News from the Financial Services Compensation Scheme

outlook

January 2018

Compensating consumers since 2001

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CHIEF EXECUTIVE'S STATEMENT

Mark Neale, Chief Executive

> "We were also particularly pleased with the proposal that FSCS's compensation limit for investments and for mis-selling should rise to £85,000."

When I wrote the introduction to the April edition of *Outlook*, I cautioned that we did not have 20/20 vision and that our levies for the year ahead were only "final" in the sense that they represented the best assessment we could make on the information then available. As always, a major purpose of this edition of *Outlook* is, therefore, to alert you to what changed in the first six months of the year and to any implications for our levies.

One important change affects the rules under which we operate. Following consultation, the Financial Conduct Authority (FCA) announced on 31 October that FSCS's levy year for the industry classes regulated by the FCA, which has previously run from 1 July to 30 June, should, from 2018/19, align with the financial year.

This is a welcome tidying up, making FSCS's levy year clearer to understand, but it does mean that FSCS must necessarily, to achieve alignment treat either 2017/18 or 2018/19 as a nine-month year. That in turn raises the question of whether, in a nine-month year, annual limits should be abated commensurately.

The FSCS Board has considered these issues with a view to fairness, consistency with the rules and firms' reasonable expectations.

The Board believes, after careful consideration, that these criteria would be best met by:

- proceeding with the levies announced in April and already collected for the levy year running from 1 July 2017 to 30 June 2018 and raising any supplementary levy or returning any excessive surplus that may arise over this period under our well-established policies;
- setting the levies for the 2018/19 financial year to reflect the additional costs expected to fall in that year between 1 July 2018 and 31 March 2019; and
- pro rating the levy limits applicable in that financial year, 2018/19, to 75 per cent of the annual limits to reflect the fact that firms' revenues available to fund the levy will be commensurately lower over this time period.

We have discussed the approach with the FCA, who are consulting on rules providing for this transition.

FSCS intends similarly to align the levy and finance years for general insurers (in respect of which FSCS has the necessary power under the existing rules) and is discussing with the Bank of England a rule change to achieve alignment for deposit-takers too.

> Customer satisfaction improved from 59 per cent in summer 2016 to a high of 83 per cent in summer 2017.

This approach to alignment means that FSCS would continue to treat 2017/18 as a full levy year on the basis announced in April, for which firms will have already budgeted. Over that year to 30 June 2018, we can now foresee the need for one supplementary levy and one return of an excessive surplus under our policies. The levy numbers in this Outlook are calculated on this basis.

The supplementary levy arises from continuing growth in the volume of SIPP-related claims falling on life and pension advisers. Our forecast in April was that these costs would amount to around £146m, but, because of the uncertainty attached to this forecast, we elected to raise a levy of only £100m – the maximum for this sector. We now calculate that, on current volumes and average costs, we shall need to raise only around an additional £24m in 2017/18. This cost will trigger a cross-subsidy and fall on the retail pool.

By contrast, we will return £20m to general insurers where, following recoveries, we now expect a surplus by 30 June of £28m. Our policy is to return a surplus if balances are in excess of £20m.

Before moving on from compensation costs, I should also acknowledge errors made by FSCS in handling Arch Cru claims. The full story is on page 10. The essence, however, is that over five years from 2012, we made under-payments of just over £814,000 and over-payments of just over £700,000. Once these mistakes came to light earlier this year as a result of a customer's complaint, we urgently established the cause of the error and reviewed our controls to reduce the risk of a recurrence. We have also made good the under-payments to the customers affected and are seeking re-payment of over-payments (where reasonable to do so). Inevitably, because of the time since settlement, some over-payments will be irrecoverable.

I can report better news on the efficiency of our compensation service. We have seen much more rapid take-up than we expected of our online facility for making claims to FSCS, which launched at the end of 2016. At the time of writing, 80 per cent of direct claims and 90 per cent of claims from representatives are reaching FSCS online.

We have been delighted with how quickly our customers have adopted this new channel. The service was designed from a user's perspective - we had customers' involvement in the design and delivery - and it shows the importance of listening to their needs. The success of the service has helped us contain the costs of claims handling despite a rise in the volume and complexity of claims and so, as things stand, this contributes to our confidence that we shall stay within our management budget.

We have also continued to invest in improving the service we provide. This benefits our customers, who are often distressed at having lost their savings, pensions or investments and have been unable to resolve their situation until they come to us. By offering an empathetic and efficient service, we help to restore confidence in the financial services industry more generally. Our customers tell us that they want us to settle their claims fairly and quickly and for us to give them updates on progress and make things simple and easy – the same set of needs being addressed by the wider industry. We have simplified processes, improved communication and reduced delays. This has reduced the time it takes to settle a claim by a third. Backlogs of overdue claims are down by 90 per cent. The result has been that customer satisfaction improved from 59 per cent in summer 2016 to a high of 83 per cent in summer 2017. While there is still more to do, we have made good progress.

On other fronts, we have successfully made further recoveries from PPI lenders so far this year. This will offset costs falling on insurance intermediaries. The litigation continues and we will update further in due course.

We have also played a full part in the FCA's review of FSCS funding. On 30 October, the FCA published a further consultation paper setting out the proposed outcomes of its review. We welcome these proposals, which we hope will be seen by firms as providing a fairer and more sustainable basis for sharing the costs of compensation across the industry. We were also particularly pleased with the proposal that FSCS's compensation limit for investments and for mis-selling should rise to £85,000. If adopted following the consultation, this change will provide fuller protection for retirement savings and other investments. We recognise that there is more to do to promote understanding of, and confidence in, FSCS protection, for products other than deposits.

LATEST POSITION

Funding indicators

Classes

- Lower risk of supplementary levy
- Medium risk of supplementary levy
- Higher risk of supplementary levy

Class	Status	Reforecast closing position (£m)
Deposits (SA01)	Lower risk	2.5
General Insurance Provision (SB01)	Lower risk	28.2
General Insurance Intermediation (SB02)	Lower risk	(0.2)
Life and Pensions Provision (SC01)	Lower risk	0.2
Life and Pensions Intermediation (SC02)	Higher risk	(23.9)
Investment Provision (SD01)	Lower risk	8.2
Investment Intermediation (SD02)	Lower risk	17.6
Home Finance Intermediation (SE02)	Lower risk	(4.7)

We comment overleaf, where the variance is material.

> The deposits class is currently broadly in line with forecast and carries a low risk of supplementary levy.

Class tables

Deposits

Deposits (SA01)	Original forecast 2017/18 (£m)	Latest actuals and forecast 2017/18 (£m)	Variance (£m)	Supplementary levy indication
B/Fwd 2016/17	6.7	9.7	3.0	
Compensation	(4.2)	(4.0)	0.2	
Recoveries	0.0	0.0	0.0	
Management expenses	(11.1)	(12.2)	(1.1)	
Levies	9.0	9.0	0.0	
Surplus/Deficit	0.4	2.5	2.1	●

The deposits class is currently broadly in line with forecast and carries a low risk of supplementary levy. To date, this year, four credit unions have been declared in default with compensation totalling £4m.

Outside the annual levy cycle, for the 2008/09 legacy failures, FSCS levied £202m in summer 2017 for the interest costs accrued in 2016/17, but levy payers will see a substantial reduction in this cost going forward. On 31 March 2017, UK Asset Resolution announced the sale by Bradford & Bingley (B&B) of certain mortgage assets. On 25 April 2017, as a result of that transaction, the amount that FSCS owes to HM Treasury reduced to £4.7bn, from the previous balance of £15.7bn. Interest continues to accrue on the loan and is payable annually, six months in arrears. Therefore, each summer, FSCS raises a levy on deposit takers for the interest accrued in the 12 months ending on 31 March of that year.

As a result of the reduced balance, FSCS has now forecast interest costs for 2017/18 (which will be levied in summer 2018) at £98m. The amount levied in summer 2018 may differ materially because of the impact of interest rates, transactions on other remaining open legacy bank failures, and any further B&B asset sales.

General Insurance Provision

General Insurance Provision (SB01)	Original forecast 2017/18 (£m)	Latest actuals and forecast 2017/18 (£m)	Variance (£m)	Supplementary levy indication
B/Fwd 2016/17	22.9	33.3	10.4	
Compensation	(156.8)	(140.6)	16.2	
Recoveries	86.0	89.3	3.3	
Management expenses	(4.2)	(5.8)	(1.6)	
Levies	52.0	52.0	0.0	
Surplus/Deficit	(0.1)	28.2	28.3	●

We are currently forecasting a large surplus of £28m in this class at the end of the current levy year, because of changes in the level and timings of compensation payments.

The higher than expected opening balance was attributable in part to delays in obtaining verified broker data for Gable Insurance, which prompted us to move more costs to the current year. Despite this, we currently expect to pay out £16m less in compensation than we forecast in April. The major factor in this reduction is the lesser than expected impact of changes to the discount rate on personal injury compensation (Ogden rate). This rate was reduced by the Government in March, which resulted in an increased compensation liability on many of our estates and was reflected in our early forecast. We are also still working on some of the largest and most complex claims against Enterprise Insurance and Gable. These liabilities would have been most affected by the rate change. It has since been announced that a portion of the Ogden rate change will be reversed, subsequently lowering our overall forecast.

As we are expecting a surplus in this class of about £28m, we will make a repayment to firms of around £20m in March. ■

General Insurance Intermediation

General Insurance Intermediation (SB02)	Original forecast 2017/18 (£m)	Latest actuals and forecast 2017/18 (£m)	Variance (£m)	Supplementary levy indication
B/Fwd 2016/17	(2.6)	0.6	3.2	
Compensation	(15.0)	(19.4)	(4.4)	
Recoveries	6.0	6.5	0.5	
Management expenses	(6.5)	(5.6)	0.9	
Levies	18.0	17.7	(0.3)	
Surplus/Deficit	(0.1)	(0.2)	(0.1)	●

PPI continues to be a significant workstream this year, and we now expect a moderate increase in new claims as a result of the FCA announcing the PPI claims deadline. However, taking all factors into consideration, we have reduced the management expenses forecast for this class.

There is little risk of a supplementary levy in this class this year. ■

Life and Pensions Intermediation

Life & Pension Intermediation (SC02)	Original forecast 2017/18 (£m)	Latest actuals and forecast 2017/18 (£m)	Variance (£m)	Supplementary levy indication
B/Fwd 2016/17	7.0	15.9	8.9	
Compensation	(145.9)	(130.8)	15.1	
Recoveries	0.0	2.1	2.1	
Management expenses	(7.5)	(10.8)	(3.3)	
Levies	100.0	99.7	(0.3)	
Surplus/Deficit	(46.4)	(23.9)	22.5	

In April, FSCS expected that the compensation costs in this class were going to be £146m for this levy year, well above the £100m annual levy limit for the class. We levied to the amount of the limit rather than triggering the retail pool, because of the uncertainty around the number of claims and their value.

Since then, the overall expected compensation costs for the year have reduced. The compensation forecast is now £15m below the estimated total from April. The lower than forecast compensation payments also resulted in a higher than expected opening balance in the class in June.

The main reason behind this is the reduction in average compensation for SIPP-related claims, which make up the majority of costs in this class. In addition the six-month average cost of each SIPP-related claim has reduced from £30,000 in January 2017 to £23,000 today. This reduction in average cost has been partially offset by a 4 per cent increase in the number of claims processed in the overall class, compared to forecast, and also an increase in the overall uphold rate from 61 per cent to 66 per cent.

We are currently expecting a closing deficit in this class of £24m. We will raise a supplementary levy. As we have raised £100m from this class, the supplementary levy will be raised against the retail pool in the same manner as last year.

Investment Provision

Investment Provision (SD01)	Original forecast 2017/18 (£m)	Latest actuals and forecast 2017/18 (£m)	Variance (£m)	Supplementary levy indication
B/Fwd 2016/17	(7.2)	6.2	13.4	
Compensation	(2.3)	(0.9)	1.4	
Recoveries	0.0	8.0	8.0	
Management expenses	(0.0)	(0.1)	(0.1)	
Levies	10.0	(5.0)	(15.0)	
Surplus/Deficit	0.5	8.2	7.7	

We are receiving claims against a number of firms in this sector but are not currently forecasting any supplementary levy for this year.

Investment Intermediation

Investment Intermediation (SD02)	Original forecast 2017/18 (£m)	Latest actuals and forecast 2017/18 (£m)	Variance (£m)	Supplementary levy indication
B/Fwd 2016/17	4.1	(4.7)	(8.8)	
Compensation	(108.9)	(76.6)	32.3	
Recoveries	27.5	18.6	(8.9)	
Management expenses	(10.7)	(7.3)	3.4	
Levies	88.0	87.6	(0.4)	
Surplus/Deficit	0.0	17.6	17.6	●

This year, FSCS elected again to raise the levy on the Investment Intermediation class on the basis of the three-year historical average for compensation costs rather than our 12-month forecast, to make allowance for unforeseen failures.

As with last year, we currently expect a surplus in the class, but because of uncertainties about the size and timing of potential compensation payable to customers of Strand Capital[1], we are not proposing a repayment to firms in this class at this time.

Home Finance Intermediation

Home Finance Intermediation (SE02)	Original forecast 2017/18 (£m)	Latest actuals and forecast 2017/18 (£m)	Variance (£m)	Supplementary levy indication
B/Fwd 2016/17	0.5	0.0	(0.5)	
Compensation	(13.3)	(17.7)	(4.4)	
Recoveries	0.0	0.0	0.0	
Management expenses	(1.4)	(1.1)	0.3	
Levies	14.0	14.0	0.0	
Surplus/Deficit	(0.2)	(4.8)	(4.6)	●

We have revised our forecasted compensation costs in this class upwards since the original levy, from £13m to £18m. This is largely because of an increase in uphold rates, which have risen from 29 per cent to 43 per cent since the start of the year, as well as a slight increase in the rate claims are processed.

We are now forecasting a £5m deficit at the end of the levy year, but this would be too small to consider a supplementary levy under our current policy[2].

1 FSCS became aware that Strand Capital had entered special administration in May 2017. FSCS is working with the joint special administrators to understand the implications for the firm's customers. https://www.fscs.org.uk/news/2017/may/update-for-customers-of-strand-capital-limited--fscs-assessing-impact-on-consumers/

2 https://www.fscs.org.uk/what-we-cover/products/home-finance-including-mortgage-advice/

TAKING ACTION

Enterprise Insurance Company Limited – what we did

Enterprise was the first high profile general insurance failure to trigger FSCS protection for some time.

Enterprise had about 1 million policies, ranging from motor, gap insurance, warranty claims, solicitors professional indemnity and teachers absence. The prospect of motorists not being able to drive at all or drive without insurance, made finding a resolution particularly urgent.

The turnaround time was rapid. The provisional liquidator was appointed on 25 July 2016. We were first advised of the company's difficulties on 22 July and declared the firm in default on 28 July, making the first payment on 3 August.

The short notice of failure and the insurer's Gibraltar location, where the insolvency legislation is less flexible than in the UK, made things more challenging.

The failure of an insurer passporting in to the UK also involves both regulators: the Prudential Regulation Authority (PRA) - with its statutory objective of policyholder protection, and the Financial Conduct Authority (FCA), as the regulator for incoming, passporting EEA insurers.

The provisional liquidator and FSCS were faced with a "hard" liquidation. This set a date for FSCS to have in place arrangements to transfer motor insurance which would terminate from that point.

In fact, FSCS secured significant transfers in the period to October, and beyond.

By the end of 2016/17, FSCS had paid out more than £40m in compensation, the majority for motor claims, and £13m for return of premium on motor policies.

Background

Enterprise offered many different forms of low cost and widely sold insurances, such as insurance-backed guarantees (IBGs) and warranties. IBGs were purchased by building contractors for the benefit of homeowners to guarantee the cost of remedial works under the "Green Deal" programme - typically for 20-year terms, but with low value premiums.

The business model of the insurer and the UK brokers and premium finance companies it dealt with were complex. The insurer sold through diverse, dispersed broker networks (MGAs), with each broker or network retaining policyholders' information. Client relationships (and data) could be held across hundreds of sub-brokers. The insurer's head office lacked a complete data set. Policyholders purchased insurance through programmes led by brokers not the insurer.

The premia of higher risk policyholders such as couriers and taxi drivers were often financed, and backed by, broker guarantees. As such, the brokers were at financial risk of policyholder default on repayments to the finance provider.

FSCS dealt with industry stakeholders including through the British Insurance Brokers' Association (BIBA) and two leading premium credit providers. This provided FSCS with an opportunity to generate stakeholder goodwill and a better understanding of FSCS's protection and requirements.

Motor Insurance

Shortly after the failure, FSCS was approached by a large broker wishing to transfer approximately 5,000 motor insurance policies. FSCS agreed to pay to the broker the 90 per cent return of premium due, on the instruction of policyholders and on the condition that the broker replicated the expiring motor insurance with a new provider, contributing the 10 per cent shortfall if required.

This ensured customer goodwill, and the avoidance of having to call on premium credit financiers. The broker had good, up to date records that FSCS could audit to verify the policyholders' eligibility, and payment was completed promptly and without difficulty.

Subsequent cases followed this model but where data quality was less satisfactory, this caused delays. Once adequate data had been provided, claims were quickly validated and paid. In some cases, verified data is still outstanding.

We have collaborated with BIBA to communicate the success of this approach and the important role of brokers but also the features (such as data quality), which assisted this outcome.

> “FSCS’s processes for calculating loss in relation to CF Arch Cru claims have been reviewed and updated.”

Non-motor

The liquidator has for the time being allowed most policies other than motor to continue in the liquidation. This has bought time for FSCS and policyholders.

Our good existing relationship with the liquidator has proven helpful. The experience underscores the importance of pre-existing relations, contingency planning, and adequate forewarning. We have also now entered into a Memorandum of Understanding with the Gibraltar FSC to enhance forewarning of future difficulties and information sharing.

The experience of Enterprise has also highlighted a number of potential improvements to FSCS protection, currently being considered with the authorities.

Arch Cru - update

CF Arch Cru funds were suspended by Capita Financial Managers in 2009. The wind up of the funds is continuing. FSCS began paying compensation to CF Arch Cru investors in 2011. CF Arch Cru investors were offered compensation on an interim basis until 2012. From 2012, investors have been paid compensation under the FCA’s Consumer Redress Scheme (CRS), using the CRS calculator.

Under CRS, the Net Asset Value (NAV) for each of the CF Arch Cru funds is used to calculate compensation. In June 2017, FSCS received a customer enquiry relating to the way their CF Arch Cru compensation had been calculated. A review of the customer’s CRS calculation identified that the calculator NAV had been incorrectly updated on four occasions, creating a cumulative error. Following the identification of these errors the CRS calculator was reviewed and tested with all required inputs updated.

In addition to the calculator inputs, a notable proportion of CF Arch Cru claims were identified where the fund charges paid by Arch Cru customers had not been accounted for at the point the compensation amount was calculated, leading to over-payments.

All CF Arch Cru claims where the CRS calculator had been used to calculate compensation have had calculations re-validated using the new calculator and updated guidance regarding charges. This was done in order to identify the total number and value of under/overpayments. As a result 1,075 customers have been identified as being underpaid a total of £814,086. The vast majority of these customers have now received additional compensation. 992 overpaid claims have been identified where FSCS will seek to recover overpaid amounts if possible. The total amount overpaid is £702,253.

FSCS’s processes for calculating loss in relation to CF Arch Cru claims have been reviewed and updated. In addition, the material impact of the issues identified with the CRS calculator has resulted in improvements being made to the way any claim calculator is designed, built and maintained.

MANAGEMENT EXPENSES UPDATE

FSCS Management expenses

Financial summary for six months to 30 September 2017

Management Expenses	YTD Actual (£m)	YTD Budget (£m)	2017/18 Forecast (£m)	2017/18 Budget (£m)
Core Costs	17.4	17.1	34.2	34.1
Outsourced Claims-handling	8.5	8.1	16.4	16.2
Total Core Costs	**25.9**	**25.2**	**50.6**	**50.3**
Strategic Change Portfolio	4.5	4.5	9.0	9.0
Total Operations and Investment Expenses	**30.4**	**29.7**	**59.6**	**59.3**
Financing & Major Recoveries Expenses	4.8	4.9	9.6	9.9
Total Management Expenses Levy	**35.2**	**34.6**	**69.2**	**69.2**

The major components of the management expenses are set out above. The latest forecast is for an outturn for the year of £69.2m, in line with the budget set at the start of the financial year.

There is an increase in Outsourced Claims-handling costs for the full year, reflecting our expectation that higher volumes of PPI and SIPP-related claims will continue for the remainder of the year.

However, we have spent less than expected on our financing costs and on the costs of recoveries from the legacy bank estates. ■

CONTRIBUTING TO CONFIDENCE AND STABILITY THROUGH **AWARENESS**

> “Consumer awareness is at 78 per cent, above our 70 per cent target.”

The FSCS plays an important role in promoting consumer confidence and reassuring people their money is safe. This contributes to financial stability and is one reason we have consumer awareness as a key imperative in our five-year vision.

New research, which followed a press campaign around the 10-year anniversary of Northern Rock, indicates consumer awareness is at 78 per cent, above our 70 per cent target.

During the first half of the year, FSCS featured in more than 1,800 articles in the traditional media and 3,700 social media posts. These conveyed the full spread of our coverage, reaching 76 per cent of all UK adults (across all demographics) an average of 21 times with our messages.

Our marketing programme targets the public to help increase or maintain awareness. It is primarily a digital programme, but also features radio advertising and partnerships with influential organisations and people.

Working with the industry is a key plank of our strategy. We're pleased to report a new ground-breaking agreement with deposit takers to use the FSCS protected badge in their mobile apps, online and in advertising.

We're grateful for the support of the industry and can see the difference this makes in the results we achieve. Our work on this front continues and is central to the new approach we're developing for insurance and pensions. We recently launched a new joint working group in this sector to help us develop proposals for firms to promote FSCS. ■

POLICY UPDATE

Funding Review

The publication of the FCA Consultation Paper CP17/36 on 30 October is a milestone in the development of an improved funding model for FSCS.

A proposed increased limit of £85,000 for investment claims is welcome as the existing limit of £50,000 has been in place since 2010 and FSCS is seeing an increase in the percentage of claims at or above the existing limit, partially driven by the increase in claims relating to investment advice and arranging around SIPPs.

The merging of the life and pensions and investment intermediation funding classes and requiring product providers to contribute 25 per cent of the compensation costs falling to the intermediation classes should help to reduce the volatility of FSCS levies to firms, in line with the conclusions of the Financial Advice Market Review (FAMR).

Questions around FSCS acting as the backstop rather than the first line of defence for consumers when a firm fails are also covered in CP17/36, alongside suggestions of holding funds in trust or surety bonds to cover losses for consumers when a firm exits the market. FSCS is fully supportive of the FCA's work in this area as the Scheme was always intended as a fund of last resort and such measures may reduce the overall FSCS bill for firms remaining in the industry. FSCS is also supportive of the FCA plans to consider a package of enhanced measures for the monitoring and supervision of the advice sector as a priority for its 2018/19 business plan.

A reduction in levy volatility and a robust and sustainable funding model that does not require constant reassessment can only benefit FSCS, our levy payers and ultimately consumers using the UK's world class financial services sector.

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