

FINANCIAL STABILITY AND DEPOSITOR PROTECTION: FURTHER CONSULTATION Cm 7436

This is my response to the further Consultation of 20 July 2008 (Cm 7430), which complements my earlier note of 23 April commenting on Cm 7308. In general, the proposals in the latest consultation document constitute a very marked and helpful advance on those published earlier. In what follows I therefore concentrate only on a narrow range of issues associated with funding any compensation scheme, in particular on paragraphs 1.66 to 1.68 of the text.

WIDENING THE DEBATE ABOUT FUNDING MODELS

2. In relation to FSCS funding, it is clearly wise not to make any absolute commitment as to how to proceed, and wise to maintain a continuing debate on pre-funding. However if that debate is to generate a good result, it needs to be widened. One central issue is whether pre-funding is advisable, whether in theory or in practice. Another is whether the scheme is best developed by enlarging the existing public structures or, rather, by developing some kind of private sector alternative. Together with Kathleen Tyson-Quah (KTQ), I published an article in the FT on Monday 18 August (page 11, copy attached) which articulated a model which is rather different to that proposed, which could with advantage be examined as the debate unfolds, **and which KTQ and I would now like to submit as part of this formal response to the consultation.** Our article points to the significant benefits that might arise from a scheme which is organised privately by the interested institutions and which need not depend heavily on pre-funding. It would appear desirable that the **next stages of discussion/consultation should explicitly consider models such as this as well as simply expanding and modifying the present FSCS.**

HOW MUCH MORE MONEY IS NEEDED BY THE COMPENSATION MECHANISM AND OVER WHAT PERIOD?

3. At a time when the difficulties arising from the sub-prime crisis and the liquidity complications generated by it are still far from solved, it is clearly important that any debate about legislating for new structures and procedures should take place against some kind of illustrative numerical backdrop. Ideally the present consultation document should have discussed at least the orders of magnitude of the extra sums required – would it be £billions, £10billions or £100billions? By the same token, the document should have indicated when such sums need to be available; e.g. more or less immediately, within a matter of months, within a year or two and so on. **At the next stage in the debate, it will be essential to know what is in the authorities' mind as regards both quantities and timing when considering the legal and institutional proposals which it is intended to enact.** It may, of course, be argued that the proposal in §1.66 to enable National Loans Fund lending to the FSCS would deal with any immediate liquidity needs and, thus, buy time for a further debate in a crisis about precisely how to organise the funding in the longer term. However to **plan** to act in such a Micawberish way would be grossly imprudent. Even if it could be defended as embodying the principle of “constructive ambiguity”, the uncertainties and dangers of such ambiguity are likely to outweigh the benefits by a very large margin.

THE ATTRACTIONS OF A PRIVATE SECTOR ALTERNATIVE

4. In the FT article submitted with this response, KTQ and I point – perhaps unexpected to some – to the virtues and benefits of the funding model and procedures developed to compensate policy claimants in the Lloyd’s marketplace, known as the Lloyd’s “Chain of Security”. This scheme enabled Lloyd’s to reconstruct and renew its market in the face of the most extreme challenges in the 1990s, and thus to preserve its record of never having failed to pay a valid claim throughout the market’s life of over 300 years. Some of the most important features of the Lloyd’s system, which could be applied indifferently to a variety of compensation funds, guarantee schemes or safety nets, include:

- a) restricting pre-funding to a modest sum, thereby avoiding immobilising a damagingly large part of the marketplace’s capital and reserves;
- b) ensuring liquidity, by providing for the reliable availability of further funds through syndicated loans, reinsurance, callable commercial loans or levies on market participants; but only when needed;
- c) mutual reassurance provided to market participants about each others’ behaviour by a central “franchise performance board” which, in the Lloyd’s case, exercises oversight of certain aspects of the conduct of each member’s business. Such reciprocal review is a central element in most of the best and most durable mutual schemes.

Such a scheme has proved in the Lloyd’s case to require **far less regulatory capital** – of the order of 60% in representative businesses – than would be required by conventional prudential regulation. Such a system **can operate truly internationally**, without necessitating complex agreements, structures and co-operation across national boundaries. In the Lloyd’s case, distressed policyholders and capital providers alike were a significant presence not just in the UK, but in North America, Australasia, South Africa and many other OECD countries. But this did not prevent Lloyd’s from engineering and financing its own financial reconstruction, essentially under English law and in an English regulatory framework.

THE THEORETICAL CASE FOR PRE-FUNDING

5. Viewed as an exercise in optimal risk management, the optimal design of a compensation or support scheme for a banking system or marketplace in distress should respect such principles as the following:

- a) it is only efficient to put aside money into a **pre-funded scheme if such money is likely to be used fairly frequently**. Thus one could justify setting the pre-funding at that level which would **meet the ebb and flow of attritional losses over a suitable period** (e.g. a year, or a business cycle) to an appropriate confidence level – very much as one might set the proper maximum working capital level in a business.

- b) it is manifestly inefficient and **undesirable to immobilise very large sums** in low yielding, very high quality bonds in order to be able to make extremely infrequent, albeit large, payments arising from long-tailed/"black swan" events. In these circumstances, reinsurance, borrowing coupled with callable levies on market participants etc. are obviously optimal.

In looking to the next stage of presentation of more detailed proposals, it is clearly very important, therefore, that the **authorities should explain clearly the thinking that dictates the funding methods proposed**. At present, the consideration of the possibility of pre-funding – which is only attractive for routine attritional losses – seems impossible to justify for the hypothetical application in a Northern Rock-type crisis – a classic long-tailed event - to which the new proposals would appear to be addressed.

WIDENING THE SECTORAL COVERAGE

6. As I argued in the second paragraph of my comment on the previous consultation, the origin of the Government's proposals is to develop a remedy to a systemic crisis which has enveloped many parts of the financial sector, wholesale and retail, banking, capital markets and OTC fora, of which the problems of Northern Rock were but one far from typical example. (Most of the credit crunch complications have arisen in wholesale businesses or in non-retail activities of the banks). In addition, financial instruments and contractual structures often directly implicate several sectors and indirectly influence several others. To cap it all such relationships arise and are propagated internationally. This suggests that it is extremely **important for the authorities to give early consideration to how they would cope with systemic crises outside the retail banking sector** – e.g. originating in some of the less transparent OTC marketplaces

INTERNATIONAL ISSUES

7. At this stage it is not yet possible to relate the comments above to the Treasury's developing thinking and consultation recently launched in "Financial stability and depositor protection: cross-border challenges and responses".

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