BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

FCA
FINANCIAL CONDUCT AUTHORITY

Consultation Paper

**FCA CP14/1
PRA CP1/14

Financial Services Compensation Scheme – management expenses levy limit 2014/15

January 2014

Contents

We are asking for comments on this Consultation Paper by 17 February 2014. The consultation is for four weeks only.

You can send them to us using the form on the FCA website at:
www.fca.org.uk/your-fca/documents/consultation-papers/cp14-01-response-form.

Or in writing to:

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Canary Wharf
London E14 5HS

Telephone: 020 7066 5428
Email: cp14-01@fca.org.uk

The FCA and PRA will make all responses to formal consultation available for public inspection unless the respondent requests otherwise. The FCA and PRA will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, the FCA and PRA may be asked to disclose a confidential response under the Freedom of Information Act 2000. The FCA and PRA may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Consultation Paper from our websites: www.fca.org.uk. or www.bankofengland.co.uk/pra/Pages/default.aspx

For paper copies, contact the FCA's order line on 0845 608 2372.

Abbreviations used in this paper

COMP	Compensation sourcebook in FCA and PRA Handbooks
CP	Consultation Paper
FCA	Financial Conduct Authority
FEES	Fees manual in FCA and PRA Handbooks
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
MELL	Management expenses levy limit
PRA	Prudential Regulation Authority
The 2012 Act	The Financial Services Act 2012

1. Overview

Introduction

1.1 This joint Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) consultation paper (CP) outlines the proposed management expenses levy limit (MELL) for the Financial Services Compensation Scheme (FSCS) for 2014/5. The MELL consulted on for 2014/15 is £80m.

Who does this consultation affect?

1.2 You should read this CP if you are an authorised firm.

Is this of interest to consumers?

1.3 This CP contains no material of direct relevance to retail financial services consumers or consumer groups. Consumers benefit from an efficient and adequately funded compensation scheme. However, costs may be passed on to consumers in the form of higher prices, meaning they indirectly pay part of the FSCS levies.

Context

1.4 The efficient and effective functioning of the FSCS helps:

- the FCA meet its consumer protection objective
- the PRA meet its objectives of ensuring the safety and soundness of PRA firms and ensuring that firms are capable of an orderly resolution

Summary of our proposals

1.5 The MELL proposed for 2014/15 is £80m, consisting of:

- FSCS management expenses of £74.7m: this is the minimum amount that will be levied for 2014/15.

- A contingency reserve of £5.3m: this allows the FSCS to levy additional funds without formal consultation by the FCA and PRA, to meet contingencies that were not expected when the annual levy was raised. This would most probably be at relatively short notice, and would not be levied unless required by the FSCS.

Equality and diversity considerations

1.6 The proposal concerns a rule change that applies to the FSCS, not to authorised persons. As such, our analysis suggests that the subject matter of the rule change does not give rise to discrimination or raise any issues in light of the public sector equality duty contained in the Equality Act 2010. However, we would welcome any comments respondents may have on any equality issues they believe arise as a result of these proposals.

Next steps

What do you need to do next?

1.7 Please send us your comments on the proposed MELL by 17 February 2014.

How?

1.8 Use the online response form on FCA's website or write to FCA at the address on page 2.

What will we do?

1.9 After reviewing consultation responses, and subject to approval in March 2014 by the FCA Board and the PRA Board, we will finalise the proposal in this CP to take effect on 1 April 2014. Invoices will be sent out from July 2014.

2.
Management expenses levy limit (MELL) 2014/15

Introduction

2.1 In this chapter we consult on the FSCS MELL for 2014/15. Management expenses are the non-compensation costs that the FSCS incurs – or expects to incur – in connection with delivering its functions.

What is the MELL?

2.2 Under the Financial Services and Markets Act 2000 (FSMA), the FCA and PRA must set a limit on the total management expenses levied, that gives the FSCS adequate resources to:

- perform its functions efficiently and economically
- provide a responsive and well-understood compensation service for financial services consumers

2.3 This represents the maximum amount of management expenses that can be incurred in the year under the FEES rules, although it is not necessarily the amount the FSCS will actually levy. The levy limit applies from 1 April 2014, the start of the FSCS's financial year, to 31 March 2015.

2.4 The draft rules for the FCA and PRA are in Appendix 1.

2.5 The amount levied to pay compensation claims is determined by the FSCS and is not consulted on. There are limits under the FEES rules on how much firms can be levied each year. The FSCS indicates its current estimated compensation figures and its related funding and levies in its Plan and Budget. This will be available on the FSCS website shortly after we publish this CP. The FSCS will confirm its actual levy requirements in early April 2014.

Proposed MELL for 2014/15

2.6 The FSCS has certain management expenses which it incurs in delivering its functions, in addition to the costs of paying compensation. These include staff, building costs, ongoing operating expenses, outsourcing and claims handling, IT, legal costs, other professional services, strategic programmes and other costs.

2.7 The management expenses levy is made up of:

- a **specific costs element**, which comprises costs attributable to a particular funding class and allocated to that class

- a **base costs element**, relating to the general costs of the FSCS (which is not dependent on the level of claims received)

Base costs are divided equally between the PRA and FCA regulatory fee classes, and then distributed in proportion to regulatory fees.

2.8 Under FSMA, as amended, the maximum levy which may be imposed to cover these management expenses (the MELL) is set under rules which must be made by the FCA Board and the PRA Board.

2.9 The FCA and PRA propose to set the MELL for 2014/15 at £80m. This consists of two components:

- **FSCS management expenses (or budget) of £74.7m:** this is the minimum amount that will be levied for 2014/15.

- **A contingency reserve of £5.3m:** this allows the FSCS to levy additional funds for management expenses up to this limit, to meet contingencies that were not expected when the annual levy was raised. This would most probably be at relatively short notice, and would not be levied unless required by the FSCS.

Table 1: Overview of FSCS budget information

FSCS Management expenses	FY14/15 Budget £m	FY13/14 Budget £m	FY13/14 Budget v FY14/15 Budget variance £m
Continuing Operations	32.3	33.4	1.1
Outsourcing	11.0	12.0	1.0
Total Operational Cost	**43.3**	**45.4**	**2.1**
Strategic change portfolio	16.3	15.9	(0.4)
Total Operations and Investment Expense	**59.6**	**61.3**	**1.7**
Financing & Major Recoveries Expenses	15.1	13.1	(2.0)
Total Management expenses	**74.7**	**74.4**	**(0.3)**
Contingency Reserve	5.3	20.0	14.7
Total MELL	**80.0**	**94.4**	**14.4**

NB: Figures in the table are rounded.

2.10 Management expenses are presented in Table 1 in the MELL format, with the FY13/14 budget being re-classified so that a direct year on year comparison can be made with the MELL proposed for 2014/15. Many of the 'Exceptional Items' previously seen in the FSCS MELL have been integrated into Operational and Investment Expenses. The management expenses cover:

- Continuing operations costs, including legal costs, facilities, IT, pension deficit funding and staff costs.

- Outsourcing costs: these are invoiced by claim type, and the budget is based on the claims forecast volumes. Individual classes are allocated an expected cost based on the claims to be processed in the new financial year. The vast majority of claims are outsourced by the FSCS, giving it flexibility to handle fluctuating numbers of claims.

- Strategic change programme costs, including investments in changes to FSCS processes, operations and systems. These investments will improve the FSCS's service to consumers and its efficiency, ensuring that the FSCS can provide protection to consumers if a firm fails while minimising costs to levy payers.

- Financing and major recoveries expenses: these cover the FSCS's pursuit of opportunities to recover the costs of compensation, including from the major banking failures of 2008/09 and other failures such as Keydata Investment Services Limited.

2.11 The management expenses of £74.7m will be made up of £16.5m in base costs and £58.2m in specific costs.

2.12 The table below shows how the proposed management expenses of the FSCS break down per class.

Table 2: Breakdown of FSCS management expenses per class

£m	FSCS	PRA	FCA
Base Costs Total	**16.5**	**8.2**	**8.2**
Specific Costs			
Deposits	19.5	19.5	-
General Insurance Provision	5	5	
Life & Pension Provision	0.2	0.2	
General Insurance Intermediation	13.5	-	13.5
Life & Pension Intermediation	3.8	-	3.8
Investment Provision	0.2	-	0.2
Investment Intermediation	14.9	-	14.9
Home Finance Intermediation	1.1	-	1.1
Specific Costs Total	**58.2**	**24.7**	**33.6**
Management Expenses Total	**74.7**	**32.9**	**41.8**

NB: Figures in the table are rounded.

2.13 Further information on the detail of the FSCS proposed budget is included in its Plan and Budget, due to be published shortly after this CP on the FSCS website.

Contingency reserve

2.14 The contingency reserve allows the FSCS to levy additional funds without further formal consultation by the FCA and PRA. The contingency reserve proposed for 2014/15 is £5.3m. This gives the FSCS access to funding to handle unexpected increases in claims volumes and other unforeseen circumstances.

2.15 The proposed contingency reserve level is not intended to reflect the costs of any particular future failures, but would provide a reasonable sum to meet any needs that may arise at short notice and allow for potential uncertainties in the financial climate.

2.16 In practice, the FSCS is unlikely to need to raise more than its budgeted expenses, unless a specific event or events make it necessary. In line with its usual practice, the FSCS will liaise with relevant parties, such as the FCA and PRA and trade associations, before raising a levy against this reserve. The FSCS will publish an explanation of the need to raise any such levy.

Q1: Do you have any comments on the proposed FSCS MELL for 2014/15?

Annex 1
Cost benefit analysis

1. The FCA and PRA are required to carry out and publish a cost benefit analysis (CBA) when proposing draft rules (sections 138I and 138J FSMA refer). We consider that the CBA set out below meets the FSMA CBA requirements.

2. Setting the MELL at the specified level of £80m allows the FSCS to raise funds to cover its expenses so it can continue operating and meeting its objective of providing a high-quality compensation scheme that is efficient, fair, approachable and responsive.

3. The benefits from the FSCS are to improve consumer confidence, increase consumer protection and financial stability. The main consumer protection benefit is the reduced financial loss to consumers in the event of firm failure. It is difficult to estimate the number of potential instances of firm failure over 2014/15 and the subsequent reduction in financial losses to consumers due to FSCS compensation. However, to illustrate the potential scale of the benefits to consumers, the average annual value of compensation paid out over the past three years is £400m.

4. The contingency reserve of £5.3m will give the FSCS some margin to meet costs that exceed its budgeted expenses and need to be funded at short notice. The FCA and PRA recognise that the FSCS needs to be able to respond quickly and efficiently to firm failures. If a particular failure or series of failures meant that the MELL needed to be increased, the FCA and PRA would take the necessary steps to enable the FSCS to meet its obligations in a timely way.

5. The MELL is set at a level that we expect to be enough for the FSCS to continue to invest in more efficient systems, so it can deliver compensation in a more cost-effective way in the long term.

6. The management expenses levy will fall on firms and may be passed on to consumers in the form of higher prices. However, given the minimal cost per firm we would not expect the impact to be significant.

Impact on mutual societies

7. Levies to cover the FSCS management expenses are levied proportionally on all authorised firms. This includes mutuals. The impact on mutuals is not considered to be significantly different to the impact on other types of firm. The proposed rules in the FCA and PRA Compensation sourcebooks (COMP) would apply to the FSCS, rather than to authorised persons, but firms would meet the cost of any additional FSCS management expenses which resulted from our proposals.

Annex 2
Compatibility statement

PRA general duties and regulatory principles

1. These proposals contribute towards achieving the PRA general objective to promote the safety and soundness of PRA authorised persons.[1]

2. The proposed rule on setting the MELL is compatible with the general objective because the continued operation of the FSCS with a MELL set at an appropriate level assists in minimising the adverse effect of the failure of a PRA-authorised person on consumers. This helps promote stability and confidence in the UK financial system.

3. The proposed rule to set the MELL is compatible with the PRA insurance objective[2] because the continued operation of the FSCS with a MELL set at an appropriate rate assists in securing an appropriate degree of protection for policyholders of a PRA-authorised person that has failed.

4. The proposed MELL is compatible with the Regulatory Principles[3] and does not have any adverse effect on competition in the relevant markets. See below for further information.

FCA general duties and regulatory principles

5. In discharging its general functions the FCA must, so far as is reasonably possible, act in a way which:

   - is compatible with its strategic objective
   - advances one or more of its operational objectives[4]
   - reflects the regulatory principles set out in FSMA[5]

   In addition, the FCA must discharge its general functions in a way which promotes effective competition in the interests of consumers.[6]

6. The proposed MELL is compatible with the regulatory principles. In particular, an appropriate balance has been struck between the need to ensure the FCA's regulatory objectives are fulfilled and the need to keep regulatory burdens to a minimum. See below for further information.

1 Sections 2B(1) and 2B(2) of FSMA.
2 Sections 2C(1) and 2C(2) of FSMA.
3 Sections 2H(1) and 3B of FSMA.
4 Section 1B(1) of FSMA.
5 Section 1B(5)(a) and section 3B of FSMA.
6 Section 1B(4) of FSMA.

7. The proposal is compatible with the duty to promote effective competition in the interests of consumers. Any levy on firms, as a result of this proposal, will take into account the business volume of the firm levied and as such is not likely to disadvantage specific groups of firms (particularly smaller firms).

8. The proposal set out in this consultation is primarily intended to advance the FCA's operational objective of consumer protection. The role of the FSCS is, in general, to provide compensation to consumers of financial products when authorised firms are unable, or likely to be unable, to meet their obligations. A compensation scheme provides a safety net, offering protection to consumers, which in turn leads to greater confidence in their dealings with financial firms, benefiting all firms and leading to a stronger financial system. If the FSCS was unable to process claims because of financial constraints due to an inappropriate MELL this would undermine the protection offered to consumers.

9. In light of this, the proposed FSCS MELL is appropriate. The proposed limit ensures the FSCS has adequate resources to perform its functions for the coming year. We have also allowed sufficient reserve to prevent disruption to the FSCS's work if they need to exceed their operating budget for unexpected reasons.

Compatibility with the regulatory principles – PRA and FCA

10. In setting the MELL the FCA and PRA have adhered to the regulatory principles. In particular:

The need to use the resources of each regulator in the most efficient and economic way

11. The FSCS is operationally independent, but accountable to the FCA and PRA, which means that our resources are not directly involved in carrying out the proposed activities.

12. The FCA and PRA rules for the FSCS include a similar requirement on it to use its resources in the most efficient and economic way when carrying out its functions. Setting the MELL, after public consultation, encourages good internal management and effective operating procedures.

The principle that a burden or restriction should be proportionate to the benefits

13. For more information please see the CBA section (Annex 1).

14. We do not consider that the change we are consulting on will have any significant effect on the other principles.

Annex 3
Consultation question

Q1: Do you have any comments on the proposed FSCS MELL for 2014/15?

Appendix 1
Draft Handbook text

Appendix

FINANCIAL SERVICES COMPENSATION SCHEME (MANAGEMENT EXPENSES LEVY LIMIT 2014/2015) INSTRUMENT 2014

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137T (General supplementary powers);
(2) section 213 (The compensation scheme);
(3) section 214 (General); and
(4) section 223 (Management expenses).

B. The rule-making powers listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This Instrument comes into force on 1 April 2014.

Amendments to the Handbook

D. The Fees manual (FEES) is amended in accordance with the Annex to this Instrument.

Citation

E. This instrument may be cited as the Financial Services Compensation Scheme (Management Expenses Levy Limit 2014/2015) Instrument 2014.

By order of the Board of the Financial Conduct Authority
[*date*]

Annex

Amendments to the Fees manual (FEES)

In this Annex, underlining indicates new text.

6 Annex 1R Financial Services Compensation Scheme – Management Expenses Levy Limit

This table belongs to FEES 6.4.2R	
Period	Limit on total of all management expenses levies attributable to that period (£)
…	
1 April 2013 to 31 March 2014	£94,400,000
<u>1 April 2014 to 31 March 2015</u>	<u>£80,000,000</u>

Appendix 1

FINANCIAL SERVICES COMPENSATION SCHEME (MANAGEMENT EXPENSES LEVY LIMIT) INSTRUMENT 2014

Powers exercised

A. The Prudential Regulation Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137T (General supplementary powers);
(2) section 213 (The compensation scheme);
(3) section 214 (General); and
(4) section 223 (Management expenses).

B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Pre-conditions to making

C. In accordance with section 138J of the Act (consultation with the Financial Conduct Authority) ("FCA"), the PRA consulted the FCA. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

Commencement

D. This instrument comes into force on 1 April 2014.

Amendments to the Handbook

E. The Fees manual (FEES) is amended in accordance with the Annex to this instrument.

Citation

F. This instrument may be cited as the Financial Services Compensation Scheme (Management Expenses Levy Limit) Instrument 2014.

By order of the Board of the Prudential Regulation Authority
[*date*]

Annex

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