News from the Financial Services Compensation Scheme

outlook

April 2014

Compensating consumers since 2001

2014/15 ANNUAL LEVY

- Key components of annual levy
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POLICY

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CHIEF EXECUTIVE'S STATEMENT

Mark Neale, Chief Executive

Welcome to this edition of Outlook in which FSCS announces that its annual levy for 2014/15 will be £276m – just below the annual levy of £285m in 2013/14 and less than the indicative forecast of £313m which we published in January.

These aggregate numbers highlight some significant differences between the levies for individual industry sectors and the indicative numbers we published in January. These differences underline the intrinsic unpredictability of the demands on FSCS.

For example, the final levy on insurance intermediaries of £38m will be significantly lower than the £62m indication we gave in January. This reflects the fact that, in January, we still expected the volumes of PPI claims to grow. In fact, we have seen a reduction in such claims in recent months, mirroring the experience of the Financial Ombudsman Service. This has led us tentatively to conclude that we may now have passed the peak of PPI claims. We are taking a prudent approach as a result by reducing the levy. I should, though, emphasise that this fall could turn out to be no more than a lull rather than the beginning of a downward trend. We will continue to monitor the situation.

By contrast, we have raised the 2014/15 levy on investment intermediaries to £112m compared to an indicative number of £105m. This is because our processing of claims against Catalyst will begin later than we expected, with the consequent compensation costs falling into 2014/15. As a result, we cancelled our plans for the supplementary levy we had previously expected to raise in 2013/14.

FSCS has always taken a prudent approach when accounting for recoveries in our levy calculations. Significant recoveries have been made in 2013/14. This demonstrates that our work in this area continues to deliver value to the industry. We only pursue recoveries where it is reasonably possible and cost effective to do so.

In 2013/14, we recovered £336m. Of these recoveries, about £79m accounted for investment recoveries, including £44m from Lifemark and Keydata (after further distributions to investors). The investment recoveries will now either go back to the industry, in the case of fund managers, or offset compensation costs in 2014/15, in the case of investment intermediaries. You will find detailed information about the latest recoveries developments on page 10.

Finally, do take the opportunity to read my industry blog, *Perspectives*, which I publish each month. I have previously stressed the importance of being accountable to our stakeholders and *Perspectives* provides an opportunity to discuss issues not only affecting FSCS, but the wider industry, so I hope that you continue to find it informative. You can also sign up to our RSS feed on our website or follow us on Twitter @FSCSNews.

OUR FIVE YEAR VISION

In January 2014, we published our *Vision for a Confident Future* in which we describe our progress so far and share our plans and strategy for the next five years.

Our vision is one of a stronger, better compensation scheme for the millions of people who use financial services. This benefits firms by increasing consumer confidence and providing an efficient and effective compensation service.

The seven imperatives that FSCS must do to deliver consumer focus, efficiency and cost effectiveness are:

Modernising our service to consumers to provide a fast, reliable and responsive service at reasonable cost. This will involve:

- an online claims service, currently in development, which will give consumers greater choice in how they interact with FSCS regarding claims
- halving the time it take us to complete claims
- removing paper applications, reducing costs

Diversifying compensation routes. This will involve:

- working with our partners (in government and the regulators) to ensure continuity of service in the event of a failure

Raising awareness of the protection we provide. This will involve:

- continuing our consumer awareness programme which raises confidence in the financial services industry
- working alongside the industry to encourage them to continue to do the heavy lifting
- extending our awareness raising to other sectors over time

Improving our value for money. This will involve:

- being transparent with the industry on our spending
- maintaining our outsource business model for handling claims
- embracing a robust procurement process

Achieving excellence as a creditor. This will involve:

- ensuring FSCS maximises what it can recover for levy payers

Deepening contingency planning. This will involve:

- working alongside our key stakeholders to produce wide-ranging contingency plans and to test them
- enhancing our ability to "scale up" (or down) quickly and cost-effectively

Engaging our people. This will involve:

- exploiting and improving our people's skills and knowledge

Our *Vision for a Confident Future* puts all our stakeholders at the heart of what we do. It reflects our commitment to being open and transparent. It's a central part of our accountability, which will enable the consumer or levy payer to measure our progress.

To read the full document, please see our *Vision for a Confident Future*, which is available on our website.

KEY COMPONENTS
OF 2014/15 ANNUAL LEVY

FSCS's annual levies are made up of a number of different components. They are, of course, primarily driven by our forecasts of compensation costs, but these costs have to be adjusted to reflect both unspent balances (carried over from the previous year) and recoveries. The levies also reflect FSCS's management expenses. And for banks, building societies and credit unions, 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.

The final levy has reduced by £37m from the indicative total. The main components of the levy and the changes are shown below.

Table 1: Final levy figures

Funding Classes	2014/15 Final Levy £m	2014/15 Indicative Levy £m	Variance £m	
Deposits (SA01)	16	24	(8)	↓
General Insurance Provision (SB01)	71	72	(1)	↓
General Insurance Intermediation (SB02)	38	62	(24)	↓
Life & Pensions Provision (SC01)	-	-	-	
Life & Pensions Intermediation (SC02)	33	40	(7)	↓
Investment Provision (SD01)	-	-	-	
Investment Intermediation (SD02)	112	105	7	↑
Home Finance Intermediation (SE02)	2	1	1	↑
Base costs	4	9	(5)	↓
	276	313	(37)	

Compensation costs

- The total proposed compensation costs for 2014/15 are £324m (higher than previously forecast by £24m after we refined our projections using current data). This follows publication of our Plan and Budget 2014/15.
- Significant recoveries totaling £336m have been made in 2013/14. Recoveries from investment defaults will shortly now either be returned to the fund managers or offset against the compensation costs for investment intermediaries.

Management expenses

- There is no change to our management expenses budget. As indicated in the Plan and Budget, we expect the 2014/15 management expenses to be £74.7m.

Major banking defaults levy

- The 2013/14 interest costs for the major bank failures of 2008/09 are currently expected to be £446m, and will be levied in July 2014. This increase reflects changes in interest rates and gilt rates since the Plan and Budget was published.
- The recovery and Dunfermline assumptions have not changed since the indicative levy was announced. The capital levy for repayment of FSCS's borrowing from HM Treasury remains £299m for the Icelandic banks, and London Scottish, plus £100m for Dunfermline.
- The total levy for the major banking failures is therefore expected to be £845m. It will be levied in July 2014 for payment to HM Treasury by 1 October 2014.

COMPENSATION COSTS

Table 2: Updated compensation costs forecast for the period to 30 June 2015

Funding Classes	12 month Forecast £m	3 year funding model £m	Used in levy £m
Deposits (SA01)	5.6	n/a	5.6
General Insurance Provision (SB01)	121.0	80.1	121.0
General Insurance Intermediation (SB02)	24.1	26.9	26.9
Life & Pensions Intermediation (SC02)	37.5	27.6	37.5
Investment Intermediation (SD02)	132.4	89.2	132.4
Home Finance Intermediation (SE02)	0.2	0.5	0.5
Total	320.8	224.3	323.9

Compensation costs

We project total compensation costs forward to 30 June 2015 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 2014/15 financial year covered by the annual levies raised in 2013/14.

Firms will receive their annual levy bill from July 2014 (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 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.

Our assumptions about compensation costs for the year ahead have been calculated using both our new 36 month funding approach and the traditional 12 month forecast. We have forecast that as at 1 July 2014, we will have funds to carry forward of £117m. The compensation costs for the period to 30 June 2015 (gross of projected recoveries) are now expected to be £324m and are set out by sector in table 2. This total is an increase of £24m from the indicative forecast for 2014/15. However, this is lower than the combined total of the projected 2013/14 levy and the proposed 2013/14 supplementary levy. This is because of significant recoveries we have made, which helps to reduce the impact on firms. These costs are used to calculate the levy amounts shown in table 1.

THE MAIN CHANGES TO THE COMPENSATION COSTS LEVY (FROM THE INDICATIVE AMOUNTS)

General Insurance Provision (SB01)

There is no material change.

General Insurance Intermidation (SB02)

In recent years, PPI trends had generally been upwards, though with some fluctuations. We therefore initially treated with caution the fall off in claims which began in 2013, but its continuation into 2014 suggests we may now have passed the peak of PPI claims and be witnessing a downward trend. That is what we have now assumed for the purpose of the levy. Clearly, it remains possible that an upward trajectory will resume.

Life & Pensions Intermediation (SC02)

The annual levy of £33m is £7m less than to the indicative levy amount of £40m announced earlier this year. This is due to FSCS updating its assumptions about compensation costs in this sector, as a result of costs in 2013/14 falling, thus reducing the three year average.

Investment Intermediation (SD02)

The 12 month compensation forecast has increased from £74m to £132m. This is a result of the £47m of Catalyst compensation, including for Maltese investors. We now project we will pay this in 2014/15. There have also been increases in claims for other investment and stockbroker product areas. The investment intermediation class has benefited from the recoveries made in 2013/14, as these costs have been offset against what would have been a higher levy figure. This demonstrates the benefits and cost- effectiveness of our recoveries.

The 12 month forecast (£132m) is now expected to exceed the three year historical average (£89m) and so the levy will now be based on the 12 month forecast. The indicative levy was calculated using the compensation forecast derived from the three year model. As a result, the annual levy has only increased from £105m to £112m. Further information regarding Catalyst can be found in our recent news updates.

Further information on the compensation paid and claims volumes over the previous 36 months can be found in the Annex on page 13.

FSCS

MANAGEMENT EXPENSES

FSCS management expenses in 2014/15 will total £74.7m, as indicated in the Plan and Budget 2014/15. The major components of the budget are set out below.

Table 3: Management expenses

	2013/14 Forecast (£ m)	2013/14 Budget (£m)	2014/15 Budget (£ m)
Continuing Operations			
Staff costs	16.6	16.4	17.0
External Providers	1.4	2.5	2.5
Facilities	2.0	2.3	2.2
IT	1.9	2.2	2.4
Legal Costs	1.2	1.4	1.3
Communications	4.1	4.0	4.1
Pension Deficit Funding	2.0	3.1	1.6
CEO contingency	0.0	0.2	0.3
Other	0.6	1.3	0.9
Subtotal Continuing Ops	**29.8**	**33.4**	**32.3**
Outsourcing	11.9	12.0	11.0
Operational Total	**41.7**	**45.4**	**43.3**
Strategic Change Portfolio	9.8	15.9	16.3
Operational & Investment Expense Total	**51.5**	**61.3**	**59.6**
Bank facility fees	4.5	4.9	4.9
Keydata Investment Services Limited Recovery Expense	3.8	7.2	7.2
Major banking failure related Management expenses	1.0	1.0	3.0
Total Management Expenses	**60.8**	**74.4**	**74.7**

> “The total operational and investment expense falls by £1.7m year-on-year as we have offset cost pressures in certain areas with savings in others.”

The total operational and investment expense falls by £1.7m year-on-year, as we have offset cost pressures in certain areas with savings in others. Approximately £2.2m of savings are included in the budget, largely reflecting efficiencies in outsourcing and external provider costs and a reduction in the Scheme's pension deficit funding liability.

We continue to follow the business model of using outsource providers to process the great majority of claims. This allows us to respond efficiently to fluctuations in demand. At the same time we minimise our fixed costs by retaining only a small specialist in-house capability for low volume, complex claims and to support outsourcing.

We have reclassified the annual consumer awareness programme into our main expenditure budget. The programme costs will now sit within the Communications department budget whereas the costs previously fell into the change programme.

The 2013/14 year forecast has a total management expense of £60.8m in comparison to the budget for 2014/15 which is £74.7m. The main variances are in the strategic change portfolio, largely due to the 'Connect' programme. The key investment this year is the continuation of this programme, which will streamline our claims management processes, benefiting both consumers and levy payers. We are re-engineering our claims processes onto a single consistent and well-controlled platform, which can also be used by our outsource partners. This will enable claimants to engage with us through channels they find convenient, including the introduction of an online claim facility, with an upgrading of our website. The costs are likely to be incurred in the current financial year. Our change programme will realise further efficiency gains in subsequent years.

The Keydata recovery expenses for 2013/14 have been less than budgeted due to lower than anticipated activity in the on-going litigation. However, this is planned to increase to the previous year's levels as the cases get closer to trial.

Additionally, this year there is an increase in the major banking failure related expenses. This is due to FSCS budgeting for more work on the issues and possible outcomes for the Bradford and Bingley (B&B) estate. The interest charge for the B&B loan is the largest expense for levy payers.

The costs for 2013/14 are lower than the predicted budget, leading to a reduction in future year's levy calculations, as a result of higher opening balances than expected. On the whole this relates to some of the larger project costs being deferred into 2014/15. These arise from the timing of projects and costs incurred in development, and are not increasing the costs year-on-year.

FINAL BASE COSTS LEVY FOR 2014/15

Table 4: Final base costs levy for 2014/15 compared with indicative base costs levy in the Plan and Budget 2014/15

FCA	PRA	Fee Block	FCA £m	PRA £m
A000		Minimum fee block	0.20	
AP00		FCA Prudential fee	0.11	
A001	PA01	Deposit acceptors	0.39	1.40
A002		Home finance providers and administrators	0.12	
A003	PA03	General Insurers	0.14	0.79
A004	PA04	Life Insurers	0.23	0.89
A005	PA05	Managing Agents at Lloyd's	0.00	0.00
A006	PA06	The Society of Lloyd's	0.00	0.04
A007		Fund managers	0.34	
A009		Operators, Trustees and Depositaries of collective investment schemes and Operators of personal pension schemes or stakeholder pension schemes	0.12	
A010		Firms dealing as principal in investments	(1.00)	
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)	0.57	
A014		Corporate finance advisers	0.07	
A018		Home finance providers, advisers and arrangers	0.11	
A019		General insurance mediation	0.02	
A021		Firms holding client money or assets or both	(0.55)	
			0.88	3.12

From 1 April 2014 the FCA are changing its fee block structure. Block A12-Advisory arrangers, dealers or brokers (holding or controlling client money or assets, or both) will no longer exist. A new fee block A21-Firms holding client money or assets or both will be established that contains broadly the same firm population and so the surplus on the A12 fee block of £0.8m at 31 March 2014 will be allocated to A21.

RECOVERIES

Major bank defaults

FSCS continues to be an active member of creditors' committees of all the failed estates (apart from Bradford & Bingley, which is discussed below). We continue to receive dividends in respect of our claims which are used to reduce the borrowing that FSCS has with HM Treasury resulting from compensating consumers at the time these banks failed. Recoveries totaling £240.8m have been made from these estates in the last financial year (2013/14).

Bradford & Bingley ("B&B")

The run-off of the B&B business continues, with UK Asset Resolution overseeing the business on behalf of HM Treasury. As B&B did not enter an insolvency process, there is no creditors' committee. While B&B forecast repayment of the FSCS claim in full, the timing of repayment remains uncertain.

Dunfermline

The independent valuer reported on recovery amounts in the counter factual insolvency scenario on 31 July 2012. At FSCS's request the valuer issued a Reconsideration. The report has been accepted by FSCS and HM Treasury. FSCS's liability to HM Treasury will not be finalised until the end of the resolution process, but the Scheme's last financial statements contained a provision of £540m based on the latest information available at that time.

HM Treasury has indicated that it is likely to request an interim payment by 1 October 2014. We currently expect this to amount to £100m and plan to levy for it at the same time as the annual interest charge in July.

Keydata and Lifemark recoveries

Significant recoveries have been made across Keydata and Lifemark. We continue to pursue recoveries where it is reasonable and cost effective to do so and these amounts demonstrate that our recoveries strategy is working.

Keydata

FSCS's court proceedings against a large number of IFA firms in connection with the sale of Keydata Investment Services products are on-going. In August 2013, in accordance with the order made at the case management conference in March of that year, FSCS selected six lead case defendants, which would give a representative set of investor claims to be heard by the court. Since that time, FSCS has achieved confidential settlements with five of those six lead case defendants. One lead case defendant remains in the proceedings and it has served its defence on generic issues and given disclosure. Proceedings remain stayed against all remaining defendants not selected as lead case defendants. Given the need to have a representative set of investor claims heard by the court, FSCS is currently identifying appropriate replacement lead case defendants from the remaining pool of defendants. FSCS will make representations to court about its specific intentions with regard to the selection of lead case defendants at the upcoming case management conference, now likely to be scheduled in early May, when it is anticipated that further directions for trial will be made and a revised timetable will be set.

Lifemark

FSCS involvement in the issues arising from the failure of Lifemark S.A. is nearly concluded. FSCS received total payments on account from the trustee in the region of 10.5% of the nominal value of the issued Lifemark bonds. FSCS has already distributed funds to Lifemark claimants with compensatable losses over £30,000 whose claims were assigned to the Scheme. FSCS received a further distribution payment from the trustee in the region of 2% at the end of March 2014, with a further payment(s) expected later in the year. We expect to be in a position to allocate the recoveries remaining between the affected levy payer classes (investment provision and investment intermediation) in May/June 2014. The recoveries received from Lifemark will ultimately be less than the original investment value, but will be substantially greater than would otherwise have been the case without FSCS's action.

2008/09

MAJOR BANK FAILURE LOAN COSTS UPDATE

The 2014/15 interest cost for the 2008/09 major bank failures is now forecast at £446m compared to £439m announced in the Plan and Budget 2014/15. The total levy for the major banking failures is expected to be £845m, a slight increase on the indicative amount of £838m.

Table 5: HM Treasury loan balance

	2014/15 Budget (£m)	2013/14 Forecast (£m)
Opening balance		
-Capital	16,591	17,246
-Interest	446	429
Add: Interest costs	448	446
Paid by recoveries		
Less: recoveries	(169)	(292)
Paid by levy payers		
-Less: repayments	(299)	(363)
-Less: interest	(446)	(429)
Closing balance	16,571	17,037

POLICY

EU Deposit Guarantee Scheme Directive (DGSD) update and impact on FSCS

The draft EU Deposit Guarantee Scheme Directive (DGSD) proposes a number of changes which will impact on FSCS. The main aim of the DGSD is to improve and harmonise coverage and pay-out arrangements for customers of credit institutions across Europe.

The main changes that member states' deposit guarantee schemes, including FSCS, will have to adopt include:

- Extending the eligibility criteria to include medium and large businesses. Some exclusions still apply including deposits held by financial institutions, deposits by pension and retirement funds (personal pensions and OPS of small and medium sized enterprises are covered) and public authorities (local authorities with a yearly budget not exceeding €500,000 may be covered).
- Payout of depositors within seven working days of a failure. The Directive will allow until 2023 for member states to implement this.
- Protection for temporary high balances.
- Funding – mandatory contributions paid by credit institutions for DGS purposes and access to ex-post funding in the event that the available financial means of a DGS are insufficient to repay depositors.
- Risk-based levies (which will not be introduced until May 2016).
- Mandatory consumer disclosure.
- Stress testing deposit guarantee scheme systems every three years.

The implementation date will be 12 months after entry into force. FSCS expects the DGSD to come into force around the middle of 2014.

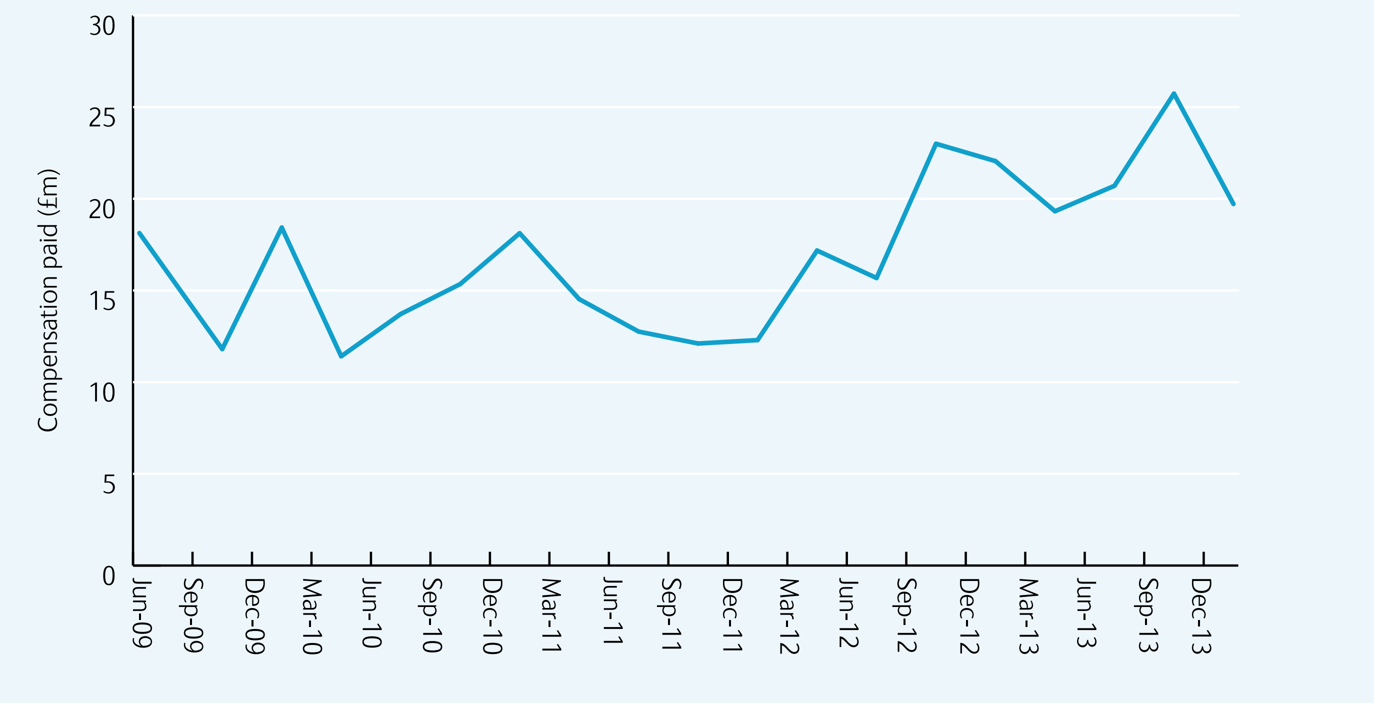
Financial Services (Banking Reform) Act 2013

The Act received Royal Assent in December. It sets the platform for bank reform and added the bail in tool for bank resolution. The Act also introduced two statutory duties for FSCS – to have regard to the need to ensure it operates effectively and efficiently and to minimise public expenditure. Both are important considerations, which FSCS welcomes and fully accepts as appropriate to the discharge of its functions.

ANNEX

General Insurance Provision (SB01)

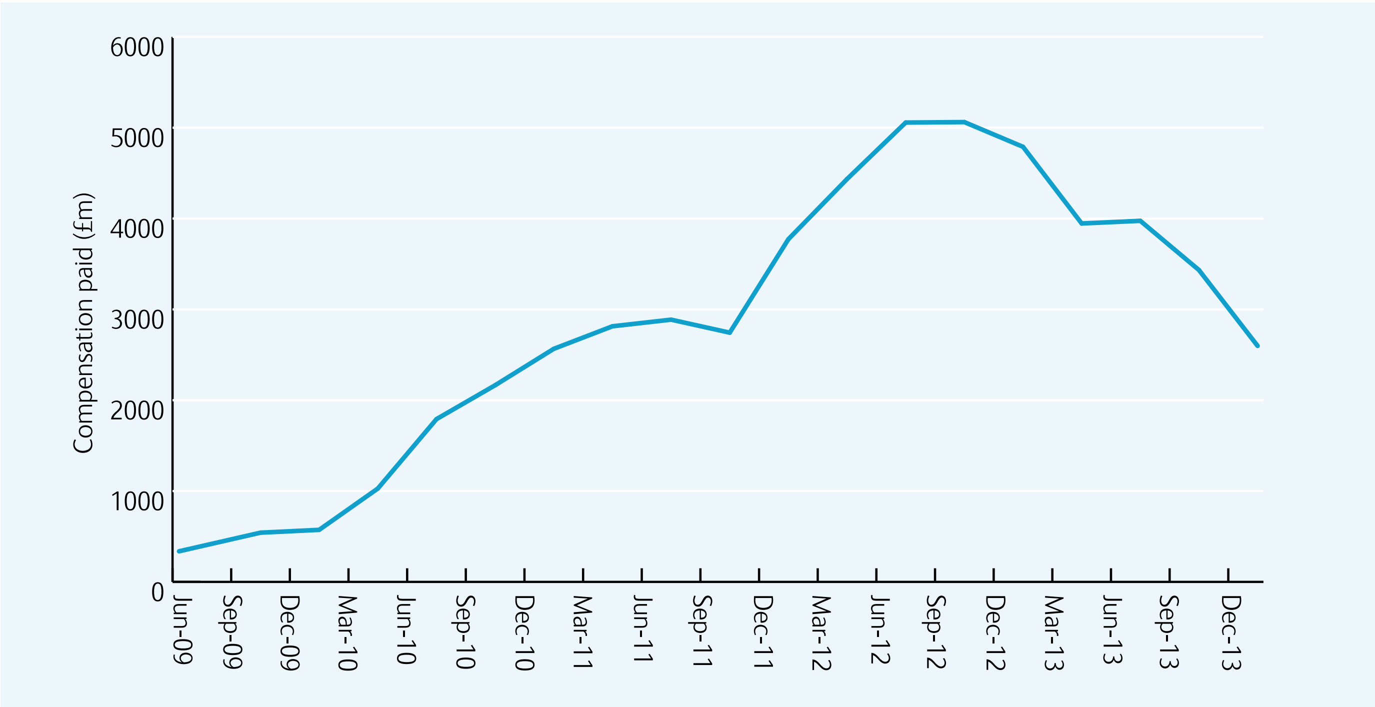
Chart 1: Compensation paid for period to 31 December 2013



General Insurance Intermediation (SB02)

Chart 2: Compensation paid for period to 31 December 2013

Chart 3: Number of claims for period to 31 December 2013



Life & Pensions Intermediation (SC02)

Chart 4: Compensation paid for period to 31 December 2013

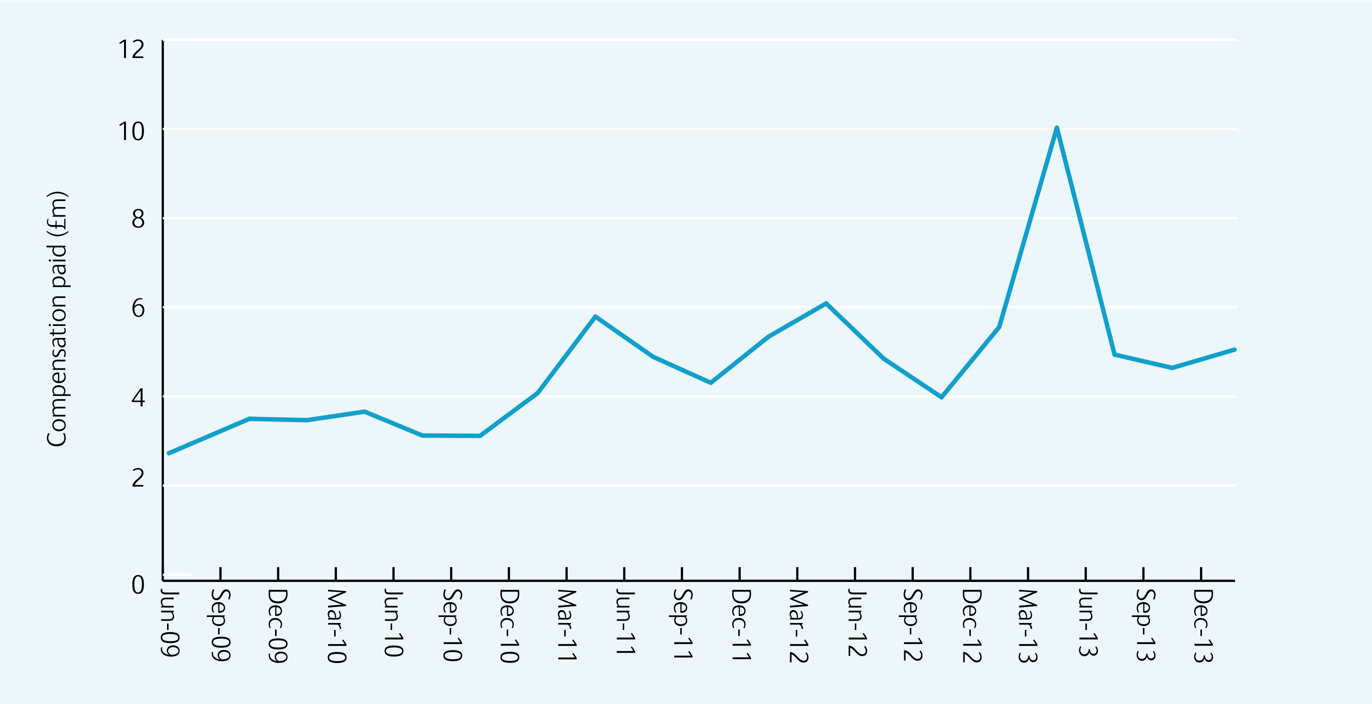
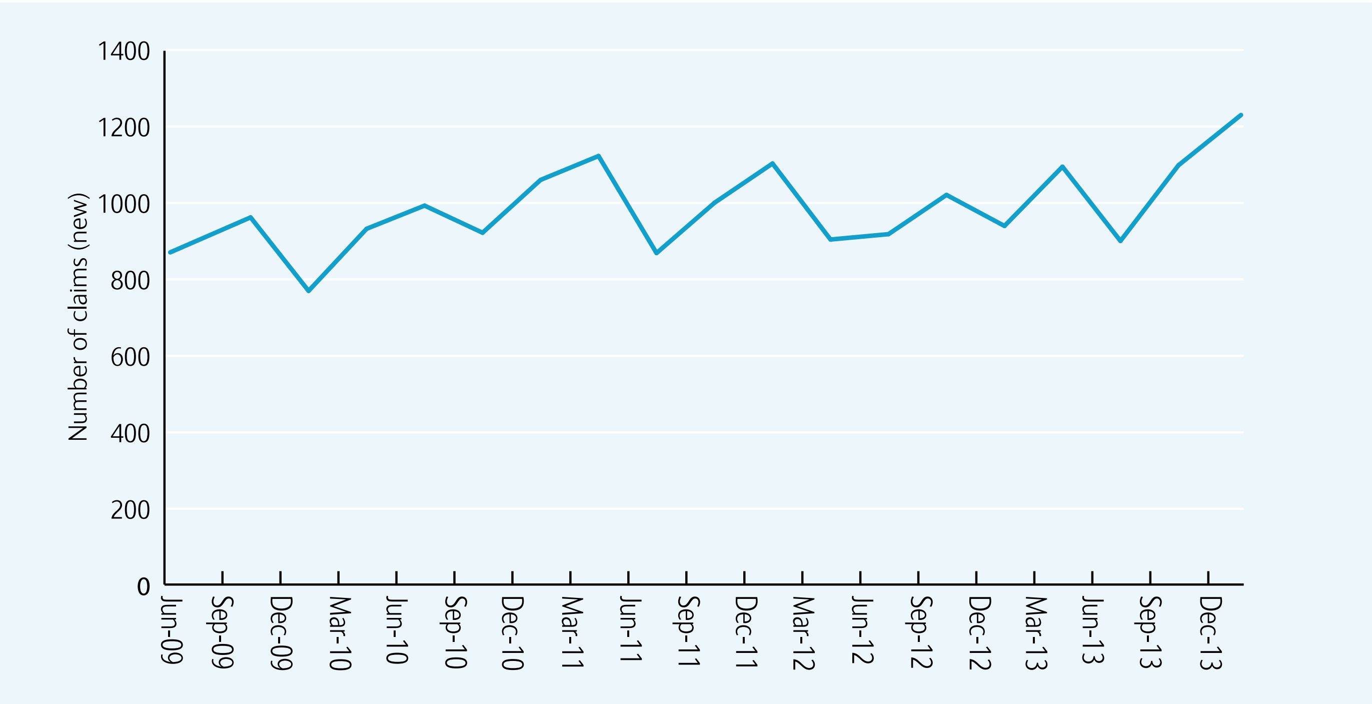


Chart 5: Number of claims for period to 31 December 2013



Investment Intermediation (SD02)

Chart 6: Compensation paid for period to 31 December 2013

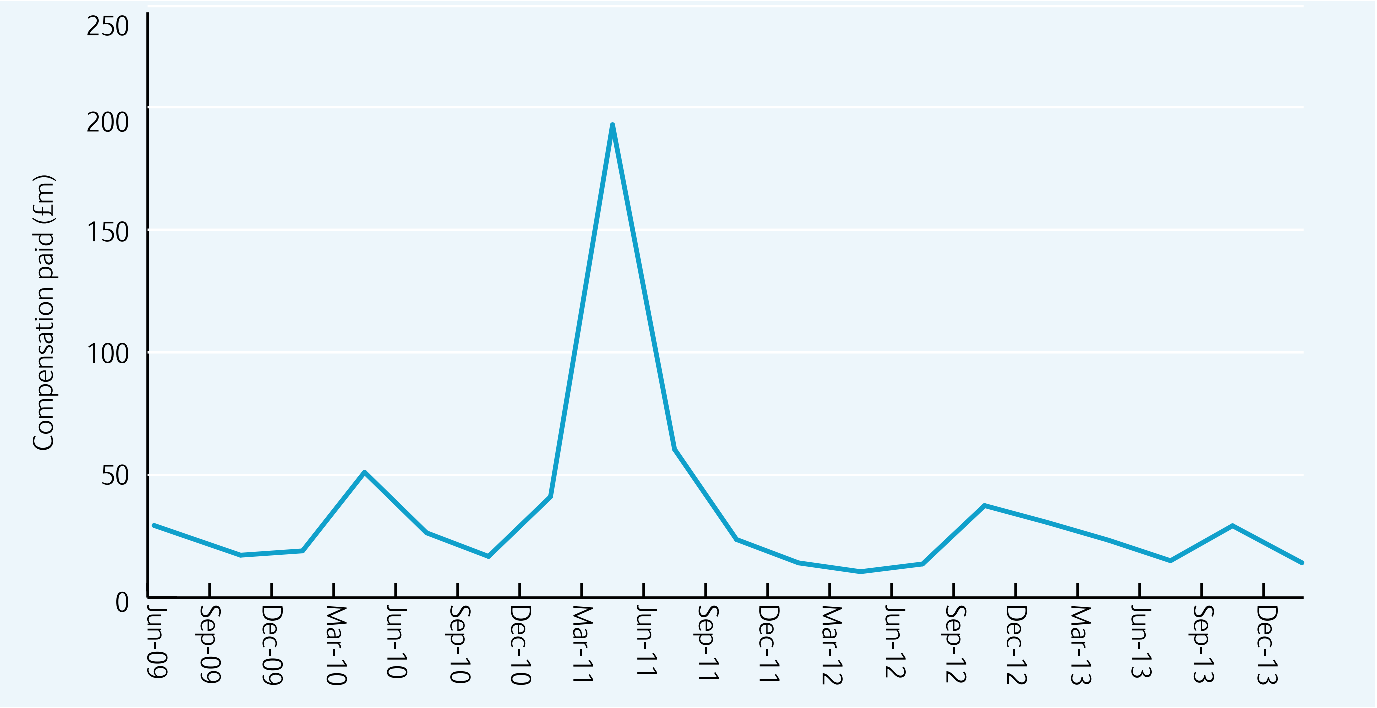


Chart 7: Number of claims for period to 31 December 2013