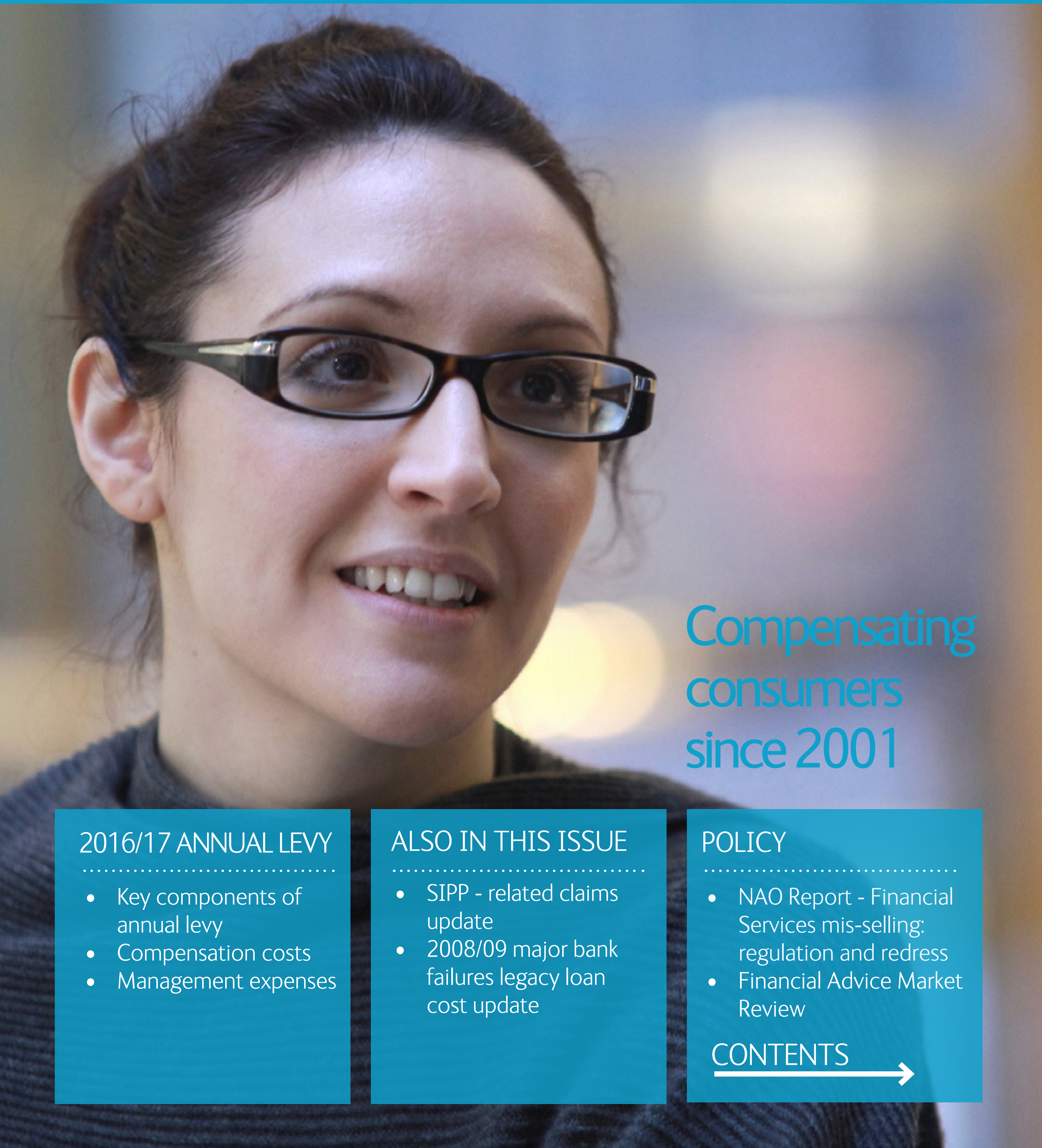
News from the Financial Services Compensation Scheme

outlook

fscs
Financial Services
Compensation Scheme

April 2016



Compensating consumers since 2001

2016/17 ANNUAL LEVY

- Key components of annual levy
- Compensation costs
- Management expenses

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- 2008/09 major bank failures legacy loan cost update

POLICY

- NAO Report - Financial Services mis-selling: regulation and redress
- Financial Advice Market Review

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CHIEF EXECUTIVE'S STATEMENT

Mark Neale, Chief Executive

In this edition of Outlook, we set out and explain our annual levies for 2016-17. We do so against a background of heightened interest in FSCS's levies following the publication of the Financial Advice Market Review.

So let us start with the facts.

This year's FSCS levies will, in aggregate, total £337m. That's lower than the indicative number we published in January of £363m, but higher than the levy for 2015/16 of £319m.

As before, these numbers do not include our levy on banks, building societies and credit unions to recover the interest costs of our loan from HM Treasury in respect of Bradford & Bingley: we also estimate that figure at £337m; nor do we include any unforeseen and sizeable defaults.

The reduction in the final levy compared to our January indication is reflected in falls in the levies for most industry sectors, including the investment intermediation sector which has seen a £14m decrease. The exception is the life and pensions intermediaries' levy which rises by £10m to £90m, because of an increase in the average cost of Self Invested Personal Pension (SIPP) -related claims[1].

In other respects, we have calculated our levies on the same basis we set out in January. This reflects the compensation expenses we expect to incur in the year ahead and associated management expenses offset by forecast recoveries and any balances remaining at the end of 2015/16. Our management expenses are falling for the second successive year as set out in our January Plan and Budget.

Compared to the January numbers, we expect to see higher fund balances at the end of this year as our new claims handling process beds in. As part of this new process, we collect the majority of evidence needed to assess a claim when the claim is first submitted. This has led to some backlogs at the beginning of the new process which we expect to resolve in 2016/17. To help address this, we revised our application forms this month –making them easier for customers to understand and complete. Under our funding rules, any unspent funds may be used to meet compensation costs in following years.

The most striking thing about the levies this year is their stability in the intermediary sectors. They are little changed in aggregate from last year. This is unusual. Our levies have in the recent past been marked by volatility and it is this which, understandably, many businesses find hard to absorb.

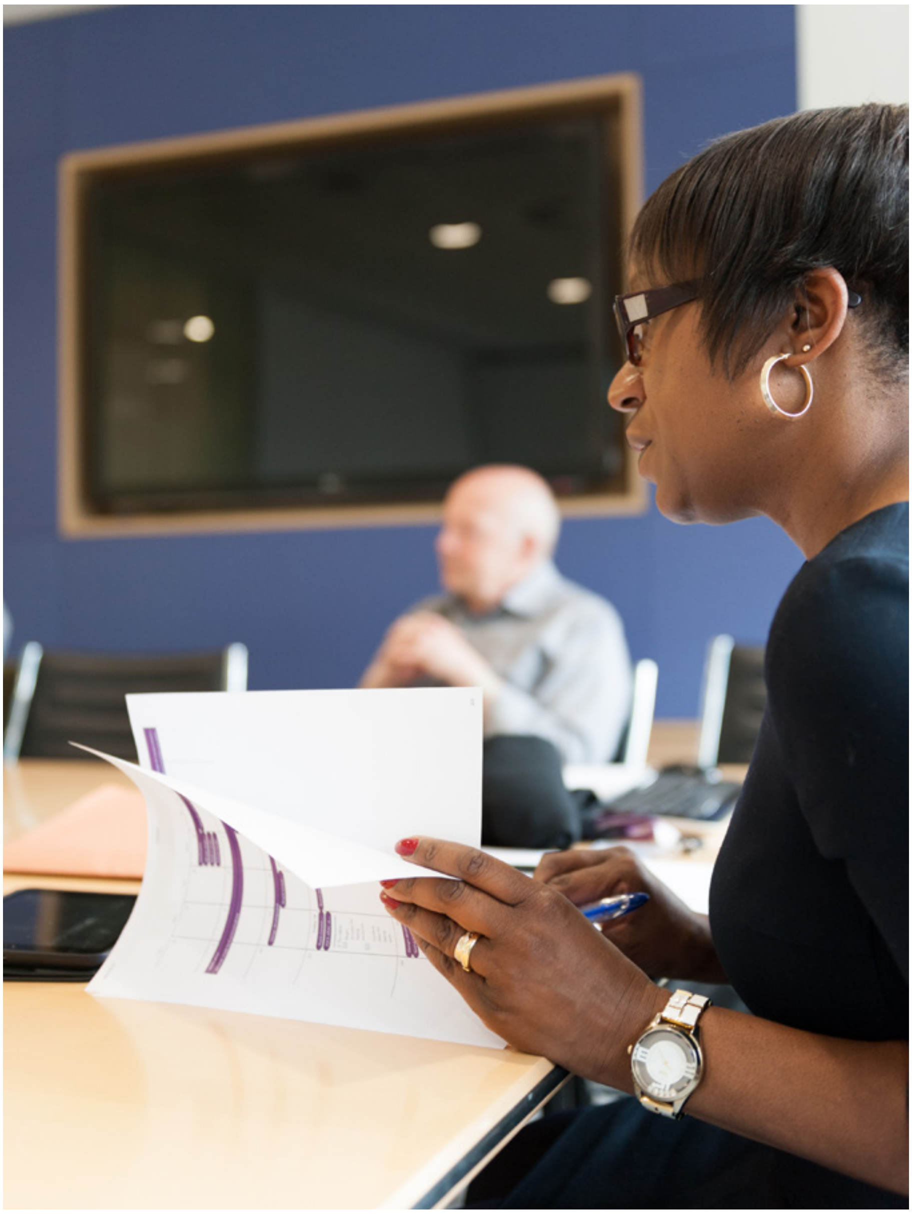
We very much welcome, therefore, the recommendations of the Financial Advice Market Review which invites the Financial Conduct Authority's (FCA's) forthcoming review of our funding to look at three possible reforms:

[1] These are claims which arise from advice about investments held within SIPPs

> Compared to the January numbers, we expect to see higher balances at the end of this year as our new claims handling process beds in.

- levying FSCS's compensation costs across broader pools than the current funding classes;
- dampening volatility through long-term borrowing in order to smooth the impact of major failures, such as Keydata; and
- risk weighting FSCS's levies so that firms running higher risk business models make a proportionately higher contribution to our levies.

We very much look forward to working with the FCA and the industry to explore the practicality of each of these possible ways forward. This is a welcome debate.



KEY COMPONENTS

OF 2016/17 ANNUAL LEVY

FSCS has reduced the final levy of £337m by £26m from the indicative forecast. This is largely because of a £39m reduction in forecast compensation in 2015/16, which funds are carried forward to this year.

The calculation of FSCS's annual levy is made up of several different components. It is primarily driven by our forecast of compensation costs, but the levy has to be adjusted to reflect both unspent balances or deficits (carried over from the previous year) and recoveries. The final levy also includes FSCS's management expenses.

For banks, building societies and credit unions, typically the greater part of the annual levy is accounted for by the continuing cost of FSCS's liabilities for the 2008/09 bank and building society failures. However, a combination of past years' levy payments and recoveries has significantly reduced the remaining balance. We expect that the interest incurred in 2015/16 on the Kaupthing Singer & Friedlander loan (now repaid) and Bradford & Bingley loan will be the only amounts to pay for the legacy banking failure loans in 2016/17.

Table 1: Final levy figures

Funding Classes	2016/17 Final Levy £m	2016/17 Indicative Levy £m	Variance £m	
Deposits (SA01)	24	28	(4)	↓
General Insurance Provision (SB01)	91	94	(3)	↓
General Insurance Intermediation (SB02)	8	19	(11)	↓
Life & Pensions Provision (SC01)	-	-	-	
Life & Pensions Intermediation (SC02)	90	80	10	↑
Investment Provision (SD01)	2	2	-	
Investment Intermediation (SD02)	94	108	(14)	↓
Home Finance Intermediation (SE02)	6	10	(4)	↓
Base Costs	22	22	(0)	
Total	337	363	(26)	↓

Compensation costs

- The total forecast compensation costs for 2016/17 are £325m, £2m lower than our previous forecast in January's Plan and Budget.

Management expenses

- Following a consultation undertaken by the FCA and the Prudential Regulation Authority (PRA), on the Management Expenses Levy Limit (MELL), and publication of FSCS's Plan and Budget, there is no change in the proposed management expenses budget. As indicated in our Plan and Budget 2016/17, the 2016/17 management expenses budget is £67.4m – down from £69.1m in 2015/16.

COMPENSATION COSTS

Table 2: Updated compensation costs forecast for the period to 30 June 2017

Funding classes	12-month forecast £m	3-year funding model £m	Trend £m	Used in levy £m
Deposits (SA01)	4.20	n/a	-	4.20
General Insurance Provision (SB01)	98.83	91.53	-	98.83
General Insurance Intermediation (SB02)	8.61	20.33	-	8.61
Life & Pensions Intermediation (SC02)	98.05	53.29	93.71	98.05
Investment Provision (SD01)	1.80	0.35	1.48	1.80
Investment Intermediation (SD02)	90.84	109.44	-	109.44
Home Finance Intermediation (SE02)	5.66	1.78	-	5.66
Total	307.99	276.72		326.59

Compensation costs

We project total compensation costs forward to 30 June 2017 to reflect the fact that each year our annual levy is issued and becomes payable from July. The element of our levy which covers compensation costs is based on a 1 July – 30 June year, with compensation costs arising in the first quarter of the 2016/17 financial year covered by the annual levies raised in 2015/16.

Firms will receive their annual levy bills from July 2016 (payable within 30 days). The FCA has established financing arrangements for firms who wish to spread the costs of fees and levies. Details of these arrangements are available from the FCA.

Unforeseen events in financial markets can have an impact on our claims assumptions, and our funding and subsequent levy requirements may change substantially as a result. We do not levy unless there is a reasonable expectation that we will have to meet the costs of claims in a particular area.

We expect the compensation costs for the period to 30 June 2016 (gross of projected recoveries) to be £327m. Our assumptions about compensation costs for the year ahead have been calculated using both our 36-month funding approach and the 12-month forecast, although for the General Insurance Intermediation class, we did not adopt the higher 36 month figure as we do not expect that to represent forward claims costs. These are set out by sector in table 2.

For investment fund managers, the refund of Keydata recoveries will be completed to the firms who funded the cross subsidy levy on 2010/11 in the coming months.

THE MAIN CHANGES TO THE COMPENSATION COSTS

(FROM THE INDICATIVE AMOUNTS)

Life and Pensions Intermediation (SC02)

We have increased the 12-month forecast for 2016/17 by £14m from the indicative figure of £84m announced earlier this year. The main cause of this is a higher average compensation cost for SIPP-related claims (the average cost has increased from £34,800 to £41,673).

Investment Intermediation (SD02)

We now expect the compensation costs in 2015/16 to be £80m, which is £24m lower than forecast in January's Plan and Budget. We have faced some challenges with the implementation of our new claims handling system, which has resulted in delays to decisions on complex investment claims that we had previously forecast for completion in 2015/16. We are working hard to improve the new system and expect to make up the lost ground. Those delayed claims will be decided and paid, if eligible, in 2016/17. As a result, we now allow for a year end fund surplus of £39m to carry forward into 2016/17.

SIPP - RELATED CLAIMS[1] UPDATE:

FSCS continues to see high volumes of SIPP-related claims. The claims typically involve advice given by financial advisers to transfer funds from existing pension schemes and invest them in high risk, non-standard asset classes held within SIPP wrappers. The investments within the SIPP wrappers have often become illiquid.

We first started to receive a large number of these claims in 2014/15 against a few firms, including TailorMade Independent Limited, 1 Stop Financial Services, Kynaston-Carnoustie Financial Consultancy Limited and Crawford Scott Limited. FSCS's experience of SIPP-related claims against advisers was consistent with alerts previously published by the FCA in connection with the conduct of some firms involved in advising on pensions. The FCA reminded firms advising on the suitability of pension transfers of the obligation to consider both the customer's existing pension arrangement and the underlying investments intended to be held within the SIPP.

This trend continued into 2015/16 with claims against an increasing number of firms. Over the past year, FSCS paid a total of £72m compensation to claimants with such SIPP-related claims.

[1] These are claims which arise from advice about investments held within SIPPs

FSCS

MANAGEMENT EXPENSES

FSCS management expenses for 2016/17 are calculated to be £67.4m, as set out in the Plan and Budget.

The base costs are levied by reference to the FCA and PRA fee blocks. The funding rules state that FSCS's base costs are first split equally between PRA and FCA firms. The 50% share that will be allocated to PRA firms will then be allocated to the individual PRA fee blocks by reference to the share of each fee block of the total PRA fees for that year.

Likewise, the same allocation will be made for the 50% share of base costs allocated to FCA firms.

The major components of the management expenses are set out in table 3, split between classes as shown on tables 4 and 5.

Table 3: Management expenses

Continuing operations		2015/16 Forecast (£m)	2015/16 Budget (£m)	2016/17 Budget (£m)
-	Staff costs	15.9	16.5	18.2
-	Contractor costs (non Strategic-Change)	2.7	1.2	0.9
-	Facilities	2.3	2.1	2.5
-	IT	3.3	3.3	4.1
-	Communications	4.2	4.2	4.8
-	Legal & professional	2.6	2.6	2.9
-	External providers	0.7	0.8	0.9
-	Other / contingency	0.5	0.6	0.5
Subtotal		32.1	31.4	34.8
Outsourced claims handling		12.8	12.1	9.9
Outsourced printing & scanning services		0.9	0.9	0.9
Operational total		45.8	44.4	45.5
Strategic Change portfolio		12.0	12.4	10.1
Operational & investment expense total		57.8	56.8	55.6
Bank charges		4.0	4.8	6.0
Keydata Investment Services Limited recovery expenses		0.2	3.0	0.0
PPI recovery initiative		1.2	0.0	2.5
Major banking failure-related management expenses		2.4	3.0	1.5
Total management expenses (excluding pension deficit funding)		65.6	67.5	65.6
Pension deficit funding		1.9	1.6	1.8
Total management expenses		67.5	69.1	67.4

Table 4: Split of management expenses budget

Base costs total (£m)	FSCS 23.40	PRA 11.70	FCA 11.70
Specific costs			
-Deposits (SA01)	14.20	14.20	
-General Insurance Provision (SB01)	5.45	5.45	
-General Insurance Intermediation (SB02)	9.48		9.48
-Life and Pensions Provision (SC01)	0.10	0.10	
-Life and Pensions Intermediation (SC02)	5.47		5.47
-Investment Provision (SD01)	0.14		0.14
-Investment Intermediation (SD02)	8.43		8.43
-Home Finance Intermediation (SE02)	0.72		0.72
Specific costs total	43.99	19.75	24.24
Total	67.39	31.45	35.94

Table 5: Final base costs levy for 2016/17

FCA	PRA	Fee Block	FCA £m	PRA £m
A000		Minimum fee block	0.47	
AP00		FCA Prudential fee	0.41	
A001	PA01	Deposit acceptors	1.83	7.61
A002		Home finance providers and administrators	0.46	
A003	PA03	General Insurers	0.6	1.43
A004	PA04	Life Insurers	1.00	1.86
A005	PA05	Managing Agents at Lloyd's	-	-
A006	PA06	The Society of Lloyd's	0.01	0.09
A007		Fund managers	0.97	
A009		Operators, Trustees and Depositaries of collective investment schemes and Operators of personal pension schemes or stakeholder pension schemes	0.36	
A010		Firms dealing as principal in investments	1.27	
A012		Advisory arrangers, dealers or brokers (holding or controlling client money or assets, or both)	-	
A013		Advisory arrangers, dealers or brokers (not holding or controlling client money or assets, or both)	1.75	
A014		Corporate finance advisers	0.33	
A018		Home finance providers, advisers and arrangers	0.43	
A019		General Insurance mediation	0.70	
A021		Safeguarding and administering of safe custody assets (without arranging) and who hold client money under the client money rules	0.41	
			11.00	11.00

2008/09
MAJOR BANK FAILURE
LEGACY LOAN COSTS UPDATE

FSCS has now repaid the loans taken out from HM Treasury for the Icesave, Kaupthing Singer & Friedlander, Heritable Bank and London Scottish defaults through a combination of recoveries and levies. On 14 January 2016, FSCS received £236m as a final distribution for the Icesave payout. FSCS used £165m of these proceeds to make a third interim payment against the liability to contribute to the costs of resolution in 2009 of Dunfermline Building Society. The total Dunfermline liability is expected to be capped at £578m (less interest on interim payments), but we have now made 3 interim payments to HM Treasury totalling £500m. The final settlement date is still uncertain but is assumed to be 31 December 2016. The latest estimate of the final bill for Dunfermline is £46m, and we currently expect this to be paid from cash balances and other recoveries. This would mean that no further levy would be raised for Dunfermline costs.

The only loan outstanding is for Bradford & Bingley. The capital balance remains at £15,654m. Our interest forecast on the loan for the 2016/17 year currently stands at £353m. During 2016/17, we will levy for the interest accrued during 2015/16 which amounts to £337m.

As part of the budget on 16 March 2016, HM Treasury announced that it was exploring sales of the Bradford & Bingley mortgages with a view to repaying the FSCS debt owed by Bradford & Bingley - allowing FSCS to repay the loan by the end of 2017/18. This may impact on the capital balance outstanding and reduce the interest payable.

Table 6: Liabilities due to HMT for legacy bank failures

£m	Bradford & Bingley		Other loans		Dunfermline	Total
	Capital	Interest	Capital	Interest		
Opening balance at 1.4.16						
Capital	15,654					15,654
Interest		335		2		337
Other liabilities					46	46
Total opening balance	15,654	335		2	46	16,037
Add: Interest for 2016/17		353*				353*
Less: Recoveries	TBC				(46)	TBC
Levies		(335)		(2)		(337)
Closing balance at 31.3.17	**TBC**	**353***		**nil**	**nil**	**TBC**

Note: this represents an estimate of the cost before accounting for any reduction in principal.

POLICY

NAO Report - Financial Services mis-selling: regulation and redress

On 24 February 2016 the National Audit Office (NAO) published its report on financial services mis-selling.

The findings show the FCA's strategic approach to managing its interventions in response to mis-selling is evolving. The FCA is developing 'common views' to bring together data and intelligence, helping it to analyse what is happening across regulated sectors and to identify the right interventions. This should help to inform the FCA's decisions on what to prioritise and improve its understanding of risks.

The report looks at how the FCA, FSCS, the Financial Ombudsman Service and HM Treasury manage mis-selling cases, specifically, how we administer redress schemes, regulatory responses and penalties imposed on firms. The report found that mis-selling has occurred across many product areas, including bank accounts, consumer loans and insurance, and that mis-selling is still a major problem in the financial services industry - in the last five years, financial services institutions have been fined £300m for mis-selling, and compensation of at least £22.2bn was paid to more than 12m PPI customers. FSCS paid compensation of £898m for mis-selling.

The report looked at how the costs of FSCS levies are passed on to consumers by firms and examined the approach of professional indemnity (PI) insurers in firm failures.

The NAO's report noted FSCS's concern around PI insurance stating that: "inadequate PI insurance is an important reason why [FSCS] is unable to recover more (as well as a contributing factor in firms' failures); some insurance contracts explicitly disallow payments to the FSCS in the event of failure. It said that it had raised this concern with HM Treasury and the FCA." However, whilst FSCS is discussed in the report there are no key findings or recommendations that relate directly to FSCS.

The report also scrutinised the role of claims management companies (CMCs). It revealed consumers have paid CMCs fees of £3.8 - £5bn in the past five years. Around 80% of PPI complaints to the Financial Ombudsman Service and 55% of claims to FSCS were made through claims management companies. HM Treasury has since published its report on the regulation of CMCs the Independent review of claims management regulation

Financial Advice Market Review and FSCS funding

The FCA and HM Treasury published the Financial Advice Market Review, final report on 14 March 2016. The report recommends steps to provide affordable advice to consumers, as well as increasing access to advice. It also aims to address industry concerns regarding future liabilities and redress, without affecting consumer protection.

The recommendations fall into three key areas:

- affordability – these include proposals to make the provision of advice and guidance to the mass-market more cost-effective;
- accessibility – these are aimed at increasing consumer engagement and confidence in dealing with financial advice;
- liabilities and consumer redress – some industry stakeholders suggested that concerns about future liability are preventing them giving advice today. The report has made a number of recommendations to address these concerns, while ensuring consumers have adequate protection.

Two recommendations particularly relating to FSCS require further review: FSCS funding and PI insurance.

As Mark Neale noted, the report recommends that the FCA's review into FSCS funding should explore:

- risk-based levies;
- reforming FSCS's funding classes; and
- whether firms' contributions could be eased by making more extensive use of the credit facility available to FSCS.

The FCA will start the funding review this spring. In light of evidence from this review, the FCA will also consider looking at the PI insurance market, in particular the suitability and availability of cover for smaller advice firms. There are concerns that inadequate PI insurance can result in the industry absorbing the liabilities, leading to higher numbers of firms exiting the market and, if costs

POLICY

are not met, greater costs for FSCS (and the levypayers). But the Financial Advice Market Review report stated it is important to establish the relationship between PI insurance and FSCS costs first before carrying out a review of whether the PI insurance market is fit for purpose.

The FCA's review will explore various FSCS funding options related to FCA funding classes, but it is vital that FSCS protection is understood by consumers and fair to the levypayers. FSCS encourages the industry to engage with the funding review.

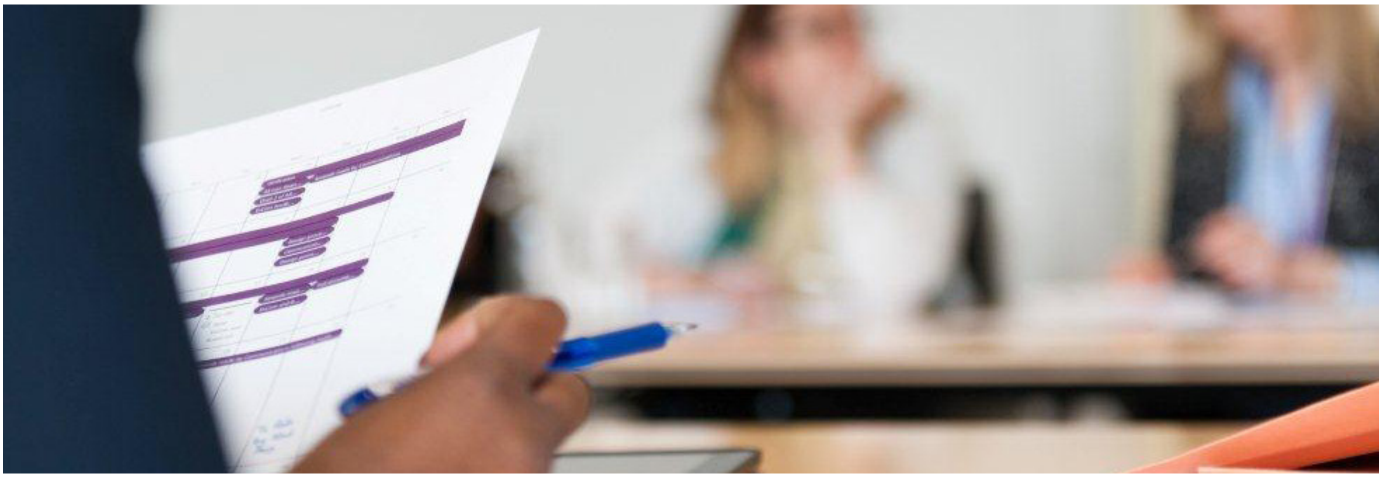
Update on the Deposit Guarantee Schemes Directive

From summer 2015, FSCS has had operational solutions in place for all aspects of the Deposit Guarantee Schemes Directive (DGSD), to deal with new eligibility, interim payments, temporary high balances etc. However, we have been working to improve current functions for:

- handling EU branch payouts with our EU counterpart schemes;
- paying temporary high balance claims; and
- working with the PRA on the publication of the recent risk based levy (RBL) consultation paper.

Under the DGSD, levies are to use a risk-based approach. The European Banking Authority (EBA) has issued guidelines for calculating the contributions and, on 4 March, the PRA published a consultation paper outlining the UK's intended approach to risk-based levies.

The consultation paper outlines how the PRA intends to calculate the degree of risk incurred by a DGS member. Levies for all deposit-takers would be risk-based, but the PRA proposes different calculation methodologies for Capital Requirements Regulation (CRR) firms, credit unions and non-EEA branches due to their different legal and supervisory regimes. The consultation period is open for three months and will close on 3 June 2016.



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FSCS Financial Services Compensation Scheme