

Protecting customers and consumers from the failure of firms – trying to make the FSCS work

The international, EU and domestic UK arrangements (via the FSCS) for depositor protection were fundamentally flawed. In recent bank failures this meant that national governments had to find the money to cover deposits, at considerable cost to taxpayers. Emergency steps were taken at the time to mitigate the expense – with urgent measures introduced at EU level and contained in the provisions of the UK Banking Act 2009. However, effective deposit guarantee schemes (DGS) are an essential part of the financial stability “system” and fundamental reform is needed in this area. Both EU and domestic governments have embarked on this process and initial consultations are underway; however, as reforming DGS links to many of the “bigger picture” issues on the systemic risk/macro-prudential agenda, it will be some time before the new arrangements are worked out. Whenever and whatever the end result may be, institutions can expect reform in this area to come at a heavy cost.

EU reform

At EU level, there is much discussion around the issue of reforming deposit guarantee schemes. BCBS published its paper on core Principles for Effective Deposit Insurance Systems in June 2009. The EU minimum requirement for deposit guarantee protection will increase to £100,000 with effect from the end of 2010. But the real issue (on which the EU has consulted recently) is whether to move from separate member-state schemes to a single pan-European scheme. The EC has recently consulted on deposit guarantee schemes and is preparing a final report, which may be accompanied by legislative proposals for a change in harmonisation requirements or possibly even for a pan-European deposit guarantee scheme. There are many “big picture” issues to resolve here – in terms of capacity, funding (would British banks pay out when a Romanian bank failed) and the relationship with national resolution/insolvency laws (which might have to be harmonised) and the (currently) national responsibility for the costs of rescue and resolution beyond industry-funded schemes.

EU discussions extend beyond the banking sector, with work underway on new legislation/amendments to harmonise/amend policyholder protection/insurance guarantee schemes and investor protection. It is currently putting together a White Paper on insurance guarantee arrangements that, likewise, could take the form of harmonisation requirements or of a EU-wide scheme. Additionally, the EC launched a review the practical application of the Investor Compensation Scheme Directive; however, it has not indicated that it may make further legislative proposals in this area.

Industry feedback to the relevant consultations currently indicates a preference for developing a framework for enhanced coordination between national schemes.

Domestic reform

In the UK it is clear that radical reform – or replacement – of the FSCS will be required. At present the UK scheme has an annual capacity of less than £4 billion, which is tiny compared to the amount of insured deposits even at a single medium-sized bank. Having made emergency changes, the FSA continued with consultations on a variety of changes to the existing scheme (gross payouts, sharing of recoveries, disclosures) and related issues such as potential coverage of temporary high balances above the maximum threshold. Already it is pressing ahead with its Single Customer View and fast payout rules.

However, much of this seems premature when many of the big-picture issues remain unresolved. One issue for any domestic scheme is whether we should continue to have cross-funding, whereby insurers and other members of the retail pool are liable to contribute by FSCS levy to the capital cost of recent bank and building society resolutions which potentially runs into billions of pounds (although only deposit takers are liable for the interest costs on FSCS borrowings now capped at £1 billion per year). This is the result of the recent use of the FSCS (now enshrined in the Banking Act 2009) as a front for payments on resolution to fund deposit transfers in a way that makes the industry (rather than the government) ultimately liable for the final costs (or most of them).

At a domestic level, the government has proposed pre-funding for deposit protection (which is now possible under the Banking Act 2009) although this will not be introduced before 2012. The BoE is in favour of risk-based premia: as most deposits are now 100% insured, there is little incentive for depositors to avoid risky banks, however, risk based insurance premium would provide an alternative form of market discipline.

The expected impact

There will be large FSCS levies in the immediate term. Deposit taking firms are currently estimated to pay just over £376m to cover interest payments up to March 2010 on FSCS loans for the bank defaults in 2008. Potentially further large levies will cover the principal amount of net compensation. However, increased levies will not only hit deposit takers. In March 2010, FSCS announced a £148m general levy for 2010/11, of which general insurers will pay £41 million. Investment intermediation firms are subject to an additional interim levy of £80m for costs relating to investment firms declared in default and claims relating to structured products.

As previously noted, the big issues are still to be resolved, however, whatever the scheme that ultimately emerges it is likely to involve increased cost for firms over many years to build up a premium pot/pre-funding reserves. If this is based on risk-based premia, it will mean yet another costly process for assessing the risk which individual firms pose.

This is certainly an area that financial institutions will need to monitor closely and lobby on. Non-banks in particular may wish to lobby for separate schemes, which take into account the difference between their own business models and those operating in the banking sector.

Timetable for reform

The EC's consultation on deposit guarantee schemes closed on 27 July 2009, the consultation response is still awaiting. It may propose measures on deposit guarantee and insurance guarantee arrangements in the course of 2010.

In the UK, some changes are taking effect immediately - FSA rules on generic disclosures on the FSCS to consumers came into effect on 1 January 2010, and new fast-payout rules are due to come into force on 31 December 2010. Eligible protected deposits tariff measure rules are scheduled to take effect on 31 December 2011.