BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

FINANCIAL CONDUCT AUTHORITY

Consultation Paper | FCA CP15/2**
PRA CP2/15

Financial Services Compensation Scheme – Management Expenses Levy Limit 2015/16

January 2015

This is a joint FCA/PRA consultation but the FCA is collecting all responses. We are asking for comments on this Consultation Paper by 16 February 2015. The consultation is for four weeks only.

You can send them to us in writing to:

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We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Consultation Paper from our website: www.fca.org.uk.

The Bank of England and the Prudential Regulation Authority (PRA) reserve the right to publish any information which it may receive as part of this consultation.

Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure, in accordance with access to information regimes under the Freedom of Information Act 2000 or the Data Protection Act 1998 or otherwise as required by law or in discharge of our statutory functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank of England or the PRA receives a request for disclosure of this information, the Bank of England or the PRA will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank of England and the PRA.

Contents

Abbreviations used in this document

CBA	Cost benefit analysis
CP	Consultation Paper
CP20/14	PRA Depositor Protection CP 20/14
FCA	Financial Conduct Authority
FEES	Fees manual
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
MELL	Management Expenses Levy Limit
PRA	Prudential Regulation Authority

1 Overview

Introduction

1.1 This Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) consultation paper (CP) sets out the consultation on the management expenses levy limit (MELL) for the Financial Services Compensation Scheme (FSCS) for 2015/16. The MELL consulted on for 2015/16 is £74.4m.

Who does this consultation affect?

1.2 You should read this CP if you are an authorised firm.

Is this of interest to consumers?

1.3 This CP is not directly relevant to retail financial services consumers or consumer groups. As costs may be passed on to consumers as higher prices, consumers may indirectly meet a part of the FSCS levies. However, an efficient and adequately funded compensation scheme is beneficial to consumers.

Context

1.4 The efficient and effective functioning of the FSCS helps the FCA meet its consumer protection objective as well as supports the PRA in meeting its general objective of promoting the safety and soundness of PRA-authorised firms.

Summary of our proposals

1.5 The MELL proposed for 2015/16 is £74.4m, consisting of:

- FSCS management expenses of £69.1m: this is the minimum amount that will be levied for 2015/16.
- a contingency reserve of £5.3m that allows the FSCS to levy additional funds, most likely at relatively short notice, without formal consultation by the FCA and PRA to meet contingencies that were not foreseen when the annual levy was raised.

Equality and diversity considerations

1.6 The proposal concerns a rule change that applies to the FSCS, not directly to authorised persons. As such, our analysis suggests that the subject matter of the rule change does not give rise to discrimination or raise any issues in light of the public sector equality duty contained in the Equality Act 2010. However, we would welcome any comments respondents may have on any equality issues they believe arise as a result of these proposals.

Next steps

What do you need to do next?

1.7 Please send us your comments on the proposed MELL by 16 February 2015.

How?

1.8 Use the online response form on our website or write to us at the postal address or email address on page 2.

What will we do?

1.9 In light of consultation responses, and subject to approval by the Boards of the FCA and PRA, we will finalise rules to take effect on 1 April 2015. Invoices will be sent out from July 2015.

2 Management expenses levy limit (MELL) 2015/16

Introduction

2.1 In this chapter we consult on the FSCS MELL for 2015/16. Management expenses are the non-compensation costs that the FSCS incurs – or expects to incur – in connection with delivering its functions.

What is the MELL?

2.2 Under the Financial Services and Markets Act 2000 (FSMA), the FCA and PRA must set a limit on the total management expenses to be levied. This allows the FSCS adequate resources to perform its functions efficiently and economically, and provide a responsive and well-understood compensation service for consumers of financial services. This represents the maximum amount of management expenses that can be incurred in the year under the FEES rules, although it is not necessarily the amount the FSCS will actually levy in the coming year. The proposed levy limit would apply from 1 April 2015, the start of the FSCS's financial year, to 31 March 2016.

2.3 The proposed rules for the FCA and PRA to set the MELL are in Appendices 1 and 2 respectively.[1]

2.4 The level of the compensation costs levy (the amount levied to pay claims) is determined by the FSCS and is not consulted on. There are limits under the FEES rules on how much can be levied on firms annually. The FSCS indicates its current estimated compensation figures and its related funding and levies in its Plan and Budget. This will be available on the FSCS website shortly after publication of this CP. The FSCS will confirm its actual levy requirements in early April 2015.

Proposed MELL for 2015/16

2.5 The FSCS has certain management expenses that it incurs in delivering its functions, in addition to the costs of paying compensation. These include, for example, staff, IT and legal costs. A management expenses levy is made up of:

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

2.6 The FCA and PRA propose to set the MELL at £74.4m for 2015/16 consisting of two components:

- **FSCS management expenses of £69.1m**: this figure is a reduction of 7.4% from 2014/15, and is the minimum amount that will be levied for 2015/16 to cover such items as staff and building costs, on-going operating expenses, IT, outsourcing and claims handling, legal or other professional services and strategic programmes.
- **a contingency reserve of £5.3m:** this allows the FSCS to levy additional funds for management expenses at relatively short notice to meet contingencies that were not foreseen when the annual levy was raised. The proposed contingency is unchanged from 2014/15, and would not be levied unless required by the FSCS.

Table 1: Overview of FSCS management expenses information

FSCS management expenses	**FY15/16 Budget £'000**	**FY 14/15 Budget £'000**	**FY14/15 Bud v FY15/16 Bud variance £'000**
Continuing operations	32,979	31,792	(1,187)
Outsourcing	12,956	11,465	(1,491)
Total operational cost	**45,935**	**43,258**	**(2,677)**
Strategic change portfolio	12,444	16,282	3,838
Total operations and investment expense	**58,379**	**59,540**	**1,160**
Financing & major recoveries expenses	10,750	15,128	4,378
Total budgeted management expenses	**69,129**	**74,668**	**5,539**
Contingency reserve	5,300	5,300	0
Total MELL	**74,429**	**79,968**	**5,539**

(Note – figures may not add up due to rounding)

2.7 Management expenses are presented in Table 1 above and cover:

- Continuing operations costs that include legal costs, facilities, IT, the pension deficit funding and staff costs.
- Outsourcing costs that are all invoiced by claim type; the budget is based on the claims forecast volumes. Individual classes are allocated the expected cost per the claims to be processed in the new financial year. The vast majority of claims are outsourced by the FSCS and this gives the FSCS flexibility to handle fluctuating numbers of claims.

- Strategic change programme costs include investments in changes to the FSCS's processes, operations and systems. These investments in change will improve both the FSCS's service to consumers and its efficiency, so the FSCS can provide protection to consumers if a firm fails while minimising costs to levy payers.
- Financing and major recoveries expenses that include the costs of the FSCS pursuing opportunities to recover the costs of compensation, including from the major banking failures of 2008/09 and other failures.

2.8 The management expenses of £69.13m will be made up of £21.14m in base costs and £47.99m in specific costs.

2.9 Table 2 shows how the proposed management expenses of the FSCS breakdown per class.

Table 2: Breakdown of the FSCS management expenses per class

£'000	FSCS	PRA	FCA
Base Costs Total	**21,138**	**10,569**	**10,569**
Specific costs			
Deposits	14,792	14,792	-
General Insurance Provision	7,233	7,233	-
Life & Pension Provision	253	253	-
General Insurance Intermediation	6,655	-	6,655
Life & Pension Intermediation	5,550	-	5,550
Investment Provision	266	-	266
Investment Intermediation	12,412	-	12,412
Home Finance Intermediation	829	-	829
Specific costs total	**47,991**	**22,279**	**25,713**
Management expenses total	**69,129**	**32,847**	**36,282**

(Note – figures may not add up due to rounding)

2.10 Further information on the FSCS proposed budget is included in its Plan and Budget, due to be published shortly after this CP on the FSCS website.

Contingency reserve

2.11 The contingency reserve allows the FSCS to levy additional funds at short notice and without further formal consultation by the FCA or PRA. The contingency reserve proposed for 2015/16 is £5.3m. This is unchanged from 2014/15, and follows a significant reduction in 2014/15 from 2013/14 (from £20m). The contingency reserve gives the FSCS access to funding to handle unexpected increases in claims volumes and other unforeseen circumstances.

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

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

Q1: Do you have any comments on the proposed FSCS MELL for 2015/16?

Annex 1
Cost benefit analysis

1. Under FSMA, the FCA and PRA are required to carry out and publish a cost benefit analysis (CBA) when proposing draft rules. We consider that the CBA set out below meets the FSMA CBA requirements.

2. Setting the MELL at the specified level of £74.4m allows the FSCS to raise funds to cover its expenses so it can continue operating and meeting its objective of providing a high-quality compensation scheme that is efficient, fair, approachable and responsive.

3. The benefits from the FSCS are to improve consumer confidence, increase consumer protection and contribute to financial stability. The main consumer protection benefit is the reduced financial loss to consumers in the event of firm failure. It is difficult to estimate the number of potential instances of firm failure in 2015/16 and the subsequent reduction in financial losses to consumers due to FSCS compensation. To illustrate the potential scale of the benefits to consumers, the expected value of compensation paid out during 2014/15 is around £300m.

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

5. The proposed MELL is set at a level that we expect to be enough for the FSCS to continue to invest in systems, improving the efficiency with which the organisation can deliver compensation in the longer term.

6. Management expenses are charged to firms and may be passed on to consumers in the form of higher prices.

7. The MELL is not expected to have any adverse effect on competition.

Impact on mutual societies

8. Levies to cover FSCS management expenses are levied proportionally on all authorised firms. This includes mutuals. The impact on mutuals is not considered disproportionate to other types of firm.

Annex 2
Compatibility statement

PRA general duties and regulatory principles

1. The PRA must, when discharging its general functions, so far as is reasonably possible, act in a way that advances its general objective – i.e. promoting the safety and soundness of PRA-authorised firms (sections 2B(1) and 2B(2) FSMA).

2. The PRA must carry out that objective primarily by:

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

3. We believe the proposed rule on setting the MELL is compatible with this general duty. The continued operation of the FSCS with a MELL set at an appropriate level assists in minimising the adverse effect of the failure of a PRA-authorised person on consumers and so helps promote stability of the UK financial system as well as confidence in the UK financial system.

4. The PRA has two complementary primary objectives for insurance. These are to promote insurers’ safety and soundness, thereby supporting the stability of the UK financial system, and to contribute to securing an appropriate degree of protection for those who are or may become policyholders. The PRA believes the proposed rule to set the MELL is compatible with this duty because the continued operation of the FSCS with a MELL set at an appropriate rate assists in securing an appropriate degree of protection for policyholders of a PRA-authorised person that has failed.

5. The PRA must also have regard to the regulatory principles in discharging its general functions and to the need to minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges those functions (sections 2H(1) and 3B of FSMA). The PRA believes the proposed MELL is compatible with these principles and does not have any adverse effect on competition in the relevant markets. See below for further information.

FCA general duties and regulatory principles

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

7. In discharging its general functions the FCA must, so far as is reasonably possible, act in a way which (a) is compatible with its strategic objective, (b) advances one or more of its operational objectives (section 1B(1) of FSMA) and (c) has regard to the regulatory principles set out in FSMA (section 1B(5)(a) and section 3B). In addition, the FCA must discharge its general functions in a way which promotes effective competition in the interests of consumers (section1B(4)).

8. The FCA believes that the proposed MELL is compatible with the regulatory principles. In particular, we believe that an appropriate balance has been struck between the need to ensure the FCA's regulatory objectives are fulfilled and the need to keep regulatory burdens to a minimum.

9. The proposal is compatible with the duty to promote effective competition in the interests of consumers. Any levy on firms, as a result of this proposal, will take into account the business volume of the firm levied and as such is not likely to disadvantage specific groups of firms (in particular smaller firms).

10. The proposal set out in this consultation is primarily intended to advance the FCA's operational objective of consumer protection. The role of the FSCS is, in general, to provide compensation to consumers of financial products when authorised firms are unable, or likely to be unable, to meet their obligations. A compensation scheme provides a safety net, offering protection to consumers, which in turn leads to greater confidence in their dealings with financial services firms, benefiting all firms and leading to a stronger financial system. If the FSCS was unable to process claims because of financial constraints due to an inappropriate MELL this would undermine the protection offered to consumers.

11. In light of this, the FCA believes that the proposed FSCS MELL is appropriate. The limit proposed ensures the FSCS has adequate resources to perform its functions for the coming year. In addition, in setting the MELL for 2015/16, we have allowed for sufficient contingency reserve to prevent disruption to the FSCS's work if they need to exceed their operating budget for unexpected reasons.

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

Compatibility with the regulatory principles – FCA and PRA

13. In this section we comment on how our proposal to set the MELL meets the requirement that the FCA and PRA must have regard to the regulatory principles in discharging their respective general functions.

The need to use the resources of each regulator in the most efficient and economical way

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

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

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

16. For more information please see the CBA section (Annex 1).

17. We do not consider that the change we are consulting on will have any significant effect on the other principles.

Annex 3
Consultation question

Q1: Do you have any comments on the proposed FSCS MELL for 2015/16?

Appendix 1
Draft FCA Handbook text

Appendix 1

FINANCIAL SERVICES COMPENSATION SCHEME (MANAGEMENT EXPENSES LEVY LIMIT 2015/2016) (FCA) INSTRUMENT 2015

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137T (General supplementary powers);
(2) section 213 (The compensation scheme);
(3) section 214 (General); and
(4) section 223 (Management expenses).

B. The rule-making powers listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 1 April 2015.

Amendments to the Handbook

D. The Fees manual (FEES) is amended in accordance with the Annex to this instrument.

Citation

E. This instrument may be cited as the Financial Services Compensation Scheme (Management Expenses Levy Limit 2015/2016) (FCA) Instrument 2015.

By order of the Board of the Financial Conduct Authority
[date]

Annex

Amendments to the Fees manual (FEES)

In this Annex, underlining indicates new text.

6 Annex 1R Financial Services Compensation Scheme – Management Expenses Levy Limit

This table belongs to FEES 6.4.2R	
Period	Limit on total of all management expenses levies attributable to that period (£)
…	
1 April 2014 to 31 March 2015	£80,000,000
<u>1 April 2015 to 31 March 2016</u>	<u>£74,429,000</u>

Appendix 2
Draft PRA Handbook text

FINANCIAL SERVICES COMPENSATION SCHEME (MANAGEMENT EXPENSES LEVY LIMIT) INSTRUMENT 2015

Powers exercised

A. The Prudential Regulation Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137T (General supplementary powers);
(2) section 213 (The compensation scheme);
(3) section 214 (General); and
(4) section 223 (Management expenses).

B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Pre-conditions to making

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

Commencement

D. This instrument comes into force on 1 April 2015.

Amendments to the Handbook

E. The Fees manual (FEES) is amended in accordance with the Annex to this instrument.

Citation

F. This instrument may be cited as the Financial Services Compensation Scheme (Management Expenses Levy Limit) Instrument 2015.

By order of the Board of the Prudential Regulation Authority
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