

FSCS's Position Statement in respect of the proper allocation of recoveries by FSCS arising from the 2010/2011 "compensation cost levies" for the Investment Funding Class (SD01 & SD02)

Background

In the summer of 2010, FSCS raised a "compensation costs levy" on the investment intermediation sub-class (**SD02**) as a result of a number of investment firm "defaults", including (but not limited to) Keydata Investment Services Limited (**Keydata**), Pacific Continental Securities Limited (**PCS**) and Wills & Co Limited (**Wills**). Following the raising of an interim levy by FSCS in January 2011, the cross-subsidy from the investment fund management sub-class (**SD01**) was triggered to support SD02. The "compensation cost levy" demand on SD02 exceeded its £100 million annual limit by approximately £232.6 million.

In view of the above, FSCS has been asked by those trade bodies whose members fall within the Investment Funding Class how FSCS will allocate any recoveries it may receive in the future arising from compensation claims paid in the 2010/2011 levy year arising from investment firm "defaults". This position statement sets out, in summary form, the approach that FSCS intends to adopt in this regard in light of the rules by which it is required to operate.

FSCS Levy Rules (FEES Chapter 6)

The relevant provisions related to the FSCS levy are set out in Chapter 6 of the Fees Manual of the FSA's Handbook (**FEES**).

By way of context, FEES 6.3.1R empowers FSCS to impose a "compensation costs levy" provided that it has reasonable grounds for believing that the funds available to it to meet relevant expenses are insufficient taking into account "...*the level of the FSCS's anticipated expenditure in respect of compensation costs in the 12 months following the levy*". FEES 6.5.1R provides that the "compensation costs levy" is made up of "...*compensation costs incurred by the FSCS, together with any compensation costs which can reasonably be anticipated as arising in the 12 months*

following the levy date...". Once FSCS has decided to impose a "compensation costs levy", it is required, pursuant to FEES 6.5.2R, to allocate that levy to the relevant sub-classes up to the relevant levy limits (which are set out in the table in FEES 6 Annex 2 R).

The particular provisions that deal with the issue of the allocation of recoveries are set out in more detail below. In particular:

FEES 6.3.19R:

"Unless FEES 6.3.20R applies, any recoveries made by the FSCS in relation to protected claims must be credited to the sub-classes to which the related compensation costs were allocated."

FEES 6.3.20R:

"(1) This Rule applies where the FSCS makes recoveries in relation to protected claims where related compensation costs would have been met by a sub-class (sub-class A) had the levy limit for sub-class A not been reached and have therefore been met by another sub-class or sub-classes.

(2) This Rule applies even though the recoveries were made in a subsequent financial year.

(3) Recoveries referred to in (1) must be applied in the following order of priority:

(a) (If the compensation costs were allocated to the general retail pool (see FEES 6.5.2R(2)) to the classes and sub-classes to which the costs were allocated in accordance with FEES 6.5.2R(2) in the same proportion as those classes and respective sub-classes contributed up to the total amount of that allocation plus interest at a rate equivalent to the Bank of England's repo rate from time to time in force.

(b) (If the compensation costs were allocated to the other sub-class in the same class as sub-class A) to that other sub-class up to the total amount of

the allocation plus interest at a rate equivalent to the Bank of England's repo rate from time to time in force; and

(c) *Sub-class A.*"

FEES 6.3.20A:

"Recoveries under FEES 6.3.20R are net of the costs of recovery."

FEES 6.3.21R:

"If the FSCS has more funds to the credit of a sub-class than the FSCS believes will be required to meet levies on that sub-class for the next 12 months, it may refund the surplus to members or former members of the sub-class on any reasonable basis."

FEES 6.4.6R:

"The FSCS must allocate any specific costs levy amongst the relevant sub-classes in proportion to the amount of relevant costs arising from, or expected to arise from, claims in respect of the different activities represented by those sub-classes."

The proper allocation of recoveries

FSCS's view is that the proper interpretation of these provisions in relation to the allocation of any recoveries by FSCS is as follows:

- (i) FSCS will first need to ascertain all the claims for compensation that it has paid¹ in the 2010/2011 levy year² relating to all those investment firm

¹ As that term is defined in the accounting policies to FSCS's Annual Report & Accounts for the year ended 31 March 2010. The definition includes both amounts paid in compensation and amounts for which offers have been made by FSCS, are due and accepted, and fully valued.

² In the context of a "compensation costs levy", it is FSCS's practice to issue levy invoices in respect of compensation costs from 1 July so that triggers the 12 month period. Accordingly, the 12 month period in the FEES rules in respect of which FSCS calculates the levy (ie, the levy year) is the period

“defaults” whose compensation costs are properly allocated to SD02 (**the Claims**).

- (ii) FSCS will then compare the amount raised by way of the “compensation costs levies” in 2010/2011 in respect of the Investment Funding Class (the “Compensation Costs Levy”) with the compensation costs of the Claims to determine whether there is any shortfall or surplus as a result. If, at 30 June 2011, the compensation costs of the Claims represents an amount less than the Compensation Costs Levy, then the difference shall be credited to the account of SD01.
- (iii) FSCS will also be required to track any recoveries it receives that are attributable to the Claims (whenever those recoveries are received) so that it can carry out the allocation exercise described at point (v) below.
- (iv) The costs that FSCS incurs in pursuing recoveries in respect of the Claims, and more generally, are properly classed as “specific costs” and so would be chargeable to SD02 in accordance with FEES 6.4.6R notwithstanding the triggering of the cross-subsidy in respect of the “compensation costs”. In the context of recoveries, FSCS is under a duty only to pursue those recoveries which are reasonably possible and cost effective to pursue (COMP 7.2.3(2)R). Once that hurdle has been overcome, FSCS must pursue those recoveries in a manner that is consistent with COMP 2.2.6R which states that FSCS “...*must have regard to the need to use its resources in the most efficient and economic way in carrying out its functions...*”.
- (v) To the extent that any recoveries are received by FSCS which are attributable to the Claims (whenever those recoveries are received) as identified at point (iii) above, FSCS will first need to deduct the costs that it incurs which are specifically attributable to those recoveries and refund

from 1 July to 30 June, reflecting the fact that the proceeds of the levy raised at the beginning of each financial year do not in practice become available until the beginning of July. FSCS has operated on this basis since its establishment in 2001.

SD02 accordingly in accordance with FEES 6.3.20A. FSCS will then apply the “net” recoveries received to SD01 first unless and until the total sum credited from such recoveries (together with any sum credited under point (ii) above) exceeds the aggregate compensation costs of the Claims together with interest at a rate equivalent to the Bank of England’s repo rate from time to time in force on the outstanding balances calculated on a daily basis. Thereafter, FSCS will apply the “net” recoveries received to SD02.

Financial Services Compensation Scheme

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