

outlook

News from the Financial Services Compensation Scheme

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introduction from the Chairman

This edition of Outlook provides details of the key points of our 2006/07 Plan and Budget, published on 1 February 2006, and gives indications of our current estimates for potential levies in the next financial year.

Levy amounts are only illustrative and may change significantly between now and when our levies are announced in April, depending on the actual incidence and volumes of claims expected at that time. However, we hope these initial indications are useful for levy payers.

Many levy payers will see that the potential initial levies are a reduction on last year, with one exception - firms in A13. FSCS continues to deal with significant volumes of endowment claims and new claims continue to arrive in high volumes. Our forecast for 2005/06 remains at 22,000 new endowment claims; that is likely to increase to 26,000 in 2006/07.

We explain in this newsletter how we are containing costs, as far as we can, as we expand to meet this growth in claims being dealt with by us.

Nigel Hamilton

Initial levy forecast at £75m

We are currently estimating an initial overall 2006/07 levy requirement (including management expenses and compensation costs) of £75.35m, a reduction of £62.65m compared to some £138m collected in 2005/06.

Full details are available in our 2006/07 Plan and Budget, which is available on our website at www.fscs.org.uk.

The reduction in overall levies is largely due to our current estimation that we will not need to raise a levy on general insurers in 2006/07. However, many other levy payers will see that their levies, based on these initial estimates, are lower than those collected in 2005/06.

The notable exception is contribution group A13, where our current estimate is that levies will increase by £10m on last year's amount (the current estimate is £47.5m in 2006/07, compared to £37.8m in 2005/06). The increase includes a forecast shortfall of £2.4m relating to the additional endowment claims being received and processed this year, following a surge in new claims received. A full breakdown for contribution groups is on page 4.

However, these initial estimates do not include any potential compensation amounts for splits claims, or claims that may arise from insurance broking (GI claims). If significant claims do arise in

relation to splits we may need a further levy to enable us to deal with them. This could affect firms in groups A7, A9, A12, A13 depending on the nature of claims received; and similarly A19 for GI claims.

Management expenses

The FSA is currently consulting on a 2006/07 Management Expenses Levy Limit (MELL) for FSCS of £37.06m.

The MELL includes a central budget for FSCS of £29.37m and a Reserve Contingency of £7.69m. This compares to forecast expenditure of £22.4m for 2005/06, including £1.3m of the 2005/06 Reserve Contingency.

This is the second year that the FSA is consulting on a reserve amount in our management expenses levy limit, because of the general uncertainty surrounding future claims volumes. It gives us the resources to deal with claims above our central claims estimates, should these occur, without having to adjust the MELL first. It is also useful for areas of particular uncertainty, such as splits and GI firms.

Plan and budget - key facts

MELL & 2006/07 levies: The FSA is consulting on a Management Expenses Levy Limit of £37.06m, which includes our central budget of £29.37m and a Reserve Contingency of £7.69m. Our current initial forecast for overall levies in 2006/07 is £75.35m.

Endowment claims remain at high volumes. We currently forecast 26,000 new claims in 2006/07, based on our mid-point of a range of forecasts. We expect to process around 63% more claims in 2006/07 than we are forecasting for 2005/06 and will be setting up new teams, recruiting more staff and increasing our use of outsourcing to help us achieve this.

Splits: We still anticipate that a significant number of claims relating to split capital investment trusts will come to FSCS, but it is too early to predict volumes or likely values, or where the costs will fall.

High street firms: we anticipate some new defaults of high street insurance brokers, but the number and value of claims is currently too uncertain to include in 2006/07 levy calculations.

Key points

- We forecast that 26,000 new endowment claims will be received during 2006/07, on top of the 22,000 new claims forecast for 2005/06. This compares with around 9,000 new endowment claims received in 2004/05.
- We intend to complete approximately 63% more endowment claims in 2006/07 (24,500 in total) than in 2005/06 (15,000). The total number of investment claims forecast to be completed in 2006/07 (around 29,000) is an increase of over 500% compared to 2004/05 (4,900).
- We aim to achieve a turnaround time of six months after a declaration of default or receipt of claim, whichever is the later.
- Our claims handling strategy is designed to:
 - help us to strike the balance between the needs of consumers and our levy payers.
 - enable us to cope with varying claims volumes, which can go up as well as down.
- Our claims handling strategy includes using a mix of increased in-house resources with an expansion of our use of outsourcing.

Staff and premises

- Our staff numbers have increased by 14% in 2005/06 and are expected to increase by a further 6.5% in 2006/07.

This means that we need to take some extra space near to our current offices to accommodate these extra staff. The amount of space needed is considerably less than if we had decided to process all claims in-house.

- Our resourcing plans assume a minimum 10% improvement in productivity.

Claims forecasting

The work at the Scheme is demand-led, yet accurate forecasting of the claims volumes expected to be received by FSCS is particularly difficult for those areas where claims are thematic and historic (e.g. mortgage endowments) rather than derived from a few particularly large defaults.

In producing the forecast ranges to support this plan our primary source of external information is the FSA. In addition, we have consulted widely, with trade associations, with external firms handling complaints, with the Financial Ombudsman Service (FOS) and insolvency practitioners. Even so there remains inherent and wide-ranging uncertainty as to both volumes of claims and the timing of their receipt.

In order to accommodate a wide range of possibilities, and thus ensure strategies and plans are appropriately flexible, the Scheme has considered a range of claims forecasts with the mid-point of these providing a basis for operational planning and expense budgets.

Claims handling strategy

Our strategy for the medium to long term is designed to help us deal with the inevitable and continuing uncertainty around claims volumes, and the assumption that FSCS will have to handle substantial numbers of endowment claims at least into 2007/08.

We are building on the claims handling strategy adopted during 2004/05, which used a mixture of flexible working practices in-house and outsourcing. Our strategy includes:

- Adopting the use of outsourcing for the majority of endowment claims. Following a competitive tender, we continue to use a minimum of two outsourcers to handle endowment claims to reduce the risks of over-dependency on any one provider. The contracts are flexible to help us manage fluctuating claims volumes. Their claims handling work is quality checked by us and we provide dedicated support and training.
- Complementing outsourcing with a dedicated in-house endowment claims processing team, which, in the medium term, will make us more effective supervisors of our outsourcers and ensure FSCS retains key skills and expertise. Our HR strategy is also focusing on developing skills across the Scheme to enable us to switch staff more rapidly between different product streams, as different issues and claims arise.
- Further developing and streamlining our processes and procedures to increase efficiencies and take advantage of automation wherever possible. The 2006/07 budget assumes productivity gains of at least 10%.

Strategy framework

Our Board has identified a number of key internal priorities for us to deliver in 2006/07, within an overall strategy framework for FSCS. These are:

- 1 Clearing the endowment claims in progress at 30 September 2005 by 31 July 2006 and reducing waiting times to six months for the majority of new claims, where a firm has been declared in default.
- 2 Completing 90% of outstanding pensions review claims by 31 December 2006.
- 3 Devising, publishing and reporting against a comprehensive set of key performance measures and service standards.
- 4 Maximising process improvements to ensure FSCS has established the right trade off between costs, quality and speed of decision-making, bearing in mind our obligation to make the right decision on each claim.
- 5 Delivering priorities within our HR strategy to ensure we attract, reward, manage and develop our people to ensure staff have the right capabilities, skills and attitudes for successful delivery of rapidly changing business challenges.

Claims forecasts 2006/07

Based on our mid-range forecasts, we are planning to complete around 63% more endowment claims in 2006/07 (24,500) than in 2005/06 (15,000). The overall number of investment claims in total forecast to be processed during 2006/07 has increased by over 500% compared to the financial year 2004/05 (4,900).

¹ Other investments and mortgage intermediaries.

² Figures relate to payments only. Insurance claims are usually handled by the appointed run-off agent and presented to FSCS for checking and payment.

³ This includes bonds that have not matured.

TYPE OF CLAIM	Estimated claims in progress at 1.4.2006	NEW CLAIMS FORECAST: Lower forecast for 2006/07	NEW CLAIMS: MID-RANGE forecast for 2006/07	NEW CLAIMS FORECAST: Upper forecast for 2006/07	Forecast decisions in 2006/07	Forecast claims in progress at 1.4.2007
Investments:						
Endowments	15,700	20,000	26,000	32,000	24,500	17,200
Precipice bonds	500	50	100	150	300	300 ³
Investment & MI ¹	450	1,200	1,400	1,650	1,600	250
Total investments	16,650	21,250	27,500	33,800	26,400	17,750
Pensions Review	1,700	250	350	450	2,000	50
Credit unions	90	200	300	400	350	40
TOTAL CLAIMS	18,440	21,700	28,150	34,650	28,750	17,840
Insurers ²	0	12,000	14,000	16,000	14,000	0

Potential splits claims and GI claims

Splits claims have been excluded from our claims forecasts for the time being, although we may have to handle a substantial number of these claims in due course. We are liaising with the administrators of Exeter Fund Managers (EFM), who have been gathering information from customers of this firm, to try to determine the likely volumes and timing of any claims which could fall within the remit of FSCS.

Currently over 4,000 investors have contacted the administrators to indicate that they may have a claim, following a mailing to over 35,000 potential creditors of EFM by the administrators. If claims are established, it is unlikely that the firm will have sufficient assets to meet them. If so, FSCS may declare EFM in default during 2006/07. The administrators are currently considering a Scheme of Arrangement and we are working with them to see whether any claims process we need to adopt could run in parallel with theirs.

What is still not clear is how many claims, what types of claims and what the value of claims might be that could come to FSCS for consideration and where the costs of claims should be allocated. We will publish further information as soon as we can.

GENERAL INSURANCE BROKING (GI): GI claims have been excluded from our claims forecasts as the likely number of defaults, claims volumes and types of claim are currently too uncertain. To date, we have dealt with a small number of claims against one firm and are looking into claims relating to a small number of other firms. So far, compensation costs have not been significant.

Claims assumptions

In producing claims forecasts, the following assumptions have been made:

(i) We currently forecast that the volume of mortgage endowment claims in 2006/07 is likely to be within a range of between 20,000 and 32,000 claims. The parameters of this range reflect the present uncertainty in the sector.

(ii) Precipice bond claims are not expected to be a major factor in 2006/07.

(iii) The Pensions Review is coming to an end, although a few claims continue to be received from members of the public. We expect to complete the majority of these claims by the end of December 2006.

(iv) No major defaults in the deposits sector are forecast in 2006/07 but, as this year, we have allowed for a small number of credit union defaults.

(v) No new failures of insurers are included. FSCS expects to manage the same insurance estates as in 2005/06.

The FSA has announced the appointment of David Hall (pictured right) as the new Chairman of the Board of FSCS for three years to 31 March 2009. He will take up his appointment on 1 March 2006, succeeding Nigel Hamilton. David is Chair of a Venture Capital-backed software company, a member of the Advisory Board of Campbell-Lutyens (a specialist advisory investment bank in private equity), and a consultant to the Board of C Hoare & Co. From 1973-2000 he was at Boston Consulting Group where his roles included Senior Vice President serving on the firm's Worldwide Executive Committee and Chairman of the Worldwide Financial Services Practice Group. David has an MA in economics from Jesus College, Cambridge, and an MSc from London Business School.



David Hall

Assumptions :

A1 - surplus funds are not being repaid. A distribution of less than £5.0m is not likely to be cost effective; during 2006/07, at current outflow levels, the A1 fund balance is close to that figure.

A19 & A18 - at this time no compensation costs or related levies are proposed as these are currently too uncertain. Some core management costs are included.

A7 - A14: compensation cost estimates and the average compensation payment and uphold rates applied for mortgage endowment, precipice bond and other cases are: £2,300 and 39%; £8,200 and 88%; £12,000 and 42% respectively. The A13 levy includes costs of £2.4m rolled forward from 2005/06.

Pensions review - the aim is to minimise the fund balance as far as possible, allowing for any over-runs, by 31 December 2006, with no future levies intended.

Initial levy estimates by contribution group

Levies by contribution group	Group	2005/06 ⁴ Forecast levy	2006/07 INDICATIVE levy	Increase / (decrease)
		£m	£m	£m
Accepting deposits				
Deposit takers	A1	0.0	0.0	0
Insurance				
General insurance	A3	52.2	0.0	(52.2)
Life insurance	A4	0.0	0.0	0
Insurance intermediaries	A19	1.1	0.5	(0.6)
Investments				
Fund managers, holding client money/ assets	A7	0.2	0.3	0.1
Managers of AUTs, ACDs and depositories	A9	0.0	0.0	0
Dealers as principal	A10	0.0	0.2	0.2
Brokers holding client monies	A12	12.3	1.5	(10.8)
Brokers not holding client monies	A13	37.8	47.5	9.7
Corporate advisers	A14	0.1	0.1	0
Mortgage brokers	A18	0.4	0.3	(0.1)
Pensions review	(A16)	33.9	25.0	(8.9)
Totals		138.0 ⁵	75.4	(62.6)

Splits and GI claims not included in initial levies

Compensation costs are not included in the above initial levy estimates for potential splits claims or claims against general insurance brokers, as these are currently too uncertain. Management expense costs for handling high claims volumes relating to these areas are allowed for within the Reserve Contingency, but will not be levied unless needed. We will inform trade bodies if this becomes necessary, and will keep levy payers informed.

FSA's review of funding arrangements

The FSA is expected to publish a Discussion Paper in the first quarter of 2006 about the results of work by Oxera Consulting Limited, which has been working on a detailed analysis of the overall funding requirements of FSCS, the impact of current funding arrangements and options for the future.

We are participating fully in the review, and want to ensure that, whatever system is in place, it is practical, sustainable and cost effective, will help manage volatility in levies and provide adequate funds for those consumers who need our protection.

Whilst we acknowledge the current impact of our levies on contribution group A13, we also believe that it is essential for the long term view to be carefully considered. History has shown that significant compensation costs have previously fallen on other sectors within the remit of FSCS and its predecessor schemes; and the impact of compensation claims on new areas, such as insurance broking, is not yet clear.

We also believe any significant changes to the funding structure will need careful management to ensure a smooth transition.

Limits review: FSA issued a consultation paper on the compensation limits for FSCS in December 2005. For details visit: www.fsa.gov.uk.

Refund for A3

FSCS has announced its intention to refund a surplus of £42m to relevant firms in the general insurance contribution group A3 during the financial year 2005/06.

This is a result of significant recoveries made from general insurance estates and lower than anticipated compensation payments in the sector during this year and next.

We are unlikely to need to raise a levy on firms in contribution group A3 during 2006/07 as, based on the current claims information available from insolvency practitioners, we currently estimate that we have sufficient funds to cover costs and compensation payments until the 2007/08 levy is due for collection.

We have advised firms in this group, however, that the 2007/08 levy is likely to be significant, possibly over £100m.

For more information about this refund, and for other information of interest to levy payers, visit our industry news section at www.fscs.gov.uk.