



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

21 December 2007

Our ref: ICAEW Rep 129//07

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Dear Katie

DISCUSSION PAPER: BANKING REFORM – PROTECTING DEPOSITORS

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on *Discussions Paper: Banking reform – Protecting Depositors*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW Representation

ICAEW REP 129/07

Discussions paper: Banking reform – protecting depositors

Memorandum of comment submitted in December by the Institute of Chartered Accountants in England and Wales, in response to discussion paper *Banking reform – protecting depositors* published in October 2007.

Contents	Paragraph
Introduction	1
Who we are	2 - 3
Major points	4
Responses to questions poses in the discussion paper	5 - 18

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the Tripartite Discussion Paper: *Banking reform - protecting depositors*.

WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. It is regulated by the UK Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 129,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

4. Our major points are outlined below. The broader issues raised should be considered prior to the finalisation of a scheme for depositor protection which we do not believe can be addressed in isolation.
 - It is important to look at regulation in the round and not purely as a means of protection in a crisis.
 - The reform of supervision of liquidity risk needs to be carefully considered with a view to reducing the risk of claims on the depositors' protection scheme.
 - The Bank of England should consider reforming its approach as provider of liquidity to banks and building societies, both to ease the penal rates that it charges and to reduce the penal interest rates charged, in order to reduce the stigma in the markets for a bank or building society that is known to be borrowing from the Bank of England and to make it easier for them to do so.
 - Banks and Building Societies need to give careful consideration to their approach to stress testing to increase the chance of anticipation of problems such as those experienced in the third quarter of 2007, although it must be accepted that it would have been very difficult for institutions to have anticipated the scale of the crisis that actually emerged this year through conventional stress testing.
 - The FSA's own contingency planning and preparedness, together with that of HM Treasury and the Bank of England, should be reviewed to enable them to cope with such crises more speedily and effectively.
 - No single issue should be viewed in isolation and attention should be paid to what comes out of the other reviews of regulation, accounting and credit rating agencies.
 - The issue of whether deposit protection can prevent a crisis from happening and its role and for what players in the market should be clear.

- The issue of whether compensation measures can cope with the failure of a significant institution (probably not as the cost whether pre or post ante would be prohibitive).
- Any rescue scheme would need to make possible the running of the failed entity either by regulators or a private sector entity.
- Consideration should be given to the international dimension. A player within the scope of compensation may have overseas operations.
- Consultation should not be rushed. It is important to have considered all the potential issues arising from a proposed protection scheme together with the emerging issues mentioned above.

RESPONSES TO QUESTIONS POSED IN THE DISCUSSION PAPER

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

5. We agree with the objectives and particularly that any reform must be well understood and as straightforward a process as possible. Consumers cannot be expected to understand the more detailed provisions.

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

6. Early intervention to prevent failure of an institution is vital. Any reform should fit with other crisis management tools. In addition any deposit protection scheme has to apply to all banks. Regulators as well as banks should consider extreme but plausible scenarios in their planning.

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

7. There should be a clear definition of what constitutes critical banking functions. The focus should be on speed of access to funds. Consideration should be given to the type of institution when considering how to preserve critical banking functions where there is likely to be a difference in approach between secondary banks and large institutions. In addition there should be acknowledgement that technology based solutions are not without their own problems, for example, the difficulties of transferring data between different systems should not be underestimated.

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, eg investment business and insurance?

8. Protection should be based on research into the level of deposit that is at risk across the sector. We understand that the British Bankers' Association has research to the effect that balances are actually fairly small and £35,000 would cover 95 per cent of deposits. Any proposed limit needs to take into account the potential risk that, if compensation is too high, management may take risks that show a lack of concern for customers' money. To try to align compensation with other categories of investment raises issues regarding the structure of the FSCS.

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?

9. Speed is critical, however compensation cannot embrace critical banking services by some other means, such as a form of takeover or nationalisation. The source of any compensation payments needs to be identified as part of the scheme process. It is likely that the sale of assets will not cover immediate payments that need to be made.

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

10. The key issues to consider here are affordability and sustainability. In addition there is the question of the degree of cross-subsidy that should exist between banks, the insurance and investment sectors.

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

11. We have strong objections to a system that is in effect prefunding. Our objections relate to:-
 - the burden of the additional cost together with the immediate requirement in such a system that there be a sufficiency of funds to meet the demands of a major call on these resources; and
 - the build up over a period of time that would tie up valuable resource that could be more usefully employed by individual entities in the financial sector.

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

12. Extension of the role of the FSCS to include this responsibility could result in the creation of yet another regulator which could only add to the perceived complexity of the process in place. The focus should be on preserving the bank as a going concern or, failing that, returning depositors' funds quickly rather than the transfer of critical banking functions which would entail the requirement that all banks operate identical systems to enable transfer of critical banking functions (however defined).

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

13. Consumers need a simple message to enable them to make informed decisions regarding the risk to their funds.

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?

14. We agree that critical banking functions should be identified in order to assess the scale and be aware of the likely problems to be experienced by consumers

in the event of a banking failure. For smaller banks the preferred solution is likely to be takeover by another bank. In addition, it is hard to see how the concept of protecting critical banking services could be applied to the failure of a significant bank as it would be extremely difficult to separate these from other banking activities.

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

15. As we have commented above, the rescue of the entire bank needs to be the focus at least to allow sufficient time for customers to find alternative arrangements rather than any attempt to keep what are perceived to be the critical banking functions of a bank running.

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?

16. The size of the bank concerned will dictate the most appropriate rescue measures. It may be that a number of measures need to be worked on to accommodate different sizes of bank.

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?

17. There is clearly a need to consider overseas models that have been tested together with circumstances that led to the need to use the special regimes. Among the regimes that operate elsewhere the idea of a bridge bank and the use of a special administrator are worthy of consideration. The latter solution has more appeal since it does not involve the creation of a new legal entity and the attendant transfer of assets and liabilities to the new entity. Legal process should not cause undue delay in the rescue process. In addition there is a point with regard to the lesson to be learned from past events in the UK and that is the need to establish a course of action in a crisis scenario at an early stage. That would include ensuring that a legal mechanism was in place to deal with the take over of a bank that is in trouble (see above).

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?

18. All customers' needs should be considered in a proposed scheme. The terms and conditions of a rescue scheme need to be clearly laid down to enable consumers to understand the impact in all scenarios. The differing needs of different groups are addressed most simply by the compensation level offering complete protection to those groups that need it most. Any proposed scheme should contain a provision that would allow for regular updating to take account of changes in customer products that could affect their entitlement in a rescue scenario.

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