



Financial Services Authority

Feedback on tripartite  
consultation document:  
operation of the Financial  
Services Compensation  
Scheme (FSCS) for  
deposit protection

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## Introduction

1. In January 2008 the tripartite authorities<sup>1</sup>, working together with the FSCS, issued a consultation document *Financial stability and depositor protection*<sup>2</sup>. About 100 responses have been received to that document. Details of the responses received will be published shortly, as part of a further round of consultation on these issues to be taken forward over the summer. The FSA will then issue a consultation paper (CP) in due course on issues relevant to the compensation scheme, including limits for all the FSCS sub-schemes and not just that for deposits.
2. The Tripartite Authorities are in the process of analysing responses to the January consultation document in detail. The Authorities will be holding further discussions with interested parties such as trade bodies and consumer bodies as part of the next round of consultation, before the FSA issues the CP. So we cannot give any indication at present of our likely reaction to the responses. The purpose of this document is to enable informal discussions to continue with stakeholders in the period prior to the publication of our CP, building on discussions held with respondents and other stakeholders during the current round of consultation. The paper also explains how the current FSCS system for deposits operates and sets out other possible approaches. We propose to seek views on these options in the discussions we will be holding with interested parties before issuing our CP.

## How the current system for deposits operates and other possible approaches

3. During the current round of consultation, including discussions that the FSA and other Authorities have held with stakeholders on the issue of compensation limits, a range of views have emerged. Some hold that no increase on the current limit of £35,000 is needed, while others argue that an increase would provide consumers with a greater degree of confidence in their deposits. A general theme was that care needed to be taken with communication of the compensation limit, so that consumers were given sufficient information to be better informed than at present, but were not caused to worry by being given too much information.
4. To facilitate further debate before we issue our CP we feel it is helpful to set out in more detail than was the case in the January consultation document how the current compensation limit would be applied in the event of a bank failure, and other possible approaches. The description below looks at the position of consumers with deposits at or below the compensation limit and those with amounts exceeding that limit.
5. In October 2007 we removed coinsurance<sup>3</sup> to protect consumers up to a maximum of 100% of £35,000 and we will be consulting in our CP on the possible need for further changes. The options appear to be to keep the limit at £35,000, increase it by a finite amount or have no upper limit. There was no clear consensus on any of these

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1 FSA, HM Treasury and Bank of England.

2 [www.hm-treasury.gov.uk/media/3/5/banking\\_stability\\_pu477.pdf](http://www.hm-treasury.gov.uk/media/3/5/banking_stability_pu477.pdf)

3 Before coinsurance was removed, depositors were protected for 100% of the first £2,000 of their deposit and 90% of the next £33,000, so the maximum compensation was £31,700.

options in the feedback received on Chapter 5 of the January consultation document, and further analysis will be needed before we can put forward firm proposals.

### **Consumers with deposits at or below the FSCS limit**

6. For protected depositors with an account or accounts of a total net amount up to the limit, the situation is straightforward. If a bank fails, they will be entitled to compensation for the whole value of their deposit(s) from the FSCS. At the current limit of £35,000, this will be the case for around 97% of bank accounts and 95% of building society accounts. With a £50,000 limit this figure rises to 98% of bank accounts and 97% of building society accounts.

### **Consumers with deposits above the FSCS limit**

7. Those protected depositors who have money deposited over the compensation limit will receive compensation promptly for the amount of their deposit up to the limit (currently £35,000), in the same way as depositors with funds below the limit. So all protected depositors will receive prompt compensation up to the FSCS limit.
8. Depositors with deposits above the limit may also receive additional funds above and beyond what comes from the FSCS compensation scheme. How much they receive depends on the rate of recoveries (also known as the dividend rate) from the estate of the failed bank and how those recoveries are allocated between the FSCS and the depositor. We have identified three methods for allocating recoveries, which are broadly described below.

#### *Current loss allocation method*

9. The present method is a loss protection scheme, so the depositor is protected up to £35,000 for the net loss for any protected deposit. This means that the FSCS, in return for paying compensation of up to £35,000, takes over the depositor's rights against the bank and pays over recoveries received from the estate of the bank to the depositor unless and until the deposit has been fully repaid<sup>4</sup>.
10. So, for example, assuming a 60% recovery rate, if a protected depositor has £100,000 with the failed bank, he would initially receive £35,000 from the FSCS. The FSCS would later receive a 60% recovery (£60,000) from the liquidator and pay it over to the depositor. So the depositor's total recovery would be £95,000 and the loss £5,000. FSCS's recovery would be nil.
11. To look at this in a different way, the depositor is entitled to a recovery of £60,000 from the failed bank, leaving him, at this stage, facing a potential net loss of £40,000. But he is also entitled to compensation from the FSCS, which will cover up to £35,000 of this loss. So his total recovery is actually £95,000.
12. In reality, liquidations of banks can take many years. Therefore, depositors will have to wait until the liquidator has completed the liquidation to find out how much more

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<sup>4</sup> The payment of recoveries by the FSCS to the depositor means that the depositor suffers no disadvantage from the acceptance of the offer of compensation before receipt of the recoveries.

they might receive in total, and there is of course no certainty that they will receive any further payments.

### *Previous DPB method*

13. The system in the UK has not always worked liked this. Before the current regulatory system was set up on 30 November 2001, the Deposit Protection Board (DPB - the predecessor to the FSCS in relation to deposits) was in operation and the system worked differently. The DPB protected the first part of a protected depositor's loss. It would take over the depositor's rights against the bank (up to the amount of compensation paid) and so be reimbursed by the liquidator for any compensation payment it had made to the depositors.
14. So, following the example above and assuming today's compensation limit and a recovery rate of 60%, a depositor with £100,000 with the failed bank would have a total recovery of £60,000. The depositor would initially receive £35,000 from the DPB. Once the liquidator had finalised the liquidation, £35,000 of the £60,000 recovery would be paid to the DPB and the remainder would go to the depositor, meaning that the depositor in total would receive £60,000 and suffer a total loss of £40,000.

### *An alternative method*

15. There are other ways in which a deposit compensation scheme can work, which lie in the middle ground between the two contrasting methods mentioned above. With one such method, the depositor receives the compensation payment from the FSCS in the usual way. The recovery percentage is then applied to the remainder of their original deposit. So if the general recovery rate is 60%, the depositor could expect to recover the same proportion of their loss above the limit. (This might therefore be described as a 'rateable' method.) With this method, the recoveries are shared between the compensation scheme and the consumer.
16. Using the same example as above, the depositor has £100,000 deposited with the failed bank and as such receives compensation from the FSCS of £35,000. They are then entitled to recover part of their remaining loss (£65,000) at the 60% recovery rate. Therefore, the total recovery for the depositor is £35,000 (FSCS payment) plus £39,000 (60% of the remainder of their loss of £65,000). The total payment received by the depositor is £74,000 and the total loss is £26,000.
17. In this system the FSCS would again stand in the shoes of the depositor to recover some (but, assuming a recovery rate of less than 100%, not all) of the compensation it had paid out to the depositor. In our example, the FSCS would receive back 60% (recovery rate) of the £35,000 that it had paid out to the depositor, which would be £21,000.

### *Summary*

18. This is a complicated topic but the basic mathematics behind each of the systems is actually straightforward. There are some similarities between the three methods. Each system may, if the protected deposit exceeds £35,000, result in depositors

receiving payments in two or more instalments. And in each case, the depositor may receive in total more than the FSCS limit. But because this is also dependent on the recovery rate from the failed bank, the depositor will not know in advance how much the total payments will be.

19. With all three methods, the payments made by the FSCS that cannot be recovered from the failed bank will be a cost to FSCS levy payers. The cost to levy payers is greatest with the current method, least with the DPB method. The rateable method represents a compromise between the two, and conforms to the common understanding of what is meant by deposit compensation – full coverage up to the FSCS limit of £35,000, with the right to participate in recoveries for amounts on deposit in excess of the limit.
20. The table below summarises how the three methods would operate, assuming a consumer deposit of £100,000.

### Consumer's total recovery and levy payers' net compensation costs

	Current FSCS rules			DPB rules			'Rateable' option		
	50%	70%	90%	50%	70%	90%	50%	70%	90%
Recoveries									
Consumer receives back, including FSCS compensation	£85,000	£100,000	£100,000	£50,000	£70,000	£90,000	£67,500	£80,500	£93,500
Consumer loses	£15,000	£0	£0	£50,000	£30,000	£10,000	£32,500	£19,500	£6,500
Levy payers contribute	£35,000	£30,000	£10,000	£0	£0	£0	£17,500	£10,500	£3,500

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