arrangements to find the best means of working with management to secure the future of the institution in question.

The aim of heightened supervision should be to return the bank or building society to a state of normality, with varying degrees of strategic refocusing, depending on need. This should be the primary objective of heightened supervision and the triggering of the SRR arrangements should only be undertaken when it becomes clear that there really is no viable alternative. Entering heightened supervision should be based on quantitative and qualitative factors and should involve threshold criteria based on key regulatory ratios. We should ensure however that heightened supervision in itself does not become self-fulfilling as a result of a loss of market confidence following institutions being made subject to such arrangements. We would therefore argue that there is a balance to be achieved between objectivity and regulatory judgement in determining that there is no alternative to invoking SRR arrangements.

A decision that heightened supervision will not work, and that there is no alternative to utilising the SRR arrangements, should be taken by the Chancellor of the Exchequer on the advice of the tripartite authorities and should involve responsibility passing from the FSA to the Bank of England; any engagement on the part of the Bank in advance of this should be limited in scope to the Bank assessing which of the SRR tools is likely to be most appropriate.

The Treasury Committee report 'Financial Stability and Transparency' recommends the establishment of a mechanism whereby warning of deteriorating market conditions from the Bank of England or the FSA would need to be formally acknowledged by financial institutions and discussed at Board level. This strikes us as being a highly practical suggestion in keeping with the UK principles-based regime.

Payment systems

The Bank of England should have responsibility for the oversight of both wholesale (large value) and retail (smaller value, higher volume) payment systems; splitting this function between the Bank and the FSA risks regulatory confusion.

Provision and disclosure of liquidity assistance

We support early legislation to provide the Bank of England with statutory immunity for acts and omissions relating to its role in providing financial stability and central banking functions. There clearly also needs to be an urgent review of money market operations and the instruments that the Bank is entitled to take as collateral. It is evident that in other jurisdictions, including within the EU, it is considered appropriate for central banks to organise rescues quietly and effectively. While it is clear that they should be accountable, the analysis of their actions should come once the situation has been resolved.

Regulatory interventions

The FSA's existing powers

3.1 To what extent does the FSA's range of existing powers reduce the likelihood of failure of a bank, and under what circumstances would they not be effective?

The FSA already has extensive powers³ to reduce the likelihood of bank failure - circumstances have shown however that they are not effective if they are not deployed in a timely and consistent fashion. This is reflected in the conclusions reached by the FSA's Internal Audit that "...the ARROW risk framework provides the appropriate underpinning to support effective risk-based supervision". The FSA's Internal Audit report notes that the FSA did not use the available framework effectively or as intended. Failure to utilise powers does not justify new powers – if anything the reverse is true.

Dialogue between the bank and its regulator at senior level employing the appropriate degree of challenge reduces the risk of failure but should be improved. This may require strengthening the quality of personnel and resourcing of FSA supervision but we do believe the FSA has the ability to create the right cadre of people within its organisation with appropriate level of insight, expertise and understanding.

Our view is in line with the FSA's Internal Audit recommendations for strengthening of the supervisory resources at the FSA, such as significantly enhancing the current training arrangements to ensure that staff receive appropriate training and that the assigned roles match their skills and expertise. The Internal Audit report recommends the recruitment of additional staff for the development of sub-sector resource as a way of improving the quality of FSA's financial and sectoral analysis.

The industry understands this may result in a greater short term cost in regulation and believes that if reasonable this is an appropriate price to pay to avoid the sort of catastrophic failure that we have experienced in the case of Northern Rock and is a more appropriate route to take than adding to the FSA's powers.

3.2 Are the FSA's existing powers, and in particular the application of them, clear, and how could they be further clarified?

We believe that the FSA already has a number of tools at its disposal, notably in its ARROW process and peer group reviews. These do not lack clarity, but should perhaps be applied more consistently and with greater vigour. We do not envisage

³ These include powers to require information and conduct investigations (Part XI FSMA), disciplinary measures (Part XIV FSMA) and, ultimately, the power to revoke approved person status of senior employees and directors (Part V FSMA and authorised person status (Part IV FSMA).

there to be a need to bring forward new GENPRU or BIPRU rules for the application of business-as-usual supervision – rather the existing powers should be used more effectively.

FSA supervisory information requirements

The consultation document proposes that banks be in a position to provide additional evidence to the FSA at short notice that they are meeting threshold conditions on an ongoing and forward-looking basis.

3.3 To what extent are the annual and one-off costs of the new information requirement on banks proportionate? Can they be quantified?

We need to consider the full ramifications for providing information at short notice to satisfy FSA on threshold conditions. This will cover the information needs relating to business right across a banking group and competition issues in terms of the new regime being applied differently to credit institutions operating in the UK through passport rights etc as well as the impact on the attractiveness on the UK as financial centre.

Further thought needs to be given to the nature of the information FSA and the other tripartite authorities require, and the trade off between the benefits to be gained by the tripartite authorities from receiving any new information and the cost of producing and reviewing it.

The functionality to produce a capital plan and a liquidity plan at short notice may or may not be available at firms, particularly those which operate in the UK via subsidiaries. It is likely that the capital planning process for such firms will be the responsibility of a central non-UK function, and legal entity cuts might not easily be produced. So there may be a need to differentiate the requirements applied to firms depending on their size and organisational structure, and on capital/liquidity support being available from the parent company.

The FSA has received unprecedented amounts of management information - on liquidity, exposure, capital and payments - over the last 6 months and should now have a clear view on what does and does not work.

The provision of information at short notice is likely to be impractical for a number of existing reports and banks need greater clarity on the proposed requirements before being able to comment upon whether their many existing MI sources will be enough. Previous FSA consultations on the 'Factbook', requiring regularly updated information to be available to FSA at short notice, have not resulted in sufficient clarity being achieved.

We are very concerned that the tripartite authorities may be under-estimating the practicalities and the costs involved in new requirements. It is impossible to quantify these without more detail about the information which would be required, to whom it would be reported, and the frequency and time permitted. It would therefore be very useful if the FSA could propose a standard MI pack and supporting protocols for updates.

3.4 How effective would the new information requirement be in identifying and addressing a sudden deterioration in a bank's financial soundness?

The FSA already has adequate powers to demand any information from a bank under Section 165 FSMA. It does not need further powers to enable it to do this, but it does need the confidence to ask for additional information when it believes this to be necessary.

We therefore believe that, while liquidity stresses can strike more quickly than solvency problems, good dialogue and monitoring of market conditions should mitigate the need for such immediately available information. There is always going to be a trade-off between immediacy and quality; an unduly curtailed deadline may not provide sufficient time for information on which major decisions about whether or not a bank will continue in business can reasonably be based.

Information sharing by the FSA

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 H M Treasury require?

We believe that it should be possible to share information in the vast majority of cases between the tripartite authorities, particularly where the stability of an individual institution or the financial system in general is under threat. There may be cases where, because eventual criminal prosecution is warranted, this does not happen.

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?

The Bank of England should have statutory oversight responsibilities for both wholesale (large value) and retail (smaller value, but volume) payment systems and this function should not be split between the Bank and the FSA. The Bank's oversight responsibilities should also encompass embedded payment systems, such as securities settlement systems, and thought should be given as to whether oversight should be extended to what are notionally retail products such as cards, where there is no other obvious oversight authority. The maintenance of the stability of the overall national payment system is a core central banking function and essential to the economy. Although the payment system landscape is fragmented, there are increasing technical and systemic interdependencies.

3.7 Which elements of such a payments systems regime should be effected through statutory powers?

There is a dialogue to be had about the extent to which there is a need for the payments system regime to be encapsulated in statute in areas such as:

- The establishment of the Bank of England's formal oversight role working with the existing self-regulatory framework.
- Formal 'designation' (and withdrawal of designation) of appropriate payment systems (in line with the Settlement Finality Directive).
- Formal powers to examine payment system providers to ensure that their rules and procedures meet required standards.

- Ensuring the orderly and efficient functioning of the national payment systems.
- Accountability, with the Bank continuing to publish an annual Oversight of Payment Systems report, covering developments as well as action(s) taken.

The tripartite authorities should limit their consideration to ensuring that payments can be made quickly and avoid complex changes to oversight, or changes which could have major implications for the payments systems themselves.

Some form of light touch statutory authority for the Bank of England would be in keeping with the kind of regime that operates within other countries. However, the proposed further consultation needs to take account of the possibility that the lack of statutory authority in this area, and the use of self-regulatory mechanisms where appropriate, may be one of the reasons for London's position as the pre-eminent financial centre. Whatever is done, therefore, the statutory powers must not stifle innovation.

Statutory powers should focus on the tripartite authorities' ability to obtain data from payment systems and participants, plus the ability to enforce investment in risk management controls that mitigate against single points of failure.

Liquidity assistance and disclosure

Disclosure of liquidity assistance

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?

Yes. We support measures aimed at increasing the range of collateral which can be lodged with the Bank of England. We doubt the relevance of the Companies House registration regime for banks since neither the interbank market nor the capital markets in which banks operate place any significant degree of reliance on this regime. But to the extent therefore that the Companies House registration regime acts as a deterrent to the lodging of a wider range of collateral with the Bank we would support the disapplication of that regime to banks and building societies.

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?

We would support an exemption for all collateral granted to the Bank of England or other recognised central bank but not to third parties generally. We would also support the bank of England providing liquidity to the market on a more regular basis and would see great merit in liquidity support taking various guises, including support to individual institutions, so that we end up with a more flexible approach to the Bank providing solvent institutions with liquidity support without this necessarily being viewed as being on an "emergency" basis.

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

We see little logic in extending the notice period; if it is accepted that the regime does not serve any useful purpose insofar as it relates to collateral provided by banks to the Bank of England then the exemption route seems preferable. Extending the 21 day period would also potentially give rise to unfair treatment of other secured parties and raise complex priority questions.

Protection for the Bank of England

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

We believe that the weekly return sheet should be discontinued in relation to the reporting of the Banking Department’s assets and liabilities. In its place, the Bank should continue to disclose, on a monthly basis, the quantum of the Note Issue, together with such balances, as outstanding in its weekly and monthly monetary policy (including open market) operations.

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?

Yes, we believe that this is appropriate, as it was when the Bank undertook its banking supervisory functions under the Banking Acts 1979 and 1987. We also suggest that this immunity is explicitly extended to the Bank’s proposed statutory functions relating to the oversight of payment systems (in keeping with our response to questions 3.6 and 3.7 above).

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?

Yes, this seems to us appropriate, particularly where the enforceability of collateral relates to a failing bank. However, we suggest that the legal and insolvency aspects of such a move will need to be examined carefully, both in relation to the Bank’s charge over collateral in its money market operations (eg repos) and the impact more generally on the ranking of creditors in a (bank) insolvency. But we think that existing laws and practices around title transfer and the taking of a charge over an asset and considerations about transfers at undervalue and undue preference are already well established and should not be disturbed.

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?

Yes. In general terms, we suggest that funds provided by the Bank of England should be provided on no less favourable terms than those granted to other deposit-takers such as banks.

3.15 What risks are there to building societies granting floating charges over their assets to the Bank of England?

The Building Societies Association is better placed to comment on this.

CHAPTER 4: REDUCING THE IMPACT OF A FAILING BANK

Special Resolution Regime

We can see why the tripartite authorities would want to have a special resolution regime as part of its toolkit for dealing with an ailing institution but would stress the complexity of the issues involved. We therefore believe that the specific proposals should be subject to full consultation in advance of legislation being introduced into Parliament. The Government should not draw up the proposals on the basis of using the FSCS to fund SRR costs in advance of insolvency; this would be a major departure from the current purpose of the FSCS – to insulate depositors from loss up to a pre-defined limit – and we do not support this.

The consultation document states that there is no intention to assign preferred creditor status to depositors. We are concerned however that the proposed SRR may nevertheless have this effect. If so, this would disturb the property rights of other stakeholders. There may, in particular, be consequences for other counterparties and bank credit ratings, and unless the various contractual arrangements are fully thought through in advance, the mere act of putting in place legislation providing powers to invoke an SRR could significantly raise the capital and economic cost of transactions. This would potentially reduce the attractiveness of London compared to other financial centres.

We believe that if there was to be a transfer of business out of a troubled bank, whether a directed transfer or a bridge bank procedure, it would be preferable for this to encompass the entirety of the institutions business. Failing this, care needs to be taken to ensure that parties dealing with the residual presence of the bank are not severely disadvantaged.

It is important that the triggers for intervention are a combination of both objective criteria and principles-based measures. A pre-requisite for entry into the SRR should be failure against objective criteria, such as the meeting of minimum regulatory ratios. The tripartite authorities may then proceed to the SRR, but would not be required to do so. In designing the regime it is important that thought is given to the circumstances in which it may need to be invoked and the processes that would be followed. Invoking the SRR should involve responsibility passing from the FSA to the Bank of England; any prior involvement of the Bank however should be limited strictly to its assessment of the way in which the SRR should be applied.

The impact of special resolution tools on cash in the payments system needs to be carefully considered. Thought also needs to be given to whether there is a need to extend statutory immunity to the restructuring officer that may be appointed to oversee the bank during the implementation of the SRR in certain circumstances.

Bank-specific insolvency procedure

A new bank-specific insolvency procedure would be a major departure and we believe that there are many issues that need resolving before proceeding with this proposal, including the consequences of banks owning fund managers, brokers and more. The special resolution tools for pre- and post-insolvency are blurred and need to be more clearly defined.

As with other elements of the SRR, substantial issues arise which need reviewing in detail before the appropriateness of establishing this procedure can be evaluated. This includes the effect on contractual rights benefiting non-depositor creditors of UK banks which may be impacted by these proposals. As with the SRR, it is essential that set-off and netting rights,

as well as the ability to realise collateral or enforce security interests be preserved. If this were not to be the case, the capital and economic cost of transactions would rise.

Trigger and process for the special resolution regime

4.1 Do you agree there should be a special resolution regime for banks?

While it may be that an SRR should be part of the tripartite authorities armoury of tools to deal with failing institutions there is insufficient clarity in the consultation document around how this will operate. As discussed below, a number of the measures seem to us to be unworkable or to have (possibly) unintended adverse consequences in terms of the competitiveness of the UK market. In particular, there are issues concerning property rights that must first be understood and resolved. Subject to the resolution of these issues in a way which does not impair the rights of stakeholders other than shareholders, we believe that there may be justification for the existence of a pre-insolvency measure to enable the transfer of a bank to another bank or the state in order to enable its continuation, leaving such stakeholders' rights undisturbed.

It would be useful to distinguish the SRR as a pre-insolvency measure from the special insolvency regime for banks as there are a number of points in the consultation where the two appear to be confused. Insolvency carries with it a host of different issues from those which arise in a pre-insolvency situation. We do not believe that it is helpful to conflate the two.

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 H M Treasury?

Yes. Individual banks employ different business and risk management models; a prescriptive list of factors that would trigger intervention would not be appropriate. If there was to be an SRR clarity around the criteria for trigger points would be essential. At the same time an overly mechanical approach, with little margin for judgement, would need to be avoided. We suggest that there be some explicit requirements that would tend to indicate that an SRR may be the appropriate next step, such as an ongoing breach of quantitative capital and liquidity requirements and an inability to meet threshold conditions, but that overlaid on these decision criteria should be a requirement for supervisory judgement and where necessary forbearance.

Any trigger points will need to be considered extremely carefully with a special reference to "material change clauses" in securitisation and structured product contracts. Any change to the current set-off rules in insolvency would have a very significant impact on the City's attractiveness as a financial centre. Other than perhaps for a limited and temporary period of time counterparties rights should not be suspended before a bank actually becomes insolvent. Any suspension will require careful judgement. This is in addition to the question of the form the SRR intervention should take.

4.3 Do you agree that the trigger should be linked to regulatory guidance material?

Yes. This should be clearly spelt out in guidance in the FSA handbook, particularly in relation as to how and when it will apply, emphasising that it should only be triggered as a last resort.

We suggest that there be some explicit requirements that would tend to indicate that an SRR may be the appropriate next step, such as an ongoing breach of quantitative capital and liquidity requirements and an inability to meet threshold conditions, but that overlaid on these decision criteria would be a requirement for supervisory judgement and where necessary forbearance.

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

Please see our summary comments and response to question 4.1. We see the SRR as the very last step. An SRR may improve the social outcomes where banks are failing but the efforts of the tripartite authorities and banks should be focused on ensuring a credit institution does not get into serious problems in the first place.

4.5 Do you agree that the potential abridgement of property rights in the special resolution regime can, in principle, be justified with a suitable public interest test?

The potential abridgement of property rights is an area of fundamental concern and our answer is dependent on the form that this would take. While we recognise the argument for permitting short freezes in order to put the SRR arrangements into place, the implications would need to be considered very carefully. More fundamental abridgements such as any disturbance of creditor ranking or second order impacts on the enforceability of the widely used and very effective on- and off-balance sheet netting agreements could potentially be highly detrimental. These are based on English law and are key components in ensuring the City is the world's leading international financial centre. The efficacy of such agreements should be safe-guarded.

Though there are various references in the chapter to possible 'adjustments' to private law rights, there is a need for much greater clarity on how these rights could be affected under the proposals. Clarity is needed also on the criteria for the payment of compensation. Would compensation levels be related to the losses incurred by counterparties or to the available assets at liquidation (or both)?

The effect of directed or mandatory transfers on the rights of creditors, members and other stakeholders is of profound importance; erosion of proprietary or personal rights against a failing bank could have serious ramifications for counterparties' management of credit and insolvency risk. In turn this could have catastrophic consequences for UK banks' standing internationally, causing their cost of credit to increase and access to liquidity to decrease (or even disappear) at times of stress. Partial transfers, whether to another bank or a bridge bank, are particularly fraught with risk of cherry-picking and unfair prejudice to stakeholders.

Particular areas of concern are:

- The potential disturbance of set-off and netting arrangements. Uncertainties around the ability to close out contracts against a defaulting counterparty on a net basis would significantly increase credit risk. This would also increase regulated counterparties' capital requirements (and therefore costs) associated with dealing in derivatives and securities financing arrangements.
- The ability of counterparties to realise collateral held by way of title transfer against the bank.
- The ability of counterparties to enforce security interests (legal charge, lien etc).

- Impact on the rights of assignees of rights of the bank.
- The impact on the rights of employees.
- The impact on pension rights.

Any disturbance of these rights should be kept to an absolute minimum, if at all. Any losses should fall to shareholders in the first instance.

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

A public interest test should be clearly defined and supported by appropriate guidance. Consideration should be given to the application of the public interest test being subject to challenge at court (but only "post facto").

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?

We believe that such a power can be justified in very limited circumstances, ie if all other means - for instance those outlined in our response to question 4.1 – have failed. For this directed transfer tool to be effective, a relevant provision will need to be introduced in the FSMA 2000, which gives the tripartite authorities this power. We see this as analogous to powers enjoyed by the former Building Societies Commission in enabling the takeover of failing building societies, and that of the French Commission Bancaire, which can also effect the takeover of a failing bank by a healthy entity.

Given the risk to stakeholder rights inherent in a partial transfer of the business, we can see reasons why the directed transfer should be limited to the whole of the business of the bank. To allow for partial transfer gives rise to very substantial concerns as to the effective preference of those persons whose dealings are effectively transferred in the directed transfer, leaving those others party to arrangements with a residual banking business which in all likelihood is insolvent. It also raises questions around certainty for close-out netting. The authorities should therefore not be able to 'cherry pick' particular transactions but look at the failing bank's exposure to particular counterparties in their entirety. For instance a counterparty may have a portfolio of off-balance sheet exposures to the failing bank, some of which are in the money and others of which could only be closed out at a loss. It would be unfair for only the in-the-money transactions that are in profit to be transferred leaving the others in the residual bank.

While some efforts could be made to mitigate the effects of partial transfer (such as applying an 'all or nothing' approach to individual counterparties), we believe that the public policy concerns around unfairness of splitting a failing business in this way (not to mention the potential adverse impact on the ability of struggling banks to raise finance) cannot justify the use of a partial transfer. In addition, even if this route were countenanced, there would remain significant practical difficulties in splitting a business and effecting a partial transfer, which would render this option almost impossible to effect within the sort of timeline likely to be necessary to save a failing bank.

A procedure already exists under Part VII of the Financial Services and Markets Act 2000 in relation to the transfer of a bank's business (including its deposit-taking

business). If the authorities are concerned about the publicity surrounding an application for such a transfer scheme, views could be taken as to whether it might be appropriate (in extreme cases) to allow applications under Part VII to be heard *ex parte* provided that creditor rights are not affected. It is essential in terms of the fairness and transparency of the regime that any creditor whose rights are adversely affected is entitled to be heard by the court in relation to the proposed transfer.

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

Judicial review is a procedure in English administrative law by which English courts supervise the exercise of public power. This power is however confined to purely procedural grounds – where the official action was illegal or improper. Judicial reviews are a challenge to the way in which a decision has been made, rather than the rights and wrongs of the conclusion reached. It is suggested that judicial review is not retained as an exclusive remedy and other methods are retained eg court action. The Companies Court would appear to be the appropriate forum for hearing actions on a directed transfer. In going forward, the Government will also need to be mindful of any differences in English and Scottish law that may have a bearing.

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 Financial Services Tribunal is entirely separate from the FSA and has no regulatory agenda. All regulatory decisions of the FSA can be referred to the tribunal; it is there to provide an independent, impartial and judicial oversight of the FSA's decisions. The issue arising here is whether the tribunal, which is largely made up of lawyers, can draw on the appropriate knowledge, skills and experience. Further, it has no remit with respect to HM Treasury or the Bank of England. There are also issues concerning the basis of any decisions that the tribunal might make and whether and in what context these would set precedents. It is therefore not clear that the tribunal would be the appropriate forum.

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 some flexibility in the description of these circumstances is also desirable?

Yes, but only in circumstances where the directed transfer is not possible due to an absence of willing transferees of the banking business. For the same reasons as given above in our response to question 4.7, we believe there is a case for such transfer being of the whole business of the bank.

In the event of a partial transfer it is important to ensure that the division is on a coherent basis and that the arrangements work in such a way that all the creditors of the original institution benefit from the value protected as a result of the partial transfer into the bridge bank and not just the parties to the elements transferred. This is essential if the arrangements are to respect the existing creditor ranking. In the case of a group of companies in most instances it would be less disruptive to adopt an entity-by-entity view.

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

While there is merit in removing shareholders' rights, where there is a strong likelihood of the loss of any residual shareholder value in the enterprise, and directors' rights, as they have been responsible for running the bank to a point where it is at risk of failing, creditors/counterparties' rights should not be compromised.

It is right that there should be compensation but there are many issues arising. Would the amount of compensation have to be related to the value of the bank's assets on liquidation?

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

Please see our response to question 4.8.

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

Please see our response to question 4.9.

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?

We recognise the argument presented in the consultation document for a new insolvency procedure for banks. That said, the proposals would involve a profound change to the existing framework and it is considered that a detailed review of the possible implications is essential before committing to legislation. Also the insolvency arrangements cannot be considered in isolation. The best way forward in this area could be dependent on the (yet to be specified) details of other changes being considered, notably the revised model for the FSCS.

It is explained, in paragraph 4.37, that the principal objective of the bank liquidator would be to assist the FSCS in achieving rapid payments to eligible depositors and that this aim should not be prejudiced by working in the best interests of the creditors as a whole. This suggests that creditors could be disadvantaged by the way the liquidator discharged his functions and gives rise to concerns similar to those articulated above. Clarification is needed here.

If the tripartite authorities wish to have control over entry into the insolvency procedure, the existing legislation could be amended to accommodate this requirement.

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?

Once an insolvency procedure has commenced, it is difficult to see how a bank can continue trading. The nature of operating an account has effectively two characteristics: the service of operating an account, and the maintenance of a

fluctuating debit-credit relationship. Permitting the latter in an insolvency would necessarily involve consideration of whether this affected the *pari passu* treatment of creditors in a way that could not be justified on public policy grounds if such treatment resulted in depositor preference, which the consultation document indicates is not the intention.

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?

According to paragraph 4.37 a further objective would be to protect the interests of creditors. We agree with this.

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

Please see our response to question 4.14.

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?

Please see our response to question 4.14.

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

We believe that the role of the FSCS should be to address the needs of depositors. The costs of insolvency procedure should be dealt with by the administrator or liquidator. The industry should not subsidise the costs of insolvency via the FSCS levy.

Please also see our response to question 4.14.

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

It is not clear from the information provided on the special resolution regime that de facto depositor preference would not occur anyway if this proposal is implemented. We have concerns on the impact on banks funding arrangements associated with the introduction of depositor preference and would therefore advise against it. This is a matter that would need further consideration in the context of the detailed proposals.

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?

Please see our response to question 4.14. In addition we would note that in the event of the model proposed in the consultation document being adopted, once notice of starting insolvency proceedings had been given the tripartite authorities would need to be in a position to take action immediately to prevent the bank facing irresistible pressures.

Governance and operation of the special resolution regime

4.22 What should the governance arrangements for SRR be?

In addition to our responses to questions 4.14 and 4.17, we would add that in administering the SRR the Bank of England should be accountable for their administration and management of the regime. This should include it:

- Justifying the choice made of independent market advisors and restructuring officers, and the fees and/or packages paid to such advisors and officers.
- Setting objectives for the restructuring officers, and verifying their achievements against these objectives.
- Assessing the benefits and the costs accruing to the general public of employing the SRR instead of the normal insolvency regime each time use is made of the SRR arrangements.

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?

We agree with the proposal that the tripartite authorities should be permitted to appoint a restructuring officer to oversee the bank during the implementation of the special resolution tools. We see this role as a critical part of the infrastructure of the SRR and would favour the role being filled by an industry practitioner or professional with relevant experience. An issue that needs to be considered is whether, in addition to the provision of statutory immunity to the Bank of England, there is also a need for statutory immunity to be extended to the restructuring officer.

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

Our only comment is to note that an SRR may not necessitate the appointment of a restructuring officer.

Temporary public ownership

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?

We envisage that there may be circumstances where temporary public ownership could be the least worst response to a failing bank but that pre-definition of the circumstances under which it would be appropriate for such powers to be exercised could be counterproductive if they resulted in rumour and debate about how close a particular credit institution were to being taken into temporary public ownership. This would only be reasonable course of action if one of the very largest banks were at risk. We trust that, given their recent experience, the tripartite authorities will recognise the right circumstances when they see them.

Resolution of building societies and other 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 alongside a similar model for banks?**

We cannot see any reason why the arrangements should not be the same for building societies.

- 4.30 Do you agree that the Treasury should make an Order under the 2007 Act to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members?**

The Building Societies Association is better placed to comment on this.

Requirements on banks

Funding the special resolution regime

- 4.31 Should the industry contribute to the costs of an SRR?**

No. We envisage that the costs of the SRR would be paid for from the proceeds of the bank's transfer or winding up. Given that on a pre-insolvency SRR procedure, there is a solvent bank with some enterprise value, it seems wrong that any person other than the shareholders (and following them creditors) should bear the cost of any action. We understand that there will be cost involved in SRR arrangements but do not see any grounds for providing a soft cushion in the form of industry funding.

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

Please see our response to question 4.31 above; on a directed sale of a solvent bank or transfer of a solvent bank to a bridge bank, post-action quantification and payment by the transferee should be straightforward. On an insolvency, payment out of the insolvent estate in the same way as any other insolvency seems appropriate, and is consistent with insolvency law today.

Contingency planning & 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?**

An agent bank's connection to and relationship with a settlement bank is normally governed by competition and commercial considerations. There may, however, be a role for the Bank of England as part of its proposed formal payment system oversight responsibilities (see response to question 3.7 above) where the failure of a settlement bank threatens the orderly functioning of the payments system. In all likelihood, however, the only feasible solution will be the use of a bridge bank.

4.34 Are there contingency measures that banks could adopt to ensure that their organisation and structure are compatible with the tools proposed in the special resolution regime?

Banks should have contingency plans to switch payment providers and systems. The FSA should review these plans in accordance with its assessment of firms' risks in its normal prudential supervision, notably in relation to Pillar 2, and the ARROW and the Resilience Benchmarking frameworks.

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?

It is not at all clear from the consultation paper what financial collateral arrangements are to be changed.

The vast majority of financial collateral arrangements in the UK rely on the willingness of the courts not to re-characterise title transfer arrangements, and insolvency close-out under the existing insolvency regime.

We see no case for changing the law on title transfer collateral. In the case of other collateral, we are not aware of any particular shortcoming in the existing framework, subject to certain defects in the financial collateral regime as it relates to security interests which are not particularly significant in the context of the UK market.

4.36 Do you have any suggestions as to future revisions to the financial collateral regime that should be considered?

UK arrangement should be compatible with measures expected to result from the forthcoming revision of the EU Financial Collateral Directive.

CHAPTER 5: CONSUMER CONFIDENCE AND COMPENSATION ARRANGEMENTS

Deposit protection

The deposit protection scheme is only necessary as a last resort when the regulatory system has not prevented the failure of a deposit-taking institution. Thus the best protection for depositors will come from well run, appropriately capitalised and profitable banks, operating in effectively regulated and stable markets.

Within this context, we appreciate the Government's desire to act swiftly to build depositor confidence in the system and to enhance clarity and certainty about the outcome in the event of a bank failure. Some of the measures, while well intentioned, could be counter productive in this respect. In particular, announcing a pre-funded scheme conveys the impression that pre-funding necessary, but would invariably involve an explanation that we cannot say when, if ever, the pre-fund would be built up to a level required to cover all eventualities. Similar considerations apply in respect of requiring the development of a single customer view given the extended time that would be needed by many to make systems changes of the nature involved. We therefore believe the emphasis should be more on broadcasting a clear statement about the compensation scheme providing 100% payment up to the agreed limit and that this is backed up by the Bank of England. Depositors would then be clear about what they would receive and have confidence in the money being paid.

In reviewing the adequacy of the deposit element of the FSCS, we believe the following three factors should be considered:

- Scope: which customers, banks and deposits are covered by the scheme.
- Funding: who funds the scheme, through what mechanism and ownership of loss distribution.
- Execution: how the scheme is practically implemented and communicated to customers.

We believe that a move to gross payments may be a pre-requisite to overcoming the practical difficulties in achieving faster payout and/or continued access to guaranteed account money; viewed in conjunction with 100% coverage to £35,000, which covers 96% of individual depositors, gross payments would provide a powerful combination to underpin consumer confidence in the scheme. We are currently giving this further thought and would add that we would in any case wish gross payments to be calculated once payments had worked through the settlement system. We would also need to ensure that the customer understood the basis on which gross payments were made and that this had no bearing on the obligation to repay liabilities, whether mortgages, loans or overdrafts.

Scope

The recent removal of the co-insurance element of the depositor compensation scheme within the £35,000 limit is a highly significant improvement in the protection provided under the scheme.

Simplicity in the eligibility criteria should be achieved by restricting cover to individuals and SMEs. We see no grounds for expanding the scope of eligibility to those entities less in need of protection and see their concerns as lying more in the disruption of their property rights if the legislative changes conspire to provide depositors with de facto preferential creditor status.

Funding

The banking industry has supported improvements in the terms of the FSCS and fully signs up to working with the tripartite authorities to find the means of achieving faster payout in the event of insolvency; we have also agreed to a revised funding structure for the FSCS involving ex-post levy contributions of up to £4 billion per year. But in the highly concentrated UK market we cannot see a role for pre-funding as such arrangements would be either punitive or tokenistic and neither is advisable. Pre-funding would also constitute a drag on bank liquidity and would tie up capital that could otherwise be better utilised. While there may be many pre-funded schemes around the World, there is also a significant body of research that suggests that deposit insurance is not necessarily the right approach and that pre-funding does not play an instrumental role in enhancing consumer confidence⁴.

The source of liquidity for faster payments needs to be agreed especially if a move to gross payments is implemented. We believe that the FSCS, supported by the Bank of England, has a liquidity role to play to facilitate faster payments and to reassure consumers that a large enough pool of money exists so as to avoid a run on the bank.

Execution

While we support the objective of achieving faster compensation payments in the event of failure, there may be practical limits on this. We believe that there may be simpler and more effective means of bringing about faster payments than the approach identified in the consultation document. We plan to come forward with alternatives.

There are major practical implications arising from the single customer view as proposed in the consultation document and it needs to be appreciated that the impact assessment has failed to reflect the huge cost and deployment of IT resource that it would involve for many institutions. This would be to the detriment of other potential improvements in bank IT platforms, would appear unnecessary and would take many years to achieve. Again, other options can bring about the required end result. For all of these reasons, as a practical matter, the emphasis needs to be on the preservation and use of existing accounts and bank infrastructures, to the maximum extent possible. The need for the single customer view is predicated on the export of data to FSCS from an institution's IT infrastructure and we are not sure this is the best way to proceed.

We therefore believe that far greater thought needs to be given to the natural parameters of what can be achieved in terms of ensuring efficient and orderly compensation payout and, where necessary, the arrangement of replacement banking facilities. For any but the smallest institutions seven days is not seen as realistic and fails to take account of the time it takes for balances to settle, let alone issues concerning the single customer view. Moreover, it needs to be appreciated that the industry would struggle to cope with account opening in the event of a large scale withdrawal of banking facilities as a result of an overnight imposition of the bank-specific insolvency procedures. We fully accept, however, that faster payout and an orderly provision of replacement banking facilities is a critical element in maintaining customer confidence and are committed to exploring with the Authorities measures which the industry can agree to on the basis that they are deliverable in practice

⁴ See for example 'Does deposit insurance increase banking system stability? An empirical investigation' published Asli Demirgüç-Kunt and Enrica Detragiache, World Bank Development Research Group and IMF Research Department; also 'Is deposit insurance a good thing and, if so, who should pay for it?', published by Alan D Morrison, Saïd Business School & Merton College, University of Oxford, and Lucy White, Harvard Business School.

and which help consumers appreciate that their money, up to any applicable limit, is truly 'safe'.

Raising awareness

Raising consumer awareness of the terms of the compensation scheme arrangements should be undertaken using a variety of channels: the FSA, the FSCS, consumer bodies and the banks themselves. Careful thought needs to be given to the core messages and we must guard against raising awareness of available compensation inadvertently resulting in risk-averse customers misinterpreting the information imparted.

Compensation limit and coverage

Compensation limit and calculations

5.1 How would a higher compensation limit affect consumer confidence?

We do not believe that a higher limit would necessarily have a material effect on consumer confidence. BBA data shows that £35k is sufficient as 96% of individual deposit and savings accounts are fully covered at this level. A move to a higher level brings additional costs disproportionate to any potential uplift in consumer confidence⁵. We believe that the removal of the co-insurance element of the deposit protection scheme within the current £35k limit has already had a significant impact on consumer confidence. In addition, the current limit leaves the UK scheme competitively placed internationally⁶.

The consumer awareness research in the consultation document⁷, which shows that only 1% of respondents correctly identified the current level of £35k despite the recent interest surrounding Northern Rock, suggests that the precise level itself is of little ongoing interest to consumers. We do not believe that the level of deposit protection was a key driver in starting the run on Northern Rock so it is important that other factors are considered in relation to maintaining consumer confidence in the banking system.

Improved consumer understanding and awareness of the FSCS should increase consumer confidence and trust on the deposit protection arrangements in place during adverse market conditions. We see a consumer education need here which should be addressed through a co-ordinated approach by Government, FSA, FSCS, industry and consumer groups. The new 'Money Guidance' service proposed under the Thoresen Review will also have an important role to play here.

We believe that there may be a case for further improvements to the compensation arrangements and plan to research the different forms which this may take.

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

While there may be a case for a further increase in compensation limits, it needs to be borne in mind that a higher limit, coupled with the removal of co-insurance, could

⁵ Appendix A, figure 1 shows that £50k = 98% of individual accounts and 57% of deposits by value; £100k = 99% of individual accounts and 73% of deposits by value.

⁶ Appendix A, figure 2

⁷ Financial Stability and Depositor Protection: strengthening the framework: Chart 5.4 pg 80

undermine the incentives for consumers to take responsibility for their financial choices. Consumers could be less discerning with their choice of bank as they would be encouraged to select the highest interest rate available up to the level of the raised limit regardless of the risk profile of the bank. However, consumer awareness of the compensation limit would need to increase from existing levels for consumers to be encouraged to act less responsibly in relation to a higher limit. We note however the intention to raise consumer awareness as a desired outcome of the proposed reforms.

Higher compensation limits across the various FSCS broad classes would similarly reduce the need for consumers to consider credit risk in the context of asset allocation.

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

The higher the compensation limit for deposits the greater the risk of market distortion between deposits and other asset classes if other compensation limits are not similarly adjusted. While consumers do not necessarily view deposits as a natural substitute for other asset classes a relatively higher limit for deposits would increase the relative attractiveness of deposits over riskier asset classes. This could lead to sub-optimal asset allocation decisions by the consumer.

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?

The first option of diversification is not practical in circumstances where a large sum of money is held for a short period time given restrictions on account opening.

The third option, of applying increased FSCS compensation limits to accounts which meet certain conditions, is effectively a variant of option 2 (private deposit insurance) but with the risk transferred onto the banking industry. We do not believe that the FSCS was designed to provide cover for significant deposits and other exceptional circumstances, but to act as a safety net for the first tranche of personal liquidity.

We would be concerned with moves to expand the scheme to cover a wider range of scenarios. Such a move has been considered and discounted in the past under previous consultations.

The second option facilitates a market solution to this issue and is therefore our preferred option although we acknowledge that there is currently no market for this product in the UK. Whilst the development of a private deposit insurance market merits serious consideration we do not see mandating deposit-taking institutions to offer such insurance as an appropriate use of legislation and would be concerned that a statutory requirement may in fact reduce depositors' confidence in other mechanisms for depositor protection.

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

It could be argued that certain circumstances are more deserving of additional protection as the large balance has arisen as an integral part of a transaction for

which the depositor has no alternative, such as house purchases. However, this risks an extension of the coverage of the compensation limit beyond its original purpose and the risks attached to a higher limit as discussed above in response to question 5.2.

If customer understanding of the FSCS increases, this will help customers to take an informed decision in managing the risks associated with maintaining large deposits over the limit

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 payouts?

There is a range of circumstances where a consumer may not have direct control over where funds in which they have an interest are deposited, which may therefore potentially have an impact on the levels of FSCS compensation they can receive if they have other accounts with the same bank. For example, accounts held by a qualified guardian for a disabled person; money invested through a credit union; where the consumer is a beneficiary of a trust account and many more.

We note that the current rules in the COMP section of FSA's Handbook which cover the ability of trustees and beneficiaries to make FSCS claims are already complex and vary depending on the type of trust. As a general principle, we believe that the rules for claiming under the FSCS should be as transparent, and simple, as possible, to aid consumer understanding and confidence.

We agree that FSA needs to consult further on the options for dealing with the type of accounts covered by question 5.6, taking full account of the logistical, and potential IT issues, which may arise if compensation is linked to the other investments of the beneficiaries (which could run into hundreds of individuals or more in some cases).

Faster compensation payment

New process

5.7 What are your views on a one-week target for FSCS payment?

We believe that consumer expectation of faster payout is an essential feature of a credible deposit guarantee scheme and understand the motivation for seeking a shorter timeframe for FSCS payments. But we do not see seven day payout as achievable for any but the smallest institutions.

We view the single customer view proposal as impractical and disproportionately expensive and believe that there may be simpler and more effective means of bringing about faster payment. Producing the relevant customer information to inform eligible compensation payments is only part of the equation in delivering a one week FSCS payment. We believe that there are significant additional operational barriers which render a one week payout as unachievable, especially for a larger bank.

There are a number of barriers to achieving a one week payout in practice which need to be explored in more detail concerning practical difficulties in arranging orderly mass transfer of accounts within 5 days: scale; AML obligations; credit assessment;

direct debits; access to ATMs; mortgages; general availability of capacity to undertake this without grinding to a halt.

We believe it would be more effective to use the existing infrastructure of the failing bank to facilitate faster payout.

The size of the failed institution would impact the ability to achieve a payout in the target time given the operational complexities and logistical issues inherent in larger institutions which operate millions of customer accounts, including the logistics of opening new accounts for a significant number of customers in such a short time frame and the impact of unsettled cash payments in the settlement system.

If the existing infrastructure of the failed bank is used it would be important to differentiate between the provision of compensation payments and the transfer of existing, or opening of new current accounts to facilitate the receipt of compensation payments.

The interaction between a single customer view, or an effective alternative, and SRR tools will need to be considered, for instance, the use of the proposed partial transfer SRR tool could require systems to be sufficiently flexible to disaggregate the single customer view if necessary.

Once the new regime is decided there must be a moratorium against further significant change in the near future.

Please also refer to our responses to questions 5.11, 5.20 and 5.24 - 5.27 below.

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?

While it might be feasible for banks to treat FSCS cheques as cleared funds it would be necessary to separately identify these cheques. Cheques might not be the most effective or practical way to make payments under the FSCS as it might be possible to use existing payment channels from the failed bank. Alternative payment solutions to cheques, such as electronic transfers, should be properly considered.

The fraud risks associated with the production and dispatch of a significant number of cheques, which could run to many millions, need to be carefully considered.

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

Please see our response to question 5.8.

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

Interim payments could provide essential short term liquidity for consumers' basic needs in the event that a full payout is not possible within a week. Other countries such as Japan operate an interim payments approach.

The impact on market liquidity in the event of the failure of a major clearer suggests interim payments could also have a practical role to play in maintaining financial

stability. Interim payments could also provide the FSCS more time to verify eligible claims and minimise losses associated with payments to ineligible claimants.

Improved consumer awareness of the features of the deposit protection scheme could address the presentational issues associated with the delay to full repayment of deposits inherent in an interim payment approach. Consumers should be clear that they would receive their full entitlement in due course.

We recognise that interim payments would still require customers to open a new account if one is not in place already.

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?

While many banks have a 'customer relationship' platform enabling them to provide services on the basis of an overall understanding of the account facilities and other services provided to customers, this is not always on a group-wide basis and invariably would not have the capacity for totalling up balances on a real time basis. Moreover, even if such a capability could be developed, to maintain a group-wide customer database with automatic payout by the FSCS in mind would involve data maintenance and cleansing to an improbably high standard for an event that was highly unlikely to occur.

We therefore see major practical implications arising from the single customer view as proposed in the consultation document and are concerned that the impact assessment has failed to reflect the huge cost and deployment of IT resource that it would involve for many institutions. This would be to the detriment of other potential improvements in bank IT platforms, would appear unnecessary and would take many years to achieve.

While our members' are still in the process of assessing the full impact of a move to a single customer view our initial assessment is that it could take a large bank with significant legacy systems at least 3 years to design and implement the necessary changes and cost in the region of £25 million to £50 million per institution. The cost of this measure across the industry would therefore be in the region of several hundred million pounds. It would involve further ongoing cost and add significantly to the scale of any future IT projects involving customer-facing systems since any change to the IT platform would need to be tested across the SCV data capability.

We believe that the costs would be entirely disproportionate to the potential benefits given the low probability of the data being used in practice. The expected regulatory reforms considered elsewhere in this response should lead to a stronger preventative regulatory regime which should make bank defaults even less likely than at present.

Given the above our members are actively considering whether there are additional means of speeding up payout in addition to any reduction in the timeframe that would result from payments being made on a gross basis.

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

We believe that a move to a common data standard or format is unnecessary, would add constraints to banks' data developments, have vast cost implications for the banking industry and would fail any cost benefit analysis.

Please refer to our responses to questions 5.7 and 5.11.

5.13 What information should be included in a single customer view and what would be the implications for firms or different information requirements?

The information as suggested in the consultation document seems sensible although, as discussed above, we consider a move to a single customer view as unrealistic.

Eligibility

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

There would be significant practical difficulties in applying 'flags' to ineligible accounts, particularly where the eligibility criteria are detailed and complex. A more practical approach would be to have a simple set of criteria for scheme eligibility.

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

The existing scope for eligible claimants adequately covers those in need of protection and should be retained. The consultation document proposes to significantly expand the current definition of 'eligible claimant' to incorporate a wider range of claimants for whom the scheme was not originally designed to protect.

We see no grounds for expanding the scope of eligibility to those entities less in need of protection and see their concerns as lying more in the disruption of their property rights if the legislative changes conspire to provide depositors with de facto preferential creditor status.

Gross payments

5.16 To what extent would gross payments help maintain depositor confidence and speed up payment?

It may be that a move to gross payments for eligible depositors will prove to be a prerequisite for finding a practical means of achieving faster compensation payments compatible with providing depositors with access to their account money. This is something that we are giving further thought. But it is important to ensure that gross payments are calculated after taking account of payments working through the settlement system and that customers understand the basis on which gross payments are made, ie that it has no bearing on their obligation to repay liabilities, whether mortgages, loans or overdrafts. We would also ask for the opportunity to think through the potential ramifications for the rights of other creditors in the event of an insolvency. We need, in particular, to persuade ourselves that it does not result in an unintentional move to preferred creditor status for depositors.

Gross payments could have a significant effect on liquidity requirements due to the timing difference between a failed bank's liabilities and its recoverable assets. The FSCS could therefore have a liquidity provision role, supported by the Bank of England, to facilitate gross payments.

We have highlighted in our response to question 5.6 the significant operational barriers for making payments within a seven day deadline and believe this to be impractical for a large bank.

Gross payments could perhaps best be facilitated using the existing infrastructure of a failed bank, where the bank acts as agent of the FSCS. This could involve payments from the insolvent bank's estate; the FSCS providing upfront liquidity for payments on a 'pass-through' basis, or a combination of these two approaches. It may also form an integral part of other approaches aimed at providing retail depositors with access to their account money.

Gross payments from an insolvent bank's estate would require a change to the insolvency law, but would have the benefit of ensuring that the failed bank contributed to minimising the cost of funding for the compensation paid. The FSCS would need to guarantee to reimburse the failed bank's estate for any subsequent shortfall in asset recoveries arising from depositors receiving gross payments in order to preserve the rights of non-depositor creditors.

An alternative option would see the FSCS providing upfront liquidity to provide gross payments to depositors without immediate recourse to the assets of the insolvent bank's estate. We believe that the FSCS, backed by the Bank of England, providing liquidity for gross payments, if necessary, would be the most effective approach for delivering faster payment while underpinning consumer confidence in the context of a post-funded scheme.

Maintenance of the bank's existing infrastructure should be a key objective when implementing SRR tools at the pre-insolvency stage.

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

Gross payments can be justified by maintaining customers' liquidity position so long as it is appreciated that this has no bearing on the recovery of the corresponding bank assets. We do not believe that it would be fair to customers to offset liquid savings against long term mortgage obligations, especially given the shorter compensation settlement timeframe envisaged under the deposit protection scheme reforms.

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

Our response to question 5.16 explains the potential role the FSCS could play in providing liquidity to facilitate gross payments.

The trade off between the benefits of gross payout (to facilitate faster payment) and additional FSCS costs of debt collection should be considered.

It should be noted that the costs to the FSCS, and ultimately the industry, would be higher under gross payouts because of the increased liquidity funding requirement and the potential shortfall in recoveries relative to a set-off procedure.

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

Mandatory set-off is currently enshrined in insolvency law, although different arrangements exist under administration. It will be necessary to understand the full legal ramifications from a move to gross payments under revised FSCS rules from a wholesale or commercial perspective. Please also refer to our response to question 5.16.

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?

We believe that the automatic disbursement of cheques creates too great a risk of fraud.

Many customers hold savings accounts for a number of years without making a transaction, as the dormant accounts initiative has shown. In such circumstances, there is a strong likelihood that the address details held by the failed bank will be out of date. If cheques are sent automatically to these addresses, there is a high risk that they will be intercepted and fraudulently cashed. The speed of issue will also mitigate against these customers being able to correct their out of date address details.

The issue of un-presented cheques and their impact on the customer balance also becomes a consideration with faster payment. There is the potential here for fraud or an adverse impact on third parties.

It is difficult to see how it is possible to reconcile the alternative of electronic payments with the removal of the formal claims process, both in terms of being able to identify appropriate recipient accounts and the acceptance by the claimant of the assignment of their rights to the FSCS.

FCSC funding and liquidity

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

We are strongly of the view that a pre-funded deposit protection scheme is inappropriate for UK market. We believe that there should be greater appreciation of the limited ability of deposit protection schemes to save a troubled bank and the impracticality of devising a scheme large enough to cope with the failure of a large UK institution.

We have significant concerns over the competitiveness impacts on the UK financial sector of moving to a pre-funded deposit protection scheme. The costs of moving to a pre-funded scheme would be significant and would have a harmful effect on banks' competitiveness and their ability to lend to business and individuals alike. The industry has already sustained a significant cost increase from the removal of co-insurance and, subject to further consideration of the issues involved, would be prepared to take on the additional costs of a move to gross payments.

We do not believe that the introduction of pre-funding to cover prospective losses would help deliver the Government's policy objectives of consumer confidence and competitiveness for the financial system. Given the concentration of the UK market,⁸ we believe that this would reduce, rather than improve, consumer confidence, as the majority of deposits are held in institutions for which the size of such a fund would almost certainly be inadequate to meet potential liabilities. Furthermore, pre-funding would tie up capital that could otherwise be effectively utilised. We also believe that the move to a pre-funded scheme in the UK would cause an unnecessary drain on the liquidity position of banks.

We believe that a hybrid funding model, comprising a mixture of pre- and post-funding, would be ineffective in building consumer confidence as the pre-funded pot would, by definition, be even less likely to meet potential liabilities; and, though to a lesser degree, a hybrid scheme would still act as a drain on bank liquidity and resources.

The revised funding structure for the FSCS, as defined by the FSA in PS 07/19, allows for an initial post-funding levy of up to £1.8 billion per annum to be raised from deposit-taking institutions alone, with a further £2.2bn available from the deposit-takers and wider financial services industry combined. The FSA set the new levy thresholds partly on the basis of industry affordability following independent research undertaken by Oxera and prior to the removal of co-insurance from the deposit scheme. This funding structure should cover the vast majority of potential loss events through bank defaults⁹.

We note that in the US scheme, operated by the FDIC, the pre-fund was created for the purposes of closure and/or failure of a large number of small entities operating in that market. It is not set up to resolve problems in a bank the size of Northern Rock nor does the US system necessarily need a pre-fund to operate.

Consumer confidence is driven by expectations that money can be retrieved in a crisis. We believe it would be impractical to build up a UK fund of sufficient size to deliver this. The United States ex-ante scheme of \$49bn, built up over many years and in relation to circa \$4 trillion insured deposits, is approximately equivalent to Northern Rock's retail deposit base prior to the run. So unless it is a small institution that is in distress there would not be enough in the fund to head off a run.

Whilst a pre-funded scheme would provide a ready pool of liquidity in the event of a bank default there are other more efficient means of delivering liquidity for prompt payout.

FDIC insurance is backed by the "full faith and credit of the United States Government". We believe that a similar arrangement whereby the UK government provides support for an FSCS deposit scheme which borrows funds only when required provides the most effective balance for achieving a credible scheme in the eyes of the consumer whilst minimising costs to the industry. (Please refer to our response to question 5.16.)

⁸ Appendix A, figure 3.

⁹ Appendix A, figure 4. Due for implementation on 1 April 2008 under PS 07/19. Oliver Wyman research suggests that new £4bn scheme capacity would cover expected bank default losses in 249 out of 250 years.

In summary:

- The post-funded model is deemed appropriate and proportionate for the UK market and should be retained.
- A move to a pre-funded model is deemed disproportionately expensive and ineffective given the large banks' market concentration feature of the UK deposit market.
- A pre-funded scheme would lead to sub-optimal capital utilisation and ongoing opportunity costs for banks.
- Costs would inevitably be passed through to consumers so that a pre-funded scheme would act as a tax on savings.
- Consumer confidence in the viability of a pre-funded scheme could be undermined by the small size of the fund relative to the large institutions in the sector.
- The new FSCS funding structure should cover the vast majority of potential loss events through bank defaults.
- Large banks are less likely to fail given wider diversification and closer regulatory scrutiny. It is therefore harder to justify the costs of building a pre-funding pool for the UK banking sector relative to the US market.
- Faster payout can be achieved more cost effectively through other means such as FSCS borrowing arrangements, which are underwritten by the industry, or more prompt levying of the industry.
- The introduction of a pre-funded model would create a hybrid model in effect as a post funded element would also be required in any event to cover significant failures and to rebuild a pre-funded pool in the event of payout.
- Pre-funded levies could reduce UK banks' corporation tax payments to the Exchequer if the FDIC approach is adopted.
- The cost effectiveness of the FDIC model, if applied to the UK market, is questionable given its low payout frequency and unproven ability to deal with a large bank failure.

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?

Please see our response to question 5.21.

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

Enhanced FSCS borrowing facilities could provide more flexibility and offer a more cost effective alternative to pre-funding for achieving faster compensation payments, so long as the borrowing is not drawn down until it is actually required for payment. The costs would need to be passed on to the banks at a commercial rate on interest.

Opening new accounts

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

A clear distinction needs to be drawn between savings accounts and current accounts.

For savings accounts, it is more feasible that compensation could be paid within a week. Many customers will already have another account (current or savings) where payment could be credited. For those that do not, opening a new savings account is practicable provided there is ID verification and a cheque to deposit, and subject to capacity constraints, which in turn will be largely driven by the size of the failed institution. In any case, delay beyond a week is less likely to cause undue hardship in all but a small number of cases.

For current accounts, the issues are much greater. There is a real need for continuity of service for the customer, for example to receive salary and pay bills. New account opening of itself could be achieved in branch through a streamlined process in around 20 minutes provided there was adequate customer verification. However, it would take substantially longer to provide the full functionality the customer requires including the production of debit cards (normally, over a week) and the transfer of all standing order and direct debit payments (normally, up to 3 months) which is not all within the control of the bank opening the new account. Direct credits (such as salaries) and direct debits would need to be amended by the originators. Access to credit facilities would require further assessment and checks.

The greatest hurdle to achieving the one week target for account opening, however, would be the capacity constraints inherent in dealing with a failed institution of substantial size. Branch access would be required to open new accounts and deposit cheques, but the entire banking sector would be overwhelmed in the case of, for example, a clearing bank failure. Stock availability of plastics is limited, as is the capacity of fulfilment centres. Normal timescales would inevitably be extended in dealing with the scale of activities.

Given the strain on the UK financial services system that would result from trying to process large-scale FSCS payouts quickly, it would be preferable to maintain the viability of individual institutions and continue to use existing bank infrastructures wherever feasible. In the case of a clearing bank failure, the only practical solution would be to keep the bank running – transferring millions of accounts to other banks would not be feasible.

Please also refer to the concerns expressed in our response to question 5.7.

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

The systemic risks need to be considered in relation to a move to accelerated account opening.

5.26 How else could the account opening process be sped up?

Please see our response to question 5.24.

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

There would be a need for liquidity support in certain circumstances.

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?

The industry generally supports measures aimed at improving consumer awareness and confidence in the deposit protection arrangements and are reviewing the different forms that this may take.

Raising consumer awareness of the terms of the compensation scheme arrangements should be undertaken using a variety of channels – the FSA, the FSCS, consumer bodies and the banks themselves.

Careful thought needs to be given to the core messages and we must guard against raising awareness of available compensation inadvertently resulting in risk-averse customers misinterpreting the information imparted. For their part the banks could give thought to how best to use existing channels and means of communications eg annual/monthly statements, websites, leaflets etc. More innovative approaches such as messaging with tax returns (as those over the limit will probably have to complete them) should also be considered.

Those banks accepting deposits from UK customers, who are subject to full FSCS cover, could be required to display a FSCS approved 'kitemark' in relevant product literature/internet pages etc, to aid consumer understanding and confidence.

5.29 How should disclosure requirements be imposed?

We view disclosure as just one tool to raise consumer awareness. The BBA intends to undertake consumer research to identify the most effective package of measures.

Other protection for consumers

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?

There are a number of potential options which could be explored, including: using the Post Office through some form of giro production; some means of voucher against which large supermarkets or retailers could provide cash-back; or issuing pre-paid cards that ATMs would recognise to enable withdrawal of funds. In some cases the use of Post Office Card Accounts (or the Government Card Account) may provide the answer on a temporary basis.

Other changes to compensation arrangements

Increasing FSCS management flexibility

5.31 What are your views on the proposed changes to increase FSCS management flexibility?

While some streamlining of operations is clearly possible, there are significant issues to consider in determining the extent of these. There are also real, operational impediments to some of the possible changes identified in the consultation document.

5.32 Are there other possible changes which could increase management flexibility for the FSCS or enable it to process a large volume of claims quickly in the most cost-effective way?

We are in the process of reviewing alternative approaches that would overcome the practical difficulties associated with processing a large volume of claims.

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?

Risk-based levies are more relevant in the case of pre-funded compensation arrangements and as we have explained above we do not regard pre-funding as being relevant to the concentrated UK market. Moreover, if the intention behind the proposal is to influence the risk appetite of individual institutions, then we are inclined to the view that existing prudential measures provide a more effective means of achieving this.

Banknote issuance

The consultation paper refers to the arrangements governing the issuing of Scottish and Northern Irish banknotes, resurrecting 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, and the industry had a number of concerns about the original 2005 proposals, some of which could have significant unintended consequences. However, we support the principle 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.

EEA membership of the FSCS

A further issue is the arrangement whereby EEA banks offering deposit-taking facilities in the UK are required to be a member of the home country deposit-protection arrangements but can voluntarily opt into the UK scheme on a top up basis. We believe banks involved in the FSCS on this basis may prefer EU deposit protection arrangements to be based on full membership of the host country scheme.

CHAPTER 6: STRENGTHENING THE BANK OF ENGLAND

We support the codification in statute of the Bank of England's responsibility for financial stability and the overhaul of its money market operations in support of liquidity and payment systems.

Bank of England's objectives

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

We support this. It will enable the Bank to take these formal, statutory responsibilities seriously, and moreover commit the Bank to resourcing its financial stability area more appropriately. Court also needs to raise its game in relation to all developments and risks affecting the economy. We also believe that the statute should be extended – separately - to the Bank's role in the oversight of payment systems (see answer to question 3.7 above).

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?

We support the proposals to:

- Formalise the Chairmanship of Court under the Senior Independent Non-Executive Director;
- Reduce the size of the Court to a more manageable level and improve efficiency and decision-making; and
- Improve the expertise of Court members, with notably a minimum level of experience in financial services, as well as broader economic issues among its members. For instance, a minimum of one [or two] serving commercial bankers.

We also believe that the following further steps should be taken:

- Enhancing the accountability of the Bank's Executive to the Court in relation to financial stability, including the submission of reports, and the acting upon advice from Court;
- A similar requirement in relation to the Bank's statutory responsibility for the oversight of payment systems;
- The participation of a Court member as an observer in the Bank's Financial Stability Board (which should be chaired by the Governor);
- The inclusion, in the Court's annual Non-Executive Directors' report of a summary of the Court's advice to the Executive on financial stability and payment systems oversight matters, and appropriate follow-up; and
- An annual dialogue between the banking industry and the Bank – including a member of Court – on the spending of income from cash ratio deposits which funds the Bank's (financial stability and monetary policy) functions.

CHAPTER 7: EFFECTIVE COORDINATION

We support the proposed strengthening of the tripartite arrangements but see the answer as lying more in the assignment of clear roles and responsibilities for each of the three parties and view this as being the key to improving coordination.

As observed in the Treasury Committee report 'Financial Stability and Transparency', the international nature of the recent instability in the global financial markets and the instantaneous nature of world communications "make national borders largely irrelevant to the transmission of some shocks".

The strengthening of cross-border cooperation under the aegis of the Financial Stability Forum and the International Monetary Fund is therefore of central importance given the global marketplace and international transfer of risk.

In a global banking market practical cross-border supervisory cooperation is also critical in terms of more effective supervision. This is arguably where the greatest systemic risks lie.

Coordination in the UK

Tripartite arrangements & operational arrangements and the MoU

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

We agree that the MoU underpinning the tripartite arrangements needs revision in order to clarifying institutional responsibility, leadership in a crisis, and external communication. We are unsure, however, whether a COBR like mechanism is the right way forward, since the tripartite authorities, not elected politicians, should principally be responsible for the day-to-day response to a financial crisis, drawing on resources from the private sector as necessary. We therefore believe that the way forward has more to do with the establishment of clear roles and responsibilities within the tripartite authorities and an understanding of the process which will trigger the engagement of different parties. As we see it, the FSA should retain responsibility for day-to-day regulation, including the application of heightened supervision, while any decision to invoke the SRR arrangements should be taken by the Chancellor of the Exchequer on the advice of the tripartite authorities. At that point, responsibility for implementing the SRR should transfer from the FSA to the Bank of England.

International arrangements

Financial stability forum, IMF & an early warning system for global financial risks

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

The corollary of ever more global financial markets is the increasingly international nature of financial shocks and risks. We support, therefore, the focus on measures to strengthen international coordination by developing a more robust framework for international cooperation and are supportive of measures intended to strengthen cooperation both internationally and in the EU.

There may also be a case for the discussion of measures aimed at improving the effectiveness of the FSF to include an evaluation of its membership. Consideration should be given to extending membership – perhaps in an associate form – to the Chinese and Indian authorities. Otherwise, we agree with the policy responses identified and with the assumption that the FSF is the body best placed to bring together national authorities and international standard setters.

The improvements proposed to strengthen the IMF's surveillance function are pragmatic and deliverable.

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?

We agree that greater cooperation of the type proposed between the FSF and IMF would provide national regulators with valuable information about possible future risks. This is not to say, as is recognised, that this should in anyway replace national assessments of risk. Rather it should be seen as a mechanism to strengthen existing practices.

The paper rightly identifies the importance of increasing interaction with the global financial services industry. The International Banking Federation has a major role to play in this respect.

Managing cross-border crises

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

We believe that on balance the proposal will aid cross-border crisis resolution but that, as with all legislative action that relates to financial services, we believe that coordinated top-down policy development, led by authoritative international bodies such as the Bank for International Settlements is the right way to proceed. The international nature of many financial service companies and the interrelationship between market participants in different jurisdictions underlines the need to ensure that the UK arrangements now under discussion are compatible with arrangements in place in other countries, notably within the G10 and the EU. But this is not to say that we should seek to saddle ourselves with arrangements that look excessively bureaucratic or unwieldy.

A Impact Assessment

We are concerned that the tripartite authorities have failed to reflect substantial costs to the industry in the Impact Assessment based on a lack of appreciation of the scale of the IT changes that would be involved in delivering the single customer view as proposed in the consultation document.

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

Paragraphs A.206 to A.213 relate to the proposal for a single customer view enabling the FSCS to obtain information from banks and building societies at an earlier stage. Paragraph A.210 states: "There are no significant ongoing or one-off direct costs associated with this measure. This is because the amount of information being required is the same; its just the timing that is different." The cost quantification is given as negligible.

There are major practical implications arising from the single customer view and the impact assessment has failed to reflect the huge cost and deployment of IT resource that it would involve for many institutions. Making these systems changes would be to the detriment of other potential improvements in bank IT platforms, would appear unnecessary and would take many years to achieve. Other approaches would meet the underlying objective without institutions incurring the cost and disruption involved in the identified solution.

While our members are still in the process of assessing the full impact of a move to a single customer view our initial assessment shows that it would take a large bank with significant legacy systems to cope with at least 3 years to design and implement the necessary changes and cost in the region of £25 million to £50 million per institution. The cost of this measure across the industry would therefore be in the region of several hundred million pounds. It would involve further ongoing cost and add significantly to the scale of any future IT projects involving customer-facing systems since any change to the IT platform would need to be tested across the SCV data capability.

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

Only in scale for most.

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

They would not be adversely affected.

Measures which the BBA would wish to place on the table

Included specifically in answers to questions 3.7, after 5.33, 6.1 and 6.2; we have additionally explained that we are considering further the means of ensuring faster payout without requiring the single customer view as proposed in the consultation document.

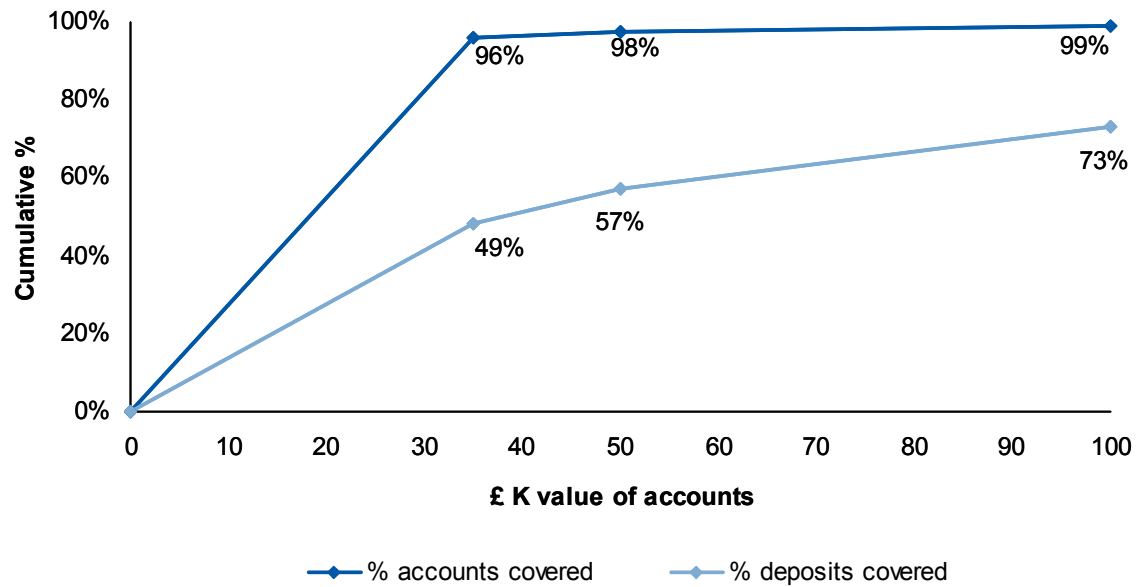
Figure 1: coverage by FSCS deposit limits

Figure 1 shows that the FSCS deposit limit of £35k covers 96% of savings accounts. Increasing the limit would therefore only result in full coverage of a very small percentage of additional depositors.

Figure 1: coverage of UK consumer savings accounts and balances at FSCS limits of £35k, £50k and £100k

UK consumer savings accounts

Distribution of deposits



Source: BBA data based on two Tier 1 banks

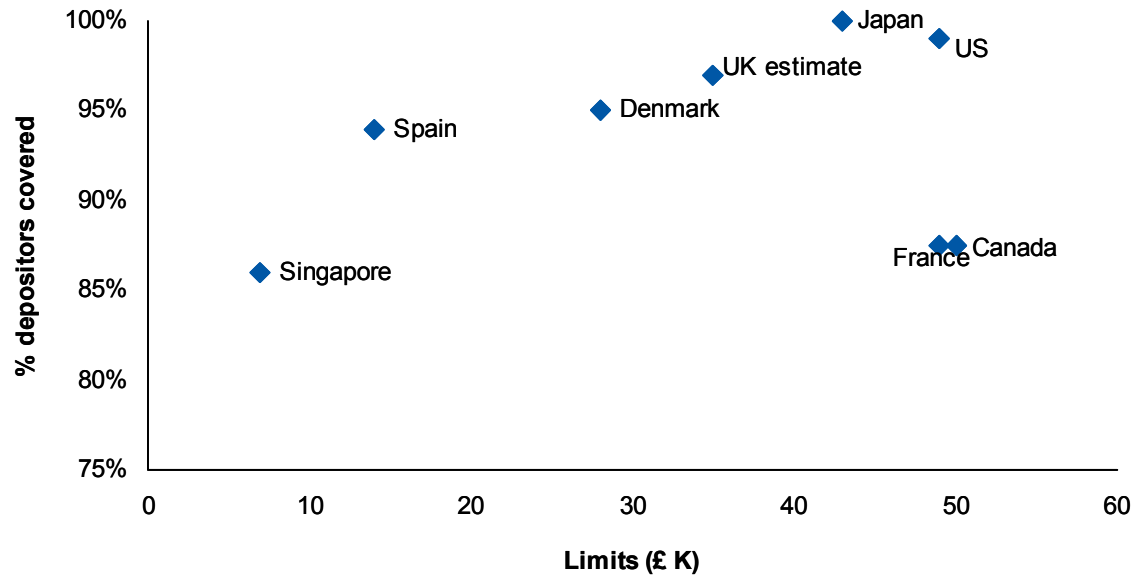
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Figure 2: international comparison on coverage

Figure 2 compares coverage to other international schemes. The percentage of depositors fully covered in the UK compares favourably with other similar countries.

Figure 2: international comparison of deposit insurance coverage by value and percentage of depositors covered

Customer coverage vs. limits of schemes



Sources: Oliver Wyman analysis, "Deposit Insurance Actual and Good Practice" IMF, Garcia (2000)

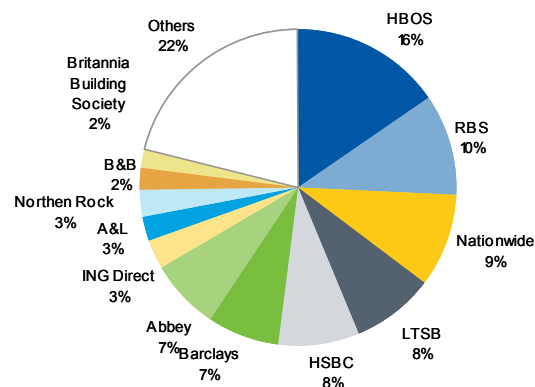
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Figure 3: deposit concentrations in the UK and US

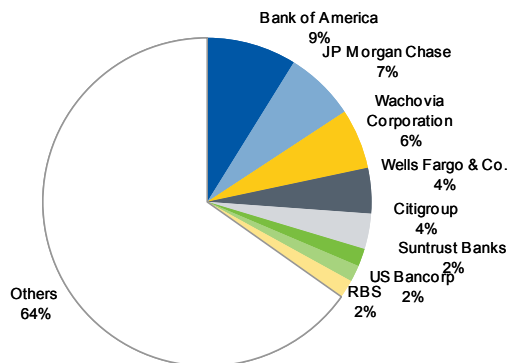
Figure 3 shows the concentration of deposit-taking institutions in the UK and the US. In the US, there are many smaller banks making up a large percentage of the overall deposit base; in the UK, the majority of deposits are held with a small number of institutions. Therefore the main concern of most individual depositors is failure of a larger institution, and it is unlikely that an ex-ante fund could be large enough to reassure depositors of these institutions.

Figure 3: deposit concentrations in the UK and the US

UK retail deposit market share



US retail deposit market share



Source: Deposit Insurance Around the World: A Comprehensive Database, World Bank (2005), FDIC, Oliver Wyman Analysis, Bankscope

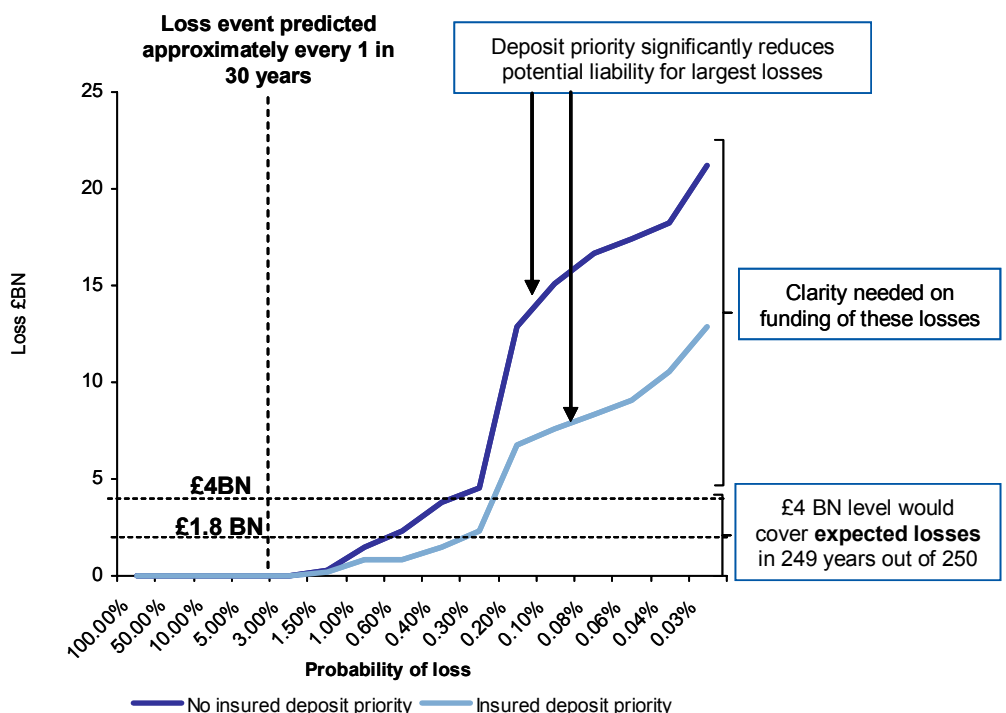
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Figure 4: supporting evidence on funding

Figure 4 shows a simulated loss distribution based on the top 50 UK deposit-taking institutions. We estimate that the current FSCS funding regime (maximum £4Bn per annum) is sufficient to cover losses expected at the 1-in-250 years level. However, the scheme would not be able to fund the (extremely unlikely) event of failure of one or more of the largest deposit-taking institutions.

Figure 4: simulated net loss distribution of guaranteed deposits, with and without deposit priority

Modeled cumulative loss distribution for deposit insurance scheme



Source: Oliver Wyman analysis
 1. Recovery rate of 80% assumed for no deposit priority, 90% for deposit priority with no volatility applied to rates, 25% correlation assumed between institutions

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