Financial Services Compensation Scheme

outlook

News from the Financial Services Compensation Scheme

Issue 13 | July 2006

180% increase in completed claims

Welcome to our new look industry newsletter, Outlook. This issue highlights some of the key facts from our 2005/06 Annual Report, which was also published this month.

Our primary focus in the last financial year (1 April 2005 - 31 March 2006) has been to continue to deal with unprecedented levels of claims, particularly in relation to mortgage endowments. The number of claims we completed this year increased by 180% compared to 2004/05, which is a significant achievement compared to only a 62% increase in management expenditure.

Of those claims completed, 16,000 related to mortgage endowments. We committed to completing 15,000 of these claims during the year - a target we exceeded - and, as promised, we are on track to clear the majority of endowment claims received before 1 October 2005 by the end of July 2006. In total, new claims received this year were up by 60% on 2004/05; the majority of these relate to mortgage endowment policies.

The increase in claims being handled by the Scheme obviously has an affect on our funding requirements, and funding has been one of the biggest issues for both us and levy payers during 2005/06. With an ever increasing remit, and increases in claims volumes, financing the Scheme has become an escalating concern both to us and to those who pay the levies to finance it.

We take seriously our commitment to consumers to pay compensation, where it is due, within a reasonable timescale. Whilst we have made significant progress during 2005/06 to clear work in hand and reduce waiting times, we realise there is much more to do this year to ensure that the majority of claims are completed within our six month target (the date of default/receipt of application form, whichever is later). We also have a duty to levy payers to ensure that we are completing claims cost-effectively and efficiently.

We have reviewed and restructured the way we work to increase productivity, whilst keeping a close eye on quality. The increase in completed claims achieved during the year is partly due to the results of this work; but we believe there is more that can be achieved. This business improvement work will continue during 2006/07.

FSCS Chairman David Hall

"Funding has been one of the biggest issues for both us and levy payers this year."

Visit www.fscs.org.uk for copies of the 2005/06 Report and Accounts

Key facts, figures and trends: Claims and compensation

Copies of the full 2005/06 Annual Report and Accounts can be downloaded from our website at www.fscs.org.uk

Summary total claims figures[1]:

During 2005/06 FSCS:

- Completed 25,800 claims, compared to 9,220 in 2004/05 - an increase of 180%.
- Received 25,100 new claims, compared to 15,700 in 2004/05 – an increase of 60%.

Type of claim	Applications Received	Claims completed	Claims in hand at 31 March 2006
Investments:			
Mortgage endowments	20,100	16,000	10,800
Precipice bonds	1,500	3,150	290
Others, inc. splits	650	1,500	750
Total investments	22,250	20,650	11,840
Pensions review	2,250	4,900	1,400
Credit unions	236	237	4
M&GI firms[2]	364	2	362
Total claims	**25,100**	**25,789**	**13,606**
Insurance payments[3]	40,750	40,750	-

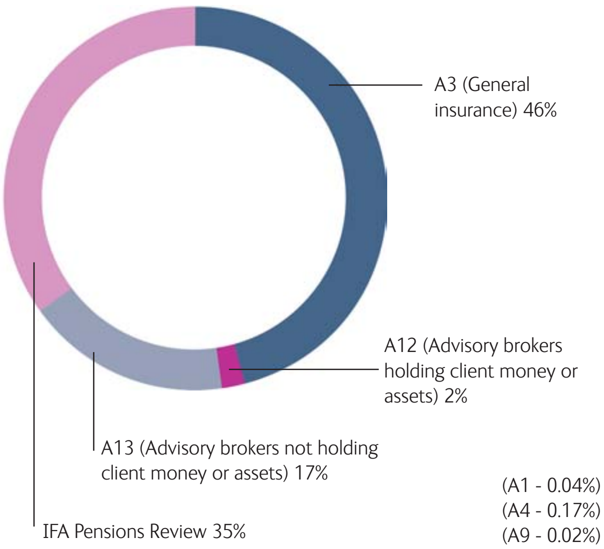
Summary total compensation figures[4]

Total compensation payments for 2005/06 amounted to £201.22m:

- £93.19m: insurance claims
- £69.75m: Pensions Review claims
- £38.19m: investment claims
- £0.09m: deposit claims

2005/06 compensation payments by contribution group:

A1	£0.09m
A3	£92.85m
A4	£0.34m
A9	£0.05m
A12	£4.62m
A13	£33.52m
(A16)	£69.75m
	£201.22m



[1] Figures are rounded
[2] Mortgage and general insurance firms.
[3] Figures relate to payments only. Insurance claims are usually handled by the appointed run-off agent and presented to FSCS for checking and payment.
[4] Mortgage advice and arranging was included from 31 October 2004 and general insurance mediation from 14 January 2005.

Key facts, figures and trends: Claims and compensation

Summary of claims & compensation figures by product

Investment claims[5]**:**

- In total 22,250 new investment claims were received during the year, an 87% increase over 2004/05. The majority of new claims related to mortgage endowments (20,100).
- In total 20,650 investment claims were completed during the year, a 320% increase over 2004/05.
  - 16,000 mortgage endowment claims completed. 46% resulted in an offer of compensation.
  - 3,150 precipice bond claims completed. 84% resulted in an offer of compensation.
  - 1,500 general investment claims were completed. 40% resulted in an offer of compensation.
  - Average compensation payments for investments were:
    - £2,000 for mortgage endowments
    - £7,000 for precipice bonds
    - £13,500 for other general investment.
- At the year end 62% of investment claims had been with the Scheme for six months or less.

[5] Not including Pensions Review.

Special summary note on mortgage endowments:

- Our target to complete 15,000 claims by 31 March 2006 was exceeded - 16,000 were completed during the year.
- We committed to completing mortgage endowment claims received before 1 October 2005 against firms in default by 31 July 2006. We are currently on track to achieve this.
- For new claims received after this date, we aim to reduce turnaround times for new mortgage endowment claims to six months, where a firm has been declared in default.

Pensions Review:

- 2,250 new claims were received during the year.
- 4,900 decisions were issued during the year, an increase of 25% over 2004/05.
- 81% of decisions resulted in an offer of compensation.
- Average compensation payment was £22,700.

Accepting Deposits:

- 236 new claims were received during the year.
- 237 decisions were issued during the year.
- 87% of decisions resulted in an offer of compensation.
- Average compensation payment was £417.
- 82% of claims were dealt with within 3 months.

Insurance:

- Insurance claims are usually handled by the appointed run-off agent.
- They are then presented to FSCS for checking and payment.
- Requests for payments from the appointed run-off agents to enable them to pay settled claims are usually completed within five days.
- 40,750 payments were made in 2005/06.

Key facts, figures and trends: Financial Summary

Management expenses

Our Management Expenses Levy Limit (MELL), set annually after consultation by the FSA, limits the amount FSCS can levy and spend on management costs. For further information on how FSCS is funded see page 39 of the 2005/06 Annual Report.

- FSCS's MELL for 2005/06 was £27.03m, based on forecast budget expenditure of £21.05m and including a reserve contingency of £5.6m.
- Total actual management expenses expenditure for 2005/06 was £22.60m, and includes expenditure of £1.55m of the reserve contingency element of our management expenses due to the increased number of endowment claims handled during the year.

Management expenses, compensation and recoveries year by year

1 December 2001 – 31 March 2006

- Total management expenses and compensation payments from 1 December 2001 – 31 March 2006 amounted to £871.25m.
- Total levies raised from 1 December 2001 – 31 March 2006 amounted to £664.64m.
- Total recoveries received from 1 December 2001 – 31 March 2006 amounted to £320.39m.

2005/06 levies

During 2005/06 the levy collected was £137.40m.

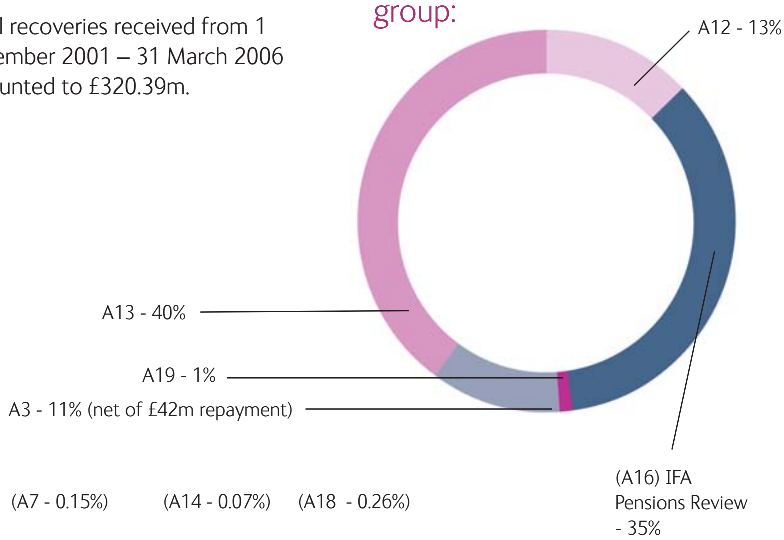
Accepting Deposits: A1 - £nil.
(FSCS held sufficient funds to cover anticipated compensation payments and management expenses.)

Insurance:
A3 (General insurance) - £10.30m (*net of £42m repaid in March 2006*).
A4 (Life insurance) - £nil. (FSCS held sufficient funds to cover anticipated compensation payments and management expenses.)

Designated investments:	£83.66m.
A7	0.21
A12	12.24
A13	36.99
A14	0.10
(A16)	34.12

Mortgage advice and arranging:
A18 - £0.36m.
General insurance mediation:
A19 - £1.08m.

2005/06 levies by contribution group:



Funding

The FSA is currently reviewing the funding structure of FSCS, and a Discussion Paper was published in March 2006. The review will continue during 2006/07. Any changes to the funding structure are therefore unlikely to be implemented before the Autumn of 2007.

Under the current funding structure, for levying purposes, firms are allocated to contribution groups, based on their regulatory permissions.

Forecasting funding requirements
After taking into account the forecast fund balances for each contribution group at the start of the levy period, estimated interest receipts, and potential recoveries, we consider the resources needed to handle the different types of claim, their likely costs and the likely value of compensation payments. We then calculate the required levy amount to ensure the forecast fund balance at the end of the financial year is sufficient to cover the required funding until the date of the next levy collection (assumed to be 1 July each year).

Due to the inherent difficulties of forecasting accurately, estimates are subject to change. Any differences between the levies raised (plus recoveries received) and the forecast costs of paying compensation in any one year are reflected in the levies for the subsequent year, taking into account fund balances. Ultimately, firms only pay for costs attributable to their contribution group(s).

Recoveries

Recoveries of £108.69m were received in 2005/06, and related almost entirely to the general insurance contribution group. A refund of some £42m was made to general insurers (contribution group A3) during the year as a result of recoveries received and a temporary slowdown in compensation payments anticipated.

Key issues in 2005/06

Below is a brief overview of some of the issues we have been dealing with in 2005/06. You can download the full 2005/06 Annual Report from our website at www.fscs.org.uk

Despite all the challenges FSCS has faced, I hope the progress we have made in handling significant numbers of claims demonstrates our commitment to improving our service, delivering on our promises, and achieving our goal, which is to provide an effective and efficient compensation service for UK consumers and help to maintain confidence in the financial services sector.
- Loretta Minghella

Chief Executive, Loretta Minghella

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Levies and funding

The increases in the numbers of claims being dealt with have resulted in dramatic increases in the levies being paid by many levy payers. The biggest increases have been experienced by investment advisers in the A13 contribution group (A13: investment advisers not holding client money). This is because claims relate mainly to investment advice given on endowments by firms that would be in this contribution group were they in business today.

During 2005/06 levies of around £50m were raised in the investment advisers sector – almost £37m in the A13 contribution group alone. Despite this significant levy, later in the year FSCS had to warn levy payers of a potential shortfall in the A13 group because of the volume of endowment claims being received and handled. Indeed, we had to use part of our Management Expenses Reserve Contingency to enable us to handle increases in these claims. After consultation with trade bodies, we agreed that any shortfall should be carried forward to 2006/07 levies.

However, there was more bad news to come for the A13 Group. A further significant levy (£47.5m), for this group was forecast in our 2006/07 Plan and Budget published in January 2006, and subsequently confirmed in our 2006/07 levy announcement at the end of March 2006. Once again this directly relates to endowment claims, and includes a shortfall of some £3.0m which is carried forward from 2005/06.

General insurance refund

Firms in other contribution groups also saw significant levies during 2005/06, but it wasn't bad news for every group. After several years of significant levies, we were pleased to be able to refund some £42m to general insurers in March 2006. This followed substantial recoveries achieved from insolvent insurance estates and a temporary drop-off in the claims they have been funding – mainly those against insolvent insurers Chester Street Insurance Company Ltd and Independent Insurance Company Ltd. Nevertheless, we still anticipate significant claims arising in these estates for some years to come, so this is not an end to levies in this sector.

However, firms in groups such as the IFA Pensions Review contribution group (formerly A16), will note that levies have been reducing as these claims come to an end. We currently expect that the 2006/07 levy of £25m will be the last for this contribution group.

Key issues in 2005/06

Split capital investment trusts

Splits have been a major issue for much of the year but the impact of potential claims is still uncertain. This is largely because of the difficulties in determining the nature of claims that investors may have and the cause of any losses.

The complexity, under the current funding system, of determining where any compensation costs should ultimately be allocated is a further important factor. We have been working closely with the administrators of Exeter Fund Managers and, more recently, the joint liquidators of BFS Investments plc, to determine what help we may be called upon to give to consumers who have lost money from investing in these products.

The insolvency practitioners have been gathering information from investors, and progress is being made. But it will still be some time before we can determine the numbers and types of claims we may be dealing with.

In the meantime, we have been working with the insolvency practitioners to enable our processes to interlink to ensure that the compensation process is as efficient and simple as possible, bearing in mind our particular legal obligations. Levy payers should note that we do still anticipate the need to levy for splits claims, but the timing and size of the levy, and where levies should be allocated, remains too uncertain to forecast.

Insurance broking

We have now had a full year of dealing with issues arising from general insurance broking defaults, and potential defaults, which brings with it new types of claims and challenges for us. During the year we declared only two defaults, but are aware that a number of other firms could potentially generate claims for FSCS.

Fortunately claims experienced during the year have not been significant in financial terms, but we continue to monitor this sector carefully.

Stakeholder relations

We are continuing to develop relationships with consumer and trade bodies alike as part of a more proactive communications and public affairs strategy. We have received positive feedback from stakeholders about our approach, which includes regular one-to-one liaison meetings and the establishment of an Industry Forum, which brings together trade bodies from across the sector.

Funding issues

Funding has been one of the biggest issues for both us and levy payers this year. We want a system that is:

- practical
- perceived to be fair
- sustainable
- cost-effective, and
- able to give us funds when needed.

We recognise the views of product providers and intermediaries who, understandably, do not want to pay for the mistakes and misdemeanours of other firms. But when there is a loss of confidence in products like endowments, precipice bonds or splits, or in the advice on which investors rely, it affects the whole sector.

Having sufficient funds to pay compensation to consumers who bought products from firms that are now in default acts as a safety net from which providers, intermediaries and consumers all benefit.

The issue of FSCS funding is being looked at by the FSA's Funding Review Project Board and the Funding Review Industry Advisory Group, and we are represented on both. Preliminary results of the review were published in the FSA's Discussion Paper in March, along with background research by economic consultants Oxera.

We have indicated our preference for an approach which would spread the costs over wider groups of firms than the current system does, and would provide "catastrophe" cover for a significant failure, or series of failures, to ensure that, going forward, our funding structure is sustainable, fair and proportionate.

We look forward both to continuing the debate and to the FSA's decision on future funding which is expected later in 2006/07.