



Annual Report 2008/09

By David Hall, Chairman

2008/09 was an extraordinary year for the financial services industry and for the Financial Services Compensation Scheme (FSCS). The global financial crisis created an unprecedented set of demands on the FSCS during the year. In the six months from the end of September, the Scheme paid out more than £21bn. By contrast, from our inception in 2001 until September 2008, we paid out some £1bn in total.

Our *Annual Report and Accounts 2008/09* describes our work during the year to respond to the turmoil in the markets and to provide compensation to consumers during a time of great anxiety for them.

The failure of five banks, Bradford & Bingley plc (B&B), Landsbanki Islands hf (Icesave), Heritable Bank Plc (Heritable), Kaupthing Singer & Friedlander Limited (KSF) and London Scottish Bank Plc (London Scottish) required the FSCS to deliver compensation in new and different ways. We paid compensation to individual depositors in accordance with our well-established statutory role in relation to the Icelandic bank failures and London Scottish. We also paid deemed compensation, the sums representing what we would have paid to individual claimants, for the bulk transfer of accounts in the cases of B&B, Heritable and KSF, implementing orders made under the Banking (Special Provisions) Act 2008. We agreed to act on behalf of HM Treasury both for the tax payer funded element of the compensation offered by the Government and in respect of Iceland's Depositors' and Investors' Guarantee Fund (DIGF) for Icesave default. Just before the year end, the Dunfermline Building Society failed and although we were not called on to pay compensation at that point, we expect to contribute to the net cost of the failure in due course.

Whilst our involvement with these failures attracted the most publicity last year, we continued to pay compensation across a wide range of defaults. In particular, the Scheme dealt with two of the largest investment intermediary failures in recent years, Pacific Continental Securities (UK) Limited and Square Mile Securities Limited.

The FSCS has proven itself sufficiently robust to manage the extraordinary demands that have been placed on it in the last year across a widening remit. What has become clear, however, is the need to strengthen the Scheme in a number of ways. Public awareness of the Scheme's role is too low, our operating model requires development and there are real concerns in the industry about how we are funded. At the same time, the changes to the FSCS compensation framework outlined in the FSA's Policy Statement earlier this month (see page 6) will see us working with the authorities and the industry to implement wide ranging changes to the Scheme that we believe will benefit consumer confidence.

The full FSCS *Annual Report and Accounts 2008/09* can be downloaded from our website at www.fscs.org.uk

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David Hall, Chairman

Message from the Chief Executive

Loretta Minghella

At the start of the year, it was clear that the future would hold much change for the FSCS, including new legislation following the run on Northern Rock. However, we could not have predicted a financial crisis as severe as this one, requiring the FSCS to play such a significant role in protecting consumers and supporting financial stability.

Despite the turmoil in the markets, the first half of the year was relatively uneventful for the FSCS. We concentrated on resolving claims already in our work in progress, which steadily diminished to the point where at the start of September we had fewer than 3,000 claims to complete, lower than at any time since I joined the FSCS in 2004. At the same time, we continued to work closely with the Tripartite authorities on compensation reform and, mindful that the markets were very uncertain, refined our contingency planning with a view to being able to respond quickly if necessary.

In relation to the five banking defaults, the FSCS originally borrowed the necessary funds through separate short-term facilities from the Bank of England and (for London Scottish) from HM Treasury. The Bank of England facilities have since been re-financed with longer term loans from HM Treasury.

All these loan facilities are on an interest-only basis for the first three years, and are calculated at 12 month LIBOR plus 30 basis points. The FSCS will pay interest in arrears, with interest for the period to 31 March each year being payable on 1 October of that year. So, for the period to 31 March 2009, interest will be payable on 1 October 2009, and so on.

Levies in the first three years for the five defaults will fall on the Deposit class of levy payers only. We agreed with HM Treasury an annual cap on the levy arising from the interest on these loans and related management expenses of £1bn per financial year until 31 March 2012, and any amounts above this will be waived by HM Treasury. The principal outstanding at 2012 will then be repaid on a timetable to be determined by the FSCS and HM Treasury depending on market conditions at the time.

The FSCS's initial contributions to help fund the transfer of deposits from B&B to Abbey National and certain deposits from Heritable and KSF to ING were £14bn, £0.5bn and £2.5bn respectively. The contributions represented the FSA's estimates of the liabilities eligible under Scheme rules. To ensure the correct amounts have been paid by the Scheme, the FSCS has engaged independent consultants to validate the payments made. More information about the validations can be found in the *Annual Report and Accounts 2008/09*.

Of the five banks, the default of Icesave presented the biggest operational challenge the FSCS has ever faced. The bank's failure left 214,000 UK depositors extremely anxious that they were going to lose their money. However, we rose to this challenge by developing an innovative solution to paying out a large number of claims in record time – by 31 March 2009, £3.9bn had been paid to the holders of 273,142 accounts – £2.1bn in respect of the coverage of Iceland's Depositors' and Investors' Guarantee Fund, £643m paid on behalf of HM Treasury and the balance of £1.2bn for the FSCS's own account. Prompted by the bank failures, the volumes of emails, letters and calls the FSCS received in 2008/09 was 234,300. This represents an increase of nearly 220% from the previous year.

The FSCS works hard to provide an efficient and cost effective service for consumers and levy payers alike. Whilst the second half of the year meant that we had to concentrate on providing services to consumers as quickly as possible in exceptional circumstances, we continued to be mindful of the need to manage our costs effectively. We finished the year with our management expenses at £31.47m (excluding loan interest) which is only £6.73m more than the £24.74m projected in the Plan and Budget 2008/09.

The Scheme takes very seriously its obligation to levy payers to ensure that it pursues recoveries wherever practicable. The recent banking failures have changed our role in recoveries as much as they have in relation to the delivery of compensation itself. You can find more details of the recovery processes in relation to the five banks on pages 13 – 14 of the *Annual Report and Accounts 2008/09*.

Of course, our remit is broader than the banking sector and throughout the year we continued to deal with defaults across the whole financial services industry. We have begun to receive a number of payment protection insurance claims this year, and although it is too early to say whether this will be a rapidly growing area of our work, as it has been for others, we do expect to receive more of these claims in 2009/10.

Annual Report review:

Annual Report headlines

Banking defaults

- Five banks were declared in default during 2008/09 and one building society entered the Special Resolution Regime (SRR)
- Total compensation payments for the bank failures, including bank transfers amounted to £20.9bn
- £2bn was paid in respect of coverage for Iceland's Depositors' and Investors' Guarantee Fund and £0.8bn on behalf of HM Treasury. The balance of £18.1bn was paid out on the FSCS's own account
- The total number of accounts for which customers have been compensated relating to the bank defaults is about 3.5 million

Other defaults

- 119 firms were declared in default
- The FSCS paid over £92m in compensation payments including almost £51m for general insurance claims
- Total claims received were 11,082, a reduction of 33% on 2007/08
- Total claims completed were 10,887, a reduction of 50% on 2007/08
- Claims in respect of Pacific Continental Securities (UK) Limited and Square Mile Securities Limited were the biggest drivers of new investment claims at 3,770
- Splits claims completed during the year totalled 2,740



Loretta Minghella,
Chief Executive

Claims key facts and figures

Summary of total claims figures (excluding banking failures)

Summary of claims by product		
Type of claim	Claims received 2008/09	Claims completed 2008/09
Splits	895	2,740
Pacific Continental Securities	2,410	890
Square Mile Securities	1,360	190
Other investments	860	800
Mortgage endowments	3,820	4,975
Pensions review & FSAVCs	313	428
Credit unions	605	660
Insurance intermediaries	740	150
Mortgage advice	79	54
Total claims	11,082	10,887
Insurance payments*		8,890

* Insurance claims are usually handled by the appointed run-off agent and then presented to the FSCS for checking and payment.

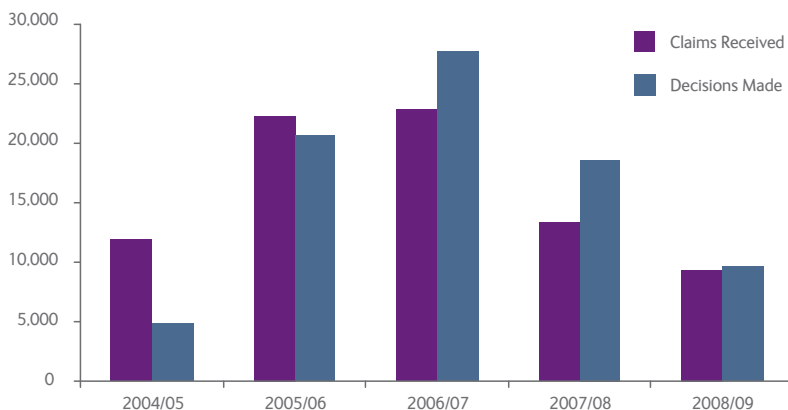
A detailed breakdown of each banking default can be found in section four of the *Annual Report and Accounts 2008/09*.

Investment claims*

- 9,345 new claims were received during the year, compared to 13,275 in 2007/08, a reduction of 30%
- 9,595 claims were completed during the year, compared to 18,615 in 2007/08, a reduction of 48%
- 2,740 splits claims were completed. 24% resulted in an offer of compensation
- 1,880 other general investment claims were completed. 69% resulted in an offer of compensation
- 4,975 mortgage endowment claims were completed. 49% resulted in an offer of compensation
- Average compensation payments for investments were:
 - o £8,820 for splits claims
 - o £14,210 for other general investment claims
 - o £2,290 for mortgage endowment claims

* Some investment claims, for example mortgage endowment claims, are to be funded by the life & pensions class.

Investment claims and decisions made



Pensions review and free standing additional voluntary contribution claims (FSAVCs)

- 313 new claims were received during the year, compared to 390 in 2007/08, a reduction of almost 20%
- 428 claims were completed during the year, compared to 505 in 2007/08, a reduction of 15%
- 74% of decisions resulted in an offer of compensation
- The average pensions review compensation payment was £29,217

Credit unions

- Three credit unions were declared in default during the year, compared to 10 in 2007/08
- 605 new claims were received during the year, compared to 2,680 in 2007/08, a reduction of more than 77%
- 660 claims were completed during the year, a reduction of 76%
- Over 69% of credit union claims were completed within four weeks, and 93% within 8 weeks
- 93% of decisions resulted in an offer of compensation
- The average compensation payment was £480

General insurance provision

- 8,890 payments were made in 2008/09, compared to 9,346 in 2007/8
- Compensation payments totalled £50.8m
- The increase in total spend from £45.8m in 2007/8 to £50.8m in 2008/9 reflects the increasing cost of mesothelioma claims from Chester Street
- The largest spend was on historic employers' liability covers issued by Chester Street. The compensation cost to the Scheme of this estate stands for the year at £40.3m

Insurance intermediation

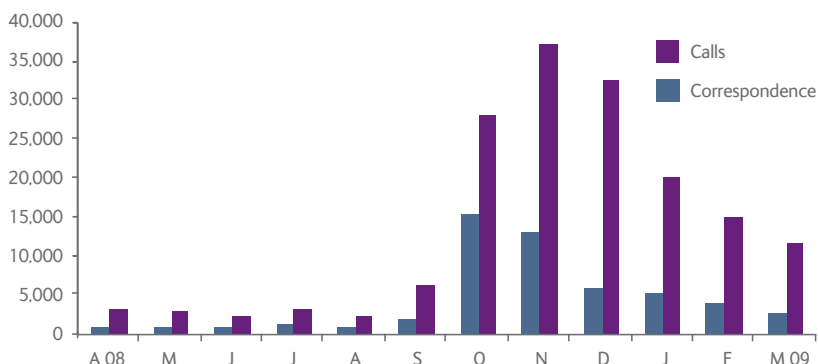
- 740 new claims were received during the year, compared to 110 in 2007/08, an increase of over 570%
- 150 claims were completed during the year, compared to 70 in 2007/08, an increase of 115%
- 56% of decisions resulted in an offer of compensation
- The average compensation payment was £1,380

Home finance intermediation

- 2008/09 was the first year in which the FSCS paid claims against mortgage brokers
- 79 new claims were received during the year, compared to 35 in 2007/08, an increase of 125%
- 54 claims were completed during the year, compared to 20 in 2007/08, an increase of 170%
- 24% of decisions resulted in an offer of compensation
- The average compensation payment was £25,800
- New claims are expected to continue in increasing volumes in 2009/10

Update on customer enquiries/complaints

Number of telephone enquiries and items of correspondence received by the Customer Services Team by month



A total of 234,300 enquiries were received by our Customer Services and Initial Enquiries teams during 2008/09, an increase of nearly 220% on last year's figure. These queries related to specific claims against the major banking defaults, and general enquiries about all aspects of the protection provided by the Scheme, particularly in relation to banks, building societies and insurance companies.

The Customer Services Team's (CST) target was to resolve 90% of all telephone calls within 48 hours. This was achieved each month, despite the significantly higher number of calls taken this year.

The team also aimed to resolve 90% of all written enquiries within 15 working days. Again, this target was met each month, despite the greatly increased volumes of emails and letters received by CST since September 2008.

Financial summary

Fund balances

Fund balances as at 31 March 2009 amounted to a deficit of £20.16bn. This was after deducting £19.77bn compensation costs for Specified Deposit Defaults and £390.28m loan interest and other interest of £36.16m.

Fund balances by Sub-class	
Sub-class	Balance £m
SA01 - Deposit	(433.19)
SB01 - General Insurance Provision	34.45
SB02 - General Insurance Intermediation	0.93
SC01 - Life & Pensions Provision	0.21
SC02 - Life & Pensions Intermediation	9.43
SD01 - Investment Fund Management	(1.61)*
SD02 - Investment Intermediation	(6.27)
SE01 - Home Finance Provision	0.00
SE02 - Home Finance Intermediation	0.86
	(395.19)
SDD compensation costs**	(19,767.47)
	(20,162.66)

* The year end fund balance for SD01 was lower than expected, due to higher than forecast compensation costs for splits claims. These claims continue to come in at volumes which, whilst low, are slightly higher than forecast for 2009/10. Our current expectation is that, in the absence of additional defaults affecting this sub-class, there could be a year end deficit on SD01 at 31 March 2010 of £2m to £2.5m. We are not currently planning an interim levy in respect of this sub-class but will keep levypayers informed.

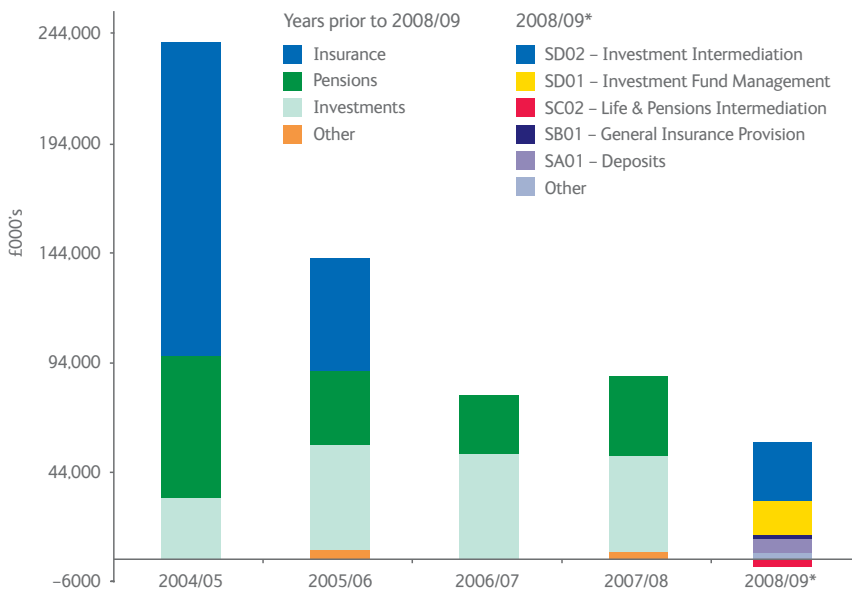
** Includes the current estimated validation adjustment of £1.71bn for Heritable and Bradford and Bingley.

Levies

During 2008/09 the levy invoiced was £170.62m (excluding the credit notes issued as part of the "clean break" exercise to repay the contribution group balances at 31 March 2008).

Sub-class	Gross before credit notes £m	Net of credit notes £m
SA01 - Deposit	5.06	5.06
SB01 - General Insurance Provision	73.69	1.75
SB02 - General Insurance Intermediation	2.01	0.63
SC01 - Life & Pensions Provision	0.98	0.63
SC02 - Life & Pensions Intermediation	32.58	(5.93)
SD01 - Investment Fund Management	7.76	17.04
SD02 - Investment Intermediation	47.10	44.13
SE01 - Home Finance Provision	0.00	0.00
SE02 - Home Finance Intermediation	1.44	1.44
	170.62	64.75

Levies: 5 year trends



* The FSCS moved to a new funding system on 1 April 2008. Under the new funding system, the Sub-classes changed so it is not possible to make direct comparisons between the old and new system. The first key refers to the four years prior to 2008/09 with the old Sub-schemes. The second key refers to the year 2008/09 and the new Sub-classes.

Management expenses

- Our Management Expenses Levy Limit (MELL) is set annually by the FSA after consultation. It limits the amount the FSCS can levy and spend on interest and other management costs.
- The FSCS's MELL for 2008/09 was originally set at £30.24m, based on forecast budget expenditure of £24.74m plus a reserve contingency of £5.50m.
- Total actual management expenses for 2008/09 were £31.47m (excluding loan and other interest). Including loan interest payable of £390.28m and other interest payable of £36.16m this amounted to £457.91m.
- The MELL was raised to £1bn in October 2008.

Recoveries

During 2008/09, the FSCS made recoveries of £17.97m. Under the FSCS rules, we are required to pursue recoveries where "reasonably possible and cost-effective". Our Recoveries Policy is available on our website at www.fscs.org.uk.

FSCS sets £406m levy for bank failures in 2008/09

Banks, building societies and credit unions have been asked to pay £406m as their initial contribution to the costs of the bank failures of 2008. We have now issued a levy to deposit taking firms in respect of the interest charges on the loans and related management expenses. This is the first FSCS levy for the costs of the banking failures up to 31 March 2009 and is explained in more detail in [the letter](#) that was sent to the Deposit trade bodies.

Investment default update

Pacific Continental Securities (UK) Ltd:

There have been over 3,300 claims against Pacific Continental Securities (UK) Ltd to date, with over 2,800 already completed, and £31.6m in compensation paid out.

Square Mile Securities Limited: The FSCS has already received over 2,000 claims against Square Mile Securities Limited and completed more than 1,500, paying £14.8m in compensation.

Estimates for the costs of Pacific Continental Securities (UK) Ltd have reduced slightly from our original projections of between £40m and £70m to between £40m and £60m. Estimated costs for Square Mile Securities Limited have increased from our original predictions of between £5 and £15m to between £20 and £25m.

Echelon Wealth Management, a "contracts for difference" broker, was confirmed to be in default in May. The FSCS has started paying claims and expects to deal with up to 900 claims against the firm for the return of cash held on behalf of its clients. To date the FSCS has paid compensation for 28 claims totalling over £189,000.

Global Trader Europe Limited, was declared in default in July, by which time the FSCS had already received 85 claims. The FSCS expects to receive up to 400 claims against the firm for the return of trading account balances held by the firm on behalf of investors.

Update on reform issues

FSA Policy statement on banking and compensation reform

The Financial Services Authority has published a new policy statement on banking and compensation reform (PS 09/11).

Among the proposals contained in the [document](#) are:

- Simplifying the FSCS eligibility requirements for deposit claims;
- Moving to gross payout to depositors;
- A requirement on deposit takers to maintain a “single customer view” to allow the FSCS to achieve a faster payout; and
- New disclosure requirements on deposit takers to provide information about the FSCS to their customers.

FSCS Chief Executive, Loretta Minghella, said: “We welcome the FSA Policy Statement, which marks the next phase of improvements to the FSCS that will benefit consumers. Both we and the industry have much to do to implement the FSA’s new rules. We are committed to working with the industry to deliver these changes. Once we have done so, it will be much easier for the FSCS to respond quickly should a deposit taker fail. That will be good news for consumers and will help to promote consumer confidence.”

Government white paper on reforming financial markets

The Government has published a white paper entitled ‘Reforming Financial Markets’, which sets out its proposals for reforming the financial system; some of these will affect the FSCS.

The proposals include moving towards pre-funding for the FSCS in the future, expanding our statutory governance and reviewing our remit and accountability arrangements. On the latter point, the Government proposed possible changes to allow us to act as a UK agent for compensation schemes in other countries.

Update on the FSCS’s limits of compensation payable, increase from 1 January 2010

New limits for the FSCS will come into effect on 1 January 2010 and are as follows:

- **Investments:** protection for 100% of £50,000 (currently 100% of the first £30,000 and 90% of the next £20,000).
- **Home finance advice and arranging:** protection for 100% of £50,000 (currently 100% of the first £30,000 and 90% of the next £20,000).
- **Non-compulsory insurance provision (both general and life insurance):** protection for 90% of the claim, with no upper limit (currently 100% of the first £2,000 and 90% of the remainder, with no upper limit).
- **Mediation of non-compulsory general insurance and pure protection contracts** (term, critical illness and income protection insurance): protection for 90% of the claim, with no upper limit (currently 100% of the first £2,000 and 90% of the remainder, with no upper limit). There will be no change to compulsory insurance, such as motor third party and employers’ liability insurance, including mediation. This will remain at 100% protection with no upper limit.

