News from the Financial Services Compensation Scheme

outlook

FSCS
Financial Services
Compensation Scheme

April 2013

Compensating consumers since 2001

2013/14 ANNUAL LEVY

- Key components of annual levy
- Levy and compensation costs
- Management expenses

ALSO IN THIS ISSUE...

- Recoveries
- 2008/09 bank failure loan costs update

POLICY

- FSCS's role in new regulatory framework
- FSCS's new funding model

CHIEF EXECUTIVE'S SUMMARY

Mark Neale, Chief Executive

Welcome to this edition of Outlook in which FSCS confirms its annual levy for the coming year. To remind you, our levy covers not only the compensation costs which we expect to incur in the year ahead, but also the management costs of FSCS.

In addition, we levy the deposit-takers annually to meet the costs of the HM Treasury loans we entered into following the 2008 bank failures. From this year, our levy will include re-payment of the principal as well as interest. Also new this year, interest payments will score as compensation costs which are subject to the sector classes' annual threshold, not as FSCS's management expenses.

Excluding the costs of these legacy loans, we have set the levy for 2013/14 at £285m. This is a reduction of £26m compared to the £311m announced in the Plan and Budget 2013/14, which was published in February. You can find a full explanation on page 6 of why the numbers have changed between our indicative view and our final determination.

As always, I remind you that these claims projections are not set in stone and, accordingly, the annual levy is not necessarily the last word on compensation costs for the year ahead. We set the levy conservatively to reflect the compensation costs we expect to incur. That avoids making premature demands on the industry for costs which have not yet crystallised. However, I usually warn that, because of the unpredictability of the demands we face, there is the risk of interim levies during the year. We have raised additional levies in each of the previous five years, for example, but, if the need arises again this year, we will do all we can to provide as much notice to the industry as possible.

I am also very conscious that levy payers have taken a keen interest in FSCS's recoveries, particularly in respect of Keydata and other major failures. You will find more information about the latest recoveries developments on page 9.

I have discussed in previous editions of Outlook the importance of FSCS having a sustainable funding model. Following the conclusion of the FSA review of our funding model, we begin the new financial year with new funding arrangements. The FSA review has been a valuable exercise which opened up welcome debate on how FSCS is funded. I am conscious that the final outcome was not welcomed by all: in a zero sum game there is no plausible outcome which could have achieved unanimous support. Nonetheless, the new arrangements provide a reasonable basis for sharing the costs of compensation across the industry and a model we will use for the foreseeable future.

That does not mean, however, that the debate about the way FSCS is funded should now close down. Much of the unpredictability of the current funding

> We have set the levy for 2013/14 at £285m. This is a reduction of £26m compared to the £311m announced in the Plan and Budget.

arrangements could be eliminated by a move to pre-funding, but at the expense of taking capital out of the industry ahead of need. The industry needs to be clear how it views this trade-off. And there is a good economic case for introducing a risk weighting to levy contributions, but only if an objective and robust way can be found of capturing the additional risk presented by different business models. I hope this technical challenge will be embraced in the years ahead, rather than filed in the "too difficult" drawer. However, I do appreciate that pre-funding cannot be implemented under the current legislation.

We also begin the new financial year under a new regulatory regime and have been forging strong and effective working relationships with both the Prudential Regulation Authority and Financial Conduct Authority. Building on this start is one of our priorities for 2013/14. Details of FSCS's role in the new regulatory framework are outlined on page 11.

The Government is also taking the opportunity in the Banking Reform Bill currently before Parliament to legislate on aspects of FSCS's governance. As an important part of the public arrangements for resolving failing financial services businesses and a key player in aiding financial stability, we fully recognise that this is appropriate. We also fully accept that FSCS should operate efficiently and effectively, with high standards of openness and disclosure, and should, where called on, deliver compensation as cost-effectively as possible. Equally, it is important that FSCS continues to be independent in its decision-making.

Both these points – the need to operate efficiently, but also independently – are strongly borne out by FSCS's latest stakeholders survey. You can find a summary of the results in this edition of Outlook.

And don't forget that every month I publish my industry blog, Perspectives, in which I comment on topical issues in FSCS's work. You can also sign up to our RSS feed on our website or follow us on Twitter @FSCSNews

How we arrive at claims and levy assumptions

When determining the key assumptions used in our planning, budgets, funding and levies, we face a high degree of uncertainty about the likelihood and timing of possible defaults and the volumes, types and timing of claims arising. Our assumptions are based on our experience of current claims trends as well as other information from the FCA, the Financial Ombudsman Service and the industry. Clearly, these assumptions may change over time. Recent years have shown that some unexpected, larger failures have significantly impacted our estimates. Accordingly, we monitor claims trends and default prospects and review and update assumptions, to help us determine the resources, expenses and levies required to pay the claims we expect within target service levels.

As a result, the assumptions should not be viewed as forecasts. In particular, they do not provide a risk outlook for possible new claims areas.

KEY COMPONENTS
OF 2013/14 ANNUAL LEVY

Compensation Costs

- The total proposed levy for 2013/14 has reduced by £26m to £285m after we refined our projections following publication of our FSCS Plan and Budget 2013/14.
- General insurance intermediation firms will see a reduction in their levy, while investment intermediation firms will see an increase in their levy compared to the indicative levy amounts published earlier this year.

Management expenses

- The 2013/14 management expenses are expected to be £73.4, as indicated in the FSCS Plan and Budget.

Interest on loans from HM Treasury

- The 2012/13 interest costs for the major bank failures of 2008/09 amount to £429m, and will be levied in July 2013.
- This levy will also include principal for repayment of the loans. We will publish a further update at that time confirming how this total is calculated and what deposit takers can expect in the next few years.
- We now forecast that the interest cost for 2013/14, to be levied in July 2014, will be £371m (previously £380m).

LEVY

AND COMPENSATION COSTS

Table 1: Updated compensation costs forecast for the period to 30 June 2014

Funding Classes	2013/14 Final £m	2013/14 Indicative £m	2013/14 Increase/ Decrease £m
Deposits (SA01)	7.49	7.49	0.00
General Insurance Provision (SB01)	118.54	118.54	0.00
Genral Insurance Intermediation (SB02)	44.72	48.51	(3.79)
Life and Pensions Intermediation (SC02)	28.31	29.56	(1.25)
Investment Intermediation (SD02)	64.66	61.83	2.83
Home Finance (SE02)	0.50	0.40	0.10
Total	**264.22**	**266.33**	**(2.11)**

Compensation costs

We project total compensation costs forward to 30 June 2014 to reflect the fact that 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 2013/14 financial year covered by the annual and interim levies raised in 2012/13.

Unforeseen events in financial markets can impact upon 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 general levy are based on "most likely" claims assumptions for the year ahead. We then adjust these costs to reflect recoveries we shall achieve over the same period and our projection of the fund balances at 30 June.

We have forecasted that as at 1 July 2013, we will have funds of £51m in respect of levies raised in 2012/13 (including the 2012/13 interim levy on firms in the insurance intermediation and investment intermediation sectors announced in March).

The compensation costs for the period to 30 June 2014 (gross of projected recoveries) are quantified as £264m and are set out by sector in table 1. These costs are used to determine the levy amounts shown in table 2.

Firms will receive their annual levy bill around July 2013 (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.

Table 2: Final levy figures

Funding Classes	2013/14 Final Levy £m	2013/14 Indicative Levy £m	Variance
Deposits (SA01)	7.00	11.00	(4.00)
General Insurance Provision (SB01)	115.00	122.00	(7.00)
Genral Insurance Intermediation (SB02)	54.00	58.00	(4.00)
Life & Pensions Provision (SC01)	-	-	-
Life & Pensions Intermediation (SC02)	13.00	17.00	(4.00)
Investment Fund Management (SD01)	-	-	-
Investment Intermediation (SD02)	78.00	76.00	2.00
Home Finance Provision (SE01)	-	-	-
Home Finance Intermediation (SE02)	-	-	-
Base costs	18.00	27.00	(9.00)
	285.00	**311.00**	**(26.00)**

The main changes to the levy explained

General insurance provision (SB01)

The annual levy of £115m represents a reduction of £7m compared to the indicative levy amount of £122m announced earlier this year. Claims are lower than initially predicted in 2012/13 resulting in a higher opening fund. Additionally, a further Drake Insurance recovery is now expected in 2013/14. Taken together, the effect of these reduces the levy from our earlier estimate.

General insurance intermediation (SB02)

The levy for firms in the insurance intermediation sector reduces by £4m to £54m compared to the indicative levy of £58m announced earlier this year. This is due to FSCS updating its assumptions about compensation costs in this sector.

Investment intermediation (SD02)

The levy for firms in the investment intermediation sector has increased since the indicative levy proposals made earlier this year, rising from £76m to £78m because of additional investment claims.

Other sectors

The levies for all other sectors have either remained the same, or have not changed significantly.

Prospects in 2013/14

FSCS expects that PPI claims will continue to be received in significant numbers particularly from Claims Management Companies who continue to be active in this type of business. This is in line with the wider market expectations and the experience of the Financial Ombudsman Service.

Other major investment defaults such as MF Global UK Limited, Worldspreads Ltd and Pritchards Stockbrokers Limited, are expected to be largely completed during 2013/14. CF Arch Cru eligible claimants will, from 1 April 2013, be paid by the FSCS based on the FCA redress scheme calculation rather than the previous interim basis with top up payments.

Claims that were paid before 1 April 2013 will not be reassessed but may be eligible for top-up payments.

Following the 'EL Trigger' ruling by the Supreme Court at the end of March 2012 on policy cover for mesothelioma claims, FSCS was able to recommence paying these claims and we expect that during 2013/14 FSCS will continue to pay the backlog of mesothelioma claims that had built up pending this decision. During 2013/14, FSCS will also be paying claims with regard to two new insurance defaults (Municipal Mutual Insurance and Lemma Insurance Europe Ltd).

FSCS

MANAGEMENT EXPENSES

FSCS's management expenses in 2013/14 will total £73.4m, as indicated in the Plan and Budget 2013/14. The major components of the budget are set out below.

Table 3: Management Expenses

Management Expenses	2013/14 Budget £m	2012/13 Budget £m	2012/13 Forecast £m
Existing operations			
- Staff costs	15.3	14.7	15.1
- External providers	1.3	1.1	1.1
- Facilities	2.8	3.0	3.1
- IT	2.4	2.7	2.4
- Legal costs	1.3	1.2	1.3
- Communications	0.5	0.5	0.5
- Other	0.7	0.7	0.8
Subtotal	**24.3**	**23.9**	**24.3**
Outsourcing costs	11.2	13.6	14.3
Operational total	**35.5**	**37.5**	**38.6**
Strategic change portfolio			
- Original 5 year programme	12.4	14.6	14.4
- New initiatives	3.5	0.0	0.0
Subtotal	**16.0**	**14.6**	**14.4**
Operational & investment expense total	**51.4**	**52.1**	**53.0**
Exceptional items	14.8	9.1	5.8
Keydata Investment Services Limited - recoveries	7.2	3.9	7.7
Total operational & investment expense budget total	**73.4**	**65.1**	**66.5**

Total operational and investment expense fell by £1.5m year-on-year, as management has sought to offset cost pressures in certain areas with savings in others. Approximately £0.8m of savings are included in the budget, largely reflecting renegotiations in outsourcing costs and lower premises costs following the office move.

The costs of running FSCS would be falling were it not for the costs of the continued investment in ensuring FSCS meets future demands and other exceptional items, including the cost of recoveries. Our change programme costs are expected to be £1.4m higher than 2012/13, but will realise efficiency gains in subsequent years.

The total base costs levy for 2013/14 will be £24.3m, as indicated in this year's Plan and Budget, £0.3m higher than 2012/13.

The new funding rules propose a change in the definition of specific costs. The previous definition was that a specific cost only included those costs that were directly related to a specific firm in default. However the new rules broaden the definition to include all costs that are related to a class.

The result of the change in definition is that the following costs now become specific costs allocated to a class (and not base costs):

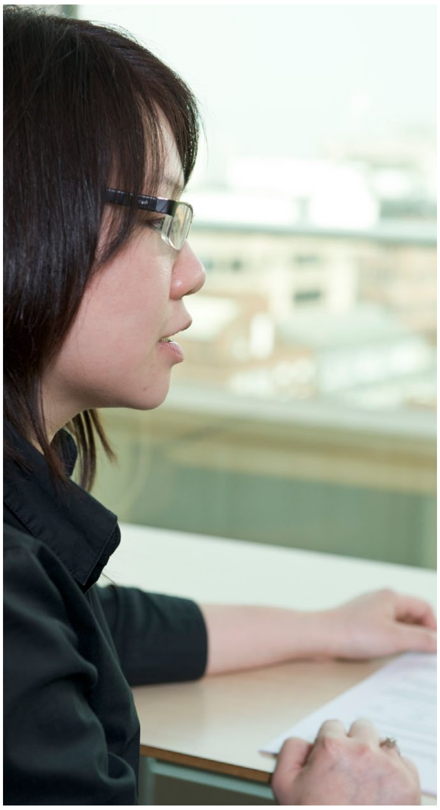
- deposits readiness costs (including Single Customer View (SCV) verification, external payment providers, thematic review, IT costs for Siebel 8.1) will now be allocated to the Deposits class;
- consumer awareness will also be allocated to the Deposits class as the awareness programme is targeted at deposit protection;
- legal, professional and other costs relating to pre-default work will now be allocated to the class in which the default may occur.

The overall effect for levy paying firms of the change in definition is that £10m of costs will switch from base to specific, of which £9m will be allocated to the deposit taking class.

Table 4: Final base costs levy for the 2013/14 compared with indicative base costs levy in the Plan and budget 2013/14

FCA	PRA	Fee Block	FCA £m	PRA £m
AP00		FCA Prudential fee	0.4	-
A000		Minimum fee block	0.2	0.0
A001	PA01	Deposit acceptors	(0.2)	9.4
A002		Home finance providers and administrators	0.3	-
A003	PA03	General insurers	0.3	1.6
A004	PA04	Life insurers	0.6	2.0
A005	PA05	Managing agents at Lloyd's	0.0	0.1
A006	PA06	The Society of Lloyd's	(0.0)	0.1
A007		Fund managers	0.7	-
A009		Operators, Trustees and depositaries of collective investment schemes and Operators of personal pension schemes or stakeholder pension schemes	0.3	-
A010		Firms dealing as principal in investments	1.2	-
A012		Advisory arrangers, dealers or brokers (holding or controlling client money or assets, or both)	0.9	-
A013		Advisory arrangers, dealers or brokers (not holding or controlling client money or assets, or both)	0.1	-
A014		Corporate finance advisers	0.2	-
A018		Home finance providers, advisers and arrangers	0.1	-
A019		General insurance mediation	(0.2)	-
			4.9	**13.1**

RECOVERIES



Major bank defaults

The position for Bradford & Bingley remains that the company expects to repay FSCS's 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 (recoveries to date now total 76% and 77.23% of the original compensation amount respectively).
We have also received dividends totalling 35.1% from London Scottish Bank PLC, and also a first dividend of 45% on Southsea Mortgage and Investment Company Limited. We have now recovered about 50% of the claim in the winding up of Icesave.

Dunfermline Building Society

Following the resolution of Dunfermline Building Society in March 2009, HM Treasury appointed Ian Burns as the independent valuer pursuant to s.214D(3) of the Financial Services and Markets Act 2000 and the statutory regulations. The valuer issued a report and determination dated 31 July 2012, and we published the determination notice on our website.

We have made a request of the valuer to reconsider the determination, which is awaited.

Keydata Investment Services

FSCS's court proceedings against a large number of IFA firms in connection with the sale of Keydata Investment Services products are still continuing.
The proceedings were stayed for a period of 12 months to allow the parties to complete various preliminary administrative tasks and, where appropriate, engage in settlement discussions. To date FSCS has settled claims with a number of defendants for a variety of reasons, the terms of which are confidential. These are generating recoveries that are helping to reduce the costs of the failure. The remaining parties are still subject to the legal proceedings and, as the FSCS remains confident of its position, we will continue to pursue the claims through the court process. Case Management Conferences in the Keydata Lifemark and Keydata SLS related proceedings took place in the last week of March 2013. The court gave directions for preparations for trial at these hearings, and the proceedings will now continue with procedural steps such as disclosure of documents and service of defences.

Lifemark S.A

Our involvement in the issues arising from the failure of Lifemark S.A. is drawing to a conclusion following the enforcement of the security held over Lifemark S.A's assets by the Trustee on behalf of its creditors. Short term liquidity funding provided by the FSCS to preserve the assets following enforcement has now been repaid by the Trustee from the proceeds of a competitive sale of the assets. This combined with other maturities which have been collected by the Trustee during the enforcement will enable some recoveries to be realised by Lifemark's creditors.

These recoveries will fall some way short of the original investment value (the Trustee of the assets has previously issued a public notice stating that the expected returns will be approximately 10% of the capital invested), but will be substantially higher than would otherwise have been the case without the FSCS's intervention. Lifemark recoveries are not deducted from the levy requirement and are repaid to the industry only after receipt of the funds.

2008/09

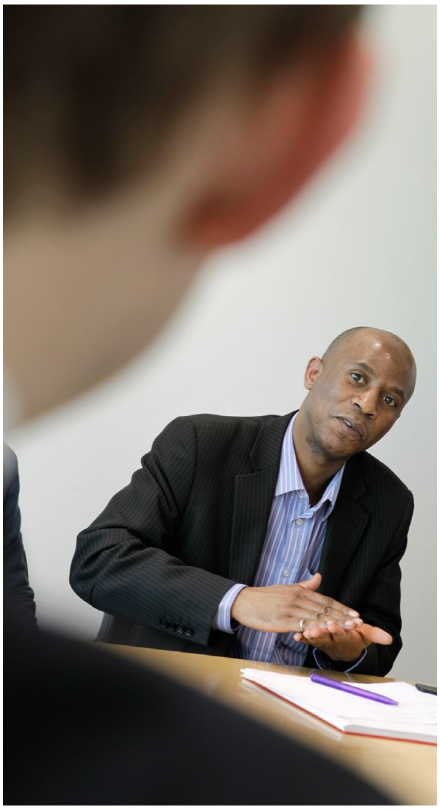
MAJOR BANK FAILURES - LOAN COSTS UPDATE

The 2013/14 interest cost for the 2008/09 major bank failures is now forecast at £371m compared to £380m announced in the Plan and Budget 2013/14. The actual amount will be calculated after the year end by the Bank of England. The capital repayments are still to be determined by the FSCS Board. Further information on both the calculation of interest and the levy to fund capital repayments will be published on the FSCS website.

Table 5: HM Treasury loan balance

	2013/14 Budget (£m)	2012/13 Estimate (£m)
Opening balance	17,240	17,954
Add: Interest costs	371	429
Less: Repayments funded through recoveries	(258)	(714)
Payments funded by levy payers		
- Capital	(363)	0
- Interest	(371)	(429)
Estimated closing balance	**16,619**	**17,240**

POLICY



FSCS's role in the new regulatory framework

In 2010, the Government consulted on the UK's financial regulatory structure in response to the financial crisis and in late 2012 The Financial Services Act 2012 was given Royal Assent.

With effect from 1 April 2013, the Act established two new bodies to oversee financial regulation, the Prudential Regulation Authority (PRA) focusing on prudential issues, and the Financial Conduct Authority (FCA) responsible for business and market conduct. Memoranda of Understanding have been drawn up with both PRA and FCA outlining how both organisations will work with FSCS and are published on their websites.

FSCS remains a single organisation and its primary duty is still to compensate consumers of failed financial firms. FSCS will remain funded by levies on the industry but instead of reporting to the FSA will now be accountable to both PRA and FCA. Both PRA and FCA will make COMP rules. In addition, in the Financial Services (Banking Reform) Bill, two new duties on FSCS are proposed:

- to have regard to the need to ensure efficiency and effectiveness; and
- to have regard to the need to minimise public expenditure.

The Bill is currently going through Parliament.

FSCS's new funding model

On 1 April, FSCS's new funding arrangements were introduced following an extensive FSA consultation. FSCS plays a critical role in protecting consumers when firms fail. The existence of the Scheme helps to promote consumer confidence and needs a sustainable funding model to pay people compensation. It is vital that FSCS has access to adequate funding in order to meet its obligations.

FSCS is funded by a levy on authorised financial firms. The new funding model is shown on page 12, with two diagrams illustrating the funding arrangements that would be triggered in the event that any of the FCA FSCS funding classes breach their annual threshold.

Chart 1: FCA retail pool - for compensation costs exceeding the Investment Provision class threshold only

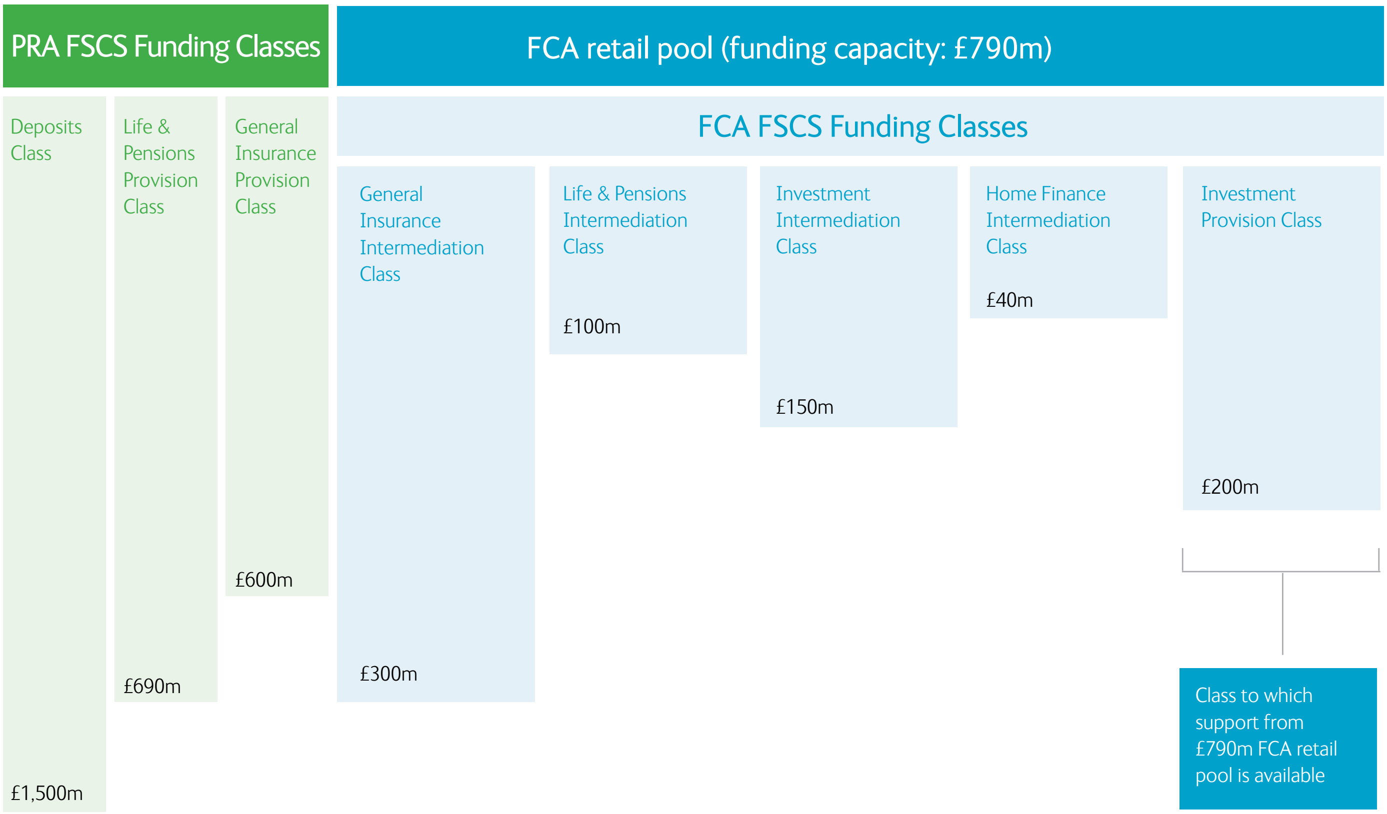
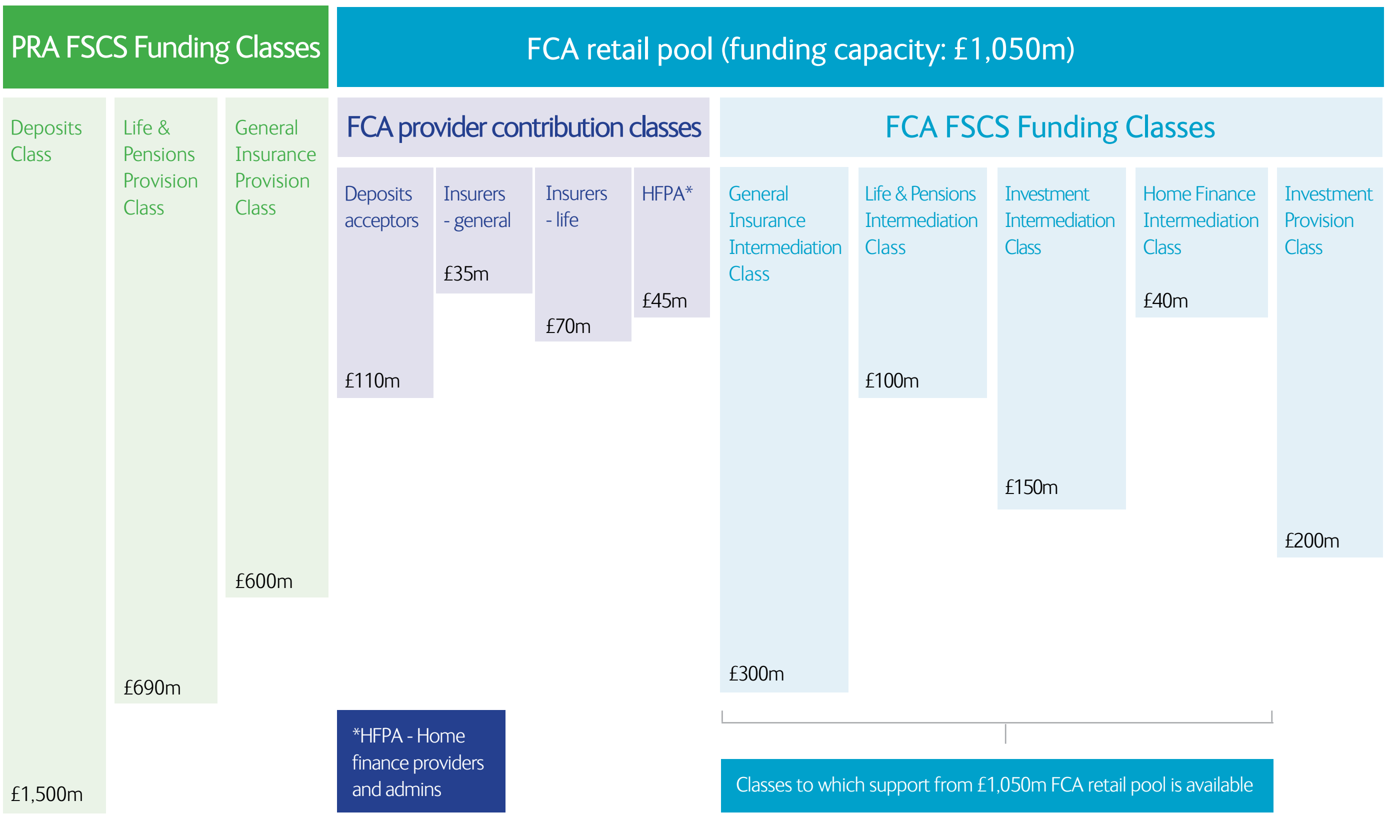


Chart 2: Revised FCA retail pool - for compensation costs exceeding an FCA Intermediaries class threshold



Under the new funding arrangements all FCA regulated deposit takers, general insurers, life insurers and home finance providers (in addition to the FCA FSCS Funding classes), are required to make contributions to the FCA retail pool in the event that an intermediation class breaches its threshold. In the event that in the Investment Provision class exceeds its threshold, only the FCA intermediation classes will contribute. FSCS will now have access to a maximum of £1,050m to fund compensation claims arising from the intermediation classes, and £790m to fund investment provision compensation claims.

The maximum amount that FSCS can raise in levies from each sector of the industry – the class thresholds so-called - have also been reviewed from the perspective of affordability, as well as historical funding needs. For the purposes of the contributions from the FCA provider contribution classes to the FCA pool, thresholds have been based on the proportion each class is required to contribute in FCA periodic regulatory fees.

There has been a change in the way management expenses are allocated so that specific costs are attributed directly to the sector they relate to and are now included in the class thresholds.

Finally, from 1 April 2014, FSCS will have the ability to, when setting the annual compensation costs levy, take into consideration the compensation costs expected in the 36 months following the levy (except for the deposit class), instead of 12 months as is currently the case.

We hope this will allow FSCS to smooth the impact of levies by looking further ahead at expected compensation costs. While FSCS can advise the industry of the total three year forecast, the annual levy will be the greater of 1/3 this figure and the costs expected in the 12 months following the levy and in either case subject to the annual class thresholds. In the summer, FSCS will publish a paper on its approach to raising compensation cost levies.

This will provide firms with guidance on FSCS' approach to managing its cash flows, including its use of borrowing.

Stakeholder meeting

On 18 February 2013 FSCS invited trade body and consumer representatives to FSCS's first stakeholder meeting. FSCS's Plan and Budget 2013/14 and its priorities for the year were discussed. FSCS plans to hold an annual stakeholder meeting to coincide with the Plan and Budget in order to increase transparency, facilitate the consultation on the Plan and Budget, and enhance our relationship with stakeholders and the industry.

Stakeholder audit

From late 2012 to early 2013, FSCS carried out its annual stakeholder audit for 2012/13, the findings of which covered general perceptions of FSCS. The audit features a quantitative survey and qualitative research by an independent agency. It is the second time FSCS has done such an audit.

The results of the audit are encouraging and, although a similar theme emerged from our previous audit, they show improvements in industry perceptions of FSCS which seem to reflect our efforts to work closely with the industry. In common with the first audit, the FSCS funding model (including the FSCS approach to recoveries) continues to be a point of contention for some sections of the industry, who would welcome additional transparency on costs, but there is recognition from stakeholders that the rules were set by the FSA, not the FSCS.

Trade bodies, consumer organisations and the authorities scored FSCS highly on a number of measures including satisfaction, how well FSCS listens and responds and favourability. FSCS communication channels were seen as useful or very useful by the vast majority of respondents.

The results showed that audiences independently cite that FSCS is consumer focused. They also support FSCS contributions, appropriate to its remit, as part of the wider debate about financial services.

Overall operational efficiency and a strong record of delivery were cited as main strengths of FSCS. There was also praise for the existence of the FSCS and recognition of its importance in reassuring consumers and building consumer confidence.

The areas for us to work on include building on our work on contingency planning, which the authorities recognise is valuable, and building on our stakeholder and policy work (which was welcomed and valued).

In addition, FSCS carried out research (for the second time) among parliamentarians on how aware they were of FSCS and a range of issues. The results show strong support for building awareness of the compensation scheme with MPs believing FSCS plays a vital role in promoting consumer confidence and financial stability. 79% of MPs agree there is lack of public awareness of FSCS and 81% believe increasing awareness of FSCS will increase consumer confidence and financial stability.

Who receives Outlook?

FSCS publishes Outlook up to four times a year to coincide with important dates in our annual calendar. It reflects our commitment to communicate with you, the levy payers, about our work. It is available on our website.

We send an FSCS email to all firms to tell them about Outlook whenever we publish the publication. We did this through the FSA using their systems and the contact information they have for firms on the register. The information was provided by firms in their returns to the FSA, not the FSCS, so the FSCS does not email firms directly. We will continue to use the FCA systems to send communications but, unfortunately, we cannot add contacts to our system.

However, you can keep in touch with us easily be subscribing to the RSS feed on our website which will alert you whenever we publish new information. You can also follow us on Twitter @FSCSNews.

Disclosure booklet

FSCS has updated the disclosure leaflet that deposit takers are required to give their customers on request. This now reflects the change from the FSA to PRA and FCA and is now available on our website here.

Contact us:
Phone: 0800 678 1100 Email: Publications@fscs.org.uk
Please include your name and address with any messages sent