STATES OF JERSEY

FINANCIAL SERVICES COMPENSATION SCHEME

Lodged au Greffe on 19th September 2008
by Deputy P.V.F. Le Claire of St. Helier

STATES GREFFE

PROPOSITION

THE STATES are asked to decide whether they are of opinion −

to request the Minister for Economic Development to present proposals prior to July 2009, for a Financial Compensation Scheme for Jersey, with aims and objectives along the lines of, or similar to, the U.K. Scheme known as, the Financial Services Compensation Scheme (FSCS).

DEPUTY P.V.F. LE CLAIRE OF ST. HELIER

REPORT

The credit crunch and the collapse of Lehman and buyout of Merrill Lynch in September of this year were identified as probably the worst state of affairs in finance in the U.S. since 1929 when the stock market collapse led to the Great Depression. This was a mark in our Global History which I outline briefly here.

Brief History of the Stock Market Collapse of 1929

Throughout the 1920s a long boom took stock prices to peaks never before seen.

From 1920 to 1929 stocks more than quadrupled in value. Many investors became convinced that stocks were a sure thing and borrowed heavily to invest more money in the market. However in 1929, the bubble burst and stocks fell dramatically. By 1932 and 1933, they hit bottom, down about 80% from their highs in the late 1920s. This had sharp effects on the economy. Demand for goods declined because people felt poor because of their losses in the stock market. New investment could not be financed through the sale of stock, because no one would buy the new stock.

But perhaps the most important effect was chaos in the banking system as banks tried to collect on loans made to stock market investors whose holdings were now worth little or nothing at all. Worse, many banks had themselves invested depositors' money in the stock market. When word spread that banks' assets contained huge uncollectable loans and almost worthless stock certificates, depositors rushed to withdraw their savings. Unable to raise fresh funds from the Federal Reserve System, banks began failing by the hundreds in 1932 and 1933.

By the inauguration of Franklin D. Roosevelt as President in March 1933, the banking system of the United States had largely ceased to function. Depositors had seen $140 billion disappear when their banks failed. Businesses could not get credit for inventory. Cheques could not be used for payments because no-one knew which cheques were worthless and which were sound.

Roosevelt closed all the banks in the United States for 3 days– a "bank holiday". Some banks were then cautiously re-opened with strict limits on withdrawals. Eventually, confidence returned to the system and banks were able to perform their economic function again. To prevent similar disasters, the federal government set up the Federal Deposit Insurance Corporation, which eliminated the rationale for bank "runs" – to get one's money before the bank "runs out". Backed by the FDIC, the bank could fail and go out of business, but then the government would reimburse depositors.

Another crucial mechanism insulated commercial banks from stock market panics by banning banks from investing depositors' money in stocks.

Today

Financial markets continue to be affected by the broad-based re-pricing of risk and de-leveraging set in train by rising levels of default in the U.S. sub-prime mortgage market in the second half of 2007. Uncertainty about banks' financial positions and the associated loss of market confidence have led to a sharp reduction in liquidity in some credit markets, ongoing strain in money markets and a tightening in availability and standards of credit to households and companies. The current protection afforded consumers and companies in the U.K. is currently guaranteed for the first £35,000 at present but current U.K. Treasury Consultation points to the fact that the lead option set to be recommended is likely to be an increase in the compensation limit for protected deposits to £50,000 on a per person per bank basis.

The news on 18th September that Lloyds TSB was in the takeover of HSBOS was later that day augmented in the J.E.P. with an article which highlighted the total lack of protection that Islanders have in respect of protection for their savings. The Manager from the Jersey Citizens' Advice Bureau said that safeguards should be put in place to protect Islanders' savings. The report focussed mainly on the ability for U.K. residents to be able to access the scheme there which guarantees the first £35,000 of savings that a consumer has in a financial institution. It did not really cover the other aspects available through the U.K. provisions that protect consumers and businesses. I believe that no protection and a blind reliance on the good names of the banks is no longer adequate or prudent for

Jersey and its international reputation and standing. The J.E.P. on 18th September quoted a director of Jersey Financial Services Commission who said that there were no immediate plans to implement a deposits scheme, but added that because Jersey only accepted large, high-ranking banks, the chance of a collapse was likely to be low. Chances of a low-level of collapse do not remove the chance all together. Low risk does not equate to no risk!

In order to ensure confidence where I believe it is needed at this time, I believe we need to understand why Jersey has not got a scheme and why it should not have one as soon as possible. After all we have a scheme and there is a low level of risk, then there will be an equally low level of risk of ever having to use it.

In the U.K. at the time of writing this, with the banking crisis deepening, the U.K. Prime Minister Gordon Brown told Sky News "The behaviour of some of the financial institutions involved had been inexcusable".

He said: "We cannot excuse the irresponsibility that took place in a number of institutions. It's got to be cleaned up and it's got to be cleaned up quickly."

Pressed by the Daily Telegraph's Editor at Large Jeff Randall on whether he had failed to regulate the markets, Mr. Brown said"tough steps" had been taken.

The Daily Mail online, on 18th September reported the following –

> "Ruthless City traders who profit from falling bank shares are facing a 'bloodbath' after they were banned in a massive crackdown by watchdogs.
>
> The short-sellers who have been blamed for the extraordinary financial turmoil of the past few days stand to lose hundreds of millions of pounds after the practice was put on hold until January by the Financial Services Authority.
>
> Gordon Brown also pledged to 'clean up' the City amid mounting political pressure to stop the so-called 'robbers in pin stripe' making money from collapsing share prices, often driven down by the traders themselves spreading false rumours.
>
> Shares in HBOS, owner of the Halifax, fell so precipitously that it was forced to accept a £12.2 billion rescue takeover by Lloyds TSB in a move that unions fear will cost tens of thousands of jobs.
>
> Aggressive short-selling also played a key role in the collapse of investment bank Lehman Brothers and the emergency bailout of U.S. insurers AIG during the most tumultuous week on the world's financial markets for 80 years."

In Conclusion

No doubt much more will transpire prior to the debate but a debate at the earliest opportunity is needed at the very least.

<u>The U.K. scheme</u>

What is FSCS?

The Financial Services Compensation Scheme is the U.K.'s statutory fund of last resort for customers of authorised financial services firms, and can pay compensation if a firm is unable, or likely to be unable, to pay claims against it. In general this happens when a firm has stopped trading, and has insufficient assets to meet claims, or is in insolvency. The FSCS service is free to the consumer.

FSCS is an independent body set up by law. It was created under the Financial Services and Markets Act 2000 (FSMA) and became the single compensation scheme on 1st December 2001 when FSMA came into force, replacing former schemes. FSCS is funded by levies on authorised firms.

What they cover

FSCS covers business conducted by firms authorised by the Financial Services Authority (FSA), the independent watchdog set up by government to regulate financial services in the U.K. and protect the rights of consumers. European firms (authorised by their home state regulator) that operate in the U.K. may also be covered.

FSCS protects –

- deposits,
- insurance policies,
- insurance broking (for business on or after 14th January 2005),
- investment business, and
- mortgage advice and arranging (for business on or after 31st October 2004).

Who is protected?

FSCS was set up mainly to assist private individuals, although some smaller businesses are also covered. Larger businesses are generally excluded, although there are some exceptions to this for deposit and insurance claims. Our rules tell us which claims are eligible and form part of the FSA's Handbook of rules and guidance, under Redress, Compensation.

As an indicative guide only, a smaller company must meet two of the following criteria (as set out in section 247 of the Companies Act 1985 or section 382 of the Companies Act 2006)–

- 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

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The U.K. Scheme can be found at the following URL http://www.fscs.org.uk/

Some of the detail from the scheme appears below:

The qualifying conditions for paying compensation

COMP 3.2.1

The FSCS may pay compensation to an eligible claimant, subject to COMP 11 (Payment of compensation), if it is satisfied that:

(1) an eligible claimant has, for claims other than claims under a protected contract of insurance, made an application for compensation;

(2) the claim is in respect of a protected claim against a relevant person who is in default;

(3) where the FSCS so requires, the claimant has assigned the whole or any part of his rights against the relevant person or against any third party to the FSCS, on such terms as the FSCS thinks fit; and

(4) in the case of a claim under a protected contract of insurance:

(a) 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

(b) 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.1

COMP 3.2.2

The FSCS may also pay compensation to a person who makes a claim on behalf of another person if the FSCS is satisfied that the person on whose behalf the claim is made:

(1) is or would have been an eligible claimant; and

(2) would have been paid compensation by the FSCS had he been able to make the claim himself, or to pursue his application for compensation further.

COMP 3.2.3

Examples of the circumstances covered by COMP 3.2.2 R are:

(1) when personal representatives make a claim on behalf of the deceased;

(2) when trustees make a claim on behalf of beneficiaries (for further provisions relating to claims by trustees, see COMP 12.6.1 R to COMP 12.6.7 R);

(3) when the donee of an enduring power of attorney makes a claim on behalf of the donor of the power;

(4) when the Master of the Court of Protection makes a claim on behalf of a person incapable by reason of mental disorder of managing and administering his property and affairs;

(5) when an eligible claimant makes a claim for compensation but dies before his claim is determined.

COMP 3.2.4

2The FSCS may also pay compensation to a firm, who makes a claim in connection with protected non-investment insurance mediation on behalf of its customers, if the FSCS is satisfied that:

(1) each customer has borne a shortfall in client money held by the firm caused by a secondary pooling event arising out of the failure of a broker or settlement agent which is a relevant person in default;

(2) the customers in respect of which compensation is to be paid satisfy the conditions set out in COMP 3.2.2 R (1);

(3) the customers do not have a claim against the relevant person directly, nor a claim against the firm, in respect of the same loss;

(4) the customers would have been paid compensation by FSCS if the customers had a claim for their share of the shortfall, and if the firm were the relevant person; and

(5) the firm has agreed, on such terms as the FSCS thinks fit, to pay, or credit the accounts of,

without deduction, each relevant customer in (1), that part of the compensation equal to the customer's financial loss, subject to the limits in COMP 10.2.

Compensation Limits

The maximum levels of compensation are:

- **Deposits: £35,000** per person (for claims against firms declared in default from 1 October 2007).

  100% of the first £35,000.*

- **Investments: £48,000** per person.

  100% of the first £30,000 and 90% of the next £20,000.

- **Mortgage advice and arranging: £48,000** per person (for business conducted on or after 31 October 2004).

  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.

- **General insurance: unlimited.**

  Compulsory insurance (e.g. third party motor): 100% of the claim. Non-compulsory insurance (e.g. home and general): 100% of the first £2,000 plus 90% of the remainder of the claim.

- **General insurance advice and arranging: unlimited** (for business conducted on or after 14 January 2005).

  100% of the first £2,000 plus 90% of the remainder of the claim. Compulsory insurance is protected in full.

** The FSA changed the rules that govern compensation payments on 1 October 2007 to increase the total limit to £35,000. For deposit claims against firms declared in default before 1 October 2007, the maximum level of compensation is £31,700 (100% of £2,000 and 90% of the next £33,000).*

Depositors may still receive a share of their savings above £35,000 back following any distribution of assets as part of the insolvency process for a failed bank. This would be a matter for the insolvency practitioner to determine and any recovery would, by necessity, vary according to the circumstances of the specific failure.

The actual level of compensation you receive will depend on the basis of your claim. FSCS only pays compensation for financial loss.

Compensation limits are per person (per firm and type of claim).
Slightly different limits and rules apply if you have a claim against an insurer or a bank that was insolvent before FSCS became operational (1 December 2001), or if your claim is against an investment firm that was declared in default before FSCS became operational.

Financial and manpower implications

The finances for the scheme can be raised through licence fees from the finance institutions as in the U.K., so the costs and manpower would be small for the States but negated in the future as they would be an ongoing consideration of the JFSC.

Background Information

BANKING BUSINESS

Banking Business (Jersey) Law 1991 growth in banks and bank deposits

Year	Number of Banks	Sterling Deposits	Currency Deposits	TOTAL
1971	25			470
1972	25			590
1973	29			950
1974	29			1,060
1975	29			1,090
1976	29			1,050
1977	33			1,250
1978	34			1,500
1979	36			6,300
1980	39			7,900
1981	40	2,483	9,772	12,255
1982	42	3,089	10,576	13,665
1983	43	3,989	13,508	17,497
1984	45	4,413	16,156	20,569
1985	49	6,129	16,342	22,471
1986	52	7,140	15,701	22,841
1987	58	8,163	15,575	23,738
1988	59	10,471	17,346	27,817
1989	59	15,913	24,466	40,379
1990	60	20,759	23,655	44,414
1991	64	20,800	22,544	43,344
1992	66	22,532	30,917	53,449
1993	70	22,335	30,580	52,915
1994	76	22,426	42,532	64,958
1995	77	26,755	61,643	88,398
1996	77	28,908	60,711	89,619
1997	82	36,254	61,061	97,315
1998	79	36,491	66,785	103,276
1999	77	37,883	70,522	108,405
2000	74	39,827	77,424	117,251
2001	64	44,057	88,116	132,173
2002	59	47,489	91,840	139,329
2003	55	47,308	101,945	149,253
2004	51	51,366	106,783	158,149
2005	47	55,280	129,361	184,641
2006	46	60,609	129,088	189,697
2007	48	69,402	142,918	212,320

(Jun) 2008	47	68,794	128,072	196,866

£ Millions

Financial Analysis of current position has been varied: I include one synopsis here below –

The following was taken from the financial website www.Bloomberg.com in relation to the analysis of the collapse of LEHMAN and the buyout of Merril Lynch.

Sept. 17 (Bloomberg) -- Lehman Brothers Holdings Inc.'s collapse and Merrill Lynch & Co.'s takeover by Bank of America Corp. are the first examples of what bankers say will be a spate of takeovers, as forced sellers seek an exit.

"There will be more bank consolidation and asset sales as people are forced to take tough decisions," said Philip Keevil, a senior partner in London at Compass Advisers LLP and former Salomon Smith Barney Inc. banker. "It will be the weak offering themselves to the strong."

Barclays Plc agreed today to buy Lehman's U.S. investment banking unit for $1.75 billion, three days after abandoning plans to acquire the entire securities firm. American International Group Inc., which received an $85 billion bailout from the U.S. government yesterday, is most likely to repay the loan by liquidating or selling assets, central bank officials told reporters on the condition of anonymity.

"We are now entering the next phase of the crisis, one that may require forced consolidation," UBS AG analyst Philip Finch said in a note to clients this week. The broker-dealer model used by investment banks is broken, and history suggests more banks will fail or be forced to merge following Lehman's collapse, he added.

Banks and insurers worldwide have booked more than $510 billion in losses and writedowns since the global credit crisis began about 13 months ago, wiping about $11 trillion from the value of global stocks along the way. That has prompted banks to seek cash injections and sell assets to shore up capital. Bank of America's $40 billion takeover ofMerrill is the biggest element of $71 billion in acquisitions announced this month alone, almost twice the amount in the same period a year ago, data compiled by Bloomberg show.

HBOS Sale Talks

Lloyds TSB Group Plc, the bank that considered buying Northern Rock Plc before it collapsed, is in discussions to buy HBOS Plc after the mortgage lender lost three quarters of its stock market value this year.

The banks are in "advanced talks," Edinburgh-based HBOS said in a statement today, without disclosing any details. A combination with Lloyds, based in London, would create a lender with a 28 percent share of the U.K. mortgage market, according to the Council of Mortgage Lenders.

"All these banks are going to have to clean up their balance sheets," said Bernard Gault, a London-based partner of Perella Weinberg Partners LLP. "People are going to have to decide what to do next."

Buyers may seek all or parts of Washington Mutual Inc., whose credit rating was cut to junk on Sept. 15, analysts and investors say. In the U.K., HBOS and Royal Bank of Scotland Plc were both earlier this year seeking to sell divisions.

Capital Raising

Seattle-based Washington Mutual has dropped 83 percent so far this year, leaving the lender with a market value of about $4 billion. Facing up to $19 billion in bad loans over the next 2½ years, the bank may be forced to sell all or part of itself to raise capital, according to analysts including Bert Ely, president of consulting firm Ely & Co. in Alexandria, Virginia. The banks may also have to sell parts of a nationwide 2,300-branch network to raise capital.

Edinburgh-based HBOS has also been exploring a sale of its Australian units that may raise as much $5.7 billion, three people familiar with the plan have said.

“There will be those looking to take advantage of the crisis,” said Charles Arsouze, a lawyer specializing in M&A, capital markets and securities law proceedings at Paris-based Fontaine Mitrani & Associates.

Edgy Buyers

Buyers are still skittish. In Europe, Royal Bank of Scotland has been struggling to sell its insurance units to bolster capital after reserves were depleted by writedowns and the purchase of part of ABN Amro Holding NV last year. Commonwealth Bank of Australia scrapped talks last month to buy ABN Amro’s investment banking and corporate finance units in Australia and New Zealand, citing financial market turmoil.

UBS’s Finch said banks that stand to benefit most from potential consolidation are Credit Suisse Group, JPMorgan Chase & Co. and HSBC Holdings Plc.

“The companies that are doing deals today are saying things have been way too expensive until now,” said Gault of Perella Weinberg Partners. “And it’s time to do something.”