

BBA RESPONSE TO THE TRIPARTITE DISCUSSION PAPER: BANKING REFORM – PROTECTING DEPOSITORS

Introduction

The British Bankers' Association welcomes the opportunity to respond to the Government's discussion paper 'Banking reform – protecting depositors: October 2007'.

The BBA is the leading UK banking and financial services trade association and acts on behalf of its members on domestic and international issues. Our 227 banking members are from 60 different countries and collectively provide the full range of banking and financial services. They operate some 130 million accounts, contribute £50BN to the economy and together make up the world's largest international banking centre.

This document outlines our general comments on the paper, provides responses to the detailed questions and raises additional issues not explicitly addressed in the discussion paper that we believe are important in relation to depositor protection and financial stability.

General comments on the discussion paper

Overview

This discussion paper focuses on issues relating to the deposit protection scheme, critical banking functions and general insolvency law including whether this should be modified with regard to banks and other deposit takers.

However, this discussion paper does not deal with many other important matters relating to the run on the Northern Rock, and consequently our response is in two parts with the second separate section considering in more depth the wider context of the credit crunch and our related recommendations¹.

The banks are very willing to engage in discussions about possible additional changes to the deposit protection aspects of the Financial Services Compensation Scheme (FSCS). It is, however, not the terms of the scheme which lead to the run on the Northern Rock, rather that deposit protection became an issue only after the bank's website crashed and after the run had started.

Nevertheless, consumer confidence in deposit protection is an important factor in financial stability and so following recent events a review of its framework is appropriate. The BBA and its members are willing to support the efforts of the tripartite authorities in conducting such a review and in the development and implementation of any appropriate changes that may be required to maintain both consumer confidence and appropriate consumer protection.

¹ Recommendations regarding financial stability, regulatory coordination and issues in the international mortgage backed securities and credit markets.

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Recourse though to the deposit protection scheme is only necessary as a last resort and 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 well regulated and stable markets. The BBA therefore emphasises the need for a thorough review of market regulation to examine the operation of existing tripartite arrangements within the broader regulatory and economic context. Further, there should be an independent review of events leading up to the run on the Northern Rock with a view to considering what lessons can be learned by the authorities and what changes should take place. The critical urgency therefore does not lie in further reforms to the deposit protection scheme rather with the completion of the reviews of the framework and its execution.

1. In Respect of the Framework

The BBA continues to support the basic framework of the tripartite and the concept of principles-based regulation and risk-based supervision. However there is a need to review the earlier stages of the regulatory process, covering the following areas:

- The clearer allocation of roles and responsibilities among the tripartite regulatory structure of HM Treasury, the Financial Services Authority and the Bank of England. In particular, to consider what steps the FSA and Bank of England can take to work more closely together;
- Re-examining the regulatory framework for prudential supervision and especially institutions' liquidity risk management;
- Clarification of the Bank of England's money market operations, reviewing how assistance is made and how it is communicated to the market;
- Better management of communicating reassuring messages to the markets;
- The international context in which these matters sit.

2. In Respect of Deposit Protection

Whilst we agree that deposit guarantees have an important part to play in financial stability, we believe that depositor protection, and in particular the need for prompt corrective action are secondary to broader issues of regulatory monitoring and supervision.

In emphasising the necessity of maintaining a stable and confidence-inspiring regime, the following elements of depositor protection are important:

- A deposit guarantee scheme that protects the vast majority of retail depositors in full;
- Simplicity and clear communication of the deposit guarantee scheme so that each depositor is aware of his or her coverage under the scheme;
- A clearly established framework for prompt corrective action in response to clearly defined and transparent risk triggers – such a framework would need to comprise relevant regulatory information tools and actions that would enable identification of issues early enough for effective corrective action by the tripartite authorities;
- Arrangements that allow access to deposits in a reasonable timeframe in the event that corrective action proves ineffective.

3. In Respect of the Wider Impact

Evidently any reforms need to take into account the wider effects that changes may cause and in particular the following:

- Introducing “moral hazard” may reduce the competitiveness of the financial services industry or the possibility that comprehensive deposit guarantees could lead to a lessening of the focus on prudential risk management;

- Placing excessive cost on the financial services industry, either in the short term or in the event of a bank failure;
- Unforeseen consequences such as changes in contractual terms applied by other stakeholders (for example changes to conditions and rates of wholesale funding and changes to the credit rating agency perspective of the UK banking industry).

Reforms to the Financial Services Compensation Scheme

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; ownership of loss distribution;
- Execution: how the scheme is practically implemented and communicated to customers.

Of these three factors, we believe that scope is likely to have the greatest effect on consumer confidence in the short-term. However, we believe that appropriate execution will be key in promoting future financial stability.

Scope

We believe that simplicity of the scheme coverage definition is essential to building consumer confidence. Some of the detailed definitional issues to be addressed include:

- Treatment of joint accounts;
- Off-setting of borrowing from the same institution;
- Coverage at the banking authorisation or brand level;
- Distinction between business and consumer customers.

In all these cases we would favour an approach that simplifies the consumer's understanding of his or her coverage under the scheme.

We believe that the existing coverage limit of £35K combined with the removal of co-insurance fulfils the objective of protecting the vast majority of retail depositors. Data collected from BBA members suggests that 96% of consumer savings accounts are covered by a £35K limit², which compares favourably with coverage in other countries. We believe that any further increase in coverage, though it may increase consumer confidence in the short-term, would undermine longer-term financial stability through increased scheme costs and by placing emphasis on deposit insurance rather than prudential regulation as the primary mechanism for depositor protection.

We do not believe that private insurance of deposits above the £35K limit is a feasible option for increasing coverage. It is unlikely that there is naturally a market for such a form of insurance – in terms of either demand or supply. Furthermore, we believe that mandating deposit-taking institutions to offer such insurance would reduce depositors' confidence in other mechanisms for depositor protection. We are not aware of any examples in other countries of deposits being protected using private insurance.

² See Appendix A for supporting evidence on coverage

Funding

In our opinion, funding of the scheme has to be transparent and affordable to the industry. The removal of the 10% coinsurance from the scheme has increased potential cost to the industry by a multiple; increasing the limit above £35K would materially add to this increased cost.

The revised funding structure for the FSCS, as defined by the FSA in PS 07/19³, allows for an initial ex-post levy of up to £1.8BN 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 combined⁴. 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.

A further increase in the limit to, say, £100K would significantly increase costs to industry for a relatively small impact in terms of increasing consumer confidence⁵. Such a move would primarily benefit business customers and wealthy individuals whilst providing marginal additional benefit to those consumers most in need of deposit protection. A move to £100K would leave the UK scheme significantly out of step with its international competitors⁶ and also increase moral hazard.

We believe that the new funding structure will cover the vast majority of potential loss events arising from bank failure. However, we acknowledge the highly concentrated nature of the UK deposit base (in contrast to, say, the US), which means that failure of one of the largest deposit-taking institutions would not be fully covered by the scheme. Clarity is requested from the tripartite authorities on how losses arising from such a large institution failure would be funded⁷.

We believe that an ex-post funding system is appropriate in the UK due to the concentrated nature, of its banking sector, unlike the US which has many smaller institutions and an ex-ante scheme. There are two primary arguments in favour of ex-post systems in concentrated markets. Firstly, consumer confidence in the viability of an ex-ante fund may be low due to the small size of the fund relative to some single, large member institutions. Secondly, a readily available liquidity pool will not be required as “big bank” failure is much less likely due to risk diversification.

We do not believe that the introduction of an ex-ante fund 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, 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, an ex-ante fund would tie up capital that could otherwise be effectively utilised. We also believe that the move to an ex-ante scheme in the UK would cause an unnecessary drain on the liquidity position of banks.

We believe that a hybrid funding model, comprising a mix of ex-ante and ex-post funding, would be even less effective than an ex-ante scheme in building consumer confidence as the ex-ante pot,

³ PS 07/19 – FSCS Funding Review – Feedback on CP 07/05

⁴ Deposit-takers will make a contribution to the additional £2.2BN through their activity in other business classes.

⁵ Appendix A provides evidence which demonstrates the significant increase in industry costs by value of accounts relative to the small uplift in the cumulative number of consumer savings accounts covered under a move to a limit of £100K.

⁶ See Appendix A, Figure 2

⁷ See Appendix B for supporting evidence on funding

other things being equal, would be smaller under the Hybrid model. In addition, a hybrid scheme would still act as a drain on bank liquidity and resources.

Execution

The practicalities of implementing the scheme are some of the most difficult issues to resolve, but also those that we believe will have the greatest long-term effect on consumer confidence. In our opinion, execution needs to cover three key areas:

- Communication to raise awareness of the existence of the scheme and the protection it offers;
- Speed of payout in the event of bank failure;
- Amount of payout.

The BBA and its members are prepared to support the tripartite authorities in developing appropriate forms of communication to raise awareness of the FSCS. We believe that this task will be made significantly easier through adhering to an approach geared towards simplicity as outlined above.

We believe that the expected speed of payout is an important factor in consumer confidence in the scheme. The current arrangements do not provide consumers with sufficient reason to resist from pursuing immediate withdrawals hence exacerbating a run on a bank.

It is not feasible to expect customer account data to be exported from one institution to another, due to the diversity and complexity of the systems used by different banks, so alternative measures should be sought.

In practical terms, speed of payout is best facilitated through existing bank channels (cheques, cash or electronic). In our view, payments would need to be paid within a few days and facilitated by the following:

- Deposits might need to be repaid on a gross basis (i.e. no netting of customer liabilities to the bank but indemnities put in place);
- Arrangements which make it possible for the staff of Bank A (or a special administrator) to take over and operate distressed Bank B's systems to execute payments.

The source of liquidity for immediate payments needs to be agreed. We believe that this liquidity should be provided by the Bank of England to reassure consumers that a large enough pool of money exists so as to avoid a run on the bank.

It will also be important for consumers to be clear on the size of the payout in the event of a bank failure. Consumers might for example receive an interim payment which is sufficient to tie them over until such time as they can switch banks.

Corrective Action and Resolution

Administration is expensive and typically leads to a step change in the value of the business. This is especially so with knowledge businesses such as banks.

It is therefore important to focus on developing preventive and corrective measures which reduce the likelihood of a distressed bank moving towards insolvency and triggering a call on the deposit scheme.

Preventative measures would need to consider a range of distress scenarios extending from an initial risk alert, which can be addressed by ongoing supervisory monitoring, through to pre-emptive action which tends towards formal administration procedures.

A more proactive intervention framework might include the following features:

- A more appropriate range of regulatory indicators – using a risk-based approach;
- A toolkit of options for action linked to clearly defined and transparent event triggers;
- Increased dialogue between the Bank of England and individual banks and the FSA to enhance intelligence gathering and inform more proactive monitoring and intervention.

Event triggers might include:

- Deteriorating financial position – especially with respect to liquidity but also capital; earnings and asset quality;
- Suspected or actual fraud;
- Significant growth in business or shift in strategic business planning;
- Other emerging threats to FSA's Threshold Conditions.

The structure and/or operation of FSA's ARROW framework could be changed to facilitate the above.

In particular we think that FSA ARROW reviews could give greater emphasis to liquidity by, for example:

- Setting out clear parameters around off balance sheet exposure and checking against them;
- Examining the relationship between the level of wholesale funding and its term relative to total assets;
- Considering short-term cash flow and coverage for calls on demand.

Regulatory intervention would be calibrated to the risk factor identified. A more proactive approach might see pre-emptive moves by the FSA, firstly by challenging the risk assessment of the entity involved, then by working more proactively with its tripartite partners, to head off, or better manage, a problem which might arise and lastly the consideration of a move towards administration or the last resort of insolvency. This approach might best be conducted under the auspices of a special administration regime for banks which falls short of a new insolvency regime.

For example; the authorities could intervene in a scenario where the bank is still solvent but a material risk has gone uncorrected or has increased. A range of intervention tools could be considered such as:

- suspension of dealing in the distressed bank's shares whilst the situation is stabilised;
- control handed to senior management of an acquiring bank or special administrator;
- critical banking functions to be maintained through a bridge bank arrangement or by one bank assuming operational control of the distressed bank.

The impact of the media would clearly need to be factored into intervention strategies.

Critical banking functions for depositors in going or gone concern scenarios would impact on the rights of other creditors. The interaction with existing insolvency legislation would need to be carefully considered.

We are aware that the tripartite authorities are undertaking their own work on potential corrective action and resolution measures and the BBA and our members are happy to collaborate on this work. One matter that needs to be explicitly addressed in addition to those identified above is the recognition that confidentiality is required as a means whereby a better and more orderly outcome can be achieved for a bank that has found itself in difficulties.

Critical Banking Functions

We believe that the continued provision of Critical Banking Functions (CBF) in the event of bank distress or failure can be separated from depositor protection, and that such a separation is worthwhile as the issues to be addressed are fundamentally different.

The former would require changes to the methods of resolution of a failing or failed institution, and is therefore intrinsically linked to the legal framework dictating the processes of administration and liquidation. Any changes to this framework (for example introducing a special administration regime) could have far-reaching consequences and will therefore require much greater scrutiny than changes that are confined to the FSCS.

We accept that UK consumers are increasingly reliant on banking services in their daily lives and provisions need to be made to maintain transactional services in the event of bank failure. These transactional services for both consumers and businesses are typically delivered through a current account which facilitates the critical functions of salary payments, cash withdrawals, debit card payments and direct debit payments. It is these critical services provided by current accounts that would need to be maintained in the event of a bank failure.

However, it is important to recognise that banks operate as an organic whole and that it will not be a simple matter to divide a bank and its personnel between critical and non-critical functions.

We recognise that business customers, especially those too large to be covered by the deposit scheme, are likely to have more complex needs than private individuals and would most likely need more time to transfer to a new provider. We emphasise the need for a well organised switch process in the event of a bank failure.

The main issue for private customers is likely to be the need for access to immediate funds, and we suggest that the Government needs to be willing to provide automatic emergency funding, via the Bank of England, of individual customers' balances up to, say, £5K per individual. This would reflect around two months' income for an average household, and should therefore allow sufficient time for replacement banking arrangements to be put in place and further payments under the scheme to be made. Such arrangements would mirror the model operated in Japan to which we refer below.

The impact of maintaining critical banking functions on banks' contingency planning arrangements would need to be carefully assessed.

In addition to the above we are aware that APACS has identified the following issues with which we concur:

- The Bank of England's settlement account would need to retain sufficient liquidity to facilitate CBF operations;
- CBF would need to be maintained notwithstanding the risk of a shrinking deposit base;
- All banks would need to be covered by any new arrangements;
- The 'window' for CBF operations would need to be communicated clearly to the public;
- The insolvency regime impact of unsecured creditors being given access to CBF needs to be considered;
- Integrity of the accounting systems to ensure effective CBF operations would need to be maintained.

Specific responses to discussion paper questions

Question 2.1: Do you agree that these are the right objectives? Are any of these objectives more important than others?

We broadly agree with the objectives for the reform of the deposit insurance scheme outlined in the discussion paper however we repeat our concerns that the discussion paper is too narrow in scope.

We believe that building consumer confidence and maintaining market confidence are the key objectives. They are crucial to preventing bank runs, increasing financial stability and maintaining the reputation of the UK financial services industry. Consumer confidence can be built by having a clear, simple scheme with an effective action plan for resolving banks at risk of moving towards a distressed state or failed institutions.

However, it is important that any reform does not distort the savings market and does protect the UK's overall international competitive position. We feel that the scheme should have a measure of risk-based funding incorporated into its design. This would better align the cost to individual firms with their business model risks; discourage inappropriate strategies and provide incentives to encourage prudential risk management.

We believe the objective of protecting the taxpayer's interest should be broadened to incorporate protection of the UK's competitive position, including not only the financial services industry, but also the wider business economy which is dependent upon the services which it supplies. Moreover, the Government needs to consider the wider international context and the effect of any proposals on international banks. We do not want the UK system to incentivise other countries to seize assets in the event of a bank failure.

Critical banking services require careful definition but we agree that consumers in the UK have become heavily reliant on electronic payments and provisions should be made to maintain defined functions in the event of a bank failure.

Question 2.2: What other issues should the Government consider when reviewing the framework for depositor protection?

In our opinion there are three further issues that the government should consider when reviewing the framework for depositor insurance.

First, the tripartite authorities should be clear on the size of bank for which the FSCS is meant to provide deposit protection on a standalone basis and the alternative crisis management arrangements for those large banks unlikely to be covered by the scheme alone. Consideration should be given to what would happen if a foreign owned deposit-taker gets into difficulty and whether this would warrant a different response?

Secondly, the competitiveness of the UK banking industry should not be adversely affected by any changes to the framework. Competitiveness could be harmed through the high cost of implementing changes, increased cost of funding for the industry resulting from changes to insolvency laws or designing a scheme that will place an undue cost on the industry when compensating depositors.

Thirdly, any revisions to the framework should not increase 'moral hazard' in the banking industry; changes to the scheme should not reduce the incentive for customers to diversify deposits or for banks to act responsibly with customers' deposits.

Question 2.3: What other issues should the Government consider when considering how best to preserve any critical banking functions?

We believe that there are a detailed set of other issues that need to be addressed when considering the preservation of critical banking functions in the UK:

- Definition of critical banking functions;
- Framework for prompt corrective action;
- Limitations of any technology-based solutions;
- Cost of implementation;
- Capacity of the broader banking system to absorb any affected customers.

Please also refer to the General Comments section above.

Question 3.1: Should the level of coverage for deposits be increased from £35,000? If so, to what level and what are the benefits and costs of doing so? Should the bank deposit limits be related to those for other sectors, e.g. investment business and insurance?

We believe that limit-setting should balance the objective of enhancing consumer confidence through adequate coverage against the implications for moral hazard and increasing the cost of the scheme. Using this rationale, we do not believe there is any reason to increase the limits of the scheme.

The current coverage limit of £35K offers excellent protection to small depositors, covering 96% of consumer savings accounts. Any increase in the limit only marginally increases the number of accounts covered whilst significantly increasing the costs. A further increase in the limit to, say £100K, could significantly increase costs to industry for a relatively small impact in terms of increasing consumer confidence⁸. Such a move would primarily benefit business customers and wealthy individuals whilst providing marginal additional benefit to those consumers most in need of deposit protection. A move to £100K would leave the UK scheme significantly out of step with its international competitors⁹.

In addition, the current UK limit of £35K is in-line with limits seen in other schemes globally. For example, coverage limits are currently \$100K (~£50K) in the US, ¥10 MM (~£43K) in Japan and €40K (~£28K) in Netherlands.

Any increase in coverage comes at a cost of increased moral hazard. An increased limit will mean depositors have a reduced incentive to diversify deposits and could impact some lenders' appetite for risk.

In addition, an increase in the coverage limit will increase the overall cost of the scheme. Significant cost increases will place a greater burden on deposit-taking institutions and the taxpayer, with negative implications for the competitiveness of the UK financial services sector.

When evaluating coverage limits it is important to consider the concept of co-insurance. The previous UK scheme included 10% co-insurance between £2K and £35K. Theoretically, introducing co-insurance should reduce moral hazard through the principle of risk-sharing. In addition, it significantly reduces the overall cost of the scheme as depositors bear the first 10% of any losses. We propose that if there were to be an increase in the coverage limit, then co-insurance would be a useful method for minimising any additional cost pressure to the scheme whilst providing some

⁸ Appendix A provides evidence which demonstrates the significant increase in industry costs by value of accounts relative to the small uplift in the cumulative number of consumer savings accounts covered under a move to a limit of £100K.

⁹ See Appendix A, Figure 2.

reassurance to a small percentage of depositors with more than £35K in deposits. Such logic was recently applied in the Netherlands. The coverage limit was raised from €20K to €40K, but with 10% co-insurance applied on deposits of between €20K and €40K.

We believe that consumer perception of deposits is fundamentally different from other products, particularly in terms of consumers' level of risk appetite. In general, consumers consider deposits to be 'safe' while investments are considered 'risky'. This is also reflected in the regulated sales process applied to investments, but not to deposits. Therefore compensation schemes do not necessarily need to be aligned across products, provided that differences in the components do not result in unintended distortions in customer buying behaviours within the savings markets.

Question 3.2: Would it be desirable to put in place arrangements to better ensure that depositors are repaid in a more timely fashion? What issues would need to be considered in assessing any new arrangements?

We believe that prompt repayment of depositors in the event of bank failure is crucial to the success of any deposit insurance scheme. Consumer research suggests that concerns about untimely repayments are one of the primary reasons why customers would "run" to withdraw deposits at a distressed bank. Therefore, there is a need for clarification on exactly how quickly such payment could occur. Depositors need to feel comfortable that they will be able to access their deposits rapidly.

We believe it is important to define how much will be repaid. If the speedy resolution of total insured deposits is deemed unrealistic, it may be beneficial to provide partial payments to cover the immediate liquidity requirements of depositors. The Japanese scheme has provisions for payments of ¥600K (~£3K) to cover the costs of immediate living expenses if full repayment is expected to take a long time.

The source of liquidity for immediate payments needs to be agreed. It is extremely unlikely that the sale of bank assets will precede the insurance payments, and as such there will be a need for immediate liquidity. We believe that this liquidity should be provided by the Bank of England to reassure consumers that a large enough pool of money exists so as to avoid a run on the bank.

A final point to note relates to the current systems capabilities of banks. Technology-based plans have been discussed (e.g. the export of data to another institution). However, we do not believe this to be a feasible option due to the diversity and complexity of the systems used in different banks. Any move to drive data and system standardisation would be both extremely cumbersome and costly to the industry. Therefore, we believe technology-based solutions are not feasible.

Question 3.3: What are the issues the Government should consider in relation to other parts of the FSCS?

We believe that there is no great need to drive consistency of coverage etc. across all products covered by the FSCS. Deposits are fundamentally different from the other products in terms of customer perception of safety.

Please also refer to our response to Q 3.1 above and in particular the need to ensure that differences in the scheme components do not result in unintended distortions in customer buying behaviours within the savings markets.

Question 3.4: What issues should the Government take into account in any further review of the funding mechanisms for the FSCS?

We believe that the funding of the scheme should be transparent and not place undue burden on the banking industry or the taxpayer. We believe that the scheme should be affordable, funded through ex-post contributions and not effect the competitiveness of the UK banking industry.

The main issues that the government should consider around funding mechanisms are:

- Total cost of scheme;
- Ownership of losses;
- Funding mechanism (ex-ante or ex-post);
- Distribution of costs across institutions;
- Introduction of depositor priority.

In terms of cost, the limits on the scheme should be set according to principles of proportionality, affordability and operability.

With regard ownership of losses, it is important to strike a balance between the level of industry and taxpayer funding. The revised funding structure for the FSCS, as defined by the FSA in PS07/19, allows for an initial ex-post levy of up to £1.8BN per annum to be raised from deposit-taking institutions, with a further £2.2BN available from deposit takers and the wider financial services industry combined. However, we acknowledge that the failure of one of the largest deposit-taking institutions would not be fully covered by the scheme. Clarity is requested from the tripartite authorities on how losses arising from such a large institution failure would be funded.

We believe that an ex-post funding system is appropriate in the UK due to its concentrated nature, unlike the US which has many smaller institutions. There are two primary arguments in favour of ex-post systems in concentrated markets. Firstly, consumer confidence in the viability of the fund may be low due to the small size of the fund relative to some single, large member institutions. Secondly, a readily available liquidity pool will not be required as “big bank” failure is much less likely due to diversification of risks. We also believe that an ex-ante scheme would cause an unnecessary drain on the liquidity position of banks. Hence, an ex-post scheme seems more appropriate in the UK.

A further issue to consider is that of pricing contributions. The current uniform pricing structure, unlike a risk-based approach, does not force riskier institutions to pay more to the fund to reflect their higher probability of default. We would be in favour of introducing a risk-based approach, providing incentives to encourage prudential risk management, so long as this did not distort competition.

Thought should be given to the potential impact on the larger banks which might be required to issue profit warnings which could in turn compound any lack of confidence in the financial services system.

In addition, other schemes, such as the US and Singapore, have implemented depositor priority as a method of reducing the overall scheme cost by improving the recovery rates on payouts made to depositors. However, we believe that such a scheme may have serious consequences that render it less applicable in the UK market. Our primary concern is the potential impact on the UK’s competitive position through an increase in the cost of funding for UK deposit-taking institutions which is likely to accompany depositor prioritisation. This is of particular relevance as UK banks are heavily reliant on wholesale funding relative to, say, the US. An increase in funding costs could seriously dampen the competitive position of UK banks.

Question 3.5: Should the role of the FSCS be extended to promote access to banking services for depositors with failed banks?

Given the concentration of current accounts with larger banks, we believe the role of the FSCS should be focused on ensuring prompt payments to depositors. Maintaining transactional services requires takeover of the management of the failed institution. This would be a substantial change in the mandate of the FSCS and we question whether it is worth investing in these capabilities.

Question 3.6: The Government would be interested in views on the best way to help consumers understand how banking deposit guarantees affect them?

We strongly agree with the government's objective of ensuring that any scheme needs to be well understood by consumers. Indeed, we believe it is crucial to the success of any scheme.

We have identified three points that are essential for consumers to understand. The first is for consumer clarity on their personal situation. They must know and understand limit levels, exactly which type of accounts and customers are covered, and the speed with which payout will occur. Secondly, there is a requirement for consumer confidence in the banking system's ability to handle failures. Here it is important to communicate a clear intervention plan. Thirdly, customers should never believe a bank is "closed for business". As such, website and branch shutdowns must be avoided. This can be managed through early, clear and effective communication to customers of the action plan to resolve a failed institution.

It is important that scheme design be sufficiently simple to enable clear and effective customer communication. In particular, the following aspects of the scheme need clarity:

- Limit levels and incorporation of co-insurance;
- Speed of payout;
- Practical method of payout;
- Definition of the domestic banks covered (brands vs. banking licenses);
- Definition of the accounts covered (current vs. savings accounts);
- Definition of the customers covered (consumer vs. business);
- Treatment of non-UK banks, offshore accounts;
- Offsetting of products.

The BBA and its members are willing to work with the government to establish the best method for communicating the scheme to consumers.

Question 3.7: Do you agree with the concept of critical banking functions? If so, what banking services might be properly regarded as so critical to the modern economy that they should continue to be provided in the event of a bank failure?

We believe that consumers in the UK are becoming increasingly reliant on banking services in their daily lives and provisions need to be made to maintain transactional services in the event of bank failure. These transactional services for both consumers and businesses are typically serviced through a current account which facilitates the critical functions of salary payments, cash withdrawals, debit card payments and direct debit payments. It is these critical services provided by current accounts that would need to be maintained in the event of a bank failure.

Please also refer to the General Comments section above.

Question 3.8: For what period of time should any critical banking functions be maintained and how this might vary in different circumstances?

We believe that critical banking services need to be preserved at a failed institution for as long as it takes depositors to set-up new current accounts at different institutions. Transfer of a current account currently takes approximately 1 month (including the set-up of new direct debits). However,

in the event of a bank failure the time taken may be lengthened if there is a high volume of demand for new accounts.

We recognise that business customers, especially those too large to be covered by the deposit scheme, are likely to have more complex needs than private individuals and would most likely need more time to transfer to a new provider.

Question 3.9: What issues should the Government consider in assessing possible arrangements, in addition to the FSCS already available, to deliver continuity of any critical banking functions in the event of a banking failure?

There are a detailed set of issues that need to be addressed when considering arrangements to preserve critical banking functions:

- Ability of payments system to handle bank failures;
- Ability of banks to make prompt payments to customers whilst limiting amounts paid to the agreed limit;
- Recognition that exporting data to another institution is not possible;
- Capacity in banking institutions to absorb new customers.

We would like to highlight that the vast majority of current account providers would be in the 'too big to fail' of institutions in the UK, hence a major event of having to maintain a significant number of current accounts is extremely unlikely.

In order to maintain competitiveness, we believe that consumers should be able to choose the new institution they would like to bank with and go through the process of transferring their account to that institution, rather than all accounts (or blocks of accounts) being transferred to a designated institution.

Please also refer to the General Comments section above.

Question 3.10: What, if any, lessons can the Government learn from other sectors and other economies? For example, from special administration regimes and pre-funded insurance type schemes such as the Federal Deposit Insurance Corporation in the United States?

Arrangements in other countries can be used to inform the UK's approach but it is important that the regime adopted fits with and supports the characteristics of UK banking industry. For example, the US is not a good example for the UK regarding funding. The US utilises an ex-ante funding system appropriate due to the high percentage of small banks in existence and a correspondingly regularity of bank failures. As noted in our response to Question 3.4, we believe the UK to be more suited to an ex-post system because of the high concentration of deposits.

Lessons can perhaps be learned from the FDIC in terms of monitoring and taking action to resolve failing and failed institutions', however these must be considered in the context of the UK regulatory framework which we support. The FDIC is empowered to take prompt corrective action and has full authority without the need for court intervention. Regular and comprehensive monitoring of institutions takes place so as to identify action requirements before a situation becomes irreversible, and triggers for action are clearly defined. Triggers are based on defined capitalisation levels, with specific actions associated with each level of undercapitalisation.

Question 3.11: How do the needs of different groups of customers differ? How should the Government take this into account in drawing up the new framework?

We believe that the scheme should differentiate between different groups of customers as little as possible to retain simplicity. At the most basic level, customers have two basic needs that should be considered, which are the same for both consumers and business customers: liquidity and transactional services.

As mentioned in our response to Q3.8, we recognise that business customers, especially those too large to be covered by the deposit scheme, are likely to have more complex needs than private individuals and would most likely need more time to transfer to a new provider. The main issue for private customers is likely to be the need for access to immediate funds.

In terms of liquidity, the key requirement is prompt access to deposits. We therefore believe that the Government should focus on mechanisms for achieving this in the event of bank failure.

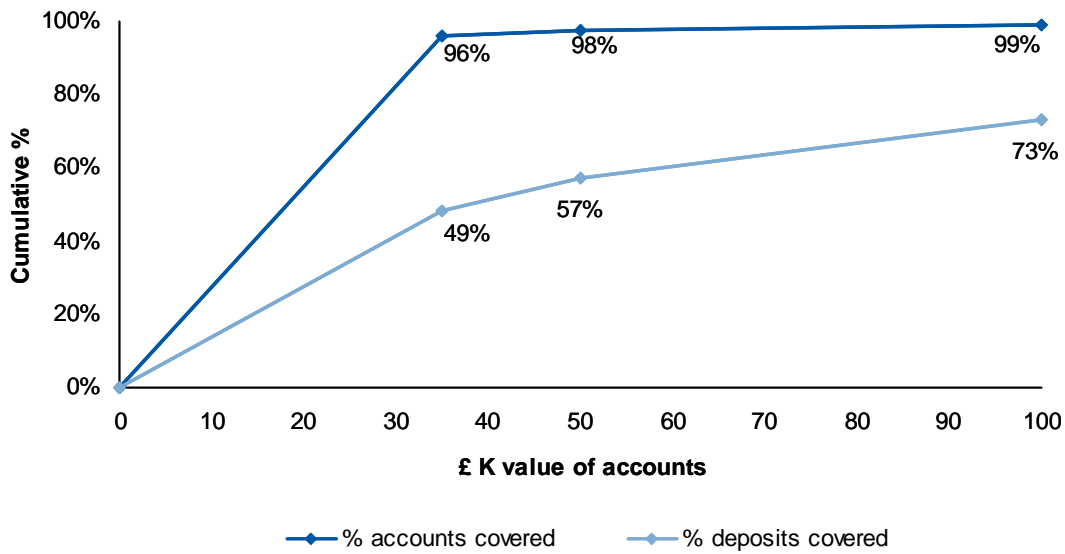
Transactional services require continued operation of the customer's current account. It is not practical to expect to export data in a timely fashion to allow accounts to be serviced by an alternative provider; the failed bank's existing infrastructure must therefore be used until transfer or services can be arranged or the failed institution is taken over by another party.

Appendix A. Supporting evidence on coverage

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



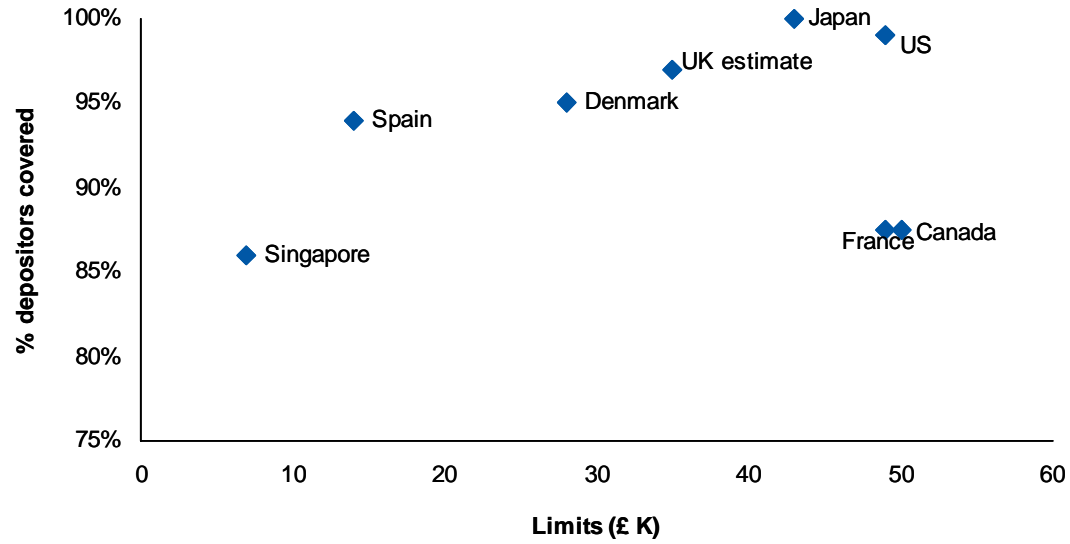
Source: BBA data based on two Tier 1 banks

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Figure 2 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)

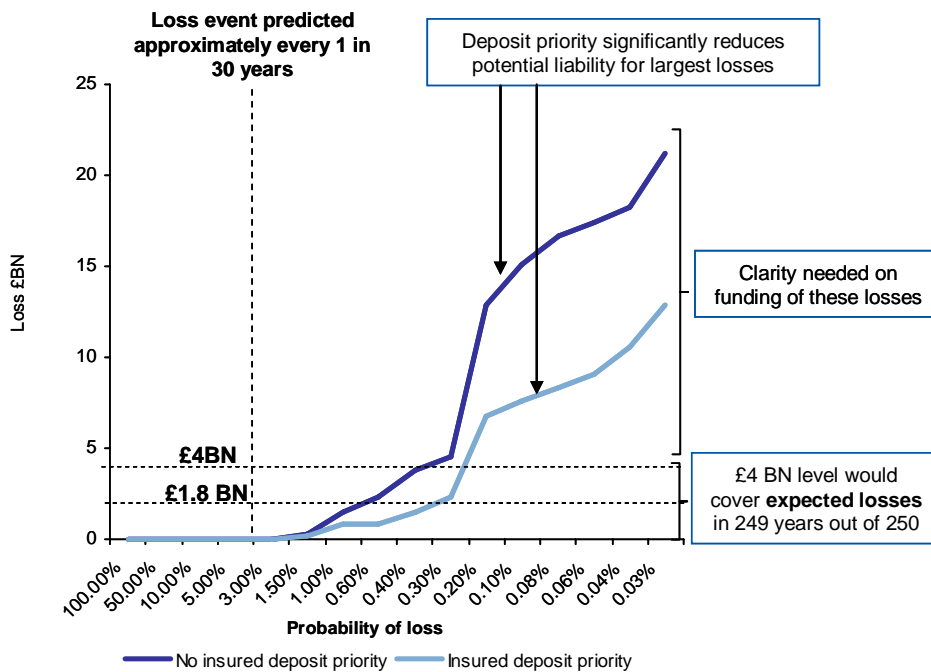
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Appendix B. Supporting evidence on funding

Figure 3 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, and clarity is sought from the tripartite authorities on the funding of these losses.

Figure 3: simulated net loss distribution of guaranteed deposits, with and without deposit priority

Modeled cumulative loss distribution for deposit insurance scheme



Source: Oliver Wyman analysis

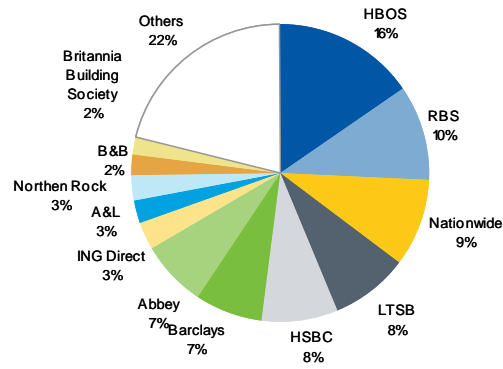
1. Recovery rate of 80% assumed for no deposit priority, 90% for deposit priority with no volatility applied to rates, 25% correlation assumed between institutions

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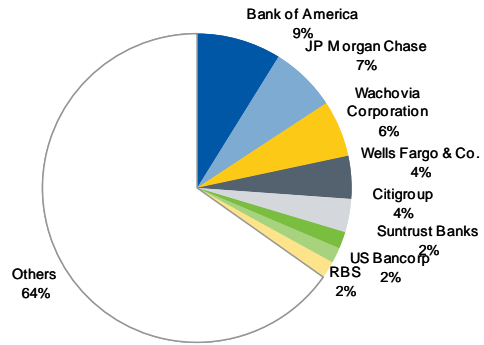
Figure 4 shows the concentration of deposit-taking institutions in the UK and the US. In the US, there are many smaller banks making up a large percentage of the overall deposit base; in the UK, the majority of deposits are held with a small number of institutions. Therefore the main concern of most 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 4: 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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