
**The Financial Services Compensation Scheme.
Just how safe is cash in the bank?**

A summary for Solicitors for the Elderly

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by

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Introduction.

The financial system does not always appear to be as secure as we might like. Clients, especially older ones, have become increasingly concerned about the security of their cash in recent months. It is also a worry for trustees and professional firms which hold money on behalf of their clients. Given recent events it seemed timely to consider what compensation might be available should the worst happen, hence the presentation of this brief overview for the benefit of SFE members and other readers.

We can all take comfort from the fact that if a bank gets into serious financial trouble a 'white knight' will often step in to assist. This happened when Barings Bank collapsed and was purchased by ING. It also happened more recently when JP Morgan Bank purchased US investment bank Bear Stearns with assistance from the Federal Reserve. In such cases the protection afforded to depositors by the Financial Services Compensation Scheme (FSCS) will not be relevant. The institution effecting the takeover will accept the liabilities of the failed deposit taker as part of the overall deal.

Sometimes the State steps in even more directly than in the case of Bear Stearns, as happened with the nationalisation of Northern Rock in February this year. In that case depositors' funds became part of the National Debt, the responsibility of HM Treasury. However, savers who lose money in a banking collapse must be prepared to turn to the FSCS for compensation if no other option presents itself. Balanced investment planning always pays due regard to the possibility of abnormal events or so-called 'outliers'. Cash management should be no different.

Banks never fail...

'... it is neither possible, nor desirable, to ensure that no bank will ever fail in any circumstance.'

(Financial Stability and Depositor Protection - Bank of England and HM Treasury - p3 January 2008)

This official acceptance of a degree of inherent insecurity within the deposit taking sector means that all UK savers should be aware of the limited level of depositor protection available to them in the worst event.

With the benefit of this knowledge the cautious (or well advised) cash saver can position their savings so as to maximise their security within the bounds of the compensatory framework. The protection and additional peace of mind provided is free of charge to the user if not to the taxpayer.

Limited awareness of the FSCS.

Unfortunately it appears that 'consumers do not have sufficient awareness of, or confidence in, the current compensation arrangements' (*Ibid: Financial Stability p8*). Only 1% of depositors even know what the FSCS claims limit is. (*FSA: Omnibus Survey, January 2008*). This basic public ignorance is unsurprising. For the most part the very existence of the FSCS remains an obscure part of the regulatory information issued by deposit takers. Obscure because it is not something which is specifically drawn to saver's attention. And if it ever was noticed it was ignored.

Until the Northern Rock crisis alerted the public to the difficulties being experienced in the financial markets during 2007-8, few savers had ever felt the need to worry about the security of their cash. Those who started to worry panicked and joined the withdrawals queue as it

stretched ever further down the street. The majority of them would, in fact, have been fully protected by the FSCS.

Obtaining information about the FSCS.

The relative obscurity of the FSCS is not improved by the nature of the 'Redress' section of the Financial Services Authority (FSA) Handbook. It contains the regulatory basis of the FSCS and is readily available from the FSA website, www.fsa.gov.uk.

Unfortunately it is 139 pages long and difficult to follow. It uses a substantial amount of jargon. To understand it properly requires frequent cross-referencing with the Handbook's colossal 340 page glossary and additional input from the helpful staff of the FSCS. (*All references to the FSA Handbook in this work are to the March 2008 edition.*)

There is a far more user friendly 'Consumer Guide' available from the FSCS website, www.fscs.org.uk. That covers the basics of the scheme but is rather short on the sort of detail more interested savers might need, particularly as regards deposits with UK branches of foreign banks, trusts and money held on professional client accounts.

Which financial institutions are covered by the FSCS?

UK incorporated banks, building societies and other financial institutions, which are regulated and authorised by the FSA, are all members of the FSCS. Certain similar European organisations operating in the UK are also members (See below for those details). Anyone can check the regulated status of an organisation on the FSA website or by calling their consumer helpline number 0845 606 1234.

If money is deposited in an unauthorised deposit taker then it will not obtain the benefit of FSCS protection. Unauthorised banks are surprisingly common, although they do not spring up on street corners like dodgy takeaways, surviving only as long as the VATman or local health inspector fails to spot them. Instead the problem usually involves unauthorised internet banks. The FSA publishes an up to date list on its website.

It should be stressed that many internet banks are perfectly legitimate financial institutions which deal with client money as securely as possible. However, some of the others have trading names which closely resemble the titles of well-known banks. It can be assumed that in some cases this represents an attempt to defraud unwitting online depositors who habitually hit the wrong keys.

What amount can be claimed from the FSCS?

The FSA amended the FSCS rules from 1st October 2007 to increase the amount of protection to eligible depositors to £35,000. (*FSA Handbook - COMP 10.2*). That is £35,000 per person, per deposit taking institution and irrespective of where in world the depositor lives. It does *not* apply either per account or per branch.

Each joint account holder is covered up to the full amount so for example two co-holders will have up to £70,000 of FSCS protection. However, if it is shown they did not own the balance equally the compensation calculation and payment due may be based upon that unequal share. (*FSA Handbook: COMP 12.6.10*)

The deposit taker must be 'in default'.

Deposits are only protected if the FSCS considers the deposit taker to be 'in default.' If for instance a withdrawal is declined and the bank concerned is still in business then a complaint must first be made direct to that bank. It may also require the aggrieved depositor to make another complaint to the Financial Services Ombudsman. Such situations might arise, for example, in the event of a mistake or identity fraud.

Even if the bank has gone out of business, closed its doors and disappeared, depositors might still have to bring a legal claim against its residual assets or owners rather than the FSCS. Only if it transpires that the bank cannot pay some or all that which is due to the depositor will any FSCS protection be available.

Doomed UK banks tend to implode in a spectacularly noticeable manner and the remnants are usually not worth scrabbling over, especially after legions of accountants and liquidation related practitioners have deducted their fees.

Who can claim under the FSCS?

(a) *Most private individuals.*

The role of the FSCS is to secure payment of 'protected claims' made by 'eligible claimants' caused by the 'default' of 'relevant persons'. In plain terms this means that the FSCS stumps up money to compensate depositors, mostly ordinary private individuals investing as such, when their bank or building society goes bust (excepting when the rules say it cannot).

The point is that, unlike some overseas arrangements, the FSCS does not operate as a 'deposit insurance' scheme. Compensation is not paid out automatically on the demise of the deposit taker.

(b) *Deceased estates.*

Deceased person's estates can make a claim through their personal representatives, the executors of their will or appointed administrators in there is no will. This is treated as though it was a claim by the deceased themselves. Only one claim can be made on behalf of the estate. Multiple claims from each beneficiary are therefore prohibited. (*FSA Handbook COMP 12.6.8*)

(c) *Mentally incapable persons.*

Mentally incapable persons can apply through their duly appointed attorney or Deputy depending upon the arrangements in place to handle their affairs. (*FSA Handbook: COMP 3.2.2*)

(d) *Trusts.*

Trusts create interesting issues of quantification for the FSCS. Trusts can arise in any number of ways. They usually involve asset protection in the form of wills, lifetime tax planning or disability related arrangements.

In simple bare trust situations (where the trust fund belongs to the beneficiary subject to administrative functions being exercised by trustees) '...the FSCS must treat the beneficiary or beneficiaries as having the claim, and not the claimant'. This means that although the trustees make the claim the beneficiary's personal financial circumstances will be taken into account in calculating liability. The trust is treated as non-existent and all the beneficiary's money with the defaulting deposit taker will be cumulated together. (*FSA Handbook: COMP 12.6.2*)

In the case of other ordinary trusts the FSCS would regard the trustees as a separate depositor even if the same trustee was trustee for several trusts. For example in the case of a will trust the compensation would be paid to 'The trustees of X deceased' and not to the individual trustees or the individual beneficiaries. The trustees would then hold it upon the terms of the particular trust instrument in the usual way.

(e) *Excluded entities.*

The FSCS protection excludes deposits made by *larger* companies (smaller companies are defined by the Companies Act 1985 so larger ones as those falling outside that definition),

larger partnerships (of the ordinary or limited liability variety with net assets over £1.4 million) and mutual associations. They are not eligible claimants.

(f) Excluded individuals.

The FSCS excludes directors and senior managers of failed banks 'where the FSCS is of the opinion that they have been responsible for, or contributed to the banks difficulties.' (*Ibid: Financial Stability pp74-75 January 2008*). It also extends to their 'close relatives' notably their spouses, parents, children brothers and sisters. (*FSA Handbook: COMP 4.2.2*)

Few anguished depositors would shed any tears over this limitation, although one might feel sympathy for their non eligible relatives. It should certainly make for some interesting family occasions, assuming the guilty parties do not leave the country. They can be expected to avoid barbeques and bonfire night parties.

(g) Out of time applications.

A formal application for compensation must be submitted to the FSCS by the saver within a six year time limit. Most savers, with the possible exceptions of Terminal 5 check-in staff, council planning officers and tractor drivers, can be expected to act far more quickly than this.

Upon what date is an FSCS claim quantified?

'For a protected deposit claim, the quantification date is the date the relevant person is determined to be in default, or the date the protected deposit was due and payable, if later.' (*FSA Handbook: COMP 12.3.1*) This means that the amount of compensation is calculated by reference to the principal sum plus accrued interest due upon the date when the deposit taking institution is deemed unable to meet protected claims against it.

This date will be determined by the FSA and FSCS. However, if interest would not have been payable at that point eg if there was a term account then the calculation would be by reference to the contractual amount due to the depositor at the date of maturity. This is to make it clear that the calculation is not to be based on an early withdrawal calculation where the depositor might have suffered a penalty.

What is the likely speed of payment?

The FSCS must pay a valid claim 'as soon as reasonably possible' (*FSA Handbook - COMP 9.2.1*). But that is only after it is happy that the general eligibility criteria have been met and it has calculated the amount of compensation due. In any event the regulations require it to settle up within three months unless the FSA agrees to an extension 'in which case payment must be made no later than six months from that date.' (*FSA Handbook - COMP 9.2.1*)

The FSCS declares that in practice it meets the majority of smaller failure claims within four weeks. There can sometimes be delays whilst they wait to obtain evidence from bank files or details from liquidators. If there was a high volume of claims resulting from a particularly large failure then some delay in payment would be inevitable.

What can be done about larger sums and client accounts?

Relatively few savers have deposits above the FSCS threshold but most people will, at some point in their lives, have a large sum in one particular account. That might be as a tax related reserve, unspent money raised by way of personal loan, money connected with a house sale or purchase, a lump sum paid from a pension scheme or an inheritance.

Especially at such times it is difficult for the depositor to split their money across various accounts with different institutions so as to minimise the default risk entailed. Similar considerations apply to money held in professional client accounts, such as solicitor's accounts operated for the executors of a will or in connection with another transaction. That is

especially if the depositor and the professional adviser's accounts are held with the same financial institution.

The FSCS will treat the underlying owner of funds in the solicitor's client account, normally their named clients to whom money is allocated, as the person to be compensated. The claims ceiling will apply to the aggregate amount owned by the depositing client in the defaulting deposit taker. That is despite the fact that depositor has no effective control over the institution used. This may seem slightly unreasonable but it is hard to see how another sort of arrangement could be any fairer or more workable.

There is to my present knowledge only one product/account available which claims to be able to achieve a broad spread of deposits over many accounts so as to retain balances within the compensatory threshold. But obviously there is a fee for that service as it is not administratively straightforward to achieve. The protection provided is not additional to that which a highly motivated wealthy cash investor could obtain for themselves if they were so minded and were well-equipped with lots of time and plenty of stamps. A costs versus benefits analysis will be required.

'Post office' accounts through National Savings and Investments have much higher than usual effective protection as they are Treasury backed and can hold much more than the FSCS claims limit. Some individuals will prefer to use them for this reason.

The key limitations of the FSCS.

(a) *The 'group problem'*

Some, superficially independent, financial institutions are part of a larger group operating under one umbrella FSA authorisation. If the group members each have separate FSA authorisation then deposits will have FSCS protection on a per institution basis. Otherwise protection applies only up to the £35,000 limit in total. This might lead to depositors having an unexpected cap placed upon their claim. The FSA website is helpful on this subject and the consumer helpline can answer specific queries for those seeking to avoid this problem.

(b) *The 'debt problem'*

FSCS payments are made 'net'. For example, if a depositor had an account, which they used for paying bills, containing £5,000 and an unsecured loan of £10,000 they would not receive any FSCS compensation under the current rules. This could create financial difficulties because it would seriously and unexpectedly disrupt that saver's cash flow, lead to termination of standing orders and create other serious liquidity related problems. It would also still leave them owing money on the balance of any loan.

It would be even worse if the debt netted off against their savings was a mortgage. This potentially very serious problem has been flagged up as a matter of concern by the authorities. (*Ibid: Financial Stability pp 15, 75-76 2008*). Savers with loans, who are concerned about the security of their cash, might well presently consider using different financial institutions for their savings and loan related needs. Keeping unsecured loans related to current expenditure as low as possible should invariably be a priority in any event. The interest rates charged upon them are typically high.

Foreign deposit takers and the FSCS.

(a) *Outline of cross-border arrangements.*

Many European Economic Area (EEA) deposit takers are legally allowed to operate in the UK without being fully FSA authorised. The EEA consists of all European Union member states together with Iceland, Lichtenstein and Norway. It is also important to note for this purpose that although the Channel Islands and Isle of Man are part of the UK they are not part of the EU.

The 'lead regulator' for many incoming EEA authorised deposit takers is the *home* state regulator and not the FSA which is the *host* state regulator. 'Incoming EEA firms... are not required to participate in the compensation scheme... They may apply to obtain the cover of, or 'top-up' into, the compensation scheme if there is no cover provided by the incoming EEA firm's home state compensation scheme or of the level or scope of the cover is less than that provided by the compensation scheme'. (*FSA Handbook COMP 1.4.1 Guidance*)

What does this mean in practice? It means that the rules concerning depositor protection can be much more complicated if a foreign based bank is used but that need not necessarily deter you from considering foreign banks. If in doubt about the particular application of the rules to a particular case you can contact the FSCS helpline on 0207 892 7300.

Banks established in other EEA states must be a member of their home state's depositor protection arrangements. The minimum requirements of those schemes are set by Treaty and are designed to protect both national depositors and, for present purposes, UK citizens who have made deposits in the UK branches of EEA banks. The protection provided for UK depositors might be, higher, lower or the same as that available to them from the FSCS.

(b) Top ups and UK subsidiaries.

If a 'topped up' EEA bank which has paid into the FSCS fails their UK depositors will first need to make a claim against the home state scheme, usually with help from the FSCS. Only then would FSCS be able to deal with any top up claims. (*FSA Handbook COMP 12.4.1*)

Alternatively banks established in EEA states may decide that they want to take deposits through a UK banking subsidiary. That is quite different to their accepting deposits directly. UK banking subsidiaries are required to be full members of the FSA and therefore their depositors automatically have the full protection of the FSCS.

UK depositors would not need to apply to a foreign compensation scheme should the need arise. The FSA is the home state regulator in such cases and the application for compensation could be made to them directly in the ordinary way.

(c) Non EEA deposit takers.

You will have already spotted that if a failed deposit taker is a branch of an overseas bank which is outside the EEA it will not be covered by the FSCS. That is unless the deposit taker is actually a UK subsidiary of the foreign bank which must be FSA authorised and also a member of the FSCS. Deposits will only be covered by the home state if it has a compensation scheme.

(d) Popular overseas destinations for cash.

The Isle of Man and the Channel Islands have traditionally been amongst the most popular homes for cash held offshore by UK depositors.

The Isle of Man Financial Supervision Commission manages a depositor's protection scheme. Protection is limited to 75% of the eligible deposit with a maximum payment of £15,000.

There is currently no depositor protection at all in Guernsey or Jersey. A scheme is apparently being considered and it may be supposed that large offshore financial centres may obtain some government support in the event of a serious difficulty arising. But this is far from guaranteed.

The Central Bank & Financial Services Authority of Ireland deposit protection scheme pays a maximum amount of 90% of the value of aggregate eligible deposits up to the minimum 20,000 Euro threshold.

If there was simply a deposit via a UK branch of the Irish bank (not a UK subsidiary) and no top up arrangement in place then an eligible UK depositor with 22,222 in their account would

receive the maximum possible compensation available (ie 22,222 Euros X 90% = 20,000 Euros). If however, there was a top up arrangement in place then the FSCS would then make up the balance to the UK maximum of £35,000.

Other key offshore financial jurisdictions provide variable levels of protection. For example the Gibraltar Deposit Guarantee Board provides depositor protection cover, very similar to that available under the Irish scheme, despite winning my award for the world's most old fashioned official financial website.

Many others, such as the Cayman Islands and British Virgin Islands, provide nothing at all by way of guarantees, excepting a lonely British frigate positioned between their tax advantages and the US sixth fleet.

A wider perspective on cash.

Cash savings should probably not normally be considered to be a long term 'investment'. Savings accounts are not as safe as they appear to be either in accounting terms, because financial institutions can go bust, or as a means of preserving purchasing power. Inflation can easily eat away at the real value of cash deposits especially after any tax due on interest paid is deducted. Cash should probably only be considered as a short term store of value for particular foreseeable needs.

Normally, unless large capital expenditure is imminent, a relatively modest amount in cash is all that is required excepting if the onset of mortality is all too obvious. The rest might reasonably be committed to widely diversified investments which are geared to meet the individuals' particular needs. Even a 100 year old apparently has a life expectancy of 2-3 years these days. Diversification should reduce risk and enhance long term returns. But that is another story with problems of its own and is well beyond the scope of this paper.

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