



Financial Stability and Depositor Protection: Further Consultation

The ABI's Response to the Tripartite Authorities consultation

Introduction

1. The Association of British Insurers (ABI) represents nearly 400 member companies, which between them provide 91% of the UK's domestic insurance. As major institutional investors controlling funds worth £1,500bn, our members are significant shareholders in and lenders to the UK banks. It works on behalf of the UK insurance industry to keep standards high and to make the insurance industry's voice heard.
2. The ABI is grateful for the opportunity to respond to '*Financial Stability and Depositor Protection: Further Consultation*' (Cm 7436). We have responded separately to the specific consultation paper on the proposed Special Resolution Regime '*Financial Stability and Depositor Protection: Special Resolution Regime*' (Cm 7459).

Overall Comments

3. This section sets out our overall comments on the consultation document. In particular it includes our comments on issues not covered by specific questions.

Special Resolution Regime

4. Additional comments on the Government's proposals for a special resolution regime are set out in our response to the specific consultation on that issue.

Compensation Arrangements

5. We believe that the proposal to enable the FSCS to borrow from the National Loans Fund (NLF) makes the current arrangements for cross-subsidy between different parts of the financial services industry obsolete. These 'general pool' arrangements, which the ABI continues to strongly oppose, should, therefore, be dismantled as the liquidity which they were designed to provide will, under the current proposals, be provided by the NLF. We believe that the events at Northern Rock, which have prompted the current consultations, show the significant differences between the

constituent parts of the financial sector and the need for separate arrangements particularly for deposit taking institutions.

6. The ABI remains opposed to pre-funding for insurers in principle and so believes that it would be entirely inappropriate to consider such arrangements for either of the insurance sub-schemes. Compensation in the event of the insolvency of an insurer is spread over many years as claims fall due and so the costs can be met using the current FSCS system of raising levies on a pay-as-you-go basis. We, therefore, believe that if the Government takes powers to introduce pre-funding that this should be limited to the deposit protection scheme.
7. We look forward to the FSA's forthcoming consultation on FSCS limits. We note that the current preferred option is to increase the deposit compensation limit to £50,000. We will provide our considered view on this proposal in our response to the FSCS limits consultation. However, it is worth noting in this context the results of a recent survey conducted for the ABI (by You Gov between June 25th - July 1 with a sample size of 3,624) which showed up the lack of public recognition of the recent increase in existing FSCS compensation limits. Only 34% of people knew that the government had increased the limit and this perhaps shows that further increases in the limit will not necessarily increase public confidence in the FSCS.
8. The current consultation is, understandably, entirely focused on the banking sector and it is unclear what, if any, proposals might be made which will affect insurers and other financial services firms. In our view the current FSCS insurance sub-schemes continue to work well and we do not believe that these need to be changed and we would be concerned if the FSA were to propose changes to the insurance sub-schemes on the basis of their concerns about the deposit protection scheme – there are fundamental differences between the banking and insurance sectors which are likely to make any such read-across inappropriate. It is, therefore, vital that the FSA continues to engage with the insurance industry if it intends to propose any significant changes to the existing arrangements.

Strengthening the Bank of England and Tripartite Co-ordination

9. We welcome the details of the Government's latest thinking on the specification of governance arrangements for the Bank of England including arrangements for the enhanced oversight of financial stability. We believe that a Financial Stability Committee (FSC) supporting the Bank and the Governor but drawing upon external expertise is the right way to proceed rather than relying on the remodelled Court itself to discharge this function. It will be important that the Court itself includes the requisite skills within its external members in order that a sufficient number of suitably qualified individuals will be available for appointment to the Committee. It is right that the Committee will also comprise senior representatives from within the Bank and we take it that this will extend somewhat beyond the ranks of those Bank full-timers who would either be Members of, or attend, Court.

10. We think it would be right, though, to reconsider whether the proposals yet represent the optimum structure. It is right that the Governor should chair the FSC but less clear that the FSC, rather than the Court, should itself be the body charged with governance oversight of the Bank executive management's activities in this area. The FSC will be most effective if it can access advice and input from senior financial sector practitioners but the most appropriate individuals for this function may not be the right ones to exercise governance oversight functions for which qualities of independence will be important. As a committee of the Court the available pool of external members to sit on the FSC will inevitably be limited whereas with an advisory committee there need be no such restriction.
11. Although the arrangements proposed in the consultation document in some ways parallel those applicable to the Monetary Policy Committee (MPC) it is important to realise that, functionally, these two committees will have significantly different roles. The MPC has a clear but narrowly targeted executive function and remit but the FSC, if it is to be effective, will need considerable scope of vision but will have limited tools at its disposal to deal with a remit with rather less quantifiably verifiable success criteria. We agree with the proposed arrangements for Court to manage the FSC in this regard and for the Bank to consult with the Treasury on a periodic basis when setting detailed objectives. The legislative framework should provide for an appropriate on-going measure of transparency over this process.

Credit Ratings Agencies

12. We agree with much of the sentiment that lies behind the commentary on the role and use of credit ratings. We support moves to improve the quality of the rating process and the governance of credit ratings agencies (CRAs), particularly the changes in the IOSCO Code. We note the self-interest of the CRAs (bearing in mind that they are commercially-driven) in these processes in order to re-establish the trust the market has in their activities.
13. Similarly we support expanded information on structured products. However, this has to be provided in an appropriate manner. Institutional investors value the data-handling role of CRAs in structured products; their key interest is access to sensitivity analysis and key data which allows them to perform their own exercises in this respect.
14. We have not identified any support among our members for differentiated ratings for corporate and structured finance products. The consensus seems to be against this.
15. The CRAs' role does not include that of auditor. Enhanced assessment of underlying data quality can only be achieved at a cost, eventually passed on to clients. We have yet to see an analysis which clearly demonstrates that benefits outweigh the costs.

16. We support the Authorities' view that strengthened and independent external monitoring of CRA performance is best undertaken at a global level and should be subject to consultation. In this context we are concerned that the EU Commission proposals, published at the end of July, provide for a limited consultation period (to 5 September) over the holiday period. We consider the proposals to be over-prescriptive and poorly drafted in terms of conveying legal certainty.
17. We note the lack of evidence that UK institutional investors were over-reliant on ratings. At a wider level there may be more justification and we note the industry initiatives, including that through the European Securitisation Forum led discussions with the EU Commission, to elaborate investor best practice in the use of ratings.
18. We support the Authorities' views on the role of ratings in regulation.

Annex

19. Our responses to specific questions from the consultation papers are set out below. We have confined our responses to those which reflect our Members' particular interests.

Questions for Consultation

Reducing the likelihood of a bank failing

3.1) The Authorities are seeking views from respondents on the extent that contractual provisions, such as those set out above may prevent the Authorities from taking appropriate action; and the merits of the two approaches set out above.

We do not see a convincing case for either approach to the supposed problem that contractual barriers might impede effective action. Such measures would fundamentally alter the protections afforded through covenants to investors, in the case of the ABI members essentially long term investors seeking a rate of return pegged to government bonds. Such carve outs would make the provision of finance to the financial services sector more specialised and less attractive.

3.2) Are the criteria as set out, the right criteria and will they provide sufficient flexibility as payment systems evolve overtime?

3.3) Is there a preferred method for recognising payment systems?

3.4) Do you agree that the indicative list in paragraph 3.47 includes all the relevant payment systems which are of systemic or system-wide importance?

3.5) Are the powers, as set out above, necessary and appropriately graduated?

We have no comments on these questions.

Reducing the impact of a failing bank

4.1) The Authorities would welcome views on the most appropriate ways to deal with other relevant entities in investment banking groups with the aim of helping to maintain financial stability.

The consultation paper rightly identifies that investment banks play a key role in the financial markets but that dealing with such entities with their focus on the wholesale markets may require different priorities than would be appropriate for institutions with a strong retail focus. Given the scale and significance of the financial markets in the UK the Authorities are right to wish to consider carefully what would be appropriate for this specialised part of the banking system.

The most significant entities of this type operating in the UK are, however, constituents of larger multinational groups. Where serious difficulties arise we would expect that the UK authorities would wish to work closely with their counterparts in other jurisdictions working collegiately but probably not needing to take the lead. There may therefore be less need for the UK authorities to have carefully tailored tools at their disposal to deal with these types of institution. Our present view is that these institutions, whether action is being taken as part of a co-ordinated response multinationally, or on a stand-alone basis by the UK authorities in respect of a UK

subsidiary, can probably be dealt with using the arrangements that would be applicable to mainstream commercial banks. We therefore have no suggestions to make at this time for bespoke arrangements.

4.2) Do you agree with the roles for the Authorities for the triggering and operation of the Special Resolution Regime?

4.3) Respondents views are sought on the practical considerations involved in developing a SRR.

Our views on the proposed SRR are set out in detail our response to the specific consultation paper on this issue which has been submitted seperately. In particular see our answers to questions 2.2-2.5 of our response to that paper.

4.4) What would be the best way to calculate the hypothetical net cost of depositor compensation payments, including the estimation of the recovery rate?

The purpose of the FSCS is to provide compensation to retail customers of a failed institution. We accept that in some cases such customers are best protected by the transfer of their accounts to another institution rather than by the payment of compensation – the FSCS has existing powers in this respect in the case of life assurers where it is under an obligation in the first instance to secure continuity of cover. We can see the merits of similar arrangements, and the necessity of the FSCS making payments to facilitate such transfers, in the banking sector.

However, we have serious concerns about the proposals for the FSCS to meet other costs of the resolution. In particular it does not appear appropriate for the FSCS to pay for the administrative costs of an SRR, for the cost of government guarantees to creditors or for any compensation payments to shareholders and original creditors. These are not costs which the FSCS would be expected to meet in other circumstances and are not costs which are directly related to providing compensation or continuity of cover to retail customers.

See our response to questions 3.51 and 3.52 of the consultation on the SRR for additional detail.

Effective compensation arrangements for depositors

5.1) The Authorities would welcome further views on the best way of introducing gross payout when there are mutual debts.

We have no comments on this question.

5.2) The Authorities would welcome further views on a possible move to pre-funding and on the proposed legal framework for pre-funding and FSCS borrowing from the National Loans Fund.

We agree that the FSCS should be able to borrow from the National Loans Fund (NLF). This will provide the FSCS with liquidity in the event of a need to make significant compensation payments at short notice.

This proposal removes the main justification for the FSA's recent introduction of the 'general pool' arrangements to the FSCS. This scheme, which the ABI remains entirely opposed to, was introduced to meet concerns about individual sub-schemes within the FSCS being unable to meet demands on them in the event of a major failure. If the FSCS can borrow from the NLF and then make recoveries from the relevant part of the industry over time then the need for the current cross-subsidy arrangements falls away. Therefore, we believe that the introduction of borrowing powers with the NLF should be accompanied by the unwinding of the general pool arrangements which will become obsolete.

The ABI remains opposed, in principle, to the introduction of pre-funding arrangements for insurers as we believe that any advantages from being able to introduce risk-weighted levies will be more than offset by the disadvantages of the loss to the industry of the money tied up in the fund. The proposal to allow the FSCS to borrow from the NLF means that pre-funding will not be needed for liquidity purposes.

The consultation paper concentrates entirely on the banking sector and it remains unclear whether there are any proposals to allow for the introduction of pre-funding in other areas, particularly insurance. We do not believe that there is any need for pre-funding arrangements in either of the insurance sub-schemes. Insurance companies rarely become insolvent so there would be a significant likelihood that such a fund would rarely, if ever, be called upon. Where insurers do become insolvent claims are spread over many years rather than having to be paid in full quickly, therefore, compensation can be funded through the normal FSCS mechanism of raising annual levies on a pay-as-you-go basis.

Impact assessment

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

This impact assessment makes explicit reference to the sectors and groups which it believes will be affected: depositors, banks, building societies, credit unions, authorities, non-financial industry.

This assessment omits two important groups from its analysis: shareholders and other (non-bank) financial services sectors. The impact assessment needs to be amended to explicitly take account of the impact on these groups. This will include both an assessment of the impact on shareholder value and also an explicit consideration of how the FSCS extends to other financial services organisations and therefore the impact on them.

In particular the impact assessment must take account of the effect on insurers and other financial sector firms of a levy on them by the FSCS under the general pool arrangements to meet the costs of a failing bank. Under the current FSCS the maximum amount which can be raised from deposit takers each year is £1.8bn. Any compensation amounts in excess of this can be levied from other firms – including general insurers up to £775m with a further £690m from life offices (with other parts of the financial sector (investment firms and intermediaries) contributing up another £725m). A levy for these amounts would have a significant impact on insurers and other firms.

A.2) Do you think that there are any significant indirect costs associated with this proposal?

Indirect costs are defined for the purposes of this consultation as the costs that occur in the event of a bank failure. The costs associated with this measure will largely depend on their impact on UK banks' ability to attract capital. They will therefore be on-going costs, rather than indirect.