

## Bankhall Update: Current Market Conditions - FSCS

As a result of the recent turmoil and in particular both the banking crisis and Lehman Brothers situation, we have received a number of queries in relation to the Financial Services Compensation Scheme (FSCS) and the protection it provides.

To assist members, this update provides information about compensation available via the FSCS and some Frequently Asked Questions in relation to what we believe is (or isn't) likely to be covered in particular scenarios.

### The FSCS

The FSCS is the UK's statutory fund of last resort for customers of financial services firms. This means the FSCS can pay compensation to consumers if a firm is unable, or **likely** to be unable, to pay claims against it. FSCS is an independent body set up under the Financial Services and Markets Act 2000 (FSMA).

FSCS covers business conducted by firms authorised by the Financial Services Authority (FSA). The rules for FSCS are made by the FSA and appear in the FSA's Compensation Sourcebook (COMP) of the FSA Handbook.

It must be remembered that if the firm is still trading then the complaint is not covered by the FSCS but another body such as the Financial Ombudsman Scheme (FOS).

The FSCS was set up mainly to assist private individuals, although small businesses are also covered. Larger businesses are generally excluded, although there are some exceptions to this for deposit and insurance claims and therefore the **eligibility** of the claimant firstly needs to be ascertained.

As an indicative guide only, a smaller company must meet two of the following criteria:

- Turnover: not more than £6.5 million
- Balance sheet total: not more than £3.26 million
- Total number of employees: not more than 50

The same levels of compensation that apply for private individuals also apply for small businesses.

In all cases (assuming the client is an eligible claimant), the following three things must apply before the FSCS can step in:

- The claimant must have suffered financial loss.
- The firm in question must be authorised by the Financial Services Authority (FSA).
- The firm must be in default which means it is unable or likely to be unable, to pay claims against.

Therefore, there are 2 scenarios where a claim can potentially be made:

- Default of the product provider or underlying investment provider (fund manager/bank etc).
- Default of the advice provider where the advice has been given and the claimant is claiming financial loss due to the advice given.

The FSCS has limits on the amount of compensation that may be payable, depending on the type of business concerned:

### Deposits

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The FSA has amended the rules to increase the limit to 100% of the first £50,000 with effect from 7 October 2008.

Hopefully, the situation for UK banks will now be a theoretical one in view of the support package for announced by the Government yesterday. These measures should, in theory, provide the confidence in the capital protection of the banks and raise their solvency both in the UK and in the world wide market.

A key factor is that the above is per person, per authorised institution. This sub-scheme is triggered when an authorised deposit taker, (such as a bank or building society) is unable, or likely to be unable, to repay its depositors.

The entitlement to compensation is calculated with reference to the value of a person's total deposit with the relevant institution, regardless of the number of accounts held by the depositor in that institution. In other words, an investor may only receive one maximum payment of £50,000 for the sum total of accounts held in one given authorised institution

Where two depositors hold a joint account, each depositor may receive a maximum of £50,000 compensation in respect of the claim, giving a total of £100,000.

Care does need to be taken as the FSCS confirms that the deposit/s may be set-off with any debts owed to the same institution to determine the total financial position. Therefore, if you owe the institution more than your deposits then there may not be a valid claim.

If the client holds a deposit with a UK branch of an EEA authorised bank then in addition to the banks own home state's States protection a top up to the FSCS may be been paid and FSCS limits would then apply. This would have been the situation if Icesave UK deposits had not been guaranteed by the UK government. In such a case the situation would have been that the first €20,000 would need to be claimed from the Icelandic scheme with the remainder from the FSCS, therefore two claims would have needed to be made.

### **Investments**

The investments sub-scheme covers two kinds of investment loss:

- When an authorised investment company goes out of business and cannot return the investments or money.
- Loss arising from bad investment advice or poor investment management

In determining the amount of compensation payable the FSCS would take account of the position the claimant would have been in had they not invested. The maximum level of compensation receivable from the scheme for a claim against an investment firm is £48,000 (100% of the first £30,000 and 90% of the next £20,000).

The scheme does not, however, cover general investment loss – which is a key factor in the Lehman Bros structured products situation where the monies placed with Lehmans would be deemed to be an investment made by DRL et al (rather than an investment made by the investor) and therefore would not be covered (at least until a case actually goes before the FSCS to give definitive confirm this).

### **Insurance**

Insurance policy holders are protected if they are insured by authorised insurance companies under contracts of insurance issued in the UK, or in some cases in the EEA, Channel Islands or Isle of Man. The scheme covers compulsory, general and life insurance and is triggered if an insurance company goes out of business or into liquidation. With effect from 14 January 2005, the scheme also covers insurance broking.

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The maximum level of compensation available from the scheme for a valid claim against an insurance company depends on the type of insurance policy, although the FSCS may arrange to transfer policies to another insurer, provide a new policy or, if this has not been possible, provide compensation.

- **Compulsory insurance** (e.g. third party motor insurance) is covered in full.
- **Non-compulsory insurance** (e.g. home insurance) - the first £2,000 of a claim or policy is protected in full. For amounts above this threshold, 90% of the remainder of the claim or value of unused premiums will be met.
- **Long-term insurance** (e.g. pension plans and life assurance) - the first £2,000 of a claim or policy is protected in full. For amounts above this threshold, the scheme covers payment to 90% of the value of a policy in liquidation.

Policyholders who invest in **insured** funds through 'tax wrappers' such as a personal pension plan or a life investment bond are protected under the long term assurance part of the FSCS (see above) if the provider goes into default.

However, there can be issues based on where you have invested and who is deemed to have made the investment. For example external funds under a SIPP could be deemed to have been purchased by the provider and not the client and therefore the provider will not be an eligible claimant should a bank or fund manager default, although if the SIPP is trust based then the trustee could be an eligible claimant on the clients' behalf.

To help mitigate this, where a fund manager fails, quite often the fund will have custodians in place to separate the units from the fund manager itself and therefore, although the fund manager has failed, the underlying assets of the fund will be safeguarded for the investor. In such circumstances there should be full value left and hopefully no loss, although there is the potential for a run of clients seeking to exit the fund manager's funds leading to a reduction in value but this would be an investment loss and therefore not covered by FSCS.

Therefore, in some cases whether or not a claim will be eligible depends on how the plan is set up and whether the investment is deemed to be the client's investment or the provider's investment. The FSCS is unable to comment further on this issue unless a claim has been made and therefore it may be necessary to contact individual product providers to give a steer on how specific plans are structured.

### Home Finance

Home financial mediation (i.e. advising and arranging activities in relation to mortgage and other home finance products) is covered under the FSCS but mortgage lending activities **do not** give rise to an eligible claim.

Home finance mediation is covered for the 100% of the first £30,000 and 90% of the next £20,000, therefore a maximum of £48,000.

### FAQ's

#### **Q. Are offshore bonds covered if the provider defaults?**

A. This would depend upon the bond provider's individual situation.

For example, Standard Life International Ltd state they are covered by the FSCS as a result of the fact they are EEA regulated (Ireland) and authorised to conduct business in the UK - therefore the FSCS should apply. However, Royal Skandia products are not covered by the FSCS because whilst Royal Skandia is authorised to conduct business in the UK and it is regulated in a non EEA state (Isle of Man). Therefore

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Royal Skandia products are covered by the Isle of Man Compensation scheme rather than the FSCS.

### **Q. What about deposits in an offshore bond?**

**A.** These are not covered by the FSCS but may be covered by the jurisdiction of the territory the bank is in (for a UK deposit as stated there is no cover, but Irish deposit are covered 100% till 2010).

### **Q. How are onshore bonds covered in the event of provider default?**

**A.** These are classified as long term insurance contracts and are therefore covered should the provider fail this may give rise to an eligible claim under the FSCS insurance sub scheme (see above).

### **Q. Are SIPPs covered?**

**A.** A SIPP is a regulated product and will therefore come under the FSCS protection. A key aspect in determining the nature of the claim is the parameters of the investments undertaken i.e. deposits will fall under deposit protection, insured funds under long term protection and mutual funds fall under the investment limits. How these interact in practice will be a decision for the FSCS.

Another item for consideration is whether the plan is trust based or not. If the plan is trust based and the wrapper fails, the trustee can claim for each individual plan holder but would be subject to investment limits. An insured SIPP would fall under the insurance sub scheme. Another key fact is that the trustee will be separate from the provider and the fund assets should also be separate.

### **Q. Is a SSAS an eligible claimant?**

**A.** Yes - but it is the trustee who will be the claimant. Additionally, an **occupational** pension scheme of an employer which is **not** a large company, large partnership **or** large mutual association may also be an eligible claimant.

### **Q. For a SSAS are the claims individual or split between the members**

**A.** The FSCS must treat the member(s) or, where relevant, the beneficiary of any member as having the claim, so the claim limits should be per individual.

### **Q. Are insured funds covered under the long term insurance element?**

**A.** Yes – but there could be the situation where the insured fund invests in external funds and therefore they may not be covered if the external fund manager failed, although in view of the custodian duties that typically exist in such arrangements, these monies should be ring fenced and the only expectation of the fund failing would be through the fund manager acting dishonestly, fraudulently or negligently.

### **Q. How are ISA's covered?**

**A.** This depends on the type of ISA – an equity ISA would fall under the investment protection and cash ISA should fall under the deposit protection.

### **Q. What happens if a fund manager goes into default?**

**A.** For Unit Trusts and OEICs then these assets should be held separately from the fund manager themselves.

**Q. Are trustees eligible to claim under FSCS and, if so, how are such claims treated?**

**A.** Yes. If a claimant's claim includes a claim as a trustee then this claim will be treated as separate from any claim being made in their own right. If the same individual claims as a trustee of more than one trust then these will be treated as claims from separate claimants.

Where there is more than one trustee in respect of a trust then their claims will be treated as that of a single trustee. Where, however, the trustee of a bare trust makes a claim then this will be treated as a claim of the beneficiary or beneficiaries.

The above does not relate to trustees of pension schemes which are covered earlier in this document

**Q. Why isn't the default by Lehman Brothers covered for investors in structured products?**

**A.** Because of the design of the product the monies placed with Lehman Brothers are classified as investments and therefore deemed to be an investment risk – although should the structured product provider fail then the client can make a claim to the FSCS. There is also the situation that the client believes that the advice was at fault. In this situation they can make a claim against the adviser – but this would not fall under FSCS unless the advisory firm itself went into default.

**Q. What is being done about the Lehman's situation?**

**A.** The situation with the structured products is that the money invested with Lehman Brothers was invested with the European elements of Lehman Brothers but with the ultimate guarantee being provided by Lehman Brothers Holdings Incorporated, the business entity that is still in chapter 11 bankruptcy protection in the US. The key factor here is that the monies are still in existence and it will be the value of these less the higher ranking creditor claims that would be made available to the plan manager and ultimately the client once the administrator has done their job. To complicate the situation further for DRL and NSFA plans, the monies are in German and Dutch companies as follows:

- For ISA Investments - Lehman Brothers Treasury Co. B.V.
- For non-ISA investments - Either Lehman Brothers Securities N.V. or Lehman Brothers Bankhaus AG

PWC are the administrators of the UK subsidiary Lehman Brothers International (Europe) Ltd and until they can unwind the structures within the European operation then the situation cannot be clarified as to what monies will and will not be payable to the plan holders. Currently they have a court order in New York for reclamation of \$8bn that was extracted from the UK subsidiary and have made a general press release as to the general update - [click here](#).

We are also aware of an issue which has arisen in relation to the DRL Enhanced Returns Plan issue 1, 2 and 3. The documents relating to these plans stated that the 3<sup>rd</sup> party provider of the securities was also protected by the FSCS.

This is now acknowledged to be incorrect. According to DRL, all affected clients were written to, advising them of the error and confirming that a refund of monies was available if they were not happy, a copy should also have been forwarded to the adviser

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We are currently collating how many advisers/clients received this communication and would appreciate your confirmation of the number either in the positive or negative please email [technicalservices@bankhall.co.uk](mailto:technicalservices@bankhall.co.uk) to respond.

Comments have also been made as to the rating of Lehman Brothers in the run up to the failure as the literature stipulated a rating of A+ - both NDFA and DRL have confirmed that the consensus rating just prior to failure was A+.

Both NDFA and DRL have issued FAQs on the current situation.

- [Click here](#) to access the DRL FAQs
- [Click here](#) to access the NDFA FAQs

So, in summary there is currently nothing that can be done in relation to the structured products until it is known from the administrators/plan managers how much is due back to the plan holders, especially as all payments are currently suspended. The only thing that can be done is where clients were due a payout or a regular income to review their financial situation to provide these monies from an appropriate alternate source.

We have provided below an extract from [www.structuredproductsonline.com](http://www.structuredproductsonline.com) providing a useful summary of the structured products and the potential payouts which Members may find useful. It must be noted that there are assumptions being made and are merely an indication of what could happen (Bankhall is not responsible for the content of third party websites).

*“If you own a Lehman Brothers structured product issued in Europe, on a basic level, it works like this. The basic components you are ultimately invested in are a bond and an option. The bond is a zero coupon, which means it is issued at a price well below par. The value you have in the bond is whatever price you have bought it at, minus a bit more if the issue is newly launched and minus a bit less if it is nearing maturity. The bond will have been issued by and in the name of Lehman Brothers.*

*In addition, there is an option that will have been bought from a counterparty. That counterparty may have been the options desk at Lehman, or it may be the same desk at another bank. If that option – based on the performance of an underlying, typically an equity index, such as the FTSE – is in the money, i.e. it is performing better than anticipated, then the counterparty will owe money to the investor.*

*Valuing the option that is closed out as a result of the Lehman’s bankruptcy is based on the probability of that option being at an expected level at expiry. This is hi-tech mathematics, but the important element for the investor is that these proceeds will have been put to one side by the counterparty, either in cash or liquid securities like US Treasuries. As the money is specifically put to one side it ranks as a secured obligation of the counterparty.*

*Once the zero coupon bond and the option have been valued, they are then packaged into a total amount that is then multiplied by the market value of Lehman bonds. Taking Lehman bonds at 50 - the level they were quoted at earlier this week - and the zero coupon at 68 and the option at 10: the bond plus option equals 78, multiplied by 50% leaves the investor with a return of 39.*

*One oddity of the structured product is that the money from the option – if there is any – is secured, and the money from the bond is unsecured. As a result, the option proceeds rank further up the creditor priority chain on bankruptcy.”*

To add some clarity to the above, creditors are re-paid in a fixed order according to the hierarchy below:

1 - Administrators & the Government (in the case that taxes are owed)

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- 2 - Secured creditors - 'fixed charge' (security fixed to a tangible asset such as the derivatives)
- 3 - Senior Unsecured creditors (including Medium Term Notes (MTNs) / Zero Coupon Bonds)
- 4 - Preferential creditors - including employees
- 5 - Subordinate Secured creditors - 'floating charge'
- 6 - Unsecured creditors - including customers
- 7 – Shareholders

As with any risk/reward situation, a lower rated bank will inherently carry more risk and will therefore have to pay a higher interest rate to their investors. This extra interest can then be used by the Structured Investment provider to boost either participation rates, IFA commission or their own margin. For example, the terms on an investment issued by an 'A' rated counterparty will be better than an identical structure issued by an 'AA' rated bank, as the higher rated bank will pay a lower level of interest. In the instance of Lehman Brothers the investment was based on 'A'+ and therefore a higher risk than an 'AA' rated bank investment.

This is particular to structured products that utilise Bonds/MTN's as the capital protection. Unfortunately the structured product market is not that simple and there are various other strategies involved. A key defining fact is that although the product may be linked with an index, there is no guarantee that the underlying derivatives will match the constituent of the index and may indeed be in uncorrelated areas – to try and obtain the information as to where these monies are actually invested is extremely difficult if not impossible.

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