Consultation Paper

CP12/16★★★

Financial Services Authority

FSCS Funding Model Review

FSA®
Financial Services Authority

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Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 25 October 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12-16-response.shtml.

Alternatively, please send comments in writing to:

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A confidential response may be requested from us under the Freedom of Information Act 2000. We 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 Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

AEI	Annual eligible income
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
CRD	Capital Requirements Directive
CASS	Client Assets sourcebook
COMP	Compensation sourcebook
DGSD	Deposit Guarantee Schemes Directive
DISP	Dispute Resolution: Complaints sourcebook
EU	European Union
FCA	Financial Conduct Authority
FEES	Fees manual
FOS	Financial Ombudsman Service
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
ICB	Independent Commission on Banking
ICSD	Investor Compensation Schemes Directive
IFA	Independent Financial Adviser
ISD	Investment Services Directive
MiFID	Markets in Financial Instruments Directive

MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries
MMR	Mortgage Market Review
NICUs	Northern Ireland Credit Unions
PRA	Prudential Regulation Authority
RDR	Retail Distribution Review
The Bill	The Financial Services Bill
The Treasury	HM Treasury

1 Overview

1.1 The Financial Services Compensation Scheme (FSCS) is the UK's statutory compensation fund for customers of authorised financial services firms. This means that it will pay compensation to eligible customers of a financial services firm that is unable, or likely to be unable, to pay claims against it.

1.2 The FSCS protects eligible consumers up to the following limits:

- Deposits: £85,000 per eligible depositor.
- Insurance provision: 100% of benefits for compulsory insurance, 90% for non-compulsory insurance.
- General insurance intermediation: 100% of benefits for compulsory insurance, 90% for non-compulsory insurance.
- Investment (including life and pensions intermediation): £50,000.
- Home finance (intermediation only): £50,000.

1.3 This protection comes at a cost which is funded by levies on the financial services industry. In turn the financial sector benefits from the increased confidence the existence of the FSCS brings for consumers. It is important for the FSCS to be adequately funded, but we also believe it is important to minimise the calls on the FSCS. This will ultimately be both through more proactive regulatory intervention and the industry being alert to poor practice.

1.4 Compensation costs are allocated to groups of firms (referred to as 'classes' in this CP) that have permission to undertake regulated activities that share a degree of affinity. When compensation costs of a class exceed a maximum amount ('annual threshold') other classes are required to fund any remaining compensation costs ('cross-subsidy').

1.5 The FSCS has had to step in to protect consumers following a number of significant failures in recent years. This has led to rising compensation costs as a result of the failures of banks and a building society in 2008/9 (which far exceeded the annual threshold of the Deposits class and was funded by borrowing by the FSCS)[1], several significant investment firms[2] and firms with PPI claims against them in the General Insurance Intermediation class. This has meant that the FSCS has had to raise higher levies than before on these sectors.

1.6 This has led to understandable concerns from industry participants and calls to review the current model, including: the class structure; how costs are allocated (the tariff measures used); affordability and unpredictability of levies; and the use, or potential use, of cross-subsidy. We have responded to industry concerns by taking a critical look at the way the FSCS is funded now, and whether there are better ways to fund it in future.

1.7 Making adequate funding arrangements for the FSCS ultimately leads to balancing potentially competing demands and there is no one or perfect solution. This paper looks at the key elements of the FSCS funding model and sets out our proposals for change, or why we are proposing to retain the current approach. The main changes we are proposing relate to cross-subsidy and annual thresholds.

1.8 This review has been undertaken against the backdrop of proposed legislative changes in the UK and the European Union (EU). While we originally started the review in 2009, we put it on a hold a year later as there was insufficient certainty about the UK and EU legislative framework for compensation arrangements. The legislative framework is not yet finalised, but we consider there is sufficient certainty to enable us to consult.

1.9 The Financial Services Bill (the Bill) currently before Parliament sets out the government's proposals for reform of the financial regulatory structure in the UK. Provisions within the Bill split responsibility for making the FSCS rules between two new regulatory authorities: the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The details of the split will be the subject of secondary legislation made under the Bill when enacted and we expect that it will provide that FSCS rules will be made by the PRA for deposit-taking and insurance provision and by the FCA for other activities. Our proposals are consistent with the way the funding model would work following such a split of regulatory responsibilities ('legal cutover'). The EU legislative process covering the guarantee schemes has not yet concluded so, while we have considered what the impact of the legislation could be, we have not included potential changes in our proposals. Based on current public proposals, we believe that we would be able to accommodate any new directive requirements into the model.

1 In 2008, the FSCS borrowed approximately £20bn to fund the costs of compensating or transferring the accounts of consumers in the failure of Bradford & Bingley, Heritable Bank, Kaupthing Singer & Friedlander, Landsbanki 'Icesave', London Scottish Bank plc and Dunfermline Building Society. This was originally financed under facilities provided by the Bank of England, and subsequently refinanced by HM Treasury. The FSCS has not yet been asked to contribute to the costs of resolving Dunfermline Building Society.

2 Including Keydata, Wills & Co, Pacific Continental Securities Limited, Mansion House, NDLF and Arc Fund Management. In January 2011 the FSCS raised an interim levy to cover costs associated with a number of these firms, which led to the use of cross-subsidy from the Investment Fund Management class (of about £233m) when the Investment Intermediation class reached its funding threshold (of £100m).

Structure of this Consultation Paper (CP)

1.10 The CP is structured as follows:

- Chapter 2 sets out the context of the review, including the main features of the current model, and developments that may affect it, including the UK regulatory reform and EU directive proposals.
- Chapter 3 considers if we should change the existing class structure of FSCS funding. We explore potential alternatives but conclude that there are continuing reasons for, and no suitable alternative to, the current arrangements.
- Chapter 4 looks at cross-subsidy between classes and recommends a retail pool for FCA classes only.
- Chapter 5 makes recommendations about the maximum amount (annual threshold) that each class may be required to pay in any given year as shown in Table 1.

Table 1: Current and proposed thresholds

Class	Current threshold	Proposed threshold
Deposits	£1,840m	£1,500m
General Insurance Provision	£775m	£600m
Life and Pensions Provision	£690m	£690m
Investment Fund Management	£270m	£200m
General Insurance Intermediation	£195m	£300m
Life and Pensions Intermediation	£100m	£100m
Investment Intermediation	£100m	£150m
Home Finance Intermediation	£60m	£40m

- Chapter 6 proposes amending the approach for determining the amount of expected compensation costs that can be included in the annual compensation costs levy and extending the forecast period from 12 to 36 months for all classes (except Deposits).
- Chapter 7 explains that we are not making any changes to the current tariff measures, because we are unconvinced of the merits of alternatives such as product levies, and have not been able to identify feasible or reliable metrics in the intermediation classes to reflect how likely a firm is to give rise to claims on the FSCS.
- Chapter 8 makes proposals to allocate the annual management expenses levy limit (MELL) between PRA and FCA classes, as well as other technical changes to improve efficiency and effectiveness.

1.11 A cost benefit analysis of the proposals is in Annex 1, a Compatibility Statement in Annex 2, a table of current classes and regulated activities in Annex 3, diagrams of the current and potential model in Annex 4, illustrative firm levy rates in Annex 5, and a list of questions in Annex 6.

1.12 We expect that any proposals in the CP would come into effect on 1 April 2013. The draft Handbook text (in Appendix 1) does not anticipate changes that may be required as a result of legal cutover. We explain our policy proposals in the context of the expected changes which we have taken into account when developing our proposals. The text and implementation date for some of our proposals may need to change depending on the timing and detail of the legal structure at legal cutover.

1.13 The paper is published alongside a report commissioned from Deloitte, which informed our proposals on the annual thresholds.[3]

Who should read this Consultation Paper (CP)?

1.14 This CP will interest all firms regulated by the FSA, whether current or potential contributors to compensation scheme funding.

1.15 We have considered the likely equality and diversity impact of our proposals. We have concluded that they do not create barriers to equality of opportunity or influence behaviour. FSCS fees are based on objective measures of the volumes of business undertaken by firms during the relevant reporting period. These measures aim to ensure that levies are proportionate to the level of business firms undertake that falls under the protection of the FSCS.

1.16 Our proposals do not directly affect consumers. In fact, implicit in our efforts to improve the funding arrangements for the FSCS is the intention that consumers' access to, and experience of, the FSCS should not be reduced. We welcome comments from respondents on this assessment.

CONSUMERS

This CP may interest consumers or consumer groups as the proposals relate to the funding of the Financial Services Compensation Scheme. The FSCS is a key source of protection for consumers as it can provide compensation to customers of authorised financial services firms that are unable to meet claims. Further information on the FSCS can be found at: www.fscs.org.uk.

3 '*Assessing the affordability and threshold of FSCS levies, Final Report*' March 2012, Deloitte.

2

Background and issues with the current model

2.1 The FSCS is funded by two types of levy: a compensation costs levy and a management expenses levy. The compensation costs levy raises money to pay the claims of consumers, while the management expenses levy relates to the money raised to fund the FSCS' annual budget.

2.2 The funding model of the FSCS was last reviewed in detail in 2006/7.[4] Changes arising from this review were made with effect from 1 April 2008. Before this date costs were allocated largely on the same basis as the FSA fees groups. Changes were made to improve the fairness and robustness of the model, and to reflect the fact that compensation costs should, as much as possible, be allocated on the basis of the activity that gave rise to the claim, i.e. to firms conducting similar activities.

Current funding model

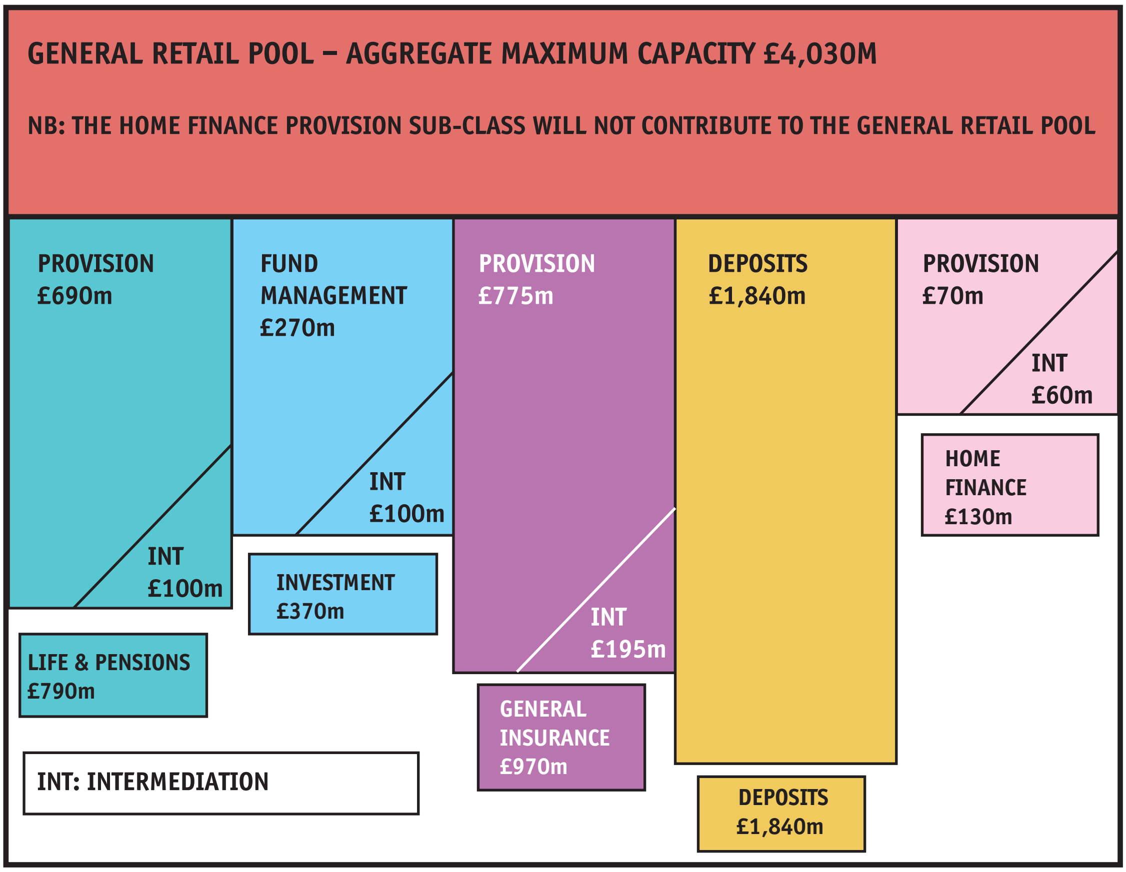
2.3 The current funding model[5] has five broad sector based classes: Deposits; life and pensions; general insurance; investment; and home finance. All of these except the deposits class are further divided into provision and intermediation sub-classes (see Figure 1).[6]

4 This review included a Discussion Paper (DP06/1 *FSCS funding review* (March 2006) www.fsa.gov.uk/pubs/discussion/dp06_01.pdf), Consultation Paper (CP 07/5 *Financial Services Authority Financial Services Compensation Scheme – Funding Review Including feedback on DP06/1* (March 2007) www.fsa.gov.uk/pubs/cp/cp07_05.pdf), Policy Statement (PS07/19 *FSCS Funding Review Feedback on CP07/5 and made text* (November 2007) www.fsa.gov.uk/pubs/policy/ps07_19.pdf) and two independent reports by Oxera *Funding of the Financial Services Compensation Scheme Report* prepared for the Financial Services Authority, March 2006 www.fsa.gov.uk/pubs/discussion/oxera_report.pdf and *Funding the Financial Services Compensation Scheme Analysis of policy options*, prepared for the Financial Services Authority, March 2007 www.fsa.gov.uk/pubs/other/oxera_report_fscs.pdf.

5 This applies to compensation costs and specific costs. Base costs (part of the FSCS' management expenses) are allocated on the same basis as FSA fees.

6 Currently the FSCS funding model has 'classes' and 'sub-classes'. A 'class' is a broad class to which the FSCS allocates levies and is based on industry sectors; a 'sub-class' is a class of firms within a broad class that carry on business of a similar nature or have other common characteristics – divided between firms carrying on provision-related activities and firms carrying out intermediation-related activities. As we are proposing to change the basis of cross-subsidy the concept of 'sub-class' and 'broad' class will end and references will be to 'class' going forward.

Figure 1: Current FSCS funding model and thresholds



2.4 Each sub-class has a limit – threshold – on the amount it can be asked to contribute to compensation costs in any given year. If this threshold is reached, any further levy requirements are met by the broad class. For instance, claims arising from a default in the Investment Intermediation class will be levied first from the Intermediation class and then the Investment Fund Management class. Once the broad class has also reached its annual threshold, the other classes in the model (representing other sectors) can be required to contribute to the cost of the default through the general retail pool. The spreading of costs to other classes where a threshold is reached in this way is called cross-subsidy.

2.5 The FSCS can raise compensation costs within the thresholds without formal consultation. It provides as much notice as possible to the industry when a levy is due. The thresholds are subject to FSA rules (we are proposing changes to the thresholds in Chapter 5). The FSCS annual management expenses levy limit is subject to annual consultation and the approval of the FSA Board. This is covered in further detail in Chapter 8.

Issues having an impact on the funding review

2.6 There are a number of significant external factors and dependencies that can have an impact on the funding of the FSCS, including regulatory reform in the UK, European directive developments and the Independent Commission on Banking (ICB).

Regulatory reform

2.7 In 2010 the government announced that it intends to reform the regulatory architecture in the UK, establishing the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).[7]

2.8 The PRA will authorise deposit takers and insurers (and some systemically important investment firms) and will have the statutory objective of promoting the safety and soundness of those firms, primarily by seeking to ensure that the business of PRA-authorised firms is carried on in a way which avoids any adverse effect on the stability of the UK financial system and by seeking to minimise the adverse effect that their failure could be expected to have on the stability of the UK financial system. Additionally, it will have a statutory objective of securing an appropriate degree of protection for policyholders of insurance firms.

2.9 The FCA will regulate all firms' interactions with consumers (conduct-related activities). This will include the conduct-related activities of deposit takers and insurers. The FCA will also authorise and prudentially supervise investment and intermediary firms. The strategic objective of the FCA is expected to be ensuring that the relevant markets function well and its operational objectives are expected to be securing an appropriate degree of protection for consumers, protecting and enhancing the integrity of the UK financial system and promoting effective competition in the interests of consumers.

2.10 The Financial Services Bill[8] proposes changes that will affect the FSCS. The split of rule-making for the FSCS will be set out in secondary legislation in the form of an order made under FSMA as amended by the Bill. The intention is that the PRA will be responsible for the deposit taking and insurance-provision activities of the FSCS and the FCA for the investment and intermediation-related activities for all sectors (including insurance intermediation). This means that both the PRA and the FCA will be writing rules for the FSCS and the FSCS will be accountable to both regulators.

2.11 Because both the current funding classes and the proposed split of responsibilities between the PRA and the FCA are based on regulatory activities, the Bill does not require us to make substantial changes. There are some implications in terms of cross-subsidy and the management expenses levy (specifically for the base cost element) and these are described in greater detail in the chapters that follow.

7 A new approach to financial regulation: judgement, focus and stability (July 2010) www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf

A new approach to financial regulation: building a stronger system (February 2011) www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf

8 www.hm-treasury.gov.uk/fin_financial_services_bill.htm

European directives

2.12 There are two related European directives: the Deposit Guarantee Schemes Directive (DGSD) and the Investor Compensation Schemes Directive (ICSD). They require Member States to establish depositor and investor protection schemes, offering certain levels and scope of protection to customers of DGSD and ICSD firms. In the UK, these obligations are met through the FSCS.

2.13 Currently, eligible depositors are protected up to £85,000 (€100,000) per depositor per authorised deposit taker, and the DGSD requires payout within 20 working days (though in the UK we have a target seven day payout for the majority of depositors). Under the terms of the ICSD, the minimum compensation available to eligible investors in EEA firms must be at least 90% of their claim for loss of money and instruments that were held on their behalf by the firm that has failed, up to €20,000. The FSCS provides greater compensation cover than the minimum ICSD requirements. The compensation limit is £50,000 and the FSCS can provide compensation in situations where a UK-authorised firm that has failed owes a civil liability to a claimant in relation to protected investment business (e.g. compensation for negligent investment advice). Currently, neither directive includes maximum-harmonised requirements (i.e. those that must be followed without discretion) in terms of the funding of compensation.

European directive proposals

2.14 In July 2010 the European Commission launched a package of proposals including a recast of the DGSD[9] and revisions to the ICSD.[10] The Commission also published a White Paper on the possibility of a European insurance guarantee scheme. These proposals are currently being negotiated by the Treasury.

2.15 The draft DGSD proposals published in 2010 by the Commission included provisions to mandate the funding of guarantee schemes, such as pre-funding and risk-based levies. Similarly, the proposals for revisions to the ICSD included some funding-related requirements, for example pre-funding. In addition, the proposals sought to align the directive with the definitions, services and activities under MiFID (the Markets in Financial Instruments Directive, which will supersede the Investment Services Directive (ISD) to which the ICSD is currently aligned).

2.16 However, negotiations on the directives have stalled. Given the continuing delay, we decided that we should proceed with our consultation now.

2.17 We are aware that the directives, if agreed, may have an impact on FSCS funding, for example the Commission's draft proposals to pre-fund or use risk-based levies in the Deposits class. We have taken this into consideration when making the proposals and recommendations in this paper. But it would be premature to consult on any potential changes that may be needed in the absence of greater certainty about the outcome of deliberations in the EU. As noted we

9 Proposals available via http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm
10 Proposals available via http://ec.europa.eu/internal_market/securities/isd/investor_en.htm

intend to ensure that changes required as a result of the directives are capable of being incorporated into the model as far as possible and appropriate.

2.18 In June 2012, the Commission also published its proposals for the recovery and resolution of financial institutions (the 'Recovery & Resolution Directive').[11] The proposal sets out the necessary steps and powers to ensure that failures across the EU are managed in a way that avoids financial instability and minimises costs to taxpayers. The proposal also includes *ex ante* financing requirements to establish a fund that can be used to:

- guarantee the assets or the liabilities of the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
- make loans to the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
- purchase assets of the institution under resolution;
- make contributions to a bridge institution; and
- any combination of the above.

2.19 The Treasury is currently negotiating these Directives on behalf of the UK. We, along with the other UK Authorities, are considering our response to the proposals and we will consider the impact on the funding arrangements of the FSCS as appropriate in the future.

Independent Commission on Banking (ICB)

2.20 The ICB, chaired by Sir John Vickers, published its final report on 12 September 2011. The Commission was set up in June 2010 by the government to conduct a review after the financial crisis highlighted the need to reduce the risk of future taxpayer-funded bailouts. The report proposed a variety of policy measures to create a more stable and competitive basis for UK banking in the longer term. The government published its response in December 2011 and a White Paper on implementing the proposals in June 2012.

2.21 We have considered the impact of the government's plans on the funding of the FSCS. A key proposal is that deposit takers will ring-fence deposits of households and SMEs. By introducing the ring-fence, critical banking services will be insulated from shocks elsewhere in the financial system and it will be easier to preserve the continuity of those services. The government also proposes to change the creditor hierarchy so that FSCS-protected deposits would be preferred in insolvency. This should give the FSCS greater protection in insolvency and mean that unsecured creditors would stand to take losses before the FSCS in a resolution scenario. We do not consider that the proposals would lead to a substantial change in the FSCS or its funding arrangements. We will keep this under consideration as Parliament's consideration of the government's legislative proposals proceed and make suitable proposals if necessary.

11 http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

3 Funding classes: structure and composition

3.1 This chapter explains the basis for the current structure of the model, the concerns that have been raised about the current approach and the alternatives we have considered. We are proposing two minor changes to the current class structure: renaming the Investment Fund Management class and removing the Home Finance Provision class from the funding model.

Requirements and guiding principles

3.2 As well as requiring us to establish a scheme, FSMA (section 213(5)) also requires the FSA to 'take account of the desirability of ensuring that the amount of the levies imposed on a particular class of authorised person reflects, so far as practicable, the amount of the claims made, or likely to be made, in respect of that class of person'.

3.3 It is important that the funding model provides clarity and certainty to both firms and the FSCS. To achieve this outcome, there must be objective and recognised criteria on which to allocate:

- firms to funding groups; and
- compensation costs to funding groups.

3.4 To accurately and adequately determine appropriate funding groups that are stable and (to the greatest extent possible) sustainable, the process of allocation needs to be:

- easy to understand;
- capable of reliable and consistent application;
- robust and not require constant reassessment;

- economical and operationally capable of practical administration; and
- result in sustainable classes.

The model

Grouping activities into funding class(es)

3.5 During the funding review in 2006/07, we moved away from contribution groups based on the FSA regulatory fee blocks and merged activity groups together where the permissions were considered sufficiently similar. The FSCS funding model currently has nine funding classes reflecting broadly recognisable industry sectors[12] and distinguishes, where applicable, between provision and intermediation.

3.6 The current FSCS funding model structure and basis of allocation reflects the principle that, in the first instance, firms should pay the costs arising from the regulated activities of failed firms that have been grouped together because they share a degree of affinity. Affinity sees firms grouped together in classes which are established by the type of activities they undertake, the products they deal with, as well as the industry sector in which they engage. This approach was designed to ensure that the FSCS funding classes have capacity to meet compensation costs generated by firms with similar permissions.

3.7 Following the financial impact of recent years' levies, the FSCS funding model became the subject of mounting criticism: firms and industry representatives increasingly claim it is unfair that they should be required to pay for the failings of other firms with whom they feel little affinity.

Allocating firms to funding class(es)

3.8 Firms are allocated to a funding class on the basis of the regulated activities they have permission to undertake. They must report the appropriate levy data determined by the tariff measure for that funding class on an annual basis. Annex 3 includes a table showing the funding classes and the regulated activities they include.

3.9 So, for funding purposes, an authorised firm whose permissions include 'advising on pension transfers and opt-outs' will be allocated to, and pay annual levies, for the Life and Pensions Intermediation class.

3.10 Firms whose permissions include more than one regulated activity may be members of (and report appropriate fee data for) one or more classes, depending on the diversity of their businesses and the classes in which their permissions are grouped. For example, 23% of firms in the Deposit class have permissions which, for FSCS funding purposes, are allocated to the General Insurance Intermediation class. This means that they will pay levies (where they report

12 Life and pensions, deposits, investments, general insurance and home finance.

relevant tariff data) in both classes.[13] Firms that belong to more than one class because of the permissions they hold will pay a levy for each class of which they are a member provided they report relevant tariff data.

Allocating costs to funding class(es)

3.11 When the FSCS is required (or expects) to pay compensation, it allocates the cost to the class that corresponds to the regulated activity that gave rise to those costs. That activity may not necessarily be the principal activity within the business model of the failed firm or the activity for which it was best known.

Case Study – Keydata Investment Services Limited

Keydata was a product provider that designed and distributed structured investment products. These were distributed both directly and via a network of independent financial advisers (IFAs). Keydata's permissions included those assigned to the Fund Management 'class' and the Investment Intermediation 'class'.

Keydata invested customers' money in bonds issued by one of two Luxembourg-based companies, SLS Capital SA (SLS) and Lifemark SA (Lifemark), which used the money raised to buy portfolios of US senior life settlement policies. Keydata marketed the bonds issued by SLS and Lifemark and acted as agent for its customers in purchasing those bonds. In the applicable terms and conditions, set out in the relevant marketing materials, Keydata confirmed that it would be 'acting as [the customer's] agent'.

During the course of a wider FSA investigation, we moved to place the firm in administration in June 2009. The FSCS subsequently confirmed Keydata was in default in November 2009. Since then, the FSCS has paid more than 23,000 claims for compensation totalling £325m in respect of losses incurred by investors in Keydata's SLS and Lifemark bonds. These costs were amongst the triggers for three of the four interim levies imposed on the Investment Intermediation class and the cross-subsidy from the Fund Management class in January 2011.

Many industry participants considered that because Keydata, as a firm, might be characterised as a product provider and investment manager, the compensation costs arising from its financial failure should be met by the Fund Management class. As a result, the FSCS' decision to allocate the costs to the Investment Intermediation class was not widely understood – indeed, this was the subject of an (unsuccessful) Judicial Review.

The FSCS, however, must allocate costs according to the regulated activities it considers gave rise to the claim. In this case, the FSCS took the view that the

13 Firms do not necessarily generate 'annual eligible income' from any or all of these permissions.

claims against Keydata arose as a result of the marketing material produced by Keydata, which was issued in connection with Keydata's 'designated investment business' under one or more of four separate regulated activities, all of which are captured within the Investment Intermediation class:

- 'dealing in investments as agent';
- 'safeguarding and administering investments';
- 'arranging safeguarding and administering of assets'; and
- 'agreeing to carry on a regulated activity'.

Alternatives considered

3.12 Neither FSMA nor the Financial Services Bill before Parliament prescribes how the classes of firms in s213(5) should be established. Conscious of the industry's concerns about the fairness of the existing model, we have investigated a number of options, including those suggested to us by the industry. The possibilities fall into the following categories:

- establish a single class per broad sector;
- establish more classes per broad sector;
- allocation to class by primary business;
- allocation to class by product; and
- classification by regulatory requirement.

Establish one single class per broad sector

3.13 At the time of the last review, we considered whether it would be appropriate to group together for funding purposes the providers and intermediaries within each of the current broad sector-based classes. We concluded that, in light of the distinct business models and focus, it would be unfair to expect both types of firm to be equally responsible for funding the costs originating within the class from distinctive business operations – i.e. the provision or manufacture of a product in comparison to the selling of and advising on a product.

3.14 When we proposed separating provision from intermediation activities in the 2006/07 review, we explained that the intermediation classes would 'not be limited to just financial advisers or brokers – they [would] include the intermediation services of the 'provider' firm'. Those providers that do operate in the intermediation of their (and other) products do therefore contribute to levies on the relevant intermediation class. However, contribution to a class is specifically for the amount of business a firm undertakes in that class.

3.15 Some may argue that a single sector class might, by virtue of its broad membership:

- be more sustainable as a whole; and
- encourage providers to have greater regard for the means by which their products are sold.

3.16 However, it is unlikely that allocating such costs to a single aggregate sector class would be any fairer or any less contentious than the current basis of allocation. We doubt that either providers or intermediaries would be supportive about the inherent cross-subsidy involved in a single class. Providers in particular are likely to resist the possibility of what they might consider one-way subsidy to intermediaries (a pattern suggested by claims trends to date).

3.17 Furthermore, a single sector class is likely to be inconsistent with the anticipated division of regulatory responsibilities between the PRA and the FCA post legal cutover.

More classes per broad sector/classes within classes

3.18 Further division of the existing funding classes is an alternative, proposed to us by industry representatives from a variety of sectors, which we have carefully considered. In each case, the intention is to isolate elements of the existing class that are believed to be 'riskier' than the other firms within the class.

3.19 Our principal concern with these proposals is that the existence of multiple classes per sector, each with a smaller membership than the current classes, may compromise the sustainability of each class as each firm within it will be exposed to a larger share of the costs allocated to that class. The smaller the class, the lower the potential threshold would be, which would increase the risk of requiring cross-subsidy support from other classes at an earlier stage and so other classes would still face costs.

3.20 In the Deposits class, it has been suggested that building societies should be in their own class because their business models are quite different from banks. We do not consider such a distinction necessary or appropriate. The legal basis for activity in this class consists of only two permissions: 'accepting deposits' and/or 'operating a dormant account fund'.[14] As all participants (except the reclaim fund) undertake the same regulated activity of 'accepting deposits' and the FSCS protects against a deposit taker failure, we believe that it remains appropriate for firms with this permission to be grouped together for funding purposes. It is also possible that the funding arrangements for the Deposits class will, in future, be determined by the DGSD, which draws no distinction between building societies and banks.

3.21 Some investment intermediary representatives have proposed the introduction of three classes per sector:

14 At legal cutover the FSA Handbook will be split between the FCA and the PRA to form two new Handbooks, one for the PRA and one for the FCA. Most provisions in the FSA Handbook will be incorporated into the PRA's Handbook, the FCA's Handbook, or both, in line with each new regulator's set of responsibilities and objectives. The designation of the activity of operating a dormant account is currently under consideration as part of the move to legal cutover.

- one for firms that only have provision permissions;
- one for firms that only have intermediation permissions; and
- a middle category of firms that have both intermediation and provision permissions.

3.22 They argue that this approach could isolate firms like Keydata from high street IFAs. This approach might also be attractive to general insurance intermediaries so that pure general insurance brokers would not be called upon to contribute to the costs of mis-selling by a large firm/insurer.

3.23 Some general insurance brokers have similarly suggested that the General Insurance Intermediation class should differentiate those firms whose only regulated activity is solely within the definition of general insurance intermediation from those who participate in other funding classes: e.g. deposit takers or home finance providers. It is argued that small bespoke intermediaries with a small customer base would therefore be shielded from what they consider to be disproportionate compensation costs that might arise from a large multi-disciplinary firm failure.

3.24 However, we are not convinced that the proposed benefits would arise. In fact, moving to this approach might lead to a greater financial burden on 'pure' general insurance brokers as it would see them grouped together with firms whose only FSA permission(s) is ancillary to their main business (e.g. car dealerships that also sell insurance). This class would be required to meet its own costs without any support from other firms with general insurance intermediation permissions (e.g. deposit takers).

3.25 Also we are not convinced that applying this 'provision only' and 'intermediation only' distinction to all the other classes in the model would be beneficial or desirable. It would introduce a further seven[15] funding classes into the model that collectively comprise fewer than 1,800 of the 16,000-plus firms that participate in the FSCS. We believe that the resulting classes are likely to be too small to sustain all but the lowest level of levy requirements and pose a greater risk of breaching thresholds and requiring additional funding (such as cross-subsidy support from other classes or commercial borrowing).

3.26 We could reallocate two regulated activities currently in the Investment Intermediation class to the Investment Fund Management class:

- 'safeguarding and administering investments'; and
- 'arranging safeguarding and administering of assets'.

3.27 These activities are allocated to the investment sector as a requirement of the ICSD.[16] The assignment of these two permissions to the Investment Intermediation class was a result of

15 'Deposit only', 'General Insurance Provision only', 'Life and Pensions Provision only', 'Life and Pensions Intermediation only', 'Home Finance Intermediation only', 'Investments Provision only', and 'Investments Intermediation only'.

16 The ICSD requires protection in respect of in-scope investment firms that safe keep and administer financial instruments (including custodianship and related services such as cash/collateral management). In-scope investment firms participate in either and/or both of these investment classes.

merging the previous A12 and A13 FSCS contribution groups (which were in line with the FSA fee blocks). FSA fee blocks A12 and A13 distinguish firms with otherwise identical permissions on the basis of whether or not the firms are also subject to the client asset rules set out in the Client Asset sourcebook (CASS) of the FSA Handbook. The distinction ensures that appropriate FSA regulatory fees can be raised to fund FSA's enhanced regulatory approach for ensuring CASS compliance.[17]

3.28 We do not propose to make such a change at this stage, as there is no strong evidence that these activities are more obviously aligned to one or the other of the two classes. Currently, almost 1,000 of the approximate 7,300 firms which have permissions that fall within the Investment Intermediation[18] class have either or both of these specific permissions. Of these firms, 77% also hold permissions within the Investment Fund Management class.

3.29 If we were to reallocate these permissions, firms that generate eligible income from these activities would continue to report the same tariff data, but in the other class. This means that the other 23% of investment intermediaries with at least one of these permissions (i.e. those that do not currently participate in the Investment Fund Management class) would be required to participate in the Investment Fund Management class going forward and, where applicable, would be exposed to a corresponding share of any levies allocated to that class.

3.30 This could increase complexities for firms in identifying and accurately reporting tariff data. When submitting tariff data, firms submit only one figure per class: the aggregate 'annual eligible income' firms generate from the regulated activities within the class. Firms are not required to submit a separate figure per regulated activity. Depending on how firms currently generate their tariff data submissions, it may be difficult to identify the 'annual eligible income' arising from these two specific permissions, separately from the other activities within the Investment Intermediation class.[19] This creates a potential risk of inconsistent approaches between firms in determining the tariff data specific to these permissions and inaccurate submissions in the Investment Fund Management class. It would also lead to operational changes.

Q1: Do you agree that we should keep 'safeguarding and administering investments' and 'arranging safeguarding and administering of assets' permissions in the current class?

17 However, firms within other regulatory fee blocks (and by consequence other FSCS funding groups) are also subject to CASS requirements and our enhanced regulatory approach to them.

18 Not all of these firms may generate 'annual eligible income' in respect of those activities.

19 Firms may need time to amend their systems to be able to report differently. We would make allowance for this in any detailed proposal, should we consult on introducing such a change.

Allocation to class by primary business

3.31 Some firms have suggested that firms should be allocated to a funding class according to their 'primary business', whether that business is FSA regulated or unregulated and unrelated to financial services.[20] Under this approach, all FSCS compensation costs generated by firms within any 'primary business' class would be met by that class, irrespective of the specific regulated activity that gives rise to the costs.

3.32 This option is considered particularly attractive to firms whose entire business is defined by the activities within the General Insurance Intermediation class. These 'pure general insurance brokers'[21] claim it is unfair that they should participate in the same class as a number of firms that have only one or two FSA permissions that are ancillary to their main business. Some of these 'pure' general insurance brokers consider that the compensation costs generated by PPI claims, which led to significant and consecutive rises in recent annual levies, were attributable in the main to this other group of firms.

3.33 We consider this approach to be problematic for a number of reasons. Unlike regulated activities, which are set out in secondary legislation, 'primary business' or 'primary categories' are characterisations not regulatory terms with defined criteria and parameters. Even if we were able to draw up a list of likely primary firm categories, allocation to a class would nevertheless require uncertain and potentially inconsistent subjective assessments either by firms or by us.

3.34 On a practical level, this approach could lead to more classes, most of which would consist of only a relatively small numbers of firms. As we outline further below, this could introduce volatility into the funding model as the level of compensation that would be affordable and sustainable for such small classes would likely be low.

3.35 The extent to which the FSCS may be called upon to pay compensation in the event that a firm fails is determined by the regulated activities undertaken by that firm, whether or not those activities were undertaken compliantly and in accordance with the legal liabilities owed to the customer by that firm and, if not, whether or not this resulted in loss for the consumer. The firm's primary business, however, may be unconnected to the triggers for compensation.

3.36 So while the firms in these classes may specialise in similar services (whether regulated or not), they would not present similar types and levels of risk to the FSCS, calling into question the extent to which firms in the class can be said to have a reasonable degree of affinity.

20 For example, a fund manager may also have permission to advise but would be perceived as a 'fund manager' not an 'adviser' and a car salesman who holds FSA GI intermediation permissions is not typically perceived as a 'GI intermediary'.

21 Those firms whose sole business is the broking of general insurance.

Allocation determined by products

3.37 This would see firms allocated to a funding class by reference to the products they manufacture or sell. The cost of compensating claims relating to these products would be met only by those firms that participate in that market. It is suggested that this approach could have shielded many general insurance intermediaries, in particular those who consider themselves 'pure general insurance brokers', from PPI compensation costs and investment intermediaries from the compensation costs generated by the failure of stockbrokers (for example Wills & Co and Pacific Continental Securities) and structured products providers'.

3.38 At a practical level, we do not consider this a robust and feasible option. Though the legal basis for activity in most of the intermediation classes is currently defined as certain regulated activities 'in relation to' or 'in respect of' broad product types, allocation exclusively by a more granular separation of products would not offer the same level of stability as the current approach. Products, unlike the activities listed in the Regulated Activities Order, continually change and develop. To ensure the accurate allocation of firms to the appropriate classes, product evolution would necessitate frequent review and amendment of the class structure, making this basis of allocation over-complicated, uneconomic and impractical. Furthermore, some products might be complex or structured in a way that makes allocation to a single class problematic.

3.39 In addition, product-based allocation would introduce the risk of inadvertently inhibiting competition. It is conceivable that firms could begin to change their offerings purely to avoid levies. This, in turn, could lead to a narrowing range of firms from which products would be available.

3.40 We appreciate why this appears an attractive option for many industry participants. Separation of firms into funding classes on this basis, however, assumes that:

- The likelihood that a consumer might require compensation from the FSCS is always determined by the product itself and not the actions of regulated firms in respect of those products (such as providing advice or acting as a trustee or depositary); and
- The 'riskiness' of a product is fixed and does not vary according to the circumstances and experience of the consumer to whom it is sold.

3.41 We consider that allocation on this basis would result in classes comprising firms that do not necessarily present similar risks to the FSCS.

3.42 From a wider regulatory perspective, the extent to which a product (by its design or distribution) might present a particular risk to consumers is relevant from a regulatory point of view. The FSA has already signalled a move to a more interventionist approach to regulation that would be built upon by the FCA. The regulator will supervise firms more intrusively and will proactively intervene earlier in the product value chain to 'weed out harmful or inappropriately marketed products'.[22]

Classification by regulatory requirement

3.43 There have been renewed calls, in particular from the intermediation classes in both the investment and life and pensions sectors, for the class structure to somehow reflect the differing prudential regimes under which firms operate, or based on the different regulatory regime e.g. a MiFID/non-MiFID or a Capital Requirements Directive (CRD)/non-CRD basis.

3.44 The prudential regime relates only to a firm's solvency and is therefore only relevant in terms of the risk of financial failure. For FSCS purposes, however, particularly in relation to firms that have intermediation permissions, the level of risk and exposure of the FSCS is not determined by solvency alone: in most cases, the extent to which the FSCS may be called upon to pay compensation in the event that a firm fails is determined by whether or not the firm breached any conduct requirement before it was declared in default. But the prudential regime provides no useful indicator of the risk of mis-selling claims.

3.45 The possibility of classes based on the prudential regimes under which firms operate was raised during the consultation in 2006/07. We responded that it would lead to a greater number of classes in the model and, if there were more classes comprising fewer firms, this could lead to sustainability issues for some of them. Also, taking account of prudential activity might lead to more volatility and less predictability. We have not had reason to change our position and do not propose to take this approach forward.

3.46 MiFID, by contrast, governs the organisation and conduct of business of those investment firms to which it applies.[23] We do not consider that the FSCS funding classes need to distinguish between those firms that are subject to the directive and those that are not. In the UK, the conduct requirements for authorised firms undertaking 'designated investment business' are broadly the same for both MiFID and non-MiFID firms and our supervisory approach does not differentiate between these groups. MiFID aims to ensure adequate and differentiated investor protection throughout the EU, but the FSCS is able to provide compensation when conduct requirements (and other civil liabilities) are breached by UK authorised firms. Whether or not a firm is subject to MiFID requirements should not make a firm more or less likely to:

22 Speech by Martin Wheatley at the Chartered Institute of Bankers, 4 May 2012: www.fsa.gov.uk/library/communication/speeches/2012/0504-mw.shtml

23 MiFID only applies to firms carrying on certain investment services and activities (reception and transmission of orders, execution of orders on behalf of clients, dealing on own account, portfolio management, investment advice, underwriting, placing of financial instruments and operation of multilateral trading facilities) in relation to certain financial instruments (including transferable securities, units in collective investment undertakings, money market instruments, financial contracts for difference and a range of derivatives and commodity derivatives).

- default; and
- breach conduct requirements (or other civil liabilities owed to the investor).

> **Q2:** Do you have any comment on our analysis of the alternative bases of allocation and class structures or any suggestions for further consideration?

Our conclusion: retain the current approach

3.47 We recognise that no basis of allocation is perfect and that some industry participants consider the current basis to be unfair. We do not propose to depart from a process of allocation by regulated activities because:

- this approach provides objective criteria for the allocation of firms, fees and levies;
- it is capable of reliable and consistent application by firms, the FSA and FSCS;
- regulated activities form the basis of much of our regulatory architecture, so using them as the basis of allocation for FSCS funding purposes should help ensure ease of comprehension and application by industry participants;
- it is economical and operationally capable of practical administration;
- there are only infrequent amendments or additions to the Regulated Activities Order[24] so regulated activities provide a suitably stable platform from which to group firms according to their business type; and
- the current basis results in sustainable classes.

3.48 When compared to the alternatives considered above, we believe allocation by regulated activities strikes the most reasonable balance between fairness, affinity and sustainability.

3.49 The resulting classes allow for coherent treatment of the industry as a whole while having due regard for the different markets that operate within it. The separation of provision and intermediation activities also mirrors the proposed division of responsibility for the FSCS under the new regulatory architecture where the PRA will be responsible for deposit taking and insurance provision and the FCA for fund management and all intermediation activities. Furthermore, the sector-related classes are broadly consistent with the scope and application of current and potential European guarantee (compensation) scheme directives for deposits and investments.

24 Since the last funding review there have been four additions to the Financial Services and Markets Act 2000 (Regulated Activities) Order. These additions introduce new regulated activities relating to e-money issuing, dormant account reclaim funds and regulation of sale and rent back agreements. They also accommodate the introduction of a new financial instrument: alternative finance investment bonds (AFIB).

3.50 In addition, we have been unable to identify a credible alternative (within the statutory and other constraints outlined in paragraph 3.2 to 3.4) without simultaneously introducing volatility and instability into the model. Alternatives that necessitate a greater number of funding classes, each with fewer participants are, amongst the other disadvantages outlined above, more likely to experience volatility. We consider that the burden on firms is likely to be less under our current approach than under any of the alternatives proposed.

Q3: Do you have any comment on our analysis or proposal to retain the current approach?

Other considerations

Investment Fund Management

3.51 We propose renaming the Investment Fund Management class the 'Investment Provision' class. We consider this new name will make explicit that the composition of the class is not limited to fund managers, but will include any firm that has permission to undertake any one or more of the relevant investment provision activities, such as Self Invested Personal Pension (SIPP) operators.

Q4: Do you agree with our proposal to rename the Investment Fund Management class the 'Investment Provision' class?

No sub-classes

3.52 As we are proposing to end the operation of cross-subsidy within broad classes, as explained in Chapter 4, we will not refer to 'sub-classes'. In future, all classes will be referred to as a 'class'.

Home Finance Provision

3.53 Although we have not found a good reason to depart from the current class structure, we propose one change. The regulated activities that form the legal basis of the Home Finance Provision class are not subject to FSCS protection. They were nevertheless grouped together into a FSCS funding class at the time the current FSCS' funding model was introduced. The sole purpose of the class was to provide an additional source of funding for home finance intermediation claims due to the 'mutual financial interest' it shared with the Home Finance Intermediation sub-class.

3.54 We propose that this class should be removed from the funding structure. This is because the activities of the class do not themselves cause a potential liability to the FSCS and direct explicit cross-subsidy between 'classes' within a 'broad class' will no longer feature in the FSCS funding model as a consequence of our proposals concerning cross-subsidy in Chapter 4.

Q5: Do you agree that it is reasonable to remove the Home Finance Provision class from the funding model?

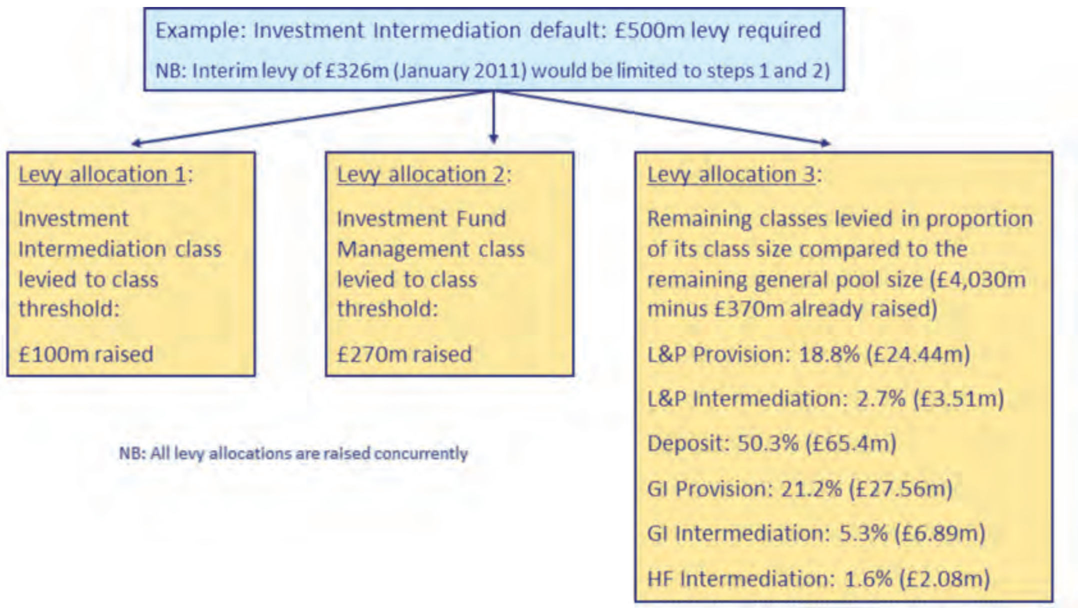
4

Spreading costs

4.1 Throughout the CP we have stressed the need for adequate funding of the FSCS. This includes considering what would happen if the annual threshold for any one or more funding class is reached in any year. A potential funding gap could be filled by a number of options including spreading the costs over a number of years (through pre-funding or borrowing) or by cross-subsidy. Following the review of 2006/07 we decided to introduce the concept of cross-subsidy from 1 April 2008.

4.2 Cross-subsidy was introduced to ensure that the FSCS would have access to funding in excess of the annual threshold of the originating class (i.e. the class to which the funding costs are allocated). These compensation costs would be raised first from the class to which they are allocated, then from the linked provision or intermediation class from the relevant sector. Costs beyond the combined thresholds for any of the five broad sector-based classes would be spread across the remaining funding classes in the model[25] (the 'general retail pool') (Figure 2).

Figure 2: Example of how cross-subsidy currently works



25 Except for the Home Finance Provision class which would only be required to pay for claims from the Home Finance Intermediation class.

4.3 In January 2011, cross-subsidy was triggered for the first time. The Investment Fund Management class was asked to contribute £233m to a compensation bill of £326m, which originated in the Investment Intermediation class. This event demonstrated that cross-subsidy could operate as an effective contingency arrangement, giving the FSCS the capacity to meet claims in the event of extraordinary but nevertheless plausible levels of compensation costs.

4.4 The levy increased the widespread opposition to the principle of cross-subsidy. We have considered carefully the impact of the levy on firms in both affected classes[26] and the volume of criticism generated by the use of this provision.

4.5 Perhaps more significantly, however, there have been a number of changes in the regulatory environment[27] since this facility was introduced, with further potentially fundamental changes anticipated as a result of regulatory reform. For the remainder of this chapter we make the assumption that the government's current proposals as described above will be enacted, while recognising that this is still the subject of Parliament's consideration.

Why have cross-subsidy?

4.6 Cross-subsidy between the provision and intermediation classes within a sector was justified on the principle of mutual financial interest. Cross-subsidy across all classes via the general retail pool was introduced on the basis of the benefit to the financial services industry as a whole from the FSCS' existence, to promote financial stability and market confidence.

4.7 So, cross-subsidy is one way of extending the funding capacity of the scheme and further spreading the costs. It provides a far bigger pool of resources for FSCS in the event of a default, both in terms of greater funding availability and a greater number of firms contributing to the costs.

Issues with cross-subsidy

4.8 There are arguments against cross-subsidy, however:

- The bigger the pool the less affinity there is for firms sharing compensation cost.
- Any subsidy artificially reduces the costs associated with providing the subsidised activity, leading to potentially distortive effects and economically inefficient outcomes, such as over-provision of the subsidised activity at the expense of other more productive activities.
- Sharing costs across a population of firms wider than those generating the risks posed to the scheme or benefitting from the scheme may blur risk management incentives.

26 Particularly for the Investment Fund Management class which, until then, had experienced very low FSCS levies.
27 For example, banking compensation reforms and the Special Resolution Regime as introduced via the Banking Act 2009.

- Some sectors consider cross-subsidy inappropriate and unfair as it wrongly exposes them to liabilities arising in other sectors with which they have little, or no, direct connection.

Cross-subsidy: expected PRA classes

4.9 We propose that there should be no cross-subsidy to or from the Deposits class. This is because:

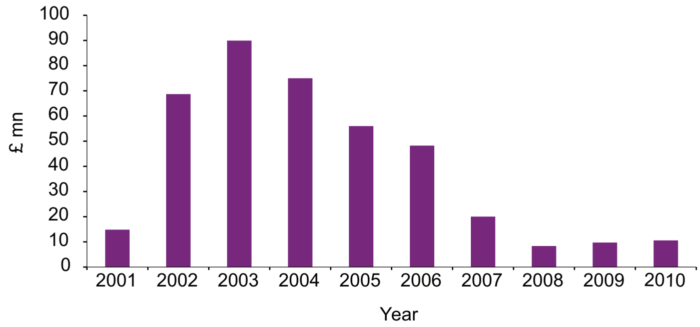
- compensation costs will only arise in the event of firms failing in this class, which would lead to a failure to repay (or ability to repay) the deposit; and
- previous experience shows that smaller, more frequent failures like credit unions, can be funded within the proposed threshold limits. Infrequent but large calls to date suggest that it may be more appropriate, for financial stability reasons and in support of the PRA's proposed regulatory objective, for the FSCS to raise the required funds through borrowing (e.g. from the National Loans Fund) rather than invoking cross-subsidy (as was the experience in 2008 with borrowing originally provided from the Bank of England, and then refinanced by the Treasury).

4.10 Similarly, we propose that there should be no cross-subsidy between the General Insurance Provision, Life and Pension Provision and Deposits classes because:

- compensation costs will arise from the failure of firms in these classes arising from rights under a contract of insurance rather than any claims under a contract of insurance (i.e. certain conduct related claims that would be covered by the Intermediation classes); and
- other than in extreme circumstances, the costs of failure (which will relate to the provision of rights under the contract of insurance) are unlikely to breach class thresholds due to the profile of claims likely to emerge and/or application of funds from the estate and are therefore unlikely to need to receive cross-subsidy from other classes. Figure 3 shows, for example, the profile of claims since the liquidation of Independent Insurance Company Ltd in 2001.[28]

28 The firm wrote general insurance and reinsurance business (mainly covering liability, property, motor and other insurance for the commercial and personal lines sectors). It went into provisional liquidation in 2001 and continues in run-off. Since 2001, £500m of assets have been realised for the benefit of the creditors. The FSCS has paid out approximately £404m (including £12m by the Policyholder Protection Board pre Dec 2001). The firm is expected to enter a scheme of arrangement later this year.

Figure 3: Claims profile since liquidation of Independent Insurance Company



4.11 For the same reasons we do not believe that there should be a cross-subsidy between the General Insurance Provision and Life and Pension Provision classes and the General Insurance Intermediation and Life and Pension Intermediation classes respectively. We are conscious that, to a degree, this approach undermines the natural affinity between these providers and their intermediaries. But cross-subsidy is only likely to be one-way and could have distortive effects – such as over-provision of the subsidised activities or reduced risk management incentives.

4.12 If cross-subsidy is ended as we propose, the funding for the PRA classes will have three sources:

- annual compensation cost levies (subject to the relevant annual affordability threshold);
- commercial or other borrowing facilities (currently £1bn); and
- the potential to borrow from the National Loans Fund (NLF).[29]

4.13 Greater dependency on the latter two sources ensures that the costs continue to be met by the originating class. Rather than spreading the compensation costs in excess of the annual affordability thresholds across a wider levy base, the excess costs of PRA classes will be spread over time. Borrowing funds to enable this spread carries costs and risks for both the industry and the FSCS.

Commercial borrowing

4.14 The FSCS commercial borrowing facilities are intended to address short-term liquidity issues, rather than to be an alternative to industry funding. Currently, the FSCS has a syndicated financing facility[30] to enable it to access funds up to £1bn in the event of a significant failure so it can pay out compensation without having to wait for a special levy to be raised.

29 If the claims were of significant size then the FSCS could choose to approach the NLF prior to accessing its commercial borrowing facilities.
30 The 2012/13 MELL budget includes £6.1m for a syndicated short term financing facility.

4.15 Commercial borrowing has its limitations as a long-term funding source for the FSCS. The cost of the facility currently enjoyed by the FSCS (and any future facilities/loans) will be borne by the levy payer.[31] As with any financing facility or loan the terms of the arrangement will determine the period over which the loan must be repaid. Also, commercial borrowing is only available for as long as the lenders are willing to enter into such agreements with the FSCS. It cannot be assumed that this will always be the case.

Access to the NLF

4.16 As a result of the Banking Act (2009), the FSCS may ask to borrow from the NLF in the event that one or more significant defaults give rise to claims in excess of the commercial borrowing from time to time, currently £1 billion.[32] This facility provides a substantial funding backstop. But it is not guaranteed and the terms of any borrowing, for instance the interest rate applied, would be negotiated on a case-by-case basis, so that the cost of borrowing is not known.

> **Q6:** Do you agree with our recommendation to end cross-subsidy from, to and between the PRA classes?

Cross-subsidy: expected FCA classes

4.17 In the absence of cross-subsidy funding from PRA classes, it is essential that the funding arrangements for the FCA classes continue to offer the FSCS sufficient capacity to pay all eligible claims, even where these exceed the annual class thresholds. Compensation costs to date have been material and cross-subsidy has already been triggered (though only once so far).

4.18 If a firm fails, activities falling within FCA classes can give rise to a variety of different sorts of claims for compensation from the FSCS. These include claims for loss of client assets and money and claims for mis-selling or negligence by the failed firm (relating to a variety of different sorts of product). These classes can therefore experience significant peaks and troughs, not only in the number of firm failures but also the number and value of claims.

4.19 As Chapter 5 explains, we propose to adjust the class thresholds to achieve a better balance between the funding needs for each class and affordability for the firms within them. In order to ensure costs are met so as to maintain FSCS' ability to pay compensation and maintain consumer confidence, we propose that compensation costs in excess of these thresholds should be met from a wider pool of levy payers. The wider the funding base, the

31 As noted the £1bn facility in place costs £6.1m for the first year but the cost may change in future years.
32 The protocol between the Treasury, the FSA and FSCS does not specify the circumstances in which the application to borrow would be successful. It should not be assumed that the NLF would accede to all requests.

more likely it is that appropriate levels of funding will be accessible when a particular class threshold is reached.

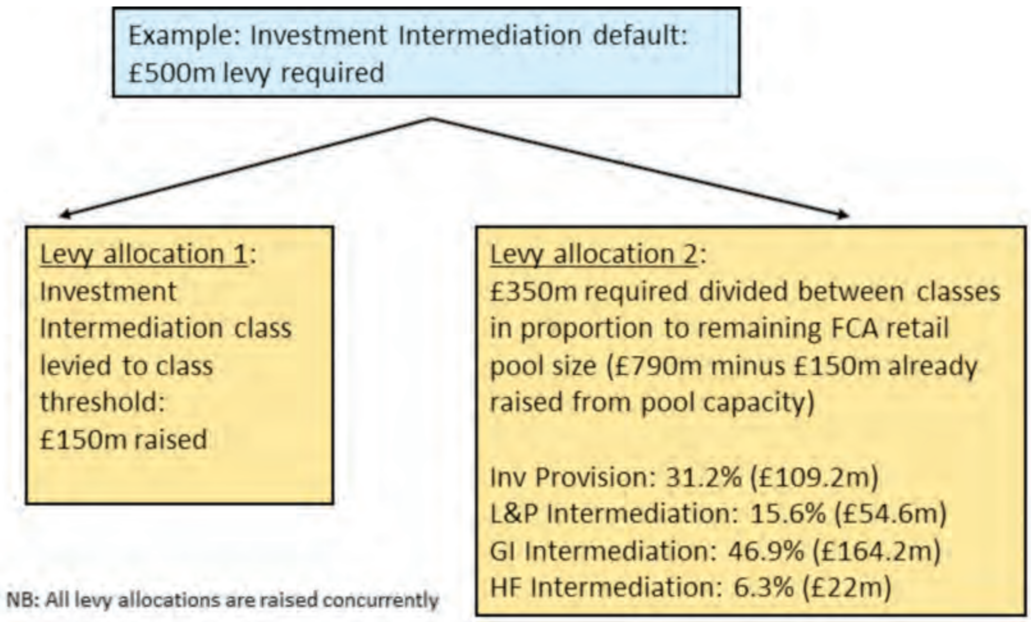
4.20 We do not expect classes to reach their thresholds on a regular basis but it remains a possibility. But where a threshold has been reached we consider it is essential to ensure the FSCS can fund eligible compensation claims.

4.21 This wider pool will no longer take the form of initial mutual support between provision and intermediation firms within the same broad sector. We have outlined above that the Deposits and Insurance Provision classes will no longer receive or provide cross-subsidy; so insurance providers will no longer provide explicit cross-subsidy to insurance intermediaries.

4.22 Instead, cross-subsidy for compensation costs will be from an FCA retail pool made up of those classes that potentially give rise to compensation claims: Investment Provision, Investment Intermediation, Life and Pensions Intermediation, General Insurance Intermediation and Home Finance Intermediation. As the Home Finance Provision class features in the current funding model exclusively to provide the first level of support to the Home Finance Intermediation class, our proposal will also result in the removal of this class from the model.

4.23 If the FCA retail pool is triggered (as a class threshold has been reached), the other future FCA classes will contribute to a funding requirement in proportion to their thresholds. The share of any levies from the triggering of the pool will vary depending on which class has reached its threshold. An example is shown in Figure 4, but the distribution would vary, for example, if the Life and Pension Intermediation class reached its threshold because the percentage shares of the remaining classes would change.

Figure 4: Example of levy allocation post proposed changes to cross-subsidy



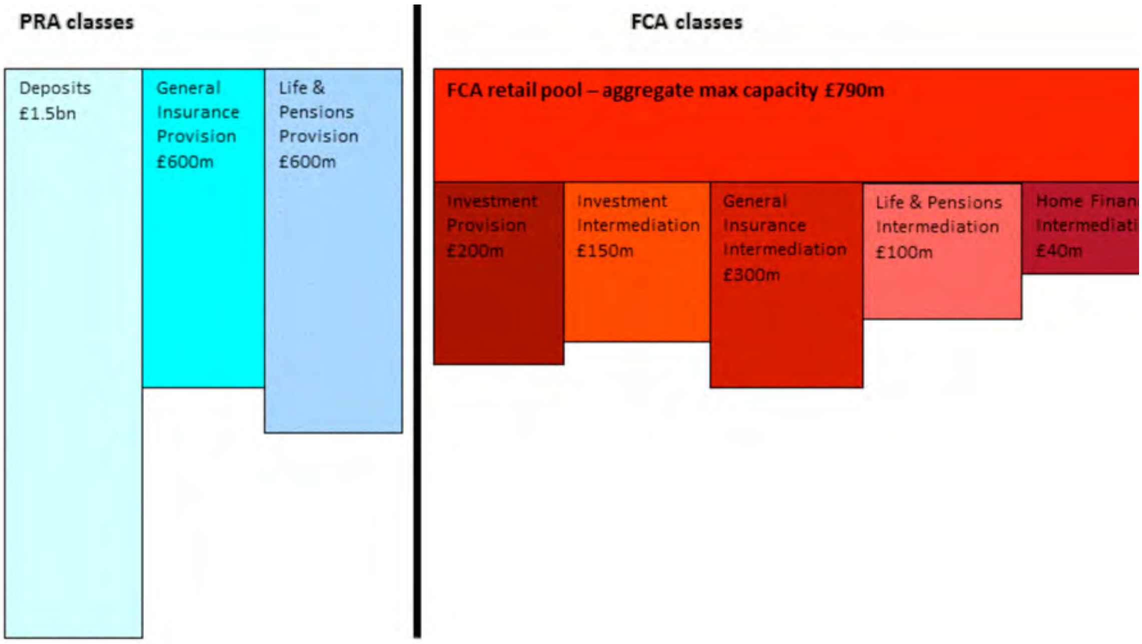
Q7: In the absence of direct funding support from the PRA classes, do you agree with our recommendation to establish an FCA retail pool?

4.24 The FSCS will continue to have the discretion to determine the most appropriate source of additional funding in the event that a class threshold is reached. This may in some circumstances lead to the use of commercial borrowing, for short-term liquidity purposes for example, which may delay or prevent the triggering of cross-subsidy. However, commercial borrowing is not a long-term funding solution as it attracts costs that must be borne by the originating class. Repeated threshold breaches by FCA classes could lead to costs accruing beyond the classes' ability to pay in the long term. So it is unlikely that commercial borrowing would be considered the most appropriate option.

4.25 A case can be made that moving to a pre-funded model for the intermediation classes could increase the funding capacity for these classes and so reduce the need for alternative sources of funding such as cross-subsidy. Establishing a pre-fund could reduce volatility by smoothing costs to firms and reduce some unpredictability, as defaults in the intermediation classes are frequent but costs, for example as a result of mis-selling, are unpredictable.

4.26 Whether we change regulations on pre-funding for these classes remains a decision for government.

Figure 5: FSCS funding model if proposed changes are made (including threshold changes in Chapter 5)



5 Class thresholds

5.1 Under our rules there is a maximum amount, or threshold, that each class can be required to pay for compensation costs each year.[33] The current thresholds are shown in Table 2 and have applied since 1 April 2008, following the previous FSCS funding review. The reasons for the proposed thresholds are explained later in the chapter.

5.2 The current thresholds were set at the time based on specific percentages of the estimated financial size of each class (of between 3.5% and 7.5%). The previous review looked at the illustrative impact on average small, medium, and large firms in each class but we were unable at that time to assess the impact of the thresholds on individual firms.[34]

Table 2: Current and proposed FSCS class thresholds

Class	Current threshold	Proposed threshold
Deposits	£1,840m	£1,500m
General Insurance Provision	£775m	£600m
Life and Pensions Provision	£690m	£690m
Investment Fund Management	£270m	£200m
General Insurance Intermediation	£195m	£300m
Life and Pensions Intermediation	£100m	£100m
Investment Intermediation	£100m	£150m
Home Finance Intermediation	£60m	£40m

5.3 We committed to regularly reviewing the thresholds and so we have considered whether the thresholds should be changed. We looked at the competing demands of funding needs for each class[35] and affordability to firms and have aimed to set the thresholds at a level that would constitute an appropriate balance between the two.

33 FEES 6 Annex 2.
34 Primarily due to changes in the proposed class structure, thresholds and tariff measures in most classes.
35 We looked at the historic funding requirements in each class in the past eight years as an indicator of the potential funding needs in the future but recognise that this is not necessarily an indicator of future claims.

5.4 To allow us to assess the affordability for firms, we asked Deloitte to model the impact of different potential thresholds on individual firms using FSA returns data from the 16,000-plus firms that participate in the FSCS. We then determined at what level the thresholds should be set. Deloitte has produced a comprehensive report of its work, which is published alongside this CP and summarised below.[36]

5.5 In considering the proposals in this chapter it is important to remember that the thresholds we are proposing represent the maximum amount that could be raised from firms in a particular year. Historically, claims on the FSCS have nearly always been significantly less than the maximum. The exception was when the threshold for the Investment Intermediation class was reached in 2010/11.

The methodology for assessing thresholds

Deloitte's approach for modelling the impact of thresholds

5.6 Deloitte developed the methodology (outlined in detail in their report) in consultation with us and discussed its high level approach bilaterally with eight trade associations. The analysis undertaken was based on anonymised returns data for the 16,000-plus firms participating in the FSCS.

5.7 The Deloitte work models the key drivers of revenue and cost for the main types of firms within each FSCS class. Given the broad range of business models within most classes, a practical approach was the use of 'stylised firms' that represent typical firms in different segments within each class. These stylised firms were then used to estimate the funding capacity for the whole class, by setting a range of percentage of profits (from 10% to 100%) that could be paid as a levy in a given year. Using stylised firms allows the analysis of affordability to take account of the impact of different scenarios.

5.8 The modelling methodology was made up of two phases. Phase 1 focused on calculating a range of potential class thresholds using a simplified profit and loss account (P&L) for stylised firms to assess affordability at a company level. A percentage of profits that a stylised company could afford to pay as an FSCS levy in any given year was used and grossed up to calculate the threshold for the class. The profits available included an assessment of the impact of various macroeconomic, regulatory, and competitive scenarios for the future.

5.9 Phase 2 assessed the impact of a range of potential thresholds on actual firms by calculating a levy for each (based on threshold and tariff base data) and assessing the impact on profitability and on regulatory capital reserves above the minimum regulatory requirements (referred to in the Deloitte report as 'surplus capital').

5.10 For their analysis we asked Deloitte to take into account the following:

36 http://www.fsa.gov.uk/pubs/other/deloitte-29mar12.pdf

- **Affordability.** The impact of the levies on firms should be expressed in terms of the number of firms that may have to exit the market as a result of the levy.
- **Economic scenarios.** The assessment of firm affordability should be robust to a reasonable range of economic outcomes (what is referred to as the low, base and high case) since thresholds may be fixed for a number of years.
- **Regulatory scenarios.** Some of the changes in the regulatory environment (e.g. Basel III, Solvency II, Retail Distribution Review (RDR) and Mortgage Market Review (MMR) may impact on a firm's ability to afford levies, especially where cost increases relating to regulatory changes are not fully passed through to customers.
- **Potential for cost 'pass-through'.** Depending on market structures and characteristics, firms may be able to 'pass-through' some or all of the costs of funding the levy (as well as other regulatory costs) to their customers. The extent of cost pass-through will differ between, on the one hand, levy components that are predictable and known in advance (e.g. pre-fund contributions and legacy costs payments) and, on the other, ex-post levies, which are more unpredictable and therefore more difficult to absorb into firms' business models.
- The impact of **other potential predetermined levy costs that would be known by firms in advance**, e.g. legacy cost repayments and pre-funding in the Deposits class.

5.11 As indicated above, the Deloitte work shows in detail how various thresholds would impact on the firms participating in each class, in terms of the number of firms for which the levy would exceed their annual profits. We refer to this as 'firms that would become unprofitable' but this does not mean that they will necessarily go out of business as a result of the levy requirement.[37] We also looked at the impact in terms of the number of firms that would have to use more than 5% of their surplus capital to fund the levy. These impacts are set out for three different regulatory and economic scenarios: the base case, low case and high case.

5.12 The modelling did not take account of the extent to which a firm might be supported financially by the group to which it belongs. We believe that the model cannot take account of such a scenario because:

- levy requirements are placed upon authorised entities (i.e. firms, not groups), which are therefore the suitable unit to assess the affordability of various thresholds;
- the modelling is done for all firms participating in the FSCS across the nine classes, which requires a homogeneous set of data for each of them;
- data on potential group affiliation is not comprehensively and readily available for all firms in a class; and
- whether or not a group will actually provide financial support is a decision that will vary between groups and is impossible to model.

37 If there were prolonged periods of unprofitability the impact could be exacerbated.

5.13 As with any modelling approach, there are limitations to the specific model that we have developed for our purpose and these are set out in the Deloitte report accompanying this CP.

Our approach for setting the thresholds

5.14 We used the Deloitte report as one of the inputs to our review and compared the impacts on firms to the funding needs of each class. The aim was to identify thresholds that strike an appropriate balance between these two competing aims and between classes as consistently as possible.

5.15 The modelling showed that, when measured in terms of impact on firms' profits, the existing thresholds impose different levels of burden for each class. We tried to reduce these differences by changing some of the thresholds, unless our assessment of a particular class suggested we should do otherwise (e.g. because historic funding needs or projections into the future would demand it).

5.16 There is a trade-off between the level at which the threshold for a class is set and the total costs accruing to firms in that class over time. A lower threshold now might decrease the immediate payment burden on firms. But if a (lower) threshold is reached and the funding gap has to be met by a loan, then the additional interest costs accruing over time through the repayment of the loan might offset the benefit of the initially lower threshold.

5.17 We are also aware that the modelling is done for each class separately but many firms participate in two or more classes and may therefore be impacted if thresholds of several classes were reached simultaneously. Our analysis indicated that our proposals are not undermined if the low probability scenario of all class thresholds being reached simultaneously occurred.

Deposits class

5.18 The calculation of the threshold for the Deposits class differs from most of the other classes outlined further below as we know of particular costs that will, or are likely, to arise:

- Firms have to repay the legacy costs from the 2008 banking defaults (the FSCS borrowed £20.4bn to fund the costs of compensating or transferring the accounts of the failed banks). In March 2012 after discussions with the Treasury, the FSCS announced that the interest rate on the loans would increase to 12 months LIBOR plus 100 basis points from 1 April 2012 onwards.[38] This rate will be subject to a floor equal to the Treasury's own cost of borrowing, as represented by the gilt rate for borrowing of an equivalent duration. For 2012/13, the interest is expected to be around £510m. The FSCS also announced that it will be levying three roughly equal annual instalments to start making repayments on the principal amount that will not be recovered on the

38 For details, see FSCS website at: www.fscs.org.uk/industry/news/2012/march/refinancing-of-loans-for-2008-0-v6tamywr/index.html

non-Bradford & Bingley loans. This could range from £250m to £350m. The aggregate annual legacy costs that will be levied from firms from July 2013 could be between £760m and £860m.[39]

- Other potential predetermined levy costs that are known in advance would include pre-funding if mandated by the DGSD.

5.19 For the purposes of this CP and the underlying threshold modelling, we assumed that the firms in the class will be required to contribute a maximum of £1bn a year in total for potential predetermined costs that would be known by firms in advance and additional costs would be levied only in the event of further defaults. We recognise that this assumption is uncertain and subject to related regulatory initiatives, including the final requirements of the DGSD and the recently proposed Recovery & Resolution Directive.

5.20 The modelling in the class distinguishes between five different segments: large banks; building societies; credit unions; other banks with only deposit-taking activities; and other banks carrying out deposit and home financing activities.[40]

5.21 The modelling took into account macroeconomic and regulatory cost adjustments for the five segments. For example, in the base case scenario, the three bank segments are assumed to be able to pass through to customers at a rate of 85% for other potential predetermined costs that would be known by firms in advance (e.g. pre-funding and legacy costs) as these costs are predictable so can be factored into firms' pricing. The rate for building societies and credit unions was assumed to be a conservative 0%.[41] This reflects the assumption that these businesses are affected differently by the current low interest rate environment and have more limited sources of funding. For example, building societies are more likely to be locked into long-term fixed contracts, which may limit their ability to pass-through costs. If we did not include cost pass-through assumptions the impact on firms would increase.

5.22 Our modelling suggests that once other potential predetermined levy costs (i.e. the modelled £1bn) and macroeconomic and regulatory adjustments have been taken into account, nine of the 470 profitable firms in the class would become unprofitable.[42]

5.23 We then modelled the impact of different thresholds ranging between £100m and £800m, in £100m increments. Again we assessed the number of firms for which the levy would exceed profits or use up more than 5% of their surplus capital. As shown in Table 3, a further levy of £500m would see nine firms becoming unprofitable. These are in addition to the nine firms that would become unprofitable following the modelling above (so 18 in total). One firm would have to access more than 5% of its surplus capital to fund the levy.

39 As stated in PS11/18 *FSA Regulation of Credit Unions in Northern Ireland* (December 2011) Northern Ireland credit unions which participate in the Deposits class will not contribute to the costs of failures that occurred before 31 March 2012 www.fsa.gov.uk/static/pubs/policy/ps11_18.pdf

40 Given that Northern Ireland Credit Unions (NICUs) will not submit their first returns to us before 31 March 2013, we were unable to include them in the analysis. As credit unions (including NICUs) represent only 0.18% of protected deposits, we do not expect their exclusion to have any material bearing on the modelling of the class threshold.

41 We also modelled a cost pass-through assumption of 40% for building societies. The results were not materially different.

42 A total of 645 firms participate in the Deposits class, 175 of which reported negative profits in 2010/11. They were not included in the analysis as they do not add analytical value for the affordability of threshold options.

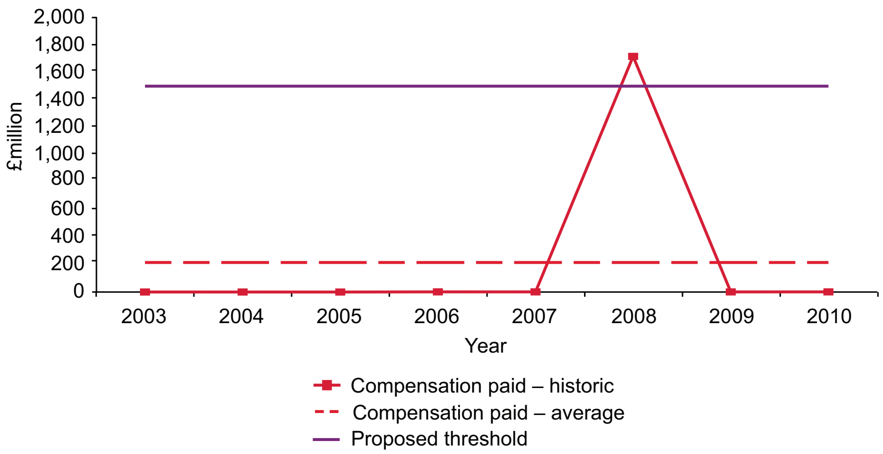
Table 3: The impact of ex-post levy thresholds options in the Deposits class, base case

	Impact on profits	Impact on surplus capital	
Class threshold	Number of firms that would become unprofitable	Number of firms whose implied levy is greater than surplus capital	Number of firms whose implied levy is greater than 5% of surplus capital
£800m	14	3	2
£700m	12	2	2
£600m	10	2	2
£500m	9	2	1
£400m	9	2	1
£300m	7	2	1
£200m	6	2	1
£100m	4	2	1

5.24 Figure 6 shows the historic funding need in the class between 2003 and 2010, including the Icelandic failures in 2008 but excluding the default of Bradford & Bingley (which exceeded the class threshold at the time and required a government loan to the FSCS). As the aggregate FSCS compensation claims in the other years were comparatively low, they do not show in the figure.

5.25 We believe a £1.5bn threshold for the Deposits class would represent an adequate amount of funding capacity while limiting the impact on the industry. By contrast an ex-post threshold in excess of £500m would not increase the funding capacity significantly but would increase the number of firms becoming unprofitable. An ex-post threshold of £800m, for example, would result in levies that exceed the profits of 14 firms.

Figure 6: Deposits class: history and average of payouts, and proposed threshold



5.26 We are proposing an annual threshold of £1.5bn. This is nominally lower than the present £1.84bn threshold available to meet compensation costs but does include an assumed annual levy of £1 billion as well as a further £500m that would be used for further defaults or ley requirements.

Q8: Do you agree with our proposal to set the class threshold for the Deposits class at £1.5bn a year?

General Insurance Provision class

5.27 The tables in the rest of this section show the number of firms that, in the base case, would become unprofitable; capital deficient; or, would require more than 5% of the capital held by the firm.

5.28 Unlike the Deposits class, the analysis for the General Insurance Provision class does not assume any other potential pre-determined levy costs that would be known by firms in advance. The rest of our analysis follows the approach set out above, in that we compared the affordability for firms with the historic funding needs in the class. The class consists of 360 firms providing general insurance business covered by the FSCS, including motor, home, and employers' liability insurance.[43] The class is segmented into live providers and run-off providers.

5.29 Table 4 shows the impact of different thresholds, with the current and proposed thresholds in shaded grey.

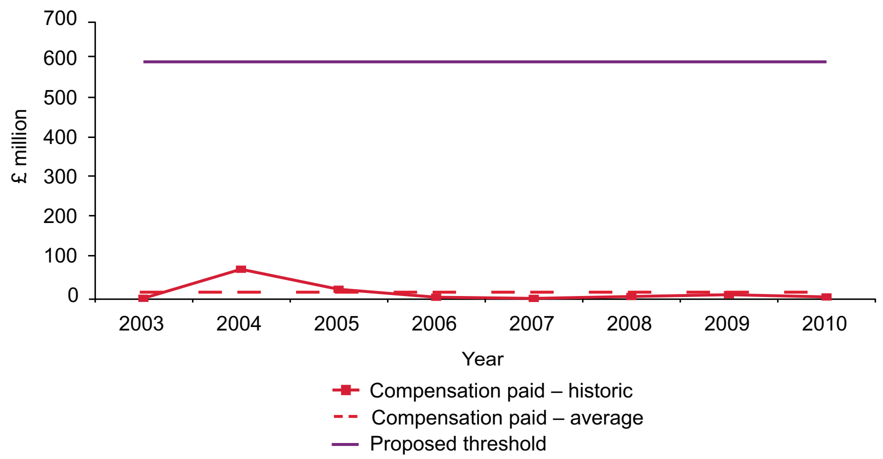
43 Business activity that is not covered includes: reinsurance, marine, aviation, goods in transit, and credit insurance.

Table 4: The impact of threshold options on firms in General Insurance Provision, base case

Using stylised firms		*Impact using data for whole firm (includes all business activities)*			
% of profits of stylised firms in class used to calculate threshold	**Implied class threshold**	**Impact on profits**		**Impact on surplus capital**	
		% of profitable firms that become unprofitable	**Number of firms that become unprofitable**	**% of firms whose implied levy is greater than surplus capital**	**% of firms whose implied levy is greater than 5% of surplus capital**
100%	£2,405m	16.1%	24	4.0%	49.7%
90%	£2,165m	12.8%	19	3.4%	46.3%
80%	£1,924m	10.7%	16	2.7%	43.6%
70%	£1,684m	10.1%	15	2.7%	42.3%
60%	£1,443m	8.7%	13	2.7%	39.6%
50%	£1,203m	6.7%	10	2.0%	36.9%
40%	£962m	6.7%	10	2.0%	30.9%
Current threshold	**£775m**	**4.7%**	**7**	**2.0%**	**24.2%**
30%	£722m	4.0%	6	2.0%	22.8%
Proposed threshold	**£600m**	**3.4%**	**5**	**2.0%**	**20.4%**
20%	£481m	2.7%	4	2.0%	18.1%
10%	£241m	0.7%	1	1.3%	4.0%

5.30 Figure 7, in turn, shows the historic FSCS payouts between 2003 and 2010. The average payout has been £16.7m and the peak payout was £76m.

Figure 7: General Insurance Provision: history and average of payouts, and proposed threshold



5.31 While the current threshold of £775m is affordable on a one-off basis, we consider it appropriate to reduce the annual threshold to £600m, which would bring the percentage down from 31% to about 25% of stylised firms' profits. Based on the historic average profile of payouts, it would still provide adequate funding. Using the class tariff measure of Eligible Gross Technical Liabilities (EGTL) as a preliminary indicator of the size of compensatable business, a £600m threshold would be sufficient to fund the default of any one but the 26 largest firms in the class.

Q9: Do you agree with our proposal to set the class threshold for the General Insurance Provision class at £600m a year?

Life and Pensions Provision class

5.32 The Life and Pensions Provision class contains providers of long-term insurance such as life insurance (including pure protection), pensions, and annuities. 188 firms are active in the class. Ownership structure was used as a single criterion to break the class into two segments: proprietary companies and mutuals/friendly societies.

5.33 Table 5 shows the impact given various thresholds. The current and proposed threshold is depicted in shaded grey, and we do not recommend any change. Under the base case assumptions, the threshold (£690m) is equal to just below 20% of class profits based on the stylised firm analysis. The implied levies based on the current threshold would result in 22% of firms having at least 5% of their surplus capital eliminated, and 3% of firms having a capital shortfall.

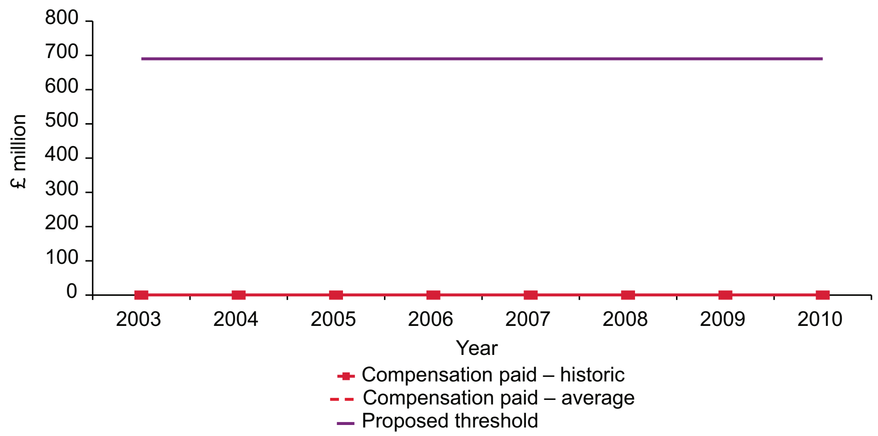
Table 5: The impact of threshold options on firms in Life and Pension Provision, base case

Using stylised firms		*Impact using data for whole firm (includes all business activities)*			
% of profits of stylised firms in class used to calculate threshold	**Implied class threshold**	**Impact on profits**		**Impact on surplus capital**	
		% of profitable firms that become unprofitable	**Number of firms that become unprofitable**	**% of firms whose implied levy is greater than surplus capital**	**% of firms whose implied levy is greater than 5% of surplus capital**
100%	£3,915m	31.3%	30	9.4%	71.9%
90%	£3,523m	30.2%	29	9.4%	66.7%
80%	£3,132m	29.2%	28	8.3%	64.6%
70%	£2,740m	26.0%	25	8.3%	59.4%
60%	£2,349m	20.8%	20	7.3%	54.2%
50%	£1,957m	19.8%	19	6.3%	50.0%
40%	£1,566m	18.8%	18	5.2%	40.6%
30%	£1,174m	16.7%	16	4.2%	33.3%
20%	£783m	12.5%	12	3.1%	24.0%
Current & proposed thresh.	£690m	**11.5%**	**11**	**3.1%**	**21.9%**
10%	£391m	8.3%	8	2.1%	14.6%

5.34 A relatively high proportion of firms in this class have an implied levy that is greater than their profits for the thresholds shown. This is likely to be driven by the high proportion of firms that only carry out protected life and pensions business. In classes where the majority of firms are active in multiple classes of business, the impact of the class thresholds on overall firm profit is smaller because of the profits generated by activities outside that class.

5.35 Figure 8, in turn, shows the historical funding needs, i.e. FSCS payouts, between 2003 and 2010. The evidence base is limited but the average payout has been £2,000 and the peak payout is £7,000.

Figure 8: Life and Pension Provision: history and average of payouts, and proposed threshold



5.36 Given the substantial funding capacity of the current threshold, there is no reason for increasing it. We see no case for lowering the current threshold either, as it represents a similar share of profits as the other classes. We therefore recommend retaining the current threshold of £690m.

> **Q10:** Do you agree with our proposal to set the class threshold for the Life and Pensions Provision class at £690m a year?

Investment Fund Management

5.37 This class includes discretionary investment managers and collective investment scheme operators and depositaries. 628 firms are active in the class, of which 311 are active only in this class. Various possible segmentations were considered by Deloitte. However, following some initial analysis it was decided that none of the segments that could potentially be modelled with the available data would behave differently under the economic or regulatory scenarios that were considered. No segmentation was therefore used for the Investment Fund Management class.

5.38 Table 6 shows the impact of various thresholds, with the current and proposed threshold depicted in shaded grey. The table shows that the current threshold for the Investment Fund Management class (£270m) is equal to just over 30% of class profits based on the stylised firm analysis.

5.39 The percentage impacts of the current threshold are comparatively high due to the high proportion of firms in this class that operate in this and perhaps one other class (Investment Intermediation). By comparison, in some other classes the impact of the class thresholds on overall firm profit is likely to be smaller due to profit they have generated in areas outside that class.

Table 6: The impact of threshold options on firms, Investment Fund Management, base case

Using stylised firms		*Impact using data for whole firm (includes all business activities)*			
% of profits of stylised firms in class used to calculate threshold	**Implied class threshold**	**Impact on profits**		**Impact on surplus capital**	
		% of profitable firms that become unprofitable	**Number of firms that become unprofitable**	**% of firms whose implied levy is greater than surplus capital**	**% of firms whose implied levy is greater than 5% of surplus capital**
100%	£807m	17.6%	103	12.8%	51.5%
90%	£726m	16.4%	96	11.6%	50.3%
80%	£646m	14.4%	84	10.8%	49.1%
70%	£565m	13.0%	76	9.4%	47.5%
60%	£484m	10.6%	62	7.9%	46.2%
50%	£404m	9.2%	54	6.8%	43.9%
40%	£323m	7.0%	41	5.0%	41.4%
Current threshold	**£270m**	**5.6%**	**33**	**3.4%**	**38.3%**
30%	£242m	5.1%	30	3.1%	37.3%
Proposed threshold	**£200m**	**4.6%**	**27**	**2.8%**	**34.3%**
20%	£161m	4.1%	24	2.6%	31.3%
10%	£81m	1.5%	9	1.7%	21.7%

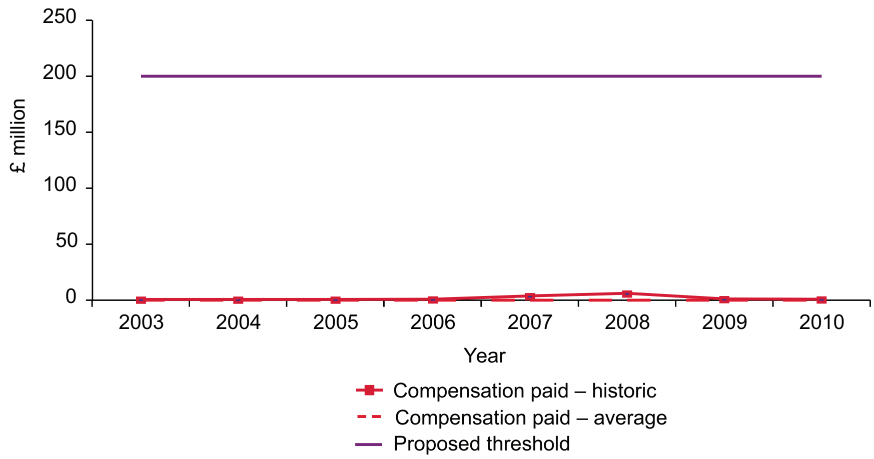
5.40 Figure 9, in turn, shows the historical FSCS payouts between 2005 and 2010. The average payout has been £1.9m, and the peak payout was £5.5m. However, in 2011, i.e. outside of the time period depicted in the table, the FSCS has received payout claims worth £21m as a result of the defaults of various firms.

5.41 It is difficult to assess the funding capacity any further, because although there is a risk of large loss in the class, it is also true that:

- the claims in respect of a fund management company's default are usually limited in scope, as the proper application of client asset rules should ensure that the financial failure of an investment firm does not give rise to an investor loss (although there is always some loss due to the costs incurred by Insolvency Practitioners when distributing client monies);

- not all of the firm's investors will be eligible for FSCS compensation; and
- FSCS compensation is limited to £50,000 per person per firm.

Figure 9: Investment Fund Management: history and average of payouts, and proposed threshold



5.42 Given the low amount of historic payouts, we recommend reducing the threshold from £270m to £200m a year. This would bring down the percentage of profits of stylised firms from the current 35% to approximately 25%.

> **Q11:** Do you agree with our proposal to set the class threshold for the Investment Fund Management class at £200m a year?

Home Finance Provision

5.43 The Home Finance provision class had originally been established for the purpose of providing cross-subsidy to the Home Finance Intermediation class if its threshold is reached. If we make the changes to the cross-subsidy rules proposed in Chapter 4, the link between provision and intermediation in a sector will be removed, ending the inclusion of Home Finance Provision in compensation cost levies.

General Insurance Intermediation

5.44 This class is made up of a range of firms, including insurance providers carrying out intermediation activities, general insurance brokers, independent financial advisers and firms that arrange insurance products as a secondary line of business to their main activity (e.g. car dealerships). Over 9,000 firms are active in this class, with almost half (43%) being only active in this class.

5.45 The segmentation criteria are based on the size of the relevant activities of the firm and distinguish between general insurance brokers and those who engage in general insurance business as a secondary activity.

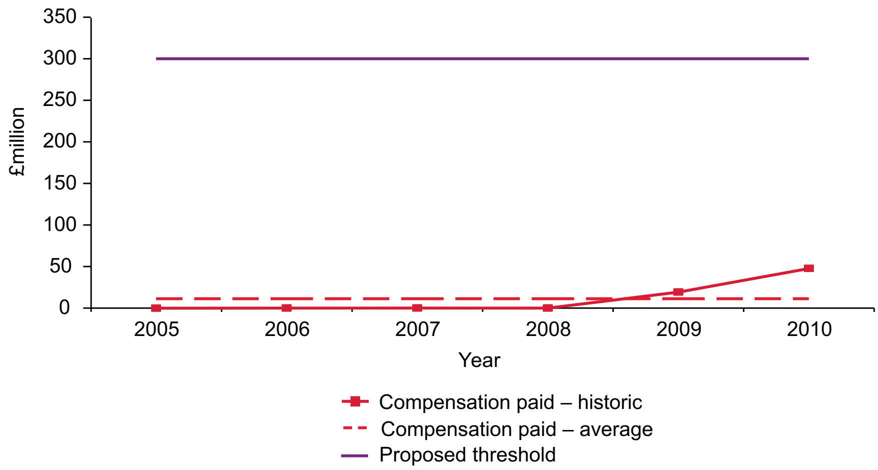
5.46 Table 7 shows the impact of the thresholds on the number of firms that would become unprofitable; capital deficient; or would require more than 5% of the capital held by the firm.

Table 7: The impact of thresholds on firms in the General Insurance Intermediation class, base case

Using stylised firms		*Impact using data for whole firm (includes all business activities)*			
% of profits of stylised firms in class used to calculate threshold	Implied class threshold	Impact on profits		Impact on surplus capital	
		% of profitable firms that become unprofitable	Number of firms that become unprofitable	% of firms whose implied levy is greater than surplus capital	% of firms whose implied levy is greater than 5% of surplus capital
90%	£1,739m	14.9%	1,276	18.2%	64.4%
80%	£1,546m	13.5%	1,154	16.5%	63.0%
70%	£1,352m	12.0%	1,025	14.8%	61.5%
60%	£1,159m	10.6%	909	13.2%	59.4%
50%	£966m	9.0%	774	11.3%	57.0%
40%	£773m	7.5%	644	9.6%	54.0%
30%	£580m	5.7%	490	7.9%	49.5%
20%	£386m	4.1%	354	5.7%	43.1%
Proposed threshold	**£300m**	**3.2%**	**281**	**5.1%**	**38.0%**
Current threshold	**£195m**	**2.1%**	**184**	**3.4%**	**31.2%**
10%	£193m	2.1%	181	3.3%	31.1%

5.47 Figure 10 shows the historical FSCS payouts between 2005 and 2010. The average payout has been £11.3m, and the peak payout was £48m.

Figure 10: General Insurance Intermediation: history and average of payouts, and proposed threshold



5.48 We see a case for increasing the current threshold in order to ensure adequate funding capacity and recommend increasing the threshold from £195m to £300m a year. This would represent approximately 15% of stylised firms' profits and would exceed the profits of 3.2% of firms.

Q12: Do you agree with our proposal to set the class threshold for the General Insurance Intermediation class at £300m a year?

Life and Pensions Intermediation

5.49 The Life and Pensions Intermediation class covers firms that provide advice or arrange long-term insurance, stakeholder, or personal pension products. As with other intermediation classes, firms active in the Life and Pensions Intermediation class range from large financial institutions and other providers to individual financial advisers.

5.50 Firms have been categorised as either being predominantly (i.e. >50%) fee or commission based, and have been segmented according to size (large, medium and small). Networks have also been identified as a separate segment.

5.51 As shown in Table 8, the current and proposed threshold of the class (£100m) is in the lower to mid-range of the percentage impact of profit of the stylised firms but much higher than 20%.

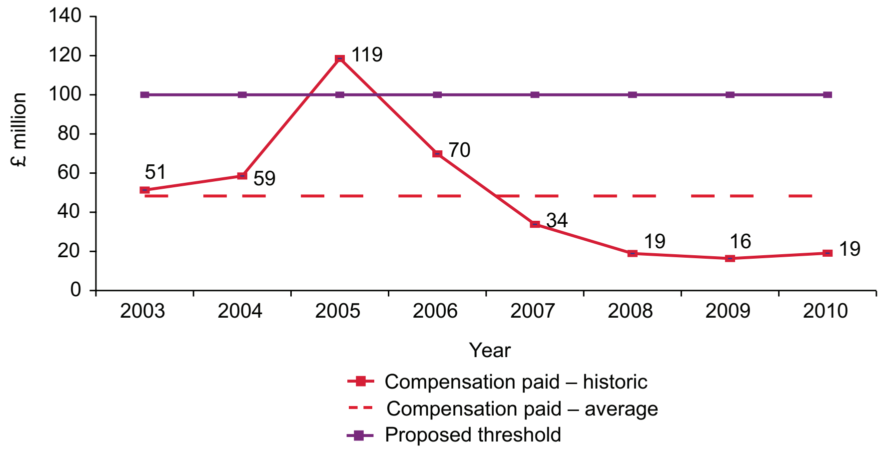
5.52 Our analysis showed that a small number of networks in this class (and all other intermediation classes) may see the levy exceed their profits. The extent to which networks are able to absorb a levy up to the threshold amount depends heavily on their ability to pass on the levy to their Appointed Representatives (ARs) as and when the levy is raised and firms are invoiced. Networks may therefore want to consider if they are able to pass these costs on, and if not, if this is an aspect of their AR contracts that they should revisit in due course.

Table 8: Impact of threshold options on firms in the Life and Pension Intermediation class, base case

Using stylised firms		*Impact using data for whole firm (includes all business activities)*			
% of profits of stylised firms in class used to calculate threshold	Implied class threshold	Impact on profits		Impact on surplus capital	
		% of profitable firms that become unprofitable	Number of firms that become unprofitable	% of firms whose implied levy is greater than surplus capital	% of firms whose implied levy is greater than 5% of surplus capital
100%	£311m	8.7%	445	10.5%	70.6%
90%	£280m	8.0%	409	9.4%	69.2%
80%	£249m	7.3%	375	8.2%	67.7%
70%	£218m	6.7%	340	7.1%	65.9%
60%	£187m	5.8%	297	5.8%	63.5%
50%	£156m	4.8%	247	4.7%	59.8%
40%	£125m	4.1%	207	3.3%	55.3%
Current & proposed thr.	**£100m**	**3.3%**	**171**	**2.8%**	**49.8%**
30%	£93m	3.2%	165	2.6%	48.2%
20%	£62m	2.4%	121	1.8%	38.4%
10%	£31m	1.0%	53	1.0%	22.0%

5.53 Figure 11, in turn, depicts the historical FSCS payouts between 2003 and 2010. The average payout has been £48m, and the peak payout was £119m.

Figure 11: Life and Pension Intermediation: history and average of payouts, and proposed threshold



5.54 Given the class and historic claims analysis, although payouts have declined in recent years, we propose to retain the current threshold going forward.

Q13: Do you agree with our proposal to set the class threshold for the Life and Pensions Intermediation class at £100m a year?

Investment Intermediation

5.55 The Investment Intermediation class covers firms that provide advice or arrange designated investment business, excluding activities that relate to long-term insurance products, stakeholder, or personal pension products. As with other intermediation classes, firms active in the Investment Intermediation class range from large financial institutions, providers, and individual financial advisers. Relatively few firms (under 7%) are active in only this class although they account for 33% of the tariff base. As with the Life and Pension Intermediation class, there are just over 2,250 firms that are active in the Investment Intermediation class and also in the other three intermediation classes.

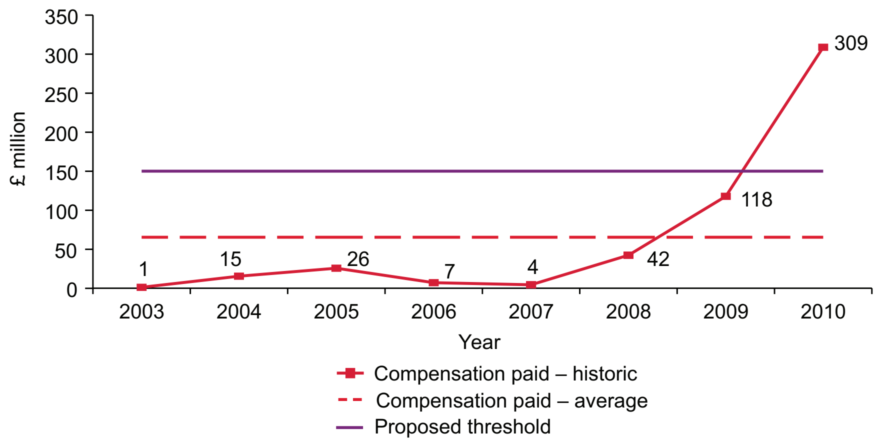
5.56 The segmentation criteria are the same as those used for the Life and Pension Intermediation class. Firms have been categorised as either being predominantly fee or commission based, and have been segmented according to size (large, medium and small). Networks have also been identified as a separate segment.

Table 9: Impact of threshold options on firms in Investment Intermediation, base case

Using stylised firms		*Impact using data for whole firm (includes all business activities)*			
% of profits of stylised firms in class used to calculate threshold	Implied class threshold	Impact on profits		Impact on surplus capital	
		% of profitable firms that become unprofitable	Number of firms that become unprofitable	% of firms whose implied levy is greater than surplus capital	% of firms whose implied levy is greater than 5% of surplus capital
100%	£626m	8.5%	432	10.4%	67.2%
90%	£564m	7.7%	393	9.3%	65.8%
80%	£501m	7.0%	355	8.1%	63.9%
70%	£438m	6.1%	312	6.5%	61.9%
60%	£376m	5.4%	275	5.4%	59.4%
50%	£313m	4.5%	229	4.2%	55.7%
40%	£251m	3.8%	191	3.4%	51.3%
30%	£188m	2.8%	142	2.3%	45.2%
Proposed threshold	**£150m**	**2.2%**	**118**	**2.0%**	**39.8%**
20%	£125m	1.8%	91	1.7%	35.7%
Current threshold	**£100m**	**1.6%**	**80**	**1.4%**	**30.7%**
10%	£63m	0.9%	46	0.9%	21.0%

5.57 Although the current threshold represents just below 20% and is therefore broadly consistent with that of most other classes, the funding capacity achieved would be limited against the historical trend. As shown in Figure 12, the existing threshold of £100m is much lower than the peak payout of £309m that occurred in 2010. Additional compensation claims are also likely to remain high.

Figure 12: FSCS payouts in Investment Intermediation: history, average, proposed threshold



5.58 We propose to increase the class threshold from £100m to £150m, which would represent approximately 25% of stylised firms' profits. If we were not constrained by affordability concerns, we would have proposed a higher threshold.

> **Q14:** Do you agree with our proposal to set the class threshold for the Investment Intermediation class at £150m?

Home Finance Intermediation

5.59 The Home Finance Intermediation class covers firms that provide advice, arrange, or make arrangements with a view to a home finance transaction. There are just over 3,900 active firms in the class, including large financial institutions and individual financial advisers, with relatively few firms (less than 3%) being active only in this class. A significant proportion of firms (over 900) are only active in this and the General Insurance Intermediation class.

5.60 The segmentation criterion used for this class is based on size as measured by the tariff base for this class. The three size bands used are consistent with those used in other intermediation classes, with the following three segments being used for our analysis of affordability: large; medium; and small.

5.61 Table 10 shows the impact of the current and proposed threshold of the Home Finance Intermediation class (£60m), which exceeds 100% of the annual profits of the stylised firms. The main driver of this result is the assumption used in developing the scenarios based on 2010/11 FSA return data, which was a challenging year for Home Finance Intermediation businesses, with an average expenditure ratio of 96% for the 'large' segment, for example. Given that the 'large' segment accounts for almost 90% of the annual eligible income in this class, this has had a significant impact on the level of thresholds constructed using the stylised firms.

Table 10: Impact of threshold options on firms, Home Finance Intermediation, base case

Using stylised firms		*Impact using data for whole firm (includes all business activities)*			
% of profits of stylised firms in class used to calculate threshold	Implied class threshold	Impact on profits		Impact on surplus capital	
		% of profitable firms that become unprofitable	Number of firms that become unprofitable	% of firms whose implied levy is greater than surplus capital	% of firms whose implied levy is greater than 5% of surplus capital
Current threshold	**60**	**1.9%**	**72**	**3.8%**	**27.0%**
100%	47	1.7%	62	3.0%	23.3%
90%	42	1.5%	56	2.9%	22.3%
Proposed threshold	**40**	**1.4%**	**51**	**2.7%**	**21.5%**
80%	37	1.3%	47	2.6%	20.8%
70%	33	1.1%	40	2.5%	19.3%
60%	28	0.9%	35	2.1%	17.5%
50%	23	0.9%	33	1.9%	15.3%
40%	19	0.7%	28	1.7%	12.8%
30%	14	0.6%	22	1.5%	10.7%
20%	9	0.4%	15	1.2%	8.1%
10%	5	0.2%	8	0.9%	4.7%

5.62 The historic FSCS payout between 2003 and 2010 has been £122,000 on average, and the peak payout was £216,000. We propose reducing the threshold from £60m to £40m.

Q15: Do you agree with our proposal to set the class threshold for the Home Finance Intermediation class at £40m a year?

6

Anticipated compensation costs: period and amount

6.1 This chapter looks at the compensation costs levy, i.e. the levy raised in order to fund compensation paid by the FSCS to eligible customers[44] of financial services firms that are declared in default. Proposals relating to the Management Expenses levy are addressed in Chapter 8.

Background

6.2 As explained in Chapter 2, our rules require the FSCS to allocate the cost of compensating eligible claims to the appropriate originating class. This class pays for the claims, up to the relevant annual threshold. So long as the amount required by the FSCS is within the annual thresholds, the FSCS can levy at any point within the year without our approval and without formal consultation.[45]

6.3 Currently, the amount the FSCS can raise as a compensation costs levy is based on the amount of compensation the FSCS has paid and an estimate of the compensation costs the FSCS expects to pay in the 12 months following the levy date.

6.4 There has been some confusion in the industry as to the levy date that the FSCS operates for the purpose of this levy. Unlike the levy period for the management expenses levy (which mirrors the FSCS financial year 1 April to 31 March), the FSCS assumes a levy date of 1 July to 30 June for the compensation costs levy.[46] This is because the FSCS does not assume the levies are raised before 1 July. We propose to make clear the compensation cost levy period in our rules.

44 Subject to the relevant eligibility criteria.

45 The FSCS maintains a regular dialogue with industry trade bodies, meeting at regular intervals throughout the year by way of information update and to expressly invite any comments ahead of key announcements made by the FSCS. There are open communication channels so that issues can be identified and discussed as necessary outside of the annual consultation timetable.

46 The FSCS has operated on this basis since it was established in 2001.

Q16: Do you agree that we should formalise in our rules the compensation costs levy period (between 1 July to 30 June each year)?

6.5 Ordinarily, the FSCS announces its anticipated annual compensation costs levy for each class when it publishes its Plan & Budget in February. The final levy amount is adjusted if necessary and confirmed in March. It is then apportioned according to the tariff data submitted by firms to determine the amounts that appear on the invoice statements sent to firms.

6.6 However, the FSCS sometimes needs to raise additional (interim) levies within that 12-month period to meet compensation costs that were not included in the cost estimate. That is not to say the FSCS did not anticipate these compensation costs at all but that it did not expect the costs to crystallise within the relevant time period or claims volumes/awards were higher than anticipated.

6.7 The FSCS can take into account a number of considerations to predict likely claims volumes and quantum. It has limited control over the timing of firm defaults and the time when compensation becomes payable. Outside the Deposits class, it is not unusual for a firm to default and the FSCS to continue paying compensation to all its eligible claimants beyond a 12-month period, particularly within the specific 12 months to 30 June (the compensation period year-end).

6.8 Within the Life and Pension and General Insurance classes, the compensation payments may be on-going because of the nature of the protected claims, but even within the Investment Fund Management and the intermediation classes, the time-span for compensation payouts can exceed 12 months. For example, Keydata was declared in default in November 2009 but the costs of compensating claims contributed to FSCS' decision to raise interim levies in March 2010, January 2011 and March 2012.[47]

6.9 At class level and firm level, there are a number of factors that can influence the time-span for compensation payouts, for example: the cause of the defaults, the nature and volume of consumer claims, complex issues requiring legal or expert advice, the availability and quality of relevant data, the level of cooperation and assistance from administrators and insolvency practitioners.

47 Not all claims to the FSCS arise immediately upon default of the firm. A number of factors contribute to speed at which claims arise, not least because not all investors will complete claims forms as quickly as others. The FSCS can only look to levy in any one year for those claims it expects to pay during the periods July to June. The phasing of compensation requirements in this case was further compounded by the fact that FSCS was unable to start considering claims in respect of the Lifemark plans until November 2010.

Extending the period over which the levy is calculated

6.10 The current 12 month period is set in our rules[48] but we now consider that this may not be appropriately aligned with the timescales over which compensation costs arise from firm failures. For this reason we propose to amend our rules so that, when setting its compensation costs levy for the separate funding classes each year, the FSCS can look to include a share of compensation costs that it can reasonably anticipate over a longer period of the subsequent three years. This proposal will apply to all classes, except for the Deposits class.

6.11 Each year, the maximum amount of anticipated compensation costs to be included in the annual levy will be, subject to the applicable annual class thresholds, the greater of:

- one-third of the three-year aggregate; or
- costs anticipated in the 12 months from the date of the levy.

6.12 For firms, the FSA and the FSCS, the fees and levy process will remain otherwise unchanged. We propose that this change should take effect from 1 April 2013.

6.13 So, for example, the FSCS may calculate that over the next three years it is reasonable to expect that the total compensation costs associated with claims originating in, for example, the Life and Pensions Intermediation class, will amount to £120m. The FSCS would therefore include £40m anticipated compensation costs in the next annual levy for that class unless more than £40m was anticipated in the 12 months following the levy.

How the FSCS calculates expected compensation costs

6.14 Currently, the FSCS follows a formal forecasting process (that is subject to internal audit) that comprises four basic components:

- anticipated claims (types, volumes and timing);
- resulting decisions (and the timing, thereof);
- likely split of decisions (uphold/reject rate); and
- likely amount of compensation.

6.15 The FSCS forms reasoned assumptions in respect of each component by taking account of, and drawing upon, a range of information sources, including (but not limited to):

- Ten years' worth of claims' experience[49] as a unitary scheme (lessons learned, trends, rolling averages and comparable cases).
- Firm-specific information (depending on the nature and immediacy of the risk this may come from the FSA, the FOS, the firm or the appointed insolvency practitioner).

48 It is through this rule that we exercise the authority given to us, under section 213 of FSMA, to grant the FSCS levy raising powers 'for the purpose of meeting its expenses (including in particular expenses incurred or expected to be incurred, in paying compensation, borrowing or ensuring risks)'. Section 213 of FSMA does not specify the time period over which these expenses should be assessed.

49 For some classes, the claims history goes back further, as the FSCS can draw upon the experience of relevant predecessor schemes.

- Indicators of thematic, product or industry risks and issues (dialogue and liaison with the FSA, the FOS and industry representatives).

6.16 The FSCS will continue to use these data sources to inform its assessment of expenses 'expected to be incurred' over the new three-year period. In addition, the FSCS is currently reviewing its horizon-scanning process to ensure it can be better prepared for failures when they happen. The review seeks to enhance the FSCS' ability to:

- identify possible future claims trends and other events that could affect FSCS in future; and
- measure the probability and impact of these events occurring.[50]

Surplus/deficit

6.17 If actual compensation costs in the year following the date of the levy turn out to be lower than was collected via the annual levy, the FSCS would continue to have the discretion that it currently has to:

- refund the surplus on a reasonable basis; or
- use the surplus to offset the expenses 'expected to be incurred' over the next three years (and thereby reduce the next annual levy).

6.18 Conversely, should actual costs in the year following the levy date exceed the annual levy raised, the FSCS will take a view as to whether or not it should:

- use other sources of funding available within the funding model, most notably cross subsidy or commercial borrowing, to provide the required liquidity until the next annual levy; or
- raise an interim levy from the originating class to cover the deficit, provided that there is sufficient capacity within the class threshold.

Benefits

6.19 We consider that this proposal can play an important role in ensuring the coherence of the funding model for the FSCS. It is consistent with our aim to strike the appropriate balance between adequacy of funding and affordability to the industry. While the proposed rule change cannot eliminate the possibility that the FSCS may need to raise interim levies in future, it may lessen the likelihood or frequency of it needing to do so. Furthermore, we believe it could deliver other benefits, such as lower volatility.

6.20 We recognise that, to date, the volatility of compensation cost levies has made it difficult for firms to anticipate the likely levy requirements in any given year. Furthermore, the 2010 and 2011 interim levies generated a significant amount of industry criticism that:

50 When the review is concluded, the FSCS expects to publish the methodology for its approach.

- firms received inadequate warning of the impending levy; and
- once raised, firms had only 30 days in which to pay.[51]

6.21 As stated in Chapter 5, the unpredictability and tight payment schedule of these levies prevents the costs to firms from being readily absorbed into their business models. This could cause many firms to consider the FSCS funding levels as unaffordable, even though thresholds are determined by reference to affordability for the class.

6.22 By taking a longer view of anticipated compensation costs, the year-to-year 'cliff edges' in levy burden may be smoothed. Furthermore, as a three-year assessment will be undertaken by the FSCS each year, industry's expectations of levy requirements might be better informed than now.

6.23 A greater degree of predictability may enable firms to make some provision for expected annual levy requirements which may, over time, give them some opportunity to adjust their pricing structure and business models.

6.24 Of course, our proposed rule change does not provide a complete solution for the funding of all possible compensation costs (in particular those attributable to the unexpected significant firm failures). It does not eliminate the possibility that the FSCS may need to raise interim levies or seek cross subsidy support from other classes in future. Nevertheless, we consider that it may reduce the likelihood or frequency of the FSCS needing to do so.

6.25 The FSCS has carefully considered how it can better forewarn the industry about likely interim levies. We do not believe that it is a process around which we can set and enforce strict criteria as the driver for an interim levy could be any (or a combination of) the factors outlined in paragraph 6.9. The amount of notice that the FSCS itself has may also be limited. The FSCS will, of course, liaise closely with relevant trade bodies as soon as practicable. The FSCS will also continue to communicate with firms, on a number of issues, through its quarterly industry publication, *Outlook*.

Why three years?

6.26 We believe that three years is most likely to deliver the expected benefits and ensure greater alignment with the typical timespan for compensation payout.

6.27 For instance, a two-year period would be too short to have any substantial smoothing effect and would not offer firms significantly more predictability or lower volatility than the current 12-month rule.

6.28 By contrast, we considered it unlikely that, using its current forecasting process, the FSCS could have a clear or reasonable expectation of the level of compensation costs it will incur beyond three years. As the FSCS can only have regard to reasonably expected costs, rather than setting the levy at a level that has sufficient capacity to cover a wide range of

51 Late payment of FSCS levies, including interim levies, attract administrative fees and interest penalties.

possibilities[52], a longer levy period could lead to frequent underestimation of the cost 'expected to be incurred'.

6.29 We concluded that a period of longer than three years was likely to reintroduce volatility into the model as it would increase the probability of the FSCS needing to utilise the additional sources of funding within the funding hierarchy.

6.30 Furthermore, on the basis of the evidence to date, we do not consider that alignment with the typical timespan of compensation payouts requires the period to be increased beyond three years.[53]

Q17: Do you have any comments on the proposal to extend the period over which expected compensation costs are assessed?

Q18: Do you agree that the proposed rule change will deliver the benefits outlined above? If not, do you have any suggestion on how they could be achieved?

52 To adopt this approach could expose firms to significantly higher annual levies than might be generated under the current rule. We do not expect that our proposal, however, should give rise to an increase in annual levy requirements, only a change in distribution.

53 Other than in the insurance classes (where claims may be paid on a long term ongoing basis), the experience of the FSCS since 2003 suggests that, on average, the time that elapses between default and the resolution of the majority of claims, does not frequently exceed three years.

7 Tariff measures

7.1 Firms pay their share of any levy requirement in proportion to their respective share of the aggregate levy base, or tariff measure, of a class. The greater a firm's business volume as measured by its share of the levy base, the greater the contribution it has to make to the levy that is being raised.

7.2 The tariff measures that apply at present are shown in Table 11. Over recent years, we have changed the tariff measures for some of the classes to improve the fairness of the allocation process. In particular, we have increasingly moved to tariff measures that reflect the amount of eligible protected business a firm undertakes so that their share of any levy is in line with the potential liability they themselves may pose to the FSCS.

Table 11: Tariff measures for FSCS classes as of 1 April 2011

Class	Tariff measure
Deposits	Protected deposits
General Insurance Provision	Relevant net premium income plus eligible portion of gross technical liabilities
Life and Pensions Provision	Relevant net premium income plus eligible portion of mathematical reserves.
Home Finance Provision	FSA periodic fee tariff measure
Investment Fund Management	Annual eligible income
General Insurance Intermediation	Annual eligible income
Life and Pensions Intermediation	Annual eligible income
Investment Intermediation	Annual eligible income
Home Finance Intermediation	Annual eligible income

7.3 In the Investment Fund Management class, for example, the levy base was changed from 'funds under management' to 'gross income' and then more recently to 'annual eligible income' (AEI). This was done because some firms argued that they had little or no eligible business and that a gross income measure required them to shoulder an unfair share of the levy burden.[54] Annual eligible income is defined as income that is 'attributable to business conducted with or for the benefit of eligible claimants and is otherwise attributable to compensatable business'. However, the definition allows firms to choose to submit all income (not just eligible income).

7.4 Similarly, the Life and Pensions and Investment Intermediation classes moved from Approved Persons as a tariff measure to AEI, aligning them with the General Insurance & Home Finance Intermediation classes. The rationale for the changes to an income-based measure was that in some of the contribution groups, the tariff measure of Approved Persons led to disproportionate results.

7.5 Although income is arguably easier to identify and administer it is also less accurate and fair because the total income of many firms includes varying amounts of non-eligible business (i.e. with customers that are not eligible to claim under the FSCS, such as institutional business). We chose to move to AEI for these classes, as it ensures that a firm's potential exposure to the FSCS compensation levy is proportionate to the potential cost to the FSCS.

7.6 Since these changes were introduced, we have been approached by firms to change the levy calculation again. Two suggestions were made in particular:

- the tariff measure itself should be replaced, either by moving back from AEI to the previous measure of gross income and/or with a 'product levy'; and
- tariff measures should be adjusted to reflect the probability that a firm exposes the FSCS to compensation payouts.

Gross income and product levies

7.7 We believe that gross income is not a desirable option as a tariff measure. Although easier to calculate, verify and administer, gross income is also less accurate and fair, as many firms may have large shares of ineligible income.

7.8 While we appreciate the industry's concerns about the interim levy in the Investment Fund Management and Intermediation classes, we believe the concerns would have been even greater if gross income had been used as a tariff measure. It would have included non-protected business and inflated the tariff measure and resultant fees for many firms. We also believe that the reporting difficulties, and the complexities involved in separating eligible from non-eligible income, should subside over time as firms build on their recent understanding of the calculation approach and the rules underpinning it. Therefore we propose to keep the tariff measure as it is.

7.9 After the FSCS raised its interim levy in January 2011, it became apparent that not all firms were adopting the same approach in relation to reporting income from collective investment schemes ('CIS'). The FSCS has published a statement that confirms how CIS

54 PS08/11 *FSCS Funding – Tariff Changes* at www.fsa.gov.uk/pubs/policy/ps08_11.pdf

income should be reported and provides information concerning the impact on tariff data submissions that have already been made.[55] If any resulting tariff data submissions have a significant redistributive effect on the class, we will consider the impact on the analysis in this CP and feed back in our Policy Statement.

7.10 This shows the need for firms to report consistently as far as possible, when determining the share of income derived from potentially eligible consumers. Some stakeholders have raised concerns that firms can gain an advantage if they spend time and resources to refine their tariff submission. We have made it clear that it is a commercial decision for firms to choose whether to either report eligible or total income. Firms should be aware that they may have to balance any benefit gained from refining their tariff data (and reducing the FSCS levies), against the increased costs of undertaking this exercise. Also, some stakeholders have suggested that it would be beneficial to automate this process within their firms, but are prohibited from doing so due to the complexities of eligibility criteria. The proposed simplification of eligibility in CP12/07 may help[56] although we need to take account of any Directive requirements when defining our eligibility criteria.

> **Q19:** Do you agree that annual eligible income remains preferable to gross income as a tariff measure for the Intermediation classes?

7.11 We are similarly unconvinced about the suggestion of replacing the tariff measure with a product levy. Product levies have been suggested by various stakeholders, particularly by independent financial advisers (IFAs), who have argued that such a measure would improve the fairness of FSCS funding and shield firms from unpredictable and rising costs. Although there may be variations, a product levy is likely to:

- be a levy attached to the transaction/sale of a product (i.e. not the product itself);
- be added to the product price and paid for by the end consumer (i.e. not the firm) at the outset (i.e. irrespective of any claims);
- produce an income stream used to build up some sort of fund; and
- set as a fixed amount (e.g. £1) or a percentage of some value (e.g. 0.01%).

7.12 The arguments that have been put forward in support of product levies include that:

- FSCS levies imposed in such transparent a way will improve consumer confidence, as the benefit obtained is made explicit;
- individuals are made aware of the costs of compensation cover; and

55 FSCS statement on reporting of annual eligible income from collective investment schemes (CIS) http://www.fscs.org.uk/industry/news/2012/june/fscs-statement-on-reporting-of-qk5f69014/index.html

56 CP12/07 *Financial Services Compensation Scheme: changes to the Compensation sourcebook* March 2012 www.fsa.gov.uk/static/pubs/cp/cp12-07.pdf

- firms are shielded from unpredictable levies.

7.13 We understand why this is considered an attractive option by many industry participants in light of recent defaults. We also accept that even though the FSCS is an industry funded model, this does not necessarily mean that consumers do not already contribute indirectly to the cost of FSCS funding[57], and that product levies would ensure greater transparency for consumers. However, there are a number of downsides to a product levy based model:

- Fairness considerations would suggest the need for risk differentiation of the various different types of products and transactions. However, it would be difficult to objectively judge how to risk-adjust the rate of levies accordingly.
- A product levy makes no differentiation between the activities of provision and intermediation, even though a significant volume of FSCS claims relate to advice given by intermediaries. Intermediaries would appear to play no role in the funding of the FSCS as the levy would be attached to the product and therefore the provider.
- Those product levies that are often cited as successful (e.g. the investor compensation fund levy in Hong Kong or the transaction fee on equity securities in the US) tend to be levies that are collected to fund the costs related to the provision of products, not to their intermediation. It is difficult to see how a comparable fee could be applied to the intermediation rather than design/provision of a product.

7.14 Furthermore, product levies of the kind outlined above are not envisaged in the legislative framework applicable in the UK:

- FSMA envisages that the compensation scheme is funded by industry, not by direct consumer contribution. This expectation is also reflected in relevant European legislation to which we must give effect through our rules.
- Product levies could be considered a form of pre-funding as levies would be raised and funds accrued irrespective of a default. As we outline in Chapter 4, however, pre-funding can only be introduced if the Treasury drafts regulations to this effect.

7.15 On balance, we are therefore not in favour of product levies and consider the existing tariff measures to be the preferred option.

Q20: Do you agree that the existing tariff measures are preferable to product levies? If not, how do you suggest the concerns expressed above could be addressed?

57 Although the extent to which cost pass through is possible varies from firm to firm, according to their business models.

Adjustments to existing tariff measures

7.16 The general principle for the tariff measures and levy bases across the classes is to relate the levy imposed on firms to the amount of potentially eligible business they undertake. The levy amount is therefore primarily calculated with reference to the size or the amount of potentially eligible business undertaken.

7.17 We have received strong representations from stakeholders that the tariff calculation should be supplemented by an adjustment that reflects how likely a firm is to give rise to claims on the FSCS and have therefore assessed the availability of reliable metrics on which such adjustments could be based in the intermediation classes and the Investment Fund Management class.

Intermediation classes

7.18 We decided to assess the suitability of potential metrics against the following criteria:

- **Reliability:** the metric must accurately reflect the probability that the FSCS is exposed to compensation claims against the firm;
- **Transparency:** the metric must bring about greater fairness in the allocation of costs in a way that is observable, comprehensible and not unduly complex;
- **Objectivity:** the metric must be based on objective data;
- **Comprehensiveness:** the metric must be based on data that is available for, and can be applied to, all firms in a class;
- **Confidentiality:** the metric must not reveal confidential information about firms;
- **Consistency:** the choice and calculation of the metric must be consistent with the metrics used by the FSA for other purposes; and
- **Cost-effectiveness:** the implementation of the metric must not incur costs that outweigh the benefits.

7.19 At present, the levies in all four intermediation classes are calculated based on annual eligible income (AEI). We considered a variety of different indicators that might be suitable to supplement the calculation of AEI, and assessed them against the above criteria.

7.20 'Reliability' was a particularly difficult criteria to satisfy because in the intermediation classes, consumers cannot raise compensation claims merely on the basis of the firm defaulting (as is the case in, say, the Deposits class), but of the firm defaulting *and* customers having a cause for a claim, such as mis-selling. The challenge in measuring the exposure of the FSCS to compensation claims was therefore to find a metric that reliably captures the probability of the *combination* of these two occurrences.

7.21 Comprehensiveness was also problematic because the intermediation classes are very large and heterogeneous: 13,300 firms participate in the General Insurance intermediation class; 6,200 firms in the Life and Pensions Intermediation class; 7,400 firms in the Investment Intermediation class; and 5,700 in the Home Finance Intermediation class. For a metric to be reliable, each of these firms would have to provide the same underlying, and standardised, set of financial data. This proved difficult because of the diverse types of firms that engage in intermediation activities – intermediaries, banks, insurance providers, stockbrokers, trustees, and many more – and the differences in financial reporting requirements that exist between them.

Number of complaints

7.22 Some stakeholders have argued that adjustments should be based on firms' reported number of complaints, because a high number of complaints should indicate a higher propensity to default and to give rise to compensation claims, which should therefore result in a mark-up in the fee calculation.

7.23 In order to test this rationale, we compared the average number of complaints for all firms in each sub-class with the average number of complaints for the firms that gave rise to the top 10 FSCS payouts in the class.[58] We were unable to identify a reliable statistical relationship. In most classes, no upward trend was discernible for the firms that defaulted. Only the firms in the General Insurance Intermediation sub-class did see surges, but they occurred in the period immediately before default. Without a recognisable upward trend well beforehand however, this would not have achieved the objective of 'making the polluter pay'.

7.24 We therefore believe that the number of complaints is an unreliable indicator for the intermediation classes. It has the further disadvantage that only a small subset (of approximately 20%) of intermediation firms actually report non-zero complaints data, with the remainder either not incurring any complaints or resolving them by the end of the next business day, which means they do not have to be reported. Finally, using this indicator may create the perverse incentive for firms to make it harder for consumers to complain.

Permission to hold client money

7.25 Representations were made to us arguing that some differentiation should be introduced between firms based on whether they can hold client money. The metric would be a binary Yes/No indicator that would command a mark-up or discount accordingly. Apparent reasons why firms should be differentiated in this way are that they might:

58 We analysed complaints data in the category 'Advising, selling, and arranging' in six monthly intervals between 2005 and 2010 to establish an indexed average of number of complaints across that period in each class. We then compared this average with the indexed number of complaints reported by a sample of firms that gave rise to the ten largest FSCS compensation payouts in these classes.

- have a greater incentive to commit fraud and 'run away' with the money, and are therefore more likely to give rise to FSCS claims (although they are of course subject to more stringent regulatory requirements); and/or
- incur larger redress claims than those not holding money (although this is arguably more an impact than a probability differentiation).

7.26 To test the rationale, we compared the percentage of active intermediation firms holding the permission with the percentage of defaulted intermediation firms holding the permission. Our analysis shows that firms with client money permissions are less likely to default than firms without the permission: 21% of intermediation firms hold client money permissions, but only 11% of defaulted intermediation firms do. This holds true for all intermediation classes.

7.27 We also compared the average value of redress paid by the FSCS for firms that hold the client money permission with the average value for firms that do not. Our analysis shows that the average value is actually lower for firms with client money permission than for those without. This is true for the General Insurance, Life and Pensions, and Home Finance Intermediation classes. Only the firms with client money permissions in the Investment Intermediation sub-class have incurred significantly higher claims against the FSCS.

7.28 We do not believe that there is sufficient evidence to justify introducing a tariff based on client money permission. While we could introduce the risk-based metric only for the Investment Intermediation class, this would introduce a difference only for this class. In addition our results are significantly affected by the default of some large client money holders so we could not be confident that this is reliable.

Permission to provide advice

7.29 We considered whether the permission to provide advice is a suitable metric. As with client money permissions, this would be a binary Yes/No indicator. The apparent reason for introducing such a metric is that firms that have the permission to give advice might be more likely to default and give rise to FSCS payouts than those that do not (e.g. execution-only brokers).

7.30 To test this, we compared the percentage of active intermediation firms that hold the permission with the percentage of defaulted intermediation firms that do. If the rationale was valid, the latter would be higher than the former. However, our analysis shows that, across the four sub classes, the share of defaulted firms is smaller (between 80 and 87%) than the share of active firms (between 97 and 100%). At any rate, we have limited statistical confidence in these figures, due to the low number of firms without the permission against which we were able to compare default performance. Therefore we are not persuaded that advice permission is a reliable indicator for the probability of firms giving rise to FSCS claims.

FSA risk scores of firms

7.31 The FSA has risk scores for the 20,000-plus firms it regulates in order to prioritise its resources.[59] The greater the risk a firm poses to the FSA and its objectives, the greater the resources the FSA tends to devote to it. This is reflected in our Advanced Risk-Responsive Operating FrameWork (i.e. ARROW scores) and more recently in the profiling of small firms. The measures are based on financial indicators as well as supervisory judgements.

7.32 We considered whether such scores and profiles would be a suitable indicator on which to base the tariff for the intermediation classes. The advantages of using such scores include the fact that they are tried and tested tools, do not require any new development effort, and use a comprehensive selection of indicators.

7.33 The downsides are significant when assessed against the criteria stated at the outset, particularly comprehensiveness and objectivity. These scores, including ARROWS, are not usually available for all of the 15,000-plus firms that participate in the intermediation classes, undermining the comprehensiveness criterion.

7.34 Further, risk scores and firm profiling involve judgements by supervisors to assist the internal prioritisation of FSA resources. They were not designed for the purpose of the accurate and fair calculation of fees.

7.35 Some of the judgements, and other information about the firm, are presently known only to the FSA and therefore not intended for public use. Both the FSA and firms are likely to have concerns if such information was accessible to the public, either explicitly or by way of comparing different levy amounts of similar sized firm.

7.36 Also, the indicators for firms' risk scores and profiles have been selected to capture the risks to FSA objectives. These are wider than the more limited risk of a firm giving rise to compensation claims against the FSCS. So, we do not believe that they are a suitable tariff measure for the intermediation classes.

7.37 We explored whether we could derive a new metric, based on an analysis of a wider set of data to derive determinants of probability. Given the uncertainty around the outcome of such a data collation exercise, we do not believe that the costs associated with additional data reporting are justified and we have discarded this option.

Number of complaints upheld by the Financial Ombubsman Service

7.38 The number of complaints made against firms and upheld by the Financial Ombudsman Service (FOS) was also considered. However, we have various concerns that we believe outweigh the benefits. The metric would suffer from the same statistical reliability problems that were set out above with regard to complaints more generally. They are likely to be worse still, given the lower number of complaints involved.

59 In the joint document published by the Bank of England and FSA, '*The Bank of England, Prudential Regulation Authority – Our approach to banking supervision*' in May 2011 it was noted that a new risk assessment framework will be developed.

7.39 Also, the FOS is an organisation that is operationally independent from us. Mechanically linking the decisions of one organisation with the decisions and judgements of another would seem inappropriate. It would also give rise to the legal challenge of 'unauthorised sub delegation' of statutory FSMA responsibilities, as the FCA's decisions on FSCS levies would be reliant on another entity's judgement. We therefore believe that the number of complaints upheld by FOS is not a suitable tariff base.

Types of products sold

7.40 Some FSCS compensation payouts can be linked to specific products that have been shown to be unsuitable for some consumers (e.g. mortgage endowments, payment protection insurance). We therefore considered whether it is suitable for FSCS levies to be based on the degree of risk posed by the type of products sold, or transactions made, in the market.

7.41 While seemingly attractive, there are several disadvantages that have led us to discard this option. First, realising any anticipated benefits from this metric would require us to assess in an objective and quantitative way the risk associated with each type of product, or group of products, throughout the life of the product. Such assessments would need to be done for thousands of products, on a continuous basis to keep up with product innovation, and as market conditions change.

7.42 Second, the degree of risk of a product varies across the population of potential customers. For example, some investments might be suitable for an experienced finance professional but very risky for a pensioner. Product risk can therefore not reliably be assessed in isolation but nearly always only in conjunction with an assessment of the characteristics of the customer to whom the product is sold.

Amount of capital held

7.43 We considered whether the amount of capital held by a firm would be a suitable indicator. Capital constitutes a buffer that is available to meet customer complaints against the firm before the FSCS has to step in to effect compensation payouts and could therefore be a suitable tariff measure.

7.44 However, the metric would ignore differences between types of firms participating in the class. Classes can include providers, intermediaries and many other types of firms, and their business models and activities are different, as are the capital requirements that apply to them.

7.45 To make the metric reliable, we would have to adjust and make consistent the capital held by the size and type of the 15,000+ firms, to a point that makes implementation impractical.

7.46 Therefore we were unable to find a metric that could reliably adjust the current tariff measure to reflect the likelihood of claims on the FSCS.

Investment Fund Management class

7.47 The same issues on potential metrics for the intermediation classes would apply to the Investment Fund Management class. The specific idea of using firms' capital held as a metric would face additional obstacles. The 1,200 firms[60] participating in the class are a very heterogeneous set of firms. Investment fund managers only account for about 45% of the class. The rest are life insurance providers, banks, pension operators, venture capital firms and others. The capital requirements to which they are subject differ significantly in complexity (BIPRU, MIPRU, Solvency II, etc.), which does not lend itself to a consistent and reliable comparison of capital held.

7.48 We were unable to find a metric that could reliably adjust the current tariff measure to reflect the likelihood of claims on the FSCS in the Investment Fund Management class.

Q21: Do you agree that the metrics considered would not reliably adjust the tariff measure to reflect the likelihood of claims on the FSCS?

Q22: If not, which metric(s) do you propose that would demonstrably meet our criteria of reliability, transparency, objectivity, comprehensiveness, confidentiality, and cost-effectiveness?

60 Of which only just over half are active – i.e. submit tariff data.

8

Management expenses

8.1 As explained earlier, the FSCS raises an annual levy to cover its operating expenses; this is known as the management expenses levy. We are required to approve this levy and do so by approving the management expenses levy limit (or MELL). The FSCS management expenses levy is made up of:

- a specific costs element – which comprises costs related to a particular default and must be paid for by the class to which the claims are allocated; and
- a base costs element – which relates to general costs of the FSCS (not dependent on the levels of claims received), such as the operating costs associated with staff salary, rent etc which is paid for by all authorised firms.

8.2 When set, the MELL also includes a reasonable level of contingency funding (generally around 10% of the total budget[61]). This covers events such as unexpected increases to claims volumes or other activities required of the FSCS. But if the approved limit set in the rules is to be exceeded then this must be formally consulted on.

8.3 This chapter looks at both what would happen at legal cutover when there will be two regulators responsible under legislation for approving the MELL, as well as proposed changes to make the MELL more efficient and transparent.

Legal cutover

8.4 Under current proposals, at legal cutover the FSCS will be accountable to both the PRA and FCA. FSMA requires that levies imposed to cover the expenses of the FSCS (i.e. the FSCS management expenses levy) are set under the rules which must then be approved by the FSA Board. After legal cutover it is expected this requirement will continue but will have to be undertaken by two regulators who both have responsibility for writing the relevant levy raising rules.

61 Since the banking crisis in 2008/09 the MELL and the contingency has been set at an increased figure of £1 billion in order to cover any increases in the interest rate applied to the FSCS banking default loans. The proposals in this chapter would see the MELL revert to its pre 2008/09 level.

8.5 We expect that the MELL will be approved in two parts to make one limit: the PRA will approve the limit for the classes and fee blocks subject to its remit; the FCA will approve the limit for its classes and fee blocks.

8.6 There would need to be a co-ordinated process between the PRA and FCA to ensure appropriate consultation on and approval of the management expenses limit. We therefore propose:

- Base costs are allocated between the expected PRA and FCA authorised firm funding classes[62] on a 50/50 basis[63] after which they will be allocated to each regulatory body's fee blocks in proportion to their regulatory cost allocation (so for example, if the FSCS base costs are estimated to be £10m then £5m will be divided between PRA classes, and £5m between FCA classes).
- Specific costs are allocated to the relevant FSCS funding class and distributed using the tariff measures relevant to those classes. This is already a feature of the rules, but each class would in future be designated as within either the PRA or FCA remit.

8.7 We believe that this would ensure that the PRA and FCA only make rules for areas for which they have oversight and responsibility.

8.8 It should be noted that a firm that undertakes activities within the remit of both the PRA and FCA will pay for a share of base costs approved by each regulator.

Q23: Do you agree that the arrangements proposed for approving the MELL post legal cutover are reasonable?

Other changes

8.9 We propose to make some further changes to improve the effectiveness and overall efficiency of the MELL.

Interest costs

8.10 The first relates to how interest costs are defined. Currently interest is treated as a specific cost. This means that interest on loans taken out by the FSCS, including the legacy cost interest payments from the 2008 banking defaults, is considered a specific cost and is part of the MELL.

62 If there are any changes to the PRA and FCA fee blocks due to legal cutover these will be taken into account as appropriate.
63 This split is broadly in line with the split of costs between the future PRA and FCA fee blocks in the past couple of years and so we feel it is appropriate.

8.11 We believe that interest costs can be considered a compensation cost as they arise as a result of funding claims and therefore should be treated as such. Also, interest costs of such a magnitude (on average £350m p.a. since the legacy costs were incurred) distort the MELL and minimise its effectiveness.

8.12 Therefore we propose to amend our rules so that interest costs are considered a compensation cost going forward. Taken with our other proposals, for instance that the Deposits class will no longer provide or receive cross-subsidy, this means that the interest costs from the 2008 banking defaults will be limited to the Deposits class as is the current position.

> **Q24:** Do you agree we should define interest as a compensation cost rather than specific cost?

What is a specific cost

8.13 Currently, specific costs relate to costs related to an actual default. An unintended effect of this is that costs which only apply to a particular class are allocated to all classes as a base cost as they do not actually relate to a default. For instance, the costs incurred by the FSCS implementing Single Customer View verification and systems improvement processes as part of the faster payout project cannot be allocated solely to deposit takers, because they are not related to a default and are instead allocated as a base cost paid for by all firms.

8.14 We propose that specific costs must only be attributable to a particular class rather than a default.

> **Q25:** Do you agree that we should make specific costs attributable to a class rather than claims in a particular class?

Thresholds

8.15 Currently, we apply thresholds to the levies that can be raised for compensation costs. However, we believe that depending on the level of claims and activities undertaken by a class, specific costs could have an impact on the levels of funding required.

8.16 Therefore we propose that the threshold that applies now to compensation costs should cover both the compensation and specific costs raised by the FSCS annually. This would be consistent with ensuring that FSCS funding has regard to affordability and sustainability and is transparent in terms of the costs it is imposing on the industry and potential impact this may have.

8.17 For the avoidance of doubt, the specific costs would still be part of the MELL approved by the PRA and FCA Boards, but any remaining funds in the class thresholds can be raised without consultation or approval by the FSCS as a compensation costs levy. It does mean that the FSCS will have fewer funds available for compensation costs but the overall limit is subject to an affordability threshold.

Q26: Do you agree that the thresholds should apply across both the compensation costs and specific costs raised by the FSCS?

9

Minor changes

9.1 Currently the FSCS can use monies levied to the credit of one class for the benefit of another for the payment of compensation costs. The FSCS will do so generally where it has reasonable grounds to believe that this would be more economical than borrowing funds from a third party or raising a levy. We propose that this capability be retained for classes within the FCA retail pool only, and that it can also be used in relation to specific costs going forward.

> **Q27:** Do you agree that it is reasonable to allow the FSCS to use monies collected for the benefit of one class within the FCA retail pool for the benefit of another in respect of specific costs where it has reasonable grounds to believe that this would be more economical than borrowing funds from a third party or raising a levy?

9.2 As a consequence of some of our changes, we also need to make some minor amendments to the Retail Mediation Activities Return (RMAR), the Dispute Resolution: Complaints sourcebook (DISP) and Compensation sourcebook (COMP). For instance, replacing the reference to sub-class to class. Also, we are updating the reference to the Bank of England's repo rate in our rules to the Bank of England official bank rate. These are minor changes with no material impact.

Annex 1

Cost benefit analysis

1. Sections 155 and 157 of the Financial Services and Markets Act (FSMA) require us to perform a cost benefit analysis (CBA) of our proposed rules and proposed guidance relating to rules, and to publish the results. The purpose of a CBA is to assess, in quantitative terms where possible and in qualitative terms where not, the economic costs and benefits of a proposed policy. Specifically, we are required to publish with the draft rules and guidance 'an estimate of the costs together with an analysis of the benefits'.

2. Some of the funding rules reviewed in this CP will not change, such as the FSCS class structure and tariff measures, and so they do not require a CBA. In this Annex we therefore focus on the proposals related to:

   - cross-subsidy;
   - class thresholds;
   - anticipated compensation costs; and
   - management expenses.

3. We note that for each proposal, costs and benefits are assessed independently from each other. Combined effects and potential inter-linkages of policy proposals are explicitly pointed out where we think they are relevant.

Baseline

4. The baseline for this CBA is the rules under which the FSCS currently operates.

Population of firms

5. The base cost-related proposals on management expenses affect all firms authorised by the FSA. The proposals on cross-subsidy, thresholds, anticipated compensation costs, as well as the specific cost-related proposals on management expenses are expected to affect the

approximately 16,000 firms that are covered by the FSCS. These firms may participate in any one or more of the nine funding classes of the FSCS, as set out in Table 12.

Table 12: Number of firms participating in the FSCS, per class[1]

Class	Number of firms
Deposit	670
General Insurance Provision	840
General Insurance Intermediation	13,170
Life and Pensions Provision	380
Life and Pensions Intermediation	6,650
Investment Fund Management	1,195
Investment Intermediation	7,600
Home Finance Provision	360
Home Finance Intermediation	5,660

6. The effects of the proposals on firms and markets are likely to vary within and across classes. Certain classes may contain firms that are operating in different markets and, vice versa, firms that operate in the same market may be allocated to different classes depending on their permissions to carry out regulated activities. Some firms are active in more than one class.

7. The benefits and costs outlined below will materialise only after a failure of a firm, and in the intermediation classes only after a firm failure in conjunction with compensation claims. The exception is the proposal on the Management Expenses Levy, the costs of which will materialise irrespective of the occurrence of defaults.

Cross-subsidy

8. Under the current funding model, in the event that the compensation costs of any of the FSCS funding classes exceeds its annual threshold other (sub) classes have to contribute. The first to be called to contribute will be the corresponding provision or intermediation class within the same broad class from which the costs originated (e.g. General Insurance Provision if the threshold in General Insurance Intermediation is reached). If the threshold of this class is reached then all the other classes will have to contribute in proportion to their size. Based on the current class thresholds the total funding available to the FSCS is just over £4bn.

1 The table states the number of participating firms for each class, which is higher than the number of 'active firms' stated in Chapter 5 when setting the class thresholds. Only the subset of these firms that reports levy data (i.e. are 'active') was used to assess the impact of the thresholds on firms.

9. The proposals in this CP will revise how cross-subsidy operates:

- There will be no cross-subsidy to or from any of the classes expected to become the PRA classes (i.e. Deposit, General Insurance Provision and Life and Pension Provision).
- Cross-subsidy will be available for the classes expected to become the FCA classes via the 'FCA retail pool' (i.e. Investment Provision, General Insurance Intermediation, Life and Pensions Intermediation, Investment Intermediation and Home Finance Intermediation). That means that if compensation costs exceed the annual threshold of an expected FCA class, the other expected FCA classes will contribute to the additional costs in proportion to their size and up to their respective thresholds.

Direct cost to regulators

10. We do not expect these changes to have any material impact on costs to the FSA[2] and the FSCS as the proposed changes will require certain procedural changes but no substantial infrastructure or systems design costs.

Costs to firms

Compliance costs

11. These changes should not give rise to any additional compliance costs for firms as they will not have to take any action to meet the new requirements.

Compensation costs

12. The proposed changes do not affect compensation costs which firms in the class that gave rise to the funding will have to pay. The proposed changes will affect the allocation of additional costs above the class threshold to the other classes when the threshold is reached.

For the classes expected to become the PRA classes

13. The classes expected to become the PRA classes will cease to benefit from the availability of funding support from other classes.[3] The FSCS will therefore need to rely on commercial borrowing facilities or access to the NLF to meet compensation costs that exceed a PRA class threshold.

2 Throughout this CBA references to costs to the FSA will refer to PRA and FCA if the proposals were to come into effect after legal cutover.

3 Based on current thresholds this would mean that £525m from the future FCA classes would not be available to the PRA classes, Also, it would mean that the funding resources of the PRA classes would also not be available between the PRA classes: Deposits £1.84bn; Life and Pensions Provision £690m; and General Insurance Provision £775m.

14. Funding from these facilities comes in the form of a loan and is potentially costly. The main cost will be the interest paid on the borrowed funds. The cost of repaying the loan will be met only from the firms in the class that gave rise to the funding need.

15. We are not able to estimate the cost of borrowing from these facilities as the cost will depend on the amount borrowed, the agreed terms of the loan and the general macroeconomic conditions.

For the classes expected to become the FCA classes

16. The first level of funding support from the corresponding provider or intermediary class within a broad class will no longer be available. Instead, costs in excess of a future FCA class threshold will be levied against the other four expected FCA classes in the FCA retail pool.

17. If cross-subsidy is needed to support, for example, the Investment Intermediation class this could result in lower costs than at present for the Investment Fund Management (Investment Provision) class as the cross-subsidy will be shared between all the FCA classes in the FCA retail pool. But all the expected FCA classes are potentially exposed earlier to cross-subsidy levies within the proposed FCA retail pool.

18. It is difficult to estimate how the changes will impact each class (or firm within the class) as it will depend on the size of the compensation cost and the composition and the size of the class. However, for illustrative purposes we present how a £500m compensation demand for the Investment Intermediation class would be distributed among the various classes, under the proposed changes to the cross-subsidy rules keeping all the other factors constant.

Table 13: Distribution of £500m compensation cost among the FSCS classes

Class	Current cross-subsidy rules	Proposed revised cross-subsidy rules	Current cross-subsidy rules	Proposed revised cross-subsidy rules
	Total		Cost per £1,000 of relevant business	
Affected class				
Investment Intermediation	£100m	£100m	£26.83	£26.83
Investment Provision (Investment Fund Management)	£270m	173m	£57.16	£36.62
General Insurance Intermediation	£7m	£125m	£0.79	£14.07
Life and Pensions intermediation	£4m	£64m	£1.32	£21.07
Home Finance Intermediation	£2.m	£38m	£1.95	£37.11
Deposits	£65m	£0m		
General Insurance Provision	£28m	£0m		
Life and Pensions Provision	£24m	£0m		
Home Finance Provision	£0m	£0m		

Note: The table shows the illustrative rates if the each class was levied in the proportions shown above based on the most recently reported tariff data submitted by firms for FSCS purposes (and used for the 2012/13 levy period). This is indicative only as the aggregate industry level tariff base varies each year so the distribution may vary.

Market impacts

19. Cross-subsidy results in the costs of the failure to be funded not just by the class in which the costs originated but also by other classes. The spreading of cost across classes might weaken the incentives of firms in the class receiving cross-subsidy to monitor the risk they accumulate, potentially distorting their risk management systems and the pricing of risk. The size of the effect would depend on how broadly the cross-subsidy is applied.

20. If cross-subsidy leads to higher compensation costs in a class, this could cause indirect impacts on markets covered by that class. How these impacts materialise will depend on the action that the firms will take to meet the higher compensation costs. Firms may pass on an increased levy to customers in the form of higher prices or absorb these costs by narrowing their margins and/or reducing product diversity and/or quality. Price increases induced by cost pass-through may impact on firms' business volumes.[4] Absorbing rising costs by narrowing margins may affect competition as it may discourage market entry and encourage exit. Any

4 The exact impact of the pass-through on the market outcome will depend on factors such as market conditions, ability for price discrimination, elasticities of supply and demand as well as possible economies of scale and scope.

effect of cost pass-through will depend on how much levies will be increased and how predictable and permanent such increases are. Alternatively, firms might decide to absorb the higher compensation cost by lowering their margins or reducing the cost by adjusting their business model and lowering their tariff base.

21. In the case of NLF funding, taxpayers will bear the cost of significant failures sooner than they would otherwise do. However, any monies borrowed would be repaid by the industry in due course.

Benefits

22. For the expected PRA classes, removing cross-subsidy is beneficial because it ensures that each class pays for the risks it carries. Confining the risk to the class in which the cost originates removes the potential for distortive effects and economically inefficient outcomes, such as over-provision of the protected activities at the expense of other more productive activities.

23. The proposed FCA retail pool aims to ensure continued and adequate funding capacity in the face of the volatile and frequent nature of the claims experienced in these classes. It consequently reduces the risk that a burden may arise for taxpayers.

24. In comparison to firms in the expected PRA classes, compensation costs arising from firms in the FCA classes are generally not related to their capital base but, where there has been a breach of a liability by the firm, they are more closely related to the volumes and values of the products they have sold. Moreover, compared to firms in the expected PRA classes, firms in the expected FCA classes fail more frequently.[5] Therefore, high compensation costs may arise that cannot be funded by the individual classes.

Thresholds

25. There is a maximum amount, or threshold, that each class can be required to pay for compensation costs each year. Table 14 provides a summary of current and proposed thresholds as well as the expected impact on firms' profitability and capital surplus.

26. The proposed thresholds were set at a level that aimed to balance the funding needs and the affordability concerns faced by each class. We asked Deloitte to carry out a detailed analysis of the affordability of the existing thresholds. The analysis has incorporated other key regulatory changes such as Basel III, Solvency II, the Retail

5 During 2010/11, the FSCS made 207 declarations of default. Though many of these firms were authorised to undertake more than one type of business,199 of these firms might reasonably be characterised as firms within the future FCA classes. 145 firms were declared in default by the FSCS in 2009/10, 137 of which are likely to have been firms within the future FCA classes.

Distribution Review (RDR) and the Mortgage Market Review (MMR) affecting firms but did not take into account potential positive effects that may arise from regulation or firms' ability to adjust their business model as a response to it. The modelling approach is summarised in Chapter 5 of this CP as well as the Deloitte report that is published alongside it. The funding needs of the class were estimated based on FSA internal analysis.

Table 14: Current and revised threshold and their expected impact on firms

Class	Current threshold	Proposed threshold	% of stylised firm profit	% of firms* whose implied levy is greater than expected profitability	No. of firms* whose implied levy is greater than expected profitability	% of firms whose implied levy is greater than 5% of surplus capital
Provision						
Deposits	£1,840m	£1,500m	45%	3.8%	18	0.4%
General Insurance	£775m	£600m	25%	3.4%	5	20.4%
Life and Pensions	£690m	£690m	<20%	11.5%	11	21.9%
Investment Provision (Fund Management)	£270m	£200m	25%	4.6%	28	34.0%
Home Finance	£70m	n/a	n/a	n/a	n/a	n/a
Intermediation						
General Insurance	£195m	£300m	<20%	3.2%	281	38.0%
Life and Pensions	£100m	£100m	>30%	3.3%	171	49.8%
Investment	£100m	£150m	25%	2.2%	118	39.8%
Home Finance	£60m	£40m	>80%	1.4%	51	21.5%

* Refers only to firms that participate in the FSCS, are active (i.e. report a levy base >0), and are profitable

Direct cost to regulators

27. We do not expect the changes to the thresholds to have any material impact on costs to the FSA and the FSCS.

Costs to firms

Compliance costs

28. It is unlikely that the proposed revision of the thresholds will give rise to any additional compliance costs for firms.

Compensation costs

29. Total compensation costs arising for firms in any given class will change for most of the classes. Chapter 5 of this CP provides a detailed discussion of how the FSA has determined the new thresholds using Deloitte's analysis.

30. The proposals would bring about higher thresholds with potentially higher total compensation costs for the General Insurance Intermediation and Investment Intermediation classes. Conversely, it is proposed to reduce the thresholds for the Deposits[6], General Insurance Provision, Investment Fund Management (Investment Provision) and Home Finance Intermediation classes. We do not propose changing the thresholds for the Life and Pension Provision or Life and Pension Intermediation classes.

31. Changes in the thresholds have no immediate impact on firms. It will only affect firms' levy contributions if the total amount of funding required exceeds the current thresholds. Firms participating in classes with higher thresholds will have to pay more than now. For the classes with lower thresholds, the cost for firms in these classes will be lower. Any costs exceeding the threshold will be transferred to other classes (in the case of the expected FCA classes) or met by external funding (in the case of the expected PRA classes).

Market impacts

32. Potential indirect impacts on the markets from increased thresholds will depend, among other factors, on the extent to which firms are able and willing to pass costs on to their customers. As explained above under the cross-subsidy proposal, firms may pass on an increased levy to customers in the form of higher prices or absorb these costs by narrowing their margins and/or reducing product diversity and/or quality. Price increases induced by cost pass-through may impact firms'

6 Although we propose to reduce the threshold in the Deposits class, the amounts that will actually be levied will be higher than in the past, as the class threshold will include any contributions that firms may have to make to build up the prefund proposed under the current draft DGSD as well as the increased repayment of the FSCS legacy cost loans from the 2008 banking failures.

business volumes.[7] Absorbing rising costs by narrowing margins may impact on competition as it may discourage market entry and encourage exit. Any effect of cost pass-through will depend on how much levies will be increased and how predictable and permanent such increases are.

33. Any potential impact will need to be assessed in the context of the trade-offs between the threshold level and the amount of money firms would have to repay in subsequent years to make up the shortfall if that threshold is reached and borrowing is needed to raise funds beyond that threshold. The lower the threshold, the more (and the more frequently) the FSCS will need to borrow and firms will have to repay in subsequent years, at an increased aggregate cost due to the additional interest that will be charged on borrowing. So a lower threshold does not necessarily represent a reduction in the total burden on firms, nor is a higher threshold synonymous with an increased burden. The funding need as such does not change; rather, the threshold level merely determines the allocation of that amount over time.

34. Additional impacts will have to be taken into account for those classes that are subject to the cross-subsidy provisions proposed in Chapter 4. In the classes for which the FCA retail pool is proposed (i.e. the intermediation and Investment Provision (Investment Fund Management) classes), a change in the thresholds could lead to a redistribution of the costs from the class responsible for the failure to the other classes, leading to net positive or negative market effects depending on the number of economic markets affected[8] and the ability of firms in each market to pass on these costs to consumers. Due to the complex dynamics of the competition environment in financial markets, we are not able to predict the direction of that impact.

35. There is a risk of firms exiting the market as a result of the incremental increase in their levy induced by the now higher threshold. Our assessment of affordability of the new thresholds has explicitly considered (based on Deloitte's analysis) the number of firms that may become unprofitable if the threshold in a class is reached (see Table 14). However, a 'firm becoming unprofitable' does not necessarily mean that they will go out of business as a result of the levy requirement.

Benefits

36. The modelling approach used to revise the thresholds will lead to a better balance of the funding needs of FSCS classes and the affordability concerns faced by each class.

7 The exact impact of the pass-through on the market outcome will depend on factors such as market conditions, ability for price discrimination, elasticities of supply and demand as well as possible economies of scale and scope.

8 FSCS classes are based on regulatory activities and not economic markets. Each class may cover more than one market and many firms participated in more than one class, based on the activities they undertake.

37. The choice of new thresholds has been informed by Deloitte's analysis, which we have used as an input in our assessment of affordability. In revising the thresholds, consideration has been given to the more complex financial and regulatory environment with the goal of clearly identifying the extent of levies impacting on firm's profitability in affected classes. Thresholds that take into account affordability for firms are also likely to minimise potential costs arising from market exits and insolvencies.

Anticipated compensation costs: amount and period

38. We are proposing to amend the approach for determining the amount of expected compensation costs that can be included in the annual FSCS compensation costs levy. The expected compensation costs that the FSCS can take into account when determining the compensation cost levy currently include those expected over one year following the date of the levy. Under the proposal, compensation costs will be estimated in a new way.

39. Each year, the amount of anticipated compensation costs to be included in the annual levy will be subject to the applicable annual class thresholds, up to the greater of:

- one third of the three year aggregate; or
- costs anticipated in the 12 months from the date of the levy.

Direct cost to regulators

40. We do not expect these changes will have any material impact on costs to the FSA.

41. To levy against a three year forecast, the FSCS would develop a detailed forecasting model to take account of the industry and external factors which contribute to defaults and compensation costs. This may cost up to £1m to develop.

Costs to firms

Compliance costs

42. The proposals should not give rise to any additional compliance costs for firms. The annual tariff data reporting process and levy raising process will remain unchanged.

Compensation costs

43. The annual compensation costs levy varies each year according to the firms that fail and the level of claims generated by those failures. Our proposal should not lead to a direct increase in compensation costs.

44. The annual compensation costs levy should not raise any affordability concerns. The levy will remain subject to the class thresholds. Moreover, the proposed change will only affect the spread of the costs of the levy requirements over time rather than bring about an additional cost to firms. The levy on firms would be greater under the proposal compared to current rules if the FSCS was to include one third of the three year anticipated costs (as this is greater than the amount required for the 12 months following the levy). However, this does not mean the firms will incur greater costs in the long term. They are costs they would incur anyway.

45. If the FSCS collects more funds than are required to meet in year costs (the 1/3 figure will be levied when this is expected to be more than is needed in the 12 months), the FSCS would continue to have the discretion that it currently has to:

- refund the surplus to firms on a reasonable basis; or
- use the surplus to offset the expenses 'expected to be incurred' over the next three years (and thereby reduce the next annual levy).

Benefits

46. By taking a longer view of anticipated compensation costs:

- the variance in levy burden from year to year may be smoothed;
- the likelihood or frequency of the FSCS needing to raise interim levies or seek additional funding from the proposed FCA retail pool should be reduced (though it does not eliminate the possibility that the FSCS may need to do so, particularly in the event of unexpected and/or significant firm failures); and
- might better inform industry's expectations of levy requirements: a greater degree of predictability may enable firms to make some provision for expected annual levy requirements (which may, over time, give them some opportunity to adjust their pricing structure and business models, though we do not know the likely scale of this effect).

47. So the proposals are likely to make financing for firms easier and lower firms' borrowing costs.

Management expenses levy limit

48. We are proposing that the Management Expenses Levy Limit (MELL) be changed in two ways:

- First, to reflect that after legal cutover the MELL will be approved in two parts under the rules: one part approved by the PRA for the classes and fee blocks expected to be subject to its remit; the other by the FCA for classes and fee block expected to be in the FCA's remit.
- Second, to improve the effectiveness and overall efficiency of the MELL we propose to classify interest costs as compensation costs, to make costs attributable to a class a specific cost rather than linking allocation to a default in a class and to apply the annual threshold to specific and compensation costs in aggregate.

Direct cost to regulators

49. We do not expect these changes to have a material impact on costs to the FSA.

Costs to firms

Compliance costs to firms

50. The proposals should not give rise to any additional compliance costs for firms. The annual tariff data reporting process and levy raising process will remain unchanged.

Compensation costs to firms

51. The FSCS levy imposed on all firms in aggregate will not change either. The impact will instead materialise in changes to the distribution and allocation of the FSCS's management expenses across firms.

52. The proposals on the approval process for the MELL post legal cutover will see a set percentage of the costs allocated between the future expected PRA and FCA classes and fee blocks. After this, costs will be allocated in line with each regulator's regulatory costs. The 50-50 percentage split of the cost will see a redistribution of some costs, but this is dependent each year on our annual funding requirement, which varies annually. The annual funding requirement of the PRA and FCA will also vary annually, and as such it is not possible to quantify the redistributive effect.

53. The change in the definition of specific costs will mean that costs currently paid for by all firms as base costs are more appropriately allocated to the class giving rise to the costs. The pattern of redistribution and increases and reduction in levies

for particular classes and firms will depend on the type of specific costs that will arise across the FSCS classes.

54. The reclassification of interest costs from specific MELL costs to compensation costs should not have an immediate impact on firms. This reclassification should mean that the MELL will reflect the costs of running the scheme and therefore increase transparency. Currently the Deposits class is the only class incurring significant borrowing costs. As they are classified as specific costs they are only incurred by the Deposits class. If the proposals in this CP go forward, borrowing costs would continue to be incurred by the Deposits class only because cross-subsidy will end for that class. For the expected FCA classes, borrowing costs could in principle be subject to cross-subsidy as they would become part of compensation costs. It will also ensure interest costs – as a cost associated with the payment of compensation – will be subject to affordability assessment and thresholds.

55. Making specific costs attributable to a particular class, rather than relying on there being a link to the claims in a particular class, will mean that class-specific costs will in future be borne by a particular class rather than the entire population of firms. The costs will be allocated to the class which has given rise to the costs, so the allocation will be fairer in the future.

Benefits

56. The changes ensure that management expenses are consistent with the potential new regulatory structure with two regulators responsible for approving a single MELL.

57. Applying the annual threshold to specific costs and compensation costs in aggregate going forward will ensure that levies, excluding those raised for base costs, are subject to affordability criteria. Although the amounts raised as specific costs are usually smaller in comparison to compensation costs we believe that this will be beneficial overall in terms of ensuring that the levies are affordable and sustainable.

Impact on Mutual Societies

58. Clause 22 of the Financial Services Bill amends the rule-making powers in the Financial Services and Markets Act, to require the Prudential Regulation Authority and the Financial Conduct Authority to provide an opinion on whether the impact of proposed rules on mutual societies is significantly different to the impact on other authorised persons. Because depending on the timing of legal cutover the rules consulted on in this paper may be made or implemented by the new regulatory bodies in 2013, this section provides the Financial Service Authority's opinion on the impact of the rules on mutuals.

59. In this CP we confirm our position that regulated activities should remain the basis on which:

- all firms, including mutuals, are allocated to funding classes; and
- compensation costs are allocated to funding classes.

60. This means that the extent to which our proposals will have an impact on any individual mutual, including any redistribution of compensation costs, will depend upon the regulated activities for which they have permission and the level of tariff data they report for these activities each year. In practice, this is no different from the impact our proposals may have on any regulated firm.

61. For example, a building society will benefit from a reduction of the class threshold in the Deposits class as will other deposit takers that are not mutuals. On the other hand, a mutual that that has permission for General Insurance Intermediation may, like other general insurance intermediaries, face higher compensation costs because it is proposed that the threshold for this class should increase.

Annex 2

Compatibility statement

1. Depending on the timing of legal cutover the provisions consulted on in this paper by the FSA may be made or implemented by the Prudential Regulation Authority and the Financial Conduct Authority in 2013 rather than the FSA. We are therefore commenting on the compatibility of our proposals both with the FSA's existing general duties and objectives, and with the draft duties and objectives of the PRA and FCA as set out in the Financial Services Bill. The current expected timetable for transition to the new regulatory bodies means our proposed rule changes would be made by the FSA. Consequently, we have met the FSA's consultation requirements as set out in FSMA, and the PRA and FCA's proposed consultation requirements, as set out in the amendments to FSMA in the Financial Services Bill. This also includes an assessment of the policy's impact on mutuals within the CBA. Should these provisions be made by the new regulators, appropriate editorial amendments would be needed to the draft provisions before their final publication.

Compatibility with the FSA's general duties

2. This section explains the reasons for concluding that our proposals are compatible with our general duties under section 2 of FSMA and our regulatory objectives, which are set out in sections 3 to 6 of FSMA. The requirement to establish a compensation scheme is set out in FSMA. This compatibility statement should be read against that legal background.

Our regulatory objectives

3. Our duty is, so far as is reasonably possible, to act in a way that is compatible with our regulatory objectives.

Consumer protection

4. The existence of a compensation scheme helps to secure protection for consumers. While this is to a large extent provided by section 213(1) of FSMA, which requires the FSA to establish a scheme to pay valid claims, the degree of protection depends on the scheme

having adequate and reliable funding arrangements that are capable of underpinning the delivery of compensation in a wide range of default scenarios. Once a decision has been made that a consumer is entitled to compensation, this should be supported by adequate funding arrangements.

5. We believe that the model described throughout the CP, in particular the class structures and arrangements for spreading costs in Chapter 4, is the best way of ensuring that the different classes of the scheme are funded to an adequate level, while limiting the exposure of particular classes. We particularly believe that the proposal for a FCA retail pool is appropriate as otherwise we would need to set much higher affordability thresholds for the FCA classes to ensure that the scheme is able to cope with potential costs. Without this, consumers may not receive the compensation they are eligible for, and this would seriously damage consumer confidence in the financial system.

Market confidence

6. Our proposals foster consumer confidence by ensuring adequate funding capacity of the scheme. At the same time, they preserve business confidence by limiting firms' exposures at a level that we consider affordable and sustainable. The existence of the compensation scheme in which consumers have confidence also helps support our market confidence objective.

Financial stability

7. Our proposals should ensure that eligible compensation claims can be funded. Our financial stability objective is particularly relevant to the Deposits class. The proposals will see an appropriately funded Deposits class that is not supported by, or required to support, any other class (i.e. no cross-subsidy). This will help ensure that risk management incentives are not blurred and minimise any economic distortions that may arise through cross-subsidy.

8. An adequately funded Deposits class will also help reduce the risk of any depositor runs as there will be certainty of repayment within the compensation limits, combined with other requirements e.g. faster payout. The Deposit class of the FSCS also helps support our financial stability objective as it can be called on to fund resolution actions taken under the Special Resolution Regime.

The reduction of financial crime

9. These proposals do not impact on the reduction of financial crime.

Compatibility with the Principles of Good Regulation

10. Section 2(3) of FSMA requires that, in carrying out our general functions, we must 'have regard' to a number of specific matters. Of these, the following matters are relevant to our proposals.

The need to use our resources in the most economic and efficient way

11. Our proposals will result in minimal costs to the FSA and the FSCS. The FSCS will incur minimal costs for the proposal to extend the period over which costs are estimated, as outlined in Chapter 6 on Anticipated Compensation Costs, which the FSCS will re-coup via its annual management expenses levy. In our view this cost is justified by the benefits the proposals will deliver to consumers in ensuring the scheme is appropriately funded as well as authorised persons as it should help smooth levy requirements for them over time.

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

12. We believe that the proposals set out in this CP have been designed to strike the right balance between the need to ensure an appropriate level of funding capacity of the scheme while limiting the exposure of particular classes of firm. We believe that by limiting burdens in this way the proposal seeks to secure benefits in a proportionate manner. A cost benefit analysis has also been carried out to support that the proposals are proportionate.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

13. Any failure on the part of the compensation scheme to make the compensation payments mandated by the scheme rules, because of inadequate funding arrangements, could cause reputational harm to the UK regulatory system, domestically and perhaps internationally.

14. We judge that the arrangements proposed or confirmed in this CP will have no or negligible negative impact on the international competitive position of the UK. This advantage will also be offset, to the extent that consumers favour firms that are covered by the scheme. It is possible that some firms might exit the market and passport back into the UK to avoid the perceived potential for higher costs arising in particular from our cross subsidy proposals. However, we believe that the extent of such exits will be limited and that the associated costs are outweighed by the benefits of our proposals.

The need to minimise adverse effects on competition and the desirability of facilitating competition between those who are subject to any form of regulation

15. So far as competition between firms in the same class is concerned, if a triggering event occurs – i.e. a need for compensation – all the firms in the same class, that is those competing directly against each other, are treated in the same way. This includes how levies are allocated to firms in the same class, and the thresholds that apply to each class. We have further tried to minimise any effects on compensation by carefully calibrating proposed class thresholds that take into account both funding need and impact of the members of each class.

16. This is particularly relevant in respect of firms that are members of classes within the FCA retail pool. In principle, any cross-subsidy in the FCA retail pool may have an adverse effect on competition, since it means that some business, or set of businesses, will not bear the full costs of its activities. However, cross-subsidy is implicit in any industry-funded compensation scheme. Bearing in mind that we regard the potential support provided by the FCA retail pool essential for adequate funding arrangements we have, as noted, sought to minimise any adverse effect on competition by proposing suitable thresholds before such cross-subsidy is triggered. This means that in normal years no such support from the FCA retail pool should be triggered.

17. In addition, costs will increase, following a default, for firms in a class. The impact on the firms in any particular class will be the same, because the thresholds have been set at affordable levels. For the scheme to be sustainable it must be affordable to its members: affordability for each class is the key determinant for the thresholds we have set.

Compatibility with the PRA's and FCA's general duties

18. This paper consults on rules which may be made or implemented by the PRA and the FCA in 2013. Accordingly, this section sets out the compatibility of these rules with the PRA and FCA's expected general duties, in line with the amendments to the Financial Services and Markets Act proposed by the Financial Services Bill.

Prudential Regulation Authority (PRA)

19. Section 138J(2)(d) of FSMA (as proposed to be amended by the Financial Services Bill) states the consultation undertaken by the PRA must include an explanation of the PRA's reasons for believing that making the proposed rules is compatible with its duties. These are considered below.

In discharging its general functions the PRA must, so far as is reasonably possible, act in a way which advances its general objective – i.e. promoting the safety and soundness of PRA authorised persons (section 2B(1) and 2B(2) FSMA as proposed to be amended by the Financial Services Bill)

20. Our proposals should ensure that eligible compensation claims can be funded. Our financial stability objective is particularly relevant to the Deposits class within the future PRA remit. The proposals will see an appropriately funded Deposits class that is not supported by, or required to support, any other class.

21. An adequately funded Deposits class will also help prevent any depositor runs as there will be certainty of repayment within compensation limits, combined with other requirements we have for depositor protection, e.g. faster payout.

22. The Deposit class of the FSCS also helps support our financial stability objective as it can be called upon to fund resolution actions taken under the Special Resolution Regime.

In discharging its general functions so far as relating to a PRA-regulated activity relating to the effecting or carrying out of contracts of insurance or PRA-authorised persons carrying on that activity, the PRA must, so far as is reasonably possible, act in a way (a) which is compatible with its general objective and its insurance objective, and (b) which the PRA considers most appropriate for the purpose of advancing those objectives (section 2C(1) and 2B(2) FSMA as proposed to be amended by the Financial Services Bill)

23. We outline above how our proposals meet the draft general objective of the PRA. The PRA also has the draft objective of securing an appropriate degree of protection for those who are or may become policyholders. Our proposals contribute to this by ensuring that there is an adequately funded compensation scheme that will be able to compensate or fund the continuity of insurance in the event of a firm failure.

In discharging its general functions, the PRA must also have regard to the regulatory principles (sections 2G and 3B FSMA as proposed to be amended by the Financial Services Bill)

24. The draft regulatory principles of the PRA are stated in section 3B of FSMA as proposed to be amended by the Financial Services Bill, and of those listed the following are relevant to our proposals:

- the need to use the resources of each regulator in the most efficient and economic way; and
- the principle that a burden or restriction that is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in

general terms, which are expected to result from the imposition of that burden or restriction.

25. We consider the statements made above continue to apply and do not intend to replicate them here.

26. Although the provision of compensation should take account of the general principle that consumers should take responsibility for their decisions, this is not directly relevant to establishing adequate funding arrangements for the scheme.

27. We consider that the principle that the regulators should exercise their functions as transparently as possible is met through our proposals. We have clear objective criteria for inclusion in classes, thresholds set by clearly defined parameters aimed at ensuring funding requirements are affordable and sustainable, and rules that will enable firms to estimate future potential levies, the actual amount of which is reliant on funding requirements.

Financial Conduct Authority (FCA)

28. Section 138I(2)(d) of FSMA as proposed to be amended by the Bill states the consultation undertaken by FCA includes an the explanation of the FCA's reasons for believing that making the proposed rules is compatible with its duties. These are considered below:

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, and (b) advances one or more of its operational objectives (section 1B(1) FSMA as proposed to be amended by the Financial Services Bill)

29. The draft strategic objective of the FCA is ensuring that the relevant markets function well. As we have already stated, the existence of a compensation scheme helps to secure protection for consumers, enabling both consumer confidence and market confidence to be maintained. Financial services firms benefit in general from such confidence. Adequate funding arrangements are central to a well-functioning scheme capable of producing these effects.

30. We consider that our proposals also help ensure that the relevant markets function well in that the proposals where possible ensure that costs are contained within the classes within which they originate.

31. The draft operational objectives of the FCA are: securing an appropriate degree of protection for consumers; protecting and enhancing the integrity of the UK financial system; and promoting effective competition in the interests of consumers.

32. We consider that the statements made under the 'Consumer Protection' heading and 'The need to minimise adverse effects on competition and the desirability of facilitating competition between those who are subject to any form of regulation' heading continue to apply. We are not replicating the text.

33. In terms of enhancing the integrity of the UK financial system, as we have mentioned above, any failure on the part of the compensation scheme to make the compensation payments mandated by the scheme rules, because of inadequate funding arrangements, could harm the UK regulatory system and have consequential impacts on the integrity of the market. Also, as mentioned, we would hope that the arrangements proposed will encourage firms to minimise incentives to blur risk management within firms and for the industry to be alert to poor practice.

In discharging its general functions the FCA must have regard to the regulatory principles (sections 1B(5)(a) FSMA as proposed to be amended by the Financial Services Bill)

34. The draft regulatory principles of the FCA are stated in section 3B of FSMA as proposed to be amended by the Financial Services Bill, and of those listed the following are relevant to our proposals:

- the need to use the resources of each regulator in the most efficient and economic way; and
- the principle that a burden or restriction that is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

35. We consider the statements made above continue to apply and are not replicating them here.

36. Although the provision of compensation should take account of the general principle that consumers should take responsibility for their decisions, this is not directly relevant to establishing adequate funding arrangements for the scheme.

37. We consider that the principle that the regulators should exercise their functions as transparently as possible is met through our proposals. We have clear objective criteria for inclusion in classes, thresholds set by clearly defined parameters aimed at ensuring funding requirements are affordable and sustainable, and rules that will enable firms to estimate future potential levies the actual amount of which is reliant on funding requirements.

Annex 3

FSCS funding classes and regulated activities

1. Please refer to Fees Sourcebook Chapter 6 Annex 3 for full rules at http://fsahandbook.info/FSA/html/handbook/FEES/6/Annex3

Class	Legal basis (i.e. regulated activities)
Deposits	*accepting deposits* and/or *operating a dormant account fund*. BUT does not include any fee payer who either effects or carries out *contracts of insurance*.
General Insurance Provision	*effecting contracts of insurance*; and/or
	carrying out contracts of insurance; and
	that are *general insurance contracts*.
General Insurance Intermediation	Any of the following in respect of *general insurance contracts*:
	dealing in investments as agent;
	arranging (bringing about) deals in investments;
	making arrangements with a view to transactions in investments;
	assisting in the administration and performance of a contract of insurance;
	advising on investments; and
	agreeing to carry on a regulated activity which is within any of the above.
Life and Pensions Provision	*effecting contracts of insurance*; and/or
	carrying out contracts of insurance; and
	that are *long-term insurance contract* (including *pure protection contracts*).

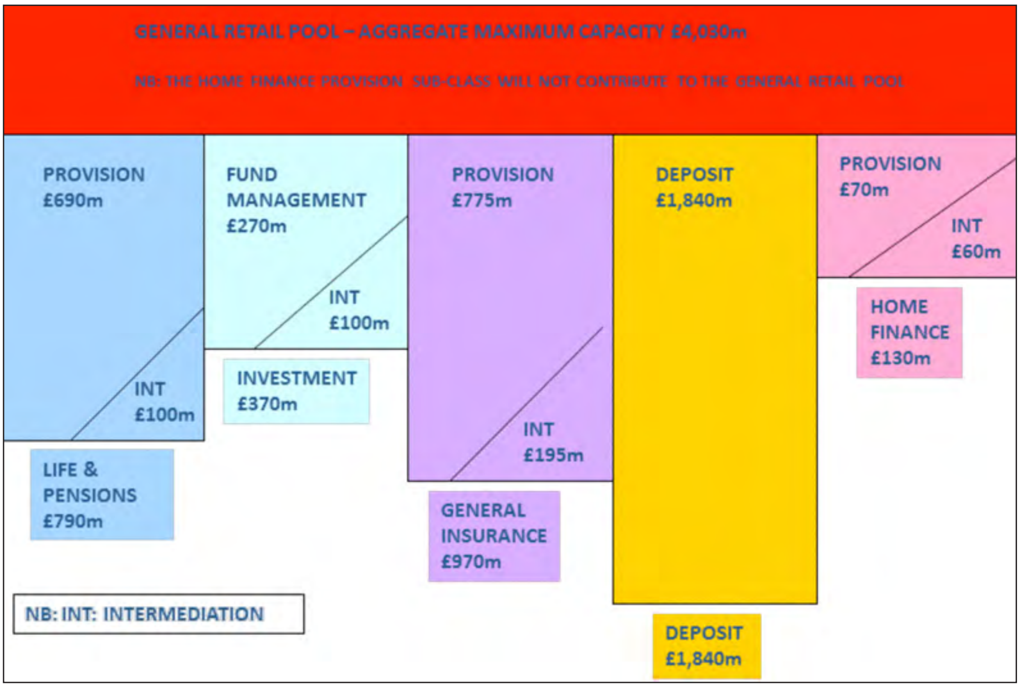
Class	Legal basis (i.e. regulated activities)
Life and Pensions Intermediation	Any of the following:
	dealing in investments as agent;
	arranging (bringing about) deals in investments;
	making arrangements with a view to transactions in investments;
	assisting in the administration and performance of a contract of insurance;
	advising on investments;
	advising on pension transfers and pension opt-outs;
	providing basic advice on a stakeholder product;
	agreeing to carry on a regulated activity which is within any of the above;
	in relation to any of the following:
	long-term insurance contracts (including *pure protection contracts*); and
	rights under a *stakeholder pension scheme* or a *personal pension scheme*.
Investment Fund Management	Any of the following:
	managing investments;
	establishing, operating or winding up a regulated collective investment scheme;
	establishing, operating or winding up an unregulated collective investment scheme;
	acting as trustee of an authorised unit trust scheme;
	acting as the depositary or sole director of an open-ended investment company;
	establishing, operating or winding up a stakeholder pension scheme;
	establishing, operating or winding up a personal pension scheme; and
	agreeing to carry on a regulated activity which is within any of the above.

Class	Legal basis (i.e. regulated activities)
Investment Intermediation	Any of the following activities in relation to *designated investment business*
	dealing in investments as principal;
	dealing in investments as agent;
	arranging (bringing about) deals in investments;
	making arrangements with a view to transactions in investments;
	advising on investments;
	providing basic advice on a stakeholder product;
	safeguarding and administering investments;
	arranging safeguarding and administering of assets;
	operating a multilateral trading facility;
	agreeing to carry on a regulated activity which is within any of the above; and
	BUT excluding activities that relate to *long-term insurance contracts* or rights under a *stakeholder pension scheme* or a *personal pension scheme*.
Home Finance Provision	Any of the activities below:
	entering into a home finance transaction;
	administering a home finance transaction; and
	agreeing to carry on a regulated activity which is within any of the above.
Home Finance Intermediation	Any of the following activities:
	arranging (bringing about) a home finance transaction;
	making arrangements with a view to a home finance transaction;
	advising on home finance transactions;
	the activities of a *home finance provider* which would be arranging but for article 28A of the *Regulated Activities Order* (Arranging contracts or plans to which the arranger is party); and
	agreeing to carry on a regulated activity which is within any of the above.

Annex 4

Diagrams of current and potential model

Current model



Potential model (proposed changes are implemented)

Annex 5

Illustrative firm levy rates with new thresholds

Class	Proposed threshold	Distribution of levy to tariff base	Tariff measure	Aggregate industry tariff base used for 2012/13 levy	Cost per £1,000 of relevant business
Deposits	£1,500m		Protected deposits	£928,088,122,694	£1.62
General Insurance Provision	£600m	£450m (75%)	Relevant net premium income	£42,627,356,464	£10.55
		£150m (25%)	Eligible portion of gross technical liabilities	£66,077,707,837	£2.27
			Total		£12.82
Life and Pensions Provision	£690m	£517.5m (75%)	Relevant net premium income	£71,056,455,691	£7.28
		£172.5m (25%)	eligible portion of mathematical reserves	£846,743,253,548	£0.20
			Total		£7.48
Investment Fund Management	£200m		Annual eligible income	£4,723,744,777	£42.34
Gen Insurance Intermediation	£300m		Annual eligible income	£8,883,506,554	£33.77
Life and Pensions Intermediation	£100m		Annual eligible income	£3,037,261,419	£32.92
Investment Intermediation	£150m		Annual eligible income	£3,726,881,083	£40.25
Home Finance Intermediation	£40m		Annual eligible income	£1,024,114,786	£39.06

The maximum cost per £1,000 is calculated by dividing the proposed threshold (i.e. the maximum potential amount that may be levied) by the aggregate industry tariff base and multiplying this figure by 1,000.

A firm can work out its indicative potential levy if they know roughly the value of their tariff base. For example if an investment fund manager has a tariff base of £5,000 then it can expect to be levied a maximum of approximately 5 * £42.34 = £211.70

A firm's share of a levy requirement will depend on the actual amount of tariff data it reports proportionate to the industry aggregate data. This will be calculated annually and invoiced by us on behalf of the FSCS.

The table shows the illustrative rates if the maximum threshold per class were levied based on the most recently reported tariff data submitted by firms for FSCS purposes (and used for the 2012/13 levy period).

The aggregate industry level tariff base varies from year so the distribution may vary.

Amounts less than the maximum potential threshold would vary depending on the amount to be levied.

Annex 6

List of questions

Chapter 3

Q1: Do you agree that we should keep 'safeguarding and administering investments' and 'arranging safeguarding and administering of assets' permissions in the current class?

Q2: Do you have any comment on our analysis of the alternative bases of allocation and class structures or any suggestions for further consideration?

Q3: Do you have any comment on our analysis or proposal to retain the current approach?

Q4: Do you agree with our proposal to rename the Investment Fund Management class the 'Investment Provision' class?

Q5: Do you agree that it is reasonable to remove the Home Finance Provision class from the funding model?

Chapter 4

Q6: Do you agree with our recommendation to end cross-subsidy from, to and between the PRA classes?

Q7: In the absence of direct funding support from the PRA classes, do you agree with our recommendation to establish an FCA retail pool?

Chapter 5

Q8: Do you agree with our proposal to set the class threshold for the Deposits class at £1.5 billion a year?

Q9: Do you agree with our proposal to set the class threshold for the General Insurance Provision class at £600m a year?

Q10: Do you agree with our proposal to set the class threshold for the Life and Pensions Provision class at £690m a year?

Q11: Do you agree with our proposal to set the class threshold for the Investment Fund Management class at £200m a year?

Q12: Do you agree with our proposal to set the class threshold for the General Insurance Intermediation class at £300m a year?

Q13: Do you agree with our proposal to set the class threshold for the Life and Pensions Intermediation class at £100m a year?

Q14: Do you agree with our proposal to set the class threshold for the Investment Intermediation class at £150m?

Q15: Do you agree with our proposal to set the class threshold for the Home Finance Intermediation class at £40m a year?

Chapter 6

Q16: Do you agree that we should formalise in our rules the compensation costs levy period (between 1 July to 30 June each year)?

Q17: Do you have any comments on the proposal to extend the period over which expected compensation costs are assessed?

Q18: Do you agree that the proposed rule change will deliver the benefits outlined above? If not, do you have any suggestion on how they could be achieved?

Chapter 7

Q19: Do you agree that annual eligible income remains preferable to gross income as a tariff measure for the Intermediation classes?

Q20: Do you agree that the existing tariff measures are preferable to product levies? If not, how do you suggest the concerns expressed above could be addressed?

Q21: Do you agree that the metrics considered would not reliably adjust the tariff measure to reflect the likelihood of claims on the FSCS?

Q22: If not, which metric(s) do you propose that would demonstrably meet our criteria of reliability, transparency, objectivity, comprehensiveness, confidentiality, and cost-effectiveness?

Chapter 8

Q23: Do you agree that the arrangements proposed for approving the MELL post legal cutover are reasonable?

Q24: Do you agree we should define interest as a compensation cost rather than specific cost?

Q25: Do you agree that we should make specific costs attributable to a class rather than claims in a particular class?

Q26: Do you agree that the thresholds should apply across both the compensation costs and specific costs raised by the FSCS?

Q27: Do you agree that it is reasonable to allow the FSCS to use monies collected for the benefit of one class within the FCA retail pool for the benefit of another in respect of specific costs where it has reasonable grounds to believe that this would be more economical than borrowing funds from a third party or raising a levy?

Appendix 1

Draft Handbook text

FINANCIAL SERVICES COMPENSATION SCHEME FUNDING REVIEW INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the powers and related provisions in:

(1) the following sections of the Financial Services and Markets Act 2000 ("the Act"):

(a) section 156 (General supplementary powers);
(b) section 157(1) (Guidance);
(c) section 213 (The compensation scheme);
(d) section 214 (General); and
(e) section 223 (Management expenses); and

(2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.

B. The rule-making powers referred to above are specified for the purposes of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 1 April 2013.

Amendments to the Handbook

D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended is amended in accordance with the Annexes to this instrument listed in column (2) below.

(1)	(2)
Glossary of definitions	Annex A
Fees manual (FEES)	Annex B
Supervision manual (SUP)	Annex C
Dispute Resolution: Complaints sourcebook (DISP)	Annex D
Compensation sourcebook (COMP)	Annex E

Citation

E. This instrument may be cited as the Financial Services Compensation Scheme Funding Review Instrument 2012.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise indicated.

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

retail pool	the pool of *classes* to which the *FSCS* allocates levies as described in *FEES* 6.5.2R, consisting of the investment provision *class*, the life and pensions intermediation *class*, the general insurance intermediation *class*, the investment intermediation *class* and the home finance intermediation *class*.

Delete the following definition.

~~*sub-class*~~	~~one of the classes of *participant firms* within a *class* set out in *FEES* 6 Annex 3 R being sub-classes that carry on business of a similar nature or have other common characteristics, to which *compensation costs* and *specific costs* are allocated in accordance with *FEES* 6.4 and *FEES* 6.5. Class A (Deposits) is to be treated as being made up of a single *sub-class*.~~

Amend the following definitions as shown.

annual eligible income	(in *FEES*) (in relation to a *firm* and a ~~*sub-*~~*class*) the annual income (as described in *FEES* 6 Annex 3R) for the *firm's* last financial year ended in the year to 31 December preceding the date for submission of the information under *FEES* 6.5.13R attributable to that ~~*sub-*~~*class*. A *firm* must calculate *annual eligible income* from such annual income in one of the following ways: …
base costs	*management expenses*~~, other than *establishment costs*,~~ which are not ~~dependent on the level of *claims* made on the *FSCS*~~ <u>attributable to any particular *class*</u>.
class	… (5) (in *FEES*) one of the ~~broad~~ classes to which *FSCS* allocates levies as described in *FEES* 6.5.7R.

compensation costs	the costs incurred: (a) in paying compensation; or ... (e) by virtue of section 61 (Sources of compensation) of the Banking Act 2009~~.~~ (including the costs of borrowing to pay such costs).
levy limit	(in *FEES*) the maximum aggregate amount of *compensation costs* and *specific costs* that may be allocated to a particular ~~*sub-class* or~~ *class* in one financial year as set out in *FEES* 6 Annex 2R.

Annex B

Amendments to the Fees manual (FEES)

In this Annex, underlining indicates new text and striking through indicates deleted text.

6 Financial Services Compensation Scheme Funding

6.1 Application

…

General structure

6.1.4 G Section 213(3)(b) of the *Act* requires the *FSA* to make *rules* to enable the *FSCS* to impose levies on *authorised persons* in order to meet its expenses. These expenses include in particular expenses incurred, or expected to be incurred, in paying compensation, borrowing or insuring risks.

6.1.4A G Section 224F of the *Act* enables the *FSA* to make *rules* to enable the *FSCS* to impose levies on *authorised persons* (or any class of *authorised persons*) in order to meet its management expenses incurred if, under Part 15A of the *Act*, it is required by HM Treasury to act in relation to *relevant schemes*. But those *rules* must provide that the *FSCS* can impose a levy only if the *FSCS* has tried its best to obtain reimbursement of those expenses from the *manager of the relevant scheme*.http://media.fsahandbook.info/Legislation/2010/2010_45.pdf

…

6.1.6 G In calculating a *compensation costs levy*, the *FSCS*:

(1) for *claims* for *protected deposits*, may include ~~anticipated~~ *compensation costs* ~~for defaults~~ expected ~~to be determined~~ in the 12-*month* period following ~~the date of the levy. The total of all *management expenses levies* attributable to a financial year will be restricted to the amount set out on an annual basis in *FEES* 6 Annex 1R.~~ 1 July in the relevant year; and

(2) for other *protected claims*, may include up to the greater of one third of the *compensation costs* expected in the 36-*month* period following 1 July in the relevant year, or the *compensation costs* expected in the 12 *months* following that date.

6.1.6A G The total of all *management expenses levies* attributable to a financial year will be restricted to the amount set out on an annual basis in *FEES* 6 Annex 1R.

6.1.7 G In order to allocate a share of the amount of *specific costs* and compensation costs to be funded by an individual *participant firm*, the funding arrangements are split into ~~five~~ eight *classes*: the ~~deposit~~ deposits *class*; the life and pensions provision *class*; the general insurance provision *class*; the investment provision *class*; the life and pensions intermediation *class*; the home finance intermediation *class*, the investment intermediation *class* and the general insurance intermediation *class*. The ~~business carried on~~ *permissions* held by a *participant firm* ~~determines~~ determine into which *class*, or *classes*, it falls.

6.1.8 G ~~Within each *class* there are one or more *sub-classes*. These relate to different types of activity carried on by *participant firms* within each *class*. Within a *class*, individual *participant firms* are allocated for funding purposes to one or more *sub-classes*, depending on their business activities. This, together with the~~ The provisions on the allocation of levies to ~~sub-~~classes up to their *levy limits*~~,~~ ~~meets~~ meet a requirement of section 213(5) of the *Act* that the *FSA*, in making rules to enable the *FSCS* to impose levies, must take account of the desirability of ensuring that the amount of the levies imposed on a particular class of *authorised person* reflects, so far as practicable, the amount of claims made, or likely to be made, in respect of that class of person. ~~The deposit *class* is made up of a single *sub-class*. This means that a reference to a *sub-class* will, unless the context otherwise requires, include a reference to the deposits *class*.~~

The management expenses levy

…

6.1.10 G A *management expenses levy* ~~under *COMP*~~ may consist of two elements. The first is a *base costs levy*, for the base costs of running the *compensation scheme* in a financial year, that is, costs which are not dependent upon the level of activity of the *compensation scheme* and which therefore are not ~~referable~~ attributable to any specific ~~default~~ *class*. …

6.1.11 G The second element of a *management expenses levy* is a *specific costs levy* for the "specific costs" of running the *compensation scheme* in a financial year. These costs ~~depend on the number of claims and types of default~~ are attributable to a *class*, and include the salaries of ~~the~~ certain staff of the *FSCS* and claims handling and legal and other professional fees ~~paid in respect of particular defaults~~. It also may include the cost of any insurance cover that *FSCS* secures against the risk of *FSCS* paying out claims above a given level in any particular ~~*sub-*~~*class* (but below the *levy limit* for that ~~*sub-*~~*class* for the year) ~~or the cost of commercial borrowing to allow *FSCS* to pay claims attributable to a particular *sub-class* in advance of the next levy. Where a *levy limit* has been reached and *FSCS* secures borrowing in order to pay claims allocated to another *sub-class* in accordance with the rules on allocation in *FEES* 6.5.2R, the costs of borrowing are attributable to the *sub-class* whose *levy limit* has been reached~~. The specific costs are allocated to the ~~sub-~~*class* which is responsible for those costs ~~under *COMP*, on the basis of the *protected claims* against that *person*~~. The *FSCS* may include in a *specific costs levy* the specific costs that the *FSCS* expects to incur (including in respect of defaults not yet declared at the date of the levy) during the financial year of the *compensation scheme* to which the levy relates. The amount that each *participant firm* pays towards the *specific costs levy* is calculated by reference to the amount of business conducted by the *firm* in each of the ~~*sub-*~~*classes* to which the *FSCS* has allocated specific costs. Each ~~*sub-*~~*class* has a separate "tariff base" for this purpose, set out in *FEES* 6 Annex 3 R. *Participant firms* may be exempt from contributing to the *specific costs levy*.

…

The compensation costs levy

6.1.14 G The *compensation costs levy* in each financial year of the *compensation scheme* is made up of the *compensation costs* which the *FSCS* has incurred and has not yet recovered from *participant firms* (less any recoveries it has made using the rights that have been assigned to it), together with<u>:</u>

(1) <u>for *claims* for *protected deposits*,</u> those *compensation costs* it expects to incur (including in respect of defaults yet to be declared) ~~over~~ <u>in</u> the 12 *months* following ~~the date of the levy~~ <u>1 July; and</u>

(2) <u>for other *protected claims*, up to the amount of:</u>

(a) <u>the *compensation costs* it expects to incur in the 12 *months* following 1 July; or, if greater</u>

(b) <u>one third of the *compensation costs* it expects to incur in the 36 *months* following 1 July (see *FEES* 6.3.1BR (Imposing management expenses and compensation costs levies)).</u>

6.1.15 G *Compensation costs* are principally the costs incurred in paying compensation. Costs incurred in securing continuity of long-term insurance<u>,</u> in safeguarding *eligible claimants* when insurers are in financial difficulties, in making payments or giving indemnities under *COMP* 11.2.3R ~~and~~<u>,</u> as a result of the *FSCS* being required by HM Treasury to make payments in connection with the exercise of the stabilisation power under Part 1 of the Banking Act 2009 <u>or in borrowing to allow the *FSCS* to pay claims attributable to a particular *class*</u> are also treated as *compensation costs*. For funding purposes, these costs are allocated by the *FSCS*, and met by *participant firms*, in the same way as *specific costs* up to relevant *levy limits* and then in accordance with the allocation provisions in *FEES* 6.5.2R. <u>Where a *levy limit* has been reached and the *FSCS* secures borrowing in order to pay claims allocated to another *class* in accordance with the rules on allocation in *FEES* 6.5.2R, the costs of borrowing are attributable to the *class* whose *levy limit* has been reached, but funded by the other *classes* in accordance with *FEES* 6.5.2R.</u>

6.1.16 G If a *participant firm* is a member of more than one ~~*sub-*~~*class* the total *compensation costs levy* and *specific costs levy* for that *firm* <u>in a particular year</u> will be the aggregate of the individual levies calculated for the firm in respect of each of thehttp://media.fsahandbook.info/Legislation/2007/2007_60.pdf ~~*sub-*~~*classes* for that year. Each ~~*sub-*~~*class* has a *levy limit* which is the maximum amount of *compensation costs* and *specific costs* which may be allocated to a particular ~~*sub-*~~*class* in a financial year for the purposes of a levy. Once the ~~costs~~ *compensation costs* levied in a particular year attributable to a particular ~~*sub-*~~*class* in the *retail pool* have exceeded the *levy limit* the excess ~~costs are~~ amount is allocated to the other ~~*sub-class*~~ *classes* in the ~~same *class*, up to the *levy limit* of that other *sub-class*, and thereafter allocated to a 'general retail pool' of all the other *sub-classes* whose *levy limits* have not been reached (with the exception of the home finance providers)~~ *retail pool* up to the *levy limit* of each such *class*. The amount of the excess ~~cost~~ *compensation costs* to be allocated to each particular ~~*sub-*~~*class* in the ~~general retail pool~~ *retail pool* is calculated pro-rata in accordance with the relative size of the *levy limit* of that ~~*sub-*~~*class* to the sum of the *levy limits* of the remainder of the ~~*sub-*~~*classes* in the ~~general retail pool~~ *retail pool* whose *levy limits* have not been reached. ~~In the case of the deposits *class*, once the costs attributable to that class have exceeded the *levy limit* the excess costs are allocated to the general retail pool.~~ The use made by *FSCS* of borrowing facilities to provide liquidity until the next levy does not affect this allocation of costs.

6.1.16A G *FSCS* may consider obtaining insurance cover, if available, against the risk that the value of claims *FSCS* pays out exceeds the *levy limits* of, or given levels within, particular *classes* ~~or *sub-classes*~~. Any costs associated with the insurance would be allocated proportionally to the *classes* ~~or *sub-classes*~~ intended to benefit from that insurance.

Incoming EEA firms

6.1.17 G *Incoming EEA firms* which obtain cover or 'top up' under the provisions of *COMP* 14 are firms whose *Home State* scheme provides no or limited compensation cover in the event that they are determined to be in default. Under *FEES* 6.6, the *FSCS* is required to consider whether *incoming EEA firms* should receive a discount on the amount that they would otherwise pay as their share of the levy, to take account of the availability of their *Home State* cover. The amount of any discount is recoverable from the other members of the *incoming EEA firm's* ~~sub-~~class.

…

6.3 The FSCS's power to impose levies

~~General limits on levies~~ Imposing management expenses and compensation costs levies

6.3.1 R The *FSCS* may at any time impose a *management expenses levy*~~,~~ or a *compensation costs levy* ~~or a *MERS* levy~~, provided that the *FSCS* has reasonable grounds for believing that the funds available to it to meet relevant expenses are, or will be, insufficient, taking into account expenditure already incurred, expected recoveries and:

(1) in the case of a *management expenses levy*, the level of the *FSCS's* ~~anticipated~~ expected expenditure in respect of those expenses in the financial year of the *compensation scheme* in relation to which the levy is imposed; ~~and~~

(2) in the case of a *compensation costs levy* relating to *claims* for *protected deposits*, the level of the *FSCS's* ~~anticipated~~ expected expenditure in respect of *compensation costs* in the 12 *months* ~~immediately~~ following ~~the levy~~ 1 July; and

(3) in the case of a *compensation costs levy* relating to other *protected claims*,

   (a) the *FSCS's* expenditure in respect of *compensation costs* expected in the 12 *months* following 1 July; or, if greater

   (b) one third of the *FSCS's* expenditure in respect of *compensation costs* expected in the 36 *months* following 1 July.

6.3.1A R A *compensation costs levy* must relate to the period 1 July to 30 June in the year in which it is levied.

6.3.1B G The FSCS will usually levy once in each period between 1 July and 30 June. However, if in any year the *compensation costs* or *specific costs* incurred, or reasonably expected to be incurred, in that year for a class of *protected claim* exceed the amounts held, or reasonably expected to be held, to meet those costs, the *FSCS* may, at any time during that period, to meet those costs, do one or more of the following:

(1) impose an interim *compensation costs levy* or *management expenses levy*;

(2) utilise other sources of funding such as commercial borrowing or other borrowing including from the National Loans Fund; or

(3) (in respect of *compensation costs*) utilise money collected from *firms* within the *retail pool* as set out in, and subject to, *FEES* 6.3.15R (Management of funds).

Imposing a MERS levy

6.3.1C R The *FSCS* may at any time impose a *MERS levy* provided that the *FSCS* has reasonable grounds for believing that the funds available to it to meet relevant expenses are or will be insufficient, taking into account relevant expenses incurred or expected to be incurred in the 12 *months* following the date of the levy.

…

Limits on compensation costs and specific costs levies on ~~sub-classes and~~ classes

6.3.5 R The maximum <u>aggregate</u> amount of *compensation costs* <u>and *specific costs*</u> for which the *FSCS* can levy each ~~*sub-class* and~~ *class* in any one financial year of the *compensation scheme* is limited to the amounts set out in the table in *FEES* 6 Annex 2R.

…

Management of funds

6.3.11 R The *FSCS* must hold any amount collected from a *specific costs levy* or *compensation costs levy* to the credit of the *classes* ~~and relevant *sub-classes*~~, in accordance with the allocation established under *FEES* 6.4.6R and *FEES* 6.5.2R.

…

6.3.13 R Interest earned by the *FSCS* in the management of funds held to the credit of a ~~*sub-*~~*class* must be credited to that ~~*sub-*~~*class*, and must be set off against the *management expenses* or *compensation costs* allocated to that ~~*sub-*~~*class*.

6.3.14 R The *FSCS* must keep accounts which ~~show~~ <u>include</u>:

(1) the funds held to the credit of each *class* ~~and relevant *sub-class*~~; and

(2) the liabilities of that *class* ~~and relevant *sub-class*~~.

6.3.15 R ~~The *FSCS* may use the money collected from *firms* within one *class* to pay *compensation costs* in respect of any *sub-class* within that *class* so long as it ensures that this is done without prejudice to the *participant firms* from whom the money has been collected.~~ [deleted]

6.3.15A G ~~*FEES* 6.3.15R deals with how the *FSCS* may use money available to it and does not affect the *rules* on allocation in *FEES* 6.5.2R. Therefore the requirement that the procedure in *FEES* 6.3.15R should not prejudice the *participant firms* does not apply to an allocation under *FEES* 6.5.2R.~~ [deleted]

6.3.16 G ~~*FEES* 6.3.15R means that, for example:~~

(1) ~~when crediting interest under *FEES* 6.3.13 R, the *FSCS* should regard any money collected from one *sub-class* which has been used to pay the compensation costs of another *sub-class* within the same *class* as standing to the credit of the first *sub-class*;~~

(2) ~~the *FSCS* should not raise a levy under *FEES* 6.3.1R on a *sub-class* solely because, as a result of the *FSCS's* action under *FEES* 6.3.15R, there appear to be insufficient funds available to the credit of the *sub-class* to meet its expenses; and~~

(3) ~~(2) would not be applicable to the extent that the funds used are in~~

~~respect of costs allocated to the *sub-class* in accordance with the *rules* on allocation in *FEES* 6.5.2 R(1) and (2).~~ [deleted]

6.3.17 R (1) The *FSCS* may use any money held to the credit of one *class* within the *retail pool* (the creditor *class*) to pay ~~compensation costs~~ *compensation costs* or *specific costs* in respect of or allocated to another *class* within the *retail pool* http://media.fsahandbook.info/Legislation/2007/2007_60.pdf(the debtor *class*) if the *FSCS* has reasonable grounds to believe that this would be more economical than borrowing funds from a third party or raising a levy.

(2) Where the *FSCS* acts in accordance with (1), it must ensure that:

…

(c) the amount lent by the creditor *class* to the debtor *class* is taken into account by the *FSCS* when considering whether to impose a ~~compensation costs levy~~ *compensation costs levy* on the creditor *class* under *FEES* 6.3.1R.

…

6.3.19 R Unless *FEES* 6.3.20R applies, any recoveries made by the *FSCS* in relation to *protected claims* must be credited to the ~~*sub-*~~*classes* to which the related *compensation costs* were allocated.

6.3.20 R (1) ~~This *rule* applies where~~ Where the *FSCS* makes recoveries in relation to *protected claims* where related *compensation costs* would have been met by a ~~*sub-*~~*class* (~~sub-~~class A) had the *levy limit* for ~~sub-~~class A not been reached and have therefore been met by another ~~*sub-*~~*class* or ~~*sub-*~~*classes* in the *retail pool*, the recoveries must be applied:

(a) first, to the *classes* to which the costs were allocated in accordance with *FEES* 6.5.2R in the same proportion as those *classes* contributed, up to the total amount of that allocation plus interest at a rate equivalent to the Bank of England's Official Bank Rate from time to time in force; and

(b) thereafter, to class A.

(2) This *rule* applies even though the recovery is made in a subsequent financial year.

(3) ~~Recoveries referred to in (1) must be applied in the following order of priority:~~

~~(a)~~ ~~(if the *compensation costs* were allocated to the general retail pool (see *FEES* 6.5.2 R(2)) to the *classes* and *sub-classes* to which the costs were allocated in accordance *FEES* 6.5.2 R(2) in the same proportion as those *classes* and respective *sub-*~~

~~*classes* contributed, up to the total amount of that allocation plus interest at a rate equivalent to the Bank of England's repo rate from time to time in force;~~

~~(b)~~ ~~(if the *compensation costs* were allocated to the other *sub-class* in the same *class* as sub-class A) to that other *sub-class* up to the total amount of that allocation plus interest at a rate equivalent to the Bank of England's repo rate from time to time in force; and~~

~~(c)~~ ~~sub-class A.~~ [deleted]

…

6.3.21 R If the *FSCS* has more funds to the credit of a ~~*sub-*~~*class* than the *FSCS* believes will be required to meet levies on that ~~*sub-*~~*class* for the next 12 *months* it may refund the surplus to members or former members of the ~~*sub-*~~*class* on any reasonable basis.http://media.fsahandbook.info/Legislation/2007/2007_60.pdfhttp://media.fsahandbook.info/Legislation/2007/2007_60.pdf

…

Firms acquiring businesses from other firms

6.3.22C R (1) This *rule* applies to the calculation of the levies of a *firm* (A) if:

(a) either:

(i) A acquires all or a part of the business of another *firm* (B), whether by merger, acquisition of goodwill or otherwise; or

(ii) A became authorised as a result of B's simple change of legal status (as defined in *FEES* 3 Annex 1 R Part 6);

(b) B is no longer liable to pay a levy; and

(c) that acquisition or change takes place after the date to which, or as of which, A's most recent statement of business under *FEES* 6.5.13R is drawn up so far as concerns the ~~*sub-*~~*classes* covered by B's business.

(2) A must pay an additional amount equal to the levy that would have been payable by B in relation to the relevant business and relevant ~~*sub-*~~*classes* if the acquisition or change in status had not taken place and B had remained liable to pay levies. The amount is based on the most recent information supplied by B under *FEES* 6.5.13R. A is included in the ~~*sub-*~~*classes* applicable to the relevant business.

…

…

6.4 Management expenses

…

Base costs levy

6.4.5 R ~~Unless~~ Subject to *FEES* 6.3.22R ~~applies~~, the *FSCS* must calculate a *participant firm's* share of a *base costs levy* by:

(1) identifying the *base costs* which the *FSCS* has incurred, or expects to incur, in the relevant financial year of the *compensation scheme*, but has not yet levied~~.~~ and:

(a) allocating 50% of those *base costs* as the sum to be levied on participants in activity groups A.1, A.3, A.4, A.5 and A.6 (as listed in *FEES* 4 Annex 1R); and

(b) allocating 50% of those *base costs* as the sum to be levied on participants in all the activity groups listed in *FEES* 4 Annex 1R;

(2) calculating the amount of the *participant firm's regulatory costs* as a proportion of the total *regulatory costs* relating to all *participant firms* for the relevant financial year~~; and~~:

(a) if the *participant firm* belongs to any of the activity groups in (1) (a), imposed by the *FSA* in respect of those groups; and

(b) if the *participant firm* belongs to any of the activity groups in (1) (b), imposed by the imposed by the *FSA* in respect of those groups; and

(3) applying the proportion calculated in (2)(a) (if any) to the ~~figure~~ sum in (1)(a), and the proportion calculated in (2)(b) (if any) to the sum in (1) (b).

6.4.5A G The effect of *FEES* 6.4.5R is that if a *participant firm* belongs to activity groups in both (1)(a) and (1) (b) of that *rule*, it will be required to pay a share of the *base costs levy* in respect of both sets of activity groups.

Specific costs levy

6.4.6 R The *FSCS* must allocate any *specific costs levy* amongst the relevant ~~*sub-*~~*classes* in proportion to the amount of relevant costs ~~arising from, or expected to arise from, claims in respect of~~ attributable to the different activities represented by those ~~*sub-*~~*classes*.

6.4.7 R The *FSCS* must calculate a *participant firm's* share of a *specific costs levy* (subject to *FEES* 6.3.22R (Adjustments to calculation of levy shares) by:

(1) identifying each of the relevant ~~*sub-*~~*classes* to which the *participant firm* belongs, using the statement of business most recently supplied

under *FEES* 6.5.13R;

(2) identifying the *management expenses* other than *base costs* which the *FSCS* has incurred, or expects to incur, in the relevant financial year of the *compensation scheme*, allocated to the ~~*sub-*~~*classes* identified in (1), but not yet levied;

(3) calculating, in relation to each relevant ~~*sub-*~~*class*, the *participant firm's* tariff base as a proportion of the total tariff base of all *participant firms* in the ~~*sub-*~~*class*, using the statement of business most recently supplied under *FEES* 6.5.13R;

(4) applying the proportion calculated in (3) to the figure in (2); and

(5) if more than one *class* ~~or *sub-class*~~ is relevant, adding together the figure in (4) for each ~~*sub-*~~*class*.

…

6.4.10A R (1) This *rule* deals with the calculation of:

…

(c) the tariff base for the ~~*class* or *sub-classes*~~ *classes* that relate to the relevant *permissions* or extensions, as the case may be.

…

…

6.5 Compensation costs

6.5.1 R ~~The *compensation costs levy* is made up of *compensation costs* incurred by the *FSCS*, together with any *compensation costs* expected to be incurred in the 12 *months* following the levy date, and which in each case have not already been subject to a levy.~~ [deleted]

6.5.2 R The *FSCS* must allocate any *compensation costs levy* ~~to the *sub-classes* in proportion to the amount of *compensation costs* arising from, or expected to arise from, claims in respect of the different activities represented by those *sub-classes* up to the *levy limit* of each relevant *sub-class* and thereafter in the following order~~:

(1) ~~any excess must be allocated to the other *sub-class* in the same *class* up to the *levy limit* of that other *sub-class* (except in the deposit *class*, for which there is only one *sub-class*); and any excess must be allocated to the other *sub-class* in the same class up to the levy limit of that other *sub-class* (except in the deposit *class*, for which there is only one *sub-class*)~~ first, to the *classes* in proportion to the amount of *compensation costs* arising from, or expected to arise from, claims in respect of the different activities represented by those *classes* up

to the *levy limit* of each relevant *class*; and

(2) ~~any excess above the *levy limit* of the *class* must be allocated to each other *sub-class*, other than the home finance provision *sub-class* E1, whose *levy limit* has not been reached (the 'general retail pool'), in proportion to the relative sizes of the *levy limits* of those remaining *sub-classes* in the general retail pool~~ thereafter, where the *levy limit* of a *class* in the *retail pool* has been reached, to each other *class* in the *retail pool* whose *levy limit* has not been reached, in proportion to the relative sizes of the *levy limits* of those remaining *classes* in the *retail pool*.

…

6.5.2B G The calculation of the relative sizes of the *levy limits* for the purpose of *FEES* 6.5.2R(2) ~~(including any allocations caused by the exhaustion of a receiving sub-class)~~ is based on the original *levy limit* for the ~~*sub-*~~*classes* (as set out in *FEES* 6 Annex 2R) and not the remaining capacity in each ~~*sub-*~~*class*. This also applies to any allocations still required after the exhaustion of a *class* to which any excess has been allocated (a 'receiving class').

6.5.2C G When *FSCS* allocates excess *compensation costs levies* otherwise attributable to a *class* which has reached its *levy limit*, in accordance with *FEES* 6.5.2R(2), a ~~*sub-class* to which any excess has been allocated (the '~~receiving ~~sub-~~class~~')~~ may, as a result of that allocation, itself reach its *levy limit*. In that case, the effect of *FEES* 6.5.2R is that any resulting excess levy beyond the *levy limit* of the receiving ~~sub-~~class is to be allocated amongst the remaining ~~*sub-*~~*classes* whose *levy limits* have not been reached, to the exclusion of the receiving ~~sub-~~class. This process is repeated until the *compensation costs levy* has been met in full or the ~~general retail pool~~ *retail pool* has been exhausted.

6.5.3 R If a *participant firm* which is *in default* has carried on a *regulated activity* other than in accordance with a *permission*, the *FSCS* must allocate any *compensation costs* or *specific costs* arising out of that activity to the relevant ~~*sub-*~~*class* which covers that activity or if a *levy limit* of the relevant ~~*sub-class* or~~ *class* has been exceeded, *FSCS* must allocate any *compensation costs levy* on the same basis as set out in *FEES* 6.5.2R.

6.5.4 R If the relevant *person* in default is an *appointed representative*, the *FSCS* must allocate any *compensation costs* or *specific costs* arising out of a *regulated activity* for which his *principal* has not accepted responsibility to the relevant ~~*sub-*~~*class* for that activity or if a *levy limit* of the relevant ~~*sub-class* or~~ *class* has been exceeded, *FSCS* must allocate any *compensation costs levy* on the same basis as set out in *FEES* 6.5.2R.

6.5.5 R (1) …

(2) If a levy relates solely to costs allocated in excess of a particular *levy limit* (1) does not apply to a *participant firm* member of the ~~*sub-class*~~

~~or~~ *class* whose *levy limit* has been exceeded.

6.5.6 R The *FSCS* must calculate each *participant firm's* share of a *compensation costs levy* (subject to *FEES* 6.3.22R (Adjustments to calculation of levy shares)) by:

(1) identifying each of the ~~*sub-*~~*classes* to which each *participant firm* belongs, using the statement of business most recently supplied under *FEES* 6.5.13R(1);

(2) identifying the *compensation costs* falling within *FEES* 6.5.1R allocated, in accordance with *FEES* 6.5.2R, to the ~~*sub-*~~*classes* identified in (1);

(3) calculating, in relation to each relevant ~~*sub-*~~*class*, the *participant firm's* tariff base as a proportion of the total tariff base of all *participant firms* in the ~~*sub-*~~*class*, using the statement of business most recently supplied under *FEES* 6.5.13R;

(4) applying the proportion calculated in (3) to the figure in (2); and

(5) if more than one *class* ~~or *sub-class*~~ is relevant, adding together the figure in (4) for each ~~*sub-*~~*class*.

~~Sub-classes~~ <u>Classes</u> and tariff bases for compensation cost levies and specific costs levies

6.5.7 R When calculating a *participant firm's* share of a *compensation costs levy* or *specific costs levy* allocated to each ~~*sub-*~~*class* the *FSCS* must use the ~~*sub-*~~*classes* and tariff bases as set out in the table in *FEES* 6 Annex 3R.

…

…

Membership of several classes ~~or sub-classes~~

…

6.5.12 G A *participant firm* may belong to more than one *class*~~, and more than one *sub-class* within the same *class*~~.

Reporting requirements

6.5.13 R (1) Unless exempt under *FEES* 6.2.1R, a *participant firm* must provide the *FSCS* by the end of February each year (or, if it has become a *participant firm* part way through the financial year, by the date requested by the *FSA*) with a statement of:

(a) ~~*sub-*~~*classes* to which it belongs; and

(b) the total amount of business (measured in accordance with the appropriate tariff base or tariff bases) which it conducted, in respect of the most recent valuation period (as specified by *FEES* 6 Annex 3R (Financial Services Compensation Scheme - classes ~~and sub-classes~~)) ending before the relevant year in relation to each of those ~~*sub-*~~*classes*.

…

(3) ~~This *rule* does not apply in relation to the home finance provision *sub-class* E1. Therefore any reference in the *Handbook* to information that is or must be supplied under this *rule* must be read, in the case of *sub-class* E1, as if it referred to the corresponding provisions relating to *FSA* periodic fees.~~ [deleted]

6.5.13A G For example, when the tariff base for a particular ~~*sub-*~~*class* is based on a *firm's annual eligible income* the valuation period for that ~~*sub-*~~*class* is the *firm's* last financial year ending in the year to 31 December preceding the financial year of the *FSCS* for which the calculation is being made. In the case of a *firm* in ~~*sub-*~~*class* A1 (Deposits) its valuation period will be 31 December.

…

6.7 Payment of levies

…

6.7.6 R If a *firm* ceases to be a *participant firm* or carry out activities within one or more ~~*sub-*~~*classes* part way through a financial year of the *compensation scheme*:

…

(2) the *FSCS* may make one or more levies upon it (which may be before or after the firm has ceased to be a *participant firm* or carry out activities within one or more ~~*sub-*~~*classes*, but must be before it ceases to be an *authorised person*) for the costs which it would have been liable to pay had the *FSCS* made a levy on all *participant firms* or firms carrying out activities within that ~~*sub-*~~*class* in the financial year it ceased to be a *participant firm* or carry out activities within that ~~*sub-*~~*class*.

…

…

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 2012 to 31 March 2013	£1,000,000,000
1 April 2013 to 31 March 2014	£[*insert figure*]

…

6 Annex 2 R Financial Services Compensation Scheme – annual levy limits

This table belongs to FEES 6.3.5R and FEES TP 2.5.2R		
~~Class~~	~~Sub-class~~	~~Levy Limit (£ million)~~
~~Deposit~~		
	~~Deposit~~	~~1,840~~
~~Life and Pensions~~		
	~~Life and Pensions Provision~~	~~690~~
	~~Life and Pensions Intermediation~~	~~100~~
~~General insurance~~		
	~~General Insurance Provision~~	~~775~~
	~~General Insurance Intermediation~~	~~195~~
~~Investment~~		
	~~Fund management~~	~~270~~
	~~Investment Intermediation~~	~~100~~
~~Home Finance~~		
	~~Home Finance Provision~~	~~70~~
	~~Home Finance Intermediation~~	~~60~~

Class	Levy Limit (£ million)
A: Deposits	1,500
B1: General insurance provision	600
B2: General insurance intermediation	300
C1: Life and pensions provision	690
C2: Life and pensions intermediation	100
D1: Investment provision	200
D2: Investment intermediation	150
E2: Home finance intermediation	40

6 Annex 3R **Financial Services Compensation Scheme - classes ~~and sub-classes~~**

This table belongs to FEES 6.5.7 R ~~and FEES TP 2.5.2R~~

Class A	**~~Deposit~~ Deposits**
Legal basis for activity in class A	…
…	

~~Class B~~	**General Insurance**
~~Sub-class~~ Class B1	General Insurance Provision
Legal basis for activity in ~~sub-class~~ Class B1	…

~~Sub-class~~ Class B2	General Insurance Intermediation
Legal basis for activity in ~~sub-class~~ Class B2	…
Tariff base	~~Sub-class~~ Class B1:…
	~~Sub-class~~ Class B2: *annual eligible income* where *annual eligible income* means annual income adjusted in accordance with this table. Annual income is calculated as the sum of (a) and (b): (a) the net amount retained by the *firm* of all brokerages, fees, commissions and other related income (for example, administration charges, overriders and profit shares) due to the *firm* in respect of or in relation to *~~sub-~~class* B2 activities, including any income received from an *insurer*; and (b) if the *firm* is an *insurer*, in relation to *~~sub-~~class* B2 activities, the amount of *premiums* receivable on its *contracts of insurance* multiplied by 0.07, excluding those *contracts of insurance* which result from *~~sub-~~class* B2 activities carried out by another *firm*, where a payment has been made by the *insurer* to that other *firm* and that payment is of a type that falls under (a). Notes relating to the calculation of the tariff base for ~~sub-class~~ *class* B2: … (3) Net amount retained means all the commission, fees, etc. in respect of *~~sub-~~class* B2 activities that the *firm* has not rebated to customers or passed on to other *firms* … (4) *~~Sub-class~~* *Class* B2 activities mean activities that fall within *~~sub-~~class* B2. They also include activities that now fall within *~~sub-~~class* B2 but that were not *regulated activities* when they were carried out. (5) A reference to a *firm* also includes a reference to any *person* who carried out activities that would now fall into *~~sub-~~class* B2 but which were not at the time *regulated activities*.

~~Class C~~	**Life and Pensions**

~~Sub-class~~ Class C1	Life and Pensions Provision
Legal basis for activity in ~~sub-~~class C1	…
~~Sub-class~~ Class C2	Life and Pensions Intermediation
Legal basis for activity in ~~sub-~~class C2	…
Tariff base	~~Sub-class~~ Class C1:… Eligible mathematical reserves are calculated in accordance with the method for calculating mathematical reserves in fee block A4 in part 2 of *FEES* 4 Annex 1 R with the following adjustments. … (7) The provisions relating to pension fund management business in Part 2 of *FEES* 4 Annex 1 R do not apply. A *firm* undertaking such business that does not carry out any other activities within *~~sub-~~class* C1 (ignoring any activities that would have a wholly insignificant effect on the calculation of its tariff base for *~~sub-~~class* C1) must use its Long-term insurance capital requirement instead of gross technical liabilities. … …
	Sub-class C2: *annual eligible income* where *annual eligible income* means annual income adjusted in accordance with this table. Annual income is calculated as the sum of (a) and (b): (a) the net amount retained by the *firm* of all brokerages, fees, commissions and other related income (for example, administration charges, overriders and profit shares) due to the *firm* in respect of or in relation to *~~sub-~~class* C2 activities including any income received from an *insurer*, and; (b) if the *firm* is a life and pensions *firm*, in relation to *~~sub-~~class* C2 activities, the amount of *premiums* or commission receivable on its life and pensions contracts multiplied by 0.07, excluding those life and pensions contracts which result from *~~sub-~~class* C2 activities carried out by another *firm*…

	Notes relating to the calculation of the tariff base for ~~sub-~~*class* C2: … (2) Life and pensions *firm* means an *insurer*. It also means a *firm* that provides *stakeholder pension schemes* or *personal pension schemes* if those activities fall into ~~sub-~~*class* D1. … (4) Net amount retained means all the commission, fees, etc. in respect of ~~sub-~~*class* C2 activities… (5) ~~Sub-~~*class* C2 activities mean activities that fall within ~~sub-~~*class* C2. They also include activities that now fall within ~~sub-~~*class* C2 but that were not *regulated activities* when they were carried out. (6) A reference to a *firm* also includes a reference to any *person* who carried out activities that would now fall into ~~sub-~~*class* C2 but which were not at the time *regulated activities*.

~~Class D~~	**Investment**
~~Sub-class~~ Class D1	~~Fund management~~ Investment provision
Legal basis for activity in ~~sub-~~class D1	…
~~Sub-class~~ Class D2	Investment Intermediation
Legal basis for activity in ~~sub-~~class D2	…
Tariff base	~~Sub-class~~ Class D1: *annual eligible income* where *annual eligible income* means annual income adjusted in accordance with this table. Annual income is equal to the net amount retained by the *firm* of all income due to the *firm* in respect of or in relation to activities falling within ~~sub-~~*class* D1.
	~~Sub-class~~ Class D2: *annual eligible income* where *annual eligible income* means annual income adjusted in accordance with this table. Annual income is equal to the net amount retained by the *firm* of all income due to the *firm* in respect of

	or in relation to activities falling within ~~sub-~~*class* D2.
	Notes on *annual eligible income* for ~~sub-~~*classes* D1 and D2:
	(1) For the purposes of calculating annual income, net amount retained means all the commission, fees, etc. in respect of activities falling within ~~sub-~~*class* D1 or D2…
…	

~~Class E~~	**Home Finance**
~~Sub-class E1~~	~~Home Finance Provision~~
~~Legal basis for activity in sub-class E1~~	~~Any of the activities below:~~
	~~*entering into a home finance transaction*;~~
	~~*administering a home finance transaction*;~~
	~~*agreeing to carry on a regulated activity* which is within any of the above.~~
~~Sub-class~~ <u>Class</u> E2	Home Finance Intermediation
Legal basis for activity in ~~sub-~~class E2	…
Tariff base	~~Sub-class E1: FSA periodic fees~~
	~~Sub-class:~~ <u>Class</u> E2: …

Notes	
…	
(2)	In calculating *annual eligible inc*ome a *firm* must apportion income between different ~~sub-~~*classes*…
…	

6 Annex 4G	**Guidance on the calculation of tariff bases**
	This table belongs to FEES 6.5.8G

		Calculation of annual eligible income for firms in ~~sub-~~class D1 who carry out discretionary fund management and are in FSA fee block A7	
-1.1	G	The tariff base for ~~*sub*~~*-class* D1 is calculated by taking gross income falling into ~~*sub*~~*-class* D1 and then deducting commission, fees and similar amounts rebated to customers or passed on to other *firms* (for example, where there is a commission chain). …	
…			
1.2	G	*Annual eligible income* should exclude	
			income received or receivable from assets managed on a non-discretionary basis, being assets that the *firm* has a contractual duty to keep under continuous review but in respect of which prior specific consent of the client must be obtained for proposed transactions, as this activity is covered in ~~*sub*~~*-class* D2 (the investment intermediation ~~*sub*~~*-class*).
…			
		Calculation of annual eligible income for firms in sub-class D1 and who carry out activities within ~~FSA~~ <u>*FSA*</u> fee block A9	
2.1	G	The calculation of income in respect of activities falling into ~~*sub*~~*-class* D1 and *FSA* fee block A9 should be based on the tariff base provisions for that fee block (in Part 2 of *FEES* 4 Annex 1R). …	
2.2	G	Although the calculation should be based on the one for fee block A9, the calculation is not the same. *FSA* fee block A9 is based on gross income. ~~*Sub*~~*-class* D1 is based on net income retained.	
	Calculation of annual eligible income for a firm in ~~sub~~-class B2 or ~~sub-~~class C2		
…			
	Difficulties in calculating annual eligible income		
4.1	G	The purpose of Note 2 in the section of notes at the end of *FEES* 6 Annex 3R (Financial Services Compensation Scheme - classes and sub-classes) is to deal with the practical difficulties of allocating income correctly between different ~~*sub*~~*-classes* and in deciding whether income falls outside *FEES* 6 Annex 3R altogether. …	
…			
	Gross technical liabilities and mathematical reserves for non-directive friendly societies		
…			
5.2	G	The figures for gross technical liabilities and mathematical reserves of a *non-directive friendly society* for the purpose of calculating its tariff base in ~~*sub*~~*-class* B1 (General Insurance Provision) and C1 (Life and Pensions Provision) are based on a valuation. …	

Annex C

Amendments to the Supervision manual (SUP)

In this Annex, striking through indicates deleted text

SUP 16 Annex 18AR

…

SECTION J: data required for calculation of fees			
	FSA	**FOS**	**FSCS**
Home Finance Mediation	see *FEES* 4 Annex 1R	*FEES* 5 Annex 1R	*FEES* 6 Annex 3R ~~sub-~~class E2
	Part 2 fee block A18	industry block 16	
Non-investment insurance mediation	see *FEES* 4 Annex 1R	*FEES* 5 Annex 1R	*FEES 6 Annex 3R* ~~*sub-*~~*class B2*
	Part 2 fee block A19	industry block 17	
Life and pension intermediation	n/a	n/a	*FEES* 6 Annex 3R ~~sub-~~class C2
Investment intermediation	n/a	n/a	*FEES 6 Annex 3R* ~~*sub-*~~*class D2*
…			

…

SUP 16 Annex 18BG

NOTES FOR COMPLETION OF

THE RETAIL MEDIATION ACTIVITIES RETURN ('RMAR')

…

Section J: data required for calculation of fees

…

Data for fees calculations	*Firms* will need to report data for the purpose of calculating *FSA*, *FOS* and *FSCS* levies.
…	
FSCS	The relevant information required is the tariff data set out

	in ~~sub-~~classes B2, C2, D2, and E2, *FEES* 6 Annex 3R. Note that *firms* are required to report tariff data information relating to all business falling within ~~sub-~~classes B2, C2, D2 and E2, *FEES* 6 Annex 3R.

…

Annex D

Amendments to the Dispute Resolution: Complaints sourcebook (DISP)

In this Annex, underlining indicates new text and striking through indicates deleted text.

1 Annex 1AG Recommended metrics

This table belongs to DISP 1.10A.8G		
Type of business	Contextualised new complaint numbers	Recommended metrics
…		
Investment (~~fund management~~ provision)	*Complaints* per £1m of annual eligible income	The *firm's* annual eligible income as defined in ~~sub-~~class D1 of *FEES* 6 Annex 3 R
Investment (intermediation)	*Complaints* per £1m of annual eligible income	The *firm's* annual eligible income as defined in ~~sub-~~class D2 of *FEES* 6 Annex 3 R
…		
Decumulation, life and pensions (intermediation)	*Complaints* per £1m of annual eligible income	The *firm's* annual eligible income as defined in ~~sub-~~class C2 of *FEES* 6 Annex 3 R
…		

Annex E

Amendments to the Compensation sourcebook (COMP)

In this Annex, striking through indicates deleted text.

14.5.1	R	Where an *EEA UCITS management company* provides *collective portfolio management* services for a *UCITS scheme* from a *branch* in the *United Kingdom*, or under the freedom to provide *cross border services*, the *FSCS* must allocate the *firm* to the ~~sub-~~*class* or ~~sub-~~*classes* which seems to the *FSCS* to be most appropriate, taking into account the nature of the *firm's* business activities

Appendix 2

Designation of Handbook Provisions

FSA Handbook provisions will be 'designated' to create a FCA Handbook and a PRA Handbook on the date that the regulators exercise their legal powers to do so. Please visit our website[1] for further details about this process.

We plan to designate the Handbook Provisions which we are proposing to create and/or amend within this Consultation Paper as follows. These designations are draft and subject to change prior to the new regulators exercising their legal powers.

All the Handbook Provisions in the draft Handbook text will be adopted by both the PRA and FCA. The exceptions are shown in the table below.

Handbook Provision	Designation
FEES 6.3.17R	FCA
FEES 6.3.20R	FCA
FEES 6.5.2BG	FCA
FEES 6.5.2CG	FCA
DISP 1 Annex 1AG	FCA
COMP 14.5.1R	FCA
SUP 16 Annex 18A	FCA
SUP 16 Annex 18B	FCA

1 One-minute guide http://media.fsahandbook.info/latestNews/One-minute%20guide.pdf

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