An Insolvency Lawyer’s Guide to the Financial Services Compensation Scheme

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Introduction

This practice note considers the nature and role of the Financial Services Compensation Scheme (“FSCS”) and its ranking in the hierarchy of creditors in the event of the insolvency of a relevant firm.

Overview of the FSCS:

What is the FSCS?

The FSCS was established by the Financial Services & Markets Act 2000 as an independent body to provide protection to customers in the event of a financial institution or financial services firm becomes unable, or likely to be unable, to pay claims itself (i.e. it is “in default”). It is a statutory fund of last resort and will provide a degree of compensation if claims cannot be paid by anyone else. The rules for making recoveries from the FSCS are set out in the COMP rules, contained in the FCA compensation sourcebook.

The FSCS is a non-profit making body, funded by levies charged on participant firms. The Prudential Regulation Authority (PRA) and the FCA are jointly responsible for the rule making and oversight of the FSCS. The rules governing funding are set out in chapter 6 of the FCA and PRA’s respective handbooks.

Which firms are covered by the FSCS?

Only “protected claims” against “relevant persons” are covered. Broadly, firms which are regulated by the FCA or the PRA are covered by the scheme. The FSCS will guarantee certain claims relating to deposits, investments, insurance, mortgage and home finance broking (but not lending) and general insurance broking where financial loss has been caused. It is not only deposits held with the claimant’s own bank or other financial institution that are covered. Deposits held in client accounts by solicitors’ firms, for example, are protected (subject to the rules on maximum compensation) in the event that the financial services firm holding the deposit fails.

Incoming EEA firms (i.e. certain firms which are carrying on or have carried on a regulated activity in the UK) are covered only if they acquire top up cover.

The role of the FSCS:

Who is eligible for compensation?

Only “eligible” persons may claim compensation. If a firm is authorised by the FCA or the PRA and it is unable, or likely to be unable, to pay its debts, that firm will be considered “in default” by the FSCS and customers with eligible claims will be able to claim compensation. COMP 6.3 contains guidance on when a relevant person will be in default. These include the appointment of a liquidator or administrator, and the approval of a voluntary arrangement, but not a scheme of arrangement.

COMP 4.2 sets out who is eligible for protection. Certain bodies are expressly excluded. These include overseas financial services institutions, collective and common investment schemes, certain pension schemes and, at present, larger companies. Some charities will be protected provided they fall within the COMP Rules. Large
corporates (which are excluded from the scheme) are defined as having at least two of the following characteristics:

(i) a turnover of £6.5 million net per annum;
(ii) a balance sheet total of more than £3.26 million; and
(iii) more than 50 employees.

Policyholders are eligible for protection if their authorised insurer is unable to meet claims against it (typically because it has entered an insolvency procedure). Re-insurance, marine, aviation, transport business and credit insurance are not covered.

The FSCS expects depositors to continue making any necessary payments in accordance with the terms of their loan following a firm being determined to be in default. Compensation will not be paid where an account does not have a credit balance.

What is protected by the FSCS?

The amount of compensation payable varies depending on the type of claim, but not by the nature of the claimant. In all cases, the policy is to compensate only financial loss suffered by the claimant. In particular:

- In the case of investment claims, the objective is to put the customer back into the position they would have been in had they not invested and not to compensate customers for so-called guaranteed returns.
- Interest owed on deposited sums at the “quantification date” (being the date for calculating compensation) is payable by the FSCS, subject to the statutory cap on compensation (see below).
- The date for calculating compensation payable on protected deposits is that on which the firm is determined to be in default and all compensation will be paid in sterling.
- In relation to protected investment business, the FSCS will determine a specific date either on, before or after the date of the determination of default.
- The FSCS will calculate the date for compensation in relation to contracts of insurance (excluding those insurance contracts referred to above which are not eligible for protection) by reference to which the liability of the firm to the claimant is to be determined. With regard to protected insurance contracts, compensation will be paid where:
  - it is not reasonably practicable or appropriate to make, or continue to make, arrangements to secure continuity of insurance under COMP 3.3.1 R; or
  - it would not be appropriate to take, or continue to take, measures under COMP 3.3.3 R to safeguard policyholders of an insurance undertaking in financial difficulties.

COMP 3.3 deals with securing continuity of insurance cover, for example by transferring policies to another insurance firm or arranging for new policies to be issued by a new insurer.

The COMP rules specify that a claimant must assign their claim in respect of a protected deposit to the FSCS and in all other cases the FSCS can request the assignment of a claim before paying compensation. If the FSCS pays compensation where there has been no assignment, it may invoke its right of automatic subrogation pursuant to COMP rule 7.3.8. The FSCS will generally pursue claims assigned to it or to which it is subrogated with insolvency practitioners where there is a prospect of a dividend, although in certain circumstances it may decide that it is not cost effective to pursue a claim. In such cases it may reassign the claim to the original claimant at the claimant’s request.

Compensation limits

The amount of compensation currently payable will vary depending on the nature of the claim:

- Deposits are capped at £85,000 per claimant per authorised firm.
• Individuals and some smaller businesses with investments in authorised firms (known as “protected investment business”) are protected for up to £50,000 of investments.

• Compensation is capped at £50,000 in respect of home finance broking.

• Claims in respect of insurance are not capped in monetary terms but compensation is limited to 90% of the loss. However, compulsory insurance is fully guaranteed.

• Claims for insurance broking are not capped but only 90% of the claim is recoverable (except where the claim relates to compulsory insurance).

These caps apply across each category of claim for the relevant authorised firm. Therefore if an individual claimant has two deposit accounts with one firm, the total amount recoverable across those two accounts will be a maximum of £85,000. Compensation is also paid out per authorisation. This means that where a depositor has deposited sums with a number of banks within the same group, compensation will be paid up to the statutory maximum for each authorisation. If the banks were covered by a single authorisation, the maximum sum that a depositor could recover would be £85,000 across all banks and bank accounts.

As, at present, only individuals and small to medium-sized businesses/entities are eligible for compensation from the FSCS (with the exception of claims in respect of certain compulsory insurances for larger businesses), while these protections go some way to preventing a run on a bank in financial difficulties, there remains a risk that larger corporate depositors and investors could still cause a run on a bank, further destabilising an already troubled institution. This issue is in part dealt with by the new recast EU Deposit Guarantee Schemes Directive (2014/49/EU), which must be implemented by 3 July 2015. This will make a number of changes to the current scheme and in particular will extend FSCS protection to most larger corporate depositors, but not those that are credit institutions or financial services firms.

Timescales for payment of compensation

The aim is to pay compensation “as soon as reasonably possible” after the claim has been assessed by the FSCS and normally within three months. In the case of protected deposits, this should normally be within 20 working days (although the FSCS aims to pay compensation within seven calendar days). These deadlines may be extended. If a claim is made against a firm that has not been declared in default by the FSCS, the FSCS estimate it may take in excess of six months to process, in part due to the fact that the FSCS will need to investigate whether the firm has funds to allow it to pay claims itself.

Ranking of claims on insolvency:

New legislation

Section 13 of Part 2 of the Financial Services (Banking Reform) Act 2013 amends Schedule 6 of the Insolvency Act 1986 so that preferential status will be afforded to deposits protected by the FSCS. This means that these claims will be paid out ahead of the majority of other creditors on a bank’s insolvency. Where the FSCS pays compensation to a claimant, it will inherit this preferential status. This provision came into force on 31 December 2014.

Directive 2014/59/EU (the Bank Recovery and Resolution Directive) and the Banks and Building Societies (Depositor Preference and Priorities) Order 2014 (SI 2014/3486), which applies to insolvencies commencing from 1 January 2015, create a new, secondary layer of preferential debt. The deposits of natural persons and micro, small and medium-sized enterprises that exceed the statutory limit for “super preferred” claims, are now afforded a secondary level of preferential status, ranking behind claims for protected amounts but ahead of floating charge and ordinary unsecured claims.

The Deposit Guarantee Scheme Regulations 2015 (DGSR) will come into force – for the most part - on 26 March 2015. The DGSR set out procedural requirements which apply to the PRA and the FSCS and also amend the Insolvency Act 1986 to introduce a new category of preferential debt.

As noted above, the order of priority in which creditors are paid will change again when the Government implements the recast Deposit Guarantee Schemes Directive.

The order of priority

Where the FSCS pays compensation, the usual order of priority in which creditors are paid out in an insolvency situation is as follows:

First, fixed charge holders are paid to the extent of their security.
Secondly, the costs and expenses of the insolvency proceedings are paid (including the insolvency practitioner’s fees).

After these costs have been met, ordinary preferential creditors are paid. Historically preferential claims largely comprised certain sums owing to employees. Now the FSCS or original claimant will also enjoy ordinary preferential status in respect of deposits made with banks or building societies for amounts of up to £85,000 per authorised firm. In addition, from 26 March 2015, a further category of ordinary preferential debt will be created whereby any debt owed by a bank, building society or credit institution to the FSCS under (new) section 215(2A) of the Financial Services and Markets Act 2000 will be treated as preferential. This debt will arise from a liability incurred where a payment has been made by the FSCS in connection with the exercise of a stabilisation power and it has taken funding actions to stabilise the bank. This will be treated as a debt due to the FSCS by the bank. Once the deposit Guarantee Schemes Directive is fully implemented, the claims of certain larger corporates will also rank as a preferential debt in this category up to the £85,000 cap.

After ordinary preferential creditors have been paid, a new layer of secondary preferential status will apply to depositors who are either individuals or micro, small or medium-sized businesses for amounts exceeding the £85,000 cap. It will also apply to eligible depositors (being individuals, micro, small and medium-sized businesses) that made deposits with an authorised credit institution but with a branch located outside of the EEA.

Provided there are sufficient funds remaining after all of the above claims have been paid, the usual order of priority remains, whereby floating charge holders will be paid next, followed by ordinary unsecured creditors. Currently this includes claims of larger corporates, but when the Deposit Guarantee Schemes Directive is fully implemented (subject to precisely how it is implemented) depositor claims for amounts exceeding the £85,000 guaranteed amount (the £85,000 amount itself ranking as a preferential debt) and which do not relate to individuals, micro, small or medium sized businesses will rank as an unsecured debt. Those benefiting from FSCS protection for investment business would also rank in this category.

After unsecured creditors have been paid, if there are any remaining realisations, statutory interest will be paid on insolvency debts and if there is then a surplus, shareholders will be paid.

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25 March 2015

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