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Dear

FSCS levies for deposit-taker defaults: implications for firms – Update

1. We write, further to Tom Huertas's letters of 31 December 2008 and 4 February 2009, to provide an update for your members on the position as regards amounts to be levied by the FSCS in respect of the five banking defaults[1] that occurred in 2008, collectively referred to as Specified Deposit Defaults (SDDs), and the one building society resolution[2] that has occurred in 2009. We also write to update you about progress the FSCS has made in determining the amounts paid by way of deemed compensation in respect of the deposit transfers from Bradford & Bingley (B&B) to Abbey National plc, and from Heritable and Kaupthing Singer & Friedlander (KSF) to ING Direct N.V. There were no such transfers for London Scottish and Icesave.

Funding the FSCS's involvement

2. The FSCS funded its liabilities in respect of B&B, Heritable, KSF, Icesave and London Scottish by borrowing under facilities originally provided by the Bank of England and subsequently refinanced by HM Treasury (the Facilities). As at 31 March 2009, the FSCS borrowings under the Facilities totalled £18.2 billion, a sum which excludes amounts for the account of HM Treasury and work on behalf of Iceland's Depositors' and Investors' Guarantee Fund (DIGF) in respect of the Icesave default and reflects a repayment received in March 2009 on KSF. The interest cost to the FSCS under the Facilities is currently £390.3 million for the period 29 September 2008 to 31 March 2009. This amount is due to be paid on 1 October 2009. Once the work in respect of the liabilities of the FSCS in respect of B&B, Heritable and KSF has been completed, it is expected that further amounts payable by or to the FSCS will be addressed by way of adjustments to the amounts borrowed under the Facilities.

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[1] The five defaults were Bradford & Bingley plc, Heritable Bank plc, Kaupthing Singer & Friedlander Limited, Landsbanki "Icesave", and London Scottish Bank plc.

[2] The resolution of Dunfermline Building Society.

Determination of the FSCS's liabilities for transferred deposits

3. As you are aware, for the three defaults of B&B, Heritable and KSF, the value of deposits transferred to Abbey and ING which were protected by the FSCS was initially estimated by the FSA. The FSCS has put in place a process with the assistance of independent consultants to establish, as required by the relevant Orders, the amount that would have been payable to eligible claimants under the FSCS's rules, had they claimed individually.

B&B

4. The work on B&B is still in progress, but it appears that the amount which the FSCS would have paid would have been likely to have been between £15.56 billion and £15.79 billion, as compared to the original estimate of £14 billion. The FSCS expects that the precise amount of its liability in respect of B&B will be about £15.75 billion. The main factors giving rise to the difference from the original estimate were the amounts on deposit that exceeded the relevant compensation limit, the amounts that were in transit at the date of default, and the accrued interest that needed to be added to the balances at the date of default. Work continues on the current findings with further analysis being undertaken and once the outcome is known, the FSCS will update levy payers.

5. What this means is that the FSCS proportion of the payments it made with HM Treasury to Abbey to fund the transfer of deposits is expected to increase. The final amount is expected to be added to the HM Treasury loan principal and the Facilities will be adjusted accordingly. In due course, arrangements will need to be made which put the parties in the position they would have been in, had the correct deemed compensation costs been known at the outset. Once the arrangements have been finalised the industry will be notified about their impact on future levies.

Heritable and KSF

6. The determination processes in respect of Heritable and KSF are underway. On Heritable, work so far suggests that the amount the FSCS would have paid in relation to the transferred accounts would have been somewhat less than the £500 million which was actually paid in October 2008. The FSCS current estimate is £457 million. Again, suitable arrangements will need to be made to put the parties back in the position they would have been in, had the lower amount been paid at the outset. The KSF work is in progress, but no figures are yet available. The FSCS contributed £2.5 billion to cover the cost of transferring the firm's online accounts, known as Kaupthing Edge accounts, to ING Direct on 8 October 2008.

Principal amounts due under the Facilities

7. The principal amounts borrowed under the Facilities are to be repaid in the first instance by applying the FSCS's share of any recoveries. The present position on recoveries is that B&B expects ultimately to repay the deemed compensation. For KSF the dividend is anticipated at a minimum of 50 pence in the pound, for Heritable the dividend is likely to be 70 - 80 pence in the pound and London Scottish 30 - 60 pence in the pound. Any potential recovery for Icesave is uncertain at this time. The first dividend payment for KSF (20 pence in the pound) has just been paid and we expect a first dividend payment on Heritable shortly. The timings for any dividend payments on the other estates are not yet clear.

8. To the extent that the Facilities have not been repaid in full by 31 March 2012, HM Treasury and the FSCS will agree amortisation schedules in respect of the Facilities

and the principal will be payable on the basis of those schedules. FSCS will then levy accordingly. This letter does not address the subject of levies in respect of principal amounts payable by the FSCS under the Facilities.

Levy details

9. When the FSCS announced its funding requirements in its 2009/10 Plan and Budget, interest payments due under the Facilities for the period 29 September 2008 to 31 March 2009, and related management expenses, were estimated to be £434 million. This estimate was subsequently reduced to £406 million, including £386.5 million in respect of interest payments due under the Facilities for the period 29 September 2008 to 31 March 2009 and £19.5 million other management expenses. The sum of the interest payments due under the Facilities for the period 29 September 2008 to 31 March 2009 is currently estimated to be £390.3 million – not taking account of the adjustments that may be made to the Facilities once the determination processes are complete.

10. Interest payments due under the Facilities are to be funded by levy payers in the Deposit Class before 1 October 2009 (when the FSCS must make these payments to HM Treasury in accordance with the terms of the Facilities).

11. The related management expenses in 2008/09 were originally estimated at £19.5 million. The actual management expenses incurred to 31 March 2009 amounted to £9.3 million, of which some is recoverable from third parties. These recoveries are in the process of quantification and agreement and will be credited on receipt.

12. As mentioned above, further interest charges and costs are expected to be incurred once the determination processes are complete, together with the final costs of the determination exercises. The FSCS Board has decided to set the amount now to be levied for 2008/09 at £406m as previously stated. Any additional interest charges and costs will be included in subsequent levies for the Deposit class.

13. For the 2009/10 levy year, the previously announced figures in Tom Huertas' letter of 4 February 2009, used by FSA and FSCS for forecast interest costs was £632.1 million,[3] and for non-interest costs, £13.3 million. Due to falling interest rates, the interest costs were updated to £493 million[3]. This was published in a FSCS levy press release on 30 March 2009. By adjusting for the currently estimated changes to the B&B payment and Heritable recovery, the annual interest cost at current interest rates would increase by some £34.3 million. So the latest forecast for the management expenses levy for SDD loan interest and related management expenses for 2009/10 is now £540.6 million. We expect this figure to be adjusted (upwards) to reflect the arrangements described in paragraphs 5 and 6 and (downwards) to reflect recoveries received, including the first KSF recovery described in paragraph 7.

14. The tariff data used by the FSA in calculating the 2008/09 levy is £941,066 million which represents the aggregate protected deposits as at 31 December 2007. To the extent that EEA firms receive a discount to reflect their home-state cover, this discount is further adjusted to reflect the decision on exit levies, as set out below. The tariff data to be used for the 2009/10 levies in due course will use similar discount arrangements and is currently forecast to be £1,010,645 million.

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[3] Given the movement of interest rates, and the unpredictability of the timing of loan draw-downs and recoveries from the estates of the defaulted banks, it is possible that this represents an under- or over-estimate of future interest costs.

How will levies be raised?

15. Levy invoices will be issued by the FSA on behalf of the FSCS to firms before the end of July 2009 for payment on 1 September 2009.

Exit levies

16. Throughout this period, the FSCS Board has considered the practical implications of the exit levy rules on firms to ensure that departing firms take a share of costs incurred on defaults arising during their period as a participant firm in the FSCS. These apply, among others, to EEA branches which no longer require cover by FSCS as a result of the coverage limits offered by the deposit guarantee scheme in their home country having increased beyond those offered by the FSCS.

17. As the FSA sets the FSCS Management Expenses Levy Limit (MELL) for only one financial year at a time, FSCS is restricted in its ability to raise a ‘one-off’ exit levy for a period beyond the applicable period of the current MELL. The FSCS Board has, therefore, agreed that exit levies will be applied on an annual basis for non-participating firms which remain authorised.

18. It is worth pointing out that any future departing firms will be liable to exit levies to cover the cost of defaults which occur prior to the date when the levy payer firm ceases to be a participating firm, until such time as it is de-authorised.

Dunfermline

19. Dunfermline Building Society was, on 30 March 2009, the first resolution dealt with under the powers set out in the Banking Act 2009 (the Act). Under the Act, the FSCS can be asked to contribute to the costs of resolution whether or not payment of compensation is made to depositors.

20. The amount that the FSCS can be asked to pay is capped at the total amount of compensation that would have been paid to eligible depositors, net of the hypothetical recoveries the FSCS would have received from the estate of the bank if it had become insolvent.

21. Under the regulations made under the Act, HM Treasury must issue to the FSCS a Notification requiring a contribution to the resolution costs. This Notification in relation to Dunfermline was issued by HM Treasury to FSCS in April 2009. The timing and size of any actual payment to be made by FSCS, and the consequent need for levies on the industry, remains unclear. No levy is therefore being raised in respect of Dunfermline at this point. A further Notification will be issued by HM Treasury to the FSCS as soon as the position is sufficiently clear. Meanwhile, FSCS is working to establish what compensation it would have been liable to pay to depositors had the transfer not taken place.

Accounting

22. FSA has continued to receive queries from firms as to how they should account for the future FSCS levies. The FSA has – as set out in previous letters - no role in determining the appropriate way in which to account for particular fact patterns. Accounting standards are set by the International Accounting Standards Board in the case of IFRS and the UK Accounting Standards Board for UK GAAP, and a firm’s directors are responsible for its accounts.

23. The position on accounting remains, to the best of our understanding, as set out in the 4 February letter.

Listing and disclosure obligations

24. Your member firms affected by these FSCS levies will need to give full consideration to the disclosure obligations that they face on an ongoing basis.

Next steps

25. The FSCS expects to be publishing its 2008/09 Annual Report at the end of July, which will contain more detail about the events of the last year.

26. This letter is being sent to the Association of Foreign Bankers, the British Bankers' Association, the Building Societies Association, to five credit union representative bodies, and to the Council of Mortgage Lenders.

Yours sincerely,

Thomas F. Huertas

Loretta Minghella