

# outlook



April 2017

A close-up photograph of a woman with dark hair pulled back, wearing black-rimmed glasses and a dark sweater. She is smiling slightly and looking off-camera to the right. The background is blurred with warm, bokeh light spots.

## Compensating consumers since 2001

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# CHIEF EXECUTIVE'S STATEMENT

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Mark Neale, Chief Executive

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Today we publish our final levies for the year ahead, 2017/18. In all we shall levy £363m to help fund compensation costs which we currently estimate at £446m.

Our *Outlook* publication explains the main drivers of these compensation costs and how we have arrived at our final levies which also, of course, reflect our expected recoveries in the year ahead.

I should caution that the use of the word “final” by no means guarantees that our forecasts of compensation costs – and hence our levies – will prove definitive.

The levies are “final” only in the sense that they reflect the best and most up-to-date assessment we can make of likely compensation costs before the year begins.

As we saw in 2016/17, when we were obliged to raise three supplementary levies but were also able to make a substantial return of funds to investment advisers, much can happen during the year for better or worse. We do not have 20/20 vision.

However what you will see is reasonable stability between the indicative forecasts we published in our *Plan & Budget* in January and these latest levy numbers.

The forecasts underpinning this year’s supplementary levies have also proved to be broadly accurate.

The only material difference concerns the costs of the Enterprise Insurance failure, which we have been able to revise down in the light of new and better data from brokers. This means we expect to end 2016/17 with a general insurance surplus of just over £20m.

Otherwise, we expect to begin 2017/18 in the position we expected.

The only substantial change to our 2017/18 forecast since January affects life and pension advisers. A fall in the average cost of SIPP-related claims means that we now forecast compensation costs next year of £146m, compared to a forecast of £163m in January. These are claims which arise from bad advice to move retirement savings from occupational pension schemes into a SIPP and to invest in risky or illiquid assets within the SIPP wrapper.

There is a commensurate fall in our levy forecast which comes down to £147m. This is still well above the annual threshold for this sector, but in view of the volatility of these claims, we plan to raise an initial levy to the limit of £100m.

This means that we begin the year with the risk of a supplementary levy later in the year which, if it became necessary, would result in costs falling on other sectors through the retail pool.

“A fall in the average cost of SIPP-related claims means that we now forecast compensation costs next year of £146m, compared to a forecast of £163m in January.”

Finally, we publish these latest levy numbers against the background of the Financial Conduct Authority’s continuing review of FSCS funding.

The consultation document published by the FCA last December represents an important and comprehensive analysis of the issues. Those issues are not simply about how to share FSCS’s costs fairly across the industry, important though that is. The paper considers the interaction between FSCS protection and firms’ own professional indemnity insurance cover, so that FSCS is the last, not first, resort. And considers the scope of FSCS protection and the limits on compensation, including for retirement savings, where currently different limits can apply.

I strongly encourage all those with an interest in these issues to continue to engage with this review.



# KEY COMPONENTS OF 2017/18 ANNUAL LEVY

FSCS has reduced the final levy by £15m from the indicative forecast to £363m as shown below. The main reason for this reduction is that compensation costs paid in 2016/17 were £26m lower than expected, offset by a forecast increase in 2017/18 of £12m. The levy relating to the 2008/09 bank and building society failures will be £202m.

The calculation of FSCS's annual levy is made up of several components. It is primarily driven by our expectations for compensation costs, but the levy has to be adjusted to reflect both unspent

balances or deficits (carried over from the previous year) and any recoveries received. 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 on Bradford & Bingley and Dunfermline Building Society final costs will be the only amounts to pay for these bank and building society failures.

The funding requirement for 2017/18 has been updated to reflect the latest compensation claims and recoveries forecasts. The variances to the indicative levy of £378m are shown in [Appendix 1](#).

Funding classes	Final levy £m
Deposits (SA01)	9
General insurance provision (SB01)	52
General insurance intermediation (SB02)	18
Life & pensions provision (SC01)	-
Life & pensions intermediation (SC02)	147*
Investment provision (SD01)	10
Investment intermediation (SD02)	88
Home finance intermediation (SE02)	14
Base costs	25
	<b>363</b>

To calculate the levy, the forecast closing fund balances of the current year at 30 June 2017 have also been updated following the latest reforecasts, including updates to the compensation, management expenses, recoveries, and levy forecast for 2016/17. The forecast compensation costs are set out in [Appendix 2](#).

\*The levy on life & pensions intermediaries is in excess of the annual limit for this sector of £100m. In view of the volatility of these claims, we plan to only raise an initial levy to the limit of £100m. We will raise an additional supplementary levy on the retail pool later in the year if required, although we currently forecast that a £47m levy on the retail pool will be required.

# COMPENSATION COSTS AND REASONS FOR MAIN CHANGES BY SECTOR

We project total compensation costs forward to 30 June 2018 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 to 30 June year, with compensation costs arising in the first quarter of the 2017/18 financial year covered by the annual levies raised in 2016/17.

Firms will receive their annual levy bills from July 2017 (payable within 30 days). Commercial financing arrangements may be available to firms that require them.

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 for compensation costs 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 2017 (gross of recoveries) to be £446m. This is an increase of £12m from the indicative forecast in January's Plan and Budget. (see [Appendix 2](#)).

Our assumptions about compensation costs for the year ahead have been calculated using both our 36-month funding approach and the 12-month forecast.

The forecast opening fund balance (at 1 July 2017) has increased by £13m to £35m since we made our indicative calculations.

The main reason is that the compensation forecast for the current year to 30 June 2017 reduced by £26m, from £445m to £419m. The reductions are mainly in the general insurance provision and life & pensions intermediation sectors. The insurance and investment intermediation sectors are largely as forecast at the turn of the year.

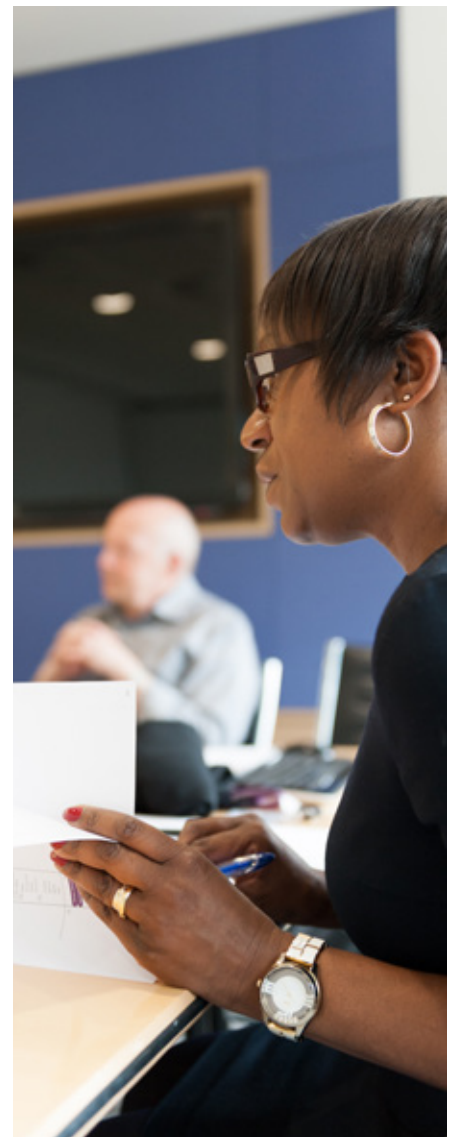
The key changes in amounts since the indicative forecast are explained below, by funding class.

## General insurance provision

The compensation forecast for 2016/17 fell by £22m from the figure of £179m used for the supplementary levy, to £157m. Most of this reduction is a result of FSCS receiving better claims data from brokers in relation to the failure of Enterprise Insurance.

We have experienced delays in obtaining verified broker data for Gable Insurance. These delays have prompted us to move £5m of costs back to the 2017/18 forecast. Reduced forecasts on Chester Street, BAI (Builders Accident Insurance) and Independent Insurance make up almost all of the rest of the 2016/17 expected underspend.

The reduction in compensation forecast in 2016/17 means that, following the £63m



“For the first time this year, the levies on deposits will be allocated on a risk-basis, as implemented by the PRA.”

supplementary levy, we will have a £23m surplus in the general insurance provision sector at the end of the 2016/17 levy year. This surplus will be set against the higher than forecast costs in 2017/18, along with the expected £86m recoveries (see page 8).

The 2017/18 compensation forecast has gone up by £29m since we announced the indicative levy in January, from £128m to £157m. This reflects in part the rephrasing of the forecast compensation costs on Enterprise Insurance and Gable Insurance, but also higher claims costs which we expect to incur following the Government's decision to change the discount rate on personal injury compensation awards, which came into effect on 20 March 2017.

As a result, injury compensation payment values are set to rise. This will have a significant impact on the insurance industry as a whole and is likely to increase FSCS's liability on many estates. We have therefore added £21m to our forecast compensation total for 2017/18.

We have not factored in any material new failures to the 2017/18 annual levy figure for this sector.

#### Life and pension intermediation

The levy has decreased by £24m from the indicative forecast largely because of a lower average compensation cost for SIPP-related claims. Approximately 93% of the costs in this class are for SIPP-related claims and the forecast average

claim value has reduced from £36,000 to £32,000.

The forecast costs for the sector in 2017/18 are now expected to be £146m, which is £17m below the indicative figure of £163m. The costs for 2016/17 have decreased by £9m since the supplementary levy was calculated for the same reason.

The 12-month forecast is still the appropriate basis for the compensation forecast as compared to the three-year historical average, as the three-year average does not sufficiently allow for the recent increase in the volume of SIPP-related claims.



“We are forecasting £27m recoveries on investment intermediation in 2017/18.”



Levies in other sectors are in-line with the indicative figures we published in our Plan and Budget in January.

#### Deposits

There has been a small reduction of £2m in the levy, which covers the usual, expected costs of several credit unions failures in the course of the year. For the first time this year, the levies on this class will be allocated on a risk-basis, as implemented by the Prudential Regulation Authority.

#### General insurance intermediation

Following the FCA's announcement of a two-year cut off for PPI claims and the surrounding publicity that can be expected to continue, we expect an increase in such claims over the next year or so.

#### Investment provision

We have increased the levy by £1m to £10m following an increase in claims in 2016/17 that was not sufficient to warrant a supplementary levy. These claims were mainly in relation to SIPP providers.

#### Investment intermediation

We continue to see claims in this sector and have adjusted the forecast costs for the year, increasing the levy by £4m to £88m. These costs relate to a range of different claims. Last year we were able to make a refund of £50m to firms in this class. However because of the historic volatility in this sector, we have decided to raise the levy on the three-year forecast model to allow for future unexpected failures and costs.

#### Home finance intermediation

The forecast levy remains unchanged at £14m. Although we had levied in January for an unexpected spike in claims on this class, these were attributable to one particular failure and do not appear to represent a trend.

#### Material recoveries

In a number of classes we reduce the levies in anticipation of recoveries. We are expecting additional recoveries in the course of the year but they are not sufficiently material or certain at this stage to be factored into the levy calculations.

**General insurance provision** – In the next few weeks we are expecting to receive a final payment from the Independent Insurance estate of around £85m, and have included this amount in the 2017/18 figures, together with a small amount from other estates.

**Investment intermediation** – We are forecasting £27m recoveries on this class in 2017/18. We expect the main sources to be Alpari and ARM (Catalyst).

**Insurance intermediation** – We have recovered £10m to date for the benefit of this class, largely as a result of claims against various lenders. Recovery work will continue, but we are not in a position to publish any forecasts.

# MANAGEMENT EXPENSES

FSCS management expenses for 2017/18 are £69.2m, as set out in the Indicative Levy in the Plan and Budget and finalised in the PRA [policy statement](#). Following publication of the Plan and Budget, FSCS was able to increase the commercial borrowing facility, from £1.1bn to £1.3bn, providing greater access to liquidity (without needing to borrow from HM Treasury). The recoveries from the 2008/09 bank failures have funded interest repayments, reducing the need to levy, and allowing additional headroom to levy for unforeseen costs against FSCS's annual limits. This is at an increased cost of about £300,000, which FSCS will absorb within the published budget.

The allocation of expenses to classes is also unchanged since the Indicative Levy was published.

In March 2017, the PRA and FCA set the FSCS Management Expenses Levy Limit

(MELL) at £74.54m, including a reserve allowance.

The latest forecast for management expenses for 2016/17 is £69.4m against a budget of £67.4m, reflecting higher claims handling costs incurred this year. These relate in particular to the costs of handling claims against Enterprise and Gable insurance companies and for SIPP-related claims.

Consequently, we needed to access between £1m and £2.5m of unlevied contingency reserve included within the MELL set by the PRA and FCA.

This was confirmed to the PRA and FCA, announced to industry trade bodies and published on our website.

We did not intend to raise any additional levy in 2016/17 for these funds. Instead

we will recover them through the 2017/18 levies.

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 management expenses budget is shown in [Appendix 3](#), the split of management expenses is in [Appendix 4](#) and the base costs are provided in [Appendix 5](#).





# 2008/09 BANK FAILURE COSTS UPDATE

FSCS has now settled all liabilities to HM Treasury arising out of the banking and building society failures of 2008/09 with the exception of Dunfermline Building Society and Bradford & Bingley.

We continue to receive dividends from the estates of some of the other failures, in particular from the administration of Kaupthing Singer and Friedlander, which are used to reduce the costs to levy payers.

For Bradford & Bingley, the interest costs for 2016/17 are £306m. We expect to meet part of this from recoveries already received and to levy for the balance of £202m during the summer of 2017.

On 31 March 2017, HMT announced Bradford and Bingley had agreed the sale of mortgage assets for £11.8bn. UK Asset Resolution announced this was expected to result in a payment of £10.9bn to FSCS and that further sales were planned with a view to fully paying Bradford and Bingley's obligations to FSCS. As repayments are received, this will reduce the size of FSCS's loan from HM Treasury and the amount of interest accruing on that loan. The interest which accrues during 2017/18 will be levied in the summer of 2018 and is expected to be materially lower than in previous years.

For Dunfermline, we expect to agree and settle the final amount of our liability to HMT during the course of 2017/18. This will be met through funds already to hand, so no further levy would be required.



# APPENDICES

## Appendix 1

### Final levy figures (by funding class)

The individual components of the final annual levy compared with the indicative levy announced in January are shown below:

Funding classes	Indicative Levy	Final Levy £m	Variance
Deposits (SA01)	11	9	(2)
General insurance provision (SB01)	52	52	0
General insurance intermediation (SB02)	13	18	5
Life & pensions provision (SC01)	-	-	-
Life & pensions intermediation (SC02)	171	147	(24)
Investment provision (SD01)	9	10	1
Investment intermediation (SD02)	84	88	4
Home finance intermediation (SE02)	14	14	-
Base costs	24	25	1
	<b>378</b>	<b>363</b>	<b>(15)</b>

## Updated compensation costs forecast for period to 30 June 2018

## Indicative Levy Proposal

2016/17				2017/18					
	Forecast (Dec 16) £m	Forecast (Feb 17) £m	Variance £m	12-month forecast £m	3-year historical average £m	Trend £m	Forecast used in final levy £m	Forecast used in indicative levy £m	
Deposits	4.34	3.46	0.88	4.20	n/a	n/a	4.20	4.20	Deposits outside scope of 3-year funding model
General insurance provision	179.42	157.59	21.83	156.78	112.72	n/a	156.78	128.13	No trend, 12-month forecast greater than 3-year average
General insurance intermediation	13.74	13.98	(0.24)	15.00	13.49	n/a	15.00	14.87	12-month forecast deemed most appropriate
Life & pension intermediation	146.20	138.32	7.88	145.92	93.84	n/a	145.92	163.32	12-month forecast deemed most appropriate
Investment provision	5.04	6.01	(0.97)	-	2.33	n/a	2.33	2.00	No trend, 3-year average greater than 12-month forecast
Investment intermediation	79.51	82.50	(2.99)	69.05	108.86	n/a	108.86	108.28	No trend, 3-year average greater than 12-month forecast
Home finance intermediation	17.22	17.50	(0.28)	13.27	7.12	n/a	13.27	13.27	No trend, 12-month forecast greater than 3-year average
	<b>445.47</b>	<b>419.36</b>	<b>26.11</b>	<b>404.22</b>	<b>338.36</b>		<b>446.36</b>	<b>434.07</b>	

## Final management expenses budget

	2016/17 forecast £m	2016/17 budget £m	2017/18 budget £m
<b>Outsourcing costs</b>	<b>15.3</b>	<b>10.8</b>	<b>15.3</b>
Employment costs	17.1	18.2	17.8
Other staff costs	2.8	0.9	0.8
<b>Total employment costs</b>	<b>19.9</b>	<b>19.1</b>	<b>18.6</b>
Strategic change portfolio	10.1	10.1	9.0
Communications	4.1	4.8	4.0
Other core costs	17.8	19.3	19.4
Major banking failures	0.2	1.5	1.0
<b>Total management expenses (excluding pension deficit funding)</b>	<b>67.4</b>	<b>65.6</b>	<b>67.3</b>
Pension deficit funding	2.0	1.8	1.9
<b>Total management expenses</b>	<b>69.4</b>	<b>67.4</b>	<b>69.2</b>

## Split of management expenses budget

	FSCS	PRA	FCA
Base costs total (£m)	27.86	13.93	13.93
Deposits (SA01)	11.13	11.13	
General insurance provision (SB01)	4.17	4.17	
General insurance intermediation (SB02)	6.48		6.48
Life & pensions provision (SC01)	0.01	0.01	
Life & pensions intermediation (SC02)	7.51		7.51
Investment provision (SD01)	0.01		0.01
Investment intermediation (SD02)	10.71		10.71
Home finance intermediation (SE02)	1.36		1.36
<b>Management expenses total</b>	<b>69.24</b>	<b>29.24</b>	<b>40.00</b>

## Final base costs levy 2017/18

FCA	PRA	Fee block	FCA £m	PRA £m
A000		Zero fee block (A000)	0.53	
AP00		FCA prudential fee (AP00)	0.45	
A001	PA01	Deposits (A001)	2.00	8.11
A002		Home finance providers (A002)	0.45	
A003	PA03	General insurance (A003)	0.70	1.93
A004	PA04	Life insurance (A004)	1.17	2.36
A005	PA05	Managing agents at Lloyds (A005)	-	-
A006	PA06	Society of Lloyds (A006)	0.01	0.10
A007		Fund managers holding (A007)	1.26	
A009		Unit trust managers (A009)	0.34	
A010		Dealing as principal (A010)	1.45	
A012		Brokers holding (A012)	-	
A013		Brokers not holding (A013)	2.17	
A014		Corporate finance (A014)	0.39	
A018		Mortgage brokers (A018)	0.44	
A019		Insurance intermediaries (A019)	0.75	
A021		Firms holding client money or assets or both (A021)	0.39	
			<b>12.50</b>	<b>12.50</b>

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