

# outlook



News from the Financial Services Compensation Scheme

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## Initial 2005/06 levy set at £160.7m

FSCS has set its initial 2005/06 levy at £160.7m, a reduction of some £42m on forecasts made in January and a reduction of £77m on 2004/05 levy amounts. This initial levy excludes funding for potential splits claims, although a further levy for these claims remains likely during 2005/06.

**Other adjustments reflect a reduction in the expected compensation payments for general insurance claims and increases in anticipated payments for precipice bond claims, based on latest claims experience.**

### Chief Executive Loretta Minghella explains.

Our Plan and Budget provided early indications of potential claims for 2005/06, and the likely costs for levy payers. As we explained then, our business is inherently uncertain and there are many variables that impact on our forecasts. Claims information changes daily and our forecasts are updated as new information is received.

Our current levy requirements, compared to forecasts published in January, illustrate just how much can change in three months. Our actual funding needs are ultimately determined by the number and value of claims received.

Whilst we have to ensure that we are adequately funded for claims we estimate we will deal with in a levy period, we also share the industry's view that levies should not be raised unnecessarily or where there is insufficient clarity about the costs and allocation of claims. Our approach reflects that.

For example, in January, the information available to us at that time suggested that we should brace ourselves for significant claims relating to splits. We included indicative figures in our forecasts.

Although the prospect of substantial volumes of splits claims remains, there are significant uncertainties about the timing, number, nature and costs of claims.

It is not sufficiently clear how much we might need to levy, and in respect of which contribution groups.

For example, Exeter Fund Managers Limited went into administration on 3 March, but it is not, so far, in default and the situation may take some time to be clarified.

In light of all the uncertainties, our Board does not believe that it is reasonable to levy for possible splits claims at this stage.

We will keep the industry informed as the splits situation develops, but firms in contribution groups A7, A9, A12 and A13 should note that a splits levy is likely, and this may impact on them.

We have also had to make some significant adjustments to the amounts allocated to contribution groups in respect of other investment claims, especially precipice bonds, to reflect our claims experience over the last three months. As a result our levy requirement for firms in A13 has increased substantially, by £7.4m.

Although the overall levy is down on last year, for many small firms levies have increased. We appreciate that this is tough news. We also recognise that firms will want more information about any additional levies as soon as possible. We will provide an update as soon as we can. **LM**



## introduction from the Chairman

This issue of *OUTLOOK* provides details of our initial levy requirements in 2005/06. It also updates forecasts given in our Plan and Budget 2005/06, which was published for the first time in January.

Whilst acknowledging that our forecasts can only be indicative, I hope that the information in our Plan and Budget and *OUTLOOK Issue 7* helped our stakeholders understand more about the work we do, and how we determine levy requirements.

It certainly prompted some very useful and constructive feedback. We recognise the significant impact our work has on the financial services industry. We are particularly grateful for the engagement of trade bodies in the process and their support for the role FSCS plays in protecting consumers and promoting consumer confidence.

Nigel Hamilton



Chief Executive, Loretta Minghella

## Key changes

**Splits costs removed** from this initial levy, although a levy remains likely during 2005/06. A levy for splits claims could have a significant impact on firms in A7, A9, A12 and A13, depending on the number and type of claims received.

This means that, initially, the **A7** levy is £0.2m, compared to a forecast of £27m, and there is currently no levy for **A9**.

**A12 levy £12.4m**, a reduction of £3.6m on the forecast. This reflects the removal of splits claims and increases in anticipated compensation payments, mainly for precipice bond claims, based on recent and current experience.

**A13 levy £37.4m**, an increase of £7.4m on the forecast. This reflects increases in compensation payment estimates mainly for precipice bond claims, based on recent and current experience.

**A3 levy £78m**, a reduction of £17m on the forecast. This reflects an expected reduction in compensation payments.

## 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 HM 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 on page 3.

Biographical details are available on our website [www.fscs.org.uk](http://www.fscs.org.uk), and in our Annual Reports.



Michael Blair, QC



Sarah Brown, OBE



Ken Culley, CBE

## Forecasting in an uncertain world

In determining our annual budgets and levies, one of the key challenges for FSCS is predicting the likely costs of claims and where those costs should be allocated.

Forecasting is a complex process. We make assumptions on the numbers and timing of new claim receipts, based on our most recent experience and claims we believe are 'in the pipeline'. We then need to estimate how many of these claims are likely to be eligible for compensation; how many are likely to be paid in the levy period (which runs to 30 June 2006); the likely value of claims; and which contribution groups will be required to fund them.

Precise claim numbers, values and allocations are always unpredictable, and successive forecasts will inevitably change over time in light of actual claims experience. However, firms ultimately only pay for claims that arise from the contribution group to which they belong.

For example, in new areas, such as the potential default of a large investment firm such as Exeter Fund Managers Limited (EFM), it is particularly difficult to determine funding requirements and where any costs might be allocated. If EFM is declared in default by us, a number of factors will affect where the costs of claims are allocated.

This will depend on where the liability to investors may fall, whether on EFM if there were any failures in its selling or management of funds, and/or on investment advisers because of their role in relation to the selling of EFM products. This will take some time to assess. FSCS is currently in discussions with the administrators, the FSA and the Financial Ombudsman Service about the likely nature and value of claims, and to determine which contribution group(s) would need to fund any compensation costs.

Our current forecasts for 2005/06 are on page 3. The costs of potential splits claims are currently excluded.

## Industry raises concerns over contribution group structure

Some firms and their trade bodies have criticised the rules which require FSCS to charge the costs of compensation to the industry by reference to the 'contribution group' covering the activity which gives rise to a claim.

Critics say the contribution groups are drawn too broadly and bracket together firms with very different business models. The levy rules were made by the FSA in 2001 after extensive consultation and these recognise that contribution groups which are too small are much more likely to become unsustainable.

We understand that the FSA is considering whether there is a need to do more to address these concerns in future years. It has made clear that there will be no changes to these funding structures for 2005/06.

FSCS levies, not including any costs for splits, will be included on a single invoice covering FSA, FOS and FSCS fees, to be sent out by the FSA from June and payable in full within 30 days.

However, the FSA is working with the Small Business Practitioner Panel, trade associations and FSCS to see if the market

can provide credit facilities to enable firms to pay by instalments.

Our current funding structure is outlined here.

For levying purposes FSCS is split into sub-schemes. Each sub-scheme contains one or more contribution groups, based on the FSA's fee blocks.

Firms are allocated to a contribution group (or groups) according to their regulated permissions (i.e. the type of business they are authorised to transact).

The sub-schemes are accepting deposits, insurance business, designated investment business, mortgage advice and arranging (from 31 October 2004) and insurance mediation (from 14 January 2005).

Only firms within a specific contribution group (or groups) can be levied in respect of compensation payments, and related management expenses, for that type of business.

A firm could be allocated to one or more contribution groups, and therefore sub-schemes, by virtue of its regulated activities.

For more information please see our website: [www.fscs.org.uk](http://www.fscs.org.uk)

## Summary of claims forecast for 2005/06

Updated estimates for likely claims in 2005/06 (excluding splits) are given in Table 1.

<b>Table 1</b> TYPE OF CLAIM	Estimate of new claims	Estimate of claims completed	Estimated compensation payments <sup>1</sup>
			£m
Investments:			
Endowments	7,000	8,400	9.3
Precipice bonds	2,700	3,700	28.0
Others, ex. splits	1,100	1,300	9.6
<b>Total investments</b>	<b>10,800</b>	<b>13,400</b>	<b>46.9</b>
Pensions Review	400	4,400	66.0
Credit unions	0	40	0.5
M&Gf firms <sup>2</sup>	1,000	700	<i>unknown</i>
<b>TOTAL CLAIMS</b>	<b>12,200</b>	<b>18,540</b>	
<i>Insurance payments</i> <sup>3</sup>	<i>12,000</i>	<i>12,000</i>	<i>159.5</i>

<sup>1</sup> Excludes FSCS management expenses.

<sup>2</sup> Mortgage and general insurance intermediaries. The value of possible compensation payments is currently unknown.

<sup>3</sup> Figures relate to payments only. Insurance claims are usually handled by the appointed run-off agent and presented to FSCS for checking and payment.

**ESTIMATED VALUE OF COMPENSATION PAYMENTS 2005/06**      **£272.9m**

## Management expenses for 2005/06

The FSA consulted on a Management Expenses Levy Limit (MELL) of £27.03m, which is now confirmed. The MELL covers our management expenses budget of £21.06m, the reserve contingency of £5.62m and other contingencies of £0.35m. The initial levy includes funding for £18.7m of the management expenses budget and excludes splits related costs. As indicated, we will not levy for the reserve contingency amounts unless absolutely necessary and we will contact trade bodies if this is likely.

## Levies by contribution group

The initial 2005/06 levy has been set at £160.7m, although, as explained, a further levy may be needed in relation to split capital investment trust claims. Such a levy could impact on firms in A7, A9, A12 and A13. Firms will be kept informed of levy requirements as the situation is clarified. Questions and answers for each contribution group are on page 4 and a breakdown by contribution groups is given in Table 2 below. This initial levy is a reduction of £77m on 2004/05 levy amounts and is £42.2m lower than forecast in January.

<b>Table 2</b> Levies by contribution group	2005/06 forecast	2005/06 Initial levy <sup>4</sup>	2004/05 levy amounts <sup>5</sup>	Increase / (decrease) on 2004/05
	£m	£m	£m	£m
<b>Accepting deposits</b>				
A1 Deposit takers	0.0	0.0	0.0	0.0
<b>Insurance</b>				
A3 General insurance	95.0	78.0	139.7	(61.7)
A4 Life insurance	0.0	0.0	0.0	0.0
<b>Investments</b>				
A7 Fund managers	27.0	0.2	0.1	0.1
A9 Managers of AUTs, ACDs and depositories	0.7	0.0	0.5	(0.5)
A10 Dealing as principal	0.0	0.0	0.3	(0.3)
A12 Brokers holding client money	16.0	12.3	7.2	5.1
A13 Brokers not holding client money	30.0	37.4	25.4	12.0
A14 Corporate advisers	0.1	0.1	0.1	0.0
<b>A18 Mortgage brokers</b>	<b>0.4</b>	<b>0.4</b>	<b>0.0</b>	<b>0.4</b>
<b>A19 Insurance intermediaries</b>	<b>1.7</b>	<b>1.3</b>	<b>0.0</b>	<b>1.3</b>
<b>Pensions review</b>	<b>32.0</b>	<b>31.0</b>	<b>64.4</b>	<b>(33.4)</b>
<b>Totals</b>	<b>202.9</b>	<b>160.7</b>	<b>237.7</b>	<b>(77.0)</b>

<sup>4</sup> The levy is set to recover anticipated compensation payments and management costs (less recoveries and interest receipts), and takes into account fund balances in hand. <sup>5</sup> Estimated

## Board of Directors

*continued*



Bernard Day, OBE



Graeme MacLennan



Luke March



Richard Pratt



Kate Williams

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Photographer 2004

# Questions and answers

## Contribution Group A1 - Accepting deposits

### Why is FSCS not raising a levy from firms in this group?

FSCS received funds from the Deposit Protection Board at N2 which are sufficient for this group's contribution to our management costs and the small number of (credit union) defaults anticipated. It would not be economic to redistribute the remaining funds held.

## Contribution Group A3 - General insurance

### FSCS originally forecast a levy of £95m for claims costs against insolvent insurance firms. Why has this been reduced?

FSCS relies on information from insolvency practitioners (IPs) about the likely cost of claims in this area. FSCS doesn't process individual claims against insolvent insurers, as these are handled by the IPs' claims handling agencies and the work is audited by FSCS.

Updated information from IPs has indicated that the overall cost of the claims against insolvent insurers would be lower than originally forecast during the last quarter of 2004/05 and during 2005/06.

The cost may be further reduced by additional recoveries which it appears may be forthcoming during the year. If this is known before levy invoices are issued, we will make any appropriate adjustments.

## Contribution Group A4 - Life insurance

### Why is FSCS not raising a levy from firms in this group?

FSCS received funds from the Policyholders Protection Board at N2 which continue to be sufficient for our current costs.

## Contribution Groups A7 - Fund managers & A9 - Managers of AUTs, ACDs and depositories

### In January FSCS forecast substantial levies on these groups. Why have these amounts now been reduced?

FSCS indicated a potential funding requirement of approximately £27.7m from firms in these groups during 2005/06, largely due to anticipated splits claims.

Although the prospect of significant claims volumes remains, much of the information we need to enable us to estimate and allocate the potential costs is currently unavailable. In light of this, our Board believes it is premature to levy at this time.

For example, the administration of Exeter Fund Managers Limited is at a very early stage. This firm has so far not been declared in default by FSCS. We are currently investigating the potential nature and complexities of any claims, and where related costs might fall.

## Contribution Group A10 - Dealing as principal

### Why is FSCS not raising a levy from firms in this group?

No claims are anticipated against firms in this group. This group's share of our management expenses are deducted from funds brought forward from 2004/05.

## Contribution Group A14 - Corporate advisers

### Why is FSCS not raising a levy from firms in this group?

No claims are anticipated against firms in this group. This group's contribution to our management expenses is taken from funds brought forward from 2004/05.

## Contribution Group A12 - Brokers holding client money

### Why has FSCS reduced the levy on firms in this group?

FSCS has removed its earlier estimates for claims relating to split capital investment trusts from this group, although we may have to levy for these later in the year. Some adjustments have also been made to reflect the likely costs of precipice bond and endowment claims in 2005/06, which have been updated in light of our latest claims experience.

See A13 below for more information.

## Contribution Group A13 - Brokers not holding client money

### Why has FSCS increased the levy on firms in this group?

Any allocation for possible splits claims has currently been deferred, but may impact on firms in this group.

However, we have adjusted the amounts included for the likely costs of precipice bond and endowment claims in 2005/06, in light of recent claims experience and current claims in hand.

In particular, the increase in the levy in A13 reflects updated forecasts which indicate an increase in anticipated compensation payments for precipice bond claims. We have now made about 1,200 decisions in relation to precipice bond claims, 900 of which were made in the last three months. This provides a much more reliable sample on which to base our forecasts for compensation costs attaching to claims in 2005/06.

## Contribution Group A18 - Mortgage brokers

### Why is FSCS only raising a small levy in this group?

Very few claims are anticipated against firms in this group. The levy reflects this group's contribution to our management expenses, including costs brought forward for the 'stub' period 31 October 2004 to 31 March 2005.

## Contribution Group A19 - Insurance intermediaries

### Why has FSCS reduced its levy on firms in this group?

The levy in this group relates to management costs for 2005/06 and for the 'stub' period from 14 January 2005, which are now expected to be lower than previously forecast. We have not included any amounts for compensation payments, as the number and value of claims is currently too uncertain. If FSCS experiences significant claims in this area a further levy may be necessary. We will inform firms if a levy becomes necessary.

## Pensions review claims

### Why has FSCS reduced its levy on firms in this group?

The FSA is passing to FSCS excess funds remaining after completing its work on the pensions review. It was agreed this should be used to help reduce the burden on firms as FSCS completes claims against departed firms. This is reflected in the levy. Our work in this area is likely to continue until at least the end of 2006, and possibly beyond that, albeit on a very much reduced scale. A further levy on firms in this group is likely in 2006/07.

More Q+As are on our website: [www.fscs.org.uk](http://www.fscs.org.uk)