News from the Financial Services Compensation Scheme

# outlook

Financial Services Compensation Scheme

Half Year Review 2011

## Compensating consumers since 2001

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# CHIEF EXECUTIVE'S STATEMENT

Mark Neale, Chief Executive

**Welcome to our new look half year edition of *Outlook*.**

In my first contribution to *Outlook* this time last year, I discussed how important it is to FSCS to account to levy payers. The supplementary levy which followed the collapse of Keydata underlined the importance of good communication. I know that many businesses felt that the Keydata levy had not been foreshadowed clearly enough, so it is worth reiterating now that communication remains an important priority for us.

*Outlook* is one of a number of ways in which we discharge our accountability. And we did in fact foresee the likelihood of significant Keydata compensation costs in *Outlook* this time last year. We shall continue to use *Outlook* wherever possible, to give an indication of the scale of any additional compensation costs which we expect to meet.

Another way of discharging our accountability is by engaging with firms through our attendance at industry events such as the Smaller Businesses Practitioner Panel and the Financial Services Practitioner Panel. These were attended this year in July and October respectively by our Director of Corporate Affairs, Alex Kuczynski. Fellow FSCS Directors and I also meet the trade bodies once a quarter to update on developments and to discuss current issues. We are always very willing to consider other ways in which we can engage effectively with the businesses that pay our bills, and will be making some suggestions about this in a later issue of *Outlook*.

Of course, there is an inherent volatility and unpredictability about FSCS's workload which always means we must necessarily be cautious in making projections about future claims volumes and compensation costs. We recognise however that many levy payers are listed companies and have important reporting obligations, particularly at this time of year.

As a result we have published our latest projection of compensation costs in 2011/12 immediately after this introduction which I hope you will find useful. You will see we may now incur higher compensation costs than we estimated in the investment intermediation sector as a result of the failures of Keydata, Wills and Co and other stock broking firms. It is possible that these higher costs may cause us to raise an interim levy on the investment intermediation sector this year, although we are not yet able to take a final decision on this. Our current projection is that we may face a deficit of at least £40 million on investment intermediaries before the next levy becomes available. Read more about this on page 5

> “There is an inherent volatility and unpredictability about FSCS’s workload which always means we must necessarily be cautious in making projections about future claims volumes and compensation costs.”

There is also a risk of a deficit in the home finance intermediation sector as a result of an increase in claims relating to mortgage advice (although no interim levy is likely). By contrast we may end the year with a surplus in the general insurance sector.

I should also note here that we expect to determine the final liabilities of both fund managers and investment intermediaries for the 2010/11 levies once the final outcome of the levy review process is known. As there remain a number of outstanding issues we cannot be sure at what point the process will be completed. However, we are working hard to complete the process of considering the requests to re-submit tariff data made by a number of firms, balancing the need to do this as quickly as we can while also treating all requests consistently and fairly. Final liabilities will also depend on relevant recoveries made – of which more below – and on the final total amount of compensation paid in 2010/11.

The counterpart of our accountability to give as much warning as possible of compensation costs is our obligation to pursue recoveries. We pursue recoveries wherever it is both reasonably possible and cost effective to do so in order to reduce the burden on our levy payers. Following the Keydata failure, FSCS is therefore considering options to maximise the value of the Lifemark estate. FSCS has also initiated legal action against firms, such as IFAs, who advised consumers to make investments in Keydata products. This builds on the recovery of £30m which FSCS has already received from Norwich & Peterborough in respect of Keydata, which has helped to reduce the impact of this failure on levy payers.

On other fronts, we were also pleased that in October the Icelandic Supreme Court upheld depositor priority in the winding up of Landsbanki Islands hf, the owner of the Icesave branch. This means that FSCS now expects to recover a very high proportion of its total claim of £4.5 billion from the Landsbanki estate (including the amount funded by HM Treasury) and we have now received the first distribution totalling over £1.3 billion. You can read more about this in the section on recoveries.

FSCS has also been working to improve its readiness for the failures it might face. We are reviewing and exercising our contingency plans to ensure that they are fit for purpose to deal with any failures that might occur, particularly in light of the likely volatility and unpredictability of claims mentioned earlier. Read more about this on page 10.

Many of you will be aware that FSCS is simultaneously engaged in discussions with HM Treasury about the re-financing of the £18 billion of loans that we took out in 2008/09 to cover the costs of five major deposit failures. We hope to bring these negotiations to a conclusion before the end of 2011/12. We will make a further announcement then.

The news that the FSA is to review our funding in the first half of 2012 marks an important step for FSCS. The existing funding system has been the subject of much debate which we welcome. We encourage the industry to take a full and active part in this review. Your input is critical to developing a funding model for FSCS that commands wide support and is sustainable.

Following the launch of our Consumer Awareness programme at the start of 2011, we have reviewed the results and are now in the process of planning phase two of the programme. Again, a key element of this will involve us working closely with the industry to ultimately raise public awareness of the protection provided by FSCS thereby instilling confidence in the financial services sector.

# LEVY UPDATE

## Funding indicators for six months to 30 September

| SUB-CLASS (SECTOR) | | STATUS | REASONS |
|---|---|---|---|
| Deposits | SA01 | On track | |
| General Insurance Provision | SB01 | Potential surplus | Compensation costs have been lower than we estimated:<br>• We have made lower payments than expected in respect of Independent Insurance and Builders Accident Insurance. |
| General Insurance Intermediation | SB02 | On track | |
| Life & Pensions Provision | SC01 | On track | |
| Life & Pensions Intermediation | SC02 | On track | |
| Investment Fund Management | SD01 | Potential cross-subsidy | Potential risk of a cross-subsidy if compensation costs for CF Arch Cru and MF Global increase total investment intermediation costs above £100m threshold. |
| Investment Intermediation | SD02 | Likely deficit | Compensation costs have been higher than we estimated, and we now expect a deficit of at least £40m:<br>• The average compensation payments in respect of KeyData and Wills & Co claims have increased<br>• We have made more decisions than we projected on claims against Keydata, Wills & Co and other stock-broking firms.<br><br>This range excludes provision for CF Arch Cru and MF Global, as we currently have no basis for determining these amounts. However, we may need to add costs for claims in respect of these firms.<br><br>Due to the unpredictability of claims volumes, you should treat this estimate with caution. |
| Home Finance Provision | SE01 | No levy | |
| Home Finance Intermediation | SE02 | Possible deficit | Compensation costs have been higher than we estimated:<br>• We have seen a substantial increase in numbers of eligible claims. |

"As expected, we are receiving increasing numbers of PPI claims, with a 60% rise compared to the same period last year"

## When does FSCS raise an interim levy?

The decision to raise an interim levy has to be made taking into account the particular circumstances that are relevant at the time. Whilst it is not therefore possible to state categorically the circumstances that would give rise to an interim levy, we feel it is important to reiterate the following guidance:

- FSCS will only raise an interim levy where it has reasonable grounds for believing that the funds available to it to meet relevant compensation costs or management expenses for the period until the next levy is due are, or will be, insufficient. We cannot levy in advance where there is not a reasonable expectation that we would have to deal with claims in a particular sector.
- Borrowing between sub-classes or using our commercial facilities is generally only utilised as a way of managing short term cash flow, or where the amount of the funding shortfall is considered to be too small to warrant an interim levy.
- We would not normally expect to raise an interim levy on any sub-class for an amount of less than £10m, and would give careful thought to amounts upwards to say £20m, especially if the compensation became due close to the end of the financial year.
- FSCS does not take levy decisions, either to trigger or otherwise affect the cross-subsidy. The key purpose of the levy is to safeguard sufficient funding for known or reasonably expected costs, applied as within the rules.

### Costs of failures in the investment intermediation sector

As explained in our Plan and Budget 2011/12, we project total compensation costs forward to 30 June each year to reflect the fact that our annual levy only becomes payable from July. In effect, the element of our levy which covers compensation costs is based on a 1 July to 30 June year. Therefore compensation costs that arise in the first quarter of the 2012/13 financial year will be covered by the annual (and if necessary) interim levies we raise in 2011/12.

As outlined in the table on page 4, we now expect to incur higher compensation costs than we estimated in relation to the investment intermediation sector as a result of the failures of Keydata, Wills and Co and other stock broking firms. These higher costs mainly reflect a combination of higher claims volumes and higher average payments. It is possible that these higher costs may cause us to raise an interim levy this year, although we shall not take a final decision until later in the financial year. Our current projection is that we may face a deficit of at least £40 million on investment intermediaries before the next levy becomes available, although this could increase if the failures of CF Arch Cru Funds and MF Global result in claims to FSCS before the end of the levy year in June 2012. In respect of compensation costs FSCS has already levied £30m for this sector in 2011/12. The levy limit for this sector is £100m.

We will keep this under review and provide details of the amount and timing of an interim levy as soon as we can if we need to raise one. We will provide an update when we publish the FSCS Plan and Budget in early February, if not before.

## 2010/11 Interim levy rebate – update on tariff data resubmissions

FSCS has started refunding those firms whose request for a reduction or remission of their share of the interim levy announced in January 2011 was accepted. These requests result from applications to resubmit tariff data by certain investment management and investment intermediary firms.

Some requests are still under review, as we have needed to obtain additional information from many firms. In addition we are still receiving new requests and now expect this may continue until the start of the second quarter of 2012. We have revised our estimate of how long this process may take, and now expect to have issued decisions to most of the firms that have applied to resubmit their tariff data by the end of 2011. However, there remain a number of outstanding issues, so that the reconciliation process will now continue into the new year. We cannot be sure at what point the process will be completed.

We will determine firms' revised share of the interim levy once the final outcome of the whole levy review process is known. This will take account of the final costs of meeting compensation claims from Keydata and recoveries received. At that point further refunds or invoices will need to be issued.

## Payment protection insurance (PPI)

As expected, we are receiving increasing numbers of PPI claims, with a 60% rise compared to the same period last year (not including claims against Welcome Financial Services Limited). We have recently initiated a Contact Programme to approximately 14,000 customers of Wilmslow Financial Services Plc. However, we have not received the volume of claims in the six months to 30 September 2011 that we had anticipated, as outlined in the *Plan and Budget 2011/12*.

## Welcome Financial Services Limited

On 2 March 2011, FSCS declared Welcome Financial Services Limited (WFSL) in default. We were satisfied the firm was unable, or likely to be unable, to pay protected claims made against it in relation to PPI. We made arrangements to contact, within 12 months, all WFSL policyholders who were sold PPI policies after 14 January 2005. FSCS has received 27,800 claims to date, of which 16,600 have been settled at a total compensation cost of £27.8m (including cash payoutsof £14.8m).

The firm's restructuring arrangements provide for the firm to make payments to FSCS to cover costs and compensation. As a result of this arrangement, the insurance intermediation sector has not been required to provide any funding to compensate customers of this firm, and FSCS is not currently planning to raise a levy in respect of these costs.

## Update on CF Arch Cru Funds

In June this year, the FSA negotiated a package of up to £54 million with Capita Financial Managers Limited, BNY Mellon Trust & Depositary (UK) Limited and HSBC Bank PLC. The money will be used to make payments to certain investors in the CF Arch Cru Funds. FSCS is considering whether it will be able to pay claims to consumers who have claims against independent financial advisors. To date, we have received around 600 claims against various independent financial advisors that are no longer trading. The Scheme is also considering how it would quantify investors' claims for compensation, not only to take account of payments from the £54 million settlement fund, but also the residual value of the CF Arch Cru Funds.

It is still too early to say how much claims relating to Arch Cru will cost, and when the costs will fall due. However, it remains possible that claims will be paid during 2011/12. Which sector is responsible for the costs is currently uncertain and likely to depend on the circumstances of individual claims.

## MF Global

MF Global was placed into the special administration regime on 31 October 2011.

FSCS now expects some customers of the firm to have eligible claims, and is working with KPMG to establish the required data relating to claimants accounts. We cannot quantify potential claims at this stage, but do expect to be making compensation payments before June 2012.

Once we know more, we will clarify what claims we may be able to consider in relation to the firm, and how investors can apply for compensation.

# RECOVERIES

## How does FSCS fund recoveries?

As with all our costs, the cost of making recoveries is funded by the levy payers. Management costs are payable by the sector responsible for the activity giving rise to the compensatable claims. FSCS does not pursue recoveries as a deterrent or in any way as quasi enforcement proceedings, but to recover value for the levy payers. Costs are first deducted from recoveries before the proceeds are credited to the account of the relevant contribution group, and applied against future compensation costs or, refunded to levy payers.

### Bank defaults

Many of you will be aware that FSCS is in discussions with HM Treasury about the re-financing of the £18 billion of loans that we took out in 2008/09 to cover the costs of five major deposit failures. We hope to bring these negotiations to a conclusion before the end of 2011/12. A further announcement will be made at that time.

On recoveries the position for Bradford & Bingley remains that the company expects to repay the FSCS claim in full, albeit not for some years. We have received good levels of interim recoveries in the administrations of Kaupthing Singer & Friedlander Limited and Heritable Bank PLC (now at 63% and 64.58% respectively), and have received a first dividend (of 13.1%) from London Scottish Bank PLC.

### Icesave

FSCS successfully resisted a legal challenge to its status as a priority creditor in the winding up of the Landsbanki estate, the owner of the UK Icesave branch. Priority creditor status had been provided under emergency legislation passed by the Icelandic Government in response to its national banking crisis. FSCS, having taken on the rights of Icesave depositors accordingly became a priority creditor in the winding up.

The FSCS case was initially heard over four days by the District Court in March 2011, who ruled in favour of FSCS's status as a priority creditor. As the appeal to the Supreme Court was considered a case of national importance, seven (as opposed to the usual five) Supreme Court judges were appointed to hear the case. Six out of seven judges rejected the appeal and ruled in favour of FSCS, affirming FSCS's position.

FSCS now expects to recover a very high proportion of its total claim of about £4.5 billion (which includes that part funded by HM Treasury) and we have now received the first distribution totalling over £1.3 billion. As a result, the amount that FSCS shall need to levy in due course to cover the irrecoverable shortfall on the Icelandic banks will fall to less than £1 billion.

### Keydata recoveries

FSCS has received recoveries relating to Keydata of £30m from Norwich & Peterborough.

We believe claims relating to some Keydata products exist against some IFAs, and we have issued legal proceedings against a number of firms to seek to recover the costs of compensation paid to investors.

The costs attributable to Keydata recoveries will first go to the Investment Intermediation sector (as it is a management expense and SD02 is the class against which FSCS has properly allocated the compensation costs). Any net recoveries (i.e. after costs) will first be allocated to the Investment Fund Management sector up to the amount that sector contributed (in the interim levy). Any remaining recoveries will be applied to the Investment Intermediation sector.

# FUNDING

## Funding review

As Mark Neale mentioned, the FSA announced on 3 October this year that it is restarting the FSCS funding review and hopes to formally consult in the first half of 2012. The review will look at issues such as the composition of the funding classes, the levy thresholds applicable to each, and their tariff bases.

The review initially started in October 2009 but was put on hold 12 months later due to uncertainties around the impact of UK regulatory reform on FSCS, and the ongoing development of EU directives.

HM Treasury has now published its proposals on the future structure, rule making arrangements and accountability of FSCS, and further progress is being made on the EU Deposit Guarantee Schemes Directive (DGSD), although the final text remains uncertain. The European Commission may publish a draft directive on bank resolution in the near future, which may also raise future funding issues for FSCS.

## European legislation

As well as the DGSD, discussions around the revised Investor Compensation Scheme Directive remain underway at the European Commission and European Parliament. FSCS remains engaged alongside HM Treasury and the FSA in putting forward the UK position with regards to the proposals.

On 12 July 2010, the European Commission published a White Paper on harmonisation of insurance guarantee schemes. The FSA and HM Treasury submitted a joint UK response to the White Paper proposals in November 2010. The Commission published the responses to the White Paper on 16 February 2011. The Commission is expected to propose a draft directive in 2013.

# CAPABILITY

## Single customer view: verification process

The production of a single customer view (SCV file) by a deposit taker within 72 hours of default is critical in ensuring that the vast majority of depositors are compensated within the seven day payout target. All deposit takers were required to be able to produce these SCV files by 1 January 2011 and, for those subject to the electronic requirements, to submit a sample file for verification by FSCS by 31 January 2011.

The FSCS verification exercise applied a large number of tests to the files to ensure that they could be used for payout in the event of the failure of the deposit taker, and by the end of July 2011 FSCS had verified all the files submitted as planned. As a number of files were assessed as not being able to support payout, the Authorities allowed these deposit takers to make the necessary changes to their files and resubmit them for verification. There are now only a small number of files that require further work, and FSCS will continue to verify these.

FSCS would like to thank all the firms involved for their hard work to achieve this very necessary milestone.

Any firms interested in further exercises should contact fasterpayoutenquiries@fscs.org.uk .

## Faster payout update

FSCS's new faster payout requirements became effective on 1 January 2011, and by 30 September 2011, we had dealt with nine deposit failures under the new process, one of which was a bank.

In line with our new faster payout commitment we paid the vast majority of customers well within our seven day payout target. All other customers with active accounts were paid within 20 working days of the bank or credit union being declared in default.

In each case we worked with these firms to ensure a single customer view (SCV) of their customers' account details was ready for the payout process. For us to be able to meet our regulatory obligations and pay customers within the target timeframe, we are dependent on the data provided by the firm.

A small number of exceptions included 11 trust accounts held by customers of Southsea Mortgage & Investment Co Ltd. These types of account are complex in nature and it was necessary to gather further information from the account holders before the claims could be completed. There are also a small number of customers in each case that we were unable to pay for reasons outside of our control. For example, in the case of customers who have gone away, are deceased, or who request that we use a different method of payment, it is not possible to pay compensation within either seven or 20 working days (and these cases are reflected in the numbers provided in the table on page 10).

| NAME OF FAILED FIRM | TYPE OF FIRM | DEFAULT DATE | NUMBER OF CUSTOMERS | AMOUNT PAID: 1 APRIL TO 30 SEPTEMBER 2011(£) |
|---|---|---|---|---|
| Havant Area Savers Credit Union Limited | Credit union | 07 January 2011 | 11 | 1,360 |
| Ilfracombe & District Credit Union Limited | Credit union | 26 January 2011 | 25 | 9,230 |
| South East Birmingham Community Credit Union Limited | Credit union | 30 March 2011 | 689 | 19,650 |
| Southend Credit Union Limited | Credit union | 13 May 2011 | 1234 | 152,610 |
| Southsea Mortgage & Investment Co Ltd | Bank | 16 June 2011 | 414 | 6,810,300 |
| Caribbean Parents Credit Union Ltd | Credit union | 21 June 2011 | 190 | 129,130 |
| Worcestershire Credit Union Ltd | Credit union | 23 June 2011 | 765 | 108,270 |
| Lee Bank/Highgate Credit Union Ltd | Credit union | 08 July 2011 | 241 | 67,140 |
| Gallowhill Credit Union Ltd | Credit union | 06 September 2011 | 153 | 112,250 |

## Contingency planning

FSCS has also been working to improve its readiness for the failures it might face. We are reviewing and exercising our contingency plans to ensure that they are fit for purpose to deal with any failures that might occur, particularly in light of the likely volatility and unpredictability of claims mentioned earlier.

We are also reviewing the way we identify future risks that could impact FSCS – our horizon scanning. This will help to ensure that FSCS can identify any claim trends and be better prepared for failures when they happen.

## CONSUMER AWARENESS – PHASE TWO

FSCS is now planning phase two of its consumer awareness programme. The first phase ended in March and FSCS has been taking what it learned to shape its approach to the next phase.

This is likely to include emphasising the protection FSCS offers consumers, above the brand, and taking a more product based approach to reach consumers. Once again, the Scheme will be concentrating on working with the industry to get the messages across. The industry has a crucial role to play in educating consumers about the protection FSCS provides. It will continue to be a key element of our strategy.

Working with the industry was a key element of phase one, including getting wide ranging input from all of the trade organisations and consumer groups. FSCS will build on its work with firms for the next wave of activity. This will include work on a training module for front line staff FSCS is developing with the Financial Skills Partnership.

Research for FSCS suggests the quality of information the industry gives to consumers about FSCS protection is improving. However there is still some way to go.

Alongside this, we are working with the FSA on new proposals for deposit takers to display information about the compensation scheme, and will look to other sectors for similar initiatives. The FSA consultation (which was published on 14 December) contains proposals to require banks, building societies and credit unions to carry posters and publications in branch as well as stickers on their doors.

We will update you on phase two of the programme in the next edition of *Outlook*.

# ANNEX 1

## FINANCIAL SUMMARY FOR SIX MONTHS TO 30 SEPTEMBER 2011

| | | ** YTD ACTUAL £M | ** YTD BUDGET £M |
|---|---|---|---|
| Management expenses | SDD* | 0.33 | 1.36 |
| | Loan Interest | 177.50 | 172.56 |
| | Other | 23.36 | 31.49 |
| | | 201.19 | 205.40 |
| Compensation costs | SDD* | 36.39 | N/A |
| | Other | 147.95 | 147.87 |
| | | 184.34 | 147.87 |
| Recoveries received | SDD* | 71.53 | N/A |
| | Other | 33.63 | 2.12 |
| | | 105.16 | 2.12 |
| Levies received | SDD* | 338.85 | 338.85 |
| | Other | 219.45 | 224.28 |
| | | 558.30 | 563.13 |

NB: These numbers exclude all compensation costs and management expenses for Welcome Financial Services Ltd.

*SDD – Specified Deposit Defaults (Bradford & Bingley Plc, Kaupthing Singer & Friedlander Limited, Heritable Bank Plc, Landsbanki Islands hf (Icesave) and London Scottish Bank Plc).

** Year to date

# ANNEX 2

## MANAGEMENT EXPENSES PROJECTION FOR THE FULL YEAR

The following table compares FSCS Management Expenses outlined in the Plan and Budget: 2011/12 with our latest projection.

| | 2011/12 PROJECTION £M | 2011/12 BUDGET £M |
|---|---|---|
| Management expenses | | |
| SDD* | 1.41 | 2.72 |
| SDD* Loan Interest | 360.69 | 344.19 |
| Continuing Operating Expenses | 34.85 | 23.00 |
| Outsourcing Costs | 12.76 | 14.12 |
| Change Programme | 16.77 | 21.89 |
| | 426.48 | 405.91 |

*SDD – Specified Deposit Defaults (Bradford & Bingley Plc, Kaupthing Singer & Friedlander Limited, Heritable Bank Plc, Landsbanki Islands hf (Icesave) and London Scottish Bank Plc).

### The key points are:

- SDD Loan interest – the increase of £16.50m in the projection compared to the original budget is due to increased interest rates.
- Continuing Operating expenses – the 2011/12 projection is £11.85m higher than the 2011/12 Budget mainly due to the necessary legal fees associated with pursuing Keydata recoveries and the bank facility fees for a loan facility for up to £1bn as short term liquidity funding for FSCS. Neither of these were in the original budget.
- Outsourcing costs – the main reason for the reduction in outsourcing costs is due to lower than anticipated PPI claims volumes.
- Change Programme – the reduction in the internal change programme projection is due to some investment projects being moved into the next financial year (2012/13).

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