

outlook



News from the Financial Services Compensation Scheme

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introduction from the Chairman

This issue of *OUTLOOK* coincides with the publication of our Plan and Budget for 2005/06, and the FSA's Consultation Paper CP05/2 on fee and levy proposals for 2005/06.

This is the first time we have published our Plan and Budget. In doing so, we hope to demonstrate that we take seriously our commitment to be accountable to our stakeholders, which include consumers and authorised firms.

The Plan and Budget provides details of our management expense requirements for 2005/06 and estimated compensation costs, supported by information about claims volumes.

This newsletter provides a summary of our Plan and Budget. The full document is available on our website, www.fscs.org.uk.

Nigel Hamilton

Overview from the new Chief Executive Our challenges: managing major change and balancing competing pressures

As the new Chief Executive of FSCS my immediate focus has been on our Plan and Budget and how best to strike the right balance between the competing needs of our stakeholders.

Over the past 18 months, there have been major changes in the nature and number of claims coming to the Scheme.

Pensions Review claims have been coming to an end, and the Scheme expects to receive only around 100 new claims in 2005/06, compared to some 3,000 in 2004/05 and more than 6,000 in 2003/04. At the same time, other investment claims have risen from 850 new claims received in 2002/03, to over 3,000 in 2003/04 and just under 10,000 in 2004/05.

We recognise that these significant changes, over a relatively short timescale, have had an impact on our key stakeholders.

For example, some consumers are having to wait longer than they and we would like for their claims to be processed, and some of our levy payers, particularly investment brokers and advisers (contribution groups A12 and A13) have seen significant increases in their levies.

During 2004/05 FSCS has been focusing on managing these changes, and

putting plans in place for the workload it now anticipates.

In addition to endowment claims, we are expecting to concentrate on new kinds of investment claims relating to precipice bonds and split capital investment trusts. We expect investment claims volumes to rise significantly.

We have also been gearing up for handling claims in the two new areas to which FSCS cover has been extended: mortgage advice and arranging, and general insurance mediation.

Although the total levy on the financial services industry as a whole is likely to be lower than last year, investment brokers and advisers will see another significant increase in levies and fund managers will see a significant increase in levies for the first time.

We include in our budget estimates:

- **known** claims - for defaults already declared, or about to be declared;
- **probable** claims - although the actual volume and timing of claims may not be clear at the time of preparing our budget, it is prudent for us to make some provision for areas that we believe are likely to give rise to claims in the financial year.

We don't include prospective claims - those that are not



New Chief Executive,
Loretta Minghella

yet sufficiently likely to warrant providing for in our central budget - but propose making reserve contingency arrangements for these claims. This gives us the flexibility within our Management Expenses Levy Limit to handle additional claims if they materialise, although we will not levy for these costs if they don't.

Striking the balance

We recognise that, whilst consumers do need a prompt, but considered, response to their claims, we also have to ensure that our levy payers do not pay any more than they need to for the mistakes or misdeeds of others. This Plan and Budget is the basis on which FSCS will try to strike a balance between managing an unprecedented level of claims in a way that will provide an efficient service to consumers, whilst keeping a close eye on costs.

Loretta Minghella

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2004/05

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Half year review 2004/05 - where we are now

Our strategy for 2004/05 has focused on continuing to review our work processes to maximise efficiencies, to improve our service to claimants and to reduce our running costs where possible.

This work is focused on:

Managing increasing claims volumes

To meet increased workloads, between March and December 2004 we increased our staff from 122 to 167 (36%). This figure includes staff on short-term contracts and temporary staff. Temporary and contract staff provide a flexible solution to help the Scheme manage short-term fluctuations in investment claims volumes, and are helping us to manage staff movements relating to the run-off of the Pensions Review.

We plan to increase full time and contract staff to around 180 by the end of 2004/05 (an overall increase of 48% compared to March 2004). Outsourcing is being used to manage the build up of claims that cannot be processed quickly enough in-house.

We have established dedicated teams for initial enquiries, mortgage endowment claims and precipice bond claims, using a mixture of redeployment from the Pensions Review teams and recruitment.

We are analysing the investment claims process to assess, in detail, how long each part of the process takes and to establish where and why waiting time occurs. Enhancements to our IT system are being developed to maximise our use of available technology and automation.

The inclusion of mortgage and general insurance firms

We do not currently anticipate that claims against mortgage firms will be significant. Investment Team staff will be available to handle claims in this area, if they arise.

A separate team has been established for general insurance mediation.

Financial targets and budgetary savings

We now forecast that management expenses for 2004/05 will be £14.6m, against an updated budget of £16.9m (and an original budget of £11.8m). Budget savings are due to a slower than anticipated build up of resources and lower claims volumes in some areas.

Financial forecasts for 2004/05

The total likely costs (including compensation payments) are given in Table 1.

	2003/04 ¹	2004/05 ²
	£m	£m
Total management expenses	11.2	14.6
Compensation payments		
<i>Insurance</i>	131.4	146.3
<i>Investments</i>	3.8	19.3
<i>Pensions Review</i>	62.0	57.7
<i>Deposits</i>	0.4	0.3
Total compensation payments	197.6	223.6
Total costs	208.8	238.2

Claims forecasts for 2004/05

Table 2 below shows our latest revised estimates for anticipated new claims received, based on current information, and our estimate for claims completed during 2004/05. This updates information published in *OUTLOOK Issue 6* (July 2004).

TYPE OF CLAIM	Claims in hand 1 April 2004	Estimate of new claims	Estimate of claims completed	Claims in hand Forecast at 31 March 2005
Investments:				
Endowments	2,600	6,000	3,500	5,100
Precipice bonds	300	3,000	1,400	1,900
Others	300	900	500	700
Total investments	3,200	9,900	5,400	7,700
Pensions Review	5,000	3,100	4,000	4,100
Credit unions	60	400	420	40
M&GI firms ³	0	0	0	0
TOTAL CLAIMS	8,260	13,400	9,820	11,840
Insurance payments ⁴	—	25,400	25,400	—

¹ Extracted from audited financial statements

² Forecast

³ Mortgage and general insurance intermediaries.

⁴ Figures relate to payments only. Insurance claims are usually handled by the appointed run-off agent and presented to FSCS for checking and payment.

Plan and Budget 2005/06

This is a brief overview of the aims and strategy for our Plan and Budget 2005/06. Our claims forecasts, management expenses proposals and levy estimates are overleaf.

In determining our annual strategy, the key challenge for FSCS is how we can balance the needs of consumers with the costs our work places on our levy payers. Part of this challenge involves predicting the numbers and timing of new claim receipts, and resourcing sensibly.

The Plan and Budget for 2005/06 is based on the following high level planning aims:

- 1** To ensure that FSCS can respond to major changes in claims volumes, either side of a central estimate, without significant claims handling delays or inefficient use of resources.
- 2** As a claims handling standard, to complete claims within 6 months (after a declaration of default), and to reduce claims handling times, where possible, without increasing costs for our levy payers in the longer term.

Strategy for 2005/06

The strategy for managing claim volatility and uncertainty focuses on two key areas:

- investment claims; and
- claims against general insurance intermediaries (from 14 January 2005).

The strategy is based on three tools:

- prediction of claims volumes;
- flexible staffing practices and outsourcing;
- a reserve contingency arrangement.

Prediction of claims volumes

Forecasting the numbers and timing of new claims is difficult, particularly for investment and general insurance mediation claims.

We liaise closely with the FSA, the Financial Ombudsman Service (FOS) and industry trade bodies. Trends (both internal and external) are closely monitored.

For investment claims in general there are few specific defaults on which to focus. Claims can come in 'off the street' from customers of a large population of former authorised firms.

For specific investment firm defaults, the potential scale of claims numbers may be available from the FSA, the FOS (where complaints have been made to them) and the liquidator (if appointed). However claims numbers may still not be determined accurately until we declare the firm in default and claims are received.

For claims against general insurance intermediaries there is very little historical data available on which to make considered predictions, and it is therefore very difficult to estimate with confidence numbers of failures or claims.

However, from the information we have been able to gather, we believe that our main exposure to compensation and activity will be in respect of fraudulent selling, eg, taking premiums and not placing cover with an authorised carrier. We are establishing a small team in-house with a capacity to handle around 700 general insurance mediation claims. We have also included a provision in the reserve contingency for possible outsourcing costs.

Flexible staffing practices & outsourcing

To meet increased workloads we plan to increase full time and contract staff to around 180 by the end of 2004/05, an overall increase for the year of 48%.

Our current policy is to outsource claims that cannot be processed quickly enough in house. This includes most of our mortgage endowment claims.

The alternative of extra staff would be more expensive, given that additional accommodation would be needed. It also leads to claim handling delays if teams have to be built and trained whilst higher volumes are arriving. Outsourcing, which we will extend where appropriate to other areas of our work, allows us to respond to rapidly changing claims levels whilst avoiding significant costs for extra space.

Reserve Contingency

Given our experiences to date, and general claims forecasting uncertainties, the FSA are consulting on the proposal for a reserve contingency of £5.6m within a Management Expenses Levy Limit of £27.03m. This is over and above the standard contingency amount regularly included by the FSA (currently £0.35m).

The reserve contingency would be triggered only if funding over and above our budget and the standard contingency were required. If the reserve contingency were used, full details of these requirements, and the implications for compensation costs, would be provided to trade bodies and explained to levy payers.

We have currently identified as potential cost areas for the reserve contingency:

- endowment claims above our central estimates;
- additional claims relating to splits; and
- outsourcing costs for claims against general insurance intermediaries.

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 the Directors 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 the approval of H.M. Treasury. FSCS is independent from the FSA, although accountable to it.

The Chairman and Chief Executive are pictured on page 1. Our other Board members are pictured here and overleaf.

Biographical details are available on our website and in our Annual Report.



Michael Blair, QC



Sarah Brown, OBE



Ken Culley, CBE

Board of Directors

continued



Bernard Day, OBE



Graeme MacLennan



Luke March



Richard Pratt



Tim Vogel



Kate Williams

Summary of claims forecast for 2005/06

Recognising the limitations of current forecasting tools available to us, our current best estimates for claims in 2005/06 are given in Table 3 below.

Table 3 TYPE OF CLAIM	Claims in hand Forecast at 1 April 2005	Estimate of new claims	Estimate of claims completed	Claims in hand Forecast at 31 March 2006
Investments:				
Endowments	5,100	7,000	8,400	3,700
Precipice bonds	1,900	3,600	4,600	900
Others, inc. splits	700	8,800	4,200	5,300
Total investments	7,700	19,400	17,200	9,900
Pensions Review	4,100	100	4,200	0
Credit unions	40	0	40	0
M&GI firms ⁵	0	1,000	700	300
TOTAL CLAIMS	11,840	20,500	22,140	10,200
Insurance payments ⁶	—	12,000	12,000	—

⁵ Mortgage and general insurance intermediaries.

⁶ Figures relate to payments only. Insurance claims are usually handled by the appointed run-off agent and presented to FSCS for checking and payment.

Management expenses for 2005/06

The management expenses budget for 2005/06 is estimated at £21.1m. This compares to the latest forecast expenditure of £14.6m for 2004/05 (budget £16.9m). The FSA are consulting on a Management Expenses Levy Limit of £27.03m for 2005/06, including amounts for contingencies.

Current levy estimates by contribution group

The total estimated levy in 2005/06, reflecting the current estimates of likely compensation costs, is £202.9m. An indication of current levy proposals by contribution group is given in Table 4 below. Early calculations of future levies are only indicative and should be treated as such. An announcement of the actual levy amounts required is expected to be made in March 2005.

Table 4 Levies by contribution group	Ref	2004/05 Actual levy £m	2005/06 Prospective levy £m	Increase / (decrease) £m
Accepting deposits				
Deposit takers	A1	0.0	0.0	-
Insurance				
General insurance	A3	135.0	95.0	(40.0)
Life insurance	A4	0.0	0.0	-
Insurance intermediaries	A19	0.0	1.7	1.7
Investments				
Fund managers	A7	0.1	27.0	26.9
Managers of AUTs, ACDs and depositories	A9	0.5	0.7	0.2
Dealing as principal	A10	0.3	0.0	(0.3)
Brokers holding client money	A12	7.2	16.0	8.8
Brokers not holding client money	A13	25.4	30.0	4.6
Corporate advisers	A14	0.1	0.1	-
Mortgage brokers	A18	0.0	0.4	0.4
Pensions review		64.1	32.0	(32.1)
Totals		232.7⁷	202.9	(29.8)

⁷ The 2004/05 levy was announced at £218.2m, but further cash amounts have been received as firm tariff amounts were updated.