THE FINANCIAL SERVICES PRACTITIONER PANEL

RESPONSE TO FSA CONSULTATION PAPER 12/16

'FSCS FUNDING MODEL REVIEW' JULY 2012

09 OCTOBER 2012

Introduction

The Financial Services Practitioner Panel has taken a keen interest in the past few years in the reform of the Financial Services Compensation Scheme ('the Scheme'). As you are aware, there is strong industry feeling regarding the fairness and predictability of the current scheme. Many firms have faced very substantial and unanticipated bills as a result of failures of companies with whom they feel they have little in common.

As such, we welcome the intention to reform the current FSCS system, and consultation on how this can be done. Our views on this are provided in more detail below.

Executive Summary:

- Overall the Panel was disappointed that the proposals did not go further in addressing the key weaknesses of the existing Scheme
    - The paper as presented fails to go far enough in assuaging industry concerns around fairness and moral hazard
- The Panel welcomes the elimination of cross-subsidy between the PRA and the FCA, but believes this could go further in also reducing cross-industry payments within the FCA
    - Whilst recognising that the FCA classes cannot be self-sustaining as in the PRA, we believe consideration should always be given to whether the FSCS could take out a loan, to be paid back by the relevant class over time, rather than paying out through the retail pool
- The Panel is disappointed that the FSA rejected introducing some form of risk-weighting into the firm tariff calculations
    - The FSA considers and rejects risk-weighting through a number of indicators, such as the number of complaints. We do not necessarily oppose this reasoning
    - However, we were surprised and disappointed that the paper did not consider the existing international alternatives available
- The FSA should consider introducing a 'right of access' to information for industry in cases such as Bradford & Bingley
- There remain mixed views in the industry regarding the possible benefits of introducing a separate funding class for Building Societies in the PRA

Detailed response:

1. *The Panel welcomes the elimination of cross-subsidy between the PRA and the FCA, but believes this could go further in also reducing cross-industry payments within the FCA*

The intention behind having separate sub-classes in the Scheme relates to the principle that the type of institution that created a risk should in the first instance be the ones to pay for it. To a certain extent, this is reasonable – if there were evidence of poor practices across a specific firm population, this class should in the first instance bear the costs of consumer redress schemes and related firm failure.

We therefore support the FSA's proposals that in the future regulatory world, there should be no cross-subsidy between classes in the PRA, or between the PRA and the FCA. However, we believe the regulator could go further in considering abolishing elements of cross-subsidy also for the FCA. We recognise that many classes in the FCA cannot be self-standing in the same manner as in the PRA, as this could threaten the sustainability of the class – and that therefore, there is an argument for keeping an FCA 'retail pool' as suggested in the paper. Yet the level of cross-subsidy could be reduced through a greater reliance on Scheme borrowing, where the FSCS takes out a loan and spreads out the cost of borrowing and repayments from the relevant class over time. We have seen this happening with deposit-takers, who will pay off loans related to the failure of Bradford & Bingley for c. ten years in total.

Such a loan arrangement, although clearly imposing more costs on the sector in question, should as far as possible be seen as preferable to relying on a collective retail scheme, as it means the sector originating the risk would be carrying more of the burden for paying for it.

2. *The Panel is disappointed that the FSA rejected introducing some form of risk-weighting into the firm tariff calculations, and did not appear to consider alternative mechanisms used in other countries*

The levies charged on firms should be related to the level of risk that individual institution poses to the Scheme. Although in general costs should be allocated to the type of industry responsible for it, it is also important to recognise that not all firms categorised into one class will present the same levels of risk to the Scheme. At the moment, the Panel views lack of such recognition as one of the key shortcomings of the FSCS. As such, we are disappointed that FSA appears opposed to introducing a differential charging structure in the future.

Firms with similar activities do not have the same risk profile, as can be seen by way of example in the advisor community. For instance, although the mis-selling of Arch cru funds was limited to a small number of firms (c. 800 out of 27,000), the FSCS impact could potentially be significant if the institution of a redress scheme leads to a high proportion of those firms failing. In our view, the failure to differentiate between the risk profiles of firms creates the risk of moral hazard, whereby riskier firms know that should reckless risks succeed they will benefit, whilst failures would be borne by the Scheme. This raises issues not just of fairness as the well-behaved firms pay for the mistakes of those who were poorly run, but also leads to an inefficient allocation of resources across the economy.

The FSA discusses, but ultimately dismisses, a number of options for introducing an element of risk-weighting into the creation of industry 'classes' as well as in determining the levy each firm would pay towards the Scheme. We do not necessarily disagree with some of the specific proposals considered and rejected (such as relying on FSA risk scores). However, we were surprised and disappointed that the FSA did not consider or acknowledge the fact that there are several other regulators around the world who do incorporate a measure of institutional risk into deposit or investment guarantee schemes.

The International Association of Deposit Insurers referenced seventeen countries who ran Schemes applying differential (risk-adjusted) premiums for deposits in 2009[1]. In addition, there are also other Schemes (such as investor protection) who have regard to institutional risk in determining who bears the costs of firm failure. Examples include the FDIC in the United States and the Canadian Investor Protection Fund.

In addition, as the FSA is aware, the current European Commission drafting on the Deposit Guarantee Scheme Directive relies on assessing firm risks. Currently, contributions to the DGS are planned to be based on each credit institutions' risk profile considering a number of harmonised factors, where risk-based contributions are assessed with reference to capital adequacy, asset quality and profitability. The ongoing discussions are interesting not only because they should provide the FSA with other alternative calculation methods to consider in its reform work, but also because the Deposit Guarantee Scheme Directive when enacted will of course also have to be implemented in the UK.

We would be interested to hear whether the FSA has considered any alternatives on the basis of other international systems, and if so, why these were not discussed in its consultation paper. Given the number of other countries that employ a risk-based system, we believe there is a strong case for the FSA to thoroughly consider whether it could build on any other Schemes in enhancing the fairness of the FSCS.

3. *We would urge the FSA to consider a right of access to information for industry in cases such as Bradford and Bingley*

Deposit-takers have repeatedly stressed their concern that they are unable to access information relating to the residual liabilities from Bradford and Bingley. Given the funding arrangements of this institution, where the FSCS took out a loan for deposit-takers to pay off over a period of time, firms that pay the loan do not have creditor rights. This means that firms do not have the same rights of access to information they would otherwise have had, which has provided a real practical challenge in terms of financial planning for firms.

We would urge the FSA to consider whether such a requirement can be introduced for firms in instances such as this, and how this could best be done.

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[1] Source: International Association of Deposit Insurers *'Funding of Deposit Insurance Systems'* 2009

4. *There remain mixed views in the industry regarding the possible benefits of introducing a separate sub-class for building societies in the PRA*

The Panel is split regarding the rationale provided by the FSA for not creating a separate funding class for building societies in the PRA.

On the one hand, there is recognition by all that building societies are subject to a number of statutory requirements in the Building Societies' Act, which limit the risks they can take on. This includes the requirement that a minimum of 50% of their funding must come from retail deposits, a requirement for 75% of assets to be secured on UK residential property, and a prohibition on engaging in speculative trading activities.

However, the Panel also recognises that there are banks that also operate lower-risk business models (including those who rely mainly on retail deposits for their funding needs). As such, the Panel as a whole cannot take a common view regarding the appropriateness of separating or not separating building societies from banks in the PRA class structure.

Conclusion

In conclusion, the Panel was disappointed that the paper did not go further in addressing some of the key weaknesses of the current FSCS. The currently ongoing reforms should provide an opportunity for the regulator to consider significant changes to this Scheme.

We have suggested that the FSA look especially at alternative Schemes being run internationally, in order to consider improving the fairness of the Scheme by introducing some element of risk-weighting. Given that a fairly large number of other countries incorporate differential premiums into their funding calculations, it would be surprising if such a study could not provide lessons for this funding model reform.

We also encourage the FSA to re-think the cross-subsidy arrangements for the future FCA, and to consider whether a greater reliance on Scheme loans (rather than cross-industry payments) could reduce moral hazard and make the FSCS more equitable. Finally, we believe there is a case for introducing a 'right of access' to information for firms in cases such as Bradford and Bingley, and note that there are a range of views on the proposals for banks and building societies to sit in the same class in the PRA.

The Panel has appreciated the opportunity to comment on these proposals, and would be happy to engage in more detail with the regulator on these topics in the future.