News from the Financial Services Compensation Scheme

outlook

Financial Services Compensation Scheme

April 2015

Compensating consumers since 2001

2015/16 ANNUAL LEVY

- Key components of annual levy
- Compensation costs
- Management expenses

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- 2008/09 major bank failures legacy loan cost update

POLICY

- EU Deposit Guarantee Schemes Directive update

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CHIEF EXECUTIVE'S STATEMENT

Mark Neale, Chief Executive

Welcome to this edition of Outlook. In it FSCS announces that its annual levy for 2015/16 will be £319m – higher than both last year's annual levy of £276m and the indicative forecast of £287m which we published in January.

The movement in the levy since our January forecast differs across the sectors; for some it has increased, whereas others will see a reduction. This again demonstrates the unpredictability of the claims that can come our way.

We have raised the 2015/16 levy for life and pensions intermediaries, primarily as a result of increased self-invested personal pension (SIPP) related claims. These claims were also the reason we raised a supplementary levy in March for the last financial year. We are now compensating eligible claimants for their investment losses in many cases. We are also seeing higher volumes of these claims and this is leading to a levy of £100m at the start of the year, according to current projections. However, it is still early days in terms of volume and value of claims coming to us so it is possible that the costs during the year might be even higher. That means that we cannot rule out, at this stage, the possibility of the costs exceeding the maximum amount we can levy on life and pension intermediaries in any one year. That could lead to a levy on all firms in the retail pool. We will provide more information as the situation becomes clearer. We've included an example of the type of SIPP related claim FSCS receives on page 7.

Of course, consumers now have greater freedom to invest their retirement savings and it is important that they do so with good understanding of the choices on offer. This is why FSCS has worked closely with Pension Wise, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) to ensure consumers are aware of, and fully understand, our protection.

Our focus remains the consumer. So I welcome the extension of FSCS protection for deposits as a result of the implementation in the UK of the EU Deposit Guarantee Schemes Directive. From July, our protection will extend to what are known as 'temporary high balances' such as the proceeds of house sales and other life events. This provides additional protection for consumers that many will welcome. There will also be changes to the way firms produce and submit their single customer view files which underpin our ability to compensate depositors in seven days in the event of failure. These are important changes and we detail the work we are doing to prepare on page 13.

The PRA also announced that all long-term insurance products and certain general insurance claims will be protected to 100% from 3 July 2015 (increased from 90%). This strengthens consumer protection and simplifies the delivery of compensation.

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Our continuing priority is to deal quickly, accurately and responsively with the claims we receive from consumers. That is why I am particularly pleased to say that our Connect programme, designed to streamline and modernise our claims handling process, will roll out from this spring. This project is just one of the ways FSCS is delivering on our imperative to modernise our service. We will continue to update the industry on the development and deployment of the Connect programme throughout the year.

And our commitment to transparency remains a focus for FSCS. Please tell us, therefore, if you find the information contained within Outlook of use and if there is other information you would like us to provide.

KEY COMPONENTS
OF 2015/16 ANNUAL LEVY

The calculation of FSCS's annual levy is made up of a number of different components. It is of course, primarily driven by our forecast of compensation costs, but the levy has to be adjusted to reflect both unspent balances or deficits (carried over from the previous year) and recoveries. The levy also reflects FSCS's management expenses. And for banks, building societies and credit unions, the greater part of the annual levy is accounted for by the continuing cost of FSCS's liabilities for the 2008/09 bank and building society failures.

The final levy has increased by £32m from the indicative forecast. The main components of the levy and the changes are shown in table 1.

Table 1: Final levy figures

Funding Classes	2015/16 Final Levy £m	2015/16 Indicative Levy £m	Variance £m	
Deposits (SA01)	13	10	3	↑
General Insurance Provision (SB01)	62	68	(6)	↓
General Insurance Intermediation (SB02)	-	-	-	
Life & Pensions Provision (SC01)	-	-	-	
Life & Pensions Intermediation (SC02)	100	57	43	↑
Investment Provision (SD01)	-	-	-	
Investment Intermediation (SD02)	116	125	(9)	↓
Home Finance Intermediation (SE02)	5	3	2	↑
Base costs	23	24	(1)	↓
	319	287	32	

Compensation costs

- The total proposed compensation costs for 2015/16 are £348m (higher than previously forecast by £57m after we refined our projections using updated data).

Management expenses

- There is no change to our management expenses budget. As indicated in our Plan and Budget 2015/16, we expect the 2015/16 management expenses to be £69.1m – down from £74.7m in 2014/15.

Major banking defaults levy

- The 2014/15 interest costs for the major bank failures of 2008/09 are £397m and will be levied in July 2015. The decrease from last year reflects changes in interest and gilt rates and recoveries achieved since the Plan and Budget 2015/16 was published.
- Our estimates of dividends from the legacy estates have increased since we published the Plan and Budget 2015/16. However we currently intend to keep the levy in respect of legacy banking failures at £750m and intend to make a larger repayment towards our Dunfermline liabilities if these increased recoveries are in fact achieved.
- The total levy for the major banking failures is therefore expected to be £750m (as forecast). It will be levied in July/August 2015 for payment to HM Treasury by 1 October 2015.

COMPENSATION COSTS

Table 2: Updated compensation costs forecast for the period to 30 June 2016

Funding Classes	12 month forecast £m	3 year funding model £m	Trend £m	Used in levy £m
Deposits (SA01)	10.9	n/a	n/a	10.9
General Insurance Provision (SB01)	104.1	87.9	n/a	104.1
General Insurance Intermediation (SB02)	9.5	37.2	-	9.5
Life & Pensions Intermediation (SC02)	96.5	33.2	84.1	96.5
Investment Intermediation (SD02)	114.8	123.6	-	123.6
Home Finance Intermediation (SE02)	1.3	1.1	3.1	3.1
Total	337.1	283.0		347.7

Compensation costs

We project total compensation costs forward to 30 June 2016 to reflect the fact that each year our annual levy is issued and becomes payable from July. The element of our levy which covers compensation costs is based on a 1 July – 30 June year, with compensation costs arising in the first quarter of the 2015/16 financial year covered by the annual levies raised in 2014/15.

Firms will receive their annual levy bill from July 2015 (payable within 30 days). The FCA has established financing arrangements for firms who wish to spread the costs of fees and levies. Details of these arrangements are available from the FCA.

Unforeseen events in financial markets can impact on our claims assumptions, and our funding and subsequent levy requirements may change substantially as a result. We do not levy unless there is a reasonable expectation that we will have to meet the costs of claims in a particular area.

Our assumptions about compensation costs for the year ahead have been calculated using both our 36 month funding approach and the traditional 12 month forecast. We have forecast that, as at 1 July 2015, we will have funds to carry forward of £79m. The compensation costs for the period to 30 June 2016 (gross of projected recoveries) are now expected to be £348m and are set out by sector in table 2. Although the 36 month forecast is higher for the General Insurance Intermediation sector, we use the 12 month forecast for reasons explained overleaf. This total is an increase of £57m from the indicative forecast for 2015/16.

THE MAIN CHANGES TO THE COMPENSATION COSTS LEVY

(FROM THE INDICATIVE AMOUNTS)

Deposits (SA01)

The increase is due to FSCS updating its assumptions about compensation costs in this sector, specifically for credit unions.

General Insurance Provision (SB01)

The annual levy of £62m represents a reduction of £6m compared to the indicative levy amount of £68m announced earlier this year. While the compensation forecast remains the same for this sector, the decrease in levy is a result of a higher opening balance as well as a reduction in the compensation forecast for the current year.

General Insurance Intermediation (SB02)

There is a clear falling trend in this class as a result of the decrease in payment protection insurance (PPI) claims that FSCS has experienced over the last 12 months. The costs of PPI are not expected to increase back to the levels of two to three years ago. The Financial Ombudsman Service is also experiencing reduced claims volumes and there are no medium or large PPI firms that are expected to fail in the near future. It is for these reasons that we feel the historical average of the last three years is not an appropriate prediction of the next three years. Therefore the 12 month forecast is more suitable. Using this forecast, it is proposed that no levy is raised for these claims this year. The costs of compensation and management expenses will be paid for by the opening fund surplus.

Life and Pensions Intermediation (SC02)

The levy for firms in the life and pensions intermediation sector has increased since the indicative levy in the Plan and Budget 2015/16, rising to £100m from £57m. This is primarily a result of increased SIPP related claims received by FSCS. This means that additional costs to this sector in 2015/16 may trigger the retail pool. However, this is based on our current projections and could change during the year. We will keep this under review and will update the industry as the costs become clearer during the course of the year. We will provide clarity on the likelihood of a levy on firms in the retail pool when we are able to do so.

Investment Intermediation (SD02)

While we expect to pay compensation costs for Alpari in 2015/16, the inclusion of these costs (£28m) has been offset by reductions in other investment workstreams. As a result of increased forecasts of recoveries, including for Alpari, the levy for the coming year has decreased.

SIPP SWITCHING CLAIMS: BACKGROUND

On 18 Jan 2013, the FSA first published concerns that firms were advising on pension transfers or switches to SIPPs without assessing the advantages and disadvantages of the underlying investments to be held in them: https://www.fca.org.uk/static/documents/alert-pension-transfers.pdf. In particular, the FSA had seen financial advisers moving customers' retirement savings to SIPPs in order to invest into high risk, often highly illiquid, unregulated investments such as overseas property developments and forestry, which are unlikely to be suitable for the vast majority of retail customers.

Following that initial alert, the regulator carried out further supervisory work, which identified serious ongoing market failings.

On 24 April 2014, a SIPP alert was posted on the FCA website: http://www.fca.org.uk/news/sipps-further-alert. It was linked to publication of enforcement action taken against partners in 1 Stop Financial Services, which had failed to comply with regulatory rules in arranging transfers to SIPPs. They operated a business model which sought to restrict advice to the merits of the SIPP wrapper itself. FCA reminded firms advising on the suitability of a pension transfer of the obligation to consider both the customer's existing pension arrangement and the underlying investments intended to be held within the SIPP.

In 2014, FSCS began to see claims from retail consumers whose pension savings had been moved to SIPPs from traditional pension plans invested in mainstream funds, or from final salary schemes, and who had very limited investment experience. Attracted by the prospect of very high and sometimes unrealistic investment returns, consumers were encouraged by introducers to make selections from a range of alternative investment propositions to invest their SIPP funds. These included overseas timeshare property developments, forestry plantations (either in the Far East or Australia) from which fuel oil was to be derived using unproven technology, carbon credits, gold and South American farmland.

SIPP SWITCHING CLAIMS
CASE STUDY:

Case study:

The claimant was single, aged 30 with one dependant and employed as a receptionist earning £27,000 a year. Existing financial assets were savings of £2,000, an ISA worth £1,500, two loans totalling £2,500 and a personal pension plan worth £30,000 invested in the managed fund. The claimant was a medium risk investor with limited investment experience.

The claimant was contacted by an unauthorised introducer who convinced them to consider alternative investments to boost their pension funds, as these were performing poorly.

The introducer recommended transferring to a SIPP so as to invest into an unregulated nursery forestry programme. The "conservatively projected returns" were said to be 13% in Year 1, 53% in Year 2, and then 93% in each of Years 3 to 5. This was to be achieved through investment into oil-producing trees registered in the claimant's name and the claimant was told they would be "able to sell your assets at any time."

The introducer then referred the claimant to a specialist pension adviser whose business was to advise on the merits of switching pension funds to SIPPs. The adviser wrote to the claimant acknowledging the referral and confirmed that information was being requested from the current pension provider. The adviser then completed a fact find and client agreement with the claimant.

The suitability report recommended that the claimant switched the personal pension plan to a SIPP. The basis for switching was to achieve higher investment returns.

£30,000 was transferred to the SIPP, of which £26,000 was used to buy 809 trees in a plantation in Cambodia (with a £250 booking fee). Two years later the promoter was placed into administration. The administrator reported that "the promoter had no title to the land in Cambodia……although the promoter purported to effect the sale of leases to third party investors." The promoter was investigated by the Serious Fraud Office and four former officers charged with fraud, of whom three have been convicted. The investor's holdings were written down by their SIPP provider to £1.

The claimant lodged a claim with FSCS for unsuitable advice for 'churning' their pension fund to invest into a single, highly speculative investment. Whilst satisfied that the claimant had been badly advised, FSCS took legal advice on whether the pension switching firm could reasonably have foreseen the possibility of failure of the investment scheme. Fraud may have broken the causal link between the bad pension transfer advice and losses suffered on collapse of the unregulated investment scheme. We decided that it had not.

A hypothetical fund value obtained from the transferring pension provider showed a loss of £1,838.71 compared to the transfer value paid into the SIPP. Adding fees/charges and commissions incurred in the SIPP increased the loss to £5,107.18. The claimant will also receive £26,000 additional compensation as the pension switching adviser is liable for the investment losses too.

ALPARI (UK) LIMITED AND LQD MARKETS (UK) LIMITED

Two foreign exchange firm failures have fallen to FSCS following the Swiss National Bank's decision on 15 January 2015 to remove the informal peg between the Swiss Franc and the Euro. This prompted volatility across foreign exchange markets and caused many companies and clients to suffer losses. These two firms have been placed into the Special Administration Regime for investment firms.

We are working with the respective special administrators. This work involves the special administrators reconciling the respective companies' accounts to confirm what clients are owed and what client monies are held. In addition, FSCS needs to satisfy itself as to what types of accounts are protected by FSCS, e.g. whether accounts relate to investment business.

We have accounted for potential compensation of £28m to be paid in relation to Alpari (UK) Limited in the current financial year. No confirmed date or compensation costs have been identified at this stage. FSCS has not yet accounted for costs in relation to LQD Markets (UK) Limited, as FSCS's involvement in relation to this firm is less certain at this time. FSCS will provide further information to claimants and the industry as soon as it is in a position to do so.

FSCS

MANAGEMENT EXPENSES

FSCS management expenses in 2015/16 are calculated to be £69.1m, as indicated in the Plan and Budget 2015/16. The PRA and FCA consulted on the Management Expenses Levy Limit (MELL) in CP2/15. The MELL has now been fixed at £74.4m as proposed. The major components of the MELL are set out in table 3 (including the base costs set out in table 5).

Table 3: Management expenses

Continuing Operations	2014/15 Forecast (£ m)	2014/15 Budget (£m)	2015/16 Budget (£ m)
- Staff costs	15.9	16.4	16.5
- Contractor costs (non-Change)	2.1	0.9	1.2
- Pension deficit funding	1.6	1.6	1.6
- Facilities	2.2	2.2	2.1
- IT	2.2	2.4	3.3
- Communications	4.1	4.1	4.2
- Legal & Professional	2.7	2.9	2.6
- External providers	0.8	0.7	0.8
- Other	0.3	0.3	0.3
- Contingency	0.9	0.3	0.3
Subtotal	**32.8**	**31.8**	**32.9**
Outsourced claims handling	10.3	11.0	12.1
Outsourced printing & scanning services	0.9	0.5	0.9
Operational Total	**44.0**	**43.3**	**45.9**
Strategic Change Portfolio	18.5	16.3	12.4
Operational & Investment Expense total	**62.5**	**59.6**	**58.3**
Bank charges	4.1	4.9	4.8
Interest received	(0.1)	0.0	0.0
Keydata Investment Services Limited recovery expenses	4.4	7.2	3.0
Major banking failure related management expenses	3.0	3.0	3.0
Total management expenses	**73.9**	**74.7**	**69.1**
Non-levied reserve for major failure	5.3	5.3	5.3
Total management expense levy limit	**79.2**	**80.0**	**74.4**

Table 4: Split of management expenses budget

Base costs total (£m)	FSCS 21.0	FCA 11.4	PRA 11.6
Specific costs			
-Deposits (SA01)	14.8	-	14.8
-General Insurance Provision (SB01)	7.2	-	7.2
-General Insurance Intermediation (SB02)	6.7	6.7	-
-Life and Pensions Provision (SC01)	0.3	-	0.3
-Life and Pensions Intermediation (SC02)	5.6	5.6	-
-Investment Provision (SD01)	0.3	0.3	-
-Investment Intermediation (SD02)	12.4	12.4	-
-Home Finance Intermediation (SE02)	0.8	0.8	-
Specific costs total	48.1	25.8	22.3
Total	**69.1**	**37.2**	**33.9**

Table 5: Final base costs levy for 2015/16

FCA	PRA	Fee Block	FCA £m	PRA £m
A000		Minimum fee block	0.5	
AP00		FCA Prudential fee	0.4	
A001	PA01	Deposit acceptors	1.8	8.0
A002		Home finance providers and administrators	0.5	
A003	PA03	General Insurers	0.6	1.6
A004	PA04	Life Insurers	1.1	1.9
A005	PA05	Managing Agents at Lloyd's	0.0	0.0
A006	PA06	The Society of Lloyd's	0.0	0.1
A007		Fund managers	1.2	
A009		Operators, Trustees and Depositaries of collective investment schemes and Operators of personal pension schemes or stakeholder pension schemes	0.3	
A010		Firms dealing as principal in investments	1.3	
A012		Advisory arrangers, dealers or brokers (holding or controlling client money or assets, or both)		
A013		Advisory arrangers, dealers or brokers (not holding or controlling client money or assets, or both)	1.9	
A014		Corporate finance advisers	0.3	
A018		Home finance providers, advisers and arrangers	0.4	
A019		General Insurance mediation	0.7	
A021		Safeguarding and administering of safe custody assets (without arranging) and who hold client money under the client money rules	0.4	
			11.4	**11.6**

2008/09
MAJOR BANK FAILURE
LEGACY LOAN COSTS UPDATE

The 2015/16 interest cost for the 2008/09 major bank failures is now forecast at £397m compared to £403m announced in the Plan and Budget 2015/16. The total levy for the major banking failures is expected to be £750m, as indicated in the Plan and Budget 2015/16.

Table 6: Liabilities due to HMT for legacy bank failures

£m	Bradford & Bingley		Other loans		Dunfermline	Total
Opening balance at 1.4.15	Capital	Interest	Capital	Interest	(see note)	
Capital	15,654		143			15,797
Interest		384		13		397
Other liabilities					448	448
Total opening balance	**15,654**	**384**	**143**	**13**	**448**	**16,642**
Add: Interest for 2015/16		350		1		351
Less: Recoveries	-		(116)			(116)
Levies		(384)	(27)	(14)	(325)	(750)
Closing balance at 31.3.16	**15,654**	**350**	**-**	**-**	**123**	**16,127**

Note: While there is a liability to HMT for Dunfermline Building Society, it is not structured as a loan but arises under legislation

POLICY

Depositor Protection

The PRA published its Policy Statement (PS6/15) on Depositor and Dormant Account Protection on 1 April 2015. This Policy Statement contains the final rules, supervisory statement and statements of policy to implement the proposals made in their earlier consultation papers (CP20/14 and CP4/15 in relation to depositor and dormant account protection).

The changes are the result of the recast Deposit Guarantee Schemes Directive (DGSD), which is effective from 3 July 2015, and other measures to support greater depositor protection in the UK.

The key changes being introduced are:

- Ex-ante funding – UK Government intends to use the bank levy to meet the recast DGSD requirements.
- Risk-based levies – European Banking Authority (EBA) has published its consultation on the guidelines. The PRA expects to publish a CP on risk-based levies, once EBA guidelines are final.
- Extension of FSCS eligibility for deposit claims – most corporate firms will now be eligible for deposit protection, regardless of size. It has also been proposed that small local authorities, with an annual budget of less than €500,000, should be eligible for FSCS deposit protection – this proposal is included in consultation paper CP15/15, issued on 1 April 2015, and open for comment until 1 May 2015.
- Payment of compensation within seven working days - by 31 December 2023, with provision for interim payments where this target cannot be met, although this is FSCS' current target.
- Temporary High Balance cover – in some circumstances depositors will be able to claim for amounts up to £1million that resulted from a specific life event, such as the sale of a house, or without limit in certain circumstances.
- New depositor disclosure requirements – standard requirements for all firms to provide depositors with an information sheet annually, and obtain acknowledgement from the depositor.
- Stress testing and peer review of FSCS – EBA guidelines awaited.
- Member State cooperation – depositors with branches of banks based in a host Member State will be repaid by the deposit guarantee scheme in that state. The depositor will remain protected by the home DGS and the home DGS will provide the funding to the host paying out.
- Enhanced SCV requirements – system and reporting changes for firms to ensure more comprehensive and standardised deposit information can be provided more quickly to support FSCS payout.
- Continuity of access – new system requirements for firms to facilitate the ability to transfer deposits to an acquiring firm in resolution, so there is the option for depositors to have continued access to their deposits rather than a payout.

POLICY

DGSD Implementation update

At FSCS, work is well under way to implement the forthcoming changes. We have liaised with the regulators throughout the consultation phases and are already making the necessary changes to our processes.

Our current activities include:

- Development of a guide for deposit-taking firms on the SCV requirements and support in the form of a dedicated enquiry mailbox and help line.
- Enhancing our systems for handling and verifying SCV files.
- Liaison with HM Treasury on arrangements regarding ex-ante funding and the bank levy.
- Working closely with our European deposit scheme counterparts to agree cross-border procedures.
- Developing effective procedures for the handling of claims for temporary high balances. FSCS will be hosting workshops for smaller firms to help with implementation.

Policyholder Protection

Also on the same date, 1 April 2015, the PRA published its Policy Statement PS5/15 on Policyholder Protection. This followed earlier consultation papers, CP21/14, CP20/14 and CP4/15, and takes into account the feedback received.

The main proposals being implemented include:

- Compensation limits – extension of compensation to 100% for all long-term insurance products and certain general insurance claims (e.g. general insurance claims arising from death or incapacity, as well as professional indemnity insurance).
- Successor firms – FSCS protection will be provided post-transfer for policyholders who have outstanding protected claims against an insurer whose claims were covered by the FSCS before their policies transferred to a successor firm.
- Assignment and subrogation – FSCS will be given flexibility in the way it seeks recoveries from failed insurers and third parties after paying out compensation, through new powers of automatic and electronic assignment and automatic subrogation of policyholders' rights.

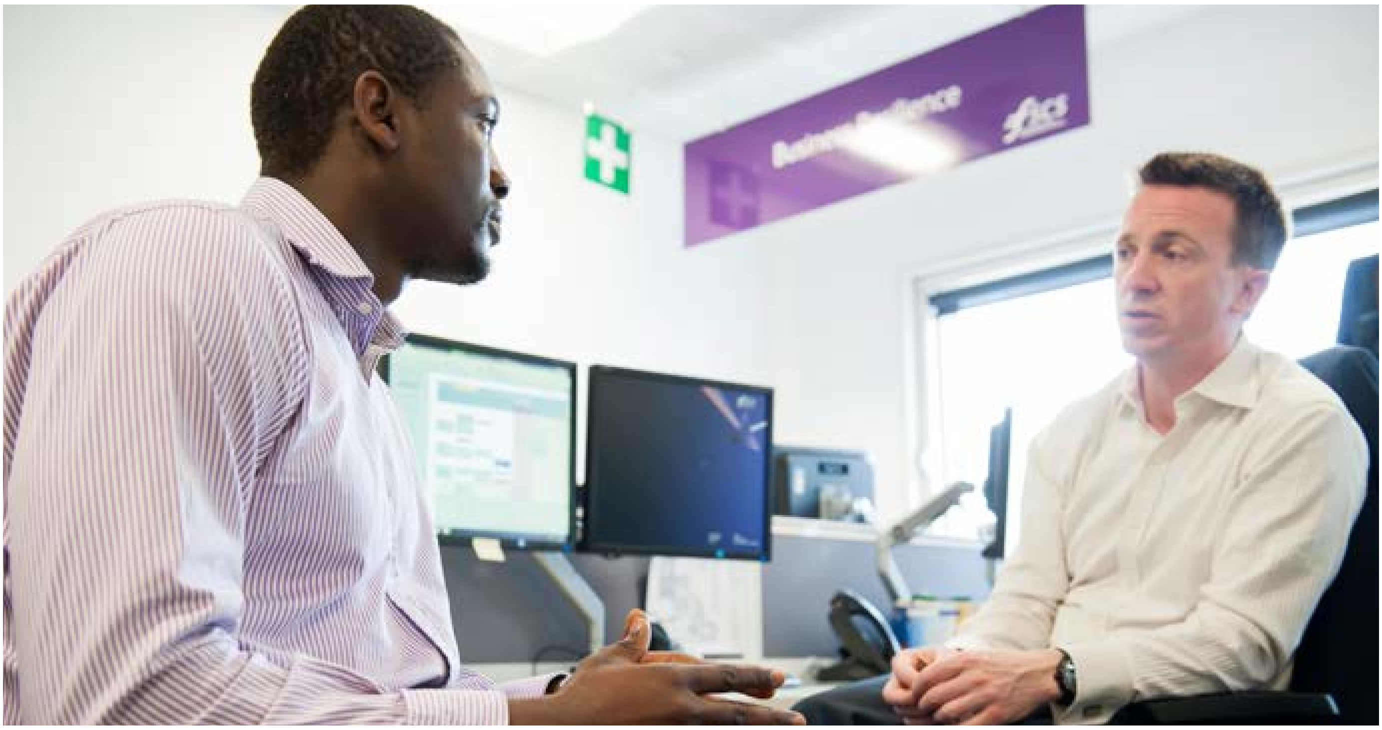
RAISING AWARENESS OF FSCS PROTECTION TO BOOST CONFIDENCE

Pension liberalisation

The Government announced changes to the UK pension system in last year's budget. These give people greater choice about how they invest their pension pot and moves away from requiring people to buy annuities. With the changes now in place, FSCS is keen to ensure consumers understand whether and how this increased choice will impact on their FSCS protection.

With this in mind, FSCS is working in partnerships with other organisations to weave the FSCS message into wider communications. We have also updated our website to ensure consumers are clear on FSCS protection.

Visit www.fscs.org.uk for more information.



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