

FINANCIAL SERVICES COMPENSATION SCHEME

Introduction

The Financial Services Compensation Scheme (FSCS) pays compensation to the customers of failed UK financial services companies. It is funded through levies on the financial services industry.

The FSCS was set up under the Financial Services and Markets Act (FSMA) and operates in accordance with detailed rules set by the Financial Services Authority (FSA). It was formed by bringing together a number of existing compensation schemes.

Detailed information on the FSCS can be found on its website - http://www.fscs.org.uk/consumer/key_facts/.

Coverage

Who is covered?

The FSCS provides coverage across the entire UK financial services sector.

The FSCS normally only covers individuals and small businesses but there are a number of exceptions in the insurance sector – all policyholders are covered where the insurance was compulsory and most policyholders, including pension fund trustees, are covered for life insurance products.

Compensation Amounts

The specific level of compensation varies between sectors:

- Deposit protection (banks, building societies and credit unions) - £50,000 per customer per institution.
- Insurance (general insurance, life insurance, advice on insurance products) – 100% of first £2,000 and 90% of remainder with no upper limit. 100% compensation is given for compulsory insurances (employers liability, 3rd party motor).
- Investments (asset managers and advisers) – maximum of £48,000 (100% of first £30,000 and 90% of next £20,000).

Generally the FSCS will pay cash compensation. Once again the main exception is in life insurance where the FSCS is under an obligation to try and get another insurer to take over the policies of the failed firm in order to ensure continuity of cover.

It is important to note that the FSCS does not pay compensation for market losses.

Geographic Scope

The geographic scope of the FSCS varies from sector to sector. This is largely dependent on whether the compensation arrangements are subject to EU regulation. The arrangements are:

- Deposit protection – FSCS covers UK based institutions (including the UK subsidiaries of overseas banks). Banks based in other EEA Member States¹ operating in the UK through branches are covered by the arrangements in their home state but where this is less than the amount of compensation available from the FSCS this can be ‘topped-up’. In these cases depositors would receive the initial part of their compensation from the overseas compensation fund and any remainder from FSCS.
- Investments – Similar arrangements to those applying to deposit protection are in place.
- Insurance – There are no EU wide arrangements in respect of insurance. The FSA, therefore, requires all insurers undertaking business in the UK (whether based in the UK, the subsidiary or branch of an overseas insurer or under passporting arrangements) to join the FSCS.

It is worth noting that the intention of the FSCS is to provide protection to consumers for business undertaken in the UK. It does not, therefore, provide cover for UK based consumers who invest in an institution based outside the UK. In these circumstances the level of compensation available will be based on the arrangements, if any, applying in the overseas jurisdiction.

Consumers should, in particular, be aware that the UK does not include the Channel Islands or the Isle of Man. These are Crown dependencies but not part of the UK. Any compensation for the failure of a firm in these jurisdictions will be dependent on the local arrangements, if any, and not the FSCS.

Funding

FSCS is funded by levies on the industry which are raised as needed.

There are a number of pools (deposit takers, general insurers, life insurers, investment firms and mortgage firms) and these, except for the deposit pool, are further divided between providers and intermediaries. Each pool and sub-pool has an annual levy limit which sets the maximum amount which that sector can be levied annually.

The FSA has recently introduced cross-subsidy arrangements between the different pools. Therefore, if the amount of compensation incurred by an individual pool exceeds its annual limit then the other pools will be levied to make up the difference. These cross-subsidy arrangements mean that it will

¹ The European Economic Area (EEA) is made up of the EU plus Iceland, Norway and Liechtenstein. Swiss-based institutions are covered by bilateral arrangements that have a similar effect.

be possible for a failure in one sector (eg a bank) to result in other parts of the industry (eg insurers) being levied to pay the compensation.

The current pool limits are:

- Deposit takers - £1,840m;
- General insurance - £970m (providers £775m, intermediaries £195m);
- Life insurance - £790m (providers £690m, intermediaries £100m);
- Investment - £370m (providers £270m, intermediaries £100m);
- Home finance - £130m (providers £70m, intermediaries £60m).

How it works

FSCS will only pay compensation once a firm is declared to be in default. Customers are required to apply for the compensation. FSCS will pay once a valid claim has been established. Payment can be made directly but very often the FSCS will operate through the liquidator of the failed firm.

Timing of payment varies. In straightforward cases, such as a failed credit union, payments will usually be made within a few weeks of the firm failing. However, in other cases (eg mortgage misselling) payment will only be made after the FSCS has decided that misselling has occurred and compensation is due. In the case of insurance claims will normally be paid as they are settled – which can mean that failed insurers can give rise to costs to the FSCS for 20 or 30 years.

Effect of the current financial crisis

The current financial crisis has led to a number of changes to the FSCS with more planned. The main concern has related to deposit protection where the original arrangements did not reassure depositors that their money was safe, that they would be compensated in a timely manner or that the FSCS had the resources to deal with the failure of even a medium-sized bank.

In practice the Government has intervened extensively to ensure that depositors in failed banks are either transferred to other institutions or paid compensation quickly. To facilitate this the Bank of England has lent considerable sums to the FSCS. The Government has directly paid compensation on amounts above the FSCS limits.

The main changes to FSCS made or proposed are:

- The deposit protection amount has been increased twice in the past year – first to £35,000 and most recently to £50,000.
- A further increase is likely in the next year as the EU has decided that the minimum deposit protection compensation level should be raised to €100,000 (about £90,000 at current exchange rates).

- The FSA is consulting on increasing the investment compensation limit to £50,000.
- FSA is considering methods to provide additional protection to customers with temporary balances above £50,000.
- FSA is also considering moving the deposit compensation limit to a 'by brand' rather than 'by bank' basis (at the moment compensation is limited to £50,000 per bank so a customer with accounts at, for example, both HSBC and First Direct would have these taken together to assess the amount of compensation payable whereas a 'by brand' approach would mean that these would be treated separately).
- FSA is also looking at ways to speed up the payment of compensation where a bank fails with the target being to make payments and have new accounts in operation within a week.
- The Government is proposing to improve the FSCS's access to funding by enabling it to borrow from the National Loans Fund and possibly to introduce pre-funding.