

**Consultation with all banking licenceholders\***  
**on**  
**options for change to the Isle of Man's**  
**Depositors' Compensation Scheme**

(\* principally those banks that are participants in the scheme)

**6<sup>th</sup> March 2008**



Financial Supervision Commission Barrantee Oaseirys

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## SECTION I Introduction

The Commission's objectives include promoting the stability of financial institutions and protecting the reputation of the Isle of Man.

As a result of the widespread international disruption in financial markets since the second half of 2007 and concurrent with an increase in the UK's compensation limit to £35,000<sup>1</sup> in October 2007, the Commission has commenced a review of the Isle of Man's depositors' compensation scheme ("DCS"), as contained in the Banking Business (Compensation of Depositors) Regulations 1991<sup>2</sup>. Also in October, a review of these Regulations and associated legislation was called for in Tynwald, together with a suggestion that an increase to the DCS in line with inflation may be appropriate.

Treasury agreed Terms of Reference for the Financial Supervision Commission to carry out a review of the DCS and other methods of depositor protection. The Commission is required to submit to Treasury reports on progress of the review, with the next report being due by the end of March 2008. This report will indicate the likely proposals for a future DCS.

The Commission met with the Isle of Man Bankers Association ("IoMBA") in January, following which detailed depositor data was requested from banking licenceholders. The survey data received from banks has been used to inform this consultation paper.

Following this month's report to Treasury, subsequent reports will focus on ways in which the Island might further protect depositors and best respond to bank illiquidity or insolvency, whilst maintaining international confidence in the Isle of Man as a financial centre. This may include consideration of regulatory intervention in troubled banks, options for deposit liabilities in insolvency and the possible necessity for preserving critical banking functions.

Before enacting any legislative changes, the Commission will formally consult on any draft legislation.

### The current DCS

The DCS was established in 1991 under the Financial Supervision Act 1988 s.21, to protect depositors in the event that a bank "*is unable, or is likely to be unable, to satisfy claims*" against it. There has only been one call on the DCS - in respect of BCCI, and all banks which contributed levies have since been repaid their contributions. As a result of this experience, there are some administrative changes to the DCS to be considered, which are outlined in Section 2C.

The current DCS compensates eligible depositors<sup>3</sup> with 75% x up to £20,000 of net eligible deposits. This limit has been the same since the scheme was introduced, as has a limit on levies from participant banks, which is 0.125% of total deposits, up to a maximum of £250,000 per year, per bank. Due to the cap on banks' contributions to the DCS, compensation payments to depositors could take many years to complete, depending on the size of the failed bank's deposit base.

The DCS Regulations were made by Treasury and the DCS is administered by the Financial Supervision Commission.

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<sup>1</sup> Formerly 100% of the first £2,000 + 90% of the next £33,000, now 100% of a depositor's first £35,000 of savings with one bank. – see <http://www.fscs.org.uk/>

<sup>2</sup> See <http://www.gov.im/lib/docs/fsc/handbooks/guides/Banking/bankingappendixc1.pdf>

<sup>3</sup> Eligible depositors include corporates and individuals, IoM residents and non-residents, with deposits of any duration in sterling and foreign currencies, net of any loans due to the bank. (See regulations for full details)

It is important that the Island considers its position in relation to its own deposit protection arrangements, as schemes in other countries covering parent groups are unlikely to cover branches or subsidiaries operating locally.

## Consultation

This document seeks the views of all banking licenceholders and other interested parties, and particularly those 31 banks which are DCS participants and are thus required to contribute levies in the event of the failure of a DCS participant.

Views are sought on the options for a future DCS outlined in this paper. The paper also provides a summary of the depositor data collected.

As this is a narrow consultation, full explanations of all options have not been provided. Most questions should be resolved by reference to the legislation at <http://www.gov.im/lib/docs/fsc/handbooks/guides/Banking/bankingappendixc1.pdf>. However, if you require further clarification of any points, please contact Susan Woolard on 689333.

The Commission recognises that any competitive advantage of the Isle of Man having a DCS needs to be weighed against the cost to participants of funding the scheme. The UK's scheme is currently under review and other financial centres may also be reviewing their positions – some smaller centres do not have deposit compensation schemes at present.

The timing of this consultation is determined by the receipt of depositor data from banks and by the need to prepare a report for Tynwald. As a result, no late submissions will be accepted.

**Please respond by Monday 31<sup>st</sup> March 2008 at the latest.**

Please submit responses to: **Mrs Susan Woolard**  
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Queries may be made to: (01624) 689333

## SECTION 2 Options for a future depositors' compensation scheme

There are many possibilities for a future DCS. However, taking into consideration all relevant factors, and after discussion with the IoMBA, the Commission has narrowed the possibilities down to those that follow. Your views on these are sought.

In submitting your comments, please give an explanation as to why you believe that the option you suggest would be the best for your bank, the banking sector on the Isle of Man, and/or the wider economy/population.

### High level options

We suggest the following "high level" options are available:

1. Remove DCS altogether  
*This option would not seem to be tenable for reputational reasons.*
2. Keep current levels of compensation and levies unchanged  
*This is an option for consideration.*
3. Revise current DCS  
*A number of options are outlined below.*

### Options for revision of current DCS

#### A. Compensation – options

The following options are listed for discussion.

This table is divided into two rows - the first assumes no change to prospective payees but looks at possible changes to the level of protection; the second considers, as an example, the possibility of restricting protection to individuals.

Compensation paid to:	Amount of compensation			
Current payees (no change)	(1) No change - (max 75% x £20,000 ie <u>£15,000</u> max)	(2) Increase by RPI since 1991 (67.9%) (max 75% x £33,000 ie <u>£25,000</u> max)	(3) 100% x £20,000 max ie <u>£20,000</u> max	(4) £ equivalent of EU min – max 90% x €20,000 @1.3 ie <u>£14,000</u> max
Individuals only ( <i>see below</i> )	(5) No change (max 75% x £20,000 ie <u>£15,000</u> max)	(6) Increase by RPI since 1991 (67.9%) (max 75% x £33,000 ie <u>£25,000</u> max)	(7) 100% x £20,000 max ie <u>£20,000</u> max	(8) £ equivalent of EU min – max 90% x €20,000 @1.3 ie <u>£14,000</u> max

*“Individuals only” definition would exclude (from the current payees): trusts, clients’ accounts, collective investment schemes, all corporates & Government; but add in shareholders & managers where these are individuals. It is possible that this might be varied to allow for “parent re child” accounts and executors of wills, although this may be more difficult administratively for banks.*

The cost comparisons of the various options for levels of coverage are shown in Section 3.

- **Option 1** has a relatively low compensation limit and takes no account of inflation since 1991. However, as it is the current scheme, it would be simple and less contentious to continue and the level of protection it offers is comparable to the requirements of the EU.
- **Option 2**, as raised in Tynwald debate, maintains the real value of the deposit protection since 1991 and is closest to the UK's current level of compensation. However, the option is considerably more costly than the current DCS.
- **Option 3** offers a material increase in the level of compensation and has the benefit of a simplified scheme. The cost would be greater than for option 1, but less than for option 2.
- **Option 4** is a variation on the existing DCS, which could benefit some small depositors but provides lower compensation where net deposits exceed £15,000. However, a formal link to the EU scheme<sup>4</sup> could be problematic if the EU raised its limits.
- **Options 5 to 8** mirror options 1 to 4, but with reduced scope of coverage and thus reduced cost.

The Commission considers that an increase in the compensation level can, realistically, only be achieved if levies are increased or if the span of coverage is reduced to individuals only.

The Commission appreciates that an "individuals only" scheme would disadvantage fiduciaries clients, trust accounts and small companies. However, the advantages of increased coverage for those most at need may outweigh the disadvantages, with little increase in the burden on banks. Additionally, it would be administratively impractical to segregate the small corporates, trusts etc. from larger entities in these categories and any "size" boundaries would be subjective.

In line with the UK's reasoning for increasing their limit to 100% of £35,000, the Commission believes that a 100% payment would remove any element of loss for depositors whose deposits are less than the DCS ceiling limit. Also, a 100% figure is easier for depositors to understand and may be more successful in forestalling bank runs. There is however a negative consideration, that a 100% payment encourages moral hazard amongst depositors, who consequently may not seek more stable/secure institutions with which to place funds, although it is debatable to what extent most individuals consider these aspects.

## **B. Levies – options**

We suggest the following options are available:

1. No change (0.125% x total deposits, min £25,000, max £250,000 p.a. per bank)
2. Increase by the same % as any change to compensation level, or by RPI since 1991  
*This may be necessary if compensation levels are to be changed.*
3. Increase to a higher amount to facilitate earlier payment to depositors  
*This option would involve a higher cost to participant banks.*

Currently the maximum annual levy payment of £250,000 is payable by any bank whose total deposits exceed £200 million. When the levy figure was set in 1991, the Isle of Man's deposit base was £9.16 billion and there were 47 DCS participants. At the end of 2007 the deposit base was £50.54 billion and there are currently 31 participants.

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<sup>4</sup> The European Union Directive specifies a minimum coverage of 90% of deposits up to €20,000 ie £14,000 maximum. This EU limit is less than the coverage in the Isle of Man's DCS where a person's net deposits exceed £15,000, but the EU limit provides higher coverage where net deposits are below £15,000 (at €1.3/£). For information, Ireland's scheme pays 90%, up to a maximum of €20,000 (ie £15,384 maximum); Gibraltar's scheme pays 90%, up to a maximum of £18,000.

## C. Administrative changes

The Commission has identified that there are several potential administrative deficiencies in the current DCS legislation – eg definitions and technical issues re interest and subrogation. These issues have come to light during the administration of the current DCS and the Commission believes it is important to address most of the issues identified. Please see Appendix A for a list of these issues.

## SECTION 3 Summary of depositor data

As mentioned earlier, the Commission has obtained data from banks to assist with this review. A few banks have yet to respond fully to the request for information.

Approximate costs of various compensation options are shown more fully in Appendix B but are highlighted below.

### **EXAMPLE COSTS OF COMPENSATING DEPOSITORS**

For illustrative purposes, the following figures are based on the deposits of an “average” bank, (defined as the total of net deposits divided by the number of participants).

<i>Option</i>	<i>Compensation payable calculated on:</i>	<i>Compensation amount payable:</i>	<i>Average cost of compensating depositors:</i>
1.	All “net” deposits (approximate calculation, using present scheme)	Current limit: 75% x £20,000 per depositor ie <u>£15,000</u> maximum	£288,665,000
2.	All “net” deposits	Limit increased by RPI since 1991 (67.9%) (per Tynwald proposal): 75% x £33,000 ie maximum <u>£25,000</u>	£481,108,000
3.	All “net” deposits	Limit increased to 100% of <u>£20,000</u> maximum	£384,886,000
4.	All “net” deposits	£ equivalent of EU limit: 90% x €20,000 @1.3 ie <u>£14,000</u> maximum	£270,864,000
5.	Individuals’ “net” deposits only	Current limit: 75% x £20,000 ie <u>£15,000</u> maximum	£250,452,000
6.	Individuals’ “net” deposits only	Limit increased by RPI since 1991 (67.9%): 75% x £33,000 ie maximum <u>£25,000</u>	£417,420,000
7.	Individuals’ “net” deposits only	Limit increased to 100% of <u>£20,000</u> maximum	£333,936,000
8.	Individuals’ “net” deposits only	£ equivalent of EU limit: 90% x €20,000 @1.3 ie <u>£14,000</u> maximum	£235,144,000

The above table illustrates the very large cost of providing protection to the depositors of an average-sized bank. In view of the maximum rate at which levies can be collected, it is apparent that the timetable for paying protection, even under the current scheme, could extend to a number of years. The Commission is concerned that there is a public perception that the DCS provides more immediate protection than is actually the case – indeed, some person are unaware that the scheme is not pre-funded in any way.

#### **Explanatory notes re table of depositor data**

- Numbers of depositors and monetary amounts are shown in actual figures.
- “Net” deposits means gross deposits less loans that can be set-off against these deposits, calculated per person.
- The “net value of deposits” represents the maximum sums that would be payable to DCS claimants. Where the relevant data is available, this is (a) the total of net deposits below £20,000 plus (b) the number of depositors x the maximum payment for net deposits over £20,000.
- The average cost of compensating depositors is an average (across all 31 participant banks) of the total compensation payable if any one of these banks failed, under each of the compensation options.
- This is snapshot of data at one date – figures are an indication only.
- Not all banks were able to supply breakdowns of deposits under and over £20,000 per depositor, therefore sub-totals may not equal totals in all fields.

**DEPOSITORS' COMPENSATION SCHEME – Administrative changes**

- a. FSC is the scheme manager – Paragraph 5(1)  
*Suggest: this should be an independent party (perhaps a public-private body)*
- b. Payment of fund surplus to participants – paragraph 8(3) (linked to paragraph 15(2) & paragraph 15(4B) issues)  
*Suggest: this is only an issue re interest payments (see I below). Per previous discussions with licenceholders, there should be clear arrangements to deal with any surplus arising.*
- c. Collective investment schemes as depositors not clearly addressed – paragraph 9(3)  
*Suggest: removal of schemes as potential claimants*
- d. Secured deposits not defined but excluded – paragraph 10(3)  
*Suggest: secured deposits should be defined*
- e. Managers, shareholders and their associates excluded from eligible depositors – paragraph 10(4)(d)  
*Suggest: these categories should not be excluded (although directors & controllers should be excluded)*
- f. IPA licenceholders not excluded from eligible depositors – paragraph 10(4)  
*Suggest: these should be excluded in line with FSC licenceholders*
- g. Public sector not excluded from eligible depositors – paragraph 10(4)  
*Suggest: this should be excluded*
- h. Set-off not defined (legal/contractual?) – paragraph 10(5)  
*Suggest: this should be clarified*
- i. Maximum payment in any year not to exceed maximum income from levies – paragraph 11(2)  
*Suggest: Treasury to consider lending to fund to enable more prompt payment. However, a power to borrow already exists in paragraph 6(5).*
- j. No time limit for payment of levies – paragraph 12  
*Suggest: There is no cap on how long levy contributions are paid for and no limit can be imposed without limiting the total compensation payable to depositors. Therefore, it is suggested there should be no change.*
- k. Depositor must subrogate rights in respect of whole deposit in order to claim under DCS – paragraph 15(2) (linked to paragraph 8(3) & paragraph 15(4B) issues)  
*Suggest: Subrogation should only be in respect of amount claimed under DCS*
- l. Depositor is charged (compounded) interest on amount of compensation (at 2% p.a. over Base Rate) from receipt of compensation until recovery of sum by scheme manager – paragraph 15(4B) (linked to paragraph 8(3) & paragraph 15(2) issues)  
*Suggest: remove this clause & not charge interest*
- m. No time limit for payment of compensation to depositors  
*Suggest: The scheme could borrow to enable more prompt payment to depositors. (The time limit for payment of compensation in the EU is 3 months. The UK are considering shortening their time limit to one week)*

**DEPOSITORS' COMPENSATION SCHEME – ANALYSIS OF DEPOSITOR DATA**  
**SUMMARY OF DATA SUPPLIED BY PARTICIPANT BANKS - February 2008**

Please see explanatory notes on page 7.

Numbers of depositors	Depositor categories	Totals for all participant banks	Average of all participant banks
	(1) Individuals	520,677	16,796
	(2) Fiduciaries' clients' & trust accounts	19,289	622
	(3) All corporates (excluding 2 & 4)	57,694	1,861
	(4) Government & Inter-bank	640	21
	Total no. below £20,000 net deposits	305,602	9,858
	Total no. over £20,000 net deposits	73,583	2,373
	<b>TOTAL NO. OF DEPOSITORS</b>	<b>599,770</b>	<b>19,347</b>
Net value of deposits	Depositor categories	Totals for all participant banks	Average of all participant banks
	(1) Individuals	£22,004,211,000	£709,813,300
	(2) Fiduciaries' clients' & trust accounts	£3,953,780,000	£127,541,300
	(3) All corporates (excluding 2 & 4)	£11,495,224,000	£370,813,700
	(4) Government & Inter-bank	£2,791,176,000	£90,037,900
	Total no. below £20,000 net deposits	£5,161,232,000	£166,491,400
	Total no. over £20,000 net deposits	£25,467,217,000	£821,523,100
	<b>TOTAL NET VALUE OF DEPOSITS</b>	<b>£42,128,947,000</b>	<b>£1,358,998,300</b>

Cost of compensating depositors	Option	Average cost of compensating depositors
	(1) Compensation for all net deposits, (approx current rules) ie 75% x up to £20,000 per depositor ie <u>£15,000</u> maximum	£288,665,000
	(2) Compensation for all net deposits, at limit increased by RPI since 1991 (67.9%) ie 75% x up to £33,000 per depositor ie <u>£25,000</u> maximum	£481,108,000
	(3) Compensation for all net deposits, at increased limit of 100% of up to £20,000 per depositor ie <u>£20,000</u> maximum	£384,886,000
	(4) Compensation for all net deposits at £ equivalent of EU limit: 90% x €20,000 @1.3 ie <u>£14,000</u> maximum	£270,864,000
	(5) Compensation for individuals' net deposits only, at 75% x up to £20,000 per depositor ie <u>£15,000</u> maximum	£250,452,000
	(6) Compensation for individuals' net deposits only, at limit increased by RPI since 1991 (67.9%) ie 75% x up to £33,000 per depositor ie <u>£25,000</u> maximum	£417,420,000
	(7) Compensation for individuals' net deposits only, at increased limit of 100% of up to £20,000 per depositor ie <u>£20,000</u> maximum	£333,936,000
(8) Compensation for individuals' net deposits only at £ equivalent of EU limit: 90% x €20,000 @1.3 ie <u>£14,000</u> maximum	£235,144,000	