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PRUDENTIAL REGULATION  
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Consultation Paper | PRA CP4/16  
| FCA CP16/3

# Financial Services Compensation Scheme – management expenses levy limit 2016/17

January 2016

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Responses are requested by:  
Monday 15 February 2016.

Please address any comments or enquiries to the PRA at [CP4\\_16@bankofengland.co.uk](mailto:CP4_16@bankofengland.co.uk) by the response deadline as set out above.

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## Contents

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<b>1</b>	<b>Overview</b>	<b>5</b>
<b>2</b>	<b>Management expenses levy limit (MELL) 2016/17</b>	<b>6</b>
<b>3</b>	<b>Statutory obligations</b>	<b>9</b>
<b>Appendices</b>		<b>13</b>

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## 1 Overview

1.1 This Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) consultation paper (CP) sets out the proposed management expenses levy limit (MELL) for the Financial Services Compensation Scheme (FSCS) for 2016/17. The MELL consulted on is £72.7 million.

1.2 The MELL ensures that the FSCS has suitable funding so that it is capable of exercising those functions conferred on it by Part XV of the Financial Services and Markets Act 2000 (FSMA). The MELL is consulted on annually.

1.3 This consultation is relevant to all authorised firms, but contains no material of direct relevance to retail financial services consumers or consumer groups upon which they might need to act. As costs may be passed on to consumers in the form of higher prices, consumers may indirectly meet a part of the FSCS levies. However, an efficient and adequately funded compensation scheme is beneficial to consumers.

1.4 Chapter 3 contains the PRA's and FCA's analysis of the costs and benefits of the proposed rules (including the impact on mutual societies<sup>1</sup>) as required by under FSMA<sup>2</sup>, and a statement regarding the PRA's and the FCA's respective competition objectives. It also contains the PRA's and FCA's assessment of the compatibility of the proposed rules with their respective Statutory Objectives and Regulatory Principles as set out in FSMA<sup>3</sup> and their duty to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out their policies, services and functions.<sup>4</sup>

### Responses and next steps

1.5 This consultation closes on Monday 15 February 2016. The PRA and the FCA invite feedback on the proposed MELL. Please address any comments or enquiries to CP4\_16@bankofengland.co.uk.

1.6 Following this consultation, the PRA and the FCA will consider any feedback and issue respective policy statements or equivalent Handbook notices (as appropriate) on the final MELL in order that the amended PRA and FCA rules can be in place for the start of the FSCS's financial year on 1 April 2016.

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1 Section 138K of FSMA.

2 Section 138J of FSMA.

3 Section 2H and section 3B of FSMA.

4 Section 149(1) of the Equality Act 2010.

## 2 Management expenses levy limit (MELL) 2016/17

2.1 In this chapter we consult on the FSCS's MELL for 2016/17. The MELL has two components: the management expenses budget and a contingency reserve.

2.2 Under FSMA, the PRA and the FCA must set a limit on the total management expenses to be levied by the FSCS. This allows the FSCS adequate resources to perform its functions efficiently and economically, and provide a responsive and well-understood compensation service for financial services consumers. The MELL represents the maximum amount that the FSCS can levy in order to fulfil the obligations imposed on it by PRA and FCA rules<sup>1</sup>, although it is not necessarily the amount the FSCS will levy in the coming year. The proposed levy limit would apply from 1 April 2016, the start of the FSCS's financial year, to 31 March 2017.

2.3 The proposed rules for the PRA and FCA to set the MELL are in Appendix 1 and 2, respectively.

### Management expenses budget

2.4 Management expenses are the costs that the FSCS incurs in connection with delivering its functions, excluding compensation costs made to or on behalf of claimants.

2.5 The management expenses budget component of the MELL is made up of:

- (i) a specific costs element – which includes the costs of assessing claims and making payments relating to a particular funding class<sup>2</sup>; and
- (ii) a base costs element – related to the general running costs of the FSCS (and is not dependent on the level of claims received). Base costs are split 50:50 between the FCA and PRA regulatory classes and then allocated in proportion to regulatory fees.

2.6 The proposed management expenses budget for 2016/17 is £67.4 million. This figure is an overall 2.5% reduction from 2015/16, and is the amount that can be levied for 2016/17 to cover on-going operating expenses, IT, outsourcing and claims handling, legal or other professional services (barring unforeseen events). It includes provision for the FSCS's current five-year strategic change programme.

2.7 See the 'Management expenses budget – further detail' section for breakdowns of the MELL by FSCS activity and funding classes.

### Contingency reserve

2.8 This allows the FSCS to levy additional funds for management expenses at short notice to meet contingencies that were not foreseen when the annual levy was raised.

2.9 The proposed contingency reserve for 2016/17 is £5.3 million. This is unchanged from 2015/16, and would be expected not to be levied unless the FSCS faced a significant unforeseen situation which necessitated additional funding. See the 'Contingency reserve – further detail' section for further information on the rationale behind the contingency reserve.

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1 The relevant PRA and FCA rules comprise the Depositor Protection Part, the Policyholder Protection Part, the Dormant Account Scheme Part, the FSCS Management Expenses Levy Limit and Base Costs Part, and the Management Expenses in Respect of Relevant Schemes Part of the PRA Rulebook, and the FEES section of the FCA handbook.

2 FSCS funding classes comprise groupings of activities regulated by the PRA and FCA for which the FSCS offers protection. Management expenses are allocated proportionately between these classes.



## Compensation costs

2.10 Separately, the level of the compensation costs levy (the amount levied to pay claims) is determined by the FSCS and is not consulted on. There are limits under the relevant PRA and FCA rules on how much can be levied on firms annually. The FSCS will indicate its current estimated compensation figures and its related funding and levies in its Plan and Budget for 2016/17. This will be available on the FSCS website shortly after publication of this CP. The FSCS will confirm its compensation cost levy requirements in early April 2016.

## Management expenses budget – further detail

2.11 Table 1 provides a breakdown of the proposed management expenses budget by activity.

**Table 1: Overview of FSCS management expenses budget information**

Management expenses	2016/17 Budget	2015/16 Budget	Variance
	£'000	£'000	£'000
Existing operations	34,759	31,368	3,391
Outsourcing	10,749	12,956	-2,207
<b>Operational total</b>	<b>45,508</b>	<b>44,324</b>	<b>1,184</b>
Strategic change portfolio	10,086	12,444	-2,358
<b>Total operational &amp; investment expense</b>	<b>55,594</b>	<b>56,768</b>	<b>-1,174</b>
Financing and recovery expenses	10,000	10,750	-750
Pension deficit funding	1,800	1,611	189
<b>Total management expenses</b>	<b>67,394</b>	<b>69,129</b>	<b>-1,735</b>

2.12 Management expenses are presented in Table 1 and cover:

- Existing operations costs: These include the costs of FSCS staff, legal and professional services, facilities, IT, and the FSCS's communications budget. This part of the budget has increased for 2016/17, in part due to a rise in FSCS's staff budget to enable the FSCS to operate its new business model more effectively. This includes provisions to recruit and retain staff in IT and data, and build capability in the senior management team and in change management. As part of building these capabilities, the FSCS is reducing its reliance on contractors, resulting in an increase in permanent staff costs which the FSCS expects to be reflected in a future reduction in contractor costs. Existing operations costs have been driven up by small rises in spend in facilities and IT systems maintenance as well as the FSCS's continuing consumer awareness work.
- Outsourcing costs: The budget in this area is based on the FSCS's claims forecast. The expected processing costs of the claims are allocated to the relevant individual funding classes for the new financial year. The processing of the vast majority of claims is outsourced by the FSCS which provides the FSCS flexibility to handle fluctuating numbers of claims. Overall management expenses related to outsourcing costs (which also include outsourced printing and scanning costs) are expected to fall in 2016/17, in part due to efficiencies created by the FSCS's strategic change programme.
- Strategic change costs: These include continuing investment to embed and refine the changes made to the FSCS's processes, operations and systems in 2015/16. The FSCS is entering the third year of its five year strategic change programme, and costs have begun to decrease as the main investments have been made and the focus shifts to embedding change.

- **Financing and major recoveries expenses:** These include the costs of the FSCS pursuing opportunities to recover the costs of compensation, including from the major banking failures of 2008/09 and other failures. Costs in this area are expected to fall by 50% in part due to the conclusion of recovery action in relation to the failure of Keydata Investment Services Ltd. This is balanced by a provision of £2.5 million to establish a workstream to seek recoveries in respect of misold PPI. This potential action would be funded by the insurance intermediary class, who would receive the benefit of any such recoveries. The FSCS will only pursue this action if it is satisfied that it would be cost effective to do so.

2.13 The management expenses budget of £67.4 million will be made up of £23.4 million in base costs and £44 million in specific costs.

**Table 2: Breakdown of the FSCS management expenses per funding class**

£'000	FSCS total	PRA classes	FCA classes
Base Costs Total	23,403	11,702	11,702
Specific costs			
Deposits	14,195	14,195	-
General Insurance Provision	5,452	5,452	-
Life & Pension Provision	102	102	-
General Insurance Intermediation	9,476	-	9,476
Life & Pension Intermediation	5,472	-	5,472
Investment Provision	141	-	141
Investment Intermediation	8,427	-	8,427
Home Finance Intermediation	724	-	724
Specific costs total	43,990	19,749	24,241
Management expenses total	67,394	31,451	35,942

(Please note that some figures may appear not to add up due to rounding)

2.14 Further information on the FSCS's proposed management expenses budget is included in its Plan and Budget for 2016/17, due to be published shortly after this CP on the FSCS website.

### Contingency reserve – further detail

2.15 The contingency reserve allows the FSCS to levy additional funds at short notice and without further formal consultation by the PRA or the FCA. The contingency reserve proposed for 2016/17 is £5.3 million. This has remained unchanged since 2014/15, following a significant reduction from £20 million in 2013/14. The contingency reserve gives the FSCS access to funding to handle unexpected increases in claims volumes and other unforeseen circumstances in order to prevent, where possible, the need for an increase in the MELL in the event of such circumstances arising.

2.16 The contingency reserve is not intended to reflect the costs of any particular future failures, but would provide a reasonable sum without further consultation to meet needs that may arise within tight timeframes.

2.17 In practice, the FSCS is unlikely to raise more than its budgeted expenses unless there is a specific event or events that require it to do so. In line with its usual practice, the FSCS will liaise with relevant parties, such as the PRA and the FCA and trade associations, before raising a levy for its contingency reserve. The FSCS will publish an explanation if the contingency reserve is levied.

### **3 Statutory obligations**

#### **Cost benefit analysis**

3.1 Under FSMA, the PRA and the FCA are required to carry out and publish a cost benefit analysis (CBA) when proposing draft rules.

3.2 Setting the MELL at the specified level of £72.7 million allows the FSCS to raise funds to cover its expenses so it can continue operating and meeting its objective of providing a compensation scheme that is efficient, fair, approachable and responsive.

3.3 The benefits from the FSCS are to improve consumer confidence, provide consumer protection and contribute to 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 in 2016/17 and the subsequent reduction in financial losses to consumers due to FSCS compensation. To illustrate the potential scale of the direct financial benefits to consumers, the expected value of compensation paid out during 2015/16 is £311.5 million, according to the latest FSCS Outlook from November 2015.

3.4 The contingency reserve of £5.3 million will give the FSCS some margin to meet costs that exceed its budgeted expenses and that need to be funded at short notice. The PRA and the FCA recognise that the FSCS needs to be able to respond quickly and efficiently to firm failures and, if a particular failure or series of failures meant that it was necessary to increase the MELL beyond the proposed total of £72.7 million, the PRA and the FCA would take the necessary steps to enable the FSCS to meet its obligations on a timely basis.

3.5 The FSCS has proposed a MELL set at a level that it expects to be enough to enable it to continue to embed the changes made to implement its five-year strategic change programme, which will improve the efficiency with which the organisation can offer protection to customers of failed financial services firms in the longer term. The Boards of the PRA and the FCA have ratified this proposal.

3.6 Management expenses are charged to firms and may be passed on to consumers in the form of higher prices. When discharging general rule-making functions, the PRA and the FCA are legally required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by authorised persons in carrying on regulated activities.

3.7 The MELL is not expected to have any adverse effect on competition as it is applied to firms proportionately.

3.8 Overall the PRA and the FCA consider that the benefits of raising the MELL outlined above outweigh the costs posed to industry, and potentially indirectly posed to consumers.

#### **Impact on mutual societies**

3.9 FSCS management expenses are levied on all authorised firms according to the volume of regulated financial services business they conduct. This includes mutual societies. The impact on mutual societies is therefore not considered disproportionate to other types of firm.

## **PRA general duties and regulatory principles**

3.10 The PRA must, when discharging its general functions, so far as is reasonably possible, act in a way that advances its general objective – ie promoting the safety and soundness of PRA-authorized firms.<sup>1</sup>

3.11 The PRA must carry out that objective primarily by:

- seeking to ensure that the business of PRA-authorized persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- seeking to minimise the adverse effect that the failure of a PRA-authorized person could be expected to have on the stability of the UK financial system.

3.12 The PRA believes that the proposed rule on setting the MELL is compatible with this statutory obligation. 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-authorized person on consumers and so helps promote stability of the UK financial system as well as confidence in the UK financial system.

3.13 The PRA has an additional primary objective for insurance. In addition to promoting insurers' safety and soundness, thereby supporting the stability of the UK financial system, it has an insurance objective to contribute to securing an appropriate degree of protection for those who are or may become policyholders.<sup>2</sup> The PRA considers that the proposed rule to set the MELL is compatible with this duty 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-authorized person that has failed.

3.14 The PRA must also have regard to the regulatory principles in discharging its general functions and to the need to minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges those functions.<sup>3</sup> The PRA believes the proposed MELL is compatible with these principles and does not have any adverse effect on competition in the relevant markets.

## **FCA general duties and regulatory principles**

3.15 Section 138I(2)(d) of FSMA requires that a consultation undertaken by the FCA includes an explanation of the FCA's reasons for believing that making the proposed rules is compatible with its duties under section 1B(1) and (5)(a). These are commented on below.

3.16 In discharging its general functions the FCA must, so far as is reasonably possible, act in a way which (a) is compatible with its strategic objective, (b) advances one or more of its operational objectives (section 1B(1) of FSMA) and (c) has regard to the regulatory principles set out in FSMA (section 1B(5)(a) and section 3B). In addition, the FCA must discharge its general functions in a way which promotes effective competition in the interests of consumers (section 1B(4)).

3.17 The FCA believes that the proposed MELL is compatible with the regulatory principles. In particular, the FCA believes that an appropriate balance has been struck between the need to

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1 Section 2B of FSMA.

2 Section 2C of FSMA.

3 Sections 2H(2), 2H(1), and 3B of FSMA.

ensure the FCA’s regulatory objectives are fulfilled and the need to keep regulatory burdens to a minimum. See below for further information.

3.18 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 (in particular smaller firms).

3.19 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 services 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.

3.20 In light of this, the FCA believes that the proposed FSCS MELL is appropriate. The limit proposed ensures the FSCS has adequate resources to perform its functions for the coming year. In addition, in setting the MELL for 2016/17, the PRA and FCA have allowed for sufficient contingency reserve to prevent disruption to the FSCS’s work if they need to exceed their operating budget for unexpected reasons.

3.21 Setting an FSCS MELL figure has no material significance for the reduction of financial crime objectives.

### **Compatibility with the regulatory principles – PRA and FCA**

3.22 This section comments on how this proposal to set the MELL meets the requirement that the PRA and the FCA must have regard to the regulatory principles outlined in section 3B of FSMA in discharging their respective general functions.

3.23 The regulatory principles most relevant to this proposal are:

**(a) The need to use the resources of each regulator in the most efficient and economical way.**

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

3.25 The PRA and the FCA rules require the FSCS to use its resources in the most efficient and economical way when carrying out its functions. Setting the MELL, after public consultation, encourages good internal management and effective operating procedures.

**(b) The principle that a burden or restriction should be proportionate to the benefits.**

3.26 The PRA and the FCA’s assessment of the fairness and proportionality of the burden and benefits relating to this proposal can be found in the cost benefit analysis section of this consultation paper.

### **Equality and diversity**

3.27 In making their respective rules and establishing their practices and procedures, the PRA and the FCA may not act in an unlawfully discriminatory manner. They are required, under the Equalities Act 2010, to have due regard to the need to eliminate discrimination and promote

equality of opportunity in carrying out its policies, services and functions.<sup>1</sup> To meet this requirement, the PRA and the FCA have performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

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<sup>1</sup> Section 149(1) of the Equalities Act 2010.

## Appendices

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- 1 Prudential Regulation Authority Rulebook: Management expenses levy limit and base costs part**
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- 2 Financial Conduct Authority Handbook: FEES manual**

## Appendix 1: Prudential Regulation Authority Rulebook: Management expenses levy limit and base costs part

### **PRA RULEBOOK: NON AUTHORISED PERSONS: FSCS MANAGEMENT EXPENSES LEVY LIMIT AND BASE COSTS INSTRUMENT 2016**

#### **Powers exercised**

- A. The Prudential Regulation Authority (“PRA”) 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 213 (The compensation scheme); and
  - (2) section 223 (Management expenses).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

#### **Pre-conditions to making**

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

### **PRA Rulebook: Non Authorised Persons: FSCS Management Expenses Levy Limit and Base Costs Instrument 2016**

- D. The PRA makes the rules in the Annex to this instrument.

#### **Commencement**

- E. This instrument comes into force on [     ].

#### **Citation**

- F. This instrument may be cited as the PRA Rulebook: Non Authorised Persons: FSCS Management Expenses Levy Limit and Base Costs Instrument 2016.

#### **By order of the Board of the Prudential Regulation Authority**

[     ]



**Annex**

In this Annex, new text is underlined and deleted text is struck through.

**Part**

# **FSCS MANAGEMENT EXPENSES LEVY LIMIT AND BASE COSTS**

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**Chapter content**

- 1. APPLICATION AND DEFINITIONS**
- 2. LIMIT ON MANAGEMENT EXPENSES LEVIES**
- 3. BASE COSTS**

**Links**

## 2 LIMIT ON MANAGEMENT EXPENSES LEVIES

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- 2.1 The total of all *management expenses levies* attributable to the period ~~1 April 2015 to 31 March 2016~~ 1 April 2016 to 31 March 2017 of the *deposit guarantee scheme*, the *dormant account scheme* or the *policyholder protection scheme* may not exceed ~~£74,429,000~~ £72,694,000 less whatever *management expenses levies* the *FSCS* has imposed in accordance with *FCA compensation scheme rules* attributable to that period.

## Appendix 2: Financial Conduct Authority Handbook: FEES manual

### FINANCIAL SERVICES COMPENSATION SCHEME (MANAGEMENT EXPENSES LEVY LIMIT 2016/2017) INSTRUMENT 2016

#### 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 2016.

#### 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 2016/2017) Instrument 2016.

By order of the Board  
[date 2016]

## 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 2015 to 31 March 2016	£74,429,000
<u>1 April</u> <u>2016 to 31</u> <u>March 2017</u>	<u>£72,694,000</u>