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Financial stability and depositor protection: special resolution regime and further consultation

I have pleasure in setting out in the following pages a response on behalf of the UK Shareholders' Association to the above papers published in July 2008.

Rather than responding to each of the questions in the two papers, we have highlighted issues which we believe are of particular importance to individuals as savers, and as shareholders (both direct and indirect). The papers address what are perceived as the immediate problems of today – they therefore omit some questions which need to be addressed for the future.

We are not aware of any consultation in relation to the most fundamental questions of all: what went wrong, and what can be done to change behaviour? It appears to us that the Government has done little to show that it understands the underlying problems that led to the current crisis. Clearly the inappropriate risk-taking and widespread ignorance of the principles of stewardship, within the financial sector especially, are worldwide phenomena. But we submit that there is much that could be done differently by companies and there must be a role for Governments to influence the environment for their domestic industry – and that includes thinking more about the responsibilities of shareholders as owners. Regulation alone is not the answer.

Should you have any points that you wish us to discuss we shall be very happy to help.

Yours sincerely

Martin White
Chairman, UK Shareholders Association

Financial stability and depositor protection: Response from The UK Shareholders' Association to CM7436 and CM7459

We are not attempting to cover many of the technical questions in the two papers. As well as venturing some points which are not addressed in the current consultations, we will refer to a number of the many responses to the consultation which preceded this one.

Special resolution regime (SRR)

We note with approval the intention to return the residual value, if any, of an institution of which the authorities take control under the SRR to the shareholders.

As shareholders, we recognise that shareholders come last in the chain of claims. However **we note with serious concern** the well-publicised responses by, inter alia, lawyers advising financial institutions that the proposals for protecting depositors involve an important change in the law which will, in the long run, damage the international competitiveness of UK financial institutions. If true, this is in nobody's interest. The lawyers argue for less haste and more reflection about the unforeseen consequences of any changes – and we would strongly support this. The phenomenon of the UK financial sector is not so durable that it cannot be seriously undermined by ill-thought out legal (or tax) changes.

We do not have special banking expertise, and we do not understand the original logic of removing the sole responsibility for the stability of the banking sector from the Bank of England.

In our view, in spite of our comments above, there is a limit to what regulatory changes can achieve; the consequences in terms of likely behaviour of all parties deserve most careful consideration – a theme to which we return again below in connection with the question “what went wrong”.

Depositor protection – discussion is too limited, as placing large amounts on deposit is not a sensible long term financial strategy

Individuals are urged to save for their own future, to reduce their reliance on the State. The Government has given mixed messages of recent years, however. Unwisely, there appears to have been a wish to encourage people to spend in order to “boost the economy”.

You cannot have it both ways. If as a nation we are net borrowers, future generations will have to pay. Encouraging spending rather than saving today may give immediate political relief, but worse long term pain. Asset price inflation, caused in part by too low real interest rates and in part by unwise lending policies and arguably also by too lax a regulatory regime on banks, may have given a warm feeling for a time.

We conclude that the Government's words about encouraging saving and investment are not sincere. Although increasing numbers of people, because of the inevitable decline of company defined benefit pensions, are having to provide for themselves, and the FSA is making significant efforts to assist with its financial education initiatives, a significant change in attitude within Government is still needed. A perfect example is the completely indefensible decision to tax the inflationary element of capital gains, with no other mitigation for long term investors.

So the scope of the depositor protection discussion is too limited. Of great concern to our members, and we note some of the individual respondents to your earlier consultation, is the risk involved in holding investments in nominee form. The intelligent way to invest, we believe, for many people, is to avoid the unnecessary expenses of complex vehicles such as insurance policies and to find a way of holding assets (such as ordinary shares) which do not involve percentages of one's assets being deducted by a service provider. Some people are using ISAs rather than pension vehicles for long term savings because of the flexibility they provide, and this involves having your investments held in nominees.

Our understanding is that there is minimal protection in the event that a nominee provider fraudulently fails to hold the assets on investors' behalf. So an individual's entire savings can be at risk to a single institution. This needs to be addressed urgently. Outlawing pooled nominee accounts would be a good start. A protected amount of £50,000 is not enough. Whilst it is sensible for individuals to hold at least some money on deposit, if the purpose of saving is more long term, we would observe that deposits, after expenses, tax and inflation, give negative real returns at the current time. They are not a sensible asset for long term savings.

What went wrong, and what would be the right response for the future?

Many respondents to the earlier consultation argued that "reform" should not be rushed in without careful thought. We would also argue that some very careful thinking is needed about the reasons for the current crisis and the fundamental failings they reveal about the governance of companies. We would urge that this be treated as a cross-party priority.

What went wrong is well known and is frequently discussed in the media. We have businesses not run in the long term interests of shareholders, but in the short term perceived interest of managers. To an extent, that short term perceived interest responds to the short term perspective of many fund managers. We note with interest the response of Unite the Union to the earlier consultation, and would share many of their concerns regarding the damage which an unsustainable high risk, high growth, way of running financial institutions can cause to employees as well as shareholders. It should also be remembered that the ultimate owners of most of the business world are current and future pensioners – so to regard the interest of shareholders and employees as being in opposition is too simplistic.

The root of the problem in our view is not regulation, but the ownership vacuum within business. Whilst considerable lip-service is given to responsible ownership by the investing institutions, we are not aware that any significant changes in action have taken place as a result.

We would recommend that policy-makers study carefully the many efforts at fresh thinking in this area. One current initiative is the "Tomorrow's Investor" project taking place at the Royal Society of Arts, but the most useful analysis of which we are aware is the "Restoring Trust" project which reported in 2004. Unfortunately the report and associated documents produced by this project are not freely available, and we believe that in the public interest they should be. However, the conclusions are succinctly stated in a speech given by its Chairman, Sir Richard Sykes on 15 June, 2004 which is freely available on the internet.

If managers owning only a small proportion of a business are left to manage it without meaningful and firm input from the owners, it is not surprising if the interests of the shareholders are not uppermost in their minds. The success of companies is in everyone's interest and the problem of the ownership vacuum deserves a serious cross-party commitment by our political leaders. The challenge should not be understated. In many ways the situation is better in the UK than in many other countries, which further emphasises the challenge. It is our belief that the changes required to change behaviour, or at least improve it somewhat, may turn out to be quite subtle, and not involve vast legislative reform. These comments are intended to apply to all companies, not just financial institutions.

We recognise the current pre-occupation with the banking situation, but would urge that any steps which prove necessary to deal with the immediate crisis are not used to set in train legal and regulatory changes unless the implications are extremely carefully thought through.

The UK Shareholders Association, September 2008

About the UK Shareholders Association (UKSA)

UKSA is the leading independent organisation which represents the interests of private shareholders in the United Kingdom. We also represent the interests of savers more generally. We campaign to protect the rights of shareholders in public companies, and to promote improved standards of corporate governance. Our educational activities, regular regional meetings, company "analyst" meetings and the resources of our web site, aim to help to inform the public on investment management. UKSA is a "not for profit" organisation which is financially supported primarily by its individual members.