Consultation Paper

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Financial Services Authority

Financial Services Compensation Scheme Management Expenses Levy Limit

Period: N2 to 31 March 2002

September 2001

FSA

Contents

The Financial Services Authority invites comments on this consultation paper. Comments should reach us by Thursday 4 October 2001.

Comments may be sent by electronic submission using the form on the FSA's website (at www.fsa.gov.uk/pubs/cp/cp109_response.html).

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

1.1 The purpose of this paper is to consult on the limit to be set on the amount that the Financial Services Compensation Scheme (FSCS) may levy in respect of management expenses incurred in the period from N2 (which will be midnight on 30 November 2001) to 31 March 2002.

1.2 FSCS will, from 1 December 2001, operate as the single compensation scheme for financial services in the UK. Although there is no current intention to levy for management expenses immediately after 30 November 2001 to cover the expenses for the period from 1 December 2001 to 31 March 2002, it is necessary to set a limit so that the management expenses for the period may be recovered retrospectively with the levies for 2002/2003, and to allow a levy to be raised earlier in unforeseen circumstances.

1.3 We propose to set the management expenses limit for the period at £4,209,000. This figure is based on FSCS's budget for the period. **We would welcome comments on the draft rule.**

2 Introduction

2.1 FSCS will, when the Financial Services and Markets Act 2000 (FSMA) comes fully into force at midnight on 30 November 2001, operate as the single compensation scheme for financial services in the UK.

2.2 In March 2001 the FSA published a consultation paper (CP86: 'Financial Services Compensation Scheme Draft Funding Rules') which set out draft funding rules for FSCS. Those rules included a draft rule setting a limit on the total of all management expenses levies attributable to each financial year. Unless that limit is set, FSCS cannot make management expenses levies for the respective year. This paper consults upon the amount of the limit for the period from 1 December 2001 to 31 March 2002 to be inserted in that draft rule.

2.3 A feedback statement on responses to CP86 is being published concurrently. That statement contains the 'final' funding rules which govern management expenses levies.

2.4 There is no current intention to levy for management expenses immediately after 30 November 2001 to cover the expenses for the period from 1 December 2001 to 31 March 2002 (although there may be unforeseen circumstances in which it may be necessary to raise a management expenses levy in that period). The majority of the management expenses expected to be incurred in that period will be covered by the levy made in April 2001 by the Investors Compensation Scheme (ICS) which will be passing the balance of their funds to FSCS. The remaining expenses will be funded retrospectively by adjustments to the levies for 2002/2003, and it is necessary to set a limit at 30 November 2001 so that in due course those adjustments can be levied.

2.5 We did not have sufficient information at the time of writing to be able to give reasonable indications of the amounts of management expenses levies that each type of firm is likely to have to pay in respect of the period from 1 December 2001 to 31 March 2002. There will be further consultation on the management expenses limit for 2002/2003 when FSCS publishes its budget for that year. We intend to give indications of the distribution of levies to types of firm at that time, which will be before any management expenses levies are raised (other than in unforeseen circumstances).

Legislative framework

2.6 The draft rule is underpinned by FSMA, which requires the FSA to set in the rules a limit on the amount of management expenses attributable to any one period.

2.7 Management expenses are defined by s.223(3) of FSMA as '*expenses incurred, or expected to be incurred, by the scheme manager in connection with its functions under this Act other than those incurred –*

(a) in paying compensation;

(b) as a result of any provision of the scheme made by virtue of section 216(3) or (4) or 217(1) or (6)' [relating to providing continuity of insurance and other costs involving insurers in financial difficulties].

2.8 The way in which the upper limit on management expenses works is set out in s.223(1) and s.223(2):

'*(1) The amount which the scheme manager may recover, from the sums levied under the scheme, as management expenses attributable to a particular period may not exceed such amount as may be fixed by the scheme as the limit applicable to that period.*

(2) In calculating the amount of any levy to be imposed by the scheme manager, no amount may be included to reflect management expenses unless the limit mentioned in subsection (1) has been fixed by the scheme.'

Management expenses levies

2.9 There are three type of management expense levies as follows:

- Base Costs Levy

  This levy is paid by all firms participating in FSCS. It is allocated to individual firms in proportion to the periodic fees they pay to the FSA. The Base Costs Levy covers those management expenses that do not vary in line with compensation activity, namely:

  – Directors' remuneration and expenses

  – Salaries and related overheads of the Chief Executive and a few corporate support staff

  – PI and directors' indemnity insurance

  – Audit and professional advice (not claim specific)

- Financing costs in respect of borrowings to meet base costs and establishment costs
- An allocation of premises and other administrative costs (not claim specific) – based on the split of the headcount of claims and support staff.

At the current level of activity, the Base Costs represent approximately 25% of total management expenses.

- Specific Costs Levy

  This levy covers all management expenses not covered by the Base Costs Levy. These expenses are directly related to the handling of claims and payment of compensation, and their level is therefore dependent on the volume of claims handled by the scheme. The Specific Costs Levy is allocated to firms in proportion to compensation costs.

- Establishment Costs Levy

  The costs of setting up FSCS will be recovered over three years from 2002/2003 through an Establishment Costs Levy. The share paid by each firm will be in proportion to the Base Costs Levy. All the set up costs will have been incurred prior to 1 December 2001.

Period from 1 December 2001 to 31 March 2002

2.10 In CP86 we stated that we saw the amount of the annual upper limit as being established as part of FSCS's annual budget-setting process. FSCS published its 'early start' budget in February 2001, which covered the operation of the Deposit Protection Scheme and the Investors Compensation Scheme, with the assumption that N2 would be at 31 July 2001. FSCS has updated its budget for the period from 1 December 2001 to the end of the financial year. FSCS's synopsis of that budget is set out in Annex B, and we propose to set the limit by reference to that budget.

2.11 The draft rule set out in Annex A sets the management expenses limit as proposed in this paper. **We would welcome comments on the draft rule.**

3 Proposal

3.1 As noted above, FSMA requires the FSA to set in the rules the maximum amount the scheme manager may levy in respect of management expenses in any one period.

3.2 This requirement promotes openness and accountability in the way that FSCS budgets for its anticipated level of activity over each period, and ensures a significant degree of budgetary control. However the management expenses limit needs to be set at a realistic level to ensure that FSCS's operational capacity is not unduly constrained by the requirement to work within that set limit.

Budget: 1 December 2001 to 31 March 2002

3.3 In February 2001, FSCS published its 'early start' report and budget for the year 2001/02, which can be obtained from FSCS at Lloyd's Chambers, 1 Portsoken Street, London E1 8BN. FSCS has updated its budget for the period from 1 December 2001 to 31 March 2002. FSCS has provided a synopsis of their budget at Annex B. The FSA proposes to set the management expenses limit by reference to that budget. The total amount of management expenses budgeted is shown and analysed in paragraph B2 of the budget synopsis. The budgeted figure of £3,826,000 aims to cover the anticipated management expenses for the period. This figure is subject to the constraints explained in the budget synopsis.

3.4 The budget is based on the reasonable expectation that the level of operations will remain at their current level throughout the period.

Contingency provision

3.5 In addition to the budgeted expenses, a contingency provision is necessary to ensure that FSCS is at all times capable of exercising its functions. We have discussed the level of contingency provision with FSCS. We consider it appropriate to include a contingency provision of £383,000, which is equivalent to 10% of management expenses. This should be adequate to allow for:

- Normal fluctuations in expense levels
- A moderate increase in headcount to increase claims handling capacity beyond that anticipated.
- Potential costs of borrowing to fund a moderate amount of expenses and compensation in excess of that anticipated.

3.6 The contingency provision is equivalent to:

- 12 days of expenses, or
- An increase in average claims staff headcount of approximately 33 for three months, or
- Interest on short term borrowing of approximately £20 million for three months.

3.7 Given our priority of ensuring that FSCS has adequate resources to carry out its functions, and that FSCS intends to publish its report on its past performance against its budget in future budget setting processes, we accept the contingency provision as reasonable.

3.8 It is clearly impractical to set a contingency provision that is adequate to meet all circumstances. Quite apart from the difficulty of quantifying such contingencies, a large provision for remote contingencies would obviate any element of budgetary control. We would propose to deal with such events, should they arise, by revising the limit for the period so that FSCS could levy additional amounts in order to function properly. The most obvious example of such a circumstance is the failure of a major deposit taker, requiring an immediate and substantial increase in resources to handle claims. Any revision would require further consultation (though the FSA could use its emergency powers to change the rule if there is insufficient time to consult).

Summary

3.9 Therefore we propose to set the management expenses limit for the period from 1 December 2001 to 31 March 2002 at the total figure of £4,209,000.

Draft Rule

COMP 13 Ann 1R: Management Expenses Levy Limit

Period	Limit on total of all management expenses levies attributable to that period (£)
1 December 2001 to 1 April 2002	4,209,000

FSCS: report & budget: 1 December 2001 to 31 March 2002

B1. In February 2001, FSCS published its 'early start': report and budget 2001/02 which showed combined scheme costs of £11.3m for the year. The budget assumed that the responsibilities of the Policyholders Protection Board (PPB) would be excluded from FSCS, prior to N2, which was expected to be 31 July 2001.

B2. The 'early start' figures have been reviewed for the four month period from N2 (30 November 2001) to 31 March 2002, and updated budget proposals, as set out below, compare with the equivalent 'early start' amounts as follows:

Budget proposals: 1 December 2001 to 31 March 2002

	Updated budget proposals £'000	Original 'early start' amounts for the period £'000
Board remuneration, staff salaries and related costs	1,854	2,151
Premises	377	411
Other administrative costs	1,595	1,482
	3,826	4,044

B3. An overall reduction of 5% is now anticipated against FSCS' 'early start' budget, which itself reflected savings of 5% on the preliminary budgeted management costs of the former active schemes.

B4. New premises were occupied at Lloyds Chambers, 1 Portsoken Street, London E1, on 18 June 2001, both on time and below the refurbishment cost budget. The costs of occupation, in particular service charge and rates, are now expected to provide savings on the original estimates.

B5. Other administrative costs include depreciation, IT, training and recruitment costs, financing and provision for professional and legal costs that may impact on FSCS. The differences between the original 'early start' budget and the updated budget proposals arise mainly from the inclusion of IT development costs which are necessary to integrate the processes and case handling of the former schemes.

B6. The management expenses will, for levy purposes, be allocated between base and specific costs. Base costs represent the day-to-day running costs of the scheme and are anticipated to be approximately £0.9m for the four month period.

B7. It is proposed that FSCS will, in future, publish its full budget, including anticipated compensation costs and capital expenditure, to coincide with the FSA's consultations on proposed management expenses limits.

B8. This synopsis is made to support the proposed limit for the four-month period from N2 to 31 March 2002.

Compatibility with the FSA's general duties under the Financial Services and Markets Act

This annex sets out why the FSA believes the rule being consulted upon in this consultation is compatible with its general duties under section 2 of FSMA. The requirement for such a statement is set out in section 155(2)(c) of FSMA.

FSMA requires a compensation scheme and it also requires the FSA to set in the rules a limit on the amount of management expenses attributable to any one period. If a limit is not set the FSCS cannot make levies in respect of its management expenses and will not be able to carry out its functions. Thus in order to comply with FSMA the FSA has to make a rule which sets a limit. Hence this compatibility statement deals only with the proposed size of the limit and not with the existence of the limit or with the FSCS generally.

The market confidence objective

The proposed size of the limit has significance for this objective to the extent that it is important to consumers that they are protected by FSCS. Market confidence could suffer if FSCS did not have adequate funds to function.

The consumer protection objective

The process of setting the limit at a reasonable level contributes to this objective by enabling FSCS to function. If the amount of the limit was not adequate to meet the reasonable operational needs of FSCS, including sufficient provision for contingencies to ensure that it should be at all times capable of carrying out its functions, then consumers might suffer unreasonable delay in the provision of compensation.

The public awareness objective

The proposed size of the limit has no material significance for this objective.

The reduction in financial crime objective

The proposed size of the limit has no material significance for this objective.

Matters to which the FSA must have regard

Section 2(3) of FSMA sets out the matters to which the FSA must have regard in exercising its rule-making and general functions. The FSA's reasons for believing that making the rule setting the amount of the management expenses limit is compatible with having regard to those principles are set out below.

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

The FSA will have little direct involvement in the administration of FSCS (other than acting as agent for FSCS and collecting levies on its behalf); FSCS will be independent of the FSA but accountable to it. The scheme rules require FSCS to have regard to the need to use its resources in the most efficient and economic way when exercising its functions. The public accountability of the exercise of setting an annual budget for management expenses and consulting on the rule setting the annual limit for management expenses will promote operating efficiency within FSCS.

- The principle that a burden or restriction should be proportionate to the benefits, considering in general terms, which are expected to result from the imposition of that burden or restriction

If the proposed amount of the limit was not adequate to meet the reasonable operational needs of FSCS, including sufficient provision for contingencies to ensure that it should be at all times capable of carrying out its functions, then the industry might suffer from the effects of any consequent unreasonable delays in the provision of compensation. On the other hand, if the proposed amount of the limit was to be set in excess of the costs of operational requirements that could be reasonably foreseen, then levies on firms might be higher than necessary. Thus firms could suffer if the amount of the limit was set either too low or too high.

The proposed size of the limit has no material significance for the following principles:

- The responsibilities of those who manage the affairs of authorised persons
- The desirability of facilitating innovation in connection with regulated activities
- The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

- The need to minimise the adverse effects on competition that may arise from any exercise of its general functions
- The desirability of facilitating competition between those who are subject to any form of regulation by the FSA

Most appropriate way of meeting the statutory objectives

Section 3 explains why the FSA considers that the proposed limit is the most appropriate one for the purpose of meeting the regulatory objectives.

Annex D

Cost benefit analysis

Section 155(2) of FSMA requires the FSA to publish a cost benefit analysis when it proposes to make rules unless the incremental costs of adopting the proposed arrangements are of no more than minimal significance.

The broader issues about the costs and benefits of the establishment of FSCS as a whole were covered in Consultation Paper 58. The costs and benefits of implementing the proposed funding arrangements for FSCS, which included the setting of an annual limit on management expenses, in comparison with continuation of the current arrangements were dealt with in Consultation Paper 86. We believe that our proposal in this paper to set the amount of the limit on management expenses will not result in any cost increases beyond those consulted upon in earlier consultation papers, and accordingly we have not carried out a further Cost Benefit Analysis.

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