

23 April 2008

DISCUSSION PAPER FINANCIAL STABILITY AND DEPOSITOR PROTECTION: STRENGTHENING THE FRAMEWORK JANUARY 2008

Abbey welcomes the Tripartite Authorities' initiative in reviewing the existing supervisory regime, including the legal framework for dealing with banks facing difficulties.

We fully support the objectives in the paper and understand the desire for urgent action.

However, at the same time, we believe that, given the scale of change proposed, it is crucial to guard against the risk of unintended adverse consequences and disproportionate action which could be very damaging to the industry, its customers and the UK economy as a whole.

For this reason, it is important to ensure that a thorough consultation process is followed and a rigorous impact assessment carried out. As a part of this, it is important to scenario test all of the proposals that are taken forward to ensure that, should they be adopted, the impacts are clearly understood.

Changes to the regulatory environment have already been made with the removal of co-funding, the introduction of a cross-subsidised FSCS funding model and more intense prudential supervision. It is important that additional measures are considered in the round to ensure they do not overshoot their target and damage the industry's competitive position.

The ambitious time table proposed for this initiative, and the pressures this will place, on both policy makers and respondents, pose a considerable risk that the consultation process could be compromised. We urge that a measured approach be taken.

Abbey Approach to responding to the Consultation.

Abbey has fully engaged with the consultation process. We have fully supported the HMT workshop process and attended senior management meetings with policymakers.

We have worked in close collaboration with the British Bankers Association in formulating the industry response to this consultation paper and we agree fully with the points made therein.

We do not intend to repeat the full extent of the BBA response here, but we do wish to highlight the key issues that we believe need to be addressed before any changes are made to the regulatory framework.

Abbey response

1. Regulatory Effectiveness

We believe that the real key to financial stability is effective supervision of firms and markets. Prevention is far better than cure. Whilst recognising the responsibility of a firm's owners and senior management, it is vital that regulatory interaction is both effective and timely to respond to changes in both the market and firms themselves.

In particular, regulators must adopt the right balance of pragmatism and robust challenge in response to liquidity and capitalisation issues.

The central banks have an important role to play in maintaining a healthy and active market and respond to calls for assistance in a pragmatic way that does not create stigma and damage confidence.

The FSA must adopt a challenging and informed approach to firm's business models and risk profile to drive transparency and prudent management of capital and liquidity. At the same time, it must strike a balance to ensure that innovation and product diversity is preserved although not at the expense of customer's interests.

It is also important that there is a tangible regulatory dividend for well managed and well capitalised firms (this is an important factor when considering scheme funding).

We recognise the challenges that this presents but we believe that the key lies less in developing new regulatory tools but more in the effective use of existing ones (albeit refined to take into account recent experience).

Deposit Protection Scheme - Funding

We do not agree that a pre-funded scheme is appropriate or proportionate. Whilst recognising that such a basis has some positive features, these are by far outweighed by the negative and detrimental impacts.

A pre-funded scheme is not appropriate for the concentrated UK banking market as it would take many decades of industry funding to build up a fund of sufficient size to compensate customers for the failure of anything but a small bank. Far from building confidence, public awareness of a pre-funded scheme that was inadequate to meet the potential calls upon it would potentially do further damage.

In addition, the punitive effect on the industry of having to contribute to a compensation scheme is not warranted based on the claims experience. The costs of taking capital out of the industry to be held in a separate fund are therefore unlikely to be justified. The failure of smaller banks can easily be addressed by the existing post-funded scheme and the failure of a larger bank would require a fund of such a size as to be unrealistic.

The cost of this basis of funding would form a barrier to entry for potential market participants in the UK, the EU and internationally. It is also a potential increased cost for UK firms that may wish to operate abroad. It is therefore important that the international competitive impacts are fully considered.

In the UK, the position of the other compensation schemes needs to be carefully considered. If the deposit protection scheme adopts a pre-funded model, it is arguable that the same principle should apply to the compensation schemes for other classes of business to maintain a level-playing field. This being the case, the costs and impacts would be much greater and the principle of pre funding should be open to wider consultation and cost benefit analysis.

Any measure that increase the costs of financial services without a corresponding increase in customer benefit should be avoided as inevitably, all costs are met by consumers.

We believe that the objectives of the scheme can equally be met by a post-funded scheme without the cost and negative factors associated with a pre-funded scheme. This would be a much more proportionate and appropriate response.

In our view, the most effective way of meeting the funding needs of the scheme is for the scheme to call on the industry for funding up to agreed limits in the normal way, with the balance of funding obtained in the short term from the money markets. In the medium to long term, the full costs of the scheme would, as now, be met by the industry. The scheme will also need to be subject to Government/Treasury guarantee.

In principle, we also support the concept of a risk-based levy and we believe that this can be applied to a post-funded scheme by applying a risk loading to annual levies.

Deposit Protection Scheme - Scheme Limit

We do not believe that a higher limit would necessarily have a material impact on consumer confidence. Our understanding is that the existing compensation limit fully covers 96% of

individual deposit and savings accounts. In addition this limit compares very favourably with other schemes across Europe.

Deposit Protection Scheme - Speed of Payment

We believe that the proposal to pay compensation within 7 days may be possible for small banks but is unrealistic for large banks. In this instance, we believe that the requirement for a fast payment can be met by a combination of using the failed banks infrastructure and the making of staged payments.

It is important to consider the logistical issues of the volume of payments and capacity in the banking system to cope with a large volume of account openings. In the event of a large bank failure, it is likely that other banks will be undergoing a similar level of both economic and transactional stress which could impair their ability for timely response to this situation. It will also be important to consider the risk of fraud and errors under such circumstances.

There will also be considerable issues with money in transit/uncleared funds and it will be important to apply some controls in order to achieve some certainty in claims management.

Special Resolution Regime

The BBA response more fully explains our position on this issue but our key concerns are below.

This is an important and complex element of the proposals and an area where we would urge extreme caution in changing established insolvency law. We believe that existing insolvency law provides all the necessary tools to manage a bank in distress and we are opposed to any changes to the existing regime unless it is clear that appropriate safeguards are in place. Our concern is that the SRR will become a self fulfilling prophesy as the implementation of an SRR is likely to be viewed by the market as an insolvency event and this could jeopardise market confidence.

It is difficult to comment on the specific elements of the SRR as the Consultation paper contains only high level proposals. It is crucial that any changes, however minor, are rigorously assessed for impact. However, based on the information provided, there are three key issues that require careful consideration:

- SRR triggers
- SRR oversight
- Property rights

SRR triggers – key points here are transparency, certainty and a qualitative as well as quantitative approach. It is important that firms understand the triggers and their position against them. However, once any quantitative threshold has been crossed, it is essential the regulators adopt a quantitative approach and take tailored actions depending on the circumstances prevailing at the time.

SRR oversight – it is correct that the FSA should take a leading role in assessing a firm's position against the triggers and fully participates in the decision as to whether an SRR is invoked. However, we do not believe the FSA should oversee the SRR arrangements due to the potential conflict of interest. We believe that another authority (such as the Bank of England) should undertake this role until the issues are resolved and stability restored.

Property rights – this is a complex area and one where unintended consequences should be avoided. We believe that the current creditor priority should be maintained and that it is important that the SRR does not give depositors preferred creditor status by default.

Single Customer View

Abbey's systems, developed in conjunction with Santander, do enable us now to achieve a single customer view, although we believe that this is a unique position. There are many

customer and business benefits in having a single view of the customer besides the advantages set out in the Consultation Paper.

Nevertheless developing this solution across all the banks will be costly and will take a number of years.

Conclusion and suggested way forward

Our view is that the proposals in this paper should be broken down into those which will have the most immediate effect and can be quickly implemented and those which require further consideration. This approach will satisfy the joint need for prompt action with measurable benefits and avoidance of unintended consequences.

Immediate actions include prevention measures which enhance the standard of supervision and reduce the likelihood of failure. In addition, there are a number of measures that can be taken to improve customer understanding of the compensation scheme so that customers are aware of the extent to which they are protected and have the opportunity to manage their risks. We believe that the industry would support prompt action in these areas and play its full part in delivery.

Measures requiring further consideration are those relating to the funding of the scheme and the SRR. Both of these proposals have the potential to fundamentally impact on the financial services market in the UK and internationally.

We therefore believe that these should be separated out and a longer timescale applied to allow for the application of better regulation process to be robustly followed. This should include cost benefit and impact assessments, scenario testing and consideration of the international and competitive impacts. Once again, the industry would fully support this analysis to ensure that a clear understanding is achieved.

Abbey remains committed to supporting the consultation process and working to develop a practical and proportionate series of measures to support Financial Stability and Depositor Protection in the UK.

Yours sincerely