

## **Comparison of the UK (FSCS) and IOM (DCS) Compensation Schemes for bank deposits**

In assessing the credibility of the IOM Depositors' Compensation in protecting depositors in the event of a bank default, it seems appropriate to consider the ways in which it differs from the equivalent scheme currently in operation in the UK – the FSCS as applied to protected deposits.

### **1. Funding mechanism and payment dates**

The potential shortcomings of the DCS related to the lack of a standing fund, with bank levies being collected only after a default has been declared, are well known. While the revisions made in 2008, allowing for the possibility of Treasury funding and borrowing by the Scheme Manager, went some way towards rectifying these shortcomings, caps on both the bank levies and the level of Treasury funding mean that timely payment of the full compensation sums payable cannot be guaranteed. In the case of KSFIOM, these hastily implemented provisions ensured that all claimants received the amount due as a single payment a little over 4 months after the default was (finally!) declared on 27 May 2009. However, there is no guarantee that this would always be possible and the Regulations continue to allow for payment to be made over several years if insufficient funds are available. The revised (2010) DCS Regulations state that “*once 28 days have elapsed after a default*”, the Scheme Manager may, “*if he considers that immediate payment in full would not be prudent ... make a payment ... on account of the compensation sum payable ('an interim payment')*” [Regulation 11(2)]. This is in stark contrast to the situation in the UK where the FSA rules stipulate that full payment should be made within 3 months of the claim being approved (and that within 5 working days of the default). [<http://fsahandbook.info/FSA/html/handbook/COMP/9/2>] From 31 Dec 2010, this delay is to be reduced to 20 working days.

### **2. Compensation sums payable**

Perhaps less well known is the marked difference in the amount of compensation actually payable to an individual depositors in a given situation. Indeed, we wonder how many of the MHKs responsible for approving the Regulations are fully aware that the DCS does not operate in the same way as the FSCS in determining this and that the IOM Scheme offers less protection than does the FSCS to all depositors with deposits over the compensation limit. As from October 2008, both the FSCS (as applied to protected deposits) and the DCS apply a 'compensation limit' of £50,000 to protected deposits. From that much publicised fact, one might be forgiven for assuming that, for a given size of deposit and a given ultimate recovery rate in liquidation, a depositor would benefit from the same degree of deposit protection in an FSCS-regulated or an FSA-regulated bank. On close examination however, this turns out not to be the case. Moreover, in neither jurisdiction do customer guidelines give any detailed explanation as to exactly what the announced compensation limit means in practice and it is necessary to turn to the detailed rules and regulations of the respective schemes.

Both schemes provide full protection for individual depositors with deposits up to the compensation limit. Depositors with deposits exceeding that amount are however treated very differently. Under the DCS, as higher-value KSFIOM depositors are painfully aware, no compensation is or will be paid to any depositor who eventually recovers £50,000 or more from the liquidation, although some may recover more of their funds earlier by virtue of what becomes effectively an interest-free loan, to be repaid back to the Scheme fund as the liquidation progresses. Thus, depositors with approved claims over the compensation limit will recover only the dividends paid out by the liquidators unless the total sum thus recovered is less than £50,000, in which case they will receive limited compensation just sufficient to top-up their recovery to that amount. Depositors who recover more than £50,000 through the liquidation receive therefore no compensation whatsoever and thus are

totally unprotected. In contrast to this, under the FSCS, the first £50,000 of each and every depositor's funds is fully protected and the loss on this part of their deposit will be fully compensated. The balance of their claim, over and above the compensation limit, will then be recovered according to the recovery rate in the liquidation. All depositors therefore have some degree of protection and will receive a compensation payment, over and above the sum recovered in liquidation. <http://fsahandbook.info/FSA/html/handbook/COMP/7/2>

Examples of the total recovery (including compensation, if any) and the corresponding compensation costs borne by the Scheme are shown in the table below for two different recovery levels (60% and 80%) and a range of deposit sizes. Under the FSCS, for a given recovery level, the actual amount of compensation paid to depositors with claims over the compensation limit will be the same, regardless of the size of the deposit. This is because the compensation represents the depositor's loss with respect to the first £50,000 of his /her deposit. Thus, in the case of an 80% recovery rate, that loss will be 20% of £50,000 = £10,000. On top of that, such a depositor will receive the liquidation dividend corresponding to the balance of his/her deposit. Under the DCS, compensation, though a lesser amount, will be paid only if the depositor's total recovery would otherwise be less than £50,000 – as in the example of a £70,000 claim in the case of a 60% recovery (compensation under the DCS = £8,000, compared with the full £10,000 under the FSCS).

### Depositor's total recovery and compensation costs

Amount of claim	With 60% final recovery rate				With 80% final recovery rate			
	FSCS (2008) rules		DCS (2008) regulations		FSCS (2008) rules		DCS (2008) regulations	
	Total recovered including compensation	Cost to FSCS	Total recovered including compensation (if any)	Cost to DCS	Total recovered including compensation (if any)	Cost to FSCS	Total recovered including compensation (if any)	Cost to DCS
<b>Up to compensation limit (£50,000)</b>								
£30,000	£30,000	£12,000	£30,000	£12,000	£30,000	£6,000	£30,000	£6,000
£50,000	£50,000	£20,000	£50,000	£20,000	£50,000	£10,000	£50,000	£10,000
<b>Above compensation limit</b>								
£70,000	£62,000	£20,000	£50,000	£8,000	£66,000	£10,000	£56,000	£0
£100,000	£80,000	£20,000	£60,000	£0	£90,000	£10,000	£80,000	£0
£200,000	£140,000	£20,000	£120,000	£0	£170,000	£10,000	£160,000	£0
£500,000	£320,000	£20,000	£300,000	£0	£410,000	£10,000	£400,000	£0

While the emphasis on providing full protection for 'small savers' is perfectly legitimate and understandable, it does seem manifestly unjust and unfair that those whose deposits exceed the compensation limit, even by quite small amounts, should receive no compensation at all for any loss, even in respect of the first £50,000 of their savings.

A clear explanation of these two methods of determining the compensation payable may be found in a consultation document issued by the FSA prior to the revision of the FSCS in October 2008. The method currently used in the DCS is in fact that which was previously used by the Deposit Protection Board (DPB – the predecessor of the FSCS in relation to deposits) before it was abandoned in November 2001 in favour of a third method, even more favourable to higher value depositors than the current FSCS, introduced as an intermediate approach when the compensation limit was raised to £50,000. <http://www.island.is/media/eydublod/03-2008.06.01-UK-Tripartite-feedback.pdf>