

Compensation Schemes

In this focus, we take a look at the compensation schemes that are in place to protect some or all of your money should a financial company stop trading. Our focus is on UK Bank Deposits, Foreign Banks and Investments.

Compensation Schemes - UK Bank Deposits

The Financial Services Compensation Scheme (FSCS) is an independent body that was founded in the UK in 2001 by the Financial Services Authority (FSA). It covers all companies regulated by the FSA, and is funded by levies on companies authorised by the FSA.

Under the FSCS, customers' deposit account savings are guaranteed up to a maximum of £50,000 per customer per institution, or £100,000 for a joint account. If a customer has more than £50,000 with a bank that collapses, they will only receive the maximum amount of £50,000 per person per institution. However, they might eventually receive additional funds following the distribution of any assets as part of the insolvency process. Interest owed to customers up to the date that the bank is found to be "in default" will be treated as part of the compensation.

The FSCS does not always cover 100% of a customer's losses. If the customer owes money to the failed firm (such as mortgages or loans), these will be taken into account when compensation is being calculated.

The FSCS aims to pay out within six months, but has never actually had to pay out for the failure of a major UK bank. However, it is likely that the UK government would do everything within its power to avoid the collapse of a British retail bank.

Compensation Schemes - Foreign Banks

Authorities in some countries, including Ireland, Germany and Greece, have issued unlimited guarantees on all bank deposits.

A foreign bank that wishes to trade within the UK, but is based outside the European Economic Area (EEA), must operate through a UK subsidiary authorised by the FSA. This means that the bank's customers will be covered by the FSCS in the same way as a UK bank.

Within the EEA itself, all EEA member states are obliged, under the EU Deposit Guarantee Schemes Directive, to establish a deposit guarantee scheme that provides a minimum level of protection for deposits of €20,000 per customer in the event of a bank's collapse. From the 30 June 2009 there will be an increased minimum compensation limit of €50,000. This limit is likely to be increased to a harmonised maximum compensation limit of €100,000 by 31 December 2010.

If a bank's home state scheme provides a lower limit of compensation than that of the FSCS (that is, less than 100% of £50,000), the bank can elect to join the FSCS to "top up" the overall level of protection. If one of these banks collapsed the home state's scheme would be responsible for claims, and would have to pay the first part of any compensation. The FSCS would only be responsible for topping-up compensation to the limit of £50,000 on deposits with the UK branch.

Compensation Schemes - Investment

The Financial Services Compensation Scheme (FSCS) encompasses investments, deposits and insurance for UK-based customers.

Investment customers can be compensated up to a maximum of £48,000 (100% of the first £30,000 and 90% of the next £20,000) for losses resulting from failure of an investment company. Pensions, on the other hand, are covered by the insurance element and each claimant will receive 100% of the first £2,000 of their claim, and 90% of the total balance. However, these payouts only take place if a company is unable, or likely to be unable, to pay claims against it.

It is worth noting that, if a mutual fund company collapses, the assets are likely to be unaffected. Assets held by such a company are not held by them directly but are instead placed in the hands of an independent custodian. This means they are protected from any mutual fund company creditors.

If an investment company does fail, it is likely the assets under management would actually be transferred to another company (subject to the shareholders' approval) so they could continue to be managed on behalf of the investors. The actual value of the assets would therefore be unaffected by any problems at the original firm and instead continue to be priced by the market.

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