Financial Services

The protection of bank depositors: new developments

by Andrew Campbell and Peter Cartwright

The subject of consumer protection in financial services is currently under review by the Financial Services Authority (FSA), which published a consultation document, *Consumer Compensation: A Further Consultation* (FSA Consultation Paper 24), in June 1999. Although the document is concerned with compensation for the full range of financial services, the purpose of this article is to focus solely on the issues involved in the protection of bank depositors.

BACKGROUND

There has been a deposit protection scheme in the UK since 1982 (having been introduced by the *Banking Act* 1979). At present the scheme provides for 90% protection for the first £20,000, with amounts in excess of that figure receiving no protection whatsoever. Accordingly, no bank depositors can obtain full protection for their savings no matter how modest the amount involved. (For details of the background to the introduction of the deposit protection scheme in the UK and the way it is operated, see A Campbell and P Cartwright, 'Banks and Consumer Protection: the Deposit Protection Scheme in the UK' in [1998] LMCLQ 128).

The provision of a deposit protection scheme is not a matter of choice. EC Directive 94/19 requires member states to provide depositor protection schemes. The requirements of the directive were introduced in the UK in 1995 by the *Credit Institutions (Protection of Depositors) Regulations* 1995 and the minimum requirements under the directive are discussed below.

The consultation document is concerned inter alia with the following questions:

- Who should receive protection?
- How much cover should be provided?
- Should 100% cover be provided?
- How should the scheme be funded?

These matters will be considered individually but, before doing so, it is necessary to consider why bank depositors should receive protection at all. We will also consider the effect of a deposit protection scheme on the risk of moral hazard and the role of co-insurance as a means to reduce this risk.

PROTECTING DEPOSITORS AND MORAL HAZARD

The safety of the financial system is of paramount importance to any government and a deposit protection scheme plays a part in the overall efforts to maintain the health of the system. Depositor protection is said to have two main aims: first, the protection of consumers and, secondly, the protection of the banking system as a whole. (In the context of European integration, it could also be said to have the aim of facilitating the single market in financial services.) Commentators differ concerning which of these is the prime aim. Macdonald, for example, considers the protection of depositors as the direct rationale for depositor protection schemes, whereas Macey and Miller look to the reduction in systemic risk for the banking system as the principal justification (see R Macdonald, *Deposit Insurance,* London: Bank of England, 1996, p. 6, and JR Macey and GP Miller *Banking Law and Regulation,* 2nd ed., New York: Aspen Law & Business, 1997, pp. 22–23).

As Helfer notes, the provision of a safety net 'raises the spectre of moral hazard' (Ricki Tigert Helfer, 'What Deposit Insurance Can and Cannot Do' in *Finance and Development,* March 1999), and it is necessary to minimise this risk to ensure that behaviour by bank management, and indeed by bank depositors, is not adversely affected by the provision of deposit insurance. Much has been written on the subject of deposit insurance and moral hazard, and it is right that governments should take the risk seriously. However, in our view there is relatively little risk of moral hazard creating any serious problems provided two criteria are satisfied. First, there should be an effective system of prudential supervision in place alongside the deposit protection scheme. Secondly, those whose behaviour could be affected should not be provided with a safety net which is too generous. In the UK the scheme has always included an element of co-insurance. All those who are protected share at least a part of the risk of an institution failing. In addition, senior officers of banks are discouraged from excessive risk-taking by the presence of a banking supervisor and laws which can make directors personally liable for the debts of their company where wrongful trading has taken place and can lead to the disqualification of the director concerned. (See also the 'fit and proper' requirement contained in Schedule 3 to the *Banking Act* 1987.) Another limitation on the scope for moral hazard is the provision that the deposits of senior management and connected persons do not receive the same protection offered to others under the scheme.

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It is suggested that where the level of protection is relatively modest, and these safeguards are present, the effect of the existence of the scheme on the level of moral hazard should be low enough not to cause concerns. (For further discussion on this point, see A Campbell and P Cartwright, 'Deposit Insurance: Bank Safety and Moral Hazard' [1999] EBLR 96).

THE ISSUES

There are a number of issues to be addressed in this context.

Eligibility

Perhaps the first question which should be considered is who should qualify for protection under the scheme. This is a very important issue, which goes to the root of the matter. The majority of those who responded to the previous consultative document were of the opinion that compensation should be directed largely towards those who are least able to sustain financial loss, i.e. private individuals and small businesses. We are also of the opinion that protection should be aimed at those least able to assess the risks involved in choosing one financial product as opposed to another. For the most part, private individuals of relatively modest means will fit into this category. Indeed, few will really be in a position to assess a particular situation adequately because of the combination of a lack of know-how and a lack of information. The exclusion of larger companies from the scheme is justifiable and desirable. At present deposits from banks, building societies, insurance companies and other financial institutions are excluded from the scheme and there does not appear to be any support for a change to this position.

Level of compensation

The level of protection when the scheme was introduced was £7,500 (at that time cover was limited to 75% of £10,000) and this was increased to £15,000 in 1987 (75% of £20,000) and to £18,000 in 1995 (90% of £20,000). The directive requires member states to provide cover of not less than 90% of €22,222 but states can provide a higher level of cover if they so wish. The level of compensation in the UK is relatively low when compared to some other countries. In the US, for example, $100,000 protection is provided with no element of co-insurance.

The responses to the previous consultation document indicated no support for the idea of providing unlimited cover to those whose deposits come within the ambit of the scheme. However, it is worth noting that there is no overall limit under the current insurance industry scheme and the FSA has stated that it sees no case for introducing a limit in that area. The FSA is also not persuaded that the limits for the deposit protection scheme and the investment protection scheme should be the same. Although it may be arguable that the levels of cover for these schemes should not be identical, it is submitted that to provide differing levels of cover provides unjustifiable complexity.

Need for co-insurance?

It has already been seen that co-insurance is not a feature of all deposit protection schemes and, indeed, at present the Investors Compensation Scheme in the UK provides 100% cover for the first £30,000 of a claim before the co-insurance aspect comes into play, with only 90% cover being provided for the next £20,000. It is difficult, in our view, to justify the provision of 100% cover in this scheme while retaining co-insurance for the entire amount of each deposit under the deposit protection scheme. If one of the aims is to provide protection to poorer consumers there needs to be some element of the compensation package that attracts 100% cover.

The principal justification for the provision of 100% cover is one of distributive justice. Those least able to bear the loss resulting from the failure of a financial institution are also those who are least able to judge the level of risk posed by that institution. There are, in our opinion, moral as well as practical reasons for providing full protection to such consumers for deposits up to a particular limit. One consequence of providing 100% cover to protect weaker consumers is that the financially better-off also benefit from this protection. It is for this reason that there should be an upper limit to the amount which receives complete protection. Above that limit it would be reasonable to introduce a further band which would attract an element of co-insurance.

Funding

It is essential that the deposit protection scheme be adequately funded by contributions from authorised financial institutions. It should not be necessary to use public funds for the purpose of compensating depositors, but where there exists adequate prudential supervision of the banking sector, coupled with a properly-funded scheme, there should be little risk of this happening. Under the new proposals the deposit protection scheme will operate as a sub-scheme and it will be necessary to ensure that where compensation payments are made a fair allocation of liabilities takes place. It would be unfair to spread the costs of a bank failure over the entire financial sector, just as it would be unfair to expect banks to pay for an insurance sector failure. Each sub-scheme should have responsibility for compensation pay-outs relating to an institution which undertakes business in that area. It is suggested in the consultation paper that institutions will be protected from contributing towards compensation pay-outs which do not relate to their area of operations. However, in some cases an institution may have to belong to more than one sub-scheme because of the nature of its business.

PROPER FUNDING

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CONCLUSION

Most Western countries currently have in place explicit schemes that provide 100% cover for deposits up to a particular level. An example of a scheme which is far more generous than the UK scheme is the Federal Deposit Insurance Corporation Scheme in the US which provides 100% cover for deposits up to $100,000. France and Germany also provide 100% cover up to a protected amount with no element of co-insurance. Ireland and Italy on the other hand follow the British position with an element of co-insurance. However, Italy's scheme provides a generous level of cover before the co-insurance element is activated. (It protects 100% of the first £74,400 and then has 75% protection up to £372,000. Source: *Consumer Compensation: A Further Consultation*, p. 51.)

As was noted earlier, we would only advocate the introduction of a deposit protection scheme where adequate prudential banking supervision exists and, in our opinion, the UK satisfies this requirement (although some would argue that even with the new regulatory environment there remains room for improvement).

on the internet

http://www.fsa.gov.uk/bank/bkgsup.htm

General information on the FSA's banking supervision regime is available on this website.

The moral hazard issue must be addressed but it is difficult to argue against providing 100% cover up to a particular level. This level can be fairly modest, perhaps protecting the first £30,000 in full. Above that the next £20,000 could receive protection but with an element of co-insurance included. It is not felt that this would create any significant moral hazard risk. Such a development would enable the poorer members of our society, most of whom are not in a position to assess the financial health or otherwise of the financial institution in which they have deposited their savings, to be fully protected. An element of co-insurance above this level can be justified, although many countries do not see the need for this.

We are also of the opinion that above a certain level no protection should be offered. Where that line should be drawn is clearly a matter for discussion.

Our research has highlighted a lack of knowledge amongst the general public about the existence of the deposit protection scheme and the levels of cover provided. In the US the level of awareness is far higher and one of the reasons for this is that bank failures are a far more common occurrence than in the UK. There have only been two well-publicised bank failures in the UK in recent years – Bank of Credit and Commerce International and Barings (the scheme was not activated in the case of Barings) – but there have been several failures of smaller, lesser-known banks which have caused the scheme to be activated: Equatorial Bank plc, Mount Banking Corporation Ltd, Rafidain Bank, Roxburghe Bank Ltd and Wimbledon & South West Finance plc.

In all of these failures depositors lost at least 10% of their savings. The introduction of the changes suggested above would do much to protect the position of poorer consumers.

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