

## Article

# Financial services compensation scheme - unusual questions in unusual times

3rd November 2008

One of the five primal instincts is self-preservation. The instinct of survival has never been more pronounced than it has over the last few weeks, with savers abandoning their hunt for rates in favour of safe havens. Although, in some cases the fire has turned out to be as hot as the frying pan. It's tin hat time. For those who like rugby league, up your jumper rugby time. The FT reads like a soap opera with daily headlines that would make Sun Editors blush.

The good news is that the panic of recent weeks has been exchanged for a more circumspect acknowledgement of the reality of recession. Whichever way we look at it, the financial world has changed. We find ourselves answering questions that we have never dreamed of asking.

Disappointingly, some are choosing to peddle misinformation. One can only assume that this is for personal gain. This is no more than financial looting, preying on the fear of the confused.

In this article, I will address those questions that have topped our most frequently asked questions list over the last week or two. This will help advisers and SIPP/SSAS members understand the protection they are afforded via the Financial Services Compensation Scheme (FSCS) and other sources. I will also try and address some of the misconceptions prevalent in the market place regarding investor protection. We will also shortly put product specific notes on our various websites.

Firstly, I need to set the scene, which predominantly involves explaining some of the basics of the FSCS, now the frequent topic of dinner parties and coffee breaks.

The FSCS is a statutory compensation scheme set up under the Financial Services and Markets Act. It provides compensation in the event of the failure of an FSA authorised firm and is funded by levies on those firms.

There are qualifying conditions under which the FSCS can make compensation payments. The conditions are:

- There must be a **relevant person in default**. This means an authorised firm or an Appointed Representative who is unable, in the opinion of FSCS or FSA, to satisfy a claim against it.
- There must be an **eligible claimant**. The FSCS essentially covers individuals and smaller companies, by reference to the Companies Act size criteria.
- There must be a **protected claim**. A valid claim under a civil liability owed by the firm to the claimant. The claim must be a protected deposit; protected contract of insurance or be in respect of protected investment business.

The FSCS operates three separate schemes for deposits, for contracts of insurance and for investment business and the limits are different in each case.

More information on the FSCS is available on its website [www.fscs.org.uk](http://www.fscs.org.uk).

Let us now address some of the ill-conceived statements that have been promulgated in the press over recent weeks by certain self-appointed spokespersons. As someone not renowned for courting controversy, I see little benefit to industry in-fighting. However, those that trade in mis-information and half-truths need to be held to account.

Two such statements that have infuriated me are:-

*Statement 1 - Insured personal pensions are safer than trust based SIPPs, as they benefit from greater protection from the FSCS. This statement has been made in the context of both insured personal pensions and SIPPs written as an insurance contract.*

*Statement 2 – SIPP/SSAS cash should be moved from a bank account into insurance bonds (cash funds) as they benefit from greater protection from the FSCS.*

In answering some of the key questions put to me over recent weeks I will hopefully provide a more balanced view on the above points. I would hope that by the time you have read these answers, you will have reached your own conclusion as to the veracity of the proclamations above.

All of the answers below must be predicated by the fact that the FSCS has never been tested in relation to SIPPs and SSASs and the FSCS is at pains to state that individual claims are treated on a case by case basis. Hence some areas are open to interpretation.

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## Questions and answers

### 1. What is covered by the FSCS?

The current maximum levels of compensation are:

- **Deposits: £50,000** per person (for claims against firms declared in default from 7 October 2008).  
100% of the first £50,000.\*
- **Investments: £48,000** per person.  
100% of the first £30,000 and 90% of the next £20,000.
- **Long-term insurance (e.g. pensions and life assurance): unlimited.**  
100% of the first £2,000 plus 90% of the remainder of the claim.

*\*The FSA changed the rules that govern compensation payments with effect from 7<sup>th</sup> October 2008 to increase the total limit to £50,000. Different rules apply for firms declared in default prior to this date.*

The FSCS also covers insurance broking and mortgage advice, which is outside the scope of this article.

### 2. How is a SIPP likely to be treated by the FSCS?

The starting point is that a trust based SIPP is considered to be an investment. Any claim connected with advice about setting up a SIPP or about the operation of a SIPP scheme will fall under the FSCS investment scheme, subject to a limit of £48,000, should the adviser or the operator fail.

Once established, the SIPP may hold regulated investments, cash deposits or insurance products. If the provider of the underlying investment in the SIPP fails, then the underlying investment will drive the treatment of the claim, i.e. whether it is covered by the deposit, investment or long-term insurance scheme.

So if a SIPP holds the following investments, below is a statement of how the FSCS would most likely treat any claim:-

**Cash deposits with a bank in default** – FSCS deposit scheme ie up to £50,000.

**Unit trusts with a fund manager in default** – FSCS investment scheme ie up to £48,000.

**Insurance bond with insurance company in default** – £2,000 plus 90% of excess unlimited.

It is important, for fear of repetition, to understand that these scenarios set out above only apply where the provider of the underlying investment (bank/fund manager/insurance company in above examples) is in default.

If, for example, a SIPP invests in an insurance company bond, which is linked to a cash fund, and one of the underlying banks fails then the “£2,000 plus 90% of the excess” protection DOES NOT apply. This is the misapprehension that makes “Statement 2” more than a little infuriating. Indeed, it is arguable whether any FSCS protection will apply; the situation would just manifest itself as a fall in the value of the insurance company cash fund. If it could be shown that the cash investment with the defaulting bank is linked to an individual investor, and assuming that the FSCS accept that this link does give the investor a right to claim, the absolute maximum compensation the individual could receive would be equivalent to that under the FSCS deposit scheme. I think I have made my point!

### 3. What is the position of trust based SIPP and SSAS products?

For all trust based SIPP and SSAS products, the investments are held under trust in the name of the trustee(s). In the event of the failure of SIPP/SSAS operator, the creditors of the company would not have any claim over the assets of the SIPP or SSAS.

Trustee companies are established for the purposes of holding assets and many are not trading companies. All cash funds are held in the name of the relevant scheme trustee(s) and are protected as bank deposits, subject to the limits of the FSCS deposit scheme.

If a loss arose to a client as a result of a SIPP operator failing in its duty to a scheme member, and it went into liquidation, a claim could potentially arise and would be covered by the FSCS.

### 4. What is the protection for an insured personal pension (including a SIPP structured as insurance contract)?

An insured personal pension holder will have a contractual arrangement with the insurance company that will then hold investments under that contract. The assets backing this contract are an asset of the insurance company and hence are on the insurance company's balance sheet. This applies equally to a SIPP written as an insurance contract which may come as a surprise to some.

If the insurance company fails then there will be a claim under the FSCS insurance scheme (100% of the first £2,000 and 90% of the balance above this amount). Any investments held by the failed insurance company would form part of its assets and would be realised to meet any claims against it.

## **5. So what is the fundamental difference between a trust based SIPP and one that is written as an insurance policy?**

As the name would suggest, under a trust based SIPP, the SIPP assets are never treated as an asset of the SIPP operator. SIPP assets are ring-fenced and secure from creditors.

If a SIPP is written as an insurance policy, then all SIPP assets are taken onto the balance sheet of the insurance company and are not ring-fenced. The logical conclusion is that such assets could be used to pay creditors in the event of the insurance company's default.

I have never made a case before to suggest that trust based SIPPs are safer than their counterparts that are written as an insurance policy, as it had always appeared a little disingenuous to scaremonger on what historically has been a non-issue. Having seen some of the world's most respected financial institutions turn to dust in a matter of hours, you will hopefully understand why I have been so annoyed at "Statement 1" above.

## **6. What is the position if a SIPP has more on deposit than the £50,000 limit?**

If an individual holds deposits in excess of the limit, he or she may get additional funds through the liquidation process, depending on the distribution of the bank's assets by the liquidator. It will depend upon what assets are available once the liquidation process is complete and how the liquidator distributes any remaining assets, i.e. the rate of recovery in the liquidation process.

The FSCS, in return for paying compensation of up to £50,000, takes over the depositor's rights against the bank. If further funds are recovered in the liquidation process they may be paid back to the depositor.

The FSA is consulting on limits generally and on how assets are distributed in such circumstances but the important point is that it may be possible to recover more than the £50,000 but it is not guaranteed.

For deposits, the FSA has now adopted the "rateable" method of calculation. The depositor would receive compensation up to the limit under the FSCS and the "recovery percentage" would then be applied to the amount of the deposit over the limit. For example, if a depositor had £100,000 with the defaulting firm and received £50,000 initial compensation from the FSCS then, if the recovery rate under the liquidation process was 50%, the total recovery for the depositor would be £50,000 (FSCS payment) plus £25,000 (50% of the remainder). Total payment to the depositor would therefore be £75,000 and a loss of £25,000.

The FSA is proposing to retain the "loss allocation method" for investment business, although it is consulting on changing the methodology to rateable for investment business as well. Under the loss allocation method the "recovery percentage" would be applied to the total value of the client's investment, without deducting the initial compensation payment made by the FSCS, up to the relevant limit.

## **7. How can I spread my risk if I have more than £50,000 in cash deposits**

The first reaction is to spread the cash between a number of institutions. However, for large deposits this is not practicable. Also, some SIPPs do not allow bank accounts to be established with banks other than the SIPP provider's default bank. So a little more creativity is required. Investing in short dated gilts and Treasury Bills have been common ways of circumventing this problem. Investing in cash OEICs is an option to spread the risk. Also, if the SIPP has cash and a mortgage, now may be good time to repay some or all of the mortgage (see below as if the cash and the mortgage are with the same bank then there is little to be gained). Premium Bonds and National Savings are a viable option for the individual investor but most of these types of investments are not permissible SIPP investments.

## **8. What if an individual owes the same institution money?**

The money owed to a claimant and owed by him or her would be netted off. So, if a person has savings but also has a loan or mortgage, then the liability on his or her borrowings would not be wiped clean but would be deducted from the claim. If the borrowings exceeded the claim, then there would effectively be no claim on the FSCS. We do not know whether, as part of the liquidation process, the liquidator would foreclose on any loans or mortgages outstanding in order to realise all assets of the bank, but we would doubt that would be the case.

## **9. How is the limit applied to joint accounts?**

The protected claim is per individual claimant. So holders of joint accounts both have protection, subject to the limits. It is not clear how SSASs would be treated in such a situation eg where the SSAS had say four members, would the protection be £200,000. This is something we are seeking to clarify with FSCS.

## **10. How is the limit applied to other deposits with the same institution?**

The limit applies to the total held by an individual claimant with the authorised bank or deposit taking institution. If a person holds deposits in different accounts e.g one held on behalf of his SIPP and one in his own current account, those deposits will be combined for the purposes of the compensation limit.

Many banks and building societies are part of the same group and whether or not you have a claim against different institutions within the same group will depend upon whether they have separate deposit taking "licences" under their FSA authorisation.

## **11. What about offshore deposits?**

The FSCS does not cover deposits held outside the European Economic Area. The EEA consists of all European Union member states and 3 non-member states: Norway, Iceland and Lichtenstein. For deposits held outside these jurisdictions, there may be local schemes

available. For example, there is a compensation scheme covering deposits in the Isle of Man although it now appears that the limit for deposits held under trust based SIPPs is only £20,000 per member. There is no scheme currently in place for the Channel Islands. Other schemes may not operate in the same way as the FSCS so individual claimants would need to contact the institution concerned or the relevant compensation scheme direct.

## 12. What about deposits with branches of EU banks operating in the UK?

The FSCS sets out information on its Website. To paraphrase, it is likely that such deposits will be covered, either fully, by the compensation scheme operating in the EU state where the bank is based, or through a top up scheme. Where compensation limits are lower in the "home" state of the bank, compensation can be topped up to the UK limit. The FSCS Website carries a list of banks that have joined the top up scheme. It is important to check the position with the bank or the FSCS as not all institutions have opted to top up compensation for both deposits and investments.

## 13. What about Group SIPPs?

Where a group of individuals are joined together in a Group SIPP, of which there are various structures in the market place, it is our understanding that the FSCS will look through the "grouped" nature of this arrangement and individual claims will be unaffected.

## 14. Does the FSCS apply to SSASs?

Whilst SSAS are not regulated products, nor is there the equivalent regulated operator status for SSAS that appears for SIPPs, the trustees of SSAS will be protected by the FSCS in relation to its underlying investments.

## Conclusion

The current market conditions are likely to be uncertain for some months to come. Uncertainty as to how a protection scheme such as FSCS works devalues the very benefits of that scheme and hopefully we will see the industry working responsibly with the FSA and FSCS to achieve a greater degree of certainty in this area. This will give advisers and savers a stable platform on which to assess risk and make informed decisions.

**END**

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## Notes for Editors

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