outlook

fscs

News from the Financial Services Compensation Scheme

ISSUE 6 | JULY 2004

introduction from the

Chairman

Welcome to the latest edition of *OUTLOOK*, FSCS' newsletter for authorised firms.

This issue coincides with the publication of our Annual Report for 2003/04.

Whilst I am pleased that the Scheme has again made savings on its management expenses, towards the end of 2003/04 FSCS has seen the beginnings of fundamental changes in our work, and the nature and quantities of claims coming to the Scheme.

Industry won't be surprised by this, most firms have been affected by increases in claims, for example, for mortgage endowment mis-selling. However, increased claims to FSCS mean increases in costs for our levy payers. Ron Devlin explains the likely impact for firms on page 4.

Nigel Hamilton

Endowment claims starting to have an impact

The latter end of the financial year 2003/04 heralded major developments both in what we do and how we work. In the last half of the year we started to see a fundamental shift in the type and volume of claims being handled by the Scheme, particularly in our Investment Sub-scheme.

Whilst our part of the Pensions & FSAVC Review is coming to a close, (we currently anticipate completing the bulk of this work sometime in 2006), FSCS has experienced an unprecedented increase in claims being received by the Scheme for other investment products. The majority of these are claims for mortgage endowment mis-selling.

This shift in claims work has resulted in a major staff reorganisation and redeployment programme and has immediate implications for our management expenses and compensation costs. See page 4 for further details.

What hasn't changed, however, is our commitment to deliver to consumers and levy payers a service that is responsive, efficient and cost effective.

During 2003/04 we implemented our new Claims Logging And Information Management System (CLAIMS) IT system, a project completed both on time and under budget.

The system will help FSCS manage changes in workflow and promote further efficiencies in our processes, for example by allowing greater use of automated workflows.

I am also pleased to report that the Scheme's actual management expenses for 2003/04 of £11.2m were £1.2m less than budget, a saving of just under 10%. This compares to expenses of £11.9m in 2002/03.

FSCS continues to evolve and take on more responsibility. On 1 January 2004 we became responsible for meeting policyholder claims should Lloyd's Central Fund fail.

With the regulation of High Street firms, FSCS will, from 31 October 2004, become responsible for compensation claims arising from mortgage business, and similarly, from 14 January 2005, general insurance intermediaries.

We are working closely with the FSA and others to ensure that these new streams of work are smoothly incorporated.

Nigel Hamilton

Interim Chief Executive

Suzanne McCarthy left the Scheme at the end of May 2004. We wish her all the best in her new role as Chief Executive of the Office of Rail Regulation. FSCS is indebted to her.

Ron Devlin agreed to take the helm from 1 June 2004 for the interim until the appointment of our next Chief Executive.

After retirement from the FSA, Ron joined FSCS in February 2001 as a Senior Adviser, providing advice and support to investment claims teams and undertaking special projects for the Chief Executive.

Interim Chief Executive, Ron Devlin

Michael Blair, QC

Sarah Brown, OBE

Ken Culley, CBE

Bernard Day, OBE

Graeme MacLennan

Luke March

Tim Vogel

John Young, CBE
(to 31.5.04)

2003/04 Full Year Review

An overview of the work of our claims teams during 2003/04

FSCS' role is to pay compensation to eligible consumers. Claims are handled by different Sub-schemes, depending on the type of claim. Here is a round-up of the work of each of our Sub-schemes for the period 1 April 2003 - 31 March 2004. Our claims teams could not operate effectively were it not for the excellent assistance they receive from our support services teams.

Accepting Deposits

The Accepting Deposits Sub-scheme deals with claims made against failed banks, building societies and credit unions. No new bank failures were reported during 2003/04.

The Accepting Deposits Team processed one claim against London Trust Bank during the year for £4,053.

FSCS received just over £2.4m in recoveries (largely from the BCCI Liquidation) in this Sub-scheme in this financial year. These enabled FSCS to distribute the sum of £4.0m on 24 October 2003 amongst those banks that contributed to the special contribution raised by the Bank of England in 1992.

It is now two years since credit unions came under the protection of FSCS. Dealing with claims in respect of credit unions now makes up the majority of the Accepting Deposits Team's work. We have declared 12 credit unions in default to date, with seven of these declared during the year. Compensation totalling £381,000 was paid to credit union members in 2003/04.

During 2003/04, FSCS recovered £141,000 from credit union bank accounts. A corporate recovery firm was appointed to act on the Scheme's behalf to recover outstanding credit union loans.

During 2003/04 the Accepting Deposits Team continued to act as the Secretariat for the European Forum of Deposit Insurers (EFDI). The EFDI was formed to contribute to the stability of European financial systems by facilitating exchange and co-operation among deposit insurance schemes across Europe.

Changes to FSCS' Board of Directors

The Board of Directors is appointed by the Financial Services Authority (FSA). Under the Financial Services & Markets Act 2000 (FSMA) the FSA appoints FSCS' Directors (*pictured on the left*) on terms which secure their independence from the FSA in the operation of the Scheme. The Chairman's appointment (and removal) is also subject to Treasury approval.

Two new members have been appointed to FSCS' Board by the FSA. Richard Pratt and Kate Williams joined the Board from 1 June 2004. John Young left the Board at the end of May 2004.

Richard Pratt was Director General of the Jersey Financial Services Commission from 1999 to 2003 and before that was Director, External Affairs, at the London International Futures and Options Exchange (LIFFE). He writes and lectures on combating money laundering and on other regulatory issues. His previous career was as a civil servant, principally with the Treasury.

Kate Williams is a licensed insolvency practitioner and a member of the Institute of Chartered Accountants in England and Wales (ICAEW). She previously worked as a Director in the Deloitte & Touche Corporate Recovery Department and at Lloyd's as Head of Corporate Member Solvency in its Risk Management Department.

Biographical details of all board members can be found in our Annual Report or on our website. FSCS' Chairman, Nigel Hamilton, is pictured on page 1.

Richard Pratt

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Kate Williams

Insurance Business

The Insurance Team is responsible for dealing with claims for compensation that arise following the failure of an authorised insurance firm. There are currently twenty-six general business insurers in insolvent run-off with protected claims, and one small life assurance firm. There have been no new insolvencies with protected claims during 2003/04. The most recent insurance insolvency affecting FSCS was Independent Insurance Company Limited in June 2001.

In a number of these insolvencies, where the majority of the liabilities have been quantified and established, the insolvency practitioner may wish to bring the 'estate' to closure. Where we have deemed it appropriate, FSCS has worked with insolvency practitioners to agree a Scheme of Arrangement designed to bring this about in order to release early and enhanced dividends to creditors, including FSCS, without extinguishing protected policyholder rights to compensation. A number of Schemes were agreed during 2003/04: for the KWELM companies, Bermuda Fire & Marine Insurance, Bryanston Insurance and Black Sea & Baltic General Insurance. FSCS was also party to Schemes of Arrangement for Drake Insurance and Municipal General Insurance.

In 2003/04 the Insurance Team has strengthened its review of claims and claims handling by introducing an in-house audit programme of run-off agencies. Audit visits have been carried out for those estates that account for 96% of FSCS' current insurance compensation expenditure.

For both claims decisions being taken and judgements being exercised in the areas of policy liability, legal liability, eligibility and quantum, we have found that generally these are consistent with good practice across all estates currently reviewed.

This audit regime has been welcomed by both the insolvency practitioners and run-off agents. Evidence suggests that our work has been instrumental in improving the processing of protected claims, and in the provision of additional resources to speed up their handling.

The Insurance Team is currently preparing for the inclusion of general insurance intermediaries. For funding purposes the FSA has established a separate Sub-scheme for these firms.

GEOLOGISTICS JUDGEMENT

The Scheme's 2002/03 Annual Report referred to the Geologistics proceedings. These concerned a claim for compensation for defence costs incurred by an Independent Insurance corporate policyholder and considered the protection available under the terms of the Policyholders Protection Act 1975. The claimant was successful at trial, and the Court of Appeal dismissed the Scheme's appeal.

However, considering the potential wider financial impact this case has on firms that contribute to the Insurance Sub-scheme levy, in 2003/04 the Scheme petitioned the House of Lords for leave to appeal this judgement. The petition was refused and the Scheme is now dealing with the matters arising from the judgement, which may have significant financial costs for the industry.

Facts and figures

- Management expenses were £11.2m (a saving of just under 10% against the published budget).
- Total compensation payments amounted to £197.6m, with recoveries of £106.2m receivable.
- The 2003/04 levy collected £87.9m (Investment Sub-scheme).

Compensation payments by Sub-scheme

- Accepting Deposits: 374 payments were made totalling £0.4m.
- Insurance Business: the value of payments totalled £131.4m. Top 3: Independent - £91.1m, Drake - £10.2m, Chester St - £16.1m.
- Designated Investments: 3,335 pensions review and 475 non-pensions review payments were made totalling £65.8m.
    - IFA pensions review claims (A16) totalled £62.0m.
    - Other designated investments totalled £3.8m.

Enquiries up by 30%

The Customer Services Team dealt with more than 53,000 written and telephone enquiries in 2003/04, an increase of around 30% compared to the previous year. The majority of these enquiries related to potential mortgage endowment claims.

Designated Investments

This Sub-scheme handles both Pensions Review and other investment claims. It is made up of a number of sections.

a) Insolvency Team

The Insolvency Team assesses the ability of former authorised firms to meet claims being made against them. If the Scheme is satisfied that a firm cannot do this, then it will be declared in default. FSCS is only able to consider claims for compensation against firms that have been declared in default.

b) Pensions Group

The Pensions Group continues to process those claims resulting from the Pensions Review and FSAVC Review that relate to "departed" firms. (A departed firm is a firm that is no longer authorised to conduct investment business, or is otherwise defunct.)

c) Investment Group

The upward trend in the volume of new claims received not relating to the Pensions & FSAVC Reviews continued into 2003/04, rising from 841 in 2002/03 to 3,342 in 2003/04.

Mortgage endowment claims accounted for the majority of new claims received. This led to the creation of a new team focused solely on processing these claims. A second team is currently being established. A separate Initial Enquiries team has also been established to help this Group manage the high number of enquiries relating to these claims.

Aside from endowments, this year has also seen the arrival of structured capital at risk products ("precipice bonds") and split capital investment trust claims. Further changes to our processes are likely to be necessary in the coming year to enable us to meet the new challenges being presented.

The Investment Group is also preparing for the inclusion of mortgage business and long-term care insurance on 31 October 2004. For funding purposes the FSA has established a separate Sub-scheme for mortgage business.

Increase in Management Expenses Levy Limit needed for 2004/05

With the industry itself facing high numbers of mortgage endowment claims I doubt any would be surprised by the news that FSCS is being affected.

The mortgage endowment situation is unprecedented for FSCS. The distinctive factors are first, the large numbers of potential claimants spread over almost all of a very large population of mostly small, and now defunct, IFAs; and, second, the prompts to policyholders to take some kind of action by regulators, firms, the media and consumer groups.

These factors render prediction of timing and numbers of claims upon the Scheme, for purposes of resourcing, extremely difficult. To a lesser extent we are also now having to take into account an increasing number of "precipice" bond claims.

Resources

It is apparent to us now, including with the benefit of experience and information not available at the time, that the resources we budgeted for 2004/05 are insufficient for the levels of claims now in hand and in prospect.

The gap is such that it cannot be bridged either by productivity gains (although we continue to seek those) or by any reasonable stretching of the time that claimants have to wait for their case to be settled.

We have taken, and are continuing to work at, measures to ensure that the Scheme is able to handle an increased level of claims efficiently, such as streamlining our enquiry and claims handling processes, further developing IT support and setting up dedicated teams.

But FSCS will need to apply significantly more resources than can be funded under the existing 2004/05 Management Expenses Levy Limit in order to process these claims in a reasonable timescale and at the levels now anticipated.

Consulting

The FSA will therefore be consulting on an increase in our Management Expenses Levy Limit for 2004/05 this month.

Our aim in seeking an increase in the Management Expenses Levy Limit is to enable the Scheme to be ready to acquire the resources it needs for processing claims as and when it needs them.

We will do this as flexibly as we can, so that, in broad terms, if claims were not to appear at the budgeted levels then we would spend less than the Limit (which in fact is the experience of the Scheme to date).

Cash-flow

We intend to delay invoicing any increase in this year's Management Expenses Levy until next year (2005/06) to help firms manage cash-flow and reduce administrative costs.

Balancing act

The Scheme performs a balancing act between keeping the burden on our levy payers to a minimum on the one hand, and providing a timely and efficient service to consumers on the other.

I am confident that the industry recognises the need to process claims in a reasonable timescale using the correct resources.

Ron Devlin, Interim Chief Executive

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Questions & answers

1. What change to the levy limit is being proposed?

The FSA will consult on increasing FSCS' Management Expenses Levy Limit for 2004/05 from £12.5m to £17.6m.

2. Why is the change necessary?

When budget planning was undertaken in October 2003 we created an annualised figure based on the number of claims received in the first six months of 2003/04, and doubled it. We intended to manage this level of claims by redeployment of staff from our Pensions Review claims teams as our part of the Pensions Review wound down. However, FSCS experienced significantly higher levels of mortgage endowment cases than predicted, particularly in the last six months of 2003/04 (see below), and the volume of pensions review claims received is also higher than anticipated, so restricting the capacity for redeployment.

Mortgage endowment enquiries and claims received:

			Enquiries	Claims
2002/03 :			**16,096**	**678**
2003/04 :			**33,456**	**2,471**
	Of which:	*April - Sept*	*14,346*	*595*
		Oct - Mar	*19,110*	*1,876*

The original budget provision was for the Scheme to handle up to 2,400 new mortgage endowment claims during 2004/05. We have reviewed and revised our claim volume assumptions, and therefore our budget, based on recent experience of enquiries and claims together with industry indicators which suggest a continuing upward trend in complaints. Publicity about time-barring is also creating a surge in complaints received.

In our Investment Sub-scheme we are now planning for up to 7,000 new mortgage endowment claims during 2004/05, and we have had to revise our estimates of the claims we will receive in respect of precipice bonds. Projections of claims flow are given below.

Type of investment claim	Claims in hand at 1.4.04	Projected new claims in year 2004/05	Expected output capacity in year 2004/05	Projected claims in hand at 31 March 2005
Endowments	2,581	7,000	6,755	2,826
Precipice bonds*	332	4,000	2,000	2,332
Pensions Review	5,315	2,418	4,785	2,948
Other	253	480	480	253
Total	*8,481*	*13,898*	*14,020*	*8,359*

**Claims are processed after a bond matures.*

3. When will firms be invoiced for increased levy costs?

To avoid undue cash flow pressures on firms any additional amounts relating to management expenses during 2004/05 will be included with FSCS' levies invoiced in 2005/06. Levies will be based on actual expenditure and will therefore not necessarily be up to the new Levy Limit. Increases in management expenses will impact mainly on firms in the A12 and A13 Contribution Groups.

4. Are these levels of claims predicted to continue?

It is currently estimated if current trends continue that FSCS will need to maintain increased activity in this area into 2005/06. This will have an impact on the Management Expenses Levy for 2005/06. It is currently predicted that the 2005/06 Management Expenses Levy Limit could be some £24.4m (including the extra £5.1m from 2004/05).

5. Will the increase in claims impact on compensation costs?

If compensation payments increase to the new levels anticipated by the Scheme, the levy for compensation costs on firms in Contribution Groups A12 and A13 could increase by around £15m. Whilst the current intention is not to levy for these costs during 2004/05, this will need to be kept under review.