

# CP12/23\*\*

Financial Services Authority

## Addressing the implications of non-EEA national depositor preference regimes



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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 11 December 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: [www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12-23-response.shtml](http://www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12-23-response.shtml).

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A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

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# Abbreviations used in this paper

<b>CBA</b>	Cost benefit analysis
<b>EEA</b>	European Economic Area
<b>EU</b>	European Union
<b>FSA</b>	Financial Services Authority
<b>FSMA</b>	Financial Services and Markets Act



# 1

## Overview

### Introduction

- 1.1 We propose that firms from non-EEA countries that operate national depositor preference regimes be required to accept deposits in the UK using a UK-incorporated subsidiary or they must implement an alternative arrangement that ensures UK depositors<sup>1</sup> are no worse off than the depositors in the home country if the firm fails.<sup>2</sup>
- 1.2 We propose giving firms two years from when the rules come into effect to take steps and put in place the necessary arrangements to comply.
- 1.3 During the transition period, we propose that firms be required to disclose information to all the UK branch customers about their home country national depositor preference regimes and highlight the fact that the claims of UK branch depositors would be subordinated to the claims of depositors in the home country in the event that the firm fails.
- 1.4 These proposals aim to ensure that firms from non-EEA countries with national depositor preference regimes take steps to address the disadvantages that UK branch depositors could face because their claims are subordinated to claims of home country depositors if a firm fails. The potential detriment to UK branch depositors would be eliminated if firms were to establish a UK-incorporated deposit taking subsidiary or undertake equally effective alternative measures.

### Background

- 1.5 National depositor preference regimes exist where, in accordance with the law or regulation of the home country, the claims of depositors in the home country are preferred to the

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1 In this consultation paper the term UK depositors refers to all deposits placed with firms in the UK and is not intended to mean the nationality of the persons who have placed deposits with firms in the UK.

2 In this consultation paper the term fails as used in relation to a firm refers to a firm placed under insolvency or liquidation or resolution proceedings.

claims of branch depositors outside the home country if the firm becomes insolvent. If the firm becomes insolvent, the claims of depositors outside the home country, such as those in UK branches are:

- subordinated to the claims of depositors of the home country; and
- depositors outside the home country could face greater losses than home country depositors if there are insufficient assets from the estate of the firm to meet their claims, due to the claims of the home country depositors being ranked ahead of the claims of depositors outside the home country.

- 1.6** The Financial Stability Board has highlighted the issue of depositor preference in its work on cross-border resolution of systemically important financial institutions in its publication, *Key Attributes of Effective Resolution Regimes for Financial Institutions*<sup>3</sup>, October 2011. According to the Financial Stability Board, ‘National laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable. The treatment of creditors and rankings in insolvency should be transparent and properly disclosed to depositors, insurance policy holders and other creditors. Recognition or support of foreign measures should be provisional on the equitable treatment of creditors in the foreign resolution proceeding.’
- 1.7** Despite such calls for the removal of national depositor preference laws there has been little evidence that countries that operate such regimes have made any attempt to change or amend their existing laws or that any change is envisaged.

## Proposals

- 1.8** We believe that firms from non-EEA countries that operate national depositor preference regimes should do more to address the risk to UK branch depositors from being subordinated to home country depositors. In this consultation paper we seek feedback on our proposals to mitigate the risks to UK branch depositors associated with firms from non-EEA countries that operate national depositor preference regimes.
- 1.9** We propose that firms from non-EEA countries that operate national depositor preference regimes should be prohibited from accepting deposits using a branch in the UK, unless they implement measures to eliminate the disadvantages that UK branch depositors would face compared to home country depositors. We expect firms to establish a UK-incorporated subsidiary to carry out their UK-based deposit-taking business or set up equally effective alternative arrangements.
- 1.10** We propose that firms should also have to disclose information about the national depositor preference regimes of their home countries and highlight the fact that the claims of depositors in the home country will be preferred to the claims of depositors outside the

<sup>3</sup> [www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)



home country. This information should be disclosed to all their UK branch customers to whom they provide deposit-taking services during the two-year period in which firms prepare to comply with our new requirements.

## Structure of this Consultation Paper

- 1.11** This Consultation Paper proposes that firms from non-EEA countries that operate national depositor preference regimes should be prohibited from accepting deposits using a branch in the UK, unless they implement measures to eliminate the disadvantages that UK branch depositors would face. Firms would have to establish a UK-incorporated deposit-taking subsidiary or set up equally effective alternative arrangements. In addition to this new requirement, firms should also disclose to UK branch depositors information about the national depositor preference regimes that operate in their home countries. Chapter 2 outlines the context for our proposals and related areas that the issue has implications for. In Chapter 3 we set out details of our proposed structural requirements. Chapter 4 contains details of our proposed disclosure requirements. Our cost benefit analysis (CBA), compatibility statement, draft Handbook text and a consolidated list of questions are included in separate annexes.

## Who should read this Consultation Paper?

- 1.12** This Consultation Paper will be of interest to firms from non-EEA countries that operate deposit-taking branches in the UK and are subject to national depositor preference regimes in their home countries.

## What is not covered in this Consultation Paper

- 1.13** This Consultation Paper does not cover the debate surrounding depositor preference in building societies and whether the claims of depositors should be ranked as depositors or owners of the societies if the society fails.
- 1.14** This Consultation Paper does not cover the Independent Commission on Banking's (ICB) recommendations to introduce a particular form of depositor preference in the UK. The recommendations were published in the final report<sup>4</sup>, September 2011 and are now being consulted on by HM Treasury in its white paper on implementing reforms for the banks, *Banking reform: delivering stability and supporting a sustainable economy*<sup>5</sup>, June 2012. The ICB recommended that deposits insured by the Financial Services Compensation scheme should be preferred as part of the measures to improve the loss-absorbing capacity of failed

<sup>4</sup> <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf>

<sup>5</sup> [www.hm-treasury.gov.uk/d/whitepaper\\_banking\\_reform\\_140512.pdf](http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf)

banks. The final decision and shape of the new UK regime are yet to be determined and will remain a matter for Parliament.

### **CONSUMERS**

The aim of this consultation paper and the proposed new rules is to require firms from non-EEA countries that operate national depositor preference regimes to eliminate the disadvantage that UK branch depositors face because their claims are subordinated to the claims of home country depositors if the firm becomes insolvent.

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# 2

## National depositor preference and related issues

- 2.1** The depositor preference regimes that exist vary in scope and nature across different countries. The preference can be based on where the deposit liabilities arise or be applied to different classes of deposits. This consultation paper is focused on national depositor preference i.e. deposits are preferred according to where the liabilities arise and are payable (i.e. jurisdiction specific).
- 2.2** The national depositor preference legislation will prefer depositors in the home country ahead of branch depositors outside the home country for the purposes of distributing the assets of the insolvent firm. Consequently branch depositors outside the home country will find themselves subordinated to depositors in the home country in the hierarchy of creditor claims.
- 2.3** Countries known to operate national depositor preference regimes include the United States, Australia, Singapore, and Turkey. This does not necessarily constitute all the countries that operate national depositor preference regimes but we researched a sample of key non-EEA countries that had branches in the UK with significant amounts of deposits.
- 2.4** This chapter provides an overview of a number of related issues that national depositor preference interacts with.

### **Deposit guarantee schemes**

- 2.5** Deposit guarantee schemes (or deposit insurance schemes or deposit protection schemes) can be found both in non-EEA countries that operate depositor preference and those that do not. The schemes vary across different countries in terms of the extent of protected deposits (maximum limits are often prescribed). The deposit guarantee schemes can be funded by the industry that they were set up to protect by imposing levies on participating

firms. In some countries the funds are collected *ex ante* whereas in others they are collected *ex post* the event(s) that gives rise to the levy.

- 2.6 Most deposit guarantee schemes contain a limit on the amount (value) of deposits that the scheme will protect as well as defined eligibility criteria for claimants. The national depositor preference statute in the United States covers home country deposits in excess of the amounts protected under the national deposit guarantee scheme making both protected and unprotected home country deposits preferred in the hierarchy of creditor claims.
- 2.7 In non-EEA countries with national depositor preference regimes, the deposit guarantee scheme will pay redress to eligible depositors and then stand in the 'place' of these preferred depositors to recover the payouts made from the estate of the insolvent firm (the deposit guarantee scheme subrogates for the eligible depositors – on receiving their monies from the deposit guarantee scheme, depositors assign their rights to receive any future entitlement from the estate of the insolvent firm to the scheme). The national deposit guarantee scheme will rank ahead of other unsecured creditors, including UK branch depositors, for the amount of protected deposits.

**Q1:** Do you have any comments on the way the national deposit guarantee scheme operates in a country with national depositor preference legislation?

## Resolution of cross-border banks

- 2.8 This consultation paper will not revisit the debates on national resolution regimes and the issues that have to be addressed to create effective resolution regimes.
- 2.9 The importance of cross-border co-operation needed to resolve global banks should not be underestimated and this is heightened where the priorities of home authorities and those of host authorities are not aligned. Co-operation between authorities is necessary given the differences in insolvency legislation and the Financial Stability Board has advocated that the order of seniority or statutory ranking of claims of shareholders, unsecured creditors (including unprotected creditors) in insolvency should be clear and predictable. Where this is the case, differences in legislation and practices have a better chance of being ironed out between the authorities.
- 2.10 Host country authorities are likely to be concerned when faced with situations where depositors are ranked differently because of national depositor preference regimes. When host country depositors are treated less favourably, co-operation between host and home country authorities in a resolution could be more challenging.

- Q2:** Do you have any comments on the implications of national depositor preference for the resolution of cross-border banks? Do you agree that the inequitable treatment of depositors outside the home country could jeopardise the resolution of cross-border banks?

## Bail-in

- 2.11** Bail-in is a new type of resolution tool that would enable resolution authorities to write down the following liabilities in a manner that respects the hierarchy of claims in liquidation: equity or other instruments of ownership of a failing firm; and unsecured and uninsured creditor claims to the extent necessary to absorb losses. Resolution authorities would also be able to convert into equity or other instruments of ownership of the firm under resolution, all or part of unsecured creditor claims in a manner that respects the hierarchy of claims in liquidation.
- 2.12** While work remains to be done to make bail-in fully operational, its inclusion in the toolkit for resolution authorities has been endorsed by the Financial Stability Board. It also plays a central role in the EU's draft directive that is intended to establish a framework for the recovery and resolution of credit institutions and investment firms.<sup>6</sup>
- 2.13** Insured depositors are specifically excluded from the scope of the bail-in tool. The bail-in tool will generally be applied to other liabilities in accordance with the hierarchy of claims in liquidation. In the case of firms from non-EEA countries that operate a national depositor preference regime it seems reasonable to expect that uninsured deposits in the UK branches will be subject to bail-in in advance of the uninsured home country deposits.

- Q3:** Do you have any comments on the implications of national depositor preference on bail-in?

## Branches of firms from non-EEA countries

- 2.14** Firms from non-EEA countries with national depositor preference regimes operate both branches and UK-incorporated subsidiaries in the UK.
- 2.15** When a firm from a non-EEA country with a national depositor preference regime uses a branch to accept deposits in the UK, the UK deposits are effectively placed with the same legal entity as the one accepting deposits in the home country. It is often the financial strength of the firm in the home country that attracts investors and customers to the

<sup>6</sup> [http://ec.europa.eu/internal\\_market/bank/docs/crisis-management/2012\\_eu\\_framework/impact\\_assessment\\_final\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_assessment_final_en.pdf)

branch in host countries. UK branch depositors are likely to be under the impression that if the firm fails, they would be entitled to participate equally in the distribution of assets from the insolvent firm's estate.

- 2.16** When a non-EEA firm fails the assets and liabilities of the UK branch would normally under insolvency proceedings be included in the estate of the firm in the home country. When a firm is insolvent, the existence of national depositor preference exacerbates the position of the UK branch depositors relative to home country depositors. Home country deposits that are preferred have a better chance of participating in the distribution of assets and recovering their proceeds from the estate of the failed firm than the UK branch deposits, which, together with all other unsecured creditors, would participate in assets that remained in the estate after insolvency administrators, secured creditors, home country depositors and any other preferred creditors had been paid. The proposals in this consultation paper highlight the disadvantages that UK branch depositors face relative to home country depositors given such circumstances.

**Q4:** Do you have any comments on the implications of national depositor preference legislation for UK branches of banks from non-EEA countries?

# 3

## Measures to address national depositor preference

- 3.1** Legislation on national depositor preference is intended to enhance the protection of home country depositors relative to depositors outside the home country. Preferring home country depositors will result in them being better protected against losses arising from claims made against the estate of a failed firm.
- 3.2** It is not acceptable that UK branch depositors are more exposed to potential losses than home country depositors if a firm fails especially when both classes of depositors have placed their deposits with the same firm. Furthermore there is the possibility that those UK losses may end up being borne by UK taxpayers if there are insufficient assets to recover from the estate of the failed firm.<sup>7</sup>

### What we are proposing

- 3.3** We believe that the firms from non-EEA countries that operate national depositor preference regimes and accept deposits in their UK branches should be required to eliminate the subordination of UK branch depositors compared to home country depositors.
- 3.4** The intended outcome is that UK branch depositors are not subordinated to home country depositors if such a firm were to become insolvent.
- 3.5** With one exception, any single measure we propose is unlikely to be applicable across all the different countries that operate national depositor preference regimes.
- 3.6** Therefore we propose introducing a new rule that will require firms to adopt measures to eliminate the subordination of UK branch depositors so that the UK branch depositors do not face the possibility of there being insufficient assets in the estate of the insolvent firm to meet their claims.

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<sup>7</sup> The estimated amount of deposits held in the UK branches of firms from non-EEA countries with national depositor preference regimes was about £800 billion (as at August 2011).

- 3.7** Firms should be prohibited from accepting deposits using a branch in the UK unless they take steps to rectify the disadvantages that UK branch depositors would face. Some firms would have to establish a UK-incorporated subsidiary for accepting deposits in the UK. This measure is available to all the deposit takers from non-EEA countries that operate national depositor preference regimes. However, firms will be able to adopt other measures provided they can demonstrate that these are equally effective. In our pre-consultation we identified other possible measures that firms could adopt.
- 3.8** If firms from a non-EEA country that operates national depositor preference place their UK deposits in a UK-incorporated subsidiary, the UK depositors would cease to be subordinated to home country depositors in the event the firms fails. When a UK-incorporated subsidiary is insolvent, all its depositors, including UK depositors would be subject to UK insolvency law, and all its depositors would be treated equally as unsecured creditors in the hierarchy of creditor claims. The result is that no individual class of the unsecured creditors category would be worse off.
- 3.9** Establishing a subsidiary in the UK is one measure that could be adopted by all the firms from non-EEA countries to address the issue of national depositor preference. We also believe that it could help prevent the misconception that UK branch depositors of a firm from a non-EEA country would be treated equally to home country depositors in the event of the firm's failure.
- 3.10** We recognise that our proposals will require firms to take steps and evaluate their strategy to maintain a deposit-taking branch in the UK. We do not underestimate the implications this will have for the UK branches and the firms in their home country. However, in the absence of any internationally co-ordinated action or individual countries unilaterally removing preference from their national laws, we believe the issue needs to be addressed. Maintaining the status quo could hinder cross-border co-operation efforts in resolving global firms.

**Q5:** Do you agree that firms should be prohibited from accepting deposits in branches in the UK without the safeguards to eliminate the subordination of UK branch depositors compared to home country depositors?

**Q6:** What steps would you take to eliminate the subordination of UK branch depositors compared to home country depositors?



## Other possible measures

- 3.11** The rules we propose will require firms to eliminate the subordination of the UK branch depositors compared to home country depositors. Firms will have to set out how they intend to meet this requirement.
- 3.12** UK branch depositors should be restored to the same rank as home country depositors in the hierarchy of creditor claims in order that UK branch depositors can be treated the same as home country depositors. Firms will be required to explain to their FSA supervisors how the chosen measure would operate under the national depositor preference legislation in their home country. Firms will also have to provide legal opinion on how the measure they are proposing would eliminate the subordination of UK branch depositors.
- 3.13** If UK branch depositors can be restored to the same rank as home country depositors in the hierarchy of claims then UK branch depositors would not be subordinated to home country depositors. Firms for whom this option is available should consider adopting it. However, the availability of this option is dependent on the way the national depositor preference legislation is written in a given country. Therefore, it is unlikely that this option will be available for all the non-EEA countries with national depositor preference regimes.
- 3.14** Firms that determine it is not feasible to restore UK branch depositors to the same rank as home country depositors on account of the way their national depositor preference legislation operates, should adopt alternative measures that will leave UK branch depositors no worse off than home country depositors. An alternative measure that might be available to firms would be to ring-fence assets of the UK branch to meet the deposit liabilities of the UK branch.
- 3.15** If firms elect to ring-fence assets in the UK branch, they should ensure that the ring-fenced assets would be available only to UK branch depositors, for example, by placing the ring-fenced assets under a trust arrangement that specifies UK depositors as the beneficiaries of that trust. Firms will be required to provide legal opinion on how the measure would eliminate the subordination of UK branch depositors, and any legal challenge will not undermine the ring-fenced assets and their intended use. Firms will have to ensure that the ring-fenced assets cannot be diverted and deployed for other uses or repatriated to the home country.
- 3.16** Firms that elect to ring-fence assets in the UK branch will have to provide to their FSA supervisor an explanation about the arrangement including which assets would be set aside, the amounts involved and a strategy to monitor the arrangement. Firms will have to demonstrate to the FSA's satisfaction that the assets pledged to the ring-fenced pool are sufficiently liquid and readily capable of being turned into funds to repay the UK branch depositors if it becomes necessary to do so.
- 3.17** Any ring-fencing arrangement of assets should be able to fulfil the criteria that: the assets will remain outside the firm's estate in liquidation; the beneficiaries will be the UK branch depositors; and legal advice is available to support this. This arrangement should ensure that there will be assets in the UK branch and UK branch depositors do not have to rely on

recoveries that might arise in the home country and severs dependency on the actions of the firm, regulatory authorities and courts in the home country.

**Q7:** How would you expect your firm to comply with the requirement to eliminate the subordination of UK branch depositors compared to home country depositors? Which of the above measures do you expect to implement and what is the basis for your selection?

**Q8:** What other measures would your firm consider implementing?

### **Implementation date**

**3.18** We recognise that firms will need time to make changes to their existing deposit-taking branches in the UK in order to comply with our proposed new requirements. We propose to give firms a two-year transitional period for them to implement the necessary changes.

**3.19** The draft rules are attached in Appendix 1. Subject to the feedback to this consultation, we intend to have new rules in place by January 2013. We propose to give firms two years to put in place the necessary arrangements to comply with the new requirements. Firms will be expected to meet these rules from January 2015.

**Q9:** Do you have any comments on the draft rules?

**Q10:** Do you agree with the two-year implementation period for firms?

# 4

## Disclosing information about national depositor preference

- 4.1 We propose that firms should also be required to disclose information about the national depositor preference regimes under which they are operating to all the customers of their UK branches from whom they accept deposits.
- 4.2 Given that the national depositor preference legislation differs from country to country we do not propose prescribing standard text for firms. The legislation is primarily written by national legislators and tends to be tailored to suit each home country both in content and objectives. It would be difficult for us to provide generic text to highlight the different ways UK branch depositors are treated compared to home country depositors.
- 4.3 The information provided on national depositor preference should be clear so that readers can comprehend the implications of the legislation. It should also be succinct and explain to the reader the consequences of placing deposits in the UK branch if the firm fails.
- 4.4 The information provided should not contain technical or legal jargon that would make it difficult to comprehend and does not inform the reader.
- 4.5 Firms will be required to discuss the text of their disclosures with their FSA supervisors before sending it to their customers.
- 4.6 The requirement for firms to disclose information about the national depositor preference regimes in their home countries will be in place during the two-year period as firms prepare to implement the new requirements to eliminate the disadvantages that UK branch depositors face.

## Which firms will these requirements apply to?

- 4.7 We propose that all firms from non-EEA countries that have national depositor preference regimes and operate deposit-taking branches in the UK should be subject to the proposed disclosure requirements.
- 4.8 Firms will be required to write to their FSA supervisors and inform them that they are operating under a national depositor preference regime in accordance with the legislation in their home country. The information should include a description of the national depositor preference regime and an explanation about the treatment of UK branch depositors.
- 4.9 We have previously asked some firms to write to their customers and provide information about national depositor preference regimes. A number of firms have continued to disclose this information in their agreements with their customers, however, other firms treated it as a one-off exercise and discontinued the practice.
- 4.10 Disclosing this information should not be left to the discretion of firms, therefore we propose that firms should inform all their customers who place deposits with the UK branch about the national depositor preference regimes of their home country.

## What should be disclosed?

- 4.11 The information that firms will have to provide to customers should state that the UK branch operates in accordance with the national depositor preference legislation of the home country. The information should inform customers of the firm about the relevant legislation and the way in which it operates.
- 4.12 In particular, the information must highlight the fact that the claims of UK branch depositors will be subordinated to the claims of depositors in the home country if the firm becomes insolvent.
- 4.13 The information must also refer to the risk of loss being greater for UK branch depositors compared to the preferred depositors of the home country as a result of their claims being subordinated in the hierarchy of creditor claims. In particular, it should explain that UK branch depositors will suffer losses before home country depositors would suffer any at all.
- 4.14 Reference to UK branch depositors merely being in a weaker position would not in itself be sufficient to highlight the risk of loss that UK branch depositors could incur if the firm becomes insolvent.

**Q11:** Have we captured the necessary information that has to be disclosed to UK branch depositors? Is there additional information that firms should disclose?

## Where should this information be disclosed?

- 4.15 Firms should disclose this information in the contracts of all customers from whom they accept deposits. This way the information is embedded in the contract between the firm and its customers.
- 4.16 The text on national depositor preference should be disclosed at an appropriate juncture, under a suitable section heading (if section headings are used in the contract) and not hidden away.
- 4.17 If there is 'master contract' that covers a range of services provided by the firm then the 'master contract' should contain the necessary information about the national depositor preference regime. Firms will not be required to disclose the information for every business line covered by the umbrella contract.
- 4.18 If the firm is providing deposit-taking services to different legal entities within a group of firms then the contract with each legal entity should contain the necessary information about the national depositor preference regime.
- 4.19 All firms will be required to include information on their national depositor preference regimes in all contracts with new deposit customers.
- 4.20 Existing customers should have their contracts governing their deposits replaced with new contracts that contain information about the national depositor preference regime under which the firm operates. When writing to existing customers with replacement contracts the firm should explain the purpose of the communication and draw attention to the information being disclosed.
- 4.21 We propose that firms which are already disclosing this information to their existing customers should reinforce the communication by writing to them and explaining the purpose of the communication and the information disclosed. By doing this, there is likely to be less confusion amongst customers who have deposited with more than one firm when they receive the communication from one firm but not others.
- 4.22 This exercise should create a start date from when the rule comes into effect so that customers of all the firms receive information about national depositor preference regimes in a timely fashion.
- 4.23 Disclosing this information will provide customers with the best means to be informed of the national depositor preference regimes to which their accounts are subject. Customers will be able to understand the consequences of the national depositor preference regime for their deposits and make an informed decision about the UK branch with whom they have placed deposits.
- 4.24 As noted above and under instruction by the FSA, a number of firms had previously written to their customers. This communication exercise was targeted at the retail customers of the firms. According to the national depositor preference legislation we researched, all home

country depositors are preferred compared to depositors outside the home country, and there is no distinction made between retail deposits and corporate deposits. Therefore we are proposing that firms should be required to inform all customers who place deposits with their UK branches, irrespective of their retail, corporate or other status.

- 4.25** We also propose that the same information should be displayed on the websites of these firms so that the information is communicated to as wide an audience as possible. In particular, the information should be displayed on all web pages where deposit-taking services are being offered by the UK branch.

**Q12:** Do you agree that firms should disclose information about the national depositor preference regimes that operate in their home countries? Do agree with the information that has to be disclosed and how it should be disclosed?

## Implementation date

- 4.26** The draft rule is attached in Appendix 1. Subject to the feedback to this consultation, we intend to have new rules in place by January 2013.
- 4.27** We propose to give firms three months to comply with this new disclosure requirement. Firms will be expected to disclose information about national depositor preference from April 2013. As some firms have previously disclosed information about the national depositor preference regimes of their home countries we expect all firms to be able to comply with this requirement without delay. The text already exists, it should be checked that it is up to date and inserted into the contracts, if not already included. This is a straightforward requirement that firms should be able to meet with minimum effort, without incurring excessive costs or involving a high degree of disruption to business processes.
- 4.28** The proposed rules on disclosing information about national depositor preference will be in place until the new requirements for firms to eliminate the subordination of UK branch depositors compared to home country depositors come into effect in January 2015.

**Q13:** Do you have any comments on the draft rules?

**Q14:** Do you agree with the three-month period for firms to put in place the disclosure requirement?

## Annex 1

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# Cost benefit analysis

1. Under the Financial Services and Markets Act 2000 (FSMA), we are required to provide an estimate of the costs and an analysis of the benefits that will arise from the policy proposals, unless we consider that the proposed rules will give rise to no costs or to an increase in costs of minimal significance.
2. A cost benefit analysis (CBA) is a statement of the differences between the baseline (broadly speaking, the current position extended to take into account developments in the immediate future) and the position that will arise if we implement the proposals.
3. In this section we describe:
  - the population of firms affected by the proposals;
  - the benefits that these proposals are likely to bring about;
  - costs expected to be incurred by the FSA;
  - the compliance costs that firms will incur; and
  - any indirect costs that may materialise in the market, e.g. impacts on firms' business models.

### Proposed rules

4. This consultation paper proposes introducing a new rule that will prohibit firms from accepting deposits using a branch in the UK unless they have taken steps to eliminate the subordination of the UK branch depositors compared to home country depositors in the hierarchy of creditor claims. We recognise that firms will require time to put in place the changes to meet our new requirements and we have therefore given firms a two-year transitional period. During the transitional period we also require firms to disclose information about the national depositor preference regimes of their home countries.

5. The proposed rule will in many instances require firms to accept deposits using a UK-incorporated subsidiary. If firms want to avoid using a subsidiary in the UK, they have to adopt alternative measures which are equally effective in eliminating the subordination of UK branch depositors compared with home country depositors. Whatever alternative measures firms adopt they should obtain legal advice to ensure that the measure is effective in eliminating the subordination of UK branch depositors compared to home country depositors. Chapter 3 of this consultation paper provides an overview of the measures firms could adopt to meet the new requirement. The alternative measures available to firms include:
- **Dual payability** – Where permitted under their home country national depositor preference statute firms could ensure that their UK branch deposits are repayable in the home country as well as the UK and therefore UK branch deposits become payable in dual locations and should be able to participate in the preference given to home country depositors.
  - **Ring-fencing assets** – Firms could ring-fence assets of the UK branch to meet its deposit liabilities, for example, under a trust arrangement that specifies the UK branch depositors as beneficiaries.

## Population of firms

6. Within the scope of our proposed regulatory changes we have identified 23 branches<sup>1</sup> of firms from non-EEA countries. These branches held deposits of approximately of £800bn<sup>2</sup>, of which approximately 80% was held by the UK branches of US firms.

## Benefits

7. The benefits from implementing measures that would lead to better protection for depositors in the UK branch against higher potential losses would materialise in the event that a firm from a non-EEA country that operates a national depositor preference regime becomes insolvent. Depositors of UK branches will benefit from improved recovery of their deposits in the event that the failed firm is not bailed out by the home country, or only the home country depositors and not UK branch depositors are bailed out. Although the likelihood of failure for such firms based in non-EEA countries with national depositor preference regimes is low, the impact could be high since significant amounts of deposits are held in UK branches.

<sup>1</sup> We are not necessarily aware of all branches of banks from non-EEA countries that operate a national depositor preference regime within the scope of our proposals, therefore there could be other firms depending on home country requirements. We note, however, if there are other firms we expect them to have insignificant levels of deposits compared to the branches we have identified.

<sup>2</sup> As at August 2011.



## Direct costs to the regulator

8. We do not anticipate our proposed changes will create any incremental costs for the FSA. Supervision of the proposed rules will not require additional resources and will fall within our existing supervisory arrangements.

## Compliance costs to firms

### Measures to eliminate the subordination of UK branch depositors compared to home country depositors

9. We surveyed branches of firms from non-EEA countries that account for most of the UK branch deposits, and received responses from firms that account for 85% of UK deposits held by branches within the scope of our proposed rules.
10. We expect firms to choose the measure that generates least incremental cost.<sup>3</sup> The results of the cost surveys indicated that the dual payability measure would be the choice for US firms, and using a deposit-taking subsidiary in the UK for firms from other non-EEA countries.
11. We estimate the total incremental costs for US banks adopting the dual payability measure to be in the region of £550 to £1120 million annually<sup>4</sup> and a one-off cost of £10 to £15 million to implement. Increased opportunity costs from deposit reserve requirements set by the Federal Reserve and the cost of deposit insurance provided by Federal Deposit Insurance Corporation (FDIC) account for most of the on-going costs.<sup>5</sup> A breakdown of these costs is provided in Table 1 below.

3 Other options may exist, which if they are chosen by banks would demonstrate that they are lower cost than the options we assess in our analysis.

4 One firm in our sample indicated that cross-country insurance cover might be needed for deposits in the UK against certain perils. Since this cost is not certain we have not included it within our cost estimates, but we note that these cost could be substantial, as the firm's estimate indicated a cost of a fraction of 1% applied across all deposits.

5 Our lower cost estimates are derived from the total costs submitted by firms grossed up for the three US firms that did not complete the survey, while our upper cost estimates are derived from the average cost per type of cost impact grossed up across the population of US firms.

**Table 1: Total incremental costs of adopting the dual payability measure (US firms)**

	Total cost (£ million)	Total cost (%)
<b>On-going costs</b>		
<b>Federal Reserve requirements costs</b>	440-900	80
<b>FDIC costs</b>	110-220	20
<b>Total</b>	550-1120	100
<b>One-off costs</b>		
<b>IT costs</b>	7-10.5	70
<b>Legal costs</b>	3-4.5	30
<b>Total</b>	10-15	100

12. The costs of staff needed to make changes to IT systems and legal costs, including adapting contracts with depositors, account for most of the one-off costs.
13. In the case of deposit-taking branches of firms from other non-EEA countries within the scope of our proposed regulation, our survey results suggested that use of a UK-incorporated subsidiary will be the preferred response. A number of the firms completing our survey found it difficult to accurately complete the costs of using a UK-incorporated subsidiary, but the results available to us suggested, on balance, the on-going incremental costs of using a subsidiary are expected to be lower than ring-fencing assets in the UK branch. We expect on-going costs to outweigh one-off costs as the key factor in firms' decisions given the size of on-going costs and the fact that many of the firms in the sample already have a UK deposit-taking subsidiary.

**Table 2: Total incremental costs of using a UK-based deposit-taking subsidiary (non-EEA firms except US firms)**

	Total cost (£ million)
<b>On-going costs</b>	100-270
<b>One-off costs</b>	160

14. Table 2 described the incremental costs to remaining non-EEA firms within the scope of our proposals. Most of the on-going costs arise from additional capital to meet regulatory requirements and client expectations; increased funding costs; and opportunity costs of investing in more liquid assets than are currently held. Other costs include those from increased staff costs for governance, risk management and reporting functions within the UK deposit-taking subsidiary.
15. The main types of one-off costs include legal, accounting and IT resources to implement the changes from accepting deposits in a branch to a subsidiary. Other costs include the

compliance and project management resources, and staff time devoted to client liaison during the process of moving deposits.

### **Disclosing information about national depositor preference regimes**

16. We estimate the incremental one-off costs of disclosing information about national depositor preference regimes to customers to be approximately £10,000 per firm.<sup>6</sup> The total estimated cost for all firms likely to be within scope of our proposed rule is £230,000. We expect costs would mainly arise from the use of legal and compliance resources to develop disclosure documents and senior management review of them. We note, however, that these incremental costs are ameliorated by the disclosure of national depositor preference status which some firms are already doing. In line with our experience of similar disclosure, we do not anticipate that the relevant firms would incur material on-going incremental costs because our requirements would be incorporated with regular reviews and issuance of new communication material undertaken for commercial reasons.

### **Market impacts**

17. We would expect increased compliance costs to be passed on to the depositors. For those depositors who had chosen where to deposit their assets in the knowledge of the depositor preference situation, these increased costs may lead them to choose another firm for their deposits, creating transaction costs for them and a loss of revenue for the firm that they exit from. Alternatively, the cost of retaining their account would be higher, and demand could decline.
18. Adopting and implementing measures to address national depositor preference is likely to impact on firms' business models. Firms from non-EEA countries may want to change their legal structure and/or move UK-based deposit-taking business from branches to their existing UK-incorporated subsidiaries.
19. Some deposit-taking branches of firms from non-EEA countries with national depositor preference have intimated that they would consider closing their UK deposit-taking business. If firms were to close their UK deposit-taking business, and not transfer it to another entity within the same firm, this would result in a loss of revenue for these firms and transaction costs for depositors.

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<sup>6</sup> See FSA (2009) Financial Services Compensation Scheme Reform CP09/3, which contained proposals similar in scope to those considered in this consultation.



## Annex 2:

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# Compatibility statement

1. This annex explains the reasons for concluding that our proposals are compatible with our general duties under section 2 of FSMA and our regulatory objectives, which are set out in sections 3 to 6 of FSMA.

### **Our regulatory objectives**

#### **Consumer protection**

2. A firm from a non-EEA country has to be authorised to carry out deposit taking activities in the UK. The firm will be levied by the UK Financial Services Compensation Scheme for depositors to provide protection to eligible consumers to a defined limit. Consumers who deposit amounts in excess of the limit and consumers who do not qualify under the eligibility criteria have to seek recourse to their funds from the estate of the insolvent firm according to the hierarchy of creditor claims under insolvency proceedings. In many countries the insolvency legislation provides that such depositors would share their entitlement on an equitable basis. However in non-EEA countries that operate under a national depositor preference regime, the home country depositors are preferred to UK branch depositors. In the absence of appropriate safeguards for UK branch depositors they are likely to contribute to any potential run on a firm by withdrawing their funds.

#### **Market confidence**

3. This objective requires us to seek to maintain confidence in the UK financial system. In our view, having appropriate safeguards for UK branch depositors will contribute to confidence in the financial system. This will occur if UK branch depositors are confident they are able to recover their deposits in the event the firm fails.

## **Financial stability**

4. These proposals should ensure that depositors are aware of the consequences for their deposits so that they can manage their deposits appropriately and are adequately protected if the firm fails. The proposals should help to ensure that firms will pay greater attention to risk management of their liabilities in order to meet the repayments due to their depositors, and in doing so, contribute to the firms being soundly and prudently managed.

## **The reduction of financial crime**

5. These proposals do not impact on the reduction of financial crime.

## **Compatibility with the Principles of Good Regulation**

6. Section 2(3) of FSMA requires that, in carrying out our general functions, we must 'have regard' to a number of specific matters. Of these, the following matters are relevant to our proposals.

### **The need to use our resources in the most economic and efficient way.**

7. Our proposals will result in minimal costs to the FSA. The proposals will be embedded within the supervision of the firms. No additional supervisory requirements are envisaged.

### **The principle that a burden or restriction should be proportionate to the benefits**

8. In our opinion the costs associated with our proposals are proportionate to the benefits delivered. We recognise that it is difficult to claim incremental benefits from these proposals, given we have not yet experienced the event occurring for which our proposals are designed to address. We also recognise that inertia has a dominant impact on consumer behaviour and the probability of consumers acting on the additional disclosure to alleviate the risk of being unprotected is low. However, given the amounts of deposits that are held in the UK branches of these firms from non-EEA countries there is a need to introduce safeguards to address the treatment of UK branch depositors compared to home country depositors for what has been a long-standing issue.

### **The international character of financial services and markets and the desirability of maintaining the competitive position of the UK**

9. The UK's high standing as an international financial centre depends in part on its reputation for sound regulation. Increased protection for UK branch depositors will help

ensure that the UK financial services market is seen, internationally and domestically, as well regulated and protecting consumers.

**The need to minimise adverse effects on competition and the desirability of facilitating competition between those who are subject to any form of regulation**

10. The disclosure requirements apply to all firms from non-EEA countries that operate under a national depositor preference regime using a UK branch. We do not anticipate that our proposals will have a material effect on competition within the market.

**Enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system)**

11. The disclosure requirements on firms will increase consumer awareness of national depositor preference regimes in non-EEA countries. As such, the proposals are consistent with this principle.

**Equality and diversity implications**

12. We have assessed the equality and diversity impact of our proposals. We do not believe these proposals have the potential to affect any of the protected groups.





## Annex 3:

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# List of questions

- Q1:** Do you have any comments on the way the national deposit guarantee scheme operates in a country with national depositor preference legislation?
- Q2:** Do you have any comments on the implications national depositor preference for the resolution of cross-border banks?
- Q3:** Do you have any comments on the implications of national depositor preference on bail-in?
- Q4:** Do you have any comments on the implications of national depositor preference legislation for UK branches of banks from non-EEA countries?
- Q5:** Do you agree that firms should be prohibited from accepting deposits in branches in the UK without the safeguards to eliminate the subordination of UK branch depositors compared to home country depositors?
- Q6:** How would you eliminate the subordination of UK branch depositors compared to home country depositors?
- Q7:** How would you expect your firm to comply with the requirement to eliminate the subordination of UK branch depositors compared to home country depositors? Which of

the above measures, do you expect to implement and what is the basis for your selection?

**Q8:** What other measures would your firm consider implementing?

**Q9:** Do you have any comments on the draft rules?

**Q10:** Do you agree with the two-year implementation period for firms?

**Q11:** Have we captured the necessary information that has to be disclosed to UK branch depositors? Is there additional information that firms should disclose?

**Q12:** Do you agree that firm should have to disclose information about national depositor preference regimes that operate in their home countries? Do you agree with the information that has to be disclosed and how it should be disclosed?

**Q13:** Do you have any comments on the draft rules?

**Q14:** Do you agree with the three-month period for firms to put in place the disclosure requirement?

## Appendix 1

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# Draft Handbook text

**SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS  
(NATIONAL DEPOSITOR PREFERENCE) INSTRUMENT 2012**

**Powers exercised**

- A. The Financial Services Authority makes this instrument in the exercise of:
- (1) the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
    - (a) section 138 (General rule-making power); and
    - (b) section 156 (General supplementary powers); and
  - (2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

**Commencement**

- C. Part I of the Annex to this instrument comes into force on [1 April 2013]. Part II of the Annex comes into force on [1 January 2015].

**Amendments to the Handbook**

- D. The Senior Management Arrangements, Systems and Controls sourcebook (SYSC) is amended in accordance with the Annex to this instrument.

**Citation**

- E. This instrument may be cited as the Senior Management Arrangements, Systems and Controls (National Depositor Preference) Instrument 2012.

By order of the Board  
[date]

## Annex

### Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

#### Part I: comes into force on 1 April 2013

The following text should be inserted as a new chapter after SYSC 21, the text is not underlined.

#### **22 National depositor preference**

##### **22.1 Application**

- 22.1.1 R This chapter applies to a *firm*, the registered office of which (or, if the *firm* does not have a registered office, its head office) is located outside the *EEA* and which has a branch in the *UK*, that has a *Part IV permission* for *accepting deposits* and is not an *insurer*.

##### **22.2 Disclosure of national depositor preference regimes**

- 22.2.1 R Where a *firm* is, or has reasonable prospect of becoming, subject to a regime described by SYSC 22.2.2R, it must disclose that fact to the depositors of its *UK branch*, including a description of the regime and its implications for their *deposits*.
- 22.2.2 R A regime as referred to in this chapter is a regime applicable on the insolvency, resolution or other failure of the *firm* that has the effect that on a distribution of the assets of the *firm* the legal or economic entitlements of some or all of the depositors of the *UK branch* receive treatment that is less favourable compared with that of equivalent depositors of a *branch* outside the *UK*. This includes preferences based on the location of the *branch*, nationality of the depositor, or place where the *deposit* is payable.

## Part II: comes into force on 1 January 2015

### 22 National depositor preference

#### 22.2 National depositor preference regimes

- 22.2.1 R ~~Where a *firm* is, or has reasonable prospect of becoming, subject to a regime described by SYSC 22.2.2R, it must disclose that fact to the depositors of its UK branch, including a description of the regime and its implications for their deposits. [deleted]~~
- 22.2.2 R ...

#### 22.3 Requirements concerning national depositor preference regimes

- 22.3.1 R A *firm* that is subject to, or has a reasonable prospect of becoming subject to, a regime described by SYSC 22.2.2R must not *accept deposits* unless it has adopted measures that ensure that the effect described in SYSC 22.2.2R does not take place.
- 22.3.2 R The *firm* must demonstrate to the FSA the effectiveness of the measures it intends to adopt to comply with SYSC 22.3.1R. If the *firm* is not yet subject to a regime described by SYSC 22.2.2R but has a reasonable prospect of becoming so, it must demonstrate to the FSA the effectiveness of the measures it proposes to adopt if it were to become subject to the regime.
- 22.3.3 R The *firm* must promptly notify the FSA that it is subject to, or has a reasonable prospect of becoming subject to, a regime described by SYSC 22.2.2R.
- 22.3.4 R A *firm* which is not subject to a regime described by SYSC 22.2.2R must monitor the regime to which it is subject in order to be able to give promptly the notice required by SYSC 22.3.3R.

## Appendix 2

# Designation of Handbook Provisions

FSA Handbook provisions will be ‘designated’ to create a FCA Handbook and a PRA Handbook on the date that the regulators exercise their legal powers to do so. Please visit our website<sup>1</sup> for further details about this process.

We plan to designate the Handbook Provisions which we are proposing to create and/or amend within this Consultation Paper as follows. These designations are draft and are subject to change prior to the new regulators exercising their legal powers.

Content of SYSC	Designation	Rationale	Assumptions and Outstanding Issues
Forbid branches of firms from non-EEA jurisdictions that are subject to national depositor preference regimes from accepting deposits in the UK unless they take steps to ensure that UK depositors are not disadvantaged by it	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA
SYSC 22.1.1R provision on the firms from non-EEA countries with a branch in the UK for accepting deposits that are within scope of the new rule	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA

<sup>1</sup> <http://media.fsahandbook.info/latestNews/One-minute%20guide.pdf>

Content of SYSC	Designation	Rationale	Assumptions and Outstanding Issues
SYSC 22.2.1R provision to disclose information about national depositor preference regimes under which the firms operate	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA
SYSC 22.2.2R provision on the description of national depositor preference regime	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA
SYSC 22.3.1R provision to prevent firms operating in under national depositor preference regimes from accepting deposits	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA
SYSC 22.3.2R provision for firms to demonstrate the effectiveness of their measures taken to mitigate the effects of national depositor preference on UK branch depositors	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA
SYSC 22.3.3R provision for firms to notify FSA about operating under national depositor preference regimes or expect to do so in the future	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA
SYSC 22.3.4R provision for firms to continuously monitor the likelihood of operating under national depositor preference regimes in the future	PRA-only	The PRA will prudentially supervise these deposit taking firms from non-EEA countries.	All deposit taking firms will be prudentially supervised by the PRA



**PUB REF: 004536**

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