

outlook

News from the Financial Services
Compensation Scheme

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Plan and Budget 2007/08

Including initial levy indications

2006/07 has been a year of consolidation in terms of our strategies for dealing with significant volumes of claims efficiently and effectively. Some of the targets we set ourselves have been very stretching. By the end of this financial year, we expect to be operating within the service standards we set out in our 2006/07 Plan and Budget, and within our management expenses budget for the year. 2007/08 will be a year in which we not only meet but also improve upon those standards, improve productivity and further reduce processing costs. This will help to ensure that whilst we try to offer an improved service to claimants in terms of waiting times we also fulfil our promise to levy payers to be as efficient as we can be in fulfilling our statutory obligations. This edition of Outlook highlights the key points from our Plan and Budget 2007/08, published on 31 January 2007. I hope you find this newsletter interesting and informative.

Management Expenses Levy Limit (MELL)

The FSA will consult on a total management expenses levy limit (MELL) for 2007/08 of £37.52m in its Consultation Paper on fees and funding, which is due out in February. This compares to a MELL for 2006/07 of £37.06m. The basis for the MELL for FSCS is a central budget of £32.04m, plus a reserve contingency amount of £5.48m, and assumes completion of over 43,000 claims during the year 1 April 2007 - 31 March 2008.

Initial levy indications

Our initial indication for total levy requirements is £104.6m (including compensation payments). Breakdowns for contribution groups are on page 3. This is an

overall increase of 40% compared to 2006/07, and reflects our expectation for claims volumes next year. Not included in these early indications are costs relating to split capital investment trust claims in relation to Exeter Fund Managers and BFS, although a separate levy during 2007/08 is likely.

Funding review

2007/08 will be crucial for FSCS in terms of our funding structure going forward. It may well be the last full year that levies are raised under the current funding system. We will engage with the FSA's consultation around the funding review and will seek to ensure that we have a system that is sustainable in the long term across the industry, smoothes volatility in compensation bills, and provides sufficient funding when we need it.



David Hall,
Chairman

Main headlines

- **Management Expenses Levy Limit (MELL) - £37.52m.**
- **Initial levy indications including compensation costs - £104.6m.**
- **A separate levy for costs relating to splits claims is likely.**

In particular we anticipate:

- continued high numbers of endowment claims (2007/08 forecast is 26,500).
- continued processing of pensions review claims as new claims continue to arrive, with a funding shortfall of around £12.5m for these claims carried forward from 2006/07.
- no levy for the A3 contribution group (general insurers).

Comparisons to 2006/07

- a forecast increase in the number of claims decisions of over 28% (43,100 compared to just under 33,500). This follows a forecast increase in 2006/07 of 35% compared to claims completed in 2005/06.
- an increase in our management expenses budget of £2.67m (9%).

Key facts: claims forecasts for 2007/08

Full details can be found in FSCS's Plan and Budget 2007/08, which is available from our website www.fscs.org.uk

Claims forecasts for 2007/08

As last year, FSCS has considered a range of claims forecasts to help us manage the uncertainties around actual claim receipt, with the mid-point of these providing the basis for operational planning and expense budgets.

Type of claim	Estimate of claims in progress 1 April 2007	New claims forecast LOWER forecast for 2007/08	New claims forecast MID POINT forecast for 2007/08	New claims forecast UPPER forecast for 2007/08	Estimate of claims completed at 31 March 2008	Estimate of claims in progress 31 March 2008 MID POINT
Investments						
Mortgage endowments	12,300	21,000	26,500	31,700	28,000	10,800
Others exc splits	660	1,000	1,200	1,400	1,200	660
Total Investments	12,960	22,000	27,700	33,100	29,200	11,460
Pensions review	660	300	440	440	790	310
Credit Unions	250	3,000	4,000	5,000	4,000	250
M&GI	720	1,500	2,550	3,600	2,550	720
Total claims**	14,590	26,800	34,690	42,140	36,540	12,740
Splits claims	3,700	2,000	4,000	5,000	6,640	1,060
Total inc. splits	18,290	28,800	38,690	47,140	43,180	13,800
<i>Insurance payments***</i>	<i>N/A</i>	<i>12,000</i>	<i>14,000</i>	<i>16,000</i>	<i>14,000</i>	<i>N/A</i>

2007/08 claims assumptions

In producing 2007/08 claims forecasts, the following assumptions have been made:

- The volume of new mortgage endowment claims in 2007/08 is likely to be within the range of 21,000 - 31,700 claims, reflecting the continued uncertainty in this sector.
- Precipice bond claims will be negligible, and these will be shown within the 'Others' investment category from now on.
- We expect to be dealing with Pensions Review claims during 2007/08 and beyond.
- Current uphold rates for mortgage endowment, pensions review and other investment cases are 46%; 83%; and 37% respectively.
- Continued claims relating to a small number of failed credit unions. The current average uphold rate for these claims is 85%.
- A small number of defaults in the insurance broking sector, although based on current experience the financial impact of these failures is unlikely to be significant.
- No new failures in the life and general insurance company sectors; FSCS currently expects to manage the same insurance estates as in 2006/07.
- The forecasts for splits claims should be considered only an initial indication.

Claims forecasts

FSCS is a demand-led organisation and the volume of claims handled is a major driver of Scheme expense, influencing the number and skills of people required to process claims and maintain target service levels. The volume of claims received in large part determines the level of outsourcing costs we incur.

The Scheme continues to combine the best knowledge, insight and expertise from trade bodies, FOS and the FSA into its estimates. However, forecasting claims volumes remains an inexact science and assumptions are not always borne out by events.

There is considerable uncertainty surrounding the volumes and timing of claims generally, and for mortgage endowment and splits claims in particular. This gives rise to considerable potential variation we must plan for.

Updated forecast claims figures for 2006/07:

Type of claim	New claims Received ¹	Claims completed ¹	Claims in hand at 31 March 2007 ¹
Investments:			
Mortgage endowments	26,000	24,500	12,300
Others, exc. splits	970	1,350	660
Total investments	26,970	25,850	12,960
Pensions review	800	1,740	660
Credit unions	4,500	4,250	250
M&GI firms ²	2,010	1,650	720
Total claims	34,280	33,490	14,590
<i>Insurance payments³</i>	<i>23,510</i>	<i>23,510</i>	<i>-</i>

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.

Key facts: initial levy indications by contribution group

Full details can be found in FSCS's Plan and Budget 2007/08, which is available from our website www.fscs.org.uk

These figures are indications only and may change. Our 2007/08 levy requirements will be confirmed in April 2007. Estimated total compensation payments in 2007/08 are £137m, based on forecast claims outputs, estimated uphold rates and forecast payment amounts. For details of the key assumptions and sensitivities, please refer to page 4.

Levy indications by contribution group

	Group	2006/07 Levy £m	2007/08 Levy £m	Increase/ (decrease) £m
Excluding splits claims costs				
Accepting deposits				
Deposit takers	A1	0.0	0.0	0.0
Insurance				
General Insurance	A3	0.0	0.0	0.0
Life Insurance	A4	0.0	0.5	0.5
Insurance intermediaries	A19	0.5	2.0	1.5
Investments				
Fund managers	A7	0.4	0.5	0.1
Managers of AUT's	A9	0.0	0.1	0.1
Dealers as principal	A10	0.2	0.3	0.1
Brokers holding client monies	A12	1.5	11.2	9.7
Brokers not holding client monies	A13	47.1	42.0	(5.1)
Corporate advisors	A14	0.0	0.1	0.1
Mortgage brokers	A18	0.3	0.4	0.1
Pensions review	(A16)	24.8	47.5	22.7
Totals		74.8	104.6	29.8

The FSA will consult on a Management Expenses Levy Limit of £37.52m, including a central budget amount of £32.04m and a reserve contingency amount of £5.48m.

Management expenses, base and specific split

	Budget 2007/08 £m	Forecast 2006/07 £m	Budget 2006/07 £m
Base Costs	5.13	3.54	3.40
Specific Costs	26.91	24.27	25.97
Total	32.04	27.81	29.37

Initial levy estimates: assumptions and sensitivities

Full details can be found in FSCS's Plan and Budget 2007/08, which is available from our website www.fscs.org.uk

Key assumptions and sensitivities: initial levy estimates

In calculating levy requirements we take into account funding requirements until the receipt of the next levy, assumed to be 1 July each year. The key assumptions made in preparing the initial levy estimates are:

1. Accepting Deposits Sub-scheme - A1 - surplus funds as at 1 April 2007 are not being repaid. This assumption is based on the view that a distribution of less than £5.0m is not likely to be cost effective and, by that time, at current outflow levels, the A1 fund balance will be below that figure.

2. Insurance payments - A3 - we have regard to insolvency practitioner estimates for each estate. In assessing our fund balances and likely funding requirements we have to take into account significant uncertainties surrounding some types of claims. The costs related to some types of claims can be very difficult to forecast, particularly where litigation may be involved. Recoveries can also have a major impact on funding and levy requirements. Due to significant recoveries in 2006/07, and a slowdown in funding requirements for protected claims, a levy is not currently anticipated in the A3 contribution group during 2007/08.

We are currently forecasting a fund balance at 31 March 2008 of around £74m. We do not currently intend to make a repayment to firms in the A3 contribution group in 2007/08 because: (1) our forecasts are based on the mid-point of a range of potential funding requirement forecasts provided by insolvency practitioners. If funding to the higher level of the range were required during 2007/08, which is a possibility, we would require significantly more funding than our current forecasts suggest; (2) funding is required to fund compensation costs anticipated in Q1 of 2008/09.

3. Investments - A7-A14 - compensation cost estimates are calculated by reference to average compensation payment and uphold rates applied for mortgage endowment, and other investment cases of: £2,000 and 46%; and £15,200 and 37% respectively. The average compensation cost is calculated using a 12-month rolling average based on actual payments made for each product type.

Potential costs for splits claims are not included.

4. The A12 levy includes a forecast funding shortfall of £0.5m rolled forward from 2006/07.

5. (A16) IFA Pensions Review claims - the 2007/08 levy (£47.5m) reflects current trends in claims receipt, average payments (£24,600) and uphold rates (83%). It includes a potential forecast funding shortfall of £12.5m rolled forward from 2006/07 and a further funding requirement of around £5m until the receipt of the next levy, assumed to be 1 July 2007.

We also expect to continue to deal with Pensions Review claims in 2008/09, which will need further funding.

6. The A19 levy includes a small number of compensation payments made during 2006/07, which were not included in the 2006/07 levy, and anticipated compensation payments during 2007/08. These are not currently expected to be significant in terms of overall value. The current average value of compensation payments made in this group is £1,000.

7. Recoveries - We seek to make recoveries where we consider it reasonable to do so, to reduce the cost to levy payers of compensation payments made by FSCS.

Where there may be potential recoveries we take action where appropriate, in accordance with the recoveries policy published on our website: www.fscs.org.uk/industry/funding/recoveries.

Recoveries are used to reduce levy requirements in the contribution groups to which they relate. In publishing the indicative levy, we take account of recoveries where the amount involved and the timing of the recovery is reasonably certain.

Questions and Answers for contribution groups are on page 5.

Splits - a key area of uncertainty

The arrival of claims relating to split capital investment trusts is one area that we have been preparing for during 2006/07, because it is likely to generate significant numbers of claims and therefore costs for levy payers.

However, the two firms with which we are potentially involved (EFM and BFS) are not yet in default so there remains a high level of uncertainty about the total number and value of claims that may come to us. When it is clear that the firms are unable to meet valid claims made against them, we will step in. We have done a lot of preparatory work to ensure that when it becomes necessary for FSCS to consider individual claims, we will be ready for them.

We have included some indicative claims forecasts for splits in our overall claims forecasts, and we have included some management expenses costs for outsourcing within our central budget and MELL. However, the number of claims is still quite uncertain, so these forecasts should be considered only indicative. We have NOT included these costs within our initial levy indications. A further amount for outsourcing is included within the reserve contingency for claims volumes received that are above our current estimates.

Potential costs

We appreciate that firms want certainty, as far as is possible, in terms of potential overall costs and the likely allocations to contribution groups. However, we cannot currently give indications for contribution groups.

Contribution groups most likely to be affected are A7, A9, A12, and to a lesser extent, A13, although it will depend on the nature of claims received, and the value of those claims, as to where costs must be allocated. We will give indications as early as we can, but firms in these groups should be aware that a separate levy for these costs is very likely during 2007. We will update our information and keep trade bodies updated, as events develop.

Questions and answers for contribution groups

Accepting Deposits (A1) & General Insurance (A3):

Why is there no levy for firms in contribution groups A1 and A3?

- FSCS holds sufficient funds to cover these firms' share of our base and specific management costs, and the forecast compensation costs expected in the 12 months following our assumed levy date (1 July 2007).

Would FSCS consider a refund to firms in A1 or A3?

- We do not currently believe it is prudent to consider a refund of potential excess funds in these contribution groups.
- In A1, we expect the majority of 'surplus' funds will be used to pay claims forecast in 2007/08.
- In A3, the costs of compensation are very uncertain and could differ significantly from current forecasts. If claims values were towards the upper end of the range estimates provided by insolvency practitioners, we would need significantly more funds during 2007/08 than currently forecast. Retaining current funds mitigates the risk of having to raise an interim levy.

Life insurance (A4):

Why is there a levy for firms in A4?

- This is the first levy raised by FSCS in this group since N2, the date FSCS took over responsibility for compensation in this area. Funds passed to FSCS from the Policyholders Protection Board for life insurance claims have now largely been exhausted. The levy is to cover these firms' share of our management expenses and forecast compensation payments for two existing insolvent insurance estates.

General insurance brokers (A19):

Why has the levy for this group increased from £0.5m to £2.0m?

- The levy includes compensation payments made in 2006/07 (which were excluded from the 2006/07 levy because of uncertainty) and forecast compensation claims in 2007/08. The relatively low value

of this levy reflects the current trend of small volumes of claims being made and low value compensation payments. (Average payment is currently £1,000).

Investments

Fund managers holding client money/assets (A7) & Managers of an AUT, ACDs and depositories (A9):

The levy for these two groups has increased by £100,000. Does this include any splits costs?

- No. Splits costs are not included in our initial levy estimates. A separate levy for these costs is likely during the year, although the value and allocations to contribution groups is currently uncertain.
- The levy reflects these firms' share of FSCS management expenses.

Dealers as principal (A10):

The levy for firms in this group has increased by £100,000. Why?

- The levy reflects these firms' share of FSCS management expenses.

Brokers holding client money (A12):

Why has the levy in A12 increased from £1.5m to £11.2m?

- The levy reflects our current forecasts for claims against A12-type firms in 2007/08 and these firms' share of our management costs (including relevant outsourcing costs for endowment claims). It also includes a forecast shortfall from 2006/07 of £0.5m.
- Claims are allocated according to the permissions of the firm to which the claim relates.

Corporate advisors (A14):

The levy for firms in this group has increased by £100,000. Why?

- The levy reflects these firms' share of FSCS management expenses.

Brokers not holding client money (A13):

Although current indications show a reduction in levy requirements in this group (from £47.1m to £42.0m), the levy for firms in this group is relatively high. Why?

- The levy reflects our current forecasts for claims against A13-type firms in 2007/08 and these firms' share of our management costs (including relevant outsourcing costs for endowment claims).
- We are currently forecasting that we will receive continuing high levels of mortgage endowment claims in 2007/08 (26,500), which is the current main driver of costs in this group. The levy allocation reflects our current forecasts, uphold rates and average payments for these claims (46%; £2,000).

IFA Pensions Review (A16)

Why has the levy in this group increased?

- We currently estimate that we will need to raise a levy of £47.5m for 2007/08. This includes a shortfall of £12.5m brought forward from 2006/07 and funding required for claims we expect to deal with during 2007/08.
- The levy estimate reflects current average uphold rates and compensation payments (83%; £24,600).
- Although these claims are tailing off, we currently forecast that we will continue to deal with claims during 2008/09, which means that a further levy may be needed in 2008/09.

Further Questions and Answers about pensions review claims are on our website.

Mortgage brokers

Mortgage brokers (A18):

The levy for firms in this group has increased by £100,000. Why?

- The levy reflects these firms' share of FSCS management expenses. To date FSCS has not received any claims against firms in this group.

Key issues - forecasting and funding

As David Hall outlines in his introduction, 2007/08 will be a year of further process improvements to minimise waiting times and increase efficiency, which benefits all our stakeholders. Our core budget reflects a modest increase over 2006/07 in terms of management costs (9%), whilst anticipating a significant increase in claims output (28%).

During 2006/07 we have consolidated our approach to managing high volumes of claims, and fluctuations in claims receipt, by further developing our use of outsourcing alongside flexible in-house teams. This helps us to manage claims volatility whilst retaining key skills in-house. That strategy has paid off. In 2005/06 claim completions were up by 180%. During 2006/07 we expect to increase the number of claims completed by 32% and by a further 28% in 2007/08.

Those results are a credit to our Claims Division, under the management of Director of Claims, Ron Devlin. It is also a tribute to the work of our support teams, such as those in Customer Services and Initial Enquiries, who are often in the frontline for FSCS. We have further developed our service standards for 2007/08, to help us to continue to improve our service for valid claimants and make our processes more efficient and cost-effective wherever possible. Details of our service standards for 2007/08 are in our full Plan and Budget, which is available from our website at www.fscs.org.uk.

Funding and efficiency

As David Hall mentions, 2007/08 will be a critical year for FSCS in terms of determining our funding structure going forward. Meanwhile compensation costs must be allocated to existing contribution groups. We realise that for many firms these levy indications will be unwelcome news. Firms should be assured, however, that we continue to increase efficiencies in claims handling and other areas. Details of our efficiency projects for 2007/08 are in our full Plan and Budget, which is available from our website.

– Loretta Minghella, Chief Executive

Quality control

A key part of our claims strategy is the use of outsourcing to help us manage sudden changes in claims volumes and claims volumes that are outside of our in-house capacity. Quality control is a very important aspect of successful use of outsourcing, and we continue to develop our work in this area. We have now started to supplement our desk-based monitoring and oversight of outsourcer fulfilment of contractual obligations with on site inspections and review. We aim to cover non-process obligations (e.g security, disaster recovery, data protection), quality control and reliability of management information as well as compliance with service standards.

We also regularly examine a random sample of our entire claims output, including work from our in-house teams, in order to make sure our decisions are fair, policies and processes are being properly applied and to learn lessons for future performance.

– Ron Devlin, Director of Claims



Chief Executive, Loretta Minghella

“2007/08 will be a year of further process improvements to minimise waiting times and increase efficiency, which benefits all our stakeholders.

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Director of Claims, Ron Devlin