

Financial Services Authority

Financial Services Compensation Scheme Funding Rules

Feedback on CP86 and 'final' text

September 2001



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This policy statement reports on the main issues arising from the consultation on 'Financial Services Compensation Scheme Funding Rules' (CP86). It also contains the post-consultative version of the rules and guidance which will apply in respect of the CP86 proposals.

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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 This paper provides feedback on Consultation Paper 86,¹ which set out the draft rules and guidance for the funding of the Financial Services Compensation Scheme (FSCS) by the financial services industry. We received 38 responses to the consultation. No significant new points were raised (although several respondents sought to reopen debate on policies already consulted upon) and we have not made any major policy changes.
- 1.2 The only significant potential change that may yet be made relates to transitional funding. Funding being on a pay-as-you-go basis, the costs arising in respect of activities before 1 December 2001 (when the FSA comes into its full powers) will exceed the amounts levied by the current compensation schemes to meet those claims, so that the balance will be funded through the new funding system for FSCS. HM Treasury has made a Transitionals Order enabling FSCS to pay claims arising after 1 December 2001 from regulated activities being carried on before that date, and there will be a separate consultation on the consequent rules (the Transitional Rules). That consultation will include consideration of whether rules for transitional adjustments to funding are needed.
- 1.3 Subject to any Transitional Rules for funding, the compensation scheme funding rules are now in ‘final’ form. They have been approved by the Board of the FSA and we expect the FSA Board to make these rules in October 2001. They will form Chapter 13 of the Compensation Sourcebook.
- 1.4 The approach to funding is governed by the principles for the scheme structure and levy arrangements established in a separate policy statement² on the compensation scheme rules other than the funding rules. Those principles are themselves underpinned by legislative requirements within the Financial Services and Markets Act 2000 (FSMA).

1 CP86: The Financial Services Compensation Scheme Funding Rules (March 2001).

2 Compensation Scheme Rules & Policy Statement: Response on CP58 (July 2001).

Response to the consultation

- 1.5 The draft rules were generally well received. Not unexpectedly, the main focus of many respondents was on the structure of the contribution groups and tariff bases. As previously indicated in CP86, FSCS funding reflects, to a considerable extent, the structure of FSA's own fee-raising arrangements, since the design of the contribution groups for FSCS levy arrangements mirror the FSA's fee blocks as far as possible. This reduces the costs of the regulatory system overall by avoiding duplication of systems for raising FSA fees and collecting FSCS levies. We have taken account of the consultation process on those fee blocks in finalising FSCS contribution groups.

Changes to the consultation text

- 1.6 The main changes to the draft rules following the consultation comments received are as follows:
- The rules now explicitly state credits for interest earned on sub-scheme funds are to be set off against management expenses for the purposes of levy calculations.
 - We have amended the rules to clarify that the interest earned or incurred by the sub-scheme must be allocated according to the funds held to the credit or debit of each contribution group, and that FSCS must not raise a levy in respect of a creditor contribution group on account of the indebtedness of debtor contribution groups.
 - A new rule has been added to allow FSCS to refund surplus funds to contribution groups (or in the case of the Accepting Deposits sub-scheme to the original levy payers).
 - The de minimis rule has been amended so that if a firm's share of all types of levy combined would be so small that it would be uneconomic to collect, FSCS may reduce them to zero.
 - A deposit-taking firm's share of a current Compensation Cost Levy for the Accepting Deposits sub-scheme is to continue to take account of all amounts previously paid by the firm as its share of levies to the Deposit Protection Board (DPB), net of amounts refunded, in addition to its share of levies allocated to the Accepting Deposits sub-scheme of FSCS.
 - To reflect the provisions of the Policyholders Protection Act 1997, the limit on the amount of Compensation Costs Levies that may be allocated to the Insurance sub-scheme in any financial year has been reduced to 0.8% of relevant net premium income. The definition of the Insurance sub-scheme's tariff base, relevant net premium income, has been corrected so that relevant reinsurance premiums ceded are not deducted.

- A new rule has been added to give effect to the policy established in the feedback to CP24 for the modification of the protected deposit tariff base. This allows FSCS to continue the approach used by the DPB, whereby if a firm itself finds it worthwhile to identify protected deposits where the depositor is not an potential eligible claimant, being a large corporate for example, then the firm may exclude such deposits from the tariff base.

2 Introduction

- 2.1 This paper provides feedback on Consultation Paper 86,¹ which set out the draft rules and guidance for the funding of FSCS by the financial services industry (the funding rules).
- 2.2 The revised funding rules are set out in Annex B of this paper. These rules will come into force when the relevant provisions of FSMA are commenced at midnight on 30 November 2001.
- 2.3 The funding rules will form Chapter 13 of the Compensation Sourcebook (COMP). The rules forming the other chapters in COMP are set out in a separate policy statement also being published at this time.

Status of the rules

- 2.4 The funding rules at Annex B of this paper are now in ‘final’ form. A few minor amendments may be necessary to take account of outstanding decisions in other areas, such as the transitional arrangements made by HM Treasury and any final amendments to definitions used in the FSA Handbook. The only other potential change of note that may yet be made, which impacts on firms, relates to transitional funding. There will be a separate consultation on the Transitional Rules arising out of the Transitionals Order made by HM Treasury.² That consultation will include consideration of whether rules for transitional adjustments to funding are needed.

Structure of the rules

- 2.5 References to the ‘final’ rules appear in the paper. To enable readers to distinguish between ‘old’ and ‘new’ rules, references to the ‘final’ text are prefixed ‘COMP’ (which stands for compensation) whereas references to the consultation text do not have a prefix. The suffix ‘R’ denotes a rule and ‘G’ a guidance note.

1 CP86: The Financial Services Compensation Scheme Funding Rules (March 2001).

2 The Financial Services and Markets Act 2000 (Transitional Provisions, Repeals and Savings)(Financial Services Compensation Scheme) Order 2001 SI 2001/2967.

3 Result of consultation on draft funding rules

Who responded to CP86?

- 3.1 Trade associations represented the largest single group of respondents. The table below gives a breakdown of respondents by category, but it should be borne in mind that there was a significant degree of overlap among the interest of respondents. A list of non-confidential respondents to CP86 appears as Annex A to this paper.

Type of respondent	Number
Deposit-takers (banks, building societies, credit unions)	4
Insurers (insurance companies)	8
Investment firms (other than professional firms)	5
Professional firms	3
Trade associations	12
Consumer groups	2
Compensation schemes	3
Regulators	1

Background

- 3.2 CP86 contained detailed proposals for funding FSCS. In particular these covered
- The structure of the scheme for the purposes of allocating compensation costs for payment;
 - The calculation of the Base Costs Levy;
 - The calculation of the Specific Costs and Compensation Costs levies;

- The calculation of the Establishment Costs Levy (i.e. the costs of setting up FSCS);
- The funding of the financial year in which N2 falls.

3.3 This section sets out the FSA's response to questions raised during the consultation. We set out the list of questions in CP86, summarise the feedback received on each issue, and explain how the rules have been modified to take account of respondent's comments. Where we have decided not to amend the rules in the way respondents suggested, we indicate why. In finalising these rules, we have taken also account, where relevant, of the FSA's consultation papers on its own fee-raising arrangements as set out in CP56,¹ CP79² and CP95.³

Q1: Do respondents agree that the proposed structure represents a practical way forward? (CP86 paras 3.5 – 3.20)

- 3.4 There was broad agreement that the proposed structure represents a practical way forward. However, while accepting the structure, several respondents expressed reservations in respect of the design of the contribution groups. We deal with the issues concerning the design of contribution blocks in paragraphs 3.16 to 3.25 below.
- 3.5 The London Investment Banking Association (LIBA) and the Fund Managers Association (FMA) reiterated that there should be no cross-subsidy not only between sub-schemes but also none between each contribution group; this would have the result that effectively each contribution group would be a sub-scheme in itself.

FSA's response: In our view, treating each contribution group as a separate sub-scheme would add an unnecessary and costly level of administration for FSCS. While it is intended to avoid cross-subsidy between contribution groups it is impractical to totally eliminate it. Within the Investment Business sub-scheme there may be various types of firms and activities, but the claims handling resource is common to all of them, except for the pension review claims which are handled separately. However remote the likelihood, we continue to recognise that a cross-subsidy arrangement other than that in respect of the pension review might be needed in the future. Whilst it would be possible to change rules, we would be going back on a principle already set.

It should be borne in mind that the total compensation costs of eligible claims will be the same whoever pays for them. There is a limit to the administrative costs that are

1 CP56: 'The FSA's post-N2 fee-raising arrangements (June 2000)'.

2 CP79: 'Feedback statement to CP56 and second Consultation paper on the FSA's post-N2 fee-raising arrangements (December 2000)'.

3 CP95: 'Third Consultation Paper on the FSA's post-N2 fee-raising arrangements including feedback on CP79 (May 2001)'.

worthwhile incurring in shuffling those costs between firms, when there is no basis for allocating them that is right in an absolute sense.

Given the reassurance already offered in our feedback on responses to CP24,⁴ we do not propose to change our position on this point.

Q2: Do respondents agree with the proposals for establishing management expenses? (CP86 paras 3.21 – 3.25)

- 3.6 The Association of British Insurers (ABI) questioned our interpretation of the definition of management expenses in FSMA. It was suggested that the “expenses incurred in paying compensation” should include not only the associated professional costs specific to each claim, but also the internal costs of administering those claims. Some practical advantages were claimed for this interpretation, though we remain unconvinced that they would outweigh the disadvantages.

FSA’s response: Whatever the respective merits of the various interpretations, our legal advice upholds our interpretation of the definition of management expenses, that it includes all management expenses other than those costs directly attributable to individual claims for compensation, particular arrangements for the continuity of long term insurance policies or assistance of insurers in financial difficulties.

- 3.7 Several respondents wished that they had figures for their likely exposure to levies, so that they could gauge the likely cost to them. Until the fee blocks are finalised, the mapping for the grandfathering process and the matching of approved persons to controlled functions reach a more advanced stage, and data is collected for the tariff bases, it will not be possible to determine reasonably reliable parameters for allocating the management expenses to every type of firm. Aside from the establishment costs of the new scheme, the overall management expenses are expected to be less than the combined equivalent management expenses of the current schemes, but some firms will pay more and others less than in the past.
- 3.8 Some firms will pay for Base Costs explicitly for the first time. These are expected to be equivalent to approximately 1.5% of the FSA fees for each firm. Specific costs are by their nature more variable. Currently most of the Specific Costs are attributable to the Investment Business sub-scheme, and most of those to the pension review contribution group.
- 3.9 Otherwise those respondents who commented agreed with the proposals, subject to concern in a few cases that appropriate controls over management expenses should be in place. There will be separate consultation over the setting of the management expenses limit.

4 Annex A to CP58: ‘Feedback from CP24 ‘Consumer Compensation: a further consultation’ and FSA’s response.’

Q3: Do respondents agree with the proposals for the calculation and allocation of the Base Costs Levy? (CP86 paras 3.26 – 3.31)

3.10 There was broad agreement to the proposals for the calculation and allocation of the Base Costs Levy to all firms.

3.11 Two small insurance companies argued that the current levy arrangements under the Policyholder Protection Board (PPB) scheme should be adopted. In common with most of the other existing schemes, the PPB makes a single combined levy to cover all its net expenses. There are periods of several years in which insurance companies (and other firms) have not had to pay levies.

FSA's response: This does not mean that firms have not had to contribute to the management expenses of their schemes; they have merely been obscured, whether by relatively large combined levies or trade body subsidies. Our approach continues to be that under FSCS the process of paying for the management expenses will be transparent, and on a pay-as-you-go basis.

3.12 The proposals included a rule that FSCS should be able to set a de minimis amount in respect of the Base Costs Levy. Where an individual firm's share of the levy is calculated as being below that figure, FSCS would have discretion not to charge the firm. Responses were divided. Broadly this proposal received support from deposit-taking and insurance firms and their trade bodies, but generally there were reservations expressed by investment business firms and their trade bodies.

3.13 Various alternative approaches were suggested, of which the following are representative. The Friendly Societies Commission (FSC) suggested that this power should be extended to include Specific Costs and Compensation Costs as well. On the other hand the FMA argued that as the Base Costs Levy is to be invoiced at the same time as the other levies and fees, there was no need for a de minimis provision. The Association of Private Client Investment Managers and Stockbrokers (APCIMS) preferred a minimum levy instead.

FSA's response: We agree that there could be circumstances where the amounts being levied on individual firms is small. On the basis that the purpose of the power to set a de minimis limit is simply to avoid levies for very small amounts that are uneconomic to collect, we see the logic of extending the power to all levies, in accordance with that general policy. Accordingly we are amending the rule to extend the power to cover all levies. That would also have the advantage that all levies invoiced together could be considered in aggregate when considering whether to apply a de minimis limit.

Although in CP86 we implied that the de minimis provision would assist small firms, the point we intended to make is that applying a de minimis provision rather than a

minimum levy would assist them. The justification for either a de minimis provision or a minimum levy is purely a question of administrative efficiency.

A minimum levy set at a realistic level that every firm would have to pay, instead of a de minimis limit, below which nothing is paid, would be punitive for certain firms, such as small friendly societies and, from mid-2002, credit unions for whom such a minimum could be equivalent to their fair share of levies for more than a decade. We believe that a minimum levy which was so disproportionate would be inappropriate.

The expected cost to larger firms is expected to be minimal. We understand that FSCS is not intending to set the de minimis level any higher than £50. We estimate that de minimis provisions would apply to firms representing less than 2% of each of the Accepting Deposits and Insurance sub-schemes, even if only the base costs levy is considered, and we do not expect the de minimis provisions to impact on the Investment Business sub-scheme.

Q4: Do respondents agree with the proposed method of allocating specific costs and compensation costs to sub-schemes and contribution groups? (CP86 paras 3.32 – 3.38)

- 3.14 There was general agreement to the proposed method of allocating specific costs and compensation costs to sub-schemes and contribution groups.
- 3.15 We proposed that allocation of recoveries would follow the same principle as for specific costs and compensation costs, which are to be allocated for levy purposes to the appropriate sub-scheme, and thence to the appropriate contribution group(s), by reference to the types of claim which generate these costs. However, the DPB believes that it would be both appropriate and practical to continue to allow the refunding of recoveries from each failed deposit-taker to those firms that contributed to the levy to meet compensation costs for that failed deposit taker, whether still within contribution group A1 (deposit-takers) or not.

FSA's response: Considered in the context that the number of failed deposit-takers is few, and the recoveries from failed deposit-takers are typically very large, we agree that this is appropriate and practical. We do not regard the consequent amendment to the draft rules to effect this as a significant change in policy, because it is continuing the DPB scheme rules so far as practical.

Similar amendments for other contribution groups are not necessary because it has not been the practice to match recoveries to the original contributors nor is it practical to do so in the future.

Q5: Do respondents have any comments about the proposed design of the contribution groups? (CP86 paras 3.29 – 3.48)

General

- 3.16 The contribution groups are inextricably linked to the fee blocks that will be adopted by the FSA for fee-raising post-N2. Indeed, many of the concerns had been raised in previous responses, and some sought to reopen debate on fee blocks for which consultation had closed. Only the Insurance sub-scheme has contribution groups with constituencies that differ from the corresponding fee blocks. Here, the split of the contribution groups corresponds to the existing split in the PPB scheme, and is between general and life business, rather than based on whether or not the firm is subject to conduct of business regulation.

FSA's response: In all other cases it is impractical for FSCS to have contribution groups with constituencies that differ from the FSA's fee blocks. Whilst we understand the concern of firms who find themselves sharing a contribution group with firms they perceive as different, division of contribution groups into ever smaller units is unsustainable. There is a balance to be struck between spreading the consequences of the default of a firm widely, so that the burden on other firms is as light as possible, and concentrating the consequences on relatively few firms carrying on similar activities. To achieve that balance, some firms of mixed type and size have to share the same contribution group.

- 3.17 We set out below details of comments and our responses about the design of particular contribution groups, and of changes to them.

Contribution group A1: deposit-takers

- 3.18 There seems to be some misunderstanding as to the tariff base for this contribution group. Our intention is to carry over the provisions of the DPB compensation scheme as far as practical. Some respondents apparently did not realise that when a levy is raised FSCS will take account of a firm's previous payments of levies raised, and refunds of recoveries made, by the DPB or FSCS for the Accepting Deposits sub-scheme. The way this will work is illustrated from the data in the table below. In this example, the DPB initial contribution was the minimum of £10,000. When a second levy is made for which the firm's proportionate share would be £4,000, the cumulative limit for the firm is £12,000 so that the firm pays only another £2,000.

Example of a levy on a firm in the deposit taking sub-scheme		
	First levy:	Second levy
Firm's protected deposits	nil	£4m
Effective rate of levy		0.1%
Firm's share of levy (before cap)		£4,000
Cumulative limit (0.3%)	nil	£12,000
Levy paid	£10,000	£2,000

- 3.19 Some deposit-takers expressed concern that they would be likely to declare higher protected deposit balances than is actually the case because of the difficulty of identifying ineligible deposits. The Building Societies Investor Protection Board (BSIPB) reiterated that building societies, who have no need to look at the accounts of their business deposits, will generally find it particularly difficult.

FSA's response: No new arguments were advanced, so we therefore see no reason to change our approach established in the feedback to CP24, in which we acknowledged that stripping out deposits by large corporates may be difficult for some firms, and not cost-effective. However, we believe that for those firms with a large proportion of wholesale business, the identification may be worthwhile. This approach is also consistent with our proposals for wholesale-only deposit takers.⁵

Contribution group A4:

- 3.20 One life assurance company with closed funds argued that closed funds cannot sustain additional costs that were not anticipated when the products were designed. They have no opportunity to absorb such costs by allowing for them in the design of new business products.

FSA's response: We are not persuaded by these arguments. The design of the product should have allowed for some contingent expenses, and the levy potential after 30 November 2001 will be broadly the same as it has been for the last 25 years. It is true the Base Costs Levy has to be paid regularly as a separate element, whether there are any life company failures or not, but as the Base Costs Levy is simply a very small loading on regulatory fees, for which the relevant tariff base is new premium income, it must be minimal (if not under the de minimis level).

Moreover, it would be impractical to take closed funds out of the specific and compensation costs levies. Many ongoing companies have what are effectively closed funds and it would surely be wrong to treat those differently from the closed funds of run-off companies. We can foresee problems of definition in practice. However, it is

⁵ CP88: 'Wholesale-Only Deposit Takers (April 2001)'.

desirable to avoid unexpectedly large costs falling on long closed funds, and we propose to revisit the issue when the rules relating to weighted allocation are reviewed in three years time.

Contribution group A9: operators, trustees and depositaries of collective investment schemes

- 3.21 The Depositary and Trustee Association (DATA) were of the view that it is inappropriate for trustees and depositaries to be mixed with operators of collective investment schemes for compensation scheme purposes, because the risks presented by the two roles were very different.

FSA's response: Whilst we appreciate DATA's arguments, in our opinion the total size of the contribution group is already small enough. It would be wrong to have a yet smaller group comprising only trustees and depositaries. The risk of default in such a sub-group may be considered relatively remote, but if one of its members did fail the cost on the others could be unacceptably high. The assessment of the relative risk of failure is necessarily subjective, but we note that, as a proportion of client funds, the tariff base for trustees and depositaries is low compared with that for operators.

Contribution group A10: dealing as principal

- 3.22 In CP86 we proposed Position Risk Requirement ('PRR') as the tariff-base for contribution group A10 in line with the proposals for the equivalent fee-block in CP79. PRR was proposed because it will not be possible to use Approved Persons as the tariff-base for this contribution group / fee-block because there is no designated controlled function for proprietary trading. However, it became clear that the proposed tariff-base was unlikely, in practice, to give enough coverage of the fee-block, because many of the firms mapping into this fee-block/contribution group have no PRR calculation.

- 3.23 Following representations from the London Investment Banking Association ('LIBA') and other trade bodies, the tariff-base for FSA fee block A10 has been changed to be the headcount of traders engaged in the dealing in investments as principal. The definition for the new tariff-base is:

'Any employee or agent, acting on behalf of an authorised person liable to pay fees to the FSA in its fee-block A10 (dealing as principal), who, as part of their duties in relation to those activities of the authorised person, commits the firm in market dealings or in transactions in securities or in other investments in the course of FSA authorised business.'

- 3.24 We propose to adopt the same tariff base for contribution group A10 as will be finally decided upon for fee block A10, for the same reasons.

Contribution groups A12 to A15

3.25 Since the publication of CP86, which set out Approved Persons as one of the bases being considered for contribution groups A12 to A15, the FSA has decided to use Approved Persons as the tariff base for the corresponding FSA fee blocks A12 to A15. We propose to use the same as the tariff-base for contribution groups A12 to A15.

Q6: Do respondents agree with the proposed contribution groups and the means of allocating the Specific Costs Levy and Compensation Costs Levy? (CP86 paras 3.49 – 3.53)

3.26 Subject to comments on contribution groups which have been covered under question 5, those who commented were in agreement with the methods of allocating the Specific Costs and Compensation Costs Levies, on the ground of avoiding complexity and expense.

Q7: Do respondents think that, in the context of compensation funding, Approved Persons is an appropriate measure of business activity for the contribution groups identified in Annex C? What measure of business volume would be a better approach? What information can respondents provide to answer the questions posed on this topic in Annex F? (CP86 paras 3.54 – 3.56)

3.27 We received six responses to CP86 in respect of the proposal to use Approved Persons as the tariff-base for contribution groups A12 to A15. All preferred various measures of income or assets related to the activity in their contribution groups. Most responses were largely reiterations of their responses to CP79 on the same issue for FSA fees. There was a larger number of responses to CP79 which represented a wider constituency and we have taken these responses into account.

3.28 The principal reservation about adopting Approved Persons as the tariff-base was concern that smaller firms that fall into several contribution groups might be 'double-charged'. Respondents argued this might happen as certain individuals in such firms could be approved not only for functions relating to the A12 to A15 fee-blocks/contribution groups, but also for functions of others (e.g. A7 relating to managing investments).

FSA's response: Our view is that these concerns are not well-founded, and that the proposed tariff-bases are fair. This is based on the fact that around half of the members of the A7, A8 and A10 fee-blocks/contribution groups will also fall into at least one of the A12 to A15 fee-blocks/contribution groups. If only a minority of such firms were 'small', then they might have been disadvantaged relative to larger firms (with potentially more specialised work forces). However, the probable distribution of the number of Approved Persons over firms within these fee-blocks/contribution groups suggests that the majority are small firms (with five or fewer approved

persons). So, as they all seem to be roughly in the same position, the allocation of levies based on the number of approved persons appears to be non-discriminatory between them.

We understand the preference of certain sectors (notably firms currently regulated by RPBs) for income or asset bases, as they felt it would be a more accurate measure of the volume of the business they carry out. However, we are more concerned about the reliability of data reported to us on income or asset-based measures (much of which, e.g. from small companies and sole traders, would not have been independently audited). None of the responses has caused us to vary this position.

- 3.29 There were suggestions that where an Approved Person fills more than one controlled function, they should be allocated on some pro rata basis between different contribution groups.

FSA's response: It should be borne in mind that the levies to be allocated over each of the relevant contribution groups are not affected by the choice of tariff-basis. Any alteration of the tariff-basis to reduce the number of Approved Persons would lead to a corresponding increase in the levy per Approved Person, which would partly offset the benefits claimed for any such alteration.

Taking all the above factors into account we intend to use Approved Persons as the tariff-base for contribution groups A12 to A15. This is the same approach as for the corresponding FSA fee blocks.

Q8: Do respondents have any comments on the comparison of the proposed funding structure with that for FSA fees? (CP86 paras 3.57 – 3.58)

- 3.30 No specific comments were received that are not covered in responses to other questions.

Q9: Do respondents have a view on the proposed exemption from the Specific Costs and Compensation Costs Levies? (CP86 paras 3.59 – 3.63)

- 3.31 Most of those commenting thought the proposed exemption from Specific Costs and Compensation Costs Levies for participant firms which do not conduct any business with potential eligible claimants was appropriate. However, the FMA dissented regarding the necessity for annual notification of exemption, thinking that firms would need to be reminded, and proposed that FSCS should assume a firm is still eligible for exemption unless otherwise notified. The FMA also disagreed with the condition that no otherwise private customers should have been classified as intermediate customers.

FSA's response: We regard the eligibility of a firm for exemption as a matter that should be established with a reasonable degree of certainty, and the annual notice of exemption is essential positive confirmation for FSCS that a firm continues to be eligible. The procedure should provide reassurance for other levy payers that it is unlikely that firms with potential eligible claimants are not paying their due share of a

levy. We do not consider it unreasonable for a firm to remember when its annual returns are due.

We have accepted that there are firms who do not conduct business that could give rise to a protected claim from an eligible claimant, but who do not comply with the conditions for claiming exemption. Accordingly, we have relaxed the process for claiming exemption to be consistent with that of the Financial Ombudsman Scheme.

Q10: Do respondents agree with the proposal to retain upper limits on requirements for levy payments? Should these be set at the same levels as currently exist? (CP86 paras 3.64 – 3.68)

- 3.32 There was unanimous agreement that the upper limits on levy payments should be retained at the current levels. However, the ABI pointed out that for the Insurance sub-scheme, the upper limit and associated levy base should be changed from the current level and basis to 0.8% of relevant net premium income before deduction of reinsurance ceded, to accord with the Policyholders Protection Act 1997, which was never commenced. We concur.
- 3.33 We received one suggestion that the upper limit for investment business, being expressed as a monetary amount, should be indexed to avoid future annual consultation. The FMA feared that because the limit for the Investment Business sub-scheme is the sum of the limits currently applying to each of the SROs the potential maximum levy on an individual firm will be greater than it is now. The FMA suggested that the limit should be divided up, or percentage limits applied (as for the other sub-schemes).

FSA's response: We do not anticipate any need for frequent consultation on the upper limit. We continue to believe that a review of the upper limit at five year intervals is sufficient.

Even if we were to agree that it was desirable, it is impractical to divide up the limit for the Investment Business sub-scheme. The current effective limit for each individual firm cannot be carried over into the new system of contribution groups, because firms from different SROs will be mixed in the same contribution group. Neither can a simple percentage limit apply, because there are different tariff bases. In any case, we believe that an attempt to divide the limit would be an unnecessary complication.

Q11: Do respondents agree with this proposal for a phased approach to weighted allocation? (CP86 paras 3.69 – 3.73)

- 3.34 The ABI, the International Underwriting Association (IUA) and some insurance firms were disappointed that we had not pursued the issue of weighting allocation at this time. Although the ABI appreciated that for reasons of practicality our current approach is to incorporate the existing rules into the compensation sourcebook, it urged us to proceed to adopt weighted allocation for insurance at the earliest possible opportunity.

- 3.35 LIBA believed that that the weighting factor tables contained within the ICS rules for SFA firms should be carried over into FSCS.

FSA's response: It is impractical to incorporate such a weighting into the fee block/contribution group structure. Each investment business fee block/contribution group will comprise a mixture of former SFA, IMRO and PIA firms. The groups are designed to comprise of firms carrying on similar activities, and so eliminate what have been in the past to some extent artificial distinctions between kinds of firms. Whether or not any weighting between kinds of firm within contribution groups is desirable, the issue will have to wait until data on the claims experience of the new contribution groups becomes available.

- 3.36 Several firms highlighted various examples where they thought the tariff base is 'unfair' in that it is not weighted toward business protected by the compensation scheme. One firm said that it was unfair for the tariff base for contribution group A7 (Fund managers holding client money) to be funds under management for both private and intermediate clients. The FMA also highlighted the position of OPS firms whom the FMA do not see as having eligible claimants.

FSA's response: We understand firms' preferences for tariff bases that they feel would be more accurate measures of the volume of their protected business. However, we are more concerned about the objectivity and reliability of data reported to us on measures which in many cases would not have been independently audited.

The funds under management tariff base is similar to that which has been applied by IMRO, and therefore the proposed tariff is no more unfair than that currently applying to the majority of firms who will be within the fund manager contribution groups.

- 3.37 Some firms perceived themselves as having negligible risk factors relative to the majority of other firms in the same sub-scheme.

FSA's response: Such perceptions are necessarily subjective, and in certain cases diametrically opposed. Although there may be attractions to the argument that levies should be weighted toward firms with a greater risk of failure, in our view there is currently no generally accepted and publicly available set of risk parameters that could be objectively applied to all firms within the same sub-scheme. While that remains the case, it is not practical to consider weighting levy allocations by risk of failure.

- 3.38 Other firms felt that risk weighting was not justified on a variety of grounds. Besides those matters set out in CP86, there is the point that the whole industry benefits from the existence of FSCS and firms conducting business with customers who would not be eligible to claim on FSCS still benefit from the 'halo effect'. In the view of the Association of Unit Trusts and Investment Funds (AUTIF), the benefits of retail investment are felt in wholesale business, and it would be wrong if the compensation costs fell only on the retail investment providers.

FSA's response: Nothing in the responses changes our view that the general approach of reflecting the current position in the various industry sectors so far as possible is the correct one at the present. What respondents have said reinforces our view that the issue of weighted allocations should be reviewed after three years, when the relevant data has become more accessible. To adopt any of these suggestions for weighted allocations on a piecemeal approach or when there is not the time for the necessary consultation would be inappropriate.

Q12: Do respondents have any comments on the proposed approach to liabilities in respect of business conducted by appointed representatives? (CP86 paras 3.74 – 3.75)

- 3.39 A few respondents were not clear what would happen if an appointed representative failed. All compensation costs arising on the failure of an appointed representative would in theory fall on the contribution group(s) for those activities. However, the appointed representative's principal would remain responsible for meeting its liabilities arising from business done by the appointed representative, so no compensation costs should arise in respect of that business, unless either the principal does not accept responsibility for the business done by the appointed representative or the principal was itself unable to meet those liabilities. In either case the compensation costs would fall on the contribution group(s) for those activities.

Q13: Do respondents agree with the proposed approach to polarisation changes? (CP86 paras 3.76)

- 3.40 Those respondents who commented agreed with the proposed approach to polarisation changes.

Q14: Do respondents agree with this approach to business carried on without permission? (CP86 paras 3.77 – 3.80)

- 3.41 The majority of respondents who commented thought that where a firm acts outside its permission the cost of meeting compensation claims should fall on the contribution group(s) to which the firm belonged. There was a minority view that an alternative might be to spread the costs of meeting compensation claims across all the sub-schemes.

FSA's response: None of the respondents who expressed these views offered reasons we found convincing. Some thought that our proposal to allocate the costs to the contribution group representing the activity which generated the claim could cause problems, but we feel that the alternatives suggested are inherently more problematic. If the compensation cost was to be allocated on some basis to the contribution group(s) to which the defaulting firm belonged, it is by no means certain that contribution group would regard the compensation costs as affordable; the activity might be attributable to a large contribution group (e.g. deposit-taking), whereas the firm's main contribution group is relatively small. On the other hand, the market share

of a firm's activity carried on without permission can be expected to be small, and consequently the compensation cost related to that activity should be affordable to the contribution group representing that activity.

Another factor that influences us is the potential incentive for 'whistleblowing' on a firm carrying on activities outside its permission. It seems to us no bad thing that the cost of default of unsupervised activities should fall on those who have the greater interest in removing unsupervised competitors from their market, and who are more likely to notice their presence.

We feel that spreading the cost of carrying on business without permission across all firms as if it were part of Base Costs (we can see no other practical way to do it) could be prejudicial to small firms who are neither carrying on the activity involved nor part of the firm's contribution group(s).

We conclude that there is no case for departing from the general approach of allocating compensation costs according to the activity carried on.

Q15: Do respondents agree with the approach that adjustments to levies on EEA firms which top up into the UK scheme should be determined by FSCS as part of its operating procedures? (CP86 paras 3.81 – 3.84)

- 3.42 Most respondents agreed that FSCS should have discretion to discount levies on EEA firms which top up into the UK compensation scheme. Some respondents expressed the view that the general approach should be that EEA firms which top up should pay the usual levy by default, but FSCS must take the home state's compensation scheme arrangements into account when determining the levy to be paid by an EEA firm.
- 3.43 The ABI pointed out that FSCS should also be able to give a discount, if appropriate, on a similar basis to incoming EEA firms who are insurers, so as to be consistent with the provisions of Section 21(2A) of the Policyholders Protection Act 1975 (inserted by the Policyholders Protection Act 1997).

FSA's response: Currently, there are no other EEA member states with compensation schemes covering insurance business. We do not believe that it is sensible to require FSCS to give a discount when such a discount would always be nil. Should any other EEA member state set up a compensation scheme for insurance business that significantly overlaps with FSCS coverage, then we would consider changing the rules as appropriate at that time.

Q16: What are respondents' views about including cross subsidy arrangements in the rules? What do respondents think would be the effect of removing the rules obligation to participate in any cross subsidy arrangement? What are respondents' views on the specific points raised in Annex F? (CP86 paras 3.85 – 3.92)

- 3.44 Although most respondents were strongly opposed to cross-subsidy between sub-schemes in general, and the majority were against enshrining in the rules the IFA/product provider cross-subsidy, there was broad support in favour of continuing this particular arrangement as a voluntary agreement and for FSCS to facilitate it.
- 3.45 However, some feared that the position of the IFAs would be more vulnerable if the arrangement was to be voluntary. Others argued that the flexibility of a voluntary arrangement is an advantage, particularly in view of the polarisation changes which could lead to significant changes in the IFA market.
- 3.46 We understand from the ABI that the relevant product providers have indicated that they are ready to support a voluntary agreement for the forthcoming year on a similar basis to the current arrangement. We believe that this is the way forward.

Q17: Do respondents agree with the proposed approach to professional firms? (CP86 paras 3.93 – 3.96)

- 3.47 Some professional firms questioned the equity of the proposal to treat them like any other authorised firm. They pointed out that although they had investment business permission, their regulated activities are a small part of the services they provide. One professional firm pointed out that they were restricted as to the percentage of income that could derive from investment business.
- 3.48 We have accepted that the Law Society's Compensation Scheme provides protection at least as good as that provided by FSCS. Consequently professional firms of solicitors covered by that scheme will be exempt from these funding rules. Other professional bodies have not elected to change their schemes, and therefore their members will not be exempt.
- 3.49 Those respondents commenting who were not professional firms agreed with the proposed approach that they should not be treated for compensation funding purposes differently from any other regulated firm with permission to carry on the same activities.

FSA's response: There are other kinds of firms who make little use of certain of their permissions. We are not persuaded by the various arguments put forward by professional firms that there is a case to treat them differently from other firms.

Q18: Do respondents agree with these proposals for FSCS's ability to call levies? (CP86 paras 3.97 – 3.101)

- 3.50 There was general agreement to the proposals for FSCS's ability to call levies.
- 3.51 Some very small firms were particularly supportive of the idea that there should be a de minimis amount below which the Base Costs Levy would not be collected, and wanted the concept extended to all classes of levy.

FSA's response: As the reason for a de minimis amount is to avoid uneconomic collections, we see no objection in principle to applying the concept to all levies. We expect any de minimis amount to be set by FSCS at a sufficiently low level that the effect on larger companies will be insignificant. De minimis amounts will not be decided upon until the relevant data becomes available.

- 3.52 The ABI suggested that there should be a facility to raise a large levy to be collected by instalments, and to cancel any instalments found subsequently to be unnecessary. The advantages are:
- Where there is uncertainty over the amounts required, a substantial levy could be raised by reference to that year, leaving the following year's tariff base untouched in case a further substantial levy is needed.
 - If experience turned out to be more favourable than expected, then uncollected instalments could simply be cancelled.
 - Administrative expenditure would be reduced by avoiding raising levies at regular intervals throughout the year.

FSA's response: We see the advantages of readily available financial resources, which would provide us with considerable assurance towards our primary statutory objective in the compensation area, namely that FSCS should be capable of carrying out its functions at all times. However, although for larger insurance companies the advantages should outweigh the disadvantages to them of adverse cash flow and profitability, most other types of firm would not be so sanguine, to judge by the tenor of their responses in respect of minimising their exposure to levies. Also, there is the potential complication of consumer credit legislation. Although it is inevitable that particular firms will feel that we have not struck the right balance between ensuring adequate funding and minimising levies on firms, we believe that the overall balance is fair. We are therefore not adopting an instalment mechanism on the lines suggested by the ABI.

- 3.53 Various firms and trade bodies commented that FSCS should not have immunity from payment made in error, provided they were made in good faith. We point out that this rule is a reflection of the statutory indemnity afforded to FSCS in FSMA.

Q19: Do respondents have any comments on cash management processes between sub-schemes? (CP86 paras 3.102 – 3.109)

- 3.54 Some firms and trade bodies were concerned that sub-schemes should not suffer from lending to another sub-scheme, but subject to there being adequate safeguards to that end, most accepted the concept of borrowing between sub-schemes.
- 3.55 Those respondents concerned about cross-subsidy between contribution groups were generally concerned about cash within a sub-scheme not being

differentiated between contribution groups. In particular, LIBA was prominent in thinking that the provision that borrowing should be “...without prejudice to the firms from whom the money has been collected...” was inadequate protection for contribution groups.

FSA’s response: For the reasons stated under paragraph 3.5 above we do not believe it is practical to divide a sub-scheme’s assets between contribution groups. That would mean that there would be separate designated bank accounts and investment holdings for each contribution group, rather than at sub-scheme level. However, we have added guidance to clarify that for one contribution group to use money levied for another contribution group without prejudice to the latter:

- interest earned or incurred by the sub-scheme must be allocated in proportion to the funds held to the credit or debit of each contribution group, and
- FSCS must not raise a levy in respect of a creditor contribution group on account of the indebtedness of debtor contribution groups.

- 3.56 Several other variations of the conditions in the rules for inter sub-scheme borrowing were suggested, mainly directed towards requiring immediate levying to repay the borrowing, and limiting the borrowing ability of a sub-scheme to its ability to levy immediately.

FSA’s response: We see the provisions for inter sub-scheme borrowing purely as a treasury management issue, entirely consistent with the objective of minimising the overall cost to firms. It makes no commercial sense for FSCS to use its external borrowing facilities when it has adequate internal cash resources, and we continue to believe that the existing safeguards in the rules are adequate. Lending schemes will benefit from returns above the deposit rates they would otherwise obtain.

Q20: Do respondents agree with the proposed approach to FSCS’s discretion to manage the cash at its disposal? (CP86 paras 3.110 – 3.112)

- 3.57 Respondents generally agreed with the flexible approach to cash management, with a general requirement in the rules that FSCS should manage its funds prudently. Some were concerned that there should be appropriate controls including a clear publicly available investment policy.

FSA’s response: We will be monitoring FSCS’s investment policy, and it is our understanding that FSCS will comment on treasury management within its statement on corporate governance in its annual report. We believe that to prescribe detailed investment rules would be unnecessarily inflexible.

Q21: Do respondents agree with this proposed approach to dealing with pre- and post-N2 defaults and resulting liabilities? (CP86 paras 3.112 – 3.120)

- 3.58 Some respondents representing Appointed Representatives who are not required to contribute prior to 30 November 2001 say that they should not be

required to contribute in future to any liabilities relating to defaults and causes of action before that date.

- 3.59 One professional body believes that it is not fair for its members to pay two sets of compensation levies: one to FSCS which includes costs relating to pre-N2 liabilities of a constituency of which professional firms were not a part and the other to its own compensation scheme to meet the pre-N2 liabilities of its members.
- 3.60 Concerns were expressed by APCIMS and others that firms currently regulated by the SFA and IMRO, whose compensation claims experience has been low compared with firms currently regulated by the PIA, would be penalised by being placed in groups with PIA firms, so inheriting a larger share of pre-N2 liabilities. Concern was also expressed that there may be latent liability for pre-N2 claims going back over several years (as with alleged endowment mis-selling).

FSA's response: We agree that it is obviously unfair for professional firms who are not exempt from FSCS to be required to contribute to two compensation schemes for overlapping periods. Our proposals to depart from existing policy and provide transitional relief for professional firms are set out in a separate consultation on transitional funding rules.

The case for transitional relief for other types of firm is different, as there is no element of duplicate contribution. Unless there were to be an excessively complex and burdensome system for calculating levies, in any pay-as-you-go compensation scheme new entrants will contribute towards claims arising before their entry. Leavers will not have to contribute toward claims paid after they have left. The FSA, after much consideration, has concluded that there should be no transitional arrangements in respect of funding the costs of compensation after 30 November 2001 to provide transitional relief other than for professional firms.

We do not expect pre-N2 defaults affecting the Investment Business sub-scheme not covered by the accumulated funds brought forward at 30 November 2001 to be significant (estimated at £6 million for all investment business groups, excluding pension review costs which are treated separately). Accordingly, we believe that saving costs by not maintaining a parallel system for liabilities relating to defaults and causes of action before 30 November 2001 outweighs the benefit to some firms of allocating compensation costs for such causes of action only to those liable to contribute before 30 November 2001.

- 3.61 Other respondents agreed it is pragmatic to allocate all compensation liabilities which FSCS deals with to the new contribution groups, irrespective of whether those liabilities relate to defaults before or after 1 December 2001.

Q22: Do respondents agree with this proposed treatment of accumulated funds brought forward into FSCS? (CP86 paras 3.121 – 3.124)

3.62 Respondents were generally supportive of the accumulated funds held by the current compensation schemes being brought forward into the respective sub-schemes within FSCS, so that firms within each sub-scheme are levied only to the extent that the compensation costs required by FSCS exceeds those accumulated funds. Some respondents thought that funds brought forward should be available only to meet the liabilities of the respective contribution groups. The extent to which that will be the case depends upon the terms of transfer from each existing non-statutory scheme and HM Treasury's Transitional Order in respect of statutory schemes. The FSA's consequential transitional rules are being consulted upon separately.

3.63 Some thought that if the accumulated funds were significant they should be repaid, but it does not appear likely that there will be significant funds in excess of requirements.

Q23: Do respondents agree with the proposed approach to allocating compensation liabilities arising from the Pension Transfer and Opt Outs Review? (CP86 paras 3.125 – 3.127)

3.64 There was unanimous agreement from those commenting that the compensation arrangements for the Pension Transfer and Opt Outs Review should continue to be ring-fenced.

3.65 The ABI pointed out that due to an oversight in drafting the Financial Services Act 1986, the ICS is unable to pay compensation to spouses and dependants of deceased investors. To fill the gap, the ABI currently pays the compensation on such claims, financed by levies on relevant ABI members. After 30 November 2001, FSCS will be able to pay compensation in respect of defaults after that date to spouses and dependants of deceased investors. There is no policy reason why FSCS should not take over the administration of claims relating to earlier defaults, and HM Treasury's Transitional Order, for which the consequential transitional rules are being consulted upon separately, enables this.

Q24: Do respondents agree with the proposed approach to recovery of establishment costs? (CP86 paras 3.128 – 3.130)

3.66 The proposal to recover establishment costs over a three year period, through an Establishment Costs Levy allocated on the same basis as the Base Costs Levy, was generally accepted.

Q25: Do respondents have any comments on our intended approach to the financial year 2001/2002? (CP86 paras 3.131 – 3.137)

3.67 Generally, respondents were supportive of the total expenditure in 2001/2002 being funded by the existing schemes under their current funding mechanisms, so avoiding the need for further levies by FSCS. The potential for cross-

subsidy should be minimised by making adjustments when calculating and collecting the levies for 2002/2003.

Q26: Do respondents agree with the approach proposed for payments?
(CP86 paras 4.2 – 4.6)

3.68 The approach proposed for levy payments was generally accepted.

Q27: Do respondents agree with the proposed approach to data collection? (CP86 paras 4.7 – 4.10)

3.69 The approach proposed for the collection of data required to calculate each individual firm's levies on an annual basis was generally accepted.

3.70 However, a couple of respondents said that they were concerned about the availability of data if it had to be provided within two months of the firm's year end, and said it should not be demanded earlier than the date by which the annual regulatory returns are required. The ABI also questioned the need for automatic annual submission, bearing in mind the history of infrequent (if any) levies by most current schemes.

FSA's response: Firms should have adequate systems in place to capture and report required information for their relevant tariff base(s). If those systems are in place, there should be no difficulty for most firms in reporting within the proposed time frame, and the data provided by those firms should be sufficient to determine the tariff bases. Some firms will have reasons why they cannot give accurate figures by the due date, and for them the rules provide for estimation of their shares of the levies and subsequent adjustment to actual figures when they become known.

Given the existence of appropriate systems, reporting an annual figure should not be an undue burden on firms. On the contrary, we believe the routine reporting should be less burdensome than ad hoc reporting in the long run. Given the funding structure we would also expect more frequent smaller levies than has generally been the case in the past.

Q28: Do respondents have any comments about the system of operation proposed? (CP86 paras 4.11 – 4.14)

3.71 The system proposed for the invoicing and collection of levies, using the FSA as levy agent, was generally thought appropriate.

Q29: Do respondents agree the proposals for administration? (CP86 paras 4.15 – 4.18)

3.72 The proposed payment terms, interest charges for late payment, and the abatement of Base Costs Levy for new entrants were generally supported.

3.73 The ABI suggested that there should be an interest charge on firms using the direct debit facility. Otherwise most firms would presumably elect to use that facility with a resulting increase in administration and costs.

FSA's response: We do not expect that the widespread use of direct debit facilities will result in increased administration and cost. Indeed, we anticipate that rather the reverse will be the case, and that is why payments by direct debit will be encouraged.

Q30: Do respondents agree with the general conclusions in Annex F? If not, can respondents provide evidence of where significant additional costs will be generated? (CP86 paras 5.1 – 5.4)

3.74 Respondents generally accepted that the proposals have tried to minimise changes in procedures and the current broad divisions between business sectors, and should lead to an efficient system that minimises the overall cost of raising funds. However, some had reservations concerning whether the divisions between types of activity were too broad. Their comments on contribution groups are included above in paragraphs 3.16 to 3.25, together with our response.

Q31: What comments do respondents have about the potential market effects of the two specific issues highlighted above? (CP86 paras 5.1 – 5.4)

3.75 The costs and benefits analysis highlighted two specific issues where the approach taken could possibly have significant potential effects on certain firms.

3.76 The first of those issues was the effect on the market if a rules obligation does not exist in respect of the IFA/product provider cross-subsidy. Most respondents on this issue gave their comments on this under question 16 (see paragraph 3.44), and did not comment further on market effects.

3.77 The second issue was the use of Approved Persons as a tariff base, which might be of particular significance to smaller firms where a few individuals may carry on several business activities. Again, most respondents gave their comments on this issue under an earlier question, 7 (see paragraph 3.27).

Refund of levies

3.78 One other significant issue raised by respondents, in respect of which we propose to amend the rules, we regard as non-contentious, and consistent with the concept of a pay-as-you-go scheme. We propose to make a rule to allow FSCS to refund surplus funds within a sub-scheme. Surplus funds are monies in excess of the amount that FSCS could levy under the rules. This situation is particularly likely to arise in the Accepting Deposits sub-scheme and may also be significant to the Insurance sub-scheme, because large recoveries from the estates of banks and insurance companies are likely to occur from time to time.

Implementation of the Policyholders Protection Act 1997

- 3.79 Another issue raised by respondents relates to the current funding rules of the PPB, the draft rules for which were incorporated in CP86. Those rules are contained in the Policyholders Protection Act 1975. That Act was intended to be amended by the Policyholders Protection Act 1997. However, that Act was never commenced and so the amended funding rules never came into force. The FSA is proposing to make compensation rules that incorporate the changes made by the Policyholders Protection Act 1997 regarding protected claims and eligible claimants, and it would be consistent to also incorporate the 1997 changes to the funding rules. We have amended the rules accordingly, by changing the definition of relevant net premium income to be the amount gross of any relevant reinsurance premiums, and by reducing the limit on the amount of Compensation Costs Levies in respect of a financial year.

4 Main changes to the consultation draft

- 4.1 This section gives details of the main differences between the ‘final’ compensation scheme funding rules (Annex B of this paper) and the text consulted upon in CP86. References to the ‘final’ text are prefixed ‘COMP’ (which stands for compensation) whereas references to the consultation text do not have a prefix. The suffix ‘R’ denotes a rule and ‘G’ a guidance note.

Exemption

- 4.2 The rules and guidance in section 13.3 have been amended so that claiming exemption is less onerous. They are consistent with the equivalent FOS funding rules.

FSCS’s power to impose levies

- 4.3 13.4.5R has been amended to clarify that all amounts previously paid by a deposit-taking firm as its share of its levies allocated to the Accepting Deposits sub-scheme or to the DPB are to be taken into account in calculating their share of a maximum current levy.
- 4.4 13.4.6R has been amended to be consistent with the Policyholders Protection Act 1997. The limit on the amount of Compensation Costs Levies that may be allocated to the Insurance sub-scheme in any financial year has been reduced to 0.8% of relevant net premium income. The definition of relevant net premium income has been changed so that relevant reinsurance premiums ceded are not deducted.
- 4.5 We have expanded 13.4.11R to clarify that credits for interest earned are to be set off against management expenses for the purposes of levy calculations.

Management of Funds

- 4.6 Guidance has been added to 13.4.13R to clarify that, where money is borrowed from one contribution group by another contribution group:
- the interest earned or incurred by the sub-scheme must be allocated according to the funds held to the credit or debit of each contribution group, adjusted for credits or debits arising from borrowings between contribution groups.
 - FSCS must not raise a levy in respect of a creditor contribution group on account of the indebtedness of debtor contribution groups.

Refunds

- 4.7 A new rule COMP 13.4.18R has been added to allow FSCS to refund surplus funds to contribution groups. Surplus funds are those funds in excess of the amount which FSCS could raise by levy in accordance with 13.4.1(2)R, or in other words in excess of the amount believed to be sufficient to cover anticipated expenditure in the next 12 months. In the case of the Accepting Deposits sub-scheme, COMP 13.4.17R provides that refunds in respect of recoveries from failed deposit-takers may be paid to the firms who originally contributed to the levy to pay for the compensation in respect of that failed deposit-taker.

Remission or reduction of levy

- 4.8 13.5.13R has been amended so that if a firm's aggregate share of all levies would be so small that it would be uneconomic to collect, the FCSC may reduce it to zero.

Compensation costs

- 4.9 13.6.7R has been amended to bring the contribution groups and tariff bases for the investment business sub-scheme into line with the activity groups and activity bases for the FSA fee-blocks.
- 4.10 A new rule COMP 13.6.13R has been added to give effect to the policy established in the feedback to CP24 for the modification of the protected deposit tariff base. This allows FSCS to continue the approach used by the DPB, whereby if a firm itself finds it worthwhile to identify protected deposits where the depositor is not a potential eligible claimant, being a large corporate, then the firm may exclude such deposits from the tariff base.

Costs and benefits

- 4.11 The FSA believes that overall these changes to the rules do not result in cost increases of more than minimal significance. Indeed, with the introduction of the refund rule potential costs have if anything been reduced. Accordingly we have not revised our earlier analysis of the costs and benefits of implementing the proposed funding arrangements for FSCS in comparison with continuation of the current arrangements, which were dealt with in Consultation Paper 86.

List of respondents to CP86

Association of British Insurers (ABI)

Association of Independent Financial Advisers (AIFA)

Association of Private Client Investment Managers & Stockbrokers (APCIMS)

Association of Unit Trust and Investment Funds (AUTIF)

AXA Sun Life

Barclays Bank Plc

Baxter & Lindley Financial Services Limited

Britannia Building Society

British Bankers' Association (BBA)

British Health Care Association

Building Societies Investor Protection Scheme (BSIPS)

Deposit Protection Board (DPB)

Depository And Trustee Association (DATA)

Edward Hollinshead

Fidelity Investment Services Limited

Financial Services Compensation Scheme

Friendly Societies Commission (FSC)

Fund Managers Association (FMA)

G Foxwell & Co

Heydale Key Registration Co Ltd

International Underwriting Association (IUA)

INVESCO Perpetual

Kauders Portfolio Management

Legal & General Assurance (Pensions Management) Limited

London Investment Banking Association (LIBA)

London Midland & Scottish Railway Running Department Insurance Society

Marks & Spencer Financial Services Limited

National Association of Citizens Advice Bureaux (NACAB)

National Consumer Council (NCC)

Patients' Aid Association

The Society of Pension Consultants (SPC)

Stockport Credit Unions Forum

Swiss Life (UK) plc

Wholesale Markets Brokers' Association (WBMA)

The FSA also received responses from a number of persons who asked that their response be treated as confidential.

'Final' funding rules

Handbook Modules

Chapter 13

Funding





13.1 Application and Purpose

Application

13.1.1

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This chapter applies to:

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- (1) every participant firm; and
- (2) the FSCS.

13.1.2

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Firms which are not participant firms (such as certain types of *incoming EEA firms*, *service companies* and *ICVCs*) are not required to contribute towards the funding of the compensation scheme.

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Purpose

13.1.3

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The purpose of this chapter is to set out the requirements on participant firms to pay levies imposed by the FSCS to provide funding for its functions.

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13.2 General structure

13.2.1 G /1 Section 213(3)(b) of the *Act* requires the *FSA* 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.

13.2.2 G /1 The FSCS may impose two types of levy: a management expenses levy, and a compensation costs levy. In the first three full years of the operation of the compensation scheme, the FSCS may impose an establishment costs levy as part of a management expenses levy. The FSCS has discretion as to the timing of the levies imposed.

13.2.3 G /1 In calculating a compensation costs levy, the FSCS may include anticipated compensation costs for defaults expected to be declared 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 *COMP* 13 Ann 1R.

13.2.4 G /1 In order to allocate a share of the amount to be funded by an individual participant firm, the funding arrangements are split into three sub-schemes: the accepting deposits sub-scheme, the insurance business sub-scheme, and the designated investment business sub-scheme. The business carried on by a participant firm determines into which sub-scheme, or sub-schemes, it falls.

13.2.5 G /1 Within each sub-scheme there are one or more contribution groups. These relate to different types of activity carried on by participant firms within each sub-scheme. Within a sub-scheme, individual participant firms are allocated for funding purposes to one or more contribution groups, depending on their business activities. This meets 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 management expenses levy

13.2.6 G /1 Section 223 of the *Act* (Management expenses) prevents the FSCS from recovering, through a levy, any management expenses attributable to a particular period in excess of the limit set in *COMP* as applicable to that period. ‘Management expenses’ are defined in section 223(3) to mean expenses incurred or expected to be incurred by the FSCS in connection with its functions under the *Act*, except:

- (1) expenses incurred in paying compensation; and

(2) expenses incurred as a result of the FSCS making the arrangements to secure continuity of insurance set out in COMP 3.3.1R and COMP 3.3.2R or taking the measures set out in COMP 3.3.3R and COMP 3.3.4 when a relevant person is an *insurer* in financial difficulties.

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A management expenses levy under COMP may consist of three 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 to any specific default. Included in this category are items such as the salary of the members of the board of the FSCS, the costs of the premises which the FSCS occupies, and its audit fees. The amount that each participant firm pays towards a base costs levy is calculated by reference to the regulatory costs paid by the *firm*. All participant firms are liable to contribute towards a base costs levy.

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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, and include the salaries of the staff of the FSCS and legal and other professional fees paid in respect of particular defaults. The specific costs are allocated to the contribution group or groups of which the relevant person in default was a member, or 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 contribution groups to which the FSCS has allocated specific costs. Each contribution group has a separate ‘tariff base’ for this purpose, set out in COMP 13.6.7R. Participant firms may be exempt from contributing to the specific costs levy.

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The third element of a management expenses levy is the costs of establishing the FSCS. The FSCS may impose an establishment costs levy only until the end of the third full financial year of operation of the compensation scheme. The amount that each participant firm pays towards the establishment costs levy is calculated on the same basis as the base costs levy, and all participant firms are liable to contribute.

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The FSA intends to consult in January each year on the amount which it will set as the limit on the management expenses attributable to the forthcoming financial year of the FSCS.

The compensation costs levy

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The compensation costs levy 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 those compensation costs it expects to incur (including in respect of defaults yet to be declared) over the 12 months following the date of the levy.

13.2.12

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Compensation costs are the costs incurred in paying compensation, securing continuity of long-term insurance and safeguarding eligible claimants when insurers are in financial difficulties. For funding purposes, these costs are allocated by the FSCS, and met by participant firms, in the same way as specific costs: see COMP 13.6.6R.

13.2.13

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If a participant firm is a member of more than one contribution group, the total compensation costs levy and specific costs levy for that firm will be the aggregate of the individual levies calculated for the firm in respect of each of the contribution groups.

Incoming EEA firms

13.2.14

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Incoming EEA firms which top up under the provisions of COMP 14 are *firms* whose *Home State* scheme provides compensation cover in the event that they are declared in default. Under COMP 13.7, 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* contribution group.

13.3 Exemption

- 13.3.1** **R** /1 A participant firm which does not conduct business that could give rise to a protected claim by an eligible claimant and has no reasonable likelihood of doing so is exempt from a specific costs levy or a compensation costs levy provided that it notifies the FSCS of this fact and the notice remains current.
- 13.3.2** **R** /1 A notice under *COMP* 13.3.1R must be given:
- (1) by 28 February 2002, in which case it will remain current until 31 March 2003; or
 - (2) as soon as practicable after the time of its authorisation by the *FSA*, in which case it will remain current until the end of the financial year of the compensation scheme in which it is given; or
 - (3) as soon as practicable after it ceases to conduct business that could give rise to a protected claim by an eligible claimant, in which case it will remain current until the end of the financial year of the compensation scheme in which it is given; or
 - (4) unless (1) applies, in February of each financial year of the compensation scheme, in which case the notice will remain current until the end of the next financial year.
- 13.3.3** **G** /1
- (1) A notice under *COMP* 13.3.1R will be renewable every 12 months.
 - (2) The financial year of the compensation scheme is the twelve months ending on 31 March.
- 13.3.4** **R** /1 A participant firm which is exempt under *COMP* 13.3.1R must notify the FSCS as soon as reasonably practicable if the conditions in *COMP* 13.3.1R no longer apply.
- 13.3.5** **G** /1 A participant firm to which the conditions in *COMP* 13.3.1R no longer apply will then become subject to *COMP* 13.
- 13.3.6** **R** /1 If, during the course of a financial year of the compensation scheme, a participant firm ceases to conduct business that could give rise to a protected claim by an eligible claimant and notifies the FSCS of this under *COMP* 13.3.2R(3), it will be treated as a participant firm to which *COMP* 13.8.7R applies.

13.4 The FSCS's power to impose levies

General limits on levies

13.4.1

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The FSCS may at any time impose a management expenses levy or a compensation costs 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:

- (1) in the case of a management expenses levy, the level of the FSCS's anticipated 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, the level of the FSCS's anticipated expenditure in respect of compensation costs in the 12 months following the levy.

13.4.2

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The calculation of levies will also take into account previous levies, where funds raised in anticipation of meeting liabilities prove either more or less than the amount actually required.

13.4.3

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The FSCS may impose one or more levies in a financial year to meet either its management expenses or its compensation costs. The FSCS may also impose interim levies, as part of its overall levy commitment. This flexibility allows the FSCS to phase its financing over the course of a financial year and thus avoid collecting levies from firms before the money is actually needed. The FSCS has committed itself in the Memorandum of Understanding with the FSA (the text of which can be found on the FSA website www.fsa.gov.uk) to publish regularly an indicative timetable for its levy procedures. [The Memorandum of Understanding has not yet been concluded.]

13.4.4

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The discretion over levying in *COMP* also gives the FSCS, if it thinks this appropriate, the ability to use third parties as its agents in raising and collecting the levies

Limits on compensation costs levies on sub-schemes

13.4.5

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The FSCS must not require a participant firm in the accepting deposits sub-scheme to pay a share of a compensation costs levy allocated to that sub-scheme to the extent that:

- (1) the share in question; plus
 - (2) all previous amounts paid by the firm either as its share of levies allocated to that sub-scheme, or under the Deposit Protection Scheme (deducting from those amounts any amount refunded under COMP 13.4.17-18 or by the Deposit Protection Scheme);
- amounts to more than 0.3% of the firm's protected deposits.

13.4.6 **R** ^{/1} The FSCS must not require a participant firm in the insurance business sub-scheme to pay a share of a compensation costs levy allocated to that sub-scheme in any financial year of the compensation scheme, to the extent that the share in question, together with all previous amounts paid by the *firm* as its share of compensation costs levies allocated to that sub-scheme in that financial year, amounts to more than 0.8% of the participant firm's relevant net premium income.

13.4.7 **R** ^{/1} The maximum amount of compensation costs for which the FSCS can levy the designated investment business sub-scheme in any one financial year of the compensation scheme is limited to £400 million.

Levy for compensation costs paid in error

13.4.8 **R** ^{/1} The FSCS may include in a compensation costs levy the costs of compensation paid by the FSCS in error, provided that the payment was made in good faith.

Management of funds

13.4.9 **R** ^{/1} The FSCS must hold any amount collected from a specific costs levy or compensation costs levy to the credit of the sub-schemes and relevant contribution groups, in accordance with the allocation established under COMP 13.5.6R and 13.6.2R.

13.4.10 **R** ^{/1} Any funds received by the FSCS by way of levy or otherwise for the purposes of the compensation scheme are to be managed as the FSCS considers appropriate, and in doing this the FSCS must act prudently.

13.4.11 **R** ^{/1} Interest earned by the FSCS in the management of funds held to the credit of a contribution group must be credited to that contribution group, and must be set off against the management expenses allocated to that contribution group.

13.4.12 **R** ^{/1} The FSCS must keep accounts which show:

- (1) the funds held to the credit of each sub-scheme and relevant contribution group; and

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- (2) the liabilities of that sub-scheme and relevant contribution group.
- 13.4.13** **R** ^{/1} The FSCS may use the money collected from firms within one sub-scheme to pay compensation costs in respect of any contribution group within that sub-scheme, so long as it ensures that this is done without prejudice to the participant firms from whom the money has been collected.
- 13.4.14** **G** ^{/1} *COMP* 13.4.13R means that, for example:
- (1) when crediting interest under *COMP* 13.4.11R, the FSCS should regard any money collected from one contribution group which has been used to pay the compensation costs of another contribution group within the same sub-scheme as standing to the credit of the first contribution group; and
- (2) the FSCS should not raise a levy under *COMP* 13.4.1R on a contribution group solely because, as a result of the FSCS's action under *COMP* 13.4.13R, there appear to be insufficient funds available to the credit of the contribution group.
- 13.4.15** **R** ^{/1}
- (1) The FSCS may use any money held to the credit of one sub-scheme (the 'creditor sub-scheme') to pay compensation costs in respect of another sub-scheme (the 'debtor sub-scheme') 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:
- (a) the creditor sub-scheme is reimbursed by the debtor sub-scheme as soon as possible;
- (b) the debtor sub-scheme pays interest at a rate equivalent to the Bank of England's repo rate from time to time in force; and
- (c) the amount lent by the creditor sub-scheme to the debtor sub-scheme is taken into account by the FSCS when considering whether to impose a compensation costs levy on the creditor sub-scheme under *COMP* 13.4.1R.
- 13.4.16** **R** ^{/1} Unless *COMP* 13.4.17R applies, any recoveries made by the FSCS in relation to protected claims must be credited to the contribution groups to which the related compensation costs were allocated.
- 13.4.17** **R** ^{/1} If the FSCS makes recoveries in relation to protected claims where the related compensation costs were allocated to the deposit takers contribution group, or in relation to compensation paid out of a special contribution under the Deposit Protection Scheme, and if the FSCS refunds the recoveries under *COMP* 13.4.18R, it must ensure that, as far as possible, the recoveries are refunded to the *firms* that contributed to the relevant compensation costs levy or special contribution (whether or not the *firms* are participant firms at the time that the recoveries are made).

13.4.18

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If the FSCS has more funds to the credit of a contribution group than the FSCS believes will be required to meet levies on that contribution group for the next 12 months, it may refund the surplus to members or former members of the contribution group on any reasonable basis.

Adjustments to calculation of levy shares

13.4.19

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The FSCS may adjust the calculation of a participant firm's share of any levy to take proper account of:

- (1) any excess, not already taken into account, between previous levies of that type imposed in relation to previous periods and the relevant costs actually incurred in that period; or
- (2) participant firms that are exempt from the levy under *COMP* 13.3; or
- (3) amounts that the FSCS has not been able to recover from participant firms as a result of *COMP* 13.4.5R or *COMP* 13.4.6R; or
- (4) amounts that the FSCS has not been able to recover from participant firms after having taken reasonable steps; or
- (5) *COMP* 13.5.8R (New participant firms), *COMP* 13.4.20R (Remission or reduction of levy) or *COMP* 13.7 (*Incoming EEA firms*); or
- (6) anything else that the FSCS believes on reasonable grounds should be taken into account.

Remission of levy

13.4.20

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If a participant firm's share of a levy would be an amount so small that, in the opinion of the FSCS, the costs of collection would be disproportionate to the amount received, the FSCS may treat the participant firm as if the share amounted to zero.

13.5 Management expenses

- 13.5.1** **R** A participant firm must pay to the FSCS a share of each management expenses levy.
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- 13.5.2** **R** The total of all management expenses levies attributable to a particular period of the compensation scheme may not exceed the limit applicable to that period set out in *COMP 13 Ann 1R*.
- 13.5.3** **R** A participant firm's share of a management expenses levy consists of one or more of:
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- (1) a share of a base costs levy; and
 - (2) a share of a specific costs levy; and
 - (3) a share of an establishment costs levy.
- 13.5.4** **R** The FSCS must ensure that each participant firm's share of a management expenses levy separately identifies the *firm's* share of the base costs levy, specific costs levy and establishment costs levy.
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- 13.5.5** **R** Unless *COMP 13.4.19R* applies, the FSCS must calculate a participant firm's share of a base costs levy by:
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- (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;
 - (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
 - (3) applying the proportion calculated in (2) to the figure in (1).
- 13.5.6** **R** The FSCS must allocate any specific costs levy amongst the sub-schemes and relevant contribution groups in proportion to the volume of relevant costs arising from, or expected to arise from, claims in respect of the different activities represented by those contribution groups.
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- 13.5.7** **R** Unless *COMP 13.4.19R* applies, the FSCS must calculate a participant firm's share of a specific costs levy by:
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- (1) identifying each of the sub-schemes and relevant contribution groups within those sub-schemes to which the participant firm belongs, using the statement of business most recently supplied under *COMP* 13.6.11R;
- (2) identifying the management expenses other than base costs or establishment costs which the FSCS has incurred, or expects to incur, in the relevant financial year of the Compensation Scheme, allocated to the contribution groups identified in (1), but not yet levied;
- (3) calculating, in relation to each relevant contribution group, the participant firm's tariff base as a proportion of the total tariff base of all participant firms in the contribution group, using the statement of business most recently supplied under *COMP* 13.6.11R;
- (4) applying the proportion calculated in (3) to the figure in (2); and
- (5) if more than one sub-scheme or contribution group is relevant, adding together the figure in (4) for each contribution group.

New participant firms

13.5.8 **R** ^{/1} A firm (other than one to which the grandfathering order applies) which becomes a participant firm part way through a *financial year* of the compensation scheme will not be liable to pay a share of a specific costs levy made in that year.

13.5.9 **G** ^{/1} New participant firms will normally have relevant tariff bases of nil as at 31 December in the *financial year* preceding that in which they join, so that they will not be required to pay a share of a specific costs levy (or a compensation costs levy because of *COMP* 13.6.6). *COMP* 13.5.8 means that that FSCS does not have to estimate the tariff base of a new participant firm.

13.5.10 **G** ^{/1} Since a firm that becomes a participant firm in the course of a *financial year* of the compensation scheme will already be obtaining a discount in relation to the base costs levy and the establishment costs levy through the modified fee provisions of *SUP* 20.7.3, no rule is necessary in *COMP* for discounts on the base costs levy or the establishment costs levy.

Establishment costs levy

13.5.11 **R** ^{/1} The FSCS must calculate a participant firm's share of an establishment costs levy on the same basis as a base costs levy under *COMP* 13.5.5R.

13.5.12 **R** ^{/1} The FSCS may not impose an establishment costs levy after the end of the third full financial year of operation of the compensation scheme.

13.6 Compensation costs

- 13.6.1** **R** ^{/1} The compensation costs levy is made up of compensation costs incurred by the FSCS, together with any compensation costs which can reasonably be anticipated as arising in the 12 months following the levy date, and which in each case have not already been subject to a levy.
- 13.6.2** **R** ^{/1} The FSCS must allocate any compensation costs levy to the individual sub-schemes and relevant contribution groups in proportion to the volume of compensation costs arising from, or expected to arise from, claims in respect of the different activities represented by those contribution groups.
- 13.6.3** **R** ^{/1} 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 contribution group which covers that activity.
- 13.6.4** **R** ^{/1} 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 contribution group for that activity.
- 13.6.5** **R** ^{/1} A participant firm (except one exempt under *COMP* 13.3) must pay to the FSCS a share of each compensation costs levy.
- 13.6.6** **R** ^{/1} The FSCS must calculate a participant firm's share of a compensation costs levy on the same basis as a specific costs levy under *COMP* 13.5.7R and *COMP* 13.5.8R.
- 13.6.7** **R** ^{/1} When calculating a participant firm's share of a compensation costs levy or specific costs levy allocated to:
- (1) the accepting deposits sub-scheme or the insurance business sub-scheme, the FSCS must use the contribution groups and tariff bases as set out in the table in *COMP* 13.6.8R.;
 - (2) the investment business sub-scheme, the FSCS must use as the contribution groups and tariff bases the correspondingly numbered *activity groups* and tariff bases as set out in part 7 of *SUP* 20 Ann 1R.;

13.6.8

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Table Table: Contribution Groups for the Accepting Deposits Sub-scheme and the Insurance Business Sub-scheme for the Financial Services Compensation Scheme (see COMP 13.6.7R (1))

SUB-SCHEME	CONTRIBUTION GROUP (references to A1, A2 etc are to the FSA Fee Blocks)	LEGAL BASIS FOR ACTIVITY (references to articles are to articles of the Regulated Activities Order)	TARIFF BASE
Accepting deposits	A1 – deposit takers	Accepting <i>deposits</i> (article 5)	<i>Protected deposits</i> (see COMP 13.6.13R)
Insurance business	A3 – Insurance activities – General insurance	Effecting contracts of insurance and/or carrying out contracts of insurance (article 9) that are rights under <i>general insurance contracts</i>	<i>Relevant net premium income</i>
Insurance business	A4 – insurance activities – Life Insurance	Effecting contracts of insurance and/or carrying out contracts of insurance (article 9) that are rights under <i>long-term insurance contracts</i>	<i>Relevant net premium income</i>

13.6.9

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Table Table: A summary of the relevant contribution groups and tariff bases for the investment business sub-scheme (see COMP 13.6.7R (2)).

SUB-SCHEME	CONTRIBUTION GROUP (references to A1, A2 etc are to the FSA Fee Blocks)	LEGAL BASIS FOR ACTIVITY (references to articles are to articles of the Regulated Activities Order)	TARIFF BASE
Designated investment business	A7 – fund managers holding client money and/or assets	Managing investments (article 33), and either: (a) holding client money; or (b) safeguarding and administering investments (article 36)	Funds under management

Designated investment business	A8 – fund managers not holding either client money and/or assets	Managing investments (article 33), but not: (a) holding client money; or (b) safeguarding and administering investments (article 36)	Funds under management
Designated investment business	A9 – managers of an <i>AUT</i> , <i>ACDs</i> and <i>depositories</i>	Any of the following: (a) establishing, operating or winding up a <i>collective investment scheme</i> ; (b) acting as a trustee of an authorised unit trust scheme; (c) acting as a <i>depository</i> , or sole director of an open-ended investment company (article 48)	Gross income
Designated investment business	A10 – dealing as principal	Dealing in investments as principal (article 12), but not: (a) dealing as principal in investments if the investments are life policies; or (b) acting as a matched principal broker	Number of traders
Designated investment business	A11 – execution only brokers	Any of the following: (a) dealing in investments as agent (article 19); (b) arranging (bringing about) deals in investments (article 21(1)); (c) making arrangements with a view to transactions in investments (article 22(2)); (d) dealing as principal in investments where the investments are life policies (article 12); (e) acting as a matched principal broker; but without <i>permission</i> to advise on investments (article 52)	Commission income

Designated investment business	A12 – brokers (excluding execution-only brokers and corporate finance advisers) – holding either client money or assets	Any of the following: (a) dealing in investments as agent (article 19); (b) arranging (bringing about) deals in investments (article 21(1)); (c) making arrangements with a view to transactions in investments (article 22(2)); with <i>permission</i> to: (i) advise on investments (article 49); (ii) hold client money; and (iii) safeguard and administer investments (article 36)	Number of <i>approved persons</i>
Designated investment business	A13 – brokers (excluding execution-only brokers and corporate finance advisers) – not holding either client money or assets	Any of the following: (a) dealing in investments as agent (article 19); (b) arranging (bringing about) deals in investments (article 21(1)); (c) making arrangements with a view to transactions in investments (article 22(2)); with <i>permission</i> to advise on investments (article 49); but not to (i) hold client money; and (ii) safeguard and administer investments (article 36).	Number of <i>approved persons</i>
Designated investment business	A14 – corporate finance advisory firms	<i>Permission</i> includes a requirement that the firm must not conduct <i>designated investment business</i> other than <i>corporate finance business</i>	Number of <i>approved persons</i>

Designated investment business	A15 – advisory only	Advising on investments (article 49), but not within A11 to A14	Number of <i>approved persons</i>
Designated investment business	A16 – pensions review	The firm was liable to pay the Pensions Review Levy to the <i>PIA</i> in 2001/ 2002	Percentage share of <i>PIA</i> 's 2001/ 2002 Pensions Review Levy

13.6.10

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A participant firm may belong to more than one sub-scheme, and more than one contribution group within the same sub-scheme.

13.6.11

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Unless exempt under *COMP* 13.3.1R, a participant firm must provide the FSCS by the end of February each year with a statement of

- (1) the contribution groups to which it belongs; and
- (2) the total amount of business (measured in accordance with the appropriate tariff base or bases) which it conducted, as at 31 December of the previous year, in relation to each of those contribution groups.

13.6.12

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If the information in *COMP* 13.6.11R has been provided to the *FSA* under other rule obligations, a participant firm will be deemed to have complied with *COMP* 13.6.11R.

13.6.13

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Where a participant firm can identify that a protected deposit was made by a *person* who is not an eligible claimant, it may exclude the amount of that deposit from the tariff base, provided that it notifies the FSCS of the amount of the deposit so excluded and provides the FSCS with such information about the deposit as the FSCS may reasonably require.

13.6.14

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Where a participant firm does not provide the statement required by *COMP* 13.6.11R, the FSCS may assess the firm for its share of the compensation costs levy or the specific costs levy on any reasonable basis (including on the basis of the statement for the previous year), making such adjustments as seem appropriate in subsequent levies once the true figures are known.



13.7 Incoming EEA firms

Levies for specific costs and compensation costs relating to the pension transfers and opt-outs review

13.7.1

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If an *incoming EEA firm*, which is a *BCD credit institution* or *ISD investment firm*, is a participant firm, the FSCS must give the firm such discount (if any) as is appropriate on the share of any levy it would otherwise be required to pay, taking account of the nature of the levy and the extent of the compensation coverage provided by the firm's *Home State* scheme.

13.8 Payment of levies

- 13.8.1** **R** A participant firm must pay its share of any levy made by the FSCS:
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- (1) in one payment; or
 - (2) where the FSCS agrees, quarterly, at the beginning of each quarter, by direct debit agreement.
- 13.8.2** **G** The amount paid under a direct debit arrangement will be adjusted on a continuous basis to take account of interim levies and other adjustments made during the course of the financial year.
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- 13.8.3** **R** A participant firm's share of a levy to which COMP 13.8.1R(1) applies is due on, and payable within 30 days of, the date when the invoice is issued.
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- 13.8.4** **R** If a participant firm does not pay its share of a levy as required by COMP 13.8.3R, it must thereafter pay additional administrative fees based on the amount outstanding at a rate of 5% over the Bank of England's repo rate from time to time in force accruing on a daily basis from the date on which the payment was due.
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- 13.8.5** **R** If a participant firm does not pay its share of a levy subject to a direct debit agreement as required by COMP 13.8.1R(2), the entire amount of the levy becomes due and payable to the FSCS, and additional administrative fees are payable at the rate set out in COMP 13.8.4R.
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- 13.8.6** **R** If a participant firm fails to make payment under COMP 13, the FSCS may:
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- (1) take steps to recover any money owed; or
 - (2) refer the matter to the FSA so that the FSA may take whatever disciplinary action it considers necessary; or
 - (3) do both (1) and (2).
- 13.8.7** **R** If a *firm* ceases to be a participant firm part way through a financial year of the compensation scheme:
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- (1) it will remain liable for any unpaid levies which the FSCS has already made on the firm; and

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- (2) the FSCS may make a levy upon it (which may be before or after the firm has ceased to be a participant firm, 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 at the time of the levy on the firm.

Definitions

Act	The Financial Services and Markets Act 2000.
article 9 default	<p>(as defined in article 9 of the <i>compensation transitionals order</i>) any of the following:</p> <ul style="list-style-type: none"> (a) the passing of a resolution for the voluntary winding up of an authorised insurance company within the meaning of section 3 of the Policyholders Protection Act 1975 in circumstances falling within section 5(1)(a) of that Act; (b) the making by the court of an order for the winding up of such a company in accordance with section 5(1)(b) of that Act; (c) the appointment of a provisional liquidator in the circumstances falling within section 15 of that Act in respect of such a company; (d) such a company becoming a company in financial difficulties within the meaning of section 16 of that Act; (e) a participating institution becoming insolvent within the meaning of section 25A of the Building Societies Act 1986; (f) the beginning of a dissolution or transfer of engagements of a member society in accordance with rule 9(2) of the Rules of the Friendly Societies Protection Scheme.
authorised person	<p>(as defined in section 31 of the Act (authorised persons)) one of the following persons authorised for the purposes of the Act:</p> <ul style="list-style-type: none"> (a) a person who has a part IV permission to carry on one or more regulated activities (b) an EEA firm qualifying for authorisation under Schedule 3 to the Act (EEA Passport Rights); (c) a Treaty firm qualifying for authorisation under Schedule 4 to the Act (Treaty firms); (d) a person who is otherwise authorised by a provision of, or made under, the Act.
base costs	management expenses, other than establishment costs, which are not dependent on the level of claims made on the FSCS.

base costs levy	a levy, forming part of the management expenses levy, to meet the base costs in the financial year to which the levy relates, each participant firm's share being calculated in accordance with COMP 13.5.5.
commencement	the beginning of the <i>commencement day</i> .
commencement day	the <i>day</i> on which section 19 of the <i>Act</i> (The general prohibition) comes into force.
compensation costs	the costs incurred in paying compensation or as a result of making the arrangements set out in COMP 3.3.2R or taking the measures set out in COMP 3.3.3R.
compensation costs levy	a levy imposed by the FSCS on participant firms to meet compensation costs, each participant firm's share being calculated in accordance with COMP 13.6.
compensation scheme	the compensation scheme established by the FSA under part XV of the <i>Act</i> (The Financial Services Compensation Scheme).
compensation transitionals order	The Financial Services and Markets Act 2000 (Transitional Provisions, Repeals and Savings) (Financial Services Compensation Scheme) Order 2001 (SI 2001/xxxx).
contribution group	one of the groups of participant firms within a sub-scheme set out in COMP 13.6.7R, being groups that carry on business of a similar nature, to which compensation costs and specific costs are allocated in accordance with COMP 13.5 and 13.6.
EEA firm	<p>(as defined in paragraph 5 of Schedule 3 to the <i>Act</i> (EEA Passport Rights)) any of the following, if it does not have its head office in the United Kingdom:</p> <ul style="list-style-type: none"> (a) an investment firm (as defined in article 1(2) of the Investment Services Directive) which is authorised (within the meaning of article 3) by its Home State regulator; (b) a credit institution (as defined in article 1 of the Banking Consolidation Directive) which is authorised (within the meaning of article 1) by its Home State regulator; (c) a financial institution (as defined in article 1 of the Banking Consolidation Directive) which is a subsidiary of the kind mentioned in article 19 and which fulfils the conditions in articles 18 and 19; (d) an undertaking pursuing the activity of direct insurance (within the meaning of article 1 of the First Life Directive or of the First Non-Life Directive) which has received authorisation under article 6 from its Home State regulator.
eligible claimant	a person who is eligible to bring a claim for compensation under COMP 4.2.1R.

employers' liability insurance	a contract of insurance against risks of the persons insured incurring liabilities to their employees
establishment costs	the costs of establishing the compensation scheme.
establishment costs levy	a levy, forming part of the management expenses levy, to meet the establishment costs, each participant firm's share being calculated in accordance with COMP 13.5.10.
financial year	1 April to 31 March.
firm	an authorised person.
FSA	The Financial Services Authority.
FSCS	The Financial Services Compensation Scheme Limited.
grandfathering order	The Financial Services and Markets Act 2000 (Transitional Provisions)(Authorised Persons etc) Order 2001 (SI 2001/2636).
Home State	<p>(1) (in relation to a credit institution) the EEA State in which the credit institution has been authorised in accordance with the Banking Consolidation Directive.</p> <p>(2) (in relation to an investment firm):</p> <p>(a) where the investment firm is a natural person, the EEA State in which his head office is situated;</p> <p>(b) where the investment firm is a legal person, the EEA State in which its registered office is situated or, if under its national law it has no registered office, the EEA State in which its head office is situated.</p> <p>(3) (in relation to an insurance undertaking with an EEA right) the EEA State in which the registered office of the insurance undertaking is situated.</p> <p>(4) (in relation to a market) the EEA State in which the registered office of the body which provides trading facilities is situated or, if under its national law it has no registered office, the EEA State in which that body's head office is situated.</p> <p>(5) (in relation to a Treaty firm) the EEA State in which its head office is situated, in accordance with paragraph 1 of Schedule 4 to the Act (Treaty rights).</p>
ICVC	investment company with variable capital.
incoming EEA firm	an EEA firm which is exercising its right to carry on a regulated activity in the United Kingdom in accordance with Schedule 3 to the Act (EEA Passport Rights).

insurance undertaking	an undertaking, whether or not an insurer, which carries on insurance business.
insurer	a firm, other than a bank, with permission to effect or carry out contracts of insurance.
investment business compensation scheme	<p>(as defined in article 2(1) of the <i>compensation transitionals order</i>) any of the following:</p> <ul style="list-style-type: none"> (a) the scheme established under section 54 of the Financial Services Act 1986 and known as the Investors Compensation Scheme; (b) the scheme established under section 22j of the Grey Paper and known as the Section 43 Compensation Scheme; (c) the scheme established by chapter II of part L:VIII of the PIA rule book and known as the PIA Indemnity Scheme; (d) the scheme resulting from an agreement dated 1 February 1999 between the Association of British Insurers and the Investors Compensation Scheme Limited for the making of payments by way of compensation to widows, widowers and dependents of persons (since deceased), in connection with advice given to such persons in relation to pensions, or the arranging of pensions for such persons, and known as the ABI/ICS scheme.
limitation	a limitation incorporated in a Part IV permission under section 42(7)(a) of the Act (Giving permission).
management expenses	(in accordance with section 223 of the Act (Management expenses)) expenses incurred or expected to be incurred by the FSCS in connection with its function under COMP, other than compensation costs; for the purposes of COMP these are subdivided into base costs, specific costs and establishment costs.
management expenses levy	a levy imposed by the FSCS on participant firms to meet the management expenses and which is made up of one or more of a base cost levy, a specific costs levy and an establishment costs levy, each participant firm's share being calculated in accordance with COMP 13.5.

participant firm	<p>a <i>firm</i> other than:</p> <ul style="list-style-type: none"> (a) an <i>incoming EEA firm</i> which is a <i>BCD credit institution</i> or <i>ISD investment firm</i> and whose <i>permission</i> is confined to <i>cross border services</i>; (b) an <i>incoming EEA firm</i> without <i>top-up cover</i> which is: <ul style="list-style-type: none"> (i) a <i>BCD credit institution</i> whose <i>permission</i> to carry on <i>regulated activities</i> from a <i>UK branch</i> is confined to <i>accepting deposits</i>; or (ii) an <i>ISD investment firm</i> (including a <i>credit institution</i> which is an <i>ISD investment firm</i>) whose <i>permission</i> to carry on <i>regulated activities</i> from a <i>UK branch</i> is confined to <i>passported activities</i>; (c) a <i>service company</i>; (d) the <i>Society</i>, in respect of activities included in its <i>permission</i> under section 315(2) of the <i>Act</i> (The <i>Society</i>: authorisation and permission); (e) a <i>member</i>, in respect of <i>effecting</i> or <i>carrying out Lloyd's policies</i>; (f) an <i>underwriting agent</i>, or <i>members' adviser</i>, in respect of <i>advising on syndicate participation at Lloyd's</i> or <i>managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's</i>; (g) an <i>authorised professional firm</i> that is subject to the rules of the Law Society (England and Wales) or the Law Society of Scotland; (h) an <i>ICVC</i>; (i) a <i>UCITS qualifier</i>.
participating deposit-taker	<p>(as defined in article 2(1) of the <i>compensation transitionals order</i>) a person who was at any time before commencement:</p> <ul style="list-style-type: none"> (a) a UK institution within the meaning of Part II of the Banking Act; (b) a participating institution within the meaning of that Part; (c) a former UK institution within the meaning of that Act; (d) a former participating institution within the meaning of Part II of that Act; or (e) a former authorised institution (within the meaning of that Act) which was not a recognised bank or licensed institution excluded by an order under section 23(2) of the Banking Act 1979.
participating institution	<p>(as defined in article 2(1) of the <i>compensation transitionals order</i>) a person who was at any time before commencement a participating institution within the meaning of section 24(4) of the Building Societies Act;</p>

partnership	(in accordance with section 417(1) of the <i>Act</i> (Definitions)) any partnership, including a partnership constituted under the law of a country or territory outside the <i>United Kingdom</i> , but not including a <i>limited liability partnership</i> .
pending application	(as defined in article 3(1) of the <i>compensation transitionals order</i>): (a) an application for compensation made before <i>commencement</i> under an <i>investment business compensation scheme</i> in relation to which a <i>terminating event</i> did not occur before <i>commencement</i> ; and (b) an application made to the <i>FSCS</i> after <i>commencement</i> under an <i>investment business compensation scheme</i> , even if at the time of application that scheme had ceased to exist.
person	(in accordance with the Interpretation Act 1978) any person, including a body of persons corporate or unincorporate (that is, a natural person, a legal person and, for example, a <i>partnership</i>).
professional firm	(in accordance with sections 325(2) (Definition of "members") and 327(2) (Exemption from the general prohibition of the Act) a <i>person</i> which is: (a) an individual who is entitled to practise a profession regulated by a <i>designated professional body</i> and in practising it is subject to its rules; or (b) a <i>person</i> (not being an individual) which is managed and controlled by one or more individuals each of whom: (i) is entitled to practise a profession regulated by a <i>designated professional body</i> ; and (ii) in practising it is subject to the rules of the <i>designated professional body</i> .
protected claim	a claim which is covered by the <i>compensation scheme</i> , as described in COMP 5.2.1R.
protected contract of insurance	a <i>contract of insurance</i> which is covered by the <i>compensation scheme</i> , as described in COMP 5.4.1R.
protected deposit	a deposit which is covered by the <i>compensation scheme</i> , as described in COMP 5.3.1R.
protected investment business	<i>designated investment business</i> which is covered by the <i>compensation scheme</i> , as defined in COMP 5.5.1R.
regulatory costs	the fees paid to the FSA under SUP 20.

<p>relevant former scheme</p>	<p>(as defined in article 2(1) of the <i>compensation transitionals order</i>):</p> <ul style="list-style-type: none"> (a) in relation to a <i>pending application</i>, the <i>investment business compensation scheme</i> under which the application was made; (b) in relation to an <i>article 9 default</i>, one of the following that applied to the default before <i>commencement</i>: <ul style="list-style-type: none"> (i) the Policyholders Protection Scheme established by the Policyholders Protection Act 1975; (ii) the Deposit Protection Scheme established by Part II of the Banking Act 1987; (iii) the Building Societies Investor Protection Scheme established by Part IV of the Building Societies Act 1986; (iv) the Friendly Societies Protection Scheme established in accordance with section 141 of the Financial Services Act 1986.
<p>relevant general insurance contract</p>	<p>any <i>general insurance contract</i> other than:</p> <ul style="list-style-type: none"> (a) a reinsurance contract; (b) a <i>Lloyd's policy</i>; (c) a contract falling within any of the following classes: <ul style="list-style-type: none"> (i) <i>aircraft</i>; (ii) <i>ships</i>; (iii) <i>goods in transit</i>; (iv) <i>aircraft liability</i>; (v) <i>liability of ships</i>; (vi) <i>credit</i>.
<p>relevant net premium income</p>	<p>the premium income in respect of protected contracts of insurance of the firm in the year preceding that in which the date for submission of the information under COMP 13.6.9R falls, net of any relevant rebates or refunds.</p>

service company	<p>a firm whose only permitted activities are making arrangements with a view to transactions in investments, and agreeing to carry on that regulated activity, and whose Part IV permission:</p> <ul style="list-style-type: none"> (a) incorporates a limitation substantially to the effect that the firm carry on regulated activities only with market counterparties or intermediate customers; and (b) includes requirements substantially to the effect that the firm must not: <ul style="list-style-type: none"> (i) guarantee, or otherwise accept responsibility for, the performance, by a participant in arrangements made by the firm in carrying on regulated activities, of obligations undertaken by that participant in connection with those arrangements; or (ii) approve any financial promotion on behalf of any other person or any specified class of persons; or (iii) in carrying on its regulated activities, provide services otherwise than in accordance with documents (of a kind specified in the requirement) provided by the firm to the FSA.
small business	<p>a <i>partnership, body corporate</i>, unincorporated association or mutual association with an annual turnover of less than £1 million (or its equivalent in any other currency at the relevant time).</p>
specific costs	<p>Management expenses other than base costs and establishment costs.</p>
specific costs levy	<p>a levy, forming part of the management expenses levy, to meet the specific costs in the financial year to which the levy relates, each participant firm's share being calculated in accordance with COMP 13.5.7R.</p>
sub-scheme	<p>one of the three sub-schemes to which the FSCS allocates liabilities for compensation costs, as described in COMP 13.6.7R.</p>
terminating event	<p>(as defined in Article 2(1) of the <i>compensation transitionals order</i>) in relation to applications made under an <i>investment business compensation scheme</i>, the withdrawal, discontinuance or rejection of the application, or its determination by a final payment of compensation to the applicant.</p>

ISBN: 0117045039

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