

Financial stability and depositor protection: strengthening the framework

A Consultation by Bank of England, HM Treasury, and the Financial Services Authority

Response by the Building Societies Association

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Introduction

1. The Building Societies Association (BSA) represents all 59 building societies in the United Kingdom. Building societies have total assets of just under £350 billion and, together with their subsidiaries, hold residential mortgages of £245 billion, more than 20% of the total outstanding in the UK. Societies hold about £215 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies also account for over 38% of all cash ISA balances. Building societies employ over 50,000 full and part-time staff and operate through more than 2,100 branches.

2. This paper provides the BSA's response to the joint consultation published by the Bank of England, HM Treasury, and the Financial Services Authority (the Authorities), *Financial stability and depositor protection: strengthening the framework* (the CP), containing proposals for strengthening the current framework for financial stability and depositor protection. BSA representatives have met Treasury officials on several occasions to discuss the CP and the current situation.

3. In the wake of the Northern Rock crisis, the CP makes proposals, with international co-operation as appropriate, in respect of the following –

- (i) the need for change
- (ii) strengthening stability and resilience of the financial system
- (iii) reducing the likelihood of banks facing difficulties
- (iv) reducing the impact if a bank got into difficulties
- (iv) providing effective compensation arrangements, and
- (vi) strengthening the Bank of England, and ensuring effective action.

4. Regarding the Financial Services Compensation Scheme (FSCS), the CP does **not** propose a higher limit for deposits and notes that the FSA will be consulting on this matter, but we include some initial comments on the subject.

5. The CP refers to "banks" for short (except when specifically referring to building societies), but it applies to all types of credit institution, including building societies. In this response, we mirror the CP's use of the term 'bank', unless the question applies to building societies only or there are building society-specific aspects. The BSA notes the contents of Statement by the Chancellor of the Exchequer to the House of Commons on 21 April 2008, which is of course relevant to the CP, but the BSA does not comment further in this response on the Chancellor's Statement.

Building Society Background

6. All UK building societies are covered by the FSCS. Building societies are mutual organisations, where each member is both a shareholder (or borrower) and customer. Under the FSCS, all building society shares are treated as deposits (except Permanent Interest Bearing Shares – PIBS). No building society has ever called on the FSCS or on its predecessor - building society-specific - scheme.

7. By section 90(2) of the Building Societies Act 1986 Act, subject to modifications set out in Schedule 15 to the 1986 Act, the main legislation pertaining to the winding up of a building society is the companies winding up legislation ie the Insolvency Act 1986 and Rules under it. Like companies, building societies may be wound up either voluntarily by special resolution, or compulsorily on various statutory grounds. Further provisions will be added by the Building Societies (Financial Assistance) Order 2008, currently before Parliament.

8. Building societies are subject to nature limits, including one on wholesale funding¹. A building society is permitted to raise a maximum 50% of its funding from the wholesale markets, but the average for the sector is around 30%.

9. Capital is held in a building society to cover the various risks that are taken by a business involved in lending – the credit risk that the borrower will not repay, the interest rate risk inherent in the balance sheet, operational risks etc. The building society sector is extremely well capitalised, which has helped ensure that no ordinary investor in a building society has lost any of their savings since at least 1945, and - so far as we are aware - for a long time before that.

Summary of the BSA's Views

10. The BSA supports the broad objectives of the CP, but cautions against hurried changes, especially those of an extensive nature or dealing with complicated matters (such as the 'special resolution regime'). However, whatever the outcome of the CP, banks and building societies should be subject to the same legislative arrangements (any necessary changes being made eg to reflect their different corporate forms).

11. The CP raises such a large number of complicated questions, and touches upon so many potential courses of action that could have unforeseen consequences, that the BSA regards it as extremely important that further, detailed work is undertaken - where appropriate - before proceeding to legislation. An arrangement like the Joint Committee on Financial Services and Markets, chaired by Lord Burns before the Financial Services and Markets Bill, might be a suitable apparatus. As Howard Davies said in 2003 -

"That pre-legislative scrutiny certainly added value, and teased out a number of complex issues which would have otherwise detained Parliament, and would have been more difficult to deal with in the traditional confrontational style of Westminster ²."

12. While the FSMA was, of course, a very long and highly significant piece of legislation, any legislation arising from the CP could have implications at least as serious as the FSMA, and in our view needs - as a minimum - the same level of pre-legislative scrutiny to avert unforeseen, and possibly very serious, detrimental consequences.

13. In relation to recent and current events - and ongoing supervision - it is very important that the FSA does not mechanistically impose particular 'solutions' (eg a specific level of liquidity) on firms - an appropriate degree of individual firm discretion should be maintained during this period of uncertainty. To impose a straightjacket on firms will reduce their flexibility and could lead to wider problems for the housing and mortgage markets. This is particularly important in view of the fact that the FSA does not expect its move towards principles based regulation to be affected by the current situation - excessive prescription in relation to liquidity might unbalance the PBR agenda.

14. The following paragraphs summarise the BSA's views on the proposals set out in the CP -

(i) Both the Treasury Committee Report ³ and the CP recognise that the fundamental responsibility for financial stability of a firm rests with the firm's Board. The BSA agrees with this proposition, which applies equally to other financial institutions. But the BSA also believes that, however many procedures are put in place, there is unlikely to be a serious regulatory bulwark against financial instability unless the Authorities are fully committed in practice to carrying out their *existing* functions in seeking to

avert such financial instability. Paragraphs 9 – 27 of the FSA's internal audit report graphically underline this point; at paragraph 27, it stated –

"We cannot provide assurance that the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the supervisory strategy was in line with the firm's risk profile."

(ii) The BSA supports the CP's broad objectives and believes that many of the proposals in the paper are sensible in principle, notably –

- additional work to improve stress testing
- co-operation with international partners on –
 - stress testing and risk management
 - liquidity regulation
 - consistent valuation and disclosure regarding asset backed securities
 - credit rating agencies
- extra requirements regarding information to the FSA, provided they are proportionate, necessary and subject to cost-benefit assessment
- better payments systems oversight, but limited to what is strictly necessary
- limited delay in disclosure of emergency liquidity assistance
- new arrangements regarding Bank of England immunity and security, provided drawn only as widely as is absolutely necessary
- modest changes, in respect of building societies, concerning Bank of England funds, floating charges, access to liquidity and rescue tools (some of which are already before Parliament in the draft Building Societies (Financial Assistance) Order 2008).

However, it is important that any changes do not have a disproportionate effect on smaller institutions; for example, if smaller firms had to bear the costs of changes without benefiting from them.

(iii) The BSA does not believe that a substantial case is currently made for radical changes, such as the introduction of a special resolution regime or pre-funding of the Financial Services Compensation Fund. While we shall, of course, consider all recommendations carefully and co-operate fully in this important work, we believe that a proportionate approach, before deciding

whether or not to introduce radical, complicated or potentially far-reaching changes, would be to –

- examine, and if appropriate move ahead with, some of the more modest changes in proposed in the CP - see (ii) above
- await the results of the FSA's supervisory enhancement programme (although we recognise that this is likely to be a matter of judgment, rather than fact), and
- investigate practical ways to improve speed of payment from the FSCS.

BSA Comments

(i) The need for change

15. Chapter 1 of the CP sets out the background, asks some general questions about the CP's proposals - such as whether they are necessary and proportionate, could be improved etc - and argues in favour of fundamental change. But the BSA believes that, however many procedures are put in place, there is unlikely to be a serious regulatory bulwark against financial instability unless the Authorities are fully committed to carrying out competently their *existing* functions in seeking to avert such financial instability. Indeed, paragraph 3.13 of the CP states that –

"The interventions and powers that are already available to the FSA are wide-ranging. In order to support the reforms outlined in this document the Authorities judge that the FSA requires a small number of additional powers."

16. This begged the question why those powers were not exercised, at an earlier stage, in relation to Northern Rock, and whether *additional* mechanisms were really necessary. It is now clear that the FSA itself believes that it badly mishandled its supervision of the expansion of Northern Rock's business model and lack of back-up credit⁴.

17. It is imperative that the failings of the Authorities in relation to the Northern Rock episode are fully recognised and addressed as appropriate. The tools proposed in the CP might be helpful if difficulties arose in future, but would be unlikely to get to the root of the problem if regulatory deficiencies like those in relation to Northern Rock, or of equivalent significance, were to be repeated.

18. The FSA has promised to address the failings. It is important to wait and see whether it can successfully – and proportionately - deal with these matters as it plans to do, before introducing new, far-reaching measures such as the 'special resolution regime' (see below). The BSA recognises that the extent of the FSA's success in its remedial activities will be a matter of judgment, but it is nonetheless appropriate to make a proper assessment at the relevant time.

19. It would be unwise to introduce large-scale legislation in haste for a number of reasons –

- as noted, the outcomes of the FSA's work in improving its regulatory activities are awaited and more far-reaching measures should be unnecessary if the FSA carries out its regulatory responsibilities effectively in future
- the next stability problem, if one arises, could be completely different from the Northern Rock situation
- complicated and wide-ranging legislation could have unintended consequences and be detrimental to the continued effective operation of the

banking system; they could, possibly, even be destabilising, especially in a difficult market.

(ii) Stability and resilience of the financial system

20. Chapter 2 explains the recent events, including how the US sub-prime problems spread internationally, summarises the international work on the problems and sets out the Authorities' views. These are a series of, mostly straightforward, proposals that the BSA supports, namely –

- additional work to improve stress testing
- co-operation with international partners on –
 - stress testing and risk management
 - liquidity regulation
 - consistent valuation and disclosure regarding asset backed securities
 - credit rating agencies.

(iii) Reducing the likelihood of a bank failing

21. Chapter 3 looks at the existing UK regulatory framework and makes proposals that are more substantial. The BSA supports these proposals in principle, subject to certain qualifications -

- extra requirements regarding information to the FSA, provided –
 - the Authorities fully recognise that firms already have onerous obligations in this area and no excessive new obligations are introduced in respect of quantity of information, turnaround times etc
 - there is a full cost-benefit assessment in relation to any extra requirements, and
 - there is much more transparency from the FSA about why *existing*, as well as any new, information is required, and greater feedback on how the information is processed and used. (As things stand, we understand from our members that firms provide a great deal of data to the FSA, but are unclear as to why the FSA finds it necessary to collect so much information.)

We note that the FSA plans to consult and the BSA will consider, and respond to, the proposals.

- better payments systems oversight - but only if limited to what is strictly necessary
- limited delay in disclosure of emergency liquidity assistance

- new arrangements regarding Bank of England immunity and security - provided drawn only as widely as is absolutely necessary
- modest changes, in respect of building societies, concerning access to liquidity - Bank of England funds, and the power to grant floating charges in favour of the Bank of England - this would put societies on a par with banks in the highly unlikely event of needing help. (We note that the Building Societies (Financial Assistance) Order 2008 has been laid before Parliament and, if approved, would allow building societies to obtain relevant financial assistance and create floating charges in favour of the Bank.)

However, unforeseen consequences must be guarded against. For example, we understand that some societies' contractual documents in respect of wholesale borrowing prevent a society from issuing a floating charge. Such matters need to be addressed.

(iv) Reducing the impact of a failing bank

22. Chapter 4 proposes the introduction of a 'special resolution regime' (SRR) giving the Authorities extra tools to achieve a more orderly resolution of a failing bank (or building society). The Association is not convinced of the need for such fundamental change as would be represented by SRR.

23. The BSA believes that, rather than introduce an entirely new process, it would be more appropriate, first of all, to wait and see whether the FSA has addressed its regulatory failings and to examine ways of ensuring faster payment to customers in the event of a firm's collapse. During that time, it would be possible to examine more fully whether existing insolvency legislation or corporate rescue regimes could be amended to achieve the relevant objectives; for instance -

- in very exceptional circumstances, and subject to clear rules, a firm might be 'deemed' insolvent, even though it is not insolvent within the current definition
- powers of shareholders to block insolvency could be removed in relation to these special cases
- the insolvency practitioner could be placed under an obligation to release moneys as soon as possible to the FSCS.

24. But no changes should be rushed. These matters – especially the proposed SRR - are part of a wider, and complicated, legal framework and could give rise to unforeseen consequences regarding such matters as –

- existing property rights
- business contracts

- systems
- building society membership rights
- transfer of consumer data – fraud prevention in relation to data security would need to be addressed
- the assumption that cheques issued by the FSCS would clear immediately – further consideration would need to be given to matters such as indemnity if normal clearing times were to be waived
- oversight of the use of discretionary powers under SRRs – credible governance would be of the utmost importance
- unplanned cost burdens inherent in new, complicated arrangements etc.

Any proposed SRR arrangements should be subject to cost-benefit analysis, and the extent to which firms would be required to have contingency plans in place to facilitate the effectiveness of the SRR needs to be clearly defined. It is important that any changes do not have a disproportionate effect on smaller institutions; for example, if smaller firms had to bear the costs of changes without benefiting from them.

25. If, nevertheless, SRRs were to be put in place, the Association believes that the building society-specific proposals should be included in the arrangements. These concern rescue tools and winding up of a building society. These changes would, broadly speaking, put building societies on a par with banks in the highly unlikely situation of a rescue being needed. However, once again, unforeseen consequences could arise – this is one reason why it is particularly important not to make rushed legislative changes. As noted above, pre-legislative scrutiny would help avert unintended consequences – see paragraph 11 above. (Again, we note, in this context, that Building Societies (Financial Assistance) Order 2008 has been laid before Parliament and awaits approval.)

(v) Consumer confidence and compensation arrangements

26. Chapter 5 focuses on the compensation arrangements under the FSCS and deals with –

- compensation limit (in principle only; the CP makes no definite proposals)
- faster compensation payments (with a one week target)
- risk-based FSCS levies
- consumer awareness and additional consumer protections.

The following paragraphs provide our comments on these topics.

- **Compensation limit**

27. We are open-minded on the question of an increased limit in relation to deposit-takers. The key point, in our view, is that very careful consideration be given before making a decision on this matter and we set out below a number of factors that need to be fully taken into account. However, we strongly oppose pre-funding, which would be counter-productive for the reasons given below (see paragraph 38).

28. **Recent changes:** it should be remembered that significant changes to the funding of the FSCS came into effect on 1 April 2008; the financial capacity of the entire scheme having been raised to a maximum of £4.03 billion per year. Therefore, taking this change together with the introduction of the retail cross-subsidy arrangements and the, slightly earlier, increase in the limit regarding deposit-takers (see below), substantial changes have already been made. The Authorities should be mindful, in assessing the validity of further changes to depositor protection arrangements, that the efficacy of these most recent improvements has not been tested and there should not be an automatic assumption that further changes are needed.

29. The BSA believes that the recent increase to 100% of the first £35,000 held with a deposit-taking institution was both proportionate in terms of the amount of increase, and simpler – because of the removal of the co-insurance element - and, therefore, more transparent for consumers than the previous arrangement.

30. **Consumer confidence:** there might be an increase in consumer confidence if compensation levels were higher, but the consumer research in the CP suggests that this would not be the case – only 1% of those responding correctly identifying the current level of £35,000 despite all the media attention to Northern Rock⁵. Public confidence might increase in the light of a higher limit if the reasons for the provisions were clearly explained to consumers.

31. If consumer confidence is the fundamental objective, then it would be boosted by guarantees as to the strength of the depositor protection scheme. The Federal Deposit Insurance Scheme in the USA is backed by the United States Government. The UK Government may, for understandable reasons, be reluctant to take on a similar commitment in respect of UK depositors, and the BSA is not advocating such a change, but the power of government guarantees should not be underestimated - indeed, they have been used extensively in the Northern Rock situation.

32. **Consumer benefit:** the Association has researched the distribution of deposits (ie both 'share' and 'deposit' accounts) within the building society sector. The figures currently available show that approximately 95% of individuals saving with a building society have balances of £35,000 or less – very similar, indeed, to

the figures for the banking sector. These balances account for approximately 69% of the total balances outstanding. We understand that the position of depositors with the banks is almost identical. An increase in the limit would raise the value of FSCS cover, but would have little effect on the number of depositors benefiting from the protection.

33. **Market consequences:** increased publicity surrounding the compensation limit would be needed in order to engender greater awareness. However, such awareness-raising carries other risks. It seems possible, for example, that it could stimulate the growth of intermediation in the deposit market, which may do nothing to enhance financial stability. Greater awareness of the compensation limit will likely mean that people with balances in excess of the compensation limit will want to spread their exposure by distributing their money between several institutions. Deposit broking services are likely to appeal to such depositors. Money is likely to be moved quickly between institutions as brokers chase the best deals for their clients. Advertising offering these services has already appeared in the financial press.

34. Although the number of depositors who have balances in excess of the current compensation limit is relatively small (ie about 5%), the balances they hold are significant: a similar phenomenon in the United States in the early 1980s contributed to instability in the US system at that time.

35. There is a risk of market distortion if the compensation levels for customers of one class are disproportionately high, although in the BSA's view £35,000 or even £50,000 would not be disproportionately high. However, if the deposit limit were to be further increased, say, to £50,000, then this would put the UK at the upper end of depositor compensation along with, broadly speaking, the United States and Italy.

36. **Moral hazard:** it is the case, as was illustrated by savings and loans organisations in the US during the 1980s, that an excessively high compensation limit can cause moral hazard for firms and customers. Callum McCarthy, the FSA's Chairman, made the point very effectively in a speech in February 2006 –

"Were the FSA to aim to relieve consumers of all adverse consequences, an environment would be created in which they no longer needed to weigh up the reasonableness of their financial decisions. No market can work effectively without involved customers. To relieve consumers of retail financial services of the consequences of their actions would destroy this as an effective market. Consumer responsibility is therefore vital to the effectiveness of financial markets."

Therefore, changes to the deposit protection scheme should be carefully designed to minimise the dysfunctional effects on incentives, weighed against the benefit of greater confidence such insurance provides. There might possibly be adverse incentives for the management of some institutions if it was clear that, whatever the risks they took with depositors' funds, those funds would be protected.

37. Turning to the issue of **pre-funding**, in the BSA's view, it is preferable to introduce measures to speed up payments to depositors, under the current FSCS arrangements, than to introduce pre-funding; and we do not see the two as necessarily going hand-in-hand.

38. The BSA opposes pre-funding because –

- it would deprive firms of, possibly significant, funds (this would be particularly unwelcome at a time of likely downturn in the economy)
- estimating an appropriate level of pre-funding would be impossible; until losses had crystallised, the likelihood would be that far too much or far too little would have been pre-paid – this could amount to a very costly, but wasted, exercise.
- any fund would be insufficient to cover deposits in the largest institutions. The high level of concentration in the UK market means that the majority of deposits would not be adequately covered by a fund.

There are other arguments against pre-funding, such as the extra costs for the FSCS in managing the funds, but we recognise that these are marginal when compared to the substantive objections noted above.

39. During the FSCS funding review, many financial services sectors, and the Financial Services Practitioner Panel, warned the FSA of the dangers in disregarding lack of capital among certain firms (especially among mortgage intermediaries) and, instead, regarding the proposed cross-sector general retail pool as a 'catch-all'. As the BSA has pointed out before, the FSCS is not a substitute for the regulator taking reasonable steps to seek to ensure that firms have the crucial building blocks of prudential regulation in place, such as prudent levels of liquidity and capital. This would be more sensible than pursuing pre-funding – and Northern Rock strongly evidences this point.

- **Faster compensation payments**

40. We have had the benefit of seeing the BBA's response to the CP and agree with the BBA's analysis (in response to CP question 5.7) that there are numerous barriers to providing a one-week (5 working days) payout including scale, money laundering requirements, credit assessment etc. However, we fully support all proportionate endeavours to reduce the current period for payments from the FSCS in the consumer interest and are very keen to participate in ongoing discussions.

41. The obvious way of facilitating fast payments is for the FSCS, backed by the Government, to provide the initial funding. This could, if necessary, be up to the overall FSCS limit, which would be significantly less than the funding provided by the taxpayer in relation to Northern Rock. In principle, this would fit well with a 'gross payments' approach (see below).

42. We note that FSA will be consulting on gross payments and we look forward to contributing to that exercise. Our initial views are that, from a customer perspective, gross payment of depositor compensation has several merits and these include –

- simplicity - it is easier for customers to understand
- speed of payment - customers do not have to wait as long for their money
- fairness - it gives customers a better deal: depositors who also have long-term mortgage loans do not have to suffer a loss of liquidity.

The BSA raised this point in 2004 in response to FSA DP24, as follows –

"The £35,000 maximum protected deposit under the Financial Services Compensation Scheme applies to each individual, not to each account held with the same firm. Accordingly, in the not uncommon event that an individual has one or more sole accounts with a firm, and/or one or more joint accounts (potentially with one or more different joint investors) with the same firm, it would be extremely difficult for most firms to track the amount actually covered by the FSCS in relation to individuals on a day-to-basis, or at all".

Nevertheless, it would be necessary to consider carefully any unintended consequences of a move towards gross payments and the FSCS consultation will provide an opportunity for more detailed scrutiny.

- **Risk-based FSCS levies**

43. Risk-based charging has its potential merits, although the risk ratings would need to be kept secret because, if they became public, that could itself be a source of financial instability. For that reason, we doubt that risk-based charging is desirable. Moreover, it would only be relevant in a pre-funded Scheme, which (as noted above) we believe would be counter-productive and we oppose.

- **Consumer awareness and additional consumer protections**

44. The foregoing paragraphs on the compensation limit contain a number of comments about consumer awareness.

45. In the light of recent developments, it would make sense to revisit the requirements in relation to the information firms must provide to customers about the FSCS. Currently, Regulation 46 of the - otherwise largely repealed - Credit Institutions (Protection of Depositors) Regulations 1995 (SI 1995 No 1442) requires the provision, on request, of a summary of the provisions of the relevant Scheme, including –

- details of the level of protection

- details of the scope of protection
- a summary of any conditions that must be fulfilled, and
- a summary of any procedural steps that must be taken.

46. Given recent events, there probably now needs to be greater specificity and uniformity as to the precise information that needs to be covered. Paragraph 5.69 of the CP notes that customers should be made aware that balances held under different brand names, owned by the same banking group, may be aggregated before the FSCS limit is applied. Full consideration should be given as to other information that might be considered for mandatory provision. Whatever the outcome, any new notification requirements should be consistent for all firms; moreover, as noted earlier, full consideration should also be given to the likely market impact of changes in this area.

(vi) Strengthening the Bank of England and ensuring effective action

47. Chapters 6 and 7 cover the providing of the Bank of England with a statutory role in the area of financial stability, changes to the Bank's governance, and co-ordination among the Authorities and co-ordination internationally. The BSA believes that these are fundamentally sensible proposals, and supports them.

48. Specifically regarding communication among the Authorities (Question 7.1, and referred to in paragraph 7.11), the BSA made the following comment to the Treasury Select Committee –

"Communication from the parties to the tripartite agreement appeared disjointed particularly in the early days of the crisis, and added to the sense of confusion. This was perhaps reflective of a lack of emphasis, in the tripartite Memorandum of Understanding, on the importance of effective communication. One of the MoU's four guiding principles is transparency, but under this principle the document refers to the public's understanding of each authority's responsibilities, rather than to how communication takes place in a crisis."

Therefore, we particularly welcome the Authorities' proposals for improving communications.

Building Society-specific Proposals

49. Some of the CP's proposals specifically relate to the building society sector, as follows –

(i) Chapter 3 makes proposals to ensure that building societies have similar **access to liquidity** as banks (by exempting funds provided by the Bank of England from the calculation of the proportion of building societies' funding that arises from wholesale funding) (see paragraphs 3.55 – 3.58 and A.85 – A.92)

(ii) Chapter 3 also proposes to give building societies **power to grant floating charges** to the Bank of England (see paragraphs 3.59 – 3.62 and A.93 – A.100).

(iii) Chapter 4 proposes that there should be similar '**rescue**' tools as proposed for banks (directed transfers, bridge banks and bank insolvency procedure) available to use for building societies (see paragraphs 4.56 – 4.64 and A.162 – A.163).

(iv) Chapter 4 also confirms that the Government will bring forward secondary legislation - under the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 - to ensure that, in the unlikely event of a **winding up of a building society**, the liabilities are applied equally to creditors and members (see paragraphs 4.66 – 4.68).

50. As noted above, the BSA does not believe a sufficient case has been made for us to support some of the far-reaching proposals (notably, SRRs) in the CP and, as far as any of the building-society specific proposals are integral to them, the support set out below applies only if the decision is ultimately taken to introduce SRRs.

(i) Access to liquidity

51. While the BSA believes that building societies follow a safe business model (see above), we also believe (as also stated above) that the Authorities should examine potential threats to financial stability as widely as is both practicable and reasonable. It would be inconsistent with that position if we were not to support the proposal in paragraph 3.57.

52. Section 7(3) of the Building Societies Act 1986 specifies certain items that may be disregarded in calculating the funding limit, including 'own funds', certain sums deposited with the society etc. By section 7(7-8), the Treasury may modify section 7(3) by, among other things, providing for particular liabilities of undertakings to be disregarded. The BSA supports the proposal to add to this list funds provided by the Bank of England. This would sensibly place building societies on par with banks in this respect and, as the impact assessment states (at paragraph A.91), have a positive impact on competition.

53. We note that relevant provisions will be made by the Building Societies (Financial Assistance) Order 2008, currently before Parliament.

(ii) Power to grant floating charges

54. The CP correctly notes that the restriction on building societies granting floating charges was intended to protect members from the risk that secured lenders might exercise an inordinate degree of control over the society in question (paragraph 3.60). We also agree that, in relation to the general business activities of societies, there is no strong case for removing the prohibition.

55. We agree with the CP that it would be sensible to create a small exception whereby building societies could create a floating charge in favour of the Bank of England only. This would, as the CP states, allow the Bank of England to grant liquidity to a building society, in the unlikely event that a society should ever need it from the Bank. Again, this would create a pro-competitive level playing field with the banks. The only risk we can envisage is that stated in the CP at paragraph A.100, but we agree that the risk is of an extremely limited nature.

56. We note again that relevant provisions will be made by the Building Societies (Financial Assistance) Order 2008, currently before Parliament. We are pleased that the Order will ensure that societies will not need to amend rules or memoranda.

57. However, as with all the proposals set out in the CP, unforeseen consequences should be guarded against. We understand that, some societies' contractual documents in respect of wholesale borrowing prevent a society from issuing a floating charge, and this matter needs to be addressed.

(iii) 'Rescue' tools

58. The FSA already has powers, outlined in paragraphs 4.59 – 4.60 of the CP, to direct a transfer of a building society's business. We acknowledge the limitations on that power referred to in the CP. Once again, we believe it highly unlikely that the powers would ever need to be used, but recognise the good sense of putting banks and building societies on broadly the same footing with regard to this matter. We believe that, in the event of such problems, a directed transfer to another building society would be the most likely option, but we recognise that – in very extreme circumstances – this might not happen.

(iv) Winding up of a building society

59. Paragraph 4.66 proposes that an order should be made to ensure that, should a building society be wound up, any assets available should be applied equally to creditors and members. The mechanism for this now exists under the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007. The BSA's settled policy is in favour of *pari passu* for creditors and members in the unlikely event of a winding up and we support the Authorities' proposal.

Responses to Specific Questions

60. The BSA responds below to a number of the specific questions set out in the CP but, in the interests of brevity, we have omitted questions to which we have no particular contribution to make; mainly, those that are bank-specific. The CP refers to "banks" for short (except when specifically referring to building societies), but it applies to all types of credit institution, including building societies. However, we mirror the CP's use of the term 'bank', unless the question applies to building societies only.

(i) General

1.1) *Please provide detail if you think that any of the proposals in this document:*

- *are necessary and proportionate;*
- *raise significant concerns; or*
- *could be improved?*

We believe that a proportionate approach, before introducing radical, complicated legislative change, would be to –

- examine, and if appropriate move ahead with, some of the more modest changes in proposed in the CP (see paragraph 14 above)
- await the results of the FSA's supervisory enhancement programme
- investigate practical ways to improve speed of payment from the FSCS.

(See especially paragraphs 15 – 19 and 22 – 25 above).

1.2) *To what extent are the proposals in this document mutually reinforcing?*

The proposals range from modest, sensible modifications to major, structural changes and, throughout the CP there are proposals that, if not very carefully worked through, could have serious unintended consequences. We believe that a more targeted approach would be preferable (see above).

1.3) *The proposals in this consultation document, unless specified, are intended to be implemented by banks, building societies and other deposit-taking firms. Please provide details where this is not appropriate.*

We agree with this proposal. All institutions that take deposits should be subject to the same, or equivalent, provisions.

(ii) Stability and resilience of the financial system (Chapter 2)

2.1) *Do you agree with the actions being taken by the Authorities in the UK to improve stress testing by banks?*

We agree with the actions being taken. The limitations of stress testing are broadly recognised; for example, that such testing tends to place too much reliance on known historical events. Indeed, Northern Rock's stress testing failed to stand-up to the circumstances it ultimately faced. The Treasury Committee Report stated –

"If the Financial Services Authority was "very unhappy" with the stress testing conducted by Northern Rock, it appears to have failed to convey the strength of its concerns to the Board of Northern Rock, and to secure remedial action."

The BSA supports the recommendations of FSA's internal audit (set out in paragraph 3.5-6 of Appendix 2 to the report) ie not to add further Handbook rules and guidance on liquidity for the time being, but to consider the case for future amendments to make it easier to understand the body of material on stress testing.

2.2) *Have the Authorities correctly identified the issues on which international work on stress testing and risk management should focus?*

Clearly, there was a fundamental international background to the Northern Rock crisis and it is right that the Authorities should work in co-operation with international partners. It is, therefore, appropriate that the FSA should intensify its work with banks to improve stress testing, on the basis outlined in paragraph 2.35 of the CP. We agree with the areas of work set out, especially testing to more extreme scenarios. Stress testing should be part of a firm's risk assessment work.

2.3) *Have the Authorities correctly identify the issues on which work on liquidity regulation should focus?*

The BSA agrees with the conclusion set out in paragraph 2.40 of the CP that the Authorities should co-operate with international partners to seek to achieve more consistency in liquidity regulation. We also welcome the FSA's discussion paper on the subject (DP 07/7) issued in December 2007, which we responded to at the end of March 2008.

However, the matter will require very careful management. On the one hand, it is crucial that the UK does not introduce mandatory requirements that could adversely affect the competitiveness of UK businesses, unless equivalent arrangements are introduced across the EU. On the other hand, firms that are potentially exposed to liquidity risk must recognise that risk and take appropriate steps to address it.

2.4) *Do you agree with the actions being taken by the Authorities to encourage full and consistent valuation and disclosure by banks?*

The BSA agrees with the CP that securitisation is likely to remain an important element of the financial system and the BSA believes it very important that securitisation remains as a significant mechanism. The BSA agrees that recent events have highlighted certain problems relating to asset backed securities, notably regarding the valuation of structured products during difficult market circumstances. As the FSA informed the Treasury Committee, Northern Rock's 'Granite' securitisation met industry norms.

Therefore, the international initiatives described in paragraph 2.45 are to be welcomed. The BSA agrees with the CP that "it is important not to rush to take regulatory action before the markets have had time to adjust to recent events", and the forthcoming international work – especially concerning consistency and transparency of valuation methodologies, is welcome.

2.5) *Have the Authorities correctly identified the issues on which international work on accounting and valuation of structured products should focus?*

Yes, we believe so (see above answer).

2.6) *Have the Authorities correctly identified the issues on which international work on credit rating agencies should focus?*

The BSA does not have enough direct experience of the operation of credit rating agencies to be able to respond in detail to questions 2.6, 2.7 and 2.8. However, under Basel II, the importance of CRAs is undoubtedly increased (eg because of the importance of ratings under the standardised approach); therefore, the matter should be reviewed. It does seem clear that this is a further topic that hinges largely on international co-operation and the BSA supports the Authorities' plans to act in a co-ordinated way with international counterparts.

2.7) *Do you agree with the Authorities' proposals to improve the information content of credit ratings?*

Yes, we believe so (see above answer).

2.8) *Do you agree with the Authorities that the preferred approach to restoring confidence in ratings of structured products is through market action and, where appropriate, changes to IOSCO Code of Conduct on Credit Rating Agencies?*

Yes, we believe so (see answer to question 2.6).

(iii) Reducing the likelihood of a bank failing (Chapter 3)

3.1) *To what extent do the FSA's range of existing powers reduce the likelihood of failure of a bank, and under what circumstances would they not be effective?*

The FSA chief executive recently said –

" It is clear from the thorough review carried out by the Internal Audit team that our supervision of Northern Rock in the period leading up to the market instability of late last summer was not carried out to a standard that is acceptable, although whether that would have affected the outcome in this case is impossible to judge.⁶ "

However, FSA's internal audit report (see especially paragraphs 10 – 27 of the report) highlights a series of very basic failures. It is difficult to see how the more senior staff in the FSA would not have recognised the problems with Northern Rock and (presumably) sought to have dealt with them, had these failures not occurred. Indeed, FSA internal audit reports (at paragraph 26) –

"the ARROW Panel would have had a fuller insight into the firm if it had received from the supervisory team, or probed in the meeting for, a more comprehensive analysis of the risks inherent in the business model [of Northern Rock] at the time ... it was understandable that the ARROW Panel reached a view that Northern Rock was low-probability risk, based on the material provided to it."

3.2) *Are the FSA's existing powers, and in particular, the application of them, clear, and how could they be further clarified?*

The FSA's existing powers – outlined in paragraphs 3.3 to 3.12 – seem clear and proportionate, in particular the bank-specific risk assessments, visits, thematic reviews and 'skilled persons reports', supplemented by the more overt powers such as corrective action, *Own Initiative Variation of Permission* procedures, power to remove directors etc. There also seems to be appropriate arrangements for escalation of intervention. Provided they are used in a prompt and diligent fashion, they seem to provide adequate arrangements.

3.3) *To what extent are the annual and one-off costs of the new information requirements on banks proportionate? Can they be quantified?*

In principle, we support the introduction of an enhanced FSA power to require information at short notice, *provided* the information is necessary in order to enable the FSA to decide whether or not exercise its powers. While we recognise that it might not be possible to identify, at this stage, the information that is likely to be sought, it would be important to clarify this so that firms can introduce relevant systems and procedures. It is important that any proposed changes be subject to proper cost benefit analysis.

We would like the FSA to have all the reasonable tools it needs to do its job but must stress, once again, that the most comprehensive set of tools possible would be

of no effect unless used effectively. It is also, as noted above, important that the FSA are transparent with the industry about why it requires particular types of data and how it will be used.

3.4) *How effective would the new information requirement be in identifying and addressing a sudden deterioration in a bank's financial soundness?*

This is a difficult question to answer in a decontextualised way, but – as stated above – in principle, we support the FSA being able to get the information it needs to identify a sudden deterioration in a firm's financial stability. But it also needs to be remembered that Northern Rock's 'deterioration' (in the sense of its development – *over years* – of an unsound business model) was not sudden – and it is just as important to monitor, and to be able to address, *gradual* deteriorations.

3.6) *Do you agree with the proposal for a new and flexible regime for payment systems oversight and, if so, how should its scope be defined?*

The CP does not provide enough information for the BSA to be able to comment, other than superficially on the point, but we note that a further, more detailed, consultation will be published. We can see a case, in principle, for better oversight to help avert the spread of contagion through the system. However, we can see no strong case for broader Government powers in relation to a system that, generally speaking, works well.

3.7) *Which elements of such a payment systems regime should be effected through statutory powers?*

See above answer.

3.8) *To what extent is the current provision to register charges at Companies House relevant to banks? Do you agree that it is appropriate to amend it?*

We doubt that an extension of the 21-day period, would make much difference because, if the problems had not been addressed within 21 days, then either it will be too late for a 'quick fix' to alleviate them or the news will have reached the public domain. In any case, we agree that third party lenders could be unfairly prejudiced

3.9) *Should any exemption for banks only apply to receipt of ELA, or should there be a more general exemption for all types of lending?*

The BSA agrees with the CP that, in very special circumstances, there could be strong arguments for delaying disclosure of emergency liquidity assistance (ELA) until temporary problems have passed (paragraph 3.38). Equally, we agree with the later statement, in paragraph 3.40, that in today's markets maintaining confidentiality of ELA may be extremely difficult.

Despite this, and notwithstanding our support – in all but exceptional cases – for transparency, it is just possible that a delay in disclosure might buy a very short period of time in which temporary problems could be addressed. Therefore, it is right that the FSA should review the guidance on the Disclosure and Transparency Rules.

3.10) *Would extending the 21-day period be a viable, alternative proposition?*

See answer to question 3.8.

3.11) *What would the effect be of removing the 'weekly return' reporting requirement? What other statutory reporting requirements disclose ELA?*

This seems to be a modest measure that could potentially be helpful in the kind of circumstances envisaged.

3.12) *Do you agree that the Bank of England should be provided with statutory immunity for any acts or omissions which relate to its role in providing financial stability and central bank functions?*

The BSA agrees in principle, but only if the immunity is drawn narrowly to capture steps taken to seek to avert a financial crisis.

3.13) *Do you agree that it is appropriate for the Bank of England to be able to rely upon its security in all such circumstances?*

Again, this might be acceptable in principle, subject to appropriately narrow drafting.

(Please note: question 3.13 is worded differently in the body of the CP, on page 45).

3.14) *Do you agree that funds provided by the Bank of England should be exempted from calculation of building societies' wholesale funding?*

We agree (see paragraphs 51 – 52 above).

3.15) *What risks are there to building societies granting floating charges over their assets to the Bank of England?*

We agree with the Authorities that any risk is of a very limited nature - see paragraphs 54 - 57 above. (We note that the Building Societies (Financial Assistance) Order 2008 has been laid before Parliament and, if approved, would allow building societies to obtain relevant financial assistance and create floating charges in favour of the Bank.)

(iv) Reducing the impact of a failing bank (Chapter 4)

4.1) *Do you agree that there should be a special resolution regime for banks?*

The BSA is not convinced of the need for such fundamental change as would be represented by a SRR. Rather than introduce an entirely new process, we believe that it would be more appropriate, first of all, to examine whether current insolvency legislation or corporate rescue regimes could be amended to achieve the relevant objectives (see paragraph 23 above). The effective use of the FSA's supervisory tools is also fundamental to this matter and, if utilised properly, should avert the need for SRR arrangements.

4.2) *Do you agree that the trigger for a bank entering a special resolution regime should be based on a regulatory judgement exercised by the FSA in close consultation with the Bank of England and HM Treasury?*

We agree and cannot see any other way in practice that this could sensibly be handled. The decision should be based on key factors including the inability of the bank to meet its liabilities, confidence in the institution, prospects of recovery etc.

4.3) *Do you agree that the trigger should be linked to regulatory guidance material?*

This seems appropriate.

4.4) *Do you agree with the special resolution regime as outlined?*

We are not yet convinced that there is a need to introduce this complicated mechanism but, if it were to go ahead, it should be used only in extreme circumstances where other mechanisms have failed or where it is clear, at a very early stage, that they would not be effective in the circumstances.

4.5) *Do you agree that the potential abridgement of property rights in the special resolution rule regime can, in principle, be justified with a suitable public interest test?*

This is one of the key aspects of the CP where unintended consequences could arise. The BBA response helpfully sets out some specific issues.

4.6) *What safeguards and appeal processes would be needed to support a public interest test for the special resolution regime?*

We have no specific comments, but welcome the assurances given in paragraph 4.18 of the CP, and the Government's plan to ensure that arrangements are fully compliant with State aid rules and competition law.

4.7) *Do you agree that the Authorities should have the power to direct a sale of a bank possibly against the wishes of the directors and shareholders?*

This is one of the few aspects of the CP where – because of their distinctive corporate status - banks and building societies are subject to different considerations. As a matter of overall principle, we agree that it should only be as a very last resort, or in *extremis*, that people should be deprived of their property rights. However, it is highly unlikely that building society members – as depositors, rather than external shareholders – would wish to block appropriate exercise of such powers.

4.8) *Is judicial review the correct mechanism for challenging a decision to institute the directed transfer?*

Judicial review might be one method of challenge but it is a process that sets high, procedural hurdles and, in no way, acts as an 'appeal' on merits or on the validity or correctness of substantive decisions.

4.9) *Is the Financial Services Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?*

The terms of reference and expertise on the Tribunal seem too narrow for this purpose. Possibly, with an expanded remit and additional expertise seconded in, the Tribunal might be able to carry out what is likely to be a rarely exercised function, but on balance the BSA favours judicial oversight.

4.10) *Do you agree that, in tightly defined circumstances, the Authorities should be able to take control of a failing bank through effecting a transfer of some or all of its assets and liabilities to a bridge bank? Do you agree that some flexibility in the description of these circumstances is also desirable?*

If there is to be a special resolution regime then, logically, a bridge bank should be a feature of it.

4.11) *Do you agree with the removal of shareholders' and directors' rights and temporary suspension of creditors' rights under this bridge bank proposal?*

This is another fundamental matter of existing property rights –whatever the outcome, the matter must be carefully considered and any unintended consequences thought through. It may be that such removal/suspension is integral to the success of the regime, but we believe that pre-legislative investigation (as described in paragraph 11 above) would be very important.

4.12) *Is judicial review the correct mechanism for challenging a decision to transfer to a bridge bank?*

See reply to question 4.8 above.

4.13) *Is the Financial Services Tribunal the right forum for resolution of transactional issues such as a valuation or distribution of proceeds among stakeholders?*

See reply to question 4.8 above.

4.14) *Should a new bank insolvency procedure be introduced for banks and building societies as an option for the Authorities instead of normal insolvency procedures?*

The BSA does not believe that a substantial case is currently made for radical changes, such as a new bank insolvency procedure. We believe that a proportionate approach, before deciding whether or not to introduce radical, complicated or potentially far-reaching changes, would be as outlined in paragraph 14(iii) above.

4.17) *Should a bank insolvency procedure be subject to the overall supervision of the Authorities?*

If introduced, yes.

4.26) *Do you agree that the special resolution regime should be extended to building societies but not other mutuals?*

We do not believe that a convincing case for a special resolution regime has been made but, if it were to be introduced, we believe banks, building societies and - in principle - other mutuals should all be on the same footing. However, we are not aware of any other deposit-taking mutuals that are of a size where the proposed SRR would, should the need to use it arise, be of a scale whereby be relevant or applicable.

4.27) *Do you agree with the proposals for a new accelerated direct transfer procedure for building societies, similar to that for banks?*

See above answer.

4.28) *Do you believe that a form of temporary public sector control through a bridge bank should be provided for building societies?*

See above answer.

4.29) *Do you agree that a building society insolvency procedure should exist for building societies alongside a similar model for banks?*

We do not believe that a convincing case for a special insolvency procedure for banks and building societies has been made but, if it were to be introduced, we believe that banks and building societies should be on the same footing.

4.30) *Do you agree that the Treasury should make an Order under the 2007 Act to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members.*

We strongly agree.

4.31) *Should the industry contribute towards the costs of an SRR?*

We see no reason why it should. In addition to corporation and other taxes, the industry funds the FSA and the Bank of England. The costs in question could presumably be met from the dissolution or transfer of the firm. However, if the industry in general was to be required to contribute, we do not believe that firms too small for the SRR to apply should be expected to do so.

4.32) *Would mechanisms other than the FSCS be appropriate for addressing such cost issues? How might such mechanisms work?*

This is yet another matter that would no doubt benefit enormously from pre-legislative scrutiny, the input of expert working groups etc. This comment applies to many of the other matters covered in the paper, especially in chapter 4 (see paragraphs 11 – 12 above).

(v) *Consumer confidence and compensation arrangements* (Chapter 5)

5.1) *How would a higher compensation limit affect consumer confidence?*

It seems unlikely that a higher compensation limit would have a substantial impact on consumer confidence. As the research quoted in the CP shows, the level of awareness of the compensation limit remains very low – at only 1% of respondents – even after the Northern Rock run (see paragraphs 30 – 31 above). It seems likely that certainty of payout is more significant to consumer confidence than the size of the limit. In the United States, the deposit protection fund operated by the Federal Deposit Insurance Corporation is backed by the US Government and that gives great assurance to depositors about the ability of the scheme to meet its commitments. A similar arrangement for the UK scheme would provide necessary comfort to depositors about the strength of the FSCS.

However, the Authorities response to this issue should depend on their assessment of the overall importance of providing this degree of reassurance to borrowers – currently the BSA is neutral on this issue. Formal, explicit taxpayer backing for all deposits up to £35,000 would be a very significant step and the BSA does not currently advocate this approach.

5.2) *How would a higher compensation limit affect the responsibility consumers have for their financial choices?*

Raising the compensation limit *per se* is unlikely to have any impact on consumers' responsibility for their financial choices. However, if coupled with awareness-raising measures, it is possible that this will prompt consumers to act less responsibly, in the knowledge that there is a safety net should things go wrong. To the extent that greater awareness of compensation limits raises the prospect of increased intermediation in the deposit market (as suggested above, see paragraph 33), consumers' responsibility for their financial choices would be diminished, as they delegated responsibility to intermediaries. This would be the case whether or not the compensation limit was increased.

5.3) *How would a higher compensation limit for deposits affect consumer perception of other financial products?*

There is a risk of market distortion if the compensation levels for customers of one class of financial services provider are disproportionately high.

5.4) *Which of the solutions to cover balances above the compensation limit is the most practical, desirable and/or proportionate, and why?*

As noted above (see paragraph 32), in the light of the Association's research, we question whether a clear practical case could be made for an increase to the current limit. Indeed, an increase in the limit would raise the value of FSCS cover, but would have little effect on the number of depositors benefiting from the protection.

5.5) *What types of large balance should be subject to additional protection, and in what circumstances?*

We cannot see many circumstances where there is a case for special treatment. Generally speaking, provided there is a transparent deposit protection limit, customers will make a judgment, balancing the very small risk of a firm collapsing against the interest rates on offer in the market.

Nevertheless, we recognise that there are limited situations where customers do not have the same degree of control over their balances as customers in the normal run of things. We agree that the most likely cases those where the customer has a large balance for a very short time (house purchase, insurance pay-outs etc) and/or where the moneys are held in a professional firm's client account. This matter would require careful consideration and we welcome the FSA consultation mentioned in paragraph 5.17.

5.6) *Are there any other circumstances, apart from client accounts, where consumers have little influence on where the accounts are opened? What are your views on how the issue of client accounts might be addressed in relation to compensation payments?*

Possibly certain trustee accounts.

5.7) *What are your views on a one-week target for FSCS payment?*

In our view, it is far preferable to introduce practical measures to speed up payments to depositors, under the current FSCS arrangements, than to bring in pre-funding (see answer to question 5.21 below). While we fully support very prompt compensation payments, a one-week target would be too ambitious in practice, especially if extended to all deposits in the failed institution. Although improvements should of course be aimed for, a realistic view must be taken of what is actually achievable.

5.11) *How quickly could banks make changes to have then necessary information readily available on account balances of FSCS-eligible depositors, and what would the cost be to them?*

See the answer to question 5.14 below.

5.12) *Should banks follow a common data standard format, and, if so, what would this entail?*

Whilst the imposition of a common data format for all banks and building societies might be administratively convenient for the FSCS, it would represent a considerable burden on building societies, particularly smaller ones, where the costs are likely to be wholly disproportionate to any potential benefit.

5.13) *What information should be included in a single customer view and what would be the implications for firms of different information requirements?*

See the answer to question 5.14 below.

5.14) *How would banks place a 'flag' on accounts that are not eligible for FSCS payments?*

The above four questions give rise to potentially significant systems implications and the suitability of FSCS requirements. There could be very significant costs, especially for smaller institutions, and there is a real risk of 'over-engineering' implicit in this part of the CP.

5.15) *Are there any other classes of depositor that should be ineligible for FSCS compensation payments and, if so, who?*

We do not believe so – the exclusions in COMP seem to be well thought out, practical and fair.

5.16) *To what extent would gross payments help maintain depositor confidence and speed up payment?*

This is a key topic on which unforeseen consequences might arise and any changes should be carefully thought through eg how the FSCS ultimately deal with set-off aspects. However, we can see some advantages – in principle – to gross payments (see paragraph 42 above).

5.17) *To what extent are gross payments justified by maintaining depositors' access to liquidity?*

See above answer.

5.18) *What are your views on the link between FSCS gross payment and set-off?*

Provided existing rights are not affected, we see these matters as compatible.

5.19) *Are there any other measures necessary to better align FSCS rules and the provisions of the proposed bank insolvency procedure?*

We remain unconvinced that introducing an entirely new procedure is necessary and believe that the possibilities for amending existing arrangements should be examined first.

5.21) *What are your views on the introduction of an element of pre-funding into the FSCS?*

The BSA opposes pre-funding for the reasons set out in paragraph 38 above.

5.22) *What steps would need to be taken to ensure that pre-funding would be compatible with other elements of the FSCS funding arrangements?*

We oppose pre-funding and believe that it would be counter-productive (see paragraph 38 above).

5.23) *What are your views on whether the FSCS should be permitted to borrow from the Government or the Bank of England?*

We believe that this would be a sensible arrangement to have in place. Moreover, we consider the UK Government should put in place an arrangement similar to that in the United States, where the FDIC scheme is backed by the “full faith and credit of the United States Government”. Such backing might be the most effective way

of ensuring consumer confidence in the compensation scheme, whilst avoiding the disproportionate and damaging drain on the industry's resources that pre-funding entails. However, whilst this is not a BSA policy, this matter needs to be given consideration if consumer confidence is the Authorities' key objective.

5.33) *What are your views on the use of risk-based levies or on the introduction of behavioural factors into the calculation of levies?*

In principle, it could be argued, that the matter should be reconsidered, in the light of (but not restricted to) the Northern Rock problem, and firms that do not have the fundamental building blocks of prudent management including, for example, proper capitalisation, should pay higher levies. However, it is difficult to see how risk-based levies could work unless there was pre-funding. Indeed, publicity could be destabilising (see paragraph 43 above) and risk-based levies could be perceived as 'duplicating' the role of the FSA. For the reasons given above, we strongly oppose pre-funding and, therefore, are not pressing the case for risk-based levies.

6.1 – 7.4) *Various questions*

The BSA supports the proposals underlying all of these questions.

FOOTNOTES

1 Section 7 of the Building Societies Act 1986 provides that at least 50% of the funds of a building society (or of the society's group) must be raised in the form of shares held by individual members of the society. The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 enables (but does not require) the Treasury to consult on a power to increase the limit by order to not more than 75%.

Section 6 of the 1986 Act provides that at least 75% of the "business assets" of a building society (or of the society's group) must be loans fully secured on residential property. "Business assets" (not a term actually used in section 6) are total assets (or total group assets) *plus* provisions for bad and doubtful debts, *less* fixed assets, liquid assets and any long-term insurance funds, and currently comprise mostly mortgage assets. Treasury may reduce the limit by order to not less than 60%.

2 www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp139.shtml.

3. *The Run on the Rock* House of Commons Treasury Committee 26 January 2008
www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf.

4 www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2008/nr.shtml.

5 Chart 5.4 on page 80 of the CP.

6 www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml