



# early start:report&budget:2001/02

Financial Services Compensation Scheme Limited **Paper - FSCS (01) 1**



*the new*

# Financial Services Compensation Scheme

**1** The Financial Services and Markets Act 2000 (FSMA) created a new, single financial services compensation scheme covering investment, deposit and insurance. The Scheme will come into existence at 'N2', being the Act's implementation date<sup>1</sup>. The Scheme will compensate eligible consumers in accordance with the Scheme's rules in the event of the failure of any FSMA authorised firm (or of any participating EEA firm). The Scheme will cover eligible claims in respect of deposits, contracts of insurance and investment business. The new Scheme will replace the existing six compensation Schemes<sup>2</sup> thereby creating a single point of contact. In March 2000 the Financial Services Authority (FSA) established the Financial Services Compensation Scheme Limited (FSCS) (a company limited by guarantee) to be the Scheme Manager for this new Scheme.

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<sup>1</sup> N2 is currently expected to be 31st July 2001.

<sup>2</sup> The six schemes are the Building Societies Investor Protection Scheme, the Deposit Protection Scheme, the Friendly Societies Protection Scheme, the Investors Compensation Scheme, the Policyholders Protection Scheme and the Section 43 Scheme. These are described at Annex B.

## Announcing the FSCS' Early Start

**2** From the 1st February the FSCS has assumed responsibility for compensation in respect of investment business (handled by the Investors Compensation Scheme (ICS)) and for providing operational resource for the arrangements for deposit protection (overseen by the Deposit Protection Board (DPB)). This report explains the reasons why the FSCS has taken this step in advance of N2. Deposit business undertaken by banks is covered by the Deposit Protection Scheme. This Scheme is operated by the Deposit Protection Board. Details are also provided of the combined Scheme's 2001/02 budget.

## Why an Early Start for the FSCS

- 3** The FSCS' Directors (listed at Annex A) were appointed by the FSA to begin preparing for delivery of compensation from N2. The FSCS Board has decided, following consultation with the FSA, the DPB and the ICS, to make an early start. This decision was reached after consideration of several powerful arguments including the need to:
- a** Ensure that high standards associated with the provision of compensation are maintained;
  - b** Maintain continuity in decision making. The wait for N2 made long term planning difficult;
  - c** Reassure staff and maintain their morale during a time of uncertainty;
  - d** Achieve managerial integration before the implementation of the FSMA and thereby diminish the risks associated with transitional periods;
  - e** Create an environment conducive to the FSCS taking a proactive approach in working together with the FSA in the development of the new Scheme's rules and procedures;
  - f** Achieve as soon as possible the benefits both to consumers and the financial services industry of bringing together the compensation schemes to the extent that this can be done in advance of N2;
  - g** Enable the FSCS Board and its Executive to begin doing the jobs for which they were recruited; and
  - h** Maintain effective control over costs.

- 4 By starting in advance of N2 to create a single organisation with its own ethos, the FSCS is following the successful leads of both the FSA (ten bodies into one) and the Financial Ombudsman Service (seven bodies into one). The DPB and ICS have worked with the FSCS to achieve this early start.

## Making Early Start Happen

### *DPB – Service Level Agreement*

- 5 The DPB is a statutory body<sup>3</sup>, and will remain in existence until N2. A Service Level Agreement has been arranged between the FSCS and the DPB under which the FSCS will provide resources to enable the DPB to carry out its functions under the Banking Act 1987. The DPB will retain its separate identity and decision making powers. The FSCS will report regularly to the DPB so that it can remain satisfied that its functions are being discharged in accordance with its statutory obligations. From 1st February 2001 employees carrying out tasks for the DPB will be FSCS employees.

### *ICS – A FSCS Subsidiary*

- 6 The ICS was appointed the Scheme Manager for investor compensation under section 54 of the Financial Services Act 1986. In November 2000 the FSA published Consultation Paper 72, 'Proposed Amendments to the Compensation Scheme Management Company', which sought views on the proposal that ICS should be replaced by FSCS in order that the FSCS could begin operating early. The responses received to that CP indicated no disagreement with this suggestion.

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<sup>3</sup> The DPB was established under the Banking Act 1987.

**7** Following CP 72's publication, both FSCS and ICS concluded that an early start could be achieved without the need for a formal rule change. They agreed that the transfer of ICS Ltd's managerial control could best be done by making it a subsidiary of FSCS Ltd. This would be achieved by:

- > FSCS Ltd becoming the shareholder of ICS Ltd; and
- > Members of the existing ICS Ltd's Board being replaced by Members of FSCS Ltd's Board at close of business on 31st January 2001.

**8** Utilising this route ICS Ltd can remain until N2 as the Scheme Manager for investor compensation. However, with the two Boards being identical and the two companies in the same group, in effect a single enterprise has been created with FSCS assuming operational control. Both companies will continue to remain independent from the FSA. ICS staff, like DPB staff, will be FSCS' employees from 1st February.

**9** The FSCS Board has also taken steps to ensure that the interests of SRO<sup>4</sup> members continue to be adequately represented. To that end it has set up three industry standing committees onto which industry representatives will be co-opted to provide a conduit for existing expertise to be made readily available to the Board. Further, it has been arranged for certain Board members to represent SRO interests until N2.

## Policyholders Protection Board

**10** The Policyholders Protection Board (PPB) provides compensation in respect of insurance business written by most general and life insurance companies. While it has not been possible for PPB to be part of the FSCS' early start, negotiations are underway to enable it to join the other active schemes under the FSCS umbrella before N2.

## Co-Location

**11** While it was hoped that the Schemes could be physically co-located as from the 1st February 2001, this has not proved possible. Achieving co-location is, however, not crucial for a successful early start.

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<sup>4</sup> Self Regulating Organisation i.e. the Investment Management Regulatory Organisation Ltd (IMRO), the Personal Investment Authority (PIA) and the Securities and Futures Authority (SFA).

**12** It was also originally hoped that FSCS could take over the ICS' premises at Cottons Centre when its lease expires at the end of June 2001. This has not been possible, and the new Scheme has had no choice but to seek other accommodation. Thus, the Scheme's offices will be located at 7th floor, Lloyds Chambers, 1 Portsoken Street, London, E1. Subject to fit-out being completed, it is intended that co-location will take place in mid June 2001. Until then the DPB and ICS will continue to function out of their current premises<sup>5</sup>. Paragraph 21 below explains the capital costs associated with co-location.

## Financial Services Compensation Arrangements After N2

**13** From N2 there will be only one compensation scheme. On that date the FSCS will assume the work carried out by all six compensation schemes. This will include, in addition to work undertaken by the DPB, ICS and PPB, the compensation arrangements now provided by the Building Societies Investor Protection Scheme (in respect of deposit taking business undertaken by building societies), the Friendly Societies Protection Scheme (in respect of insurance business carried on by friendly societies) and the Section 43 Scheme (in respect of business carried on by 'listed money market institutions' under s43 of the Financial Services Act 1986).

## Funding the Schemes Pre-N2

**14** The transfer of operational control from ICS to FSCS will not affect any monies standing to the credit or debit of ICS' contribution groups on the 1st February. Further, operational procedures for funding compensation for pre N2 claims will, until N2, remain the same, with DPB and ICS retaining, until that date, the power to raise levies, as and when necessary. Only after N2 will the FSCS have the power to raise levies.

## The Responsibility for Costs from Early Start

**15** From 1st February staff costs will be incurred by the FSCS. Responsibility for premises costs will remain with the DPB and ICS until the co-location date when FSCS will assume responsibility for its premises at 1 Portsoken Street. Until N2, when the FSCS assumes full responsibility for all expenditure, these costs will be recharged, as appropriate, to those schemes as service fees. As explained at paragraph 19 below, the FSCS' own set up costs during this period will be deferred, to be recovered from regulated firms after N2 under the new funding regime being finalised by the FSA.

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<sup>5</sup> DPB is located at FSA Headquarters, 25 The North Colonnade, London, E14 5HS and the ICS is located at Cottons Centre, Cottons Lane, London, SE1 2QB.

## Budget for 2001/02

### Summary figures

**16** Until N2 DPB and ICS will remain responsible for their own operating costs, payment of compensation and raising of funding levies. The forecast for the current year to 31st March 2001, and the 2001/02 combined budget figures for DPB and ICS together with FSCS are shown in the table of summary figures below. The forecast amounts are the combined figures provided by the DPB and ICS as at December 2000. The budget figures are based on preliminary submissions by those Schemes and the FSCS. The latter have been adapted to reflect early start arrangements.

	Forecast 2000/01 £m	Budget 2001/02 £m
Combined Scheme costs	11.4	11.3
Compensation payable	61.4	50.1
<b>Total costs</b>	<b>72.8</b>	<b>61.4</b>
<i>Funded as follows:</i>		
Interest receivable (net of tax)	1.5	0.6
Levies	72.8	61.9
Amounts deferred (see paragraph 19)	1.1	1.1
Transfer (to) reserves / funds	(2.6)	(2.2)
	<b>72.8</b>	<b>61.4</b>

## Budget for 2001/02 *continued*

### *The Combined Scheme Costs*

- 17** The budget figures above indicate that the FSCS' costs in its first full operating year (2001/02) are expected to be around 5% less than the separate DPB and ICS preliminary budgets for the same period due to expected savings in such areas as corporate management.
- 18** Scheme costs are largely demand driven. Financial and operational controls and procedures will be implemented to ensure that the new scheme operates in an economical and efficient manner.
- 19** Over the two year period to 31st March 2002, the FSCS will incur set up and revenue costs which are deferred. These are separated out in the table above and are also included within the combined Scheme costs. Until N2 the FSCS is unable to recover its costs and it is only after that date that it has the power to raise its own levies. For that reason, these amounts are 'deferred'. It is expected that deferred costs will be recovered over a period of three years from the year following N2.
- 20** In broad terms, the combined scheme costs cover:

	Forecast 2000/01 £m	Budget 2001/02 £m
Board, staff salaries <sup>6</sup> , and related costs	6.8	6.0
Premises <sup>7</sup>	1.3	1.2
Other administrative costs <sup>8</sup>	3.3	4.1
<b>Scheme costs</b>	<b>11.4</b>	<b>11.3</b>

- 21** FSCS will incur costs of a capital nature associated with the fit-out of its new premises at Portsoken Street and IT integration. These are currently estimated at some £4m. Capital amounts will be depreciated at annual rates, which will write-off the assets over their useful lives. The fit-out costs will be amortised over the period of the lease.

<sup>6</sup> Staff salaries reflect an expected reduction in the Schemes' headcount.

<sup>7</sup> Premises costs anticipate occupation of the 7th floor, Lloyds Chambers from mid-June 2001.

<sup>8</sup> Other administrative costs include such items as office services, professional fees and the amortisation of fit-out costs.

## Budget for 2001/02 *continued*

### *Compensation*

- 22** Estimates for compensation payable will be updated against circumstances prevailing nearer to 31st March 2001 when levies are set. ICS is expected to make its levy in April 2001. The contribution groups are primarily those regulated by the current SROs, and the levy will be subject to the usual consultation. The DPB is not expected to need to raise levies as its costs will be applied against their existing funds and reserves.

### *Reserves*

- 23** No allowance has been made to create a level of reserves for FSCS. This will be considered in conjunction with decisions to be taken on raising levies after N2.

## Conclusion

- 24** This paper explains the FSCS' progress in bringing two of the currently active Schemes together as from 1st February 2001 and its budget for 2001/02. The FSCS welcomes any comments on its budget which should be sent to Mr David Wilson, FSCS, Cottons Centre, Cottons Lane, London, SE1 2QB by no later than 1st March 2001.

## Annex A

# Directors of The Financial Services Compensation Scheme Ltd

*Members of the Board are:*

### **Nigel Hamilton (Chairman)**

Consultant Ernst & Young UK, former Chairman of Corporate Restructuring at Ernst & Young UK, former President of the Society of Practitioners of Insolvency, former member of the Council of The Institute of Chartered Accountants in England & Wales (ICAEW) and past Chairman of the Insolvency Practitioners Committee at ICAEW.

### **Michael Blair QC**

Chairman PIA and IMRO, formerly General Counsel FSA, General Counsel then Deputy Chief Executive at the Securities and Investments Board, Treasurer of the Bar Council 1995-98, previous career in Lord Chancellor's Department.

### **Sarah Brown**

Former director of company law at the Department of Trade and Industry, reporting member of the Competition Commission, member of the Friendly Societies Commission.

### **Kenneth Culley, CBE**

Formerly Chief Executive of the Portman Building Society, a past Chairman of the Building Societies Association, Director of Fleming Managed Growth plc, Fleming Managed Income plc, Brit Insurance Ltd and Marks and Spencer Financial Services Companies.

### **Kit Jebens, CBE**

Non-Executive Director of the Investors Compensation Scheme since 1995, Chief Executive of Life Assurance & Unit Trust Regulatory Organisation 1989-1994, previous career in the armed services.

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## Annex A

# Directors of The Financial Services Compensation Scheme Ltd *continued*

### **Graeme MacLennan**

Chartered accountant with over 30 years experience in fund management, formerly member of advisory committees on Scottish financial services and committee member at the Association of Investment Trust Companies.

### **Suzanne McCarthy (Chief Executive)**

Member of the Senior Civil Service, formerly Chief Executive of the Human Fertilisation and Embryology Authority, previous posts held in HM Treasury and Home Office, earlier career as an academic lawyer and solicitor in private practice.

### **Luke March**

Chief Executive of Mortgage Code Compliance Board, Non- Executive Director of the Investors Compensation Scheme since 1999, Corporate Governance Director of British Telecom, previously with Lloyds TSB and EMI.

### **John Young, CBE**

Chairman of the Regulatory Board and independent deputy chairman of the Council at Lloyd's, formerly director of policy and planning at the Stock Exchange, Chief Executive of the Securities and Futures Authority and then Chief Executive of the Securities and Investment Board, earlier career in institutional stockbroking.

## Annex B

# The Existing Compensation Schemes

### **1** *Building Societies Investor Protection Scheme*

The Building Society Investor Protection Scheme, established under the Building Societies Act 1986, provides cover for deposits and shares offered by building societies subject to certain exclusions. The Scheme has not to date been operated but, in the event of a building society insolvency, all authorised building societies would be required to contribute to the Fund. Each protected depositor/shareholder would be entitled to receive payment of 90% of their holding up to a maximum payment of £18,000 (20,000 euro, if greater). The Scheme covers deposits made in the European Economic Area (EEA) currencies and euro.

### **2** *Deposit Protection Scheme*

The Deposit Protection Scheme, established under the Banking Act 1987, provides cover for deposit business undertaken by banks. The Deposit Protection Board (DPB) runs the Scheme which is funded by contributions from banks. There is a modest standing fund. The scheme is triggered by the insolvency of a bank. Each protected depositor would be entitled to receive payment of 90% of their deposit up to a maximum payment of £18,000 (20,000 euro, if greater). The Scheme covers deposits made in the European Economic Area (EEA) currencies and euro with branches of UK and, subject to special rules, deposits with UK branches of banks from other EEA members states where those banks have opted to participate in the Scheme as well as in the scheme of their home state.

The DPB has made compensation payments totalling £118m since its inception in 1979 to December 2000.

### **3** *Friendly Societies Protection Scheme*

The Friendly Societies Protection Scheme is a voluntary scheme providing cover for insurance business carried on by friendly societies. The protection available is equivalent to that under the Policyholders Protection Scheme (see below) for comparable business. The Scheme has never been triggered.

### **4** *Investors Compensation Scheme*

The Investors Compensation Scheme was established by the Securities and Investments Board under the Financial Services Act 1986, and provides cover for investment business undertaken with firms regulated by the FSA (formerly the Securities and Investments Board) or one of the self-regulating organisations such as IMRO, PIA and SFA. It is a private company limited by guarantee. The Scheme is funded by levies on regulated firms. There is no standing fund.

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## Annex B

# The Existing Compensation Schemes *continued*

The Scheme is triggered by the failure of a regulated firm to meet its civil liabilities including negligence or breach of regulatory rule, in respect of investment business carried on under the 1986 Act. Eligible investors are those defined as private investors by FSA rules, (essentially private individuals and small commercial entities) and trustees other than unit trust trustees. Business carried on in the EEA via branches or cross border services by UK firms falling within the scope of the EU Investor Compensation Directive is also eligible for compensation. Relevant firms from elsewhere in the EEA carrying on business in the UK may also be able to participate in the Scheme in order to ‘top-up’ the compensation arrangements of their home state.

Each eligible investor is able to receive compensation of up to £48,000 (that is 100% of the first £30,000 of claim, together with 90% of the next £20,000). Total compensation payments over the last two years have risen significantly due mainly to Pensions Review claims. Payments totalling £238m were paid to 19,300 number of investors since its inception in 1988 to December 2000.

### **5** *Policyholders Protection Scheme*

Under the terms of the Policyholders Protection Act 1975, certain policyholders with UK policies who are prejudiced in consequence of the inability of their insurer to meet liabilities under their policy are entitled to financial protection as laid down in the Act. In general, protection is available for individuals in respect of most classes of insurance at 90% and for all policyholders at 100% where the insurance is a compulsory class (i.e. motor and employers’ liability).

The Scheme is funded by statutory levies on authorised UK insurance companies – separate levies are imposed on long term and general insurance business. The PPB has made compensation payments totalling £345.86m since its inception in 1975 to December 2000.

### **6** *Section 43 Scheme*

The Section 43 Scheme provides cover for eligible customers of firms designated as ‘listed money market institutions’ under the Financial Services Act 1986. The Scheme has never been triggered.



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