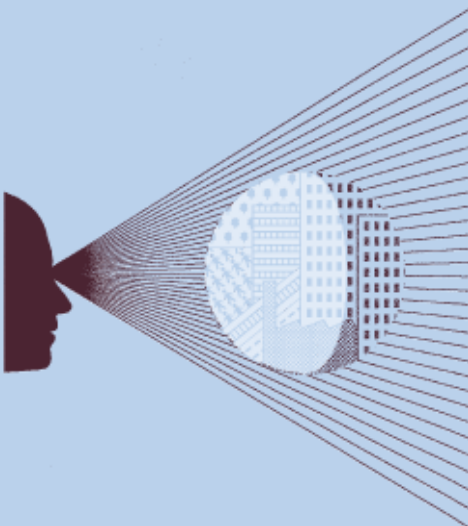


Funding the Financial Services Compensation Scheme

Analysis of policy options

Prepared for
Financial Services Authority

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Executive summary

In March 2006, the Financial Services Authority (FSA) published a Discussion Paper (FSCS Funding Review, DP06/1), setting out options for changing the current structure for funding the Financial Services Compensation Scheme (FSCS).

The FSA subsequently commissioned Oxera to support the FSCS Funding Review by providing analysis of the options set out in DP06/1, focusing on three areas.

- **Financial size and thresholds.** The proposed options require thresholds to be set, beyond which compensation costs are pooled more widely. To inform these threshold levels, empirical analysis has been undertaken to determine the financial size of the proposed broad classes (deposit, life & pensions, general insurance, investment and mortgage) and possible sub-classes, and to discuss the impact that different thresholds might have if they were set according to the financial size or ‘affordability’ of the (sub-)classes.
- **Tariff base.** A change in the overall funding structure might require new tariff bases to be identified that allow compensation costs to be allocated between firms in the proposed broad classes and possible sub-classes, and in the general pool, if it were introduced. Several tariff base options have been assessed to inform the FSA about the need for, and feasibility of, introducing new tariffs.
- **Modelling of impact.** While DP06/1 focused on design principles and the new structure from a conceptual perspective, analysis was required to understand what the proposals would mean in terms of the final bill to be paid by firms in the broad classes and sub-classes under the new structure, and how this compares with the bill under the current structure. The third area of Oxera’s analysis has therefore been to model the impact of the proposed options in terms of levies to be paid under different funding options and assuming different compensation cost scenarios.

The main objective of the analysis has been to provide the FSA with quantitative evidence to facilitate policy decisions and prepare proposals to be put forward for consultation, taking as given the design principles and options set out in DP06/1.

Given the focus on quantitative evidence, significant data gathering and analysis were required to provide the results, drawing from multiple FSA databases and industry statistics. In addition, Oxera extensively consulted industry, discussing the analysis and the emerging results with the Industry Advisory Group set up to support the Funding Review, as well as in meetings with industry associations and individual firms from different parts of the industry.

During the course of the analysis, Oxera provided the FSA with numerous outputs, summarising the evidence obtained, and, in particular, providing the data outputs of the modelling work conducted to show the impact of different funding options (and variants of those options) in terms of the FSCS levy that would be payable by firms. This report contains a selection of the analysis undertaken and modelling outputs produced.

Financial size of (sub-)classes and affordability thresholds

- The financial size of the broad classes and sub-classes was estimated with respect to the participating firms’ relevant activities only, with *relevant* here meaning specific to the activities underlying the (sub-)class in question and conducted for clients eligible to claim compensation from the FSCS (ie, FSCS-protected retail business).

- To measure the financial size of only the relevant activities, income-based measures were adopted for practical purposes—ie, in general, revenues can be allocated more easily to different activities than other financial variables. Financial size is therefore measured as the revenue generated to cover the operating costs and profits of the relevant activities.
- There is no existing evidence on the aggregate income earned from the relevant activities, and data available to conduct the sizing-up analysis is limited. The estimates of relevant income of the broad classes, as summarised in Table 1, therefore depend on assumptions, which are set out in detail in the main report.

Table 1 Overview of broad classes: number of participants and financial size

| Broad class | Estimated number of participants | Estimated relevant income (£ billion) |
|-----------------------|----------------------------------|---------------------------------------|
| Deposit | 821 | 24.3 |
| General insurance | 17,205 | 19.3 ¹ |
| Life & pensions | 5,170 | 11.2 |
| Investment | 6,917 | 7.1 |
| Mortgage ² | 7,073 | 1.8 |
| Total | 20,425 | 63.7 |

Notes: Estimates obtained by mapping the current FSCS contribution groups onto the new class structure. Data sources and assumptions as set out in the main report. The number of firms captures all FSCS participants in 2006 (which may be participating in multiple activities). ¹ Estimate of income, which adjusts for general insurance claims. ² Intermediaries only.

Source: Oxera analysis.

- As outlined in DP06/1, the next step is to determine what constitutes an affordable levy or, put differently, what affordability factors should be applied to the financial size estimates in order to derive the threshold amounts that determine the maximum levy for each class (and possible sub-class) before compensation costs are shared more widely.
- The most practical solution is to set thresholds as a simple proportion of estimated relevant income. Oxera modelled the impact of thresholds set at levels varying between 2.5% and 10% for different funding options.
- An affordable FSCS levy is key to the sustainability of the scheme. It is difficult to define what constitutes an affordable levy, but a range of benchmarks is available to inform policy decisions on the threshold level. For example, current and historical levies have all been ‘affordable’ (eg, in the sense of not triggering market exit), even for those firms in the investment advice sector that have paid levies equal to 5% or more of their income.
- The current contribution limits form another benchmark (see Table 2 below). For thresholds to deliver an overall compensation capacity similar to that in current statutory limits (around £3.7 billion), they would need to be set at more than 5% of relevant income. A 5% threshold would imply a reduction in the maximum amounts payable for deposit-takers (a threshold of 10% would correspond to the current limit, which is based on 0.3% of protected deposits on a cumulative basis), but a significant increase for general insurance and mortgage intermediaries, for which the current limit is 0.8% of relevant income.

Table 2 Thresholds compared with contribution limits (£ billion)

| Broad class | Current limit | 2.5% threshold | 5% threshold | 7.5% threshold | 10% threshold |
|--------------------------------|---------------|----------------|--------------|----------------|---------------|
| Deposit | 2.4 | 0.6 | 1.2 | 1.8 | 2.4 |
| General insurance ¹ | 0.3 | 0.5 | 1.0 | 1.4 | 1.9 |
| Life & pensions ² | 0.5 | 0.3 | 0.6 | 0.8 | 1.1 |
| Investment | 0.4 | 0.2 | 0.4 | 0.5 | 0.7 |
| Mortgage | 0.01 | 0.04 | 0.09 | 0.13 | 0.18 |
| Total | 3.7 | 1.6 | 3.2 | 4.8 | 6.4 |

Notes: ¹ The threshold for providers is based on the estimate of income, which adjusts for claims. ² The current limit is based on the limit for providers only, whereas thresholds include intermediaries. Figures may not sum due to rounding.

Source: Oxera analysis.

- A levy equal to 5% or more of relevant income could have a significant impact on the profits generated from the activities, reducing margins by one-third or one-quarter for margins of 15–20%. However, it would take a significant stand-alone failure or combined event to reach the thresholds. The levy that may be required on a one-off basis to fund compensation costs under exceptional circumstances is higher than one that presents an ongoing annual obligation for firms.
- What is affordable for firms in the industry depends on their ability to pass through costs to consumers. As long as FSCS levies increase the costs for all firms participating in the relevant market, firms should, under normal market conditions, be able to pass through the cost increases in the form of higher prices.
- Affordability is influenced by a range of other factors, and can be assessed using different criteria. In addition to the level of income and profits, or the ability to pass through costs, the other important factors are the frequency at which the levy is incurred, the level of capitalisation, liquidity, volatility in cash flow and profits, firm size, and the degree of diversification of activities.
- As most of the factors are firm-specific rather than specific to a class or sub-class, it is not clear what affordability adjustments would be required to set thresholds at the (sub-)class level.
- Setting thresholds depends on the chosen concept of affordability (or other principles, depending on policy preferences) and cannot be determined by economic and financial analysis alone. It has distributional implications and is ultimately a matter for policy.

Tariff base adjustments

- The choice of tariff base is more than a technical matter since it determines how the FSCS levy is distributed among individual firms. A diverse set of tariff bases applies under the current structure, with each contribution group having its own tariff base. As confirmed in discussions with industry and FSA experts, it would be very difficult and costly to define and implement a single tariff base that could be uniformly applied across all parts of the FSCS levy.
- However, the proposed structure can be operated without a completely uniform tariff base. What is required is a mechanism to allocate the levy at aggregate level between different groups of firms in the broad classes (Options A to D) or between the broad classes in the general pool (Options B and D)—allowing flexible choice of tariff base

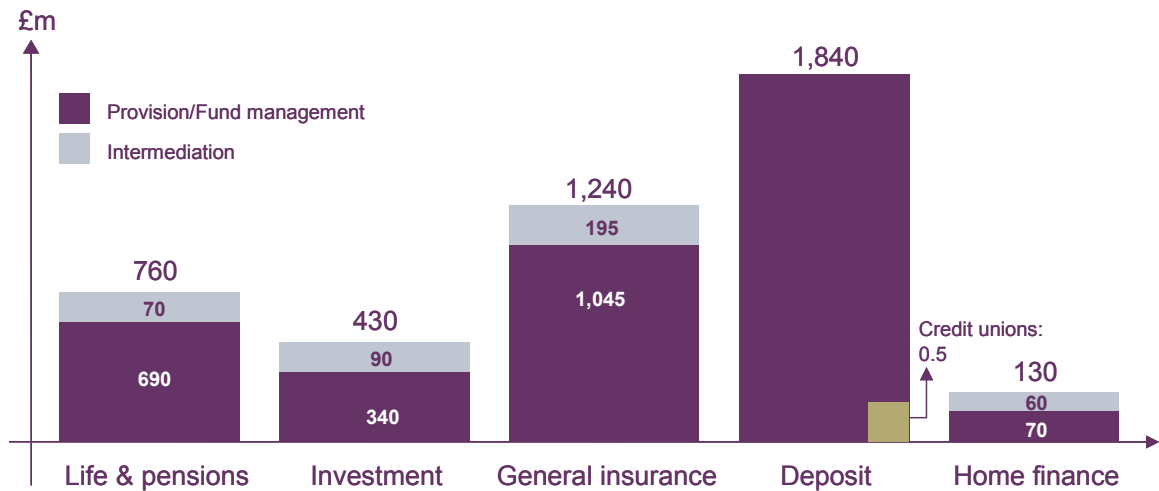
within the groups. The relative financial size estimates of different groups of firms could provide the basis for such an allocation mechanism. This would be consistent with the affordability principle, although any other allocation rule could be adopted, depending on distributional preferences.

- If the advice and sales activities of firms in the groups are to be split between the life & pensions class and the investment class, the tariff base in current contribution groups A12 and A13 (approved persons) would need to be changed under the new structure. Relevant income may be the most suitable metric to allow such a split. Introducing an income-based tariff would also address many of the concerns about the affordability of the FSCS levy for some financial advisers (even though this might be at the expense of the more profitable firms in the group). However, the required tariff base adjustment would imply that firms provide the FSA with new data that allocates income between life & pensions and investment products. While possible in principle, this may be more difficult, for example, where income relates to wrapped products or is generated on a fee basis (rather than commissions).
- Provided that the other contribution groups directly map onto the proposed classes or sub-classes under the new structure, further changes to the tariff bases could be limited. Nonetheless, options may be considered for making the tariff base more consistent across groups. In particular, in the investment class, adopting an income-based measure would allow the tariff base to capture relevant FSCS-protected business only, while also avoiding industry concerns about double-charging—although this would have cost implications in terms of data collection and verification, particularly for firms with multiple activities and a diverse client base where revenue allocation is complex.

Modelling the impact of the FSA’s preferred option

- During the course of the project, Oxera provided the FSA with a large number of modelling outputs, showing the impact of the funding options set out in DP06/1 on the allocation of the FSCS levy. These modelling outputs were provided at different threshold levels, and used different compensation cost scenarios.
- Having examined various policy options and reviewed the evidence, the FSA then requested that Oxera provide the data and analysis to evaluate the impact of a further specific option. In this option, the five broad classes are each divided into two sub-classes, with each sub-class paying for its own failures up to a threshold. If a sub-class threshold is reached, excess costs are allocated to the other sub-class. Costs in excess of both sub-class thresholds are then charged against the other broad classes in proportion to their relative threshold amounts via the general retail pool. The threshold amounts are set such that the maximum levy for a sub-class corresponds to around 7.5% of relevant income for providers and 3.5% of relevant income for intermediaries. Mortgage lenders (hereafter referred to as home finance providers) will be required to make a contribution to fund the excess costs of mortgage advisers (hereafter referred to as home finance intermediation firms) before the general retail pool is triggered, but will not be expected to contribute to the general retail pool if it is triggered by any of the other classes. The main tariff base adjustment is the change to an income-based tariff for firms and activities in the current investment sub-scheme.
- The impact of the proposed structure—in terms of the maximum levy that each sub-class and class would be expected to pay before costs are shared more widely—is illustrated in Figure 1.

Figure 1 Thresholds under the proposed option (£m)



Notes: The investment class contains a fund management sub-class (current contribution groups A7 and A9) and a second intermediation sub-class, which contains all other activities. In the deposit class, credit unions are separated from other deposit-takers.

Source: Oxera illustration based on FSA structure.

- Current and historical levies have been well below these thresholds, although they have come close for the comparatively low threshold for life & pensions intermediaries. If the current 2006/07 levy had been allocated under this structure, the main difference would have been a split in the levy for advisers and brokers (contribution groups A12 and A13) into claims relating to life & pensions products and those relating to investment products. In particular, A12 and A13 firms that exclusively engage in activities related to investment products would no longer be expected to compensate life & pensions-related failures, and vice versa.
- With the exception of large-loss events that would require levies in excess of thresholds, the impact of moving to the new structure would be limited for all firms except those in the current investment sub-scheme. In addition to the split of A12 and A13 into life & pensions- and investment-related activities, the new structure envisages a pooling of compensation costs arising from failures in fund management (A7) and collective investment scheme operation (A9), and a sharing of costs between the remaining activities (A10, A12, A13 and A14).
- The levy implications depend on both the level of income from FSCS-eligible business and the incidence of failures. For example, A7 participants would pay less than before in the event of a fund management (A7) failure, but would need to contribute and hence pay more than before if a fund operator (A9) failed.
- In addition, the impact on individual firms depends largely on the proposed new tariff base. The change to annual eligible income has important distributional implications. Broadly speaking, firms with above-average income (eg, per approved person) and above-average business for FSCS-eligible retail clients would see an increase in their levy compared with the current structure.
- This report summarises these and other modelling results, illustrating the levy implications for different compensation cost scenarios at both the aggregate level and for individual firms.

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1 Introduction

In March 2006, the Financial Services Authority (FSA) published a Discussion Paper (FSCS Funding Review, DP06/1), setting out options for changing the current structure of funding the Financial Services Compensation Scheme (FSCS).

Emphasising that funding durability and resilience are among the key principles to guide the design of a new structure, the FSA's preferred options envisage a shift of the current contribution group structure to one where FSCS participants are divided into five broad classes—deposit; general insurance; life & pensions; investment (securities, mutual funds and derivatives); and mortgage.

These broad classes might stand alone, with no cross-subsidy between them (Option A), or they might sit under a general pool, the operation of which would be triggered for large-scale losses (Option B). Alternatively, there might be sub-classes based on closer affinity within the broad classes, with each sub-class absorbing the first tranche of compensation costs associated with its own members, and with pooling within the broad class to occur once costs reach a certain threshold level (Option C). There could also be a 'widening net', with sub-classes, broad classes and a general pool (Option D).

Oxera was commissioned by the FSA to provide supporting analysis to the Funding Review in preparation of a consultation paper on FSCS funding, focusing on three areas of analysis.

- **Financial size and thresholds.** The proposed options require the setting of thresholds beyond which compensation costs would be pooled more widely, either between sub-classes (Options C and D) or between the broad classes in a general pool (Options B and D). To help with setting these thresholds, empirical analysis has been undertaken to determine the financial size of the different (sub-)classes and to discuss the impact that different thresholds would have if they were set according to the financial size or 'affordability' of the (sub-)classes.
- **Tariff base.** A change in the overall funding structure may require new tariff bases to be identified that allow the allocation of compensation costs between firms in the broad classes and sub-classes, and in the general retail pool. Different options for tariff bases have been assessed to inform the FSA about the need and feasibility of introducing new tariffs.
- **Modelling of impact.** While DP06/1 focused on design principles and new structure from a conceptual perspective, analysis was required to understand what the proposals would mean in terms of the final bill to be paid by firms in the classes and sub-classes under the new structure and how this compares with the bill under the current structure. The third area of Oxera's analysis has therefore been to model the impact of the proposed options in terms of levies to be paid under different funding options and assuming different compensation cost scenarios.

In undertaking these workstreams, Oxera has taken as given the design principles and options set out by the FSA in DP06/1. (Oxera's analysis of the options available for changing the FSCS funding structure as well as a discussion of the economics of compensation

scheme funding are set out in a separate report, published in March 2006 alongside DP06/1.¹)

Oxera's work aims to support the Funding Review with quantitative evidence to facilitate policy decisions on specific questions concerning the detailed design of a new funding structure. To facilitate this analysis, the FSA provided Oxera with access to multiple databases, containing data on the number of firms participating in the current FSCS, their characteristics (eg, primary activity of firm) and the levies they pay, and the underlying tariff data. Oxera also received financial information on FSCS participants, including data on their income and other financial variables. All firm-level data was provided to Oxera on an anonymous basis, using a company identification code rather than company name in order to meet confidentiality requirements. In addition to FSA data, Oxera has drawn from available industry statistics.

The data analysis was supported with numerous in-depth discussions with FSA experts as well as industry stakeholders, including the relevant trade associations and individual member firms.

This report summarises the main results obtained from the analysis. It is structured as follows.

- Section 2 provides an overview of the options for structuring the FSCS as set out in DP06/1, and also provides quantitative information on what the proposed models would mean in terms of firm participation.
- Section 3 presents the quantitative analysis undertaken to inform the FSA about setting thresholds. In particular, it shows estimates of the financial size of the different (sub-)classes, discusses their affordability, and illustrates how the thresholds could be set.
- Section 4 discusses the choice of tariff base under the proposed new structure and what adjustments to the tariff base may be required to make the structure operational.
- Section 5 presents the results of the impact modelling, illustrating what the proposed options would mean in terms of levies payable by different parts of the industry.
- Section 6 reports further results, based on a specific funding structure modelled by Oxera after a review of some of the initial evidence and an assessment of various options.

¹ Oxera (2006), 'Funding the Financial Services Compensation Scheme', report prepared for the FSA, March. Available at www.oxera.com and www.fsa.gov.uk.

2 Overview of the funding options in Discussion Paper 06/1

The FSCS is currently funded by 12 contribution groups, organised into five sub-schemes. These groups are linked to the FSA fee blocks, and the business carried out by each participant firm determines the contribution group(s) into which it falls. The regime works on the basis that there is no cross-subsidy between contribution groups, with FSCS costs being borne by firms in the group in which the failure arises, and costs shared on the basis of a tariff base that is specific to that contribution group. Table 2.1 summarises these features and also reports the number of participant firms per contribution group as at May 2006. In total, 20,425 firms were participating in the FSCS at that time, with many firms participating in more than one contribution group, depending on their permissions.

Table 2.1 Overview of current FSCS funding structure and participation

| Sub-scheme | Contribution group | Number of FSCS participants | Tariff base |
|-------------------------------|------------------------------------------------------|-----------------------------|-----------------------------|
| Accepting deposits | A1 Deposit-takers | 821 | Protected deposits |
| Insurance | A3 General insurers | 288 | Relevant net premium income |
| | A4 Life insurers | 258 | Relevant net premium income |
| Investment | A7 Fund managers | 1,090 | Funds under management |
| | A9 Collective investment scheme (CIS) operators, etc | 345 | Gross income |
| | A10 Principal dealers | 273 | Number of traders |
| | A12 Advisory brokers holding client money | 953 | Number of approved persons |
| | A13 Advisory brokers not holding client money | 5,277 | Number of approved persons |
| | A14 Corporate finance advisers | 595 | Number of approved persons |
| Mortgage advice and arranging | A18 Mortgage advisers and arrangers | 7073 | Annual eligible income |
| General insurance mediation | A19 General insurance intermediaries | 17,109 | Annual eligible income |

Note: Number of participants based on FSA data, referring to May 2006.
Source: FSA data.

The FSA put forward options in DP06/1 for changing this current FSCS funding structure with one that enables a wider pooling of compensation costs in order to make FSCS funding more sustainable. The proposed options were based around the following building blocks.

- **Five broad classes.** There would be five broad classes reflecting different regulated business or sectors within the financial services industry: deposit, general insurance, life & pensions, investment (securities, mutual funds and derivatives), and mortgages. Firms would participate in a class (or more than one class) according to their regulated business. Compensation costs would be charged against firms in the class in which the failure arises.

The key change to the current sub-scheme and contribution group structure is that this would bring together in one class providers and intermediaries operating in the same product market—eg, general insurance providers (contribution group A3) and intermediaries (A19), or life & pensions providers (A4) and intermediaries (firms in A12 and A13 engaging in life & pensions advice).

- **Sub-classes.** Within the broad classes, Options C and D envisage sub-classes that would be similar to the current contribution groups in that liabilities would be allocated to firms in the sub-class in which the failure arises, but only up to a threshold beyond which liabilities would be shared with other sub-classes in the broad class.

DP06/1 does not contain a detailed description of how the sub-classes would be defined. However, for the purpose of the analysis of the options in the Discussion Paper, the FSA has instructed Oxera to assume that sub-classes would generally correspond to the current contribution groups—ie, a one-to-one mapping between contribution groups and sub-classes.²

The exceptions are contribution groups A12 and A13 (advisers and brokers with and without permission to hold client money): the activities of A12 and A13 participants would be divided into life & pensions business and investment business. Advice and sales activities related to life & pensions would form a separate sub-class in the broad life & pensions class, with the corresponding activities related to investment products (securities, mutual funds and derivatives) forming a sub-class in the broad investment class.

It was also assumed, for the purpose of the analysis of the options in DP06/1, that FSCS participation requirements would not change; in particular, although DP06/1 raised the possibility of including mortgage lending in the FSCS for funding purposes, much of the following assumes that home finance providers do not participate and that mortgage intermediaries (current contribution group A18) will form a single class. Similarly, it is assumed that participation requirements in the broad classes and sub-classes are not extended to firms currently exempt from the FSCS because they have no retail customers and engage only in wholesale activities.

Table 2.2 summarises the new structure in terms of broad classes and sub-classes.

² Section 6 provides analysis using a different definition of the sub-classes.

Table 2.2 Overview of the class and sub-class structure in DP06/1

| Broad class | Sub-classes (or type of activities included in broad class) | Participants correspond to current contribution group |
|-------------------|-------------------------------------------------------------|--------------------------------------------------------------------------------------------|
| Deposit | Deposit-taking | A1 |
| General insurance | General insurance provision | A3 |
| | General insurance intermediation | A19 |
| Life & pensions | Life insurance provision | A4 |
| | Life insurance intermediation | A12 and A13 (with respect to advice and sales of life & pensions products) |
| Investment | Fund management | A7 |
| | CIS operation, depositaries, etc | A9 |
| | Advice, broking (investment intermediation) | A12 and A13 (with respect to advice and sales of mutual funds, securities and derivatives) |
| | Principal dealing | A10 |
| | Corporate finance advice | A14 |
| Mortgage | Mortgage advice and arranging | A18 |

- **General retail pool.** In Options B and D set out in DP06/1, there would be a general pool, into which all classes contribute when levies in a single class exceed a threshold level.
- **Thresholds.** A threshold refers to the level of FSCS levies, for a broad class or in a sub-class, beyond which further levies would not be borne by the broad class or sub-class in which the failure arises, but shared more widely. That is, it refers to the level at which wider pooling would occur, either between sub-classes within a broad class (Options C and D), or between broad classes in the general retail pool (Options B and D). DP06/1 does not specify the threshold levels, but suggests that, given the key design principles of funding durability and resilience, the thresholds would be based on estimates of the relative financial size of the various classes and sub-classes and application of an affordability factor.

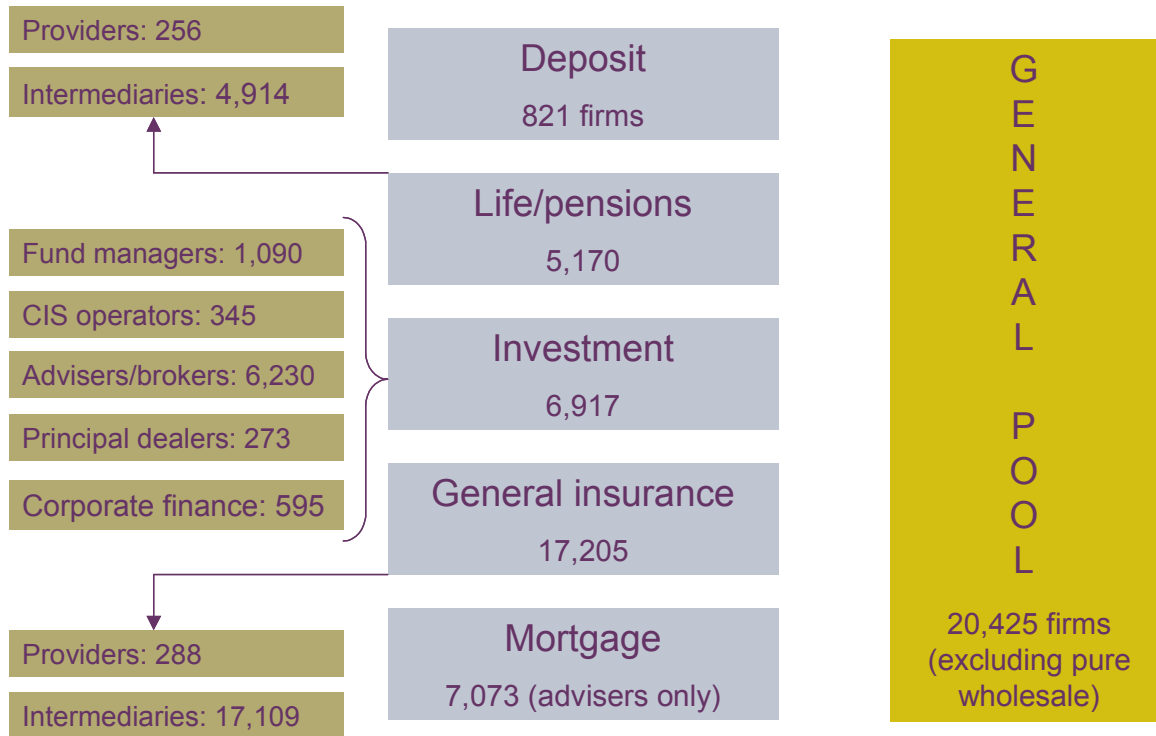
Figure 2.1 illustrates the structure proposed in DP06/1 in terms of the number of firms participating in the broad classes, potential sub-classes, and the general retail pool, based on 2006 data on contribution group participation. The number of participants was derived by mapping contribution groups onto the new structure and adjusting for multiple group participation where required.

Under the proposals, the current A12 and A13 group of advisers and brokers would be split to form an intermediary group in the life & pensions class and a group in the investment class. Data on the advice and sales activities of current FSCS participants in A12 and A13 is not available. To derive participation numbers, it was assumed that all financial advisers, banks and building societies³ participating in A12 and A13 sell and advise on both life & pensions and investment products (ie, they would participate in both classes), whereas all other types of firm (eg, stockbrokers) would only participate in the investment class.

If the general pool included all current FSCS participants, 20,425 firms would contribute to the pool based on 2006 data. The relative size of the (sub-)classes, in terms of participation numbers, is also reported.

³ Identifiable from FSA data using the 'primary category' assigned to each regulated firm.

Figure 2.1 Illustration of the proposed structure in terms of number of participants



Note: CIS, collective investment scheme.
 Source: Oxera calculations based on FSA data.

Based on this basic structure and its main building blocks, the following sections provide quantitative evidence on the relative financial size of each class and sub-class with a view to facilitate policy decisions about thresholds (section 3), and on what levies firms would have to pay under different assumptions about proposed options and thresholds (section 5). Issues pertaining to the choice of tariff base under the proposed structure are also discussed (section 4).

3 Financial size of the proposed classes and sub-classes and affordability thresholds

3.1 Objectives of analysis and methodological approach

3.1.1 Objectives of analysis

To facilitate policy decisions about the level at which to set thresholds for the broad classes (and sub-classes) and share costs between the (sub-)classes, quantitative evidence on the financial size of each (sub-)class was provided.

Information about the financial size in absolute terms measured on a uniform basis helps the assessment of the financial capacity of each class (or sub-class) to cope with failures on its own and cover any compensation costs arising, and the evaluation of the financial impact of an FSCS levy on the (sub-)class as a whole. Once the financial size has been estimated, affordability factors can be applied to derive the level of thresholds beyond which costs arising in a (sub-)class would be shared more widely.

Information on the relative financial size is helpful in determining how costs could be shared between sub-classes within a broad class, or between the broad classes in the general pool, in a way that can be consistent with the principle of affordability.

What is affordable is difficult to establish, and there are different ways in which to define the concept of affordability. As further discussed in section 3.8, the setting of thresholds and allocation of compensation costs between different groups of firms has distributional consequences and is ultimately a matter for policy. The following sets out the approach taken to estimating the financial size of the different classes (and sub-classes), with results reported for each class separately in sections 3.2 to 3.6, and a summary in section 3.7.

3.1.2 Measurement of financial size

Different measures are available to estimate the financial size of the various classes and sub-classes. The aim of this analysis is to size up the (sub-)classes with respect to their *relevant* activities, with 'relevant' meaning that:

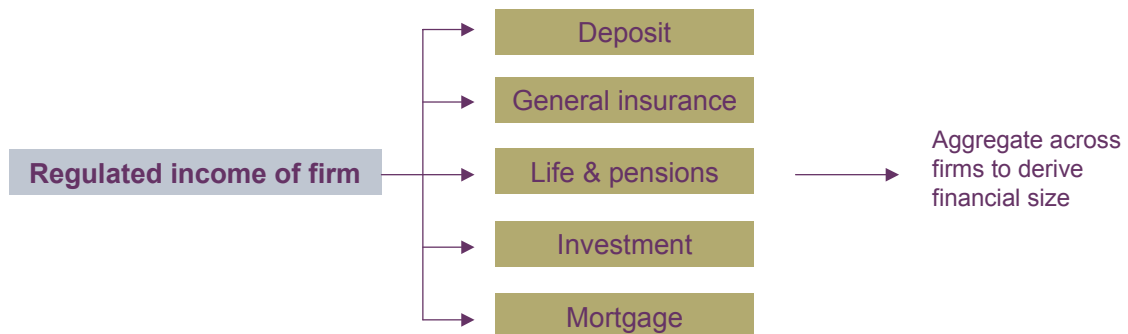
- financial size is measured only with respect to the activity that underlies the (sub-)class under consideration;
- financial size reflects only the business that is relevant for FSCS purposes in that it could give rise to a compensation claim—ie, FSCS-protected retail activities.

There is no direct data or evidence available to assess the financial size of the relevant activities; the following section provides estimates that have been generated from extensive analysis of FSA data combined with available industry statistics and information provided by the industry participants consulted as part of the study.

Financial size is estimated using an income-based measure. The main reason for relying on income in the estimation is one of practicality—revenues can in general be more easily allocated to relevant activities than other financial variables such as operating costs or capital. Broadly speaking, income has been defined as the revenue accruing from the relevant activities to cover operating costs and profits. 'Income' has different meanings in different parts of the financial services industry; however, attempts have been made to provide a measure that is consistent across classes and sub-classes, subject to the data constraints encountered.

Two approaches were considered to derive an estimate of relevant income. The first starts with the total income earned by each FSCS participant, and then allocates income to the relevant activities that underlie the classes (and sub-classes within). Firm-specific allocated income is then aggregated to obtain an estimate of the total financial size of a (sub-)class. This ‘bottom-up’ approach is illustrated in Figure 3.1.

Figure 3.1 Estimation of financial size using the bottom-up approach



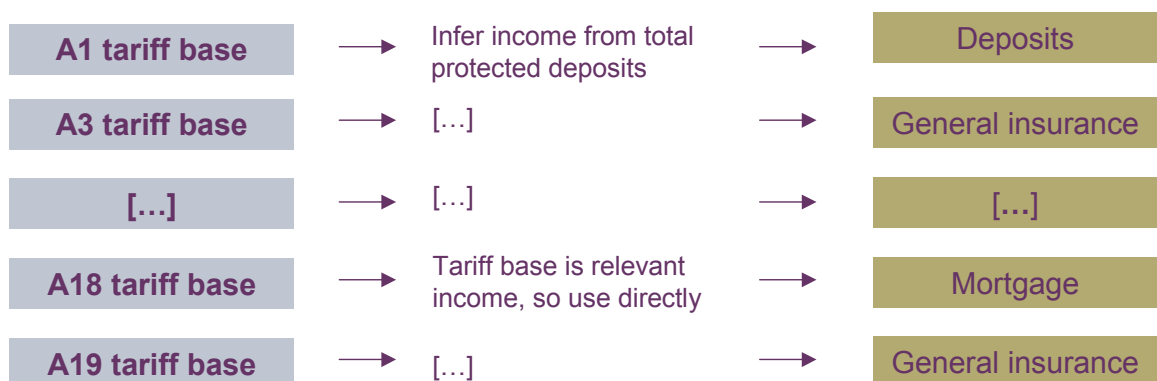
Source: Oxera.

However, although the more attractive in principle, this approach was not feasible. Income data allocated to the relevant activities is not available, and a large-scale survey of FSCS participants would have been required to obtain that data. Moreover, participating firms would have found it difficult to provide the required allocations, so even a survey may not have generated the relevant data without creating significant costs for the participating firms.

Estimation was therefore based on the alternative ‘top-down’ approach. This approach starts from the aggregate FSCS tariff base data available for each of the current contribution groups. The tariff base data is already more or less reflective of the volume of activities for each group, thereby reducing the allocation problems encountered in the first approach. For some groups, the tariff base is already a measure of income and can be directly used for sizing-up purposes. For others, where the tariff base is not income or does not fully reflect the relevant activities, the relevant income was inferred from the tariff base using additional data and assumptions, and making any required adjustments to derive an income measure that aims to be consistent across groups.

Thus, the approach taken was one in which the financial size of each contribution group was estimated from tariff base data. To the extent that the contribution groups map onto the new class and sub-class structure, the size estimates for the current groups were then used to derive the financial size of the (sub-)classes. This estimation approach is illustrated in Figure 3.2.

Figure 3.2 Estimation of financial size using the top-down approach



Source: Oxera.

The estimation is derived from various sources of data and information.

- **FSA data.** The FSA provided Oxera with aggregate and firm-level data on the FSCS tariff base, contribution group participation, and the characteristics of participants, including type of firm and financial information (eg, total income, operating expenses, capital). All firm-level data was provided on an anonymised basis, using a numeric company identifier. Additional aggregate data was provided on product sales, commissions and other statistics considered useful for the exercise.
- **Industry statistics.** Further data was obtained from industry statistics on the activities of different parts of the industry in order to provide supplementary information or to cross-check some of the results obtained from FSA data.
- **Interviews.** In addition to meetings with each of the relevant industry associations, interviews were conducted with 17 firms from different parts of the industry, and two industry associations organised round-table discussions with several of their members. These interviews provided an understanding of the issues specific to the relevant contribution groups, filled data gaps, and provided a cross-check for the assumptions required in the analysis.

3.2 Estimates of financial size: deposit class

It is proposed that deposit-takers in the current A1 contribution group form a new and separate class. The FSCS tariff base for A1 is protected deposits; firms reported £811.2 billion in protected deposits for the 2006/07 levy period.⁴

Deriving revenue from a bank or building society deposit-taking activity is not entirely straightforward since banks do not typically report separately the revenue derived from deposits, and because there are a number of sources of revenue from deposit-taking activities. These are usually referred to in bank or building society financial accounts as net interest income (which is the income earned on assets less interest paid) and fee income (eg, annual charges or charges for unauthorised overdrafts).

Furthermore, the total revenue that banks and building societies generate from deposit-taking includes revenue generated from both accounts in credit (which are FSCS-protected) and debit balances, which in theory would not be FSCS-protected since these are assets and not liabilities of deposit-takers. However, accounts are unlikely to remain in debit constantly, implying that the distinction between accounts in credit and debit may not be a significant factor. The revenue that deposit-takers generate from accounts in credit can include revenue from fees and charges, as well as revenue that can be earned using these funds. This is typically measured by using a bank or building society internal funding rate or a money market interest rate, such as 1 month LIBOR.⁵

Therefore, the analysis of the revenue generated from deposit-taking needs to answer the following questions:

- should revenue from debit balances (both fee income and interest earned) be included, and, if so, how should it be estimated?
- what is the average interest margin (interest rate earned on credit balances less average interest rate paid) on credit balances?
- is it possible to identify fee income associated with credit balances only?

⁴ Information provided to Oxera by the FSA.

⁵ For example, the Competition Commission refers to the use by banks of a 90-day average of money market rates, such as LIBOR, as an estimate of an internal funding rate. Source: Competition Commission (2002), 'The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises', p. 164.

The answers to these questions are not straightforward, as banks and building societies do not publicly report this information. Furthermore, deposit-taking by itself may not be a stand-alone activity and the way in which income is inferred depends on how it is treated.

If viewed as a stand-alone activity, the revenue from different sources associated with deposit-taking could be derived in the following way:

- income from debit balances could be estimated using income from accounts in overdraft;
- the average interest margin (income earned on credit balance less interest paid) could be determined using the interest margin banks earn on deposits (eg, the Treasury funding rate less average interest paid);
- estimation of fee income could be challenging; importantly, only income that relates solely to surplus deposits (eg, annual charges) needs to be estimated in order to avoid double-counting.

Alternatively, if deposit-taking is not viewed as a stand-alone activity, it might be appropriate to identify income specific to deposits by looking at the overall revenue generated by banks. The proportion of the total revenue based on the share of deposits in total assets can then be allocated to the deposit-taking activity. This approach is used for sizing-up purposes.

Based on industry statistics, banks' gross income as a share of assets was 3%.⁶ This comprises 1.6% for net interest income and 1.4% of fee income. Applying the 3% estimate to the total value of protected deposits would result in a fee income of £24.3 billion. The key potential consideration that may challenge the accuracy of estimates under this approach is that deposits are banks' liabilities, not assets. Applying the 3% to protected deposits assumes that the same income is generated from different sources of funding (eg, retail deposits, corporate deposits, wholesale borrowing).

On balance, given the significant data problems associated with identifying the revenue from deposits, one assumption would be to use the ratio of gross income to total assets. Using a 3% assumption, this implies that the estimated financial size of deposit-taking is £24.3 billion.

3.3 Estimates of financial size: general insurance class

The general insurance class comprises providers (contribution group A3) and intermediaries (contribution group A19). The FSCS tariff base is net premium income for providers and annual eligible income from intermediaries.

Based on numerous in-depth discussions with FSA experts and industry stakeholders, including the relevant trade associations and individual member firms, several adjustments to the original tariff base figures were made to address the following issues.

- **Relevant business.** The tariff base for providers is net premium income from protected contracts, and includes contracts for clients that are not eligible for compensation. Hence, an adjustment is required to size up the class with respect to relevant business only.
- **Comparability of estimates.** Although income-based in both cases, the tariff bases for providers and intermediaries do not present comparable measures of financial size, so a number of adjustments were considered to make the income estimates more comparable.

⁶ The data refers to 2003. Source: British Bankers' Association (2004), 'Banking Business: The Annual Abstract of Banking Statistics', Volume 21, June.

- **Double-counting.** Adjustments are required to ensure that the same income is not counted twice in the vertical relationship between providers and intermediaries, and a number of possible adjustments were examined to avoid double-counting.

3.3.1 Providers

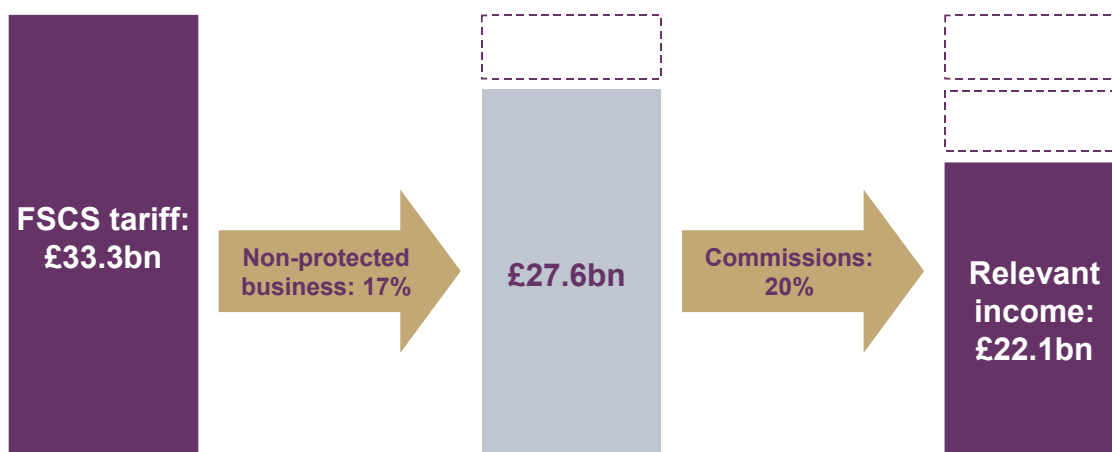
The FSCS tariff for general insurance providers (A3) was used as the starting point for sizing up the providers sub-class. The total tariff base—net premium income—reported for 2006/07 was £33.3 billion.⁷

However, the current FSCS tariff base includes net premium income from policies sold to non-protected commercial customers, and if the aim is to measure FSCS-protected business only, this income should be excluded. Data on the share of protected retail business for the relevant general insurance contracts is not directly available, and assumptions were required. Based on discussions with the industry, and after cross-checking with FSA experts, on balance it appeared reasonable to suggest that around 83% of net premiums relate to FSCS-protected contracts.

A second adjustment was required to avoid double-counting. In particular, the commissions paid to intermediaries constitute intermediary income, and including commissions twice would imply double-counting at class level. A number of estimates of the amount of commissions paid were considered, on average ranging from 15% to 25% of net premiums, although there is a large variation by type of product, and higher commissions can be observed for some types of general insurance. This range emerged from several sources of information: Oxera’s analysis of FSA data containing the financial returns of general insurance providers; data and analysis provided by the industry associations; and discussions with FSA experts and industry. On balance, it was considered appropriate to assume an average commission rate of 20%, and adjust provider income accordingly.

Figure 3.3 summarises these two adjustments made to the A3 tariff base to obtain a more relevant estimate of financial size.

Figure 3.3 Estimating financial size of general insurance providers



Source: FSA data and Oxera analysis.

In addition to the above adjustments, Oxera considered a range of further adjustments to the tariff base, and discussed these with industry stakeholders—in particular, whether it would be appropriate to remove from the financial size estimate the benefits accruing to consumers in the form of general insurance claims paid by providers. Claims amount to around 60–70% of

⁷ Information provided to Oxera by the FSA.

net premiums, so excluding these would result in a significantly lower estimate of relevant income.

A number of arguments for and against excluding claims were examined, some of which were proposed by the industry and FSA experts. In the case of claims being excluded, the appropriateness of adding investment income to obtain an estimate of financial size was also considered.

The main arguments in support of removing claims include:

- claims might be treated as an uncontrollable cost;
- claims represent costs that are specific to the general insurance industry;
- claims paid are benefits to consumers and do not accrue to insurers.

However, claims could also be considered an expense of running the insurance business, and if the financial size measure is defined as income to cover operating expenses and profits, claims should not be excluded. The key arguments for not excluding claims include the following.

- It might be argued that, for business protected by the FSCS, insurance providers can assess their claims costs in advance with reasonable accuracy. Therefore, claims would not appear to be an uncontrollable cost.
- Taking risk is the key part of the insurance business. Claims paid to policyholders are costs of this risk and are a normal part of the insurance business.
- Other (sub-)classes may also have costs that are unique to them.
- Even though claims flow to customers and do not accrue to insurers, insurers benefit when claims are lower than expected.
- Excluding claims might create a perverse relationship between the risk insurers generate for the FSCS and the amount of contribution they pay. Higher claims (and higher risk) would be associated with the lower levy.

If claims were deducted, it seems appropriate that investment income should be added back since insurers benefit from this source of income.⁸ A further adjustment may be required whereby the flow of funds into investments should also be deducted.

Claims amount to around 60–70% of premium income, based on industry statistics and FSA data. If the financial size were measured after deducting claims at a rate of 60%, the resulting estimate would be £5.5 billion. If financial size were measured after deducting claims but including investment income, the resulting estimate would increase to around £13.8 billion, assuming that investment income amounts to 30% of premium income. This provides a range of financial size estimates, depending on the treatment of claims and investment income.

Claims affect affordability, and are a cost-specific to insurers. Hence, for setting affordability thresholds (see section 3.8), profitability of the underwriting activities should be considered. For example, while the general insurance and deposit classes may be of roughly the same size (as measured by relevant income), profitability is lower for general insurers. Following discussions with the FSA, it was decided that the approach should be to deduct claims but take account of investment income.

⁸ For a summary of underwriting and trading results, see IFSL (2005), 'Insurance', City Business Series, International Financial Services London, November.

The discussion in the remainder of this report is therefore based on the financial size estimate that adjusts net premium income for claims and investment income—ie, a relevant income of £13.8 billion.

3.3.2 Intermediaries

The A19 tariff base for general insurance intermediaries is defined as annual eligible income. In principle, therefore, the tariff base would present a direct measure of the financial size of insurance intermediaries—ie, the tariff base is defined as income that relates to the relevant FSCS-protected activities.

The total A19 tariff base in 2006/07 amounted to £10.3 billion.⁹ However, although reported to the FSA, this figure appears high—particularly compared with the relevant net premium income of general insurance providers in A3—and is likely to overstate the actual income of intermediaries.

One possible reason for this high number is over-reporting by firms or double-counting between providers and intermediaries, as suggested by FSA experts and industry.

Given these concerns about the accuracy of the data, and to ensure consistency between provider and intermediary estimates, an alternative approach was adopted, which is to apply commission rates to the relevant net premium income of providers. Adopting the 20% commission rate assumption discussed above for providers would result in a relevant income estimate for insurance intermediaries of around £5.5 billion.

3.3.3 Summary

The financial size estimates for providers and intermediaries in the general insurance class are summarised in Table 3.1.

Table 3.1 Financial size of the general insurance class

| | Financial size (£ billion) | Relative size (%) |
|--------------------------------|----------------------------|-------------------|
| Providers | 13.8 ¹ | 71.4 |
| Intermediaries | 5.5 | 28.6 |
| General insurance class | 19.3 | 100 |

Notes: ¹ Estimate of income, which adjusts for general insurance claims.
Source: FSA data, industry statistics, interviews and Oxera calculations.

3.4 Estimates of financial size: life & pensions class

The new life & pensions class contains providers (contribution group A4) and intermediaries (contribution groups A12 and A13, but only with respect to their advice and sales activities relating to life & pensions products).

3.4.1 Providers

As with other classes, Oxera examined the appropriateness of using the tariff base to size up life insurance providers. The tariff base is defined as relevant net premium income, which amounts to £68 billion, as reported for the 2006/07 levy period.¹⁰ The tariff base data provided by A4 participants to the FSA is based on premiums from new business, scaled up

⁹ Information provided to Oxera by the FSA.

¹⁰ Information provided to Oxera by the FSA.

by a factor of 10. It relates to protected business, excluding pension fund business, for example.

To the extent that the premium income relates to new business, and a factor of 10 is used to scale up regular premiums, the tariff base will only accurately reflect the size of the industry under specific assumptions (eg, with respect to the average lifetime of regular premiums policies).¹¹

Using the tariff base as a starting point is therefore unlikely to be appropriate, and two broad approaches are considered instead. Under the first, it is recognised that life insurance comprises both savings and protection policies, although the tariff base does not differentiate between these. The second approach attempts to determine a proportion of premium income that reflects expenses and profit using an economic embedded value (EEV) approach. The estimates and underlying analysis for the first approach were developed in conjunction with FSA experts, and the second refers to data and analysis provided by industry.

Financial size based on the first approach

Figure 3.4 provides a stylised illustration of the methodology for the first estimation approach, where relevant income is separately derived for savings and protection policies.

For the savings component, funds under management provide the basis for estimating the financial size. The value of funds invested in different types of FSCS-protected savings product was based on the FSA data, as of the end of the third quarter of 2006.

To derive the relevant income, an estimate of the average income earned on the funds needs to be applied. This is not straightforward as fees differ by product, and no suitable data source was identified to derive reliable figures. On the grounds that a 0.75% assumption was applied to derive income for the fund management group in the investment class (see section 3.5.1 below), the same number was adopted here.

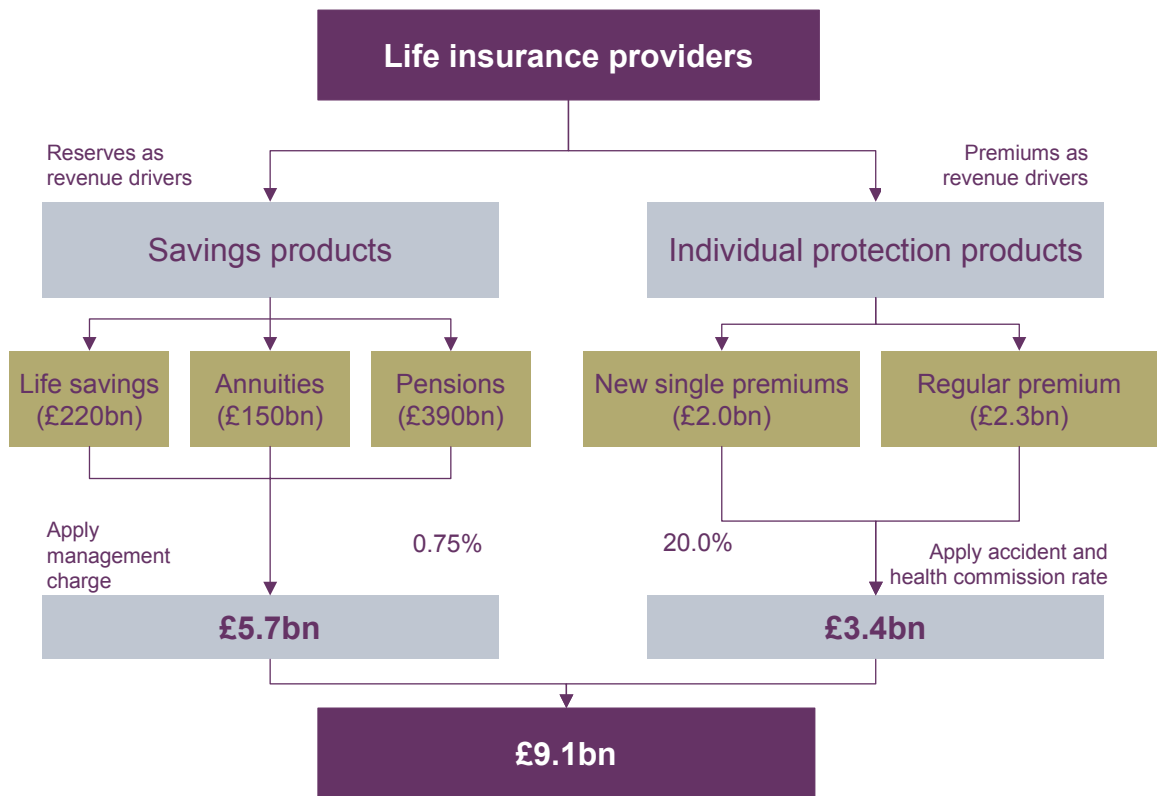
This approach results in a total relevant income estimate for savings products of £5.7 billion (see Figure 3.4), but it should be noted that the accuracy of this approach not only depends on the accuracy of the income percentage applied but also varies between different types of product. This approach seems more appropriate for unit-linked products and, in particular, for single premium (SP) policies; it might be less accurate for non-linked products.

Turning to the second component, protected policies are treated in accordance with the approach adopted for general insurance, discussed above in section 3.3.1. Income is derived from the net premium income for the FSCS-protected business, as available from FSA data, minus commissions paid to intermediaries. The premiums totalled £4.3 billion, but data on commissions is less readily available. Based on discussions with industry, it was considered appropriate to use a commission rate applying to accident and health products, which was estimated to average around 20%. The 20% estimate also corresponds to the commission rate estimate adopted for general insurance contracts above. (Again, no adjustment to the financial size estimate was made for claims paid, for the reasons discussed above for general insurance.)

Overall, this approach to estimating financial size results in a relevant income of £9.1 billion.

¹¹ Industry participants consulted as part of this project considered a factor of 5 to be more appropriate on the grounds that it gives a more realistic assessment of the relative value.

Figure 3.4 Estimating financial size of life insurance providers



Source: FSA data, interviews and Oxera calculations.

Financial size based on the second approach

The second approach attempted to estimate the proportion of premium income that reflects expenses and profit using an EEV approach. As mentioned above, the data and analysis were provided to Oxera by industry.

The embedded value is the total of the net worth of the life businesses and the value of in-force covered business. The net worth is the market value of the shareholders' funds determined on a statutory solvency basis and adjusted to add back any non-admissible assets, and consists of the required capital and free surplus. The value of in-force covered business is the present value (at the discount rate which incorporates a risk margin) of the distributable profits to shareholders arising from the in-force covered business, less a deduction for the cost of holding the required level of capital.

The high-level estimate provided by industry suggested a relevant income estimate higher than that derived under the first approach—£12.1 billion.¹² It was based on estimates of total lifetime premiums of £80.7 billion; the EEV plus expenses was estimated as 15% of premiums.

It is possible that part of the premiums included in the calculations does not relate to FSCS-protected business, which could explain why the estimate is higher than that obtained under the first estimation approach.

There are measurement uncertainties under both approaches, and further analysis using more robust data would be required to finalise estimates of the financial size of life & pensions providers. For the purpose of further analysis and modelling work in subsequent sections, however, the estimate derived under the first approach (£9.1 billion) is used.

¹² Information provided to Oxera by the FSA.

3.4.2 Intermediaries

Under the new structure, the life & pensions class would comprise both providers and intermediaries. The intermediaries participating in the life & pensions class would be firms that are currently participating in contribution group A12 and A13, but only to the extent that they engage in advice and sales with respect to life & pensions products.

For sizing-up purposes, information on the following is required:

- which firms currently participating in A12 and A13 would participate as intermediaries in the new life & pensions class;
- what proportion of their activities relates to life & pensions as opposed to investment;
- what income these firms earn with respect to those activities.

No data is readily available for this purpose, so assumptions are required in order to provide an estimate of the financial size of life & pensions intermediaries.

- **Participants.** Among the participants in A12 and A13, it is assumed that firms classified by the FSA as ‘financial advisers’ and ‘advising (and arranging) intermediaries’ would participate in the life & pensions class, as would ‘banks’ and ‘building societies’ with respect to their advice and sales of life & pensions products. Other A12 and A13 participants such as ‘stockbrokers’ and ‘investment managers’ are assumed to engage only in investment activities,¹³ although in practice it is possible that they would also participate to some degree in the life & pensions sector.
- **Proportion of life & pensions business.** Based on FSA product sales data as well as interviews with relevant firms and their associations, it is assumed that, of the fee and commission income generated by financial advisers and advising intermediaries with respect to retail investment products (ie, life & pensions as well as investment), 70% relates to life & pensions and 30% to investment products. For the advice and sales of banks and building societies, this split is assumed to be reversed—ie, 30% life & pensions products and 70% investment products.
- **Relevant income.** For many advisers, the FSA’s Retail Mediation Activities Return (RMAR) database records retail investment income, which comprises fees and commissions on retail investment products only. For RMAR firms, this data is used as the relevant measure of income, allocated between life & pensions and investment in the proportion described above (ie, 70%:30%).

For firms not captured by RMAR, income is inferred from the number of approved persons (ie, the A12 and A13 tariff base) of those firms and an estimate of relevant retail investment income per approved person. The relevant retail investment income per approved person is assumed to be £50,000 for firms in A13 and £68,000 for firms in A12.¹⁴

The results and main assumptions are summarised in Table 3.2.

¹³ Firms were identified using the FSA’s ‘primary category’ variable for classifying firms.

¹⁴ The estimates were derived by examining the ratio of retail investment income to approved persons for firms that report under RMAR and participate only in contribution group A12 or A13 (ie, firms whose approved persons are unlikely to generate income from other activities). The estimates were cross-checked in interviews with firms. Although the total income per approved person (eg, for a bank or building society) can be higher, the estimates may be adequate for capturing income earned with respect to advice and sales of retail investment products only.

Table 3.2 Life & pensions intermediaries: assumptions and sizing-up results

| | Financial advisers, advising intermediaries | | Banks, building societies | |
|-------------------------------------------------------------------------|------------------------------------------------|---------|------------------------------|----------------|
| | A12 | A13 | A12 | A13 |
| Firms in the FSA's RMAR database | | | | |
| Reported retail investment income | £310.6m | £1,762m | – | – |
| Other firms | | | | |
| Number of approved persons | 2,736 | 779 | 19,514 | 710 |
| Retail investment income per approved person | £68,000 | £50,000 | £68,000 | £50,000 |
| Total retail investment income | £186m | £39m | £1,327m | £36m |
| Total retail investment income (sum of A12 and A13) | | £2,298m | | £1,362 |
| Percentage related to life & pensions | | 70% | | 30% |
| Total income related to life & pensions | | £1,609m | | £409m |
| Total relevant income for all life & pensions intermediaries | | | | £2,017m |

Note: Figures may not sum due to rounding. The number of approved persons refers to tariff data reported for 2006/07.

Source: FSA data, interviews and Oxera calculations.

Overall, this approach generates an estimate of the total relevant income for intermediaries in the life & pensions class of just over £2 billion.

There has been concern among parts of the industry that this estimate significantly understates the income of advisers in the sector. In particular, research carried out for the Association of British Insurers (ABI) suggests that advisers generated approximately £6.5 billion of income, of which £4.7 billion was paid by life companies.¹⁵ It was not possible to ascertain the discrepancy between the figures, or to determine whether the higher estimate includes income that should not be included as relevant fees and commission in the life & pensions class.

3.4.3 Summary

A number of approaches to sizing up the life & pensions class were considered. The key challenges were to: a) establish a measure of income that would make the financial size of providers and intermediaries comparable; and b) exclude income that is not relevant for FSCS purposes (eg, the managed funds business of providers).

Table 3.3 reports the results of the sizing-up analysis, focusing on the first estimation approach for providers and also presenting the potentially low estimate for intermediaries that is based on the FSA's RMAR data and tariff data for approved persons.

For both providers and intermediaries, the ABI provided estimates based on unpublished research that exceeded the income estimates reported in the table—£12.1 billion for providers and up to £4.5 billion for intermediaries. These estimates may include some business that is not relevant for FSCS purposes, and there may be other reasons why the estimates are not reconciled. (The total size of the class would be larger, and the split between providers and advisers would be closer to 70:30 than 80:20.)

¹⁵ The research for the ABI is not in the public domain, but was provided to Oxera as part of this study.

Overall, given the uncertainties and data limitations, a range of estimates may be more appropriate. However, for the purpose of the subsequent modelling, the estimates in Table 3.3 provide the basis for the analysis.

Table 3.3 Financial size of the life & pensions class

| | Financial size (£m) | Relative size (%) |
|----------------------------------|---------------------|-------------------|
| Providers | 9,140 | 81.9 |
| Intermediaries | 2,017 | 18.1 |
| Life & pensions class | 11,157 | 100 |

Source: FSA data, interviews and Oxera calculations.

3.5 Estimates of financial size: investment class

The following summarises the estimation of the relevant income for firms in the investment class. The current contribution groups in the investment sub-scheme map directly onto the proposed class under the options presented in DP06/1 (with the exception of A12 and A13, which are split between the life & pensions and the investment classes). Hence, the starting point for the sizing-up is the tariff base for each contribution group, and then making adjustments as required to indicate an estimate of income that reflects the relevant FSCS-protected activities.

3.5.1 Fund managers

The tariff base for contribution group A7 is funds under management, and the approach taken for sizing-up purposes is to use funds under management as the basis and apply a percentage fee to derive income.

The aggregate FSCS tariff base for the group is £1.5 trillion—this includes not only FSCS-protected retail funds but also institutional funds. Industry statistics were consulted to identify the relevant funds under management.

- **Investment Management Association (IMA) asset management survey.**¹⁶ Retail assets identified in the survey amounted to some £530 billion in 2005. These assets include UK-managed unit trusts, open-ended investment companies, investment trusts, and other retail products. However, retail investors in the CIS would in general not have a claim against the fund manager but only against the CIS provider—ie, the £530 billion estimate of funds under management does not reflect ‘relevant’ A7 business for FSCS purposes.
- **ComPeer survey of UK private client wealth management industry.**¹⁷ Private client assets are estimated to amount to £308 billion. Although the definition of ‘private client’ may not directly correspond to ‘investor eligible for FSCS compensation’, and there may be other problems in using this estimate to size up the fund management group,¹⁸ this statistic was the best indication of the size of relevant FSCS-protected business in the A7 group. Relevant business would therefore amount to around only 20% of the A7 tariff base.

¹⁶ IMA (2006), ‘Asset Management Survey’.

¹⁷ ComPeer (2006), ‘Wealth Management Industry Report’.

¹⁸ For example, there may be an overlap with business in the A12 group as some of the private client assets controlled may relate to stockbroking rather than portfolio management activities.

Taking the ComPeer statistic as the basis, the next step is to apply a percentage to estimate the income earned on the relevant assets. Interviews suggested that 0.75% of assets may be a reasonable estimate for the fee earned by private client managers, although there can be significant variation.

Applying 0.75% to the estimate of relevant assets (£308 billion) would generate an estimate of relevant income for the fund management group of £2.3 billion.

3.5.2 Collective investment scheme operators and depositaries

The tariff base for firms in the A9 contribution group is already income-based—reported total gross income for FSCS participants amounts to £3,634m.¹⁹ However, as with the A7 group, the tariff base does not reflect only relevant FSCS-protected income.

The IMA records statistics on the gross sales of UK domiciled collective investment schemes, distinguishing between retail and institutional sales. Although there is some variation over time, these statistics suggest that around 60% of gross sales are for retail investors. Applying this percentage to the tariff base would generate an estimate of relevant income for CIS operators and other firms in A9 of around £2.2 billion.

3.5.3 Advisers and brokers

Current contribution groups A12 and A13 contain a diverse set of firms. The tariff base is approved persons, but no data is available to quantify the income generated by those approved persons in relation to FSCS-protected investment advice and brokerage activities (as opposed to other activities).

For many firms currently participating in A12 and A13, the new structure envisages that their advice and sales activities will be split according to whether the activities relate to life & pensions products or investment products. As discussed in section 3.4.2, it is assumed that this applies to firms classified by the FSA as ‘financial advisers’, ‘advising (and arranging) intermediaries’, ‘banks’ and ‘building societies’. Section 3.4.2 provided estimates of the total retail investment income generated by those firms, which for sizing-up purposes can then be split according to whether this income relates to life & pensions or investment products.

Table 3.4 reproduces the results contained in Table 3.2, and provides an estimate of the proportion of income for those firms that may be attributable to the investment class.

Table 3.4 Estimating income from investment advice and sales for advisers, banks and building societies

| | Financial advisers, advising intermediaries | | Banks, building societies | |
|--------------------------------------------------------|------------------------------------------------|---------|------------------------------|------|
| | A12 | A13 | A12 | A13 |
| Total retail investment income | £497m | £1,801m | £1,327m | £36m |
| Total retail investment income (sum of A12 and A13) | £2,298m | | £1,362m | |
| Percentage related to life & pensions | 70% | | 30% | |
| Percentage related to investment | 30% | | 70% | |
| Total income related to investment | £689m | | £954m | |
| Total relevant income for both types of firm | | | £1,643m | |

Source: FSA data, interviews and Oxera calculations.

¹⁹ Information provided to Oxera by the FSA.

While this provides an estimate of relevant income for the approved persons of advisers, banks and building societies, it does not include the income generated by the approved persons of other firms in A12 and A13. For example, a large number of approved persons belong to stockbrokers and investment managers, and it is assumed for the purpose of this analysis that these firms engage exclusively in activities that fall in the investment class. Thus, although no split between life & pensions and investment activities is required (ie, 100% will be allocated to the investment class), the question is what income is generated by those firms that specifically relates to investment advice and broking activities?

One important issue is that certain firms may have approved persons, but the income generated by them does not directly stem from advice and broking. For example, investment managers have approved persons in A12 and A13, yet the income generated comes from fund management activities. Attributing income to A12 and A13 activities as well as to fund management (A7) would result in double-counting.

For the purpose of this sizing-up exercise, and in the absence of more robust data, it is assumed that the approved persons of investment managers do not generate any relevant income over and above the income that is attributed to fund management. This was confirmed by interviews with a number of relevant firms. Investment managers were identified using the FSA's classification of firms, as captured by the variable 'primary category'. A similar assumption (ie, negligible A12- and A13-specific income) was made for certain other types of firm currently participating in the group.

The firms included in the sizing-up, over and above advisers, banks and building societies, are those classified as 'stockbrokers' and 'arranging intermediaries'. Since no allocated income data is available, the approach taken is one in which the tariff base (ie, the number of approved persons) is multiplied by an estimate of the income earned by approved persons. Based on a sample of firms for which data was available, as well as interviews with private client stockbrokers, income per approved person was assumed to be £150,000.²⁰ The resulting total income estimate for this group of firms would therefore be £818m, as summarised in Table 3.5. It is assumed that all of this income is relevant—ie, FSCS-protected and specific to investment advice and broking.

Table 3.5 Estimating relevant income for stockbrokers and arranging intermediaries (not including advisers, banks and building societies)

| | Stockbrokers, arranging intermediaries |
|--------------------------------------|-----------------------------------------------|
| Approved persons in A12 | 4,964 |
| Approved persons in A13 | 486 |
| Total number of approved persons | 5,450 |
| Estimated income per approved person | £150,000 |
| Total relevant income | £817,500,000 |

Source: FSA data, interviews and Oxera calculations.

Combining the relevant income estimates for all three types of firm, the total income for advice and broking in the investment class would amount to around £2.5 billion, as summarised in Table 3.6.

²⁰ The data estimate was obtained by examining a sample of stockbrokers, as classified by the FSA and for which retail investment income was recorded under the FSA's RMAR returns. The median retail investment income per approved person for firms with the data was around £150,000.

Table 3.6 Relevant income from investment advice and broking (£m)

| | Relevant income (A12) | Relevant income (A13) | Total relevant income |
|---------------------------------------------|--------------------------|--------------------------|--------------------------|
| Financial advisers, advising intermediaries | 149 | 540 | 689 |
| Banks, building societies | 929 | 25 | 954 |
| Stockbrokers, arranging intermediaries | 745 | 73 | 818 |
| Total | 1,822 | 638 | 2,461 |

Note: Figures may not sum due to rounding.
Source: FSA data, interviews and Oxera calculations.

3.5.4 Principal dealers

The tariff base for principal dealers in contribution group A10 is the number of traders, with the total reported tariff base amounting to 6,800 traders. No allocated income data is available, and deriving an income estimate is difficult, as confirmed by relevant firms that were interviewed. This would require: a) allocation of a firm's income to principal dealing activities; and b) identification of the proportion that is FSCS-protected.

Data was available to calculate the income per trader of firms that only participate in A10 (ie, that do not have permission to undertake other activities). For those firms, the median income per trader amounted to £248,000, and this estimate could be applied to extrapolate an approximate estimate of income for all A10 participants.

However, the resulting estimate would significantly overestimate 'relevant' income since the bulk of A10 activities are not carried out for FSCS-eligible clients. According to interviews with firms, 5%—or indeed significantly less—of all activities should be considered relevant for FSCS purposes. The resulting estimate of the relevant financial size of the principal dealing group would be less than £100m (ie, less than 5% of £248,000 multiplied by 6,800 traders).

3.5.5 Corporate finance advisers

A similar problem arises for firms in A14, where the current tariff base is approved persons. These activities are mainly undertaken within the large corporate finance houses and investment banks, and there is no 'typical' income per person from relevant activities.

Again, it would be possible to arrive at an estimate by calculating the income per approved persons for firms that participate in A14 only (the data for the firms that could be identified suggested a median income per person of £156,000), and multiply this by the number of approved persons (3,680 approved persons among FSCS participants in A14).

Most of the activities in A10 are not carried out for retail clients. Firms suggested that considerably less than 5% of activities would be relevant for FSCS purposes, so the relevant income for this group would be less than £30m (ie, less than 5% of £156,000 multiplied by 3,680 approved persons).

3.5.6 Summary

Based on the above assumptions, the relevant income for the investment class as a whole would amount to around £7 billion, as summarised in Table 3.7.

Table 3.7 Estimates of financial size for the investment class

| | Estimated relevant income (£m) | % of total |
|-------------------------------|--------------------------------|------------|
| Fund managers | 2,310 | 32.7 |
| CIS operators, etc | 2,181 | 30.9 |
| Advisers, brokers | 2,461 | 34.8 |
| Principal dealers | 84 | 1.2 |
| Corporate finance advisers | 29 | 0.4 |
| Total investment class | 7,064 | 100 |

Note: Figures may not sum due to rounding.

Source: FSA data, interviews and Oxera calculations.

3.6 Estimates of financial size: mortgage class

For the sizing-up exercise it is assumed that the mortgage class includes firms involved only with mortgage advice and arranging activities (ie, current contribution group A18), not mortgage lending. The current tariff base for A18 is annual eligible income. Assuming that the tariff data is correctly reported to the FSA, this measure can be directly used as an estimate of the relevant financial size of the class—ie, annual eligible income should only include income from relevant mortgage advice and arranging activities that are FSCS-protected. The latest tariff data suggests a relevant income of £1,762m.²¹

3.7 Estimates of financial size: summary and comparisons

Table 3.8 summarises the results of the sizing-up exercise for each broad class and sub-class. The total estimated relevant income for all broad classes amounts to around £63.7 billion, allocated across the broad classes (and groups within those classes).

A single estimate of financial size is reported for each (sub-)class to facilitate subsequent analysis, although a range would in some cases be more appropriate, given the data constraints and resulting uncertainties.

²¹ Information provided to Oxera by the FSA.

Table 3.8 Summary of financial size estimates

| | Estimated relevant income (£m) | % of total |
|--------------------------------------------|--------------------------------|-------------|
| Deposit class | 24,337 | 38.2 |
| General insurance class¹ | 19,332 | 30.4 |
| Providers | 13,808 | 71.4 |
| Intermediaries | 5,523 | 28.6 |
| Life & pensions class | 11,157 | 17.5 |
| Providers | 9,140 | 81.9 |
| Intermediaries | 2,017 | 18.1 |
| Investment class | 7,064 | 11.1 |
| Fund managers | 2,310 | 32.7 |
| CIS operators, etc | 2,181 | 30.9 |
| Advisers, brokers | 2,461 | 34.8 |
| Principal dealers | 84 | 1.2 |
| Corporate finance advisers | 29 | 0.4 |
| Mortgage (advice) class | 1,762 | 2.7 |
| All broad classes | 63,653 | 100 |

Notes: Figures may not sum due to rounding. Financial size estimates based on assumptions set out in sections 3.1–3.6. ¹The estimate of financial size is based on relevant net premium income after adjusting for general insurance claims and investment income.

Source: Oxera analysis.

The estimates rely on some strong assumptions, as discussed above, although the analysis makes use of available FSA data, additional industry statistics, and interviews with firms and associations to arrive at a financial size estimate that reflects the relevant income—ie, one that is relevant in the sense that it reflects the activities underlying the classes and is eligible for FSCS purposes.

Table 3.9 shows estimates of the total gross value added generated by financial corporations, as reported by the Office of National Statistics (ONS). Total gross value added for 2004 amounted to £84.75 billion. However, these numbers are not directly comparable with those presented in Table 3.8: the ONS data refers to 2004; includes different industry groupings and counts firms that are not FSCS participants; uses a concept of value added that cannot be directly compared with the income measure used in the sizing-up results; and includes business that is not eligible for FSCS purposes.

Table 3.9 Gross value added of financial corporations as reported in the ONS national accounts, 2004

| | Gross value added (£ billion) | % of total |
|----------------------------------------------------------|-------------------------------|------------|
| Monetary financial institutions | 49.92 | 58.9 |
| Other financial intermediaries and financial auxiliaries | 17.36 | 20.5 |
| Insurance corporations and pension funds | 17.47 | 20.5 |
| All financial corporations | 84.75 | 100 |

Note: Figures may not sum due to rounding.

Source: ONS (2006), 'United Kingdom National Accounts: Blue Book 2006'.

3.8 Setting affordability thresholds

Having established estimates of the financial size of different classes and sub-classes, the next step is to determine what constitutes an affordable levy, or what affordability factors should be applied to the financial size estimates to derive thresholds for the classes and sub-classes under the various options.

This section sets out approaches that might be adopted to set thresholds, and shows what different thresholds would mean in terms of the maximum levy that would be payable by firms in different classes.

3.8.1 Defining and measuring what is affordable

What constitutes an affordable FSCS levy is difficult to identify, and there are different ways of defining the concept of affordability. For example, as also discussed in DP06/1, the limit of affordability could refer to the point at which the levy makes material inroads into the profitability of firms; impedes their operational capacity (eg, increasing the costs at which the firm can raise capital); puts firms out of business; or triggers further defaults. Defining affordability and setting thresholds has distributional implications and is ultimately a policy decision. Moreover, affordability may not be the only policy principle for setting thresholds.

In addition to defining what concept of affordability to adopt, the actual metric for measuring affordability needs to be determined. There are a number of potential measures of affordability that could be used, and a useful distinction between them is whether they represent a flow or stock measure of affordability. Flow measures of affordability include revenue, costs and profits, while stock measures include, for example, the value of a firm's capital. Alternative measures of affordability can be evaluated against the following criteria:

- how conceptually appropriate is the measure of affordability?
- how practical is the measure of affordability?

Conceptually, it might be most appropriate to consider what is affordable in terms of the net present value of a firm's activities after its liabilities have been deducted, and set thresholds in relation to the impact on firm value.²² Of the flow measures of affordability, those based on profit are likely to be the most appropriate—measures based on revenue (ie, the measure used for sizing-up purposes) fail to take account of cost differences and other factors that determine profitability.

However, these conceptually more attractive measures suffer from significant practical problems. As regards value or other stock-based measures, while regulated firms are required to report data on total assets or equity reserves, this data refers to the firm or group as a whole and is not specific to the activities underlying the classes or sub-classes. Furthermore, this data represents the accounting or book value of assets and equity and not the current market value of the firm, and is therefore one step removed from being the conceptually correct measure.

Similarly, the main practical difficulty with using profit as a measure of affordability is that where regulated firms provide the FSA with data on profits, these are at the firm or group level and are not activity-specific. In addition, the measurement and interpretation of profits can differ between sub-classes and classes (eg, what are the profits in owner-managed businesses in the intermediary sector?). Moreover, while revenue can be allocated more easily, the allocation of costs is usually problematic for firms with multiple activities. It is for this reason that a revenue-based measure was selected for sizing up the various (sub-)classes in sections 3.2 to 3.7.

²² In other words, the net present value or market value of a firm's equity.

The first step is to derive thresholds from the relevant income estimates obtained, and illustrate what different thresholds would mean in terms of the maximum levy that could be charged against a single class or sub-class before wider pooling is triggered. The next step would then be to consider what adjustments to the income-based thresholds may be required to account for affordability differences between (sub-)classes.

3.8.1 Thresholds set in proportion to relevant income

Using the financial size estimates summaries in section 3.7, the most practical way of setting thresholds is to apply affordability factors to these estimates and derive thresholds as a percentage amount of relevant income. Following discussions with the FSA (as well as industry stakeholders), it was decided that Oxera should analyse and provide impact-modelling outputs for threshold percentages ranging between 2.5% and 10% of relevant income. The resulting thresholds are reported in Table 3.10.

Table 3.10 Ranges of thresholds set in relation to relevant income (£m)

| | Estimated relevant income) | 2.5% threshold | 5% threshold | 7.5% threshold | 10% threshold |
|----------------------------------|----------------------------|----------------|--------------|----------------|---------------|
| Deposit class | 24,337 | 608 | 1,217 | 1,825 | 2,434 |
| General insurance class | 19,332 | 483 | 967 | 1,450 | 1,933 |
| Providers ¹ | 13,808 | 345 | 690 | 1,036 | 1,381 |
| Intermediaries | 5,523 | 138 | 276 | 414 | 552 |
| Life & pensions class | 11,157 | 279 | 558 | 837 | 1,116 |
| Providers | 9,140 | 229 | 457 | 686 | 914 |
| Intermediaries | 2,017 | 50 | 101 | 151 | 202 |
| Investment class | 7,064 | 177 | 353 | 530 | 706 |
| Fund managers | 2,310 | 58 | 116 | 173 | 231 |
| CIS operators, etc | 2,181 | 55 | 109 | 164 | 218 |
| Advisers, brokers | 2,461 | 62 | 123 | 185 | 246 |
| Principal dealers | 84 | 2 | 4 | 6 | 8 |
| Corporate finance advisers | 29 | 1 | 1 | 2 | 3 |
| Mortgage (advice) class | 1,762 | 44 | 88 | 132 | 176 |
| All broad classes | 63,653 | 1,591 | 3,183 | 4,774 | 6,365 |

Notes: Figures may not sum due to rounding. Financial size estimates correspond to those in Table 3.8.

¹ Estimate of financial size is based on relevant net premium income after adjusting for general insurance claims and investment income.

Source: Oxera analysis.

For example, a 2.5% threshold would give the FSCS an overall compensation capacity of £1.6 billion, compared with £6.4 billion if the threshold were set at 10% of relevant income. The life & pensions class would be expected to pay for compensation costs arising in the class up to £279m if a 2.5% threshold were adopted, whereas if the thresholds were set at 10%, other broad classes would be expected to contribute to life & pensions failures only if compensation costs exceeded £1.1 billion.

The implications of different threshold levels in terms of levies to be paid by different (sub-)classes (and individual firms) were modelled, considering Options A to D as set out in DP06/1 and a number compensation cost scenarios. A full set of modelling results was submitted to the FSA, and a selection is reported in section 5.

If the affordability range is somewhere between 2.5% and 10% of income, two questions arise:

- at what level should the thresholds be fixed?
- should different percentages be applied for different classes and sub-classes to reflect potential differences in affordability?

The final decision is ultimately a matter for policy, but analysis was conducted to inform these decisions by first comparing thresholds with different benchmarks, and then discussing the criteria that may require affordability adjustments.

3.8.2 Benchmarking thresholds against current contribution limits

The obvious benchmarks for the thresholds are the current limits on the level of FSCS contributions that can be raised from different parts of the industry. These are specified in absolute terms (eg, £400m for the investment sub-scheme) or relative to the tariff base (eg, 0.8% of net premium income for life insurance providers in contribution group A4). Table 3.11 summarises the current limits that apply and, for comparative purposes, the income-based thresholds derived above.

Table 3.11 Thresholds compared with current contribution limits (£m)

| | Current limit | 2.5% threshold | 5% threshold | 7.5% threshold | 10% threshold |
|-------------------|---------------|----------------|--------------|----------------|---------------|
| Deposit | 2,434 | 608 | 1,217 | 1,825 | 2,434 |
| General insurance | 349 | 483 | 967 | 1,450 | 1,933 |
| Life & pensions | 544 | 279 | 558 | 837 | 1,116 |
| Investment | 400 | 177 | 353 | 530 | 706 |
| Mortgage (advice) | 14 | 44 | 88 | 132 | 176 |
| Total | 3,741 | 1,591 | 3,183 | 4,774 | 6,365 |

Notes: The limit for deposit class is 0.3% of protected deposits (cumulative). The general insurance limit includes 0.8% of net premium income for providers (£267m) and 0.8% of annual eligible income for intermediaries (£82m); the thresholds for providers are based on the financial size estimate, which adjusts for general insurance claims. The limit for the life & pensions class is based on the limit for life insurance providers only (0.8% of net premium income), whereas the thresholds apply to providers and intermediaries. The investment limit is £400m, and the limit for mortgage advice is 0.8% of annual eligible income.

Source: FSA data and Oxera calculations.

Current contribution limits amount to around £3.7 billion, of which more than two-thirds come from the deposit sub-scheme (unlike the other limits, however, the limit for deposit-taking activities applies cumulatively and not on an annual basis).

For thresholds to deliver an aggregate compensation capacity similar to that applying under current limits (around £3.7 billion), they would need to be set at more than 5% of relevant income overall. For the different classes, a 5% threshold would, however, have different impacts compared with the current limits. While delivering around the same maximum payable levy in both the life & pensions and investment classes, a threshold set at 5% could present a reduction in the potential levy that could be raised from deposit-takers.²³ At the same time, a 5% threshold would present an increase in the levy limit, particularly for general insurance and mortgage intermediaries.

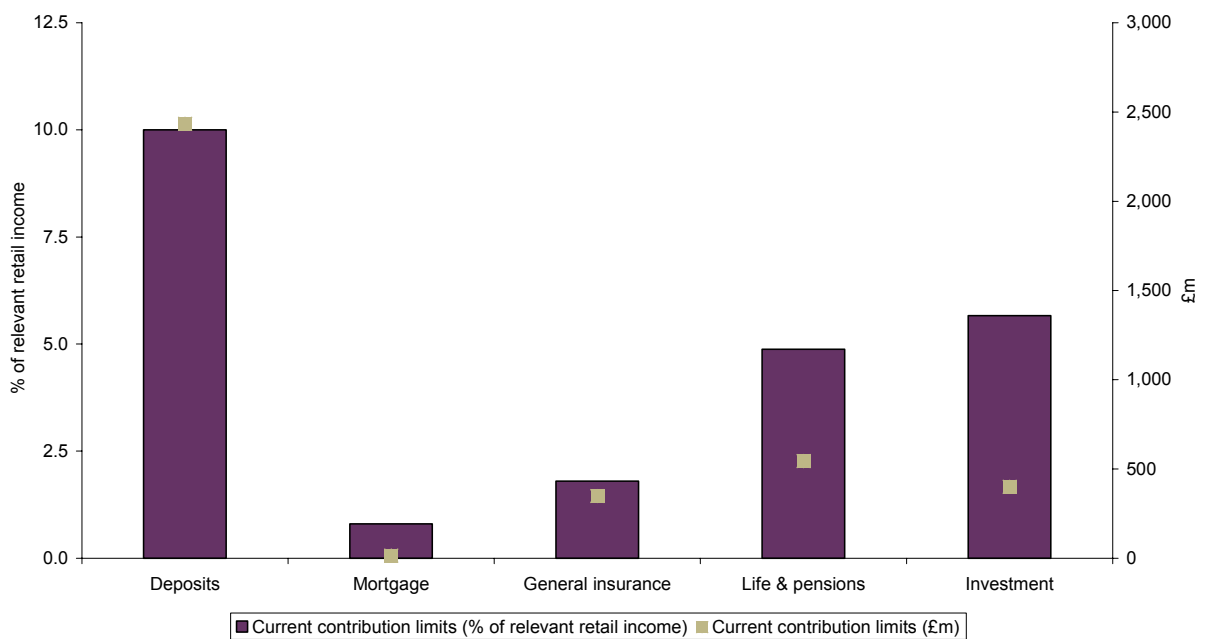
The current contribution limits in most cases date back to the FSCS predecessor schemes, and are not set on a basis that is consistent across the different parts of the industry. For

²³ This ignores the fact that the current limit for deposit-takers is not set annually, but is fixed at 0.3% of protected deposits on a cumulative basis.

example, the 0.8% limit for mortgage intermediaries (A18) and general insurance intermediaries (A19) relates to annual eligible income. For general insurance providers (A3) and life insurance providers (A4) the limit is also set at 0.8%, but in relation to net premium income, which, for reasons discussed above, is not comparable with the fee and commission income earned by intermediaries. Similarly, the deposit-taking limit is set in proportion to protected deposits, and the investment limit is set as a fixed amount, with neither being directly related to income.

Figure 3.5 illustrates the inconsistency between current contribution limits and the income estimates obtained in the sizing-up analysis. Current limits as a proportion of relevant income differ significantly between classes, ranging from 0.8% in the mortgage (advice) class to 10% for deposit-takers. Thus, if thresholds are set in proportion to relevant income, some if not all classes are likely to see a change in the maximum FSCS levy that can be imposed on firms in that class.

Figure 3.5 Current contribution limits compared with financial size estimates



Source: FSA data and Oxera calculations.

3.8.3 What is affordable, and what adjustments may be required?

The existing contribution limits may not be adequate measures of the level of FSCS levy that can be considered affordable for firms in the industry. Other benchmarks are the current and historical levies paid by firms. In aggregate, these have been well below existing limits, but for individual firms the impact of FSCS levies has been significant, with concerns being raised about their affordability. This applies in particular to some financial advisers in contribution group A13, which have paid levies in 2005/06 and 2006/07 amounting to more than 5%, and in some cases 10%, of their income (see also Figure 4.2). However, there is no evidence to suggest that FSCS levies to date have triggered market exit or firm defaults; in this context, therefore, the levies can be considered affordable even for those firms where they have amounted to a comparatively high proportion of income.²⁴ In other words, if the levies are to be set according to the principle of affordability, the relevant thresholds might be considered higher than the level of levies paid by firms to date.

²⁴ As discussed in section 4, concerns about affordability among financial advisers in current contribution group A13 could be addressed through adjustments in the tariff base (eg, from approved persons to income).

Setting thresholds in relation to relevant income does not capture possible cost differences between firms and activities. As discussed above, profits would be the conceptually better measure of the financial capacity to pay FSCS levies. Data was gathered to obtain profit margins for different parts of the industry to evaluate how varying threshold amounts would affect profitability.

Estimates of profit margins are published in industry statistics, although they are not comprehensively available (or consistently measured) for all parts of the industry, and do not reflect the profitability of activities that are specific to the proposed classes or sub-classes. A selection of published profit margins for different industries is reported in Table 3.12.

Table 3.12 Profit margins for selected industries, published estimates for various years (%)

| | Profit margin |
|-----------------------------|---------------|
| Banks | 33.0 |
| General insurers | 12.8 |
| Fund managers | 26.0 |
| Private wealth managers | 16.6 |
| Execution-only stockbrokers | 8.0 |

Sources: Banks: pre-tax profit as a % of gross banking income in 2003 is based on European Commission (2003), 'Interim Report II Current Account and Related Services', July 17th, pp. 155 and 157. Fund managers: IFSL (2006), 'Fund Management', City Business Series, August, p. 4. General insurers: pre-tax profit is averaged for 1994–2004, based on Swiss Reinsurance Company (2006), 'Measuring Underwriting Profitability of the Non-life Insurance Industry', Sigma No 3/2006, p. 8. Private wealth managers and execution-only firms: ComPeer (2006), 'Wealth Management Industry Report'.

Profit margins were also calculated from FSA data. For example, Table 3.13 shows average profit margins for a large sample of retail mediation and investment firms, calculated from data on total income and operating expenses as recorded by the FSA in its RMAR, Investment Management Firms (IMF) and Securities and Futures Firms (SFF) databases. Margins are shown separately for firms in different contribution groups; however the data is not allocated and refers only to total profits.

Table 3.13 Profit margins of retail mediation and investment firms, by contribution group

| | Profit margin (%) | No. of firms in sample |
|-------------------------------------------|-------------------|------------------------|
| A7: fund management | 13.3 | 752 |
| A9: CIS operation | 13.8 | 251 |
| A10: principal dealing | 13.9 | 126 |
| A12: advice, broking with client money | 13.3 | 544 |
| A13: advice, broking without client money | 28.2 | 4,614 |
| A14: corporate finance advice | 13.3 | 355 |
| A18: mortgage advice | 30.2 | 6,122 |
| A19: general insurance mediation | 21.1 | 14,605 |

Notes: Median values are reported for firms participating in the different contribution groups. Profit margins are in general calculated as the difference between total reported income (or turnover) and operating expenses relative to total reported income (or turnover). Only firms recorded in the FSA's RMAR, IMF and SFF databases are included.

Source: FSA data and Oxera calculations.

The profit margin estimates suggest differences between firms—eg, higher profit margins apply for banks than general insurers in Table 3.12—which would imply that setting thresholds as a fixed percentage of income could have varying impacts on the profits of different parts of the industry.

However, the estimates in Tables 3.12 and 3.13 are of limited use for the purpose of setting thresholds for different classes and sub-classes or adjusting the income-based thresholds discussed earlier. The estimates refer to firm-level profitability rather than to the different types of activity underlying the (sub-)classes, and they are not directly comparable across firms—for example, due to differences in the measurement of income and costs. There are also concerns about the data quality (eg, the high margins calculated from the data available for firms in the A13 and A18 contribution groups in Table 3.13). More fundamentally, margin on revenue is just one measure of profitability but not the conceptually most correct one—for example, differences in margins may simply be due to differences in the degree of capital intensity between firms or activities.

In general, data was not readily available, and it is beyond the scope of this study, to conduct a detailed profitability assessment and compare the profitability of activities underlying the classes and sub-classes. However, the estimates give an indication that a levy of, for example, 5% or more of relevant income could reduce profits generated from the activities by one-third or one-quarter for margins of 15–20%.

It is important to understand that the thresholds would not be expected to be reached under normal circumstances—thresholds are only relevant for large-loss events where compensation costs are considered too high for a single class or sub-class to bear, leading to a wider sharing of costs across (sub-)classes. The level of FSCS levy that may be required on a one-off basis to fund compensation costs in exceptional circumstances is higher than a levy that presents an ongoing annual obligation for firms. For example, a threshold of 10% or indeed more may be considered affordable on the assumption that this level is required only in exceptional circumstances. More generally, in theory, a larger levy infrequently incurred is potentially as affordable as a lower levy incurred frequently.

What can be considered affordable for firms depends on other factors, and a range of criteria would need to be analysed in detail to set thresholds according to the principle of affordability. In addition to the impact on profits, these criteria include (but are not limited to) the following.

- **Cost pass-through.** Affordability should be evaluated in light of firms' ability to pass through costs to consumers. Provided that FSCS levies increase the costs for all firms participating in the relevant market, firms are generally able to pass through the cost increases in the form of higher prices (in full or in part, depending on market structure). In particular, the more sustained a levy increase, the more likely it is that costs will be passed through in practice rather than borne by firm profits.
- **Capitalisation, liquidity.** Determining affordability thresholds with respect to revenue, profits or other flow measures ignores the fact that firms can use reserves to sustain temporary cost shocks. In this sense, the FSCS levy is more affordable for firms with greater capitalisation and liquidity (although these firms are precisely those least likely to generate compensation costs—ie, reflecting the inherent conflict between structuring levies according to affordability or risks²⁵).
- **Volatility of profits and cash flows.** The financial impact of the FSCS levy depends not only on profit levels but also their volatility, with cost shocks potentially having a greater impact and levies being less affordable the greater the variance in profits or cash flows.

²⁵ This trade-off is discussed in more detail in Oxera (2006), op. cit.

- **Firm size and diversification of activities.** Thresholds are set at (sub-)class level, so affordability should be measured with respect to the relevant activities. Many firms, however, have the capacity to cross-subsidise costs internally from different activities (FSCS-protected and other activities). As such, FSCS levies can be considered more affordable the more diversified a firm's operation. Firm size may also affect affordability to the extent that larger firms tend to be more diversified or have higher capital.

Affordability is thus influenced by a range of factors, including economic factors (such as the ability of firms to pass through the FSCS levy to consumers and the level of diversification) and financial factors (such as the profitability, capitalisation and liquidity of firms).

Most of the relevant factors are firm-specific rather than specific to a class or sub-class (eg, the (sub-)classes constitute a diverse set of firms in terms of size, degree of diversification and level of profitability), so it is not clear what affordability adjustments would be required when setting thresholds at the (sub-)class level. Firm-specific differences in affordability may be dealt with more effectively through adjustments in the tariff base rather than by adjusting thresholds at the aggregate level.

3.9 Summary

Setting thresholds depends on the chosen concept of affordability (or other principles, depending on policy preferences) and cannot be determined by economic and financial analysis alone. It has distributional implications and is ultimately a matter for policy.

This section has illustrated what levels of threshold would emerge—in absolute terms and in relation to current contribution limits—if thresholds were set as a percentage, or ranges of percentages, of relevant income, based on estimates of the financial size of the different classes and sub-classes.

Affordability is determined by many factors. Many of these are firm-specific rather than (sub-)class -specific, making it difficult to adjust threshold levels at the aggregate level in line with concepts of affordability. Moreover, such adjustments would add to the complexity of setting thresholds, which is an important consideration, particularly to the extent that thresholds are expected to be reached only in circumstances of large exceptional compensation events. In normal circumstances, it is the definition of classes and sub-classes as well as the choice of tariff base within those (sub-)classes that is of greater importance in determining how much an individual firm would contribute to FSCS costs.

4 Choice of tariff base in the proposed funding structure

The role of the tariff base is to share out the compensation costs among firms in each of the current contribution groups and future broad classes or sub-classes. There are different types of tariff base, and a discussion of the advantages and disadvantages of these (including, for example, the scope for moving towards a more risk-based allocation of FSCS levies) is provided in Oxera's March 2006 report prepared for the FSCS Funding Review.

This section focuses on specific issues pertaining to the choice of tariff base. It examines the extent to which current tariff bases would need to be, and can be, adjusted to provide a workable means of allocating costs under the proposed funding structure set out in DP06/1. The discussion in this section draws mainly from consultation with industry and FSA experts, taking as given the tariff base analysis contained in Oxera's March report and previous FSA consultations.

4.1 Is a uniform tariff base feasible?

Under the current funding structure, different tariff bases are used for the different contribution groups (see Table 2.1). Provided that each contribution group is kept separate and there is no pooling across groups, operating with different tariff bases is viable. However, as soon as the group definition is changed or different broad classes are formed out of existing groups (or a general pool introduced), this becomes more difficult.

DP06/1 therefore proposes for discussion the introduction of a uniform tariff base—ie, a single measure reportable by all firms for all activities and used for allocating costs at the level of broad classes, the general pool and perhaps even within the sub-classes. Can such a uniform tariff base be identified, and is it workable?

In addition to being compatible with the new funding structure, a tariff base must satisfy a number of criteria. In particular, it should be fair and proportionate, measuring only the business that is relevant for FSCS purposes (ie, business eligible for compensation) and that reflects the activity underlying the class (or sub-class) so as to avoid double-charging. The chosen tariff base should also lend itself to objective measurement, and information provision should not be overly burdensome for firms, restricting the tariff base to metrics that are already reported to the FSA or that are verifiable and readily available to firms.

There is no single measure that applies across the industry as a whole and that meets these criteria. Given the diversity of the current tariff base, introducing a new tariff base would require the collection of new information from most, if not all, firms. It would also come at the cost of changing the tariff base for the sake of uniformity to a potentially less suitable measure—eg, protected deposits is the obvious tariff base metric for deposit-takers in A1, but since it is not available for other activities, it would need to be traded in for a measure that can be consistently observed for other parts of the industry.

Income from regulated activities is one option, but the discussion and analysis in section 2 has shown how difficult it is to consistently define and measure the relevant income for activities in different classes and sub-classes. While it is possible to derive estimates that approximate the financial size of different activities at the aggregate level (eg, using the assumptions employed for the calculations in section 2), requesting individual firms to perform such an exercise and allocate their income to the relevant (sub-)class-specific activities would impose a significant burden and would be unlikely to deliver data that is objective and readily verifiable.

There is a range of other possible metrics—eg, the number of retail clients or the number (or value) of relevant transactions—but none can be considered easily workable. Interviews with industry stakeholders confirmed the view that a uniform tariff base that would work across all parts of the industry—deposits, life & pensions, investment, general insurance and mortgage advice—cannot be found, or at least would be too costly to operate in practice.

The one common metric that is readily available and that exists across all parts of the industry is the FSA periodic fee, but this metric is problematic in that it does not reflect the FSCS-protected business of firms paying the fee. Moreover, the periodic fee is charged in line with the current contribution group structure and not the proposed class and/or sub-class structure—eg, the FSA periodic fee does not draw the distinction between life & pensions and investment activities of firms in A12 and A13. Therefore, although payable by all firms with respect to different activities, the FSA fee cannot readily be used as a metric to allocate FSCS costs across or within the broad classes and sub-classes.

4.2 Funding options in DP06/1 without a uniform tariff base

The proposed funding structure under Options A to D in DP06/1 is workable even if it is not possible to identify and measure a single common tariff base that would work across the FSCS as a whole. In the absence of a common tariff base, this would require the specification of an allocation mechanism that defines fixed proportions of the levy to be allocated to different classes within the general pool, or to groups of firms within a class, allowing, with a flexible choice of tariff base, the allocation of the levy to firms within a group.

One possibility would be to allocate costs according to relative financial size. For example, based on the estimates of the relative size of the provider and intermediary sub-classes in the general insurance class, any levy charged against the class could be split between providers (current contribution group A3) and intermediaries (A19), with 80% being paid by the former and 20% by the latter. Once these (or other) proportions for the total levy have been set, allocation to individual firms within the provider or intermediary group could be based on tariff bases that differ between the two groups of firms. Indeed, it would be possible to retain the current tariff bases—ie, net premium income for providers and annual eligible income for intermediaries.

For Options A and B, these fixed proportions (which could be reviewed on a regular basis) would determine how the total levy would be shared between the ‘notional’ sub-classes or groups within a class. For example, using the general insurance example and the 80:20 estimate of relative size, in the event of a £100m levy against the class, providers would pay £80m and intermediaries £20m. Similarly, a levy against the investment class would be shared across each of the underlying groups of the class, in fixed proportions that reflect the size of the groups.

For Options C and D, the allocation in fixed proportions would start only once the sub-class threshold has been reached—see section 3 for illustrations of the threshold. Up to the threshold level, each sub-class would pay for the compensation costs arising in that sub-class, allocated in proportion to a tariff base that can be specific to that sub-class. Assuming a one-to-one mapping from current contribution groups onto new sub-classes, it would be possible to retain the existing tariff base for each sub-class.

Similarly, where the general pool in Options B and D is concerned, it would not be necessary to have firms reporting data on a uniform tariff base—allocation to the broad classes could be made on the basis of fixed proportions—for example, using estimates of relative financial size (or any other allocation rule, depending on distributional preferences).

Such an allocation approach has the advantage of allowing a flexible choice of tariff base for different groups of firms or activities. In effect, rather than specifying a uniform tariff base, the

approach requires a rule to allocate costs at the aggregate level to different groups of firms, giving flexibility for the choice of tariff base within a group.

This is advantageous if greater pooling is envisaged only in special circumstances (eg, once the affordability thresholds for the sub-classes in Options C and D are reached). If such circumstances are infrequent, defining a uniform tariff and requesting new and detailed information from firms on a regular basis for a one-off event that may or may not occur would be unlikely to be cost-effective. A simple allocation rule in those circumstances appears more warranted. This allocation rule could be designed, as discussed above, such that each class or group of firms pays according to its financial size or capacity to pay compensation costs. Such an allocation would be consistent with the FSA's affordability principle guiding much of the design of the new funding structure. However, any other mechanism to allocate costs between classes or groups of firm could be operated, depending on distributional preferences.

4.3 Possible adjustments to the current tariff base

4.3.1 From approved persons to income: A12 and A13

As discussed above, given the complexities of identifying and operating a system with a uniform tariff base that would work across the FSCS, the proposed structure is compatible with tariff bases that are specific to groups of firms—provided that an allocation rule is implemented to share costs across groups in the wider pool (such as relative financial size).

Indeed, assuming that the new structure will be defined such that the current contribution groups map directly onto the classes (or sub-classes), changes to the current tariff base to make the structure operational could in principle be limited.

The options in DP06/1 envisage the activities in the current contribution groups A12 and A13 being split between life & pensions and investment activities. The current tariff base for A12 and A13 is approved persons, which is a metric that is unsuitable for allowing such a split.

A more suitable metric would be income from relevant activities. While possible in principle, this raises a number of issues.

- Firms would need to allocate income earned according to whether it relates to advice or sales of life & pensions or investment products. As noted by the industry, this can be difficult where: a) the income is earned on a fee basis; and b) wrapped products are involved.
- The FSA would need to issue guidance on how products should be classified and what to do in those cases where allocation is difficult.
- Firms would need to provide the FSA with new data. At present, advisory firms in the retail sector submit data as part of the RMAR returns to the FSA, providing details on retail investment income earned; however this comprises both life & pensions and investment products. Other firms in A12 and A13 (eg, banks and building societies) do not currently report under RMAR and income allocation difficulties may be even more significant.

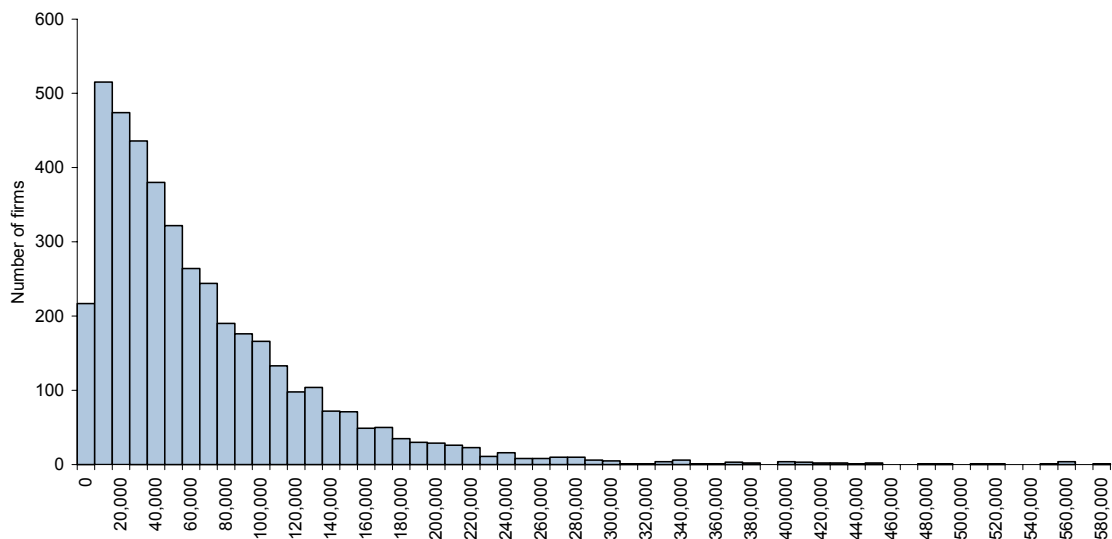
While there are practical difficulties, an income-based allocation has attractive features.

- As mentioned above, it is more compatible with the proposed funding structure than approved persons.
- An income-based tariff base for A12 and A13 would reduce or eliminate many double-charging problems observed in the current structure (eg, where the approved person

- carries out activities that do not relate to A12 and A13, such as A7 fund management activities).
- It would make the metric for intermediaries in the life & pensions and investment class consistent with the metric that is currently being used for other advisory activities (ie, mortgage advice (A18) and general insurance intermediation (A19)) that report tariff data on annual eligible income.
 - Introducing an income-based tariff would address many of the affordability concerns that have been raised for the financially weaker firms, particularly in the A13 contribution group.

Figure 4.1 shows the distribution of the ratio of retail investment income to approved persons for financial advisers and advising intermediaries that are currently participating in A13 (and for which retail investment income is available in the FSA’s RMAR database). The figure shows a wide dispersion in the ratio.

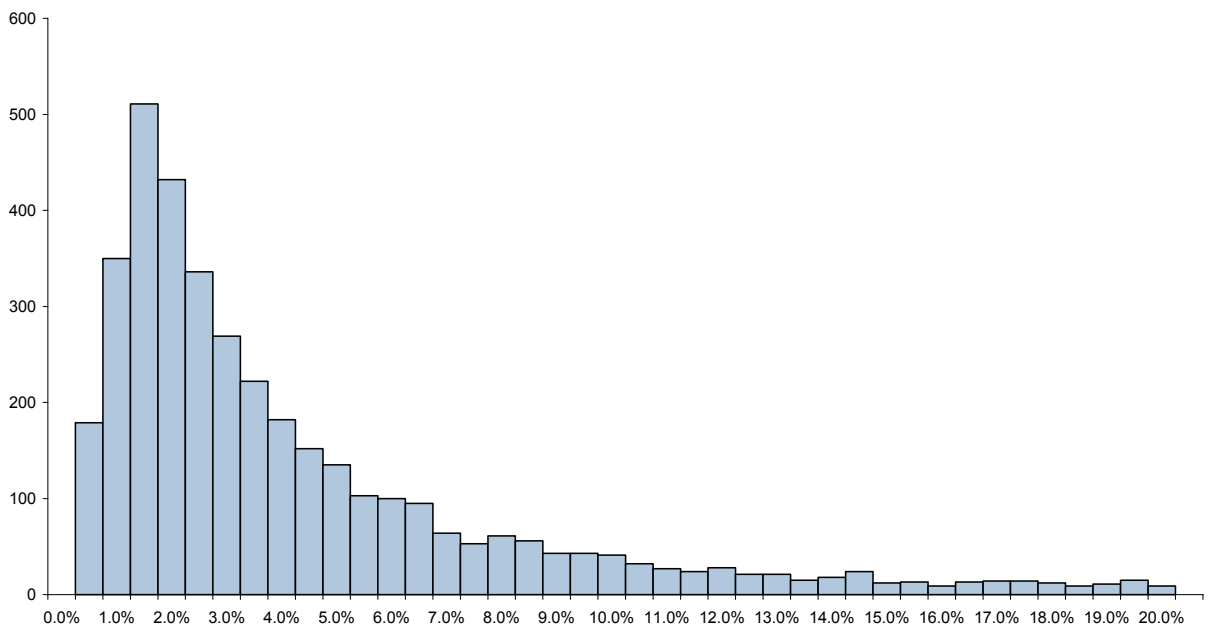
Figure 4.1 The distribution of retail investment income per approved person for financial advisers in A13, 2006 (£)



Source: FSA data and Oxera calculations.

Since the current tariff base is approved persons, firms with a low income per approved person pay the same as high-income firms. Consequently, low-income firms in A13 have paid FSCS levies that are high in proportion to their retail investment income. The average (median) ratio of FSCS levy to retail investment income is 2.9%, but for some firms the levy has amounted to more than 5%, 10%, or indeed as much as 20%, as shown in Figure 4.2.

Figure 4.2 Distribution of FSCS levy as % of retail investment income for financial advisers in A13



Source: FSA data and Oxera calculations.

Introducing an income-based tariff would redistribute the levy such that all firms would pay the same levy in proportion to income. This would reduce affordability concerns for the weaker firms, but at the expense of the financially stronger and more profitable firms.

4.3.2 Other adjustments

Other tariff bases could in principle be retained in the new structure, provided that the proposed sub-classes (other than A12 and A13) correspond to, or can be mapped directly onto, the current contribution groups.

Nonetheless, further changes may be warranted. For example, as discussed in Oxera's March 2006 report for the Funding Review, the current tariff bases are inconsistent in two main respects.

- **Metric.** There are three broad types of metric: income (A3, A4, A18 and A19), client funds held by the firm (A1 and A7), and headcount (A10, A12, A13 and A14), with further differences in each type of metric. The chosen tariff base may reflect the most practical or least costly method available for a particular group, but the diversity raises questions about consistency.
- **Relevant business.** For some contribution groups, the tariff base measures the volume of a firm's business that can give rise to claims under the FSCS, but for other groups it also includes business for clients that are not eligible for compensation. For example, protected deposits are the relevant tariff base for deposit-takers in A1, but total funds under management determine the contributions of firms in A7. Similarly, while the income-based tariffs in A18 and A19 only include business that is eligible for compensation (and specific to the activity underlying the contribution group), the headcount tariffs in the investment sub-scheme do not.

Practicality may be a key consideration, so preserving the status quo is an option (other than for A12 and A13, where some change is required to capture the proposed life & pensions and investment split).

The current investment sub-scheme, with its six contribution groups, is most diverse in terms of tariff base applied. Moving towards an income-based metric, not just for A12 and A13, would be one option to introduce greater consistency in the sub-scheme (and proposed investment class). It would also provide a means of counting only the relevant business, thereby including only FSCS-protected business and avoiding potential double-charging across activities.

- The tariff base for CIS operators, depositaries, etc in A9 is already income-based. The issue is whether the current definition of gross income could be adjusted to include only income accruing with respect to FSCS-protected retail activities. No data was available to examine the degree to which the proportion of retail business differed between A9 participants, and the distributional consequences of moving to a tariff that counted retail business only.
- The tariff base for fund managers in A7 is funds under management. Moving from this stock measure to a flow measure such as income would be possible in principle, especially given the close correlation between funds under management and the fees earned on those funds. The issue is again whether, for reasons of consistency and proportionality, business not eligible for compensation (ie, all institutional business) should be excluded from the tariff base. Defining the FSCS-protected business may not always be straightforward, and guidance would be required. Where firms considered it too costly to isolate protected business, there is a risk that they could over-report—such over-reporting already appears to apply in current contribution groups where the tariff is restricted to protected retail business (eg, A18 and A19).
- For principal dealers in A10, as well as for corporate finance advisers in A14, the transition to an income-based measure would be most difficult. In particular, the relevant activities are to a significant extent carried out within investment banks and corporate finance houses, often on a global basis. Identifying income and allocating it to the relevant activities would be a complex exercise. The proportion of relevant FSCS-protected business is very small, such that any compensation costs that could arise with respect to A10 and A14 activities are small. Hence, provided that these groups are not exposed to levies arising from failures in other groups under the proposed structure, moving towards a tariff that is based on relevant income may impose costs that outweigh the benefits.

4.4 Summary

The choice of tariff base is more than a technical matter since it determines how the FSCS levy is distributed among individual firms. A diverse set of tariff bases applies under the current structure, with each contribution group having its own tariff base. As confirmed in discussions with industry and FSA experts, it would be difficult or too costly to define a single tariff base that could be uniformly applied across all parts of the FSCS.

However, the proposed structure can be operated without a uniform tariff base. What is required is a mechanism to allocate the levy at the aggregate level between different groups of firms in the broad classes (Options A to D) or between the broad classes in the general pool (Options B and D), allowing for a flexible choice of tariff base within the groups. The estimates of the relative financial size of different groups of firms (see section 2) could provide the basis for such a mechanism—ie, costs would be allocated to the different groups in proportion to their relative size. This would be consistent with the affordability principle, but any other allocation rule could be adopted, depending on distributional preferences.

The tariff base in current contribution groups A12 and A13 (approved persons) would need to be changed under the new structure if the advice and sales activities of firms in the group are to be split between the life & pensions and investment classes. Relevant income may be the

most suitable metric to allow such a split. Introducing an income-based tariff would also address many of the concerns about the affordability of the FSCS levy for some financial advisers (if at the expense of the financially stronger firms in the group).

Provided that the other contribution groups directly map onto the proposed classes or sub-classes under the new structure, no further changes to the tariff bases would be required. However, options may be considered for making the tariff bases more consistent across groups—particularly with a view to measuring the relevant FSCS-protected business only and avoiding the scope for double-charging. In addition, as can be seen in section 6, the FSA is not proposing to map all current contribution groups onto proposed sub-classes, which has implications for required tariff base adjustments.

5 Modelling impacts under different options and scenarios

This section illustrates the impact of the funding structure in terms of levies paid by firms under the funding options set out in DP06/1. During the course of the study, Oxera provided the FSA with a large number of modelling outputs for different options and compensation cost scenarios. The full set of results is not provided in this report, but a selection is presented to illustrate at a high level what different structures would mean for different groups of firms.

In this section, impacts are reported at the aggregate level only, showing what classes (and sub-classes) would be expected to pay under various options. The firm-specific illustrations are omitted. However, section 6 contains firm-specific illustrations for the option that emerged as the FSA's preferred approach during the course of the project.

5.1 Modelling assumptions and scenarios

The impact modelling considered the levy implications under different assumptions.

- **Options A to D.** The options set out in DP06/1 vary depending on whether the levy to be paid by each of the five broad classes would be shared between different types of firm (A and B) or further divided and allocated to the sub-classes (C and D). They also differ according to whether there is a general pool in addition to the broad classes (B and D) or not (C and D). The focus of the modelling is therefore on Options B and D, since Options A and C are variants where only the general pool for very large failures is omitted, while the key issue for 'normal' compensation events appears to be whether sub-classes are introduced.
- **Allocation within broad classes.** For Option B (and A), levies are allocated to the constituent groups of firms on the basis of the relative financial size estimates obtained in section 3. For example, based on the size estimates in the life & pensions class, providers would pay 82% and intermediaries 18%. For Option D (and C), the levy would be allocated first to the sub-class in which the failure originates, with the other sub-class picking up the excess costs. Where more than one sub-class applies, the levy is shared among them according to their financial size.
- **Sub-class definition.** In Option D (and C), sub-classes are defined as in section 3, with the deposit and mortgage classes not being divided, the life & pensions and general insurance classes divided into provider and intermediary classes, and the investment class being split into five sub-classes.
- **Thresholds.** In line with the discussion in section 3.8, a range of thresholds have been considered, all established by applying a percentage to the relevant income estimates (ranges from 2.5% to 10% of relevant income have been considered).

Given that the results in this section are presented at the aggregate level only, no assumptions are required about the tariff base used to allocate levies among firms within a class or sub-class.

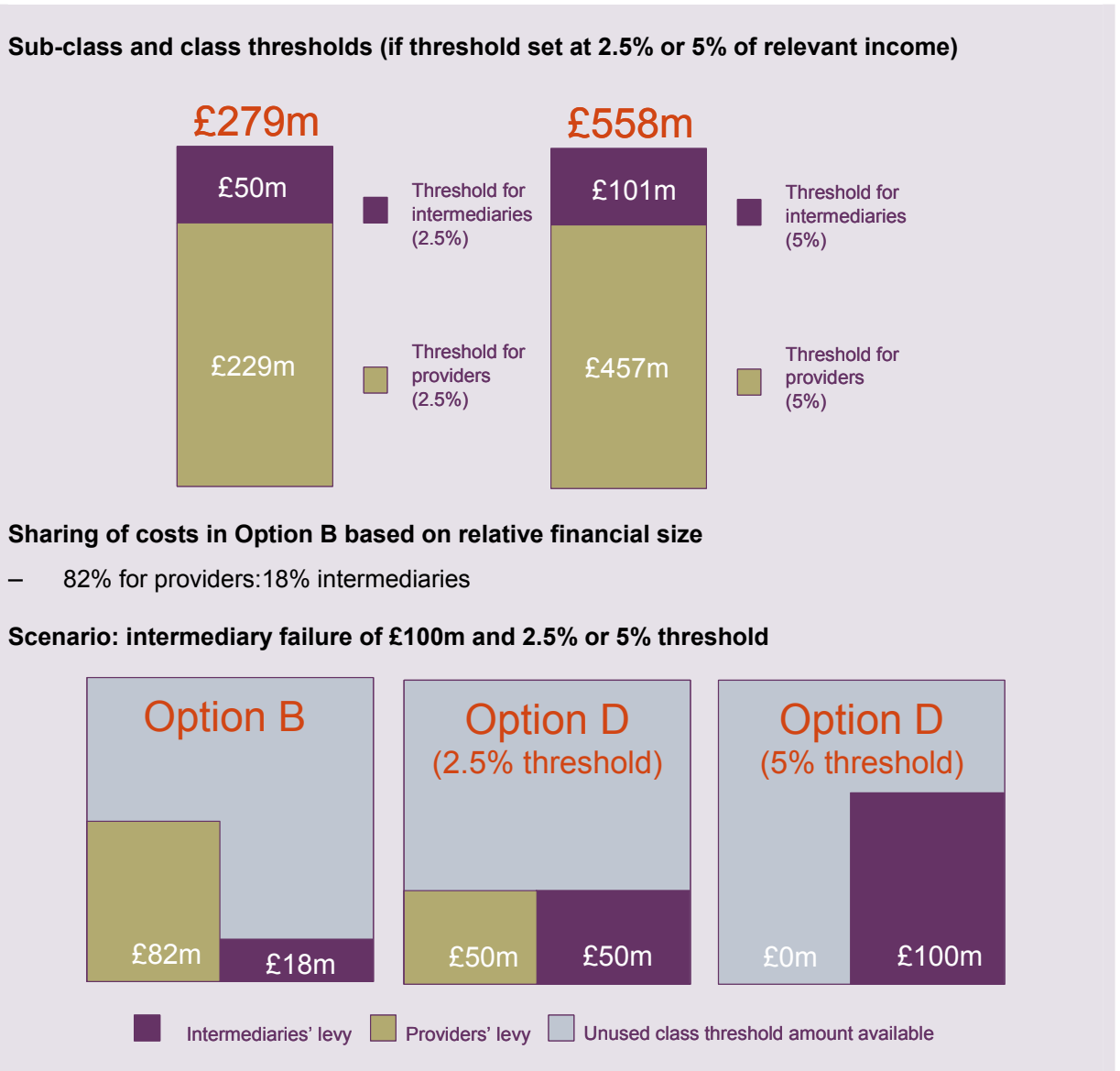
The following compensation cost scenarios were considered:

- the impact of the 2006/07 FSCS current levy;
- the impact of levies equal to £100m;
- the impact of levies up to the different thresholds;

- the impact of large-loss events, including events that would trigger pooling.

Box 5.1 provides an illustration for the life & pensions class, assuming an intermediary failure of £100m. Under Option B, providers and intermediaries would pay a share of the levy in proportion to their relative size; the allocation of the levy does not depend on the fact that the failure originated among intermediaries. In contrast, under Option D, the intermediary sub-class would pay up to its affordability limit (£50m if the threshold is 2.5% of relevant income), with the remainder being paid by the provider sub-class. If the intermediary threshold were 5% of relevant income, the full £100m would be paid by intermediaries with no levy due from providers.

Box 5.1 Impact of levies on the proposed life & pensions class



5.2 What would be the impact of the current 2006/07 levy?

In 2006/07, the initial FSCS levy amounted to £49.9m in total.²⁶ As reported in Table 5.1, many of the current contribution groups paid nothing, and the bulk of the levy was charged against advisers and brokers without client money permission (A13).

Table 5.1 FSCS levy in 2006/07

| Fee block | Levy (£m) |
|-------------------|-------------|
| A1 | 0 |
| A3 | 0 |
| A4 | 0 |
| A7 | 0.2 |
| A9 | 0 |
| A10 | 0.1 |
| A12 | 1.4 |
| A13 | 47.4 |
| A14 | 0 |
| A18 | 0.2 |
| A19 | 0.5 |
| Total levy | 49.9 |

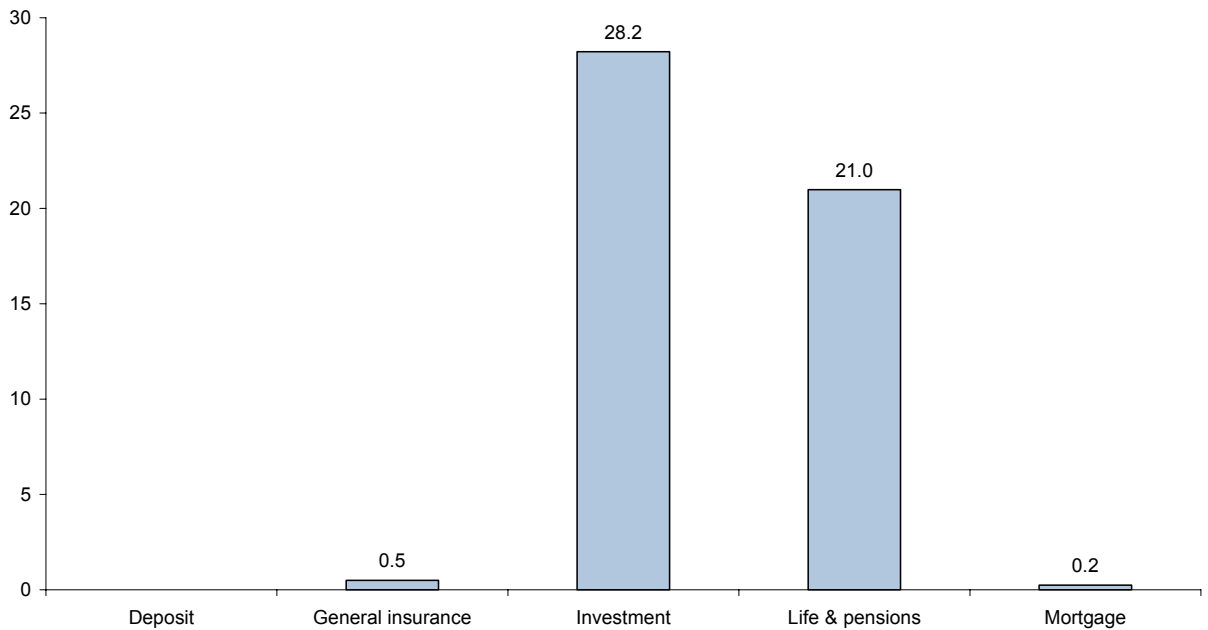
Note: Figures may not sum due to rounding.
Source: FSA.

Under the new structure, there would be changes in the allocation of the levies. In particular, the A13 levy would be split between the life & pensions and investment classes, depending on the product to which the claim related.

Figure 5.1 illustrates what would be paid by firms in each of the five broad classes if the current levy had been reallocated in line with the proposed structure. The A12 and A13 levy has been split between the life & pensions and investment classes, based on the proportion of the amount of FSCS claims in relation to the products. Using FSCS data on claims over the period from April 1st 2005 to March 31st 2006, this would result in allocating £28m of the total A12 and A13 levy to the investment class and £21m to the life & pensions class.

²⁶ Information provided to Oxera by the FSA.

Figure 5.1 Allocation of 2006/07 FSCS levy between the broad classes (£m)



Note: The current FSCS levy in A12 and A13 is allocated to life & pensions and investments using the ratio of FSCS claims over the period from April 1st 2005 to March 31st 2006. Allocation based on a longer period of claims (April 1st 2005 to October 2nd 2006) would increase the levy to £25.5m in the life & pensions class, and reduce the investment levy to £23.7m. If only the period April 1st 2006 to October 2nd 2006 is considered, the levy allocated to the life & pensions class would be £38.7m, with the investment levy equal to £10.1m. Source: FSA data and Oxera calculations.

Table 5.2 shows how the allocation the 2006/07 levy would differ between Options B and D. While the broad-class levy would not differ, the provider–intermediary split depends on which option is adopted. For example, under Option D (and C), intermediaries, as the group of originators of the claims in the life & pensions class, would pay the total levy charged against this class.²⁷ Under Option B, the levy would be allocated between intermediaries and providers according to their relative size; since providers are larger than intermediaries, they would pay the larger proportion of the levy.

²⁷ This also depends on the affordability threshold. No pooling between sub-classes would occur for a threshold of 2.5% of relevant income (or higher).

Table 5.2 Impact of 2006/07 FSCS levy under the options in DP06/1 (£m)

| | Option B | Option D |
|----------------------------|-------------|-------------|
| Deposits | – | – |
| Mortgage | 0.2 | 0.2 |
| General insurance | 0.5 | 0.5 |
| Providers | 0.4 | – |
| Intermediaries | 0.1 | 0.5 |
| Life & pensions | 20.9 | 20.9 |
| Providers | 17.1 | – |
| Intermediaries | 3.8 | 20.9 |
| Investment | 28.3 | 28.3 |
| Advisers, brokers | 9.9 | 27.9 |
| CIS operators | 8.7 | – |
| Corporate finance | 0.1 | 0.0 |
| Fund managers | 9.3 | 0.2 |
| Principal dealers | 0.3 | 0.1 |
| Total levy | 49.9 | 49.9 |

Note: The current FSCS levy in A12 and A13 is allocated to life & pensions and investments using the ratio of FSCS claims over the period from April 1st 2005 to March 31st 2006. Allocation based on a longer period of claims (April 1st 2005 to October 2nd 2006) would increase the levy to £25.5m in the life & pensions class, and reduce the investment levy to £23.7m. If only the period April 1st 2006 to October 2nd 2006 is considered, the levy allocated to the life & pensions class would be £38.7m, with the investment levy equal to £10.1m. Source: FSA data and Oxera calculations.

5.3 What would be the impact of a £100m failure?

Future levies may exceed current or historical patterns, and may be charged against contribution groups that, to date, have seen no or only limited failures. To illustrate the difference between Options B and D, Oxera modelled failures that would require a levy of £100m to be raised from different classes or sub-classes.

For a levy of this size, and an affordability threshold set at 5% of relevant income (or higher), each class would be able to compensate claims on its own, and the general pool would not be triggered. Tables 5.3 and 5.4 show, for different failures, how the allocation of the £100m levy between classes and sub-classes would differ between Options B and D.

Under Option B the allocation of the levy between the ‘notional’ sub-classes is based on estimates of relative financial size and does not depend on which group of firm generated the cost. As shown in Table 5.3, in the general insurance class, for example, intermediaries and providers would pay £29m and £71m, respectively, irrespective of whether the failure relates to general insurance intermediation or provision.

Table 5.3 Impact of a £100m levy under Option B (5% threshold) (£m)

| | Group where the failure originated | | | | |
|----------------------------|------------------------------------|----------------|----------------|----------------|---------------|
| | General insurance | | Life insurance | | Investments |
| | Providers | Intermediaries | Providers | Intermediaries | CIS operators |
| Deposits | – | – | – | – | – |
| Mortgage | – | – | – | – | – |
| General insurance | 100.0 | 100.0 | – | – | – |
| Providers | 71.4 | 71.4 | – | – | – |
| Intermediaries | 28.6 | 28.6 | – | – | – |
| Life & pensions | – | – | 100.0 | 100.0 | – |
| Providers | – | – | 81.9 | 81.9 | – |
| Intermediaries | – | – | 18.1 | 18.1 | – |
| Investment | – | – | – | – | 100.0 |
| Advisers, brokers | – | – | – | – | 34.8 |
| CIS operators | – | – | – | – | 30.9 |
| Corporate finance | – | – | – | – | 0.4 |
| Fund managers | – | – | – | – | 32.7 |
| Principal dealers | – | – | – | – | 1.2 |
| Total levy | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Note: Given that pooling between classes does not occur for a 5% threshold, it also will not occur if thresholds are set higher.

Source: FSA data and Oxera calculations.

Table 5.4 illustrates how the allocation would differ under Option D, where the sub-class triggering the claims pays first until its affordability threshold is reached. After this point, the remainder is charged to other sub-classes in the broad class. For a threshold of 5% of relevant income and a levy of £100m, each sub-class considered would be expected to pay for its own costs.

Thus, under Options B and D, allocation between sub-classes differs. Under Option D (and an affordability threshold of 5% or higher), life insurance intermediaries would fund the levy of £100m in full. Under Option B, it would be shared with providers in proportion to relevant income: £82m for providers and £18m for intermediaries. Depending on the option adopted, intermediaries would either pay £100m or £18m. This result is conditional on the affordability threshold—as illustrated in Box 5.1, a 2.5% threshold would imply a greater sharing of costs under Option D in the event of an intermediary failure.

Table 5.4 Impact of a £100m levy under Option D (5% threshold) (£m)

| | Group where the failure originates | | | | |
|----------------------------|------------------------------------|----------------|----------------|----------------|---------------|
| | General insurance | | Life insurance | | Investments |
| | Providers | Intermediaries | Providers | Intermediaries | CIS operators |
| Deposits | – | – | – | – | – |
| Mortgage | – | – | – | – | – |
| General insurance | 100.0 | 100.0 | – | – | – |
| Providers | 100.0 | – | – | – | – |
| Intermediaries | – | 100.0 | – | – | – |
| Life & pensions | – | – | 100.0 | 100.0 | – |
| Providers | – | – | 100.0 | – | – |
| Intermediaries | – | – | – | 100.0 | – |
| Investment | – | – | – | – | 100.0 |
| Advisers, brokers | – | – | – | – | – |
| CIS operators | – | – | – | – | 100.0 |
| Corporate finance | – | – | – | – | – |
| Fund managers | – | – | – | – | – |
| Principal dealers | – | – | – | – | – |
| Total levy | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

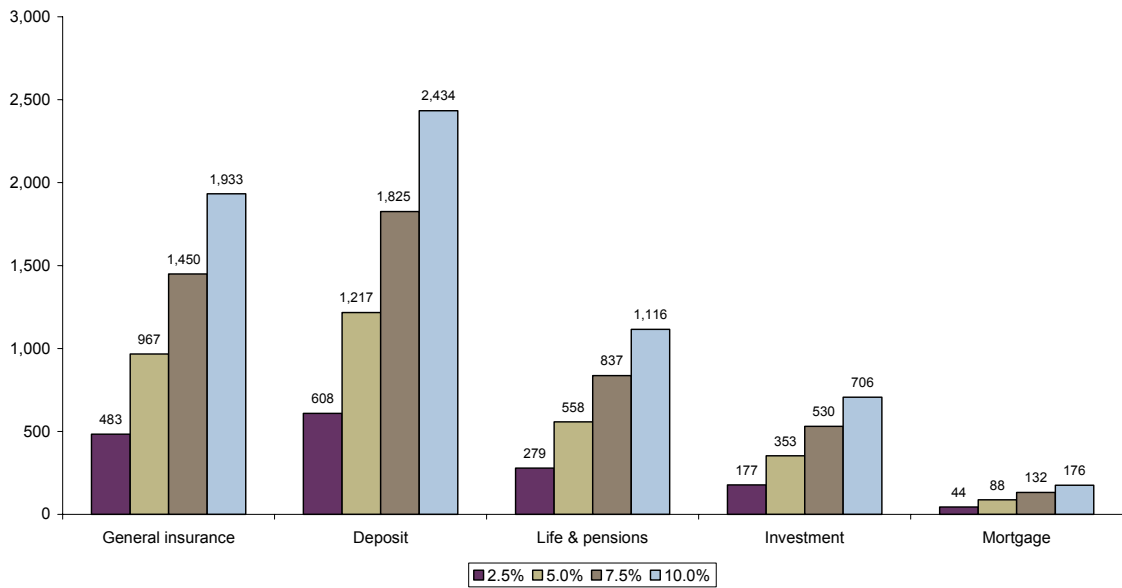
Note: Given that pooling between (sub-)classes does not occur at the 5% threshold, it also will not occur if thresholds are set higher.

Source: FSA data and Oxera calculations.

5.4 What would be the maximum amount of levy under different assumptions about thresholds?

Allocation of levies between classes and sub-classes depends on the affordability thresholds. Figure 5.2 shows the maximum amount of levy that would be paid by a broad class under different assumptions of thresholds. In other words, for Options B and D, it shows the maximum levy beyond which the general pool would be triggered. Thresholds are set as a percentage of relevant income, ranging between 2.5% and 10%, as reported in section 3.8.

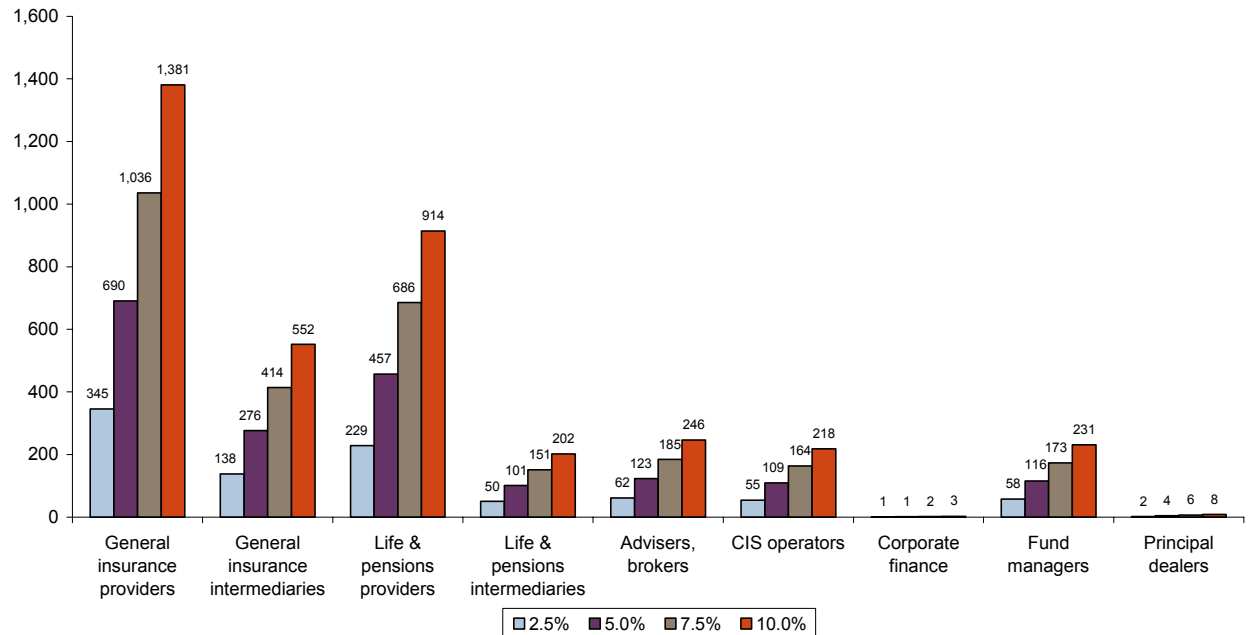
Figure 5.2 Thresholds and maximum levies before general pool is triggered (£m)



Source: FSA data and Oxera calculations.

Figure 5.3 shows the same information, but for sub-classes in Option D (and C)—ie, for different income-based thresholds, it illustrates what level of failure would be required per sub-class for the other sub-classes to start contributing to the costs.

Figure 5.3 Thresholds and maximum amounts before sub-class pooling is triggered (£m)



Source: FSA data and Oxera calculations.

5.5 What would be the impact of large-loss events?

The impact of a range of large-loss events was modelled to illustrate the effects of changing the affordability thresholds and to show the application of the general pool.²⁸ Three examples are given below.

As a first example, Table 5.5 reports the distribution of levies in the event of a CIS operator failure, triggering compensation claims of £210m in total. A threshold set at 2.5% of relevant income would trigger the general pool (for both Options B and D), and all classes participating in the FSCS would be required to contribute to the costs. CIS operators would have to pay £54.6m (up to their threshold); the other four sub-classes in the investment class would pay the difference between the threshold for the class (£176.6m) and the £54.5m paid by CIS operators. This amounts to £122.1m, which is allocated among the sub-classes according to relative financial size estimates. The difference between the original failure (£210m) and the amount compensated by the investment class (£176.6m) is allocated in the general pool between the other classes (£33.4m), again on the basis of their relative size in the total scheme.

For thresholds above 2.5% of income, the allocation would differ depending on which funding option is adopted. Under Option D, CIS operators would always pay first up to their threshold. The remainder would be allocated to the other sub-classes. When the threshold is set at 10% of relevant income, no pooling between the sub-classes would occur and CIS operators would be expected to compensate the failure themselves.

Under Option B, the investment class would pay first up to its affordability limit. Notably, for thresholds above 2.5% (5%, 7.5% and 10%), the investment class would pay for the levy in full, without triggering the general pool. The allocation within the investment class differs from that under Option D: each sub-class would pay a share of the levy in proportion to estimates of relative size.

²⁸ Expressed as a percentage of relevant income.

Table 5.5 Impact of a large-loss event of £210m among CIS operators (£m)

| Threshold | Option D | | | | Option B | | | |
|----------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | 2.5% | 5.0% | 7.5% | 10.0% | 2.5% | 5.0% | 7.5% | 10.0% |
| Deposits | 14.4 | — | — | — | 14.4 | — | — | — |
| Mortgage | 1.0 | — | — | — | 1.0 | — | — | — |
| General insurance | 11.4 | — | — | — | 11.4 | — | — | — |
| Providers | 8.2 | — | — | — | 8.2 | — | — | — |
| Intermediaries | 3.3 | — | — | — | 3.3 | — | — | — |
| Life & pensions | 6.6 | — | — | — | 6.6 | — | — | — |
| Providers | 5.4 | — | — | — | 5.4 | — | — | — |
| Intermediaries | 1.2 | — | — | — | 1.2 | — | — | — |
| Investment | 176.6 | 210.0 | 210.0 | 210.0 | 176.6 | 210.0 | 210.0 | 210.0 |
| Advisers, brokers | 61.5 | 50.9 | 23.4 | — | 61.5 | 73.1 | 73.1 | 73.1 |
| CIS operators | 54.5 | 109.0 | 163.5 | 210.0 | 54.5 | 64.8 | 64.8 | 64.8 |
| Corporate finance | 0.7 | 0.6 | 0.3 | — | 0.7 | 0.9 | 0.9 | 0.9 |
| Fund managers | 57.8 | 47.8 | 22.0 | — | 57.8 | 68.7 | 68.7 | 68.7 |
| Principal dealers | 2.1 | 1.7 | 0.8 | — | 2.1 | 2.5 | 2.5 | 2.5 |
| Total levy | 210.0 | 210.0 | 210.0 | 210.0 | 210.0 | 210.0 | 210.0 | 210.0 |

Source: FSA data and Oxera calculations.

As a second example, Table 5.6 illustrates how the levy would be allocated in the event of a major failure among life insurance providers—requiring a levy of £1 billion. The general pool would be triggered, except for a threshold set at 10% of estimated relevant income for the life & pensions class. The table shows how much the life & pensions class would be expected to pay, and how the excess costs allocated to the general pool would be shared, assuming that allocation in the general pool is based on relative financial size. For example, for a 5% threshold, the life & pensions class would pay just over half of the total levy, with £442m being charged against the general pool. There is little difference between Options B and D—ie, whether there are sub-classes only matters for levies lower than the thresholds.

Table 5.6 Impact of a large-loss event among life & pensions providers (£m)

| Threshold | Option D | | | | Option B | | | |
|----------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | 2.5% | 5.0% | 7.5% | 10.0% | 2.5% | 5.0% | 7.5% | 10.0% |
| Deposits | 334.3 | 205.0 | 75.6 | — | 334.3 | 205.0 | 75.6 | — |
| Mortgage | 24.2 | 14.8 | 5.5 | — | 24.2 | 14.8 | 5.5 | — |
| General insurance | 265.6 | 162.8 | 60.1 | — | 265.6 | 162.8 | 60.1 | — |
| Providers | 189.7 | 116.3 | 42.9 | — | 189.7 | 116.3 | 42.9 | — |
| Intermediaries | 75.9 | 46.5 | 17.2 | — | 75.9 | 46.5 | 17.2 | — |
| Life & pensions | 278.9 | 557.9 | 836.8 | 1,000.0 | 278.9 | 557.9 | 836.8 | 1,000.0 |
| Providers | 228.5 | 457.0 | 685.5 | 914.0 | 228.5 | 457.0 | 685.5 | 820.0 |
| Intermediaries | 50.4 | 100.9 | 151.3 | 86.0 | 50.4 | 100.9 | 151.3 | 180.0 |
| Investment | 97.0 | 59.5 | 21.9 | — | 97.0 | 59.5 | 21.9 | — |
| Advisers, brokers | 33.8 | 20.7 | 7.6 | — | 33.8 | 20.7 | 7.6 | — |
| CIS operators | 30.0 | 18.4 | 6.8 | — | 30.0 | 18.4 | 6.8 | — |
| Corporate finance | 0.4 | 0.2 | 0.1 | — | 0.4 | 0.2 | 0.1 | — |
| Fund managers | 31.7 | 19.5 | 7.2 | — | 31.7 | 19.5 | 7.2 | — |
| Principal dealers | 1.2 | 0.7 | 0.3 | — | 1.2 | 0.7 | 0.3 | — |
| Total levy | 1,000.0 | 1,000.0 | 1,000.0 | 1,000.0 | 1,000.0 | 1,000.0 | 1,000.0 | 1,000.0 |

Note: Figures may not sum due to rounding.

Source: FSA data and Oxera calculations.

The third example in Table 5.7 illustrates the impact of a £1 billion levy that needs to be raised due to a major failure among deposit-takers. Given the allocation assumptions, the impacts are identical between Options B and D, so only a single set of results (but for different thresholds) is reported.

The deposit-taking class is larger in terms of financial size than the life & pensions class, so the general pool is not triggered so quickly—ie, only a threshold of 2.5% of relevant income would result in levies being charged against the pool.

Table 5.7 Impact of a large-loss event among deposit-takers (£m)

| Threshold | Options B and D | | | |
|----------------------------|------------------------|--------------|--------------|--------------|
| | 2.5% | 5.0% | 7.5% | 10.0% |
| Deposits | 608.4 | 1,000 | 1,000 | 1,000 |
| Mortgage | 17.6 | — | — | — |
| General insurance | 192.6 | — | — | — |
| Providers | 137.5 | — | — | — |
| Intermediaries | 55.0 | — | — | — |
| Life & pensions | 111.1 | — | — | — |
| Providers | 91.0 | — | — | — |
| Intermediaries | 20.1 | — | — | — |
| Investment | 70.4 | — | — | — |
| Advisers, brokers | 24.5 | — | — | — |
| CIS operators | 21.7 | — | — | — |
| Corporate finance | 0.3 | — | — | — |
| Fund managers | 23.0 | — | — | — |
| Principal dealers | 0.8 | — | — | — |
| Total levy | 1,000 | 1,000 | 1,000 | 1,000 |

Note: Figures may not sum due to rounding.
Source: FSA data and Oxera calculations.

6 Modelling a new option: aggregate impact and firm-specific illustrations

Having examined different policy options and reviewed some of the evidence described in the previous sections, the FSA asked Oxera to provide the data and analysis to evaluate the impact of several more options. One option emerged as the preferred one. It varies mainly with respect to the sub-class definition and also prescribes the level of thresholds for the sub-classes and classes, as well as details on the tariff base.

This section sets out the specific funding structure modelled and the assumptions adopted (section 6.1). It then presents the results of the modelling exercise, showing both the aggregate impacts of the structure under different compensation cost scenarios (section 6.2) and firm-specific impacts using stylised illustrations for firms of different size in each of the new classes and sub-classes (section 6.3). The funding structure is taken as given, and no comment is provided other than a description to assist in understanding the quantitative results.

6.1 Funding structure and modelling assumptions

6.1.1 Funding structure

The proposed funding structure that follows includes broad classes, sub-classes, thresholds and a general retail pool. Some of the existing contribution groups map directly onto the proposed model, with some exceptions, which are as follows.

- **Investment class.** There are two sub-classes: one fund management sub-class, combining current A7 activities and CIS operation and related activities (current A9); and one sub-class (the intermediation sub-class) for all other firms, combining all current advice, broking and dealing activities (current A10, A12, A13 and A14). The latter sub-class contains only the A12 and A13 activities related to investment products, with the remainder being allocated to the life & pensions class, as discussed in section 2.
- **Deposit class.** The class corresponds to the current A1 contribution group, but proposes a small sub-class for credit unions to separate their deposit-taking activities (and related compensation costs) from those of banks and building societies.
- **Home finance class.** Referred to as the mortgage class in DP06/1 and the previous sections in this report. Two sub-classes are anticipated in this class: a home finance intermediation sub-class, and a home finance provision sub-class. However, the latter will be a contribution-only sub-class (lending activities are excluded from FSCS compensation), and will be expected to contribute to compensation costs arising in that class if the intermediation sub-class exceeds its threshold level. Home finance providers will not be expected to contribute to any costs allocated to the general retail pool under the current proposals.

The envisaged structure also specifies threshold levels for the (sub-)classes, and proposes certain changes to the tariff base for the investment class.

- **Thresholds.** Thresholds are set at sub-class level by applying specific affordability factors to estimates of financial size. Broadly speaking, threshold levels correspond to around 7.5% of relevant income for deposit-takers, insurance providers and firms in the fund management sub-class, and to 3.5% of relevant income for other sub-classes

(except credit unions and home finance providers. If the sub-class thresholds are reached, excess costs are allocated to the other sub-class in the broad class. If all sub-class thresholds are met, the general pool is triggered. Allocation in the general pool is implemented in proportion to the relative threshold amounts of the classes and sub-classes.

- **Tariff base.** The tariff base is unchanged for some sub-classes and corresponds to that applying for the current contribution groups. Changes are envisaged in the investment class (and intermediaries in the life & pensions class) where annual eligible income is proposed to be the new tariff base for all sub-classes, with a view to allowing the split between A12 and A13 activities into life & pensions and investment, and merging some of the current contribution groups in the investment sub-scheme. Changes are also envisaged in the insurance provider sub-classes, moving from net premium income to take account of mathematical reserves in addition to premium income.

Table 6.1 summarises the proposed structure to be modelled.

Table 6.1 Summary of class and sub-class structure to be modelled

| Broad class | Sub-class (and underlying contribution group) | Threshold (% of relevant income and rounded amount) | Tariff base |
|----------------------------|-----------------------------------------------------|--------------------------------------------------------|--------------------------------------------------------------------------|
| Deposits | Banks and building societies (A1) | 7.5% £1,839.5m | Protected deposits (unchanged) |
| | Credit unions (A1) | n/a £0.5m | Protected deposits (unchanged) |
| General insurance | Provision (A3) | 7.5% £1,045m ¹ | Gross premium income and mathematical reserves, protected contracts only |
| | Intermediation (A19) | 3.5% £195m | Annual eligible income (unchanged) |
| Life & pensions | Provision (A4) | 7.5% £690m | Gross premium income and mathematical reserves, protected contracts only |
| | Intermediation (part of A12 and A13) | 3.5% £70m | Annual eligible income |
| Investment | Fund management (A7, A9) | 7.5% £340m | Annual eligible income |
| | Intermediation (part of A12 and A13, A10 and A14) | 3.5% £90m | Annual eligible income |
| Home finance | Provision ² | 4% of intermediation sub-class financial size £70m | FSA periodic fee |
| | Intermediation (A18) | 3.5% for advisers, arrangers £60m | Annual eligible income (unchanged) |

Note: Information regarding the structure was provided to Oxera by the FSA. The threshold amounts were derived by the FSA after applying the specified percentages to the financial size estimates reported in section 3, adjusted to reflect the new sub-class definition and rounded up or down to present even amounts. ¹ The threshold amount is derived by applying 7.5% to the estimate of relevant net premium income after adjusting for claims and investment income (see section 3.3). ² Home finance providers (FSA feeblock A2) would be required to contribute to excess costs arising in the intermediation sub-class.

Source: Oxera.

6.1.2 Modelling assumptions

This specified structure was taken as given in modelling the impact in terms of what different groups of firms would pay under different compensation cost scenarios. Section 6.2 presents the results for different scenarios:

- the current (2006/07) FSCS levy;
- a £100m levy in the different sub-classes;
- a levy up to the relevant thresholds;
- a levy up to the current limits;
- selected hypothetical large-loss events.

In terms of modelling assumptions, aggregate impacts (ie, amount payable by each broad class or sub-class) are modelled as in section 5. Where the levy exceeds a sub-class threshold, costs are in the first instance allocated to the other sub-class in the broad class and if the levy is sufficiently high to trigger the general retail pool, costs are allocated to the remaining broad classes in proportion to the relative threshold amounts.

For the firm-specific illustrations, impacts are modelled by allocating the aggregate levy for a sub-class to stylised firms participating in that sub-class.

- **Assumed tariff base.** For many sub-classes, the tariff base is the same as the current tariff base specific to the corresponding contribution group, and the tariff base data is used to allocate costs to individual firms. However, for other sub-classes, it is proposed that the tariff base will change. This data is currently not available and would need to be collected from firms; therefore, unless otherwise stated, the illustrations are based on assumptions and/or allocating the levy to individual firms on the basis of the current tariff base.
- **Stylised firms.** Impacts are illustrated for firms of different size, as measured by the current tariff base. Results are shown for 'small', 'medium' and 'large' firms. The classification generally follows the firm-specific examples used previously by the FSA in CP05/2.²⁹ Additional examples were obtained from the distribution of the current tariff base among FSCS participants and by taking account of the charge bands contained in the FSA *Handbook* (FEES 4 Annex 2R). In general, 'small' corresponds to firms subject to the minimum fee or charge band 1; a 'medium' firm falls within charge bands 2 to 4; and a 'large' firm falls within charge bands 5 or 6. The stylised firms are described in more detail below.

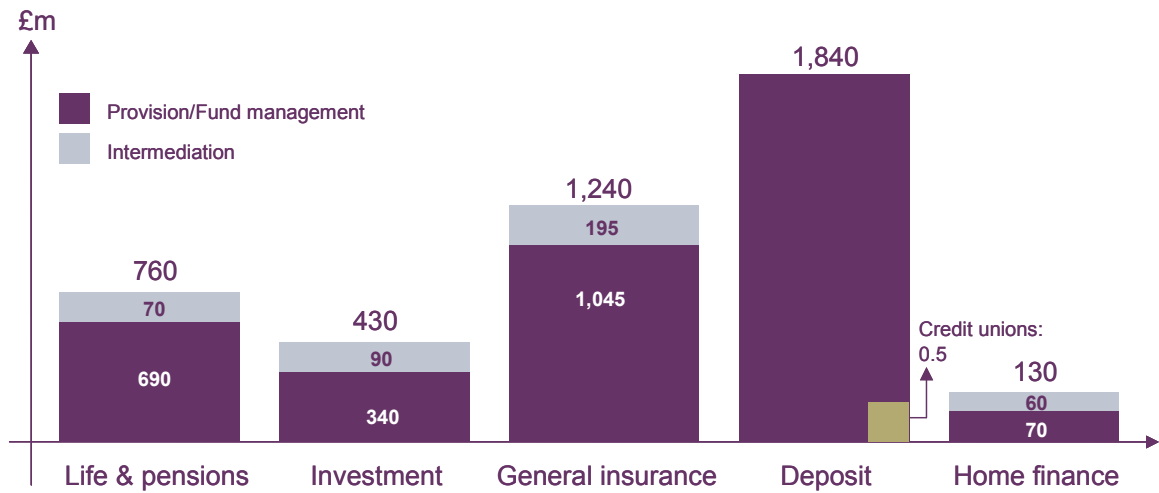
6.2 Illustration of aggregate impacts

The following illustrates what the envisaged structure would mean in terms of the aggregate levies to be paid by firms in different sub-classes and classes.

Figure 6.1 presents diagrammatically the information contained in Table 6.1. It shows the thresholds for each broad class, and for the sub-classes within. These thresholds determine how much each (sub-)class would have to pay before costs would be shared more widely.

²⁹ Information provided to Oxera by the FSA.

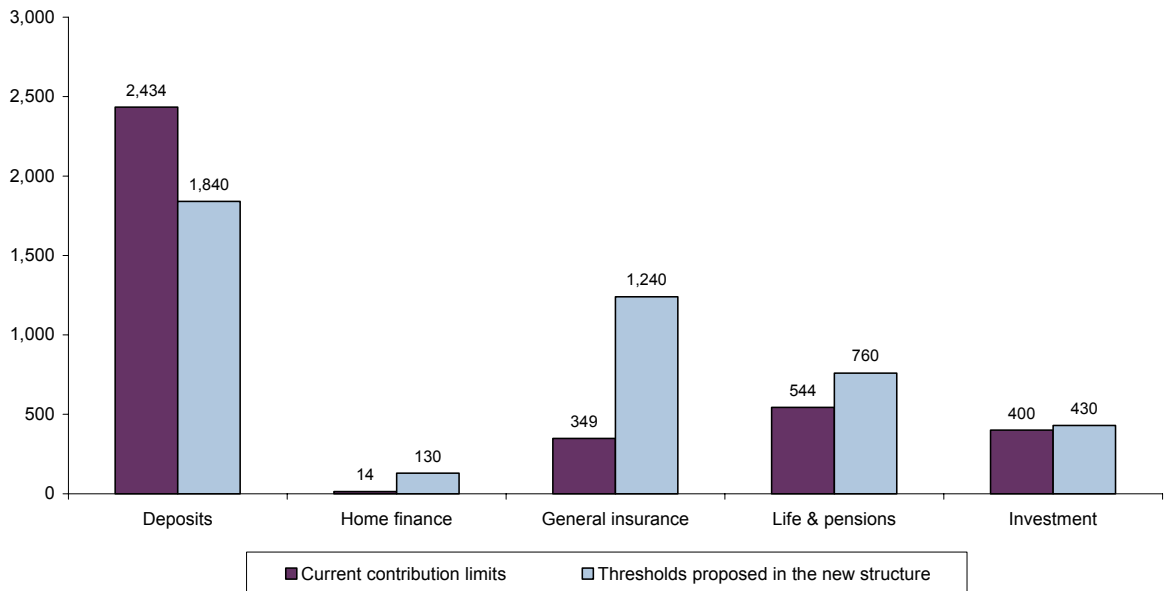
Figure 6.1 Thresholds under the proposed option (£m)



Source: Oxera illustration based on FSA structure.

Figure 6.2 and Table 6.2 compare the specified thresholds with the current contribution limits. For all classes except the deposit class, thresholds exceed current limits. For example, for the general insurance class, the threshold would be three times higher than the current limit for general insurers (A3) and intermediaries (A19) combined; the increase for the investment class would be limited (a threshold of £430m compared with the current limit of £400m). For deposit-takers, where the current limit is 0.03% of protected deposits (calculated cumulatively), the threshold would be below the limit.

Figure 6.2 Current contribution limits and thresholds (£m)



Source: FSA data and Oxera calculations.

Table 6.2 Current contribution limits and thresholds (£m)

| | Current contribution limits | Thresholds in the new structure |
|----------------------------|-----------------------------|---------------------------------|
| Deposits | 2,434 | 1,840 |
| Home finance | 14 | 130 |
| Provision | 0 | 70 |
| Intermediation | 14 | 60 |
| General insurance | 349 | 1,240 |
| Provision | 267 | 1,045 |
| Intermediation | 82 | 195 |
| Life & pensions | 544 | 760 |
| Provision | 544 | 690 |
| Intermediation | * | 70 |
| Investment | 400 | 430 |
| Fund management | * | 340 |
| Intermediation | * | 90 |
| Total | 3,741 | 4,400 |

Note: * Included in the £400m investment sub-scheme limit.
Source: FSA structure and Oxera calculations.

Actual FSCS levies have been well below both the current contribution limits and the envisaged thresholds. Table 6.3 shows how the 2006/07 levy would be allocated to the different classes and sub-classes. The main difference would be a split of the current A12 and A13 levy between the intermediary sub-classes in the life & pensions and investment classes. (In addition, the pooling of contribution groups within the investment class would mean that the £200,000 levy in A7 would be shared by current A9 participants; principal dealers (A10) and corporate finance advisers (A14) would share in the cost of the investment intermediation levy, in proportion to their relevant (retail) income.)

Table 6.3 Aggregate impact of 2006/07 FSCS levy (£m)

| | |
|--------------------------------------|-------------|
| Deposits | 0 |
| Home finance (intermediation) | 0.2 |
| General insurance | 0.5 |
| Provision | 0 |
| Intermediation | 0.5 |
| Life & pensions | 21.0 |
| Provision | 0 |
| Intermediation | 21.0 |
| Investment | 28.2 |
| Fund management | 0.2 |
| Intermediation | 28.0 |
| Total | 49.9 |

Note: The current FSCS levy in A12 and A13 is allocated to life & pensions and investments using the ratio of FSCS claims over the period from April 1st 2005 to March 31st 2006. Allocation according to a longer period of claims (April 1st 2005 to October 2nd 2006) would increase the levy to £25.5m in the life & pensions class and reduce the investment levy to £23.7m. If only the period April 1st 2006 to October 2nd 2006 is considered, the levy allocated to the life & pensions class would be £38.7m, with the investment levy equal to £10.1m. Source: FSA structure and Oxera calculations.

Table 6.4 shows the impact of a £100m levy for select sub-classes. In general, such a levy would be borne by the sub-class in which the failure originates—most sub-class thresholds are in excess of £100m. The sub-classes where a £100m levy would exceed the threshold are life & pensions intermediaries (£30m would need to be paid by providers) and investment intermediaries (£10m would need to be paid by the fund management group).³⁰

³⁰ A £100m levy would also exceed the sub-class threshold for home finance intermediation firms (home finance providers would need to contribute £40m) and credit unions (£99.5m would need to be paid by banks and building societies).

Table 6.4 Impact of £100m levy on select sub-classes (£m)

| | Sub-class where failure originates | | | |
|--------------------------------------|------------------------------------|-----------------|----------------|----------------|
| | General insurance | Life & pensions | | Investment |
| | Intermediation | Provision | Intermediation | Intermediation |
| Deposits | – | – | – | – |
| Home finance (intermediation) | – | – | – | – |
| General insurance | 100 | – | – | – |
| Provision | – | – | – | – |
| Intermediation | 100 | – | – | – |
| Life & pensions | – | 100 | 100 | – |
| Provision | – | 100 | 30 | – |
| Intermediation | – | – | 70 | – |
| Investment | – | – | – | 100 |
| Fund management | – | – | – | 10 |
| Intermediation | – | – | – | 90 |
| Total | 100 | 100 | 100 | 100 |

Note: A £100m failure originating in any of the other sub-classes would not result in pooling between classes or sub-classes, and would be paid by the sub-class in which the failure occurred.

Source: FSA structure and Oxera calculations.

Each sub-class and class would have to pay for the costs of failures originating within the (sub-)class up to the thresholds reported in Table 6.1 and Figure 6.1. Only very large-loss events would trigger the general retail pool envisaged in the new structure. Table 6.5 illustrates the impact of the structure for two such exceptional events—a provider failure in the life & pensions class requiring a levy of £1 billion, and a failure in the deposit-taking class of £2 billion.

Taking the case of the life & pensions provider failure: under the current structure, such a levy would be allocated to A4 but only up to the limit (around £544m). It is not clear how the remaining costs would be raised. Under the proposed new structure, the provider sub-class would pay up to its threshold (£690m). Intermediaries would be next to pay, with £70m being raised from them. The remainder (£240m) would be charged against the remaining classes in the general retail pool. The allocation to each class is made in proportion to the threshold level for that class, and within a class, costs are also allocated in proportion to the relative thresholds.

Table 6.5 Impact of large-loss events (£m)

| Sub-class where the failure originates | Life & pensions provision | Deposit |
|----------------------------------------|---------------------------|--------------|
| Size of failure | £1 billion | £2 billion |
| Deposits | 121 | 1,840 |
| Home finance (intermediation) | 9 | 9 |
| General insurance | 82 | 78 |
| Provision | 63 | 65 |
| Intermediation | 19 | 12 |
| Life & pensions | 760 | 48 |
| Provision | 690 | 43 |
| Intermediation | 70 | 4 |
| Investment | 28 | 27 |
| Fund management | 22 | 21 |
| Intermediation | 6 | 5 |
| Total | 1,000 | 2,000 |

Note: Figures may not sum due to rounding.
Source: FSA data and Oxera calculations.

6.3 Illustration of impacts for specific firms

The following presents illustrations of what individual firms would pay under the new structure when considering different compensation cost scenarios. The illustrations present the impact for small, medium and large firms in each of the classes and sub-classes, as discussed in section 6.1.2. Note that the new structure envisages changes in the tariff base in some of the sub-classes. Given the lack of new tariff base data, the full distributional implications for individual firms cannot be modelled in any detail.

As for the aggregate impact illustrations, the scenarios considered include the current (2006/07) levy; a £100m levy for each sub-class; and a levy up to the sub-class and class threshold. Most failures would be below these thresholds and would not trigger the operation of the general retail pool (and indeed many failures would not even trigger pooling within a broad class). The results are therefore presented for each broad class in turn, with illustrations of general pooling across the classes presented separately at the end.

6.3.1 Firms in the deposit class

Results are shown for three stylised deposit-takers of different size, as measured by their protected deposits—£2m (small), £1 billion (medium) and £50 billion (large). The impact of the proposed structure is generally similar to that under the current FSCS funding structure. The main difference comes relates to the introduction of a sub-class for credit unions, but the tariff base for credit unions and the envisaged threshold is so small that it has little impact on the overall levy due. The results therefore focus on banks and building societies.

Since no FSCS levy was raised from deposit-takers in 2006/07, the results for the impact of the current FSCS levy are omitted. Instead, Table 6.6 shows how much the stylised firms would pay if the levy were £100m. As regards income from relevant FSCS-protected activities, as estimated in section 3, the levy would on average amount to 0.4%.

Table 6.6 Impact of £100m levy for firms in deposit class

| | Small: £2m protected deposits | Medium: £1 billion protected deposits | Large: £50 billion protected deposits |
|---------------------------------------------|-------------------------------------|------------------------------------------------|------------------------------------------------|
| Amount of levy under proposed structure (£) | 246.5 | 123,268.8 | 6,163,439.3 |
| % of estimated relevant income | 0.41 | 0.41 | 0.41 |
| Amount of levy under current structure (£) | 246.5 | 123,268.8 | 6,163,439.3 |

Source: FSA data and Oxera calculations.

Table 6.7 shows the amounts payable by the firms if the threshold were reached—ie, the levy amounts to (or exceeds) £1.84 billion. In this case, firms would pay on average around 7.6% of their relevant income.

Under the current structure, the contribution limit for deposit-takers is around £2.4 billion. If this contribution limit were reached, amounts payable would be higher.

Table 6.7 Impact of levy up to threshold for firms in deposit class

| | Small: £2m protected deposits | Medium: £1 billion protected deposits | Large: £50 billion protected deposits |
|---------------------------------------------|-------------------------------------|------------------------------------------------|------------------------------------------------|
| Amount of levy under proposed structure (£) | 4,536.3 | 2,268,145.7 | 113,407,284.0 |
| % of estimated relevant income | 7.6 | 7.6 | 7.6 |
| Amount of levy under current structure (£) | 6,000 | 3,000,000 | 150,000,000 |

Source: FSA data and Oxera calculations.

6.3.2 Firms in the general insurance class

The illustrations for firms in the general insurance class apply to stylised providers and intermediaries of different size, as measured by the current tariff base: for providers, net premium income of £500,000 (small), £50m (medium) and £1 billion (large) and, for intermediaries, annual eligible income of £50,000 (small), £1m (medium) and £20m (large).

The 2006/07 FSCS levy was around £0.5m for insurance intermediaries in A19, with no levy on providers in A3. Under the new structure, this levy would also be borne by intermediaries only. Given that the levy is small and there would be no differences in the allocation, the results for individual firms are omitted. Instead, the impact is modelled for a £100m levy for the provider and intermediary sub-classes; a levy up to the threshold for each sub-class; and levies of a size that would trigger sharing of costs between the two sub-classes. In each case, costs within a sub-class are allocated in proportion to the current tariff base.

Impact of £100m levy

Table 6.8 shows how much firms would pay in the event of a levy of £100m resulting from a provider failure. The provider sub-class would pay the full levy.

Table 6.8 Impact of £100m levy due to provider failure in general insurance class

| Providers | Small: £500,000 net premium income | Medium: £50m net premium income | Large: £1 billion net premium income |
|---------------------------------------------|----------------------------------------------|-------------------------------------------|---------------------------------------------|
| Amount of levy under proposed structure (£) | 1,590.6 | 159,059.5 | 3,181,190.4 |
| % of net premium income ¹ | 0.3 | 0.3 | 0.3 |
| Amount of levy under current structure (£) | 1,590.6 | 159,059.5 | 3,181,190.4 |
| Intermediaries | Small: £50,000 annual eligible income | Medium: £1m annual eligible income | Large: £20m annual eligible income |
| Amount of levy under proposed structure (£) | 0 | 0 | 0 |
| % of annual eligible income | 0 | 0 | 0 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |

Notes: ¹ Measured with respect to net premium income (ie, the tariff base without adjustment for claims and investment income).

Source: FSA data and Oxera calculations.

Table 6.9 also shows the impact of a £100m levy, but this time assuming an intermediary failure. £100m is below the intermediary sub-class threshold, so providers would not have to contribute to the levy.

A £100m levy would exceed the current contribution limit for the intermediary sub-class, which is around £82m. This explains why the levy reported for the current structure would be less.

Table 6.9 Impact of £100m levy due to intermediary failure in general insurance class

| Providers | Small: £500,000 net premium income | Medium: £50m net premium income | Large: £1 billion net premium income |
|---------------------------------------------|----------------------------------------------|-------------------------------------------|---------------------------------------------|
| Amount of levy under proposed structure (£) | 0 | 0 | 0 |
| % of net premium income | 0 | 0 | 0 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |
| Intermediaries¹ | Small: £50,000 annual eligible income | Medium: £1m annual eligible income | Large: £20m annual eligible income |
| Amount of levy under proposed structure (£) | 487.0 | 9,740.0 | 194,800.7 |
| % of annual eligible income | 0.97 | 0.97 | 0.97 |
| Amount of levy under current structure (£) | 400 | 8,000 | 160,000 |

Notes: ¹ The individual intermediaries' levy is modelled and allocated in proportion to the 2006/07 tariff base data, which may overestimate annual eligible income on an aggregate basis (see section 3.3).

Source: FSA data and Oxera calculations.

Impact of levy up to sub-class thresholds

Table 6.10 shows what firms would pay if the required levy was sufficiently high that the thresholds were reached, both for the provider and the intermediary sub-classes.

The proposed thresholds significantly exceed current contribution limits, so the reported amounts payable under the new structure exceed those under the current structure.

Table 6.10 Impact of levy up to threshold in both sub-classes of general insurance class

| Providers | Small: 500,000 net premium income | Medium: £50m net premium income | Large: £1 billion net premium income |
|---------------------------------------------------------------------|----------------------------------------------|-------------------------------------------|---------------------------------------------|
| Amount of levy under proposed structure (£) | 15,680.9 | 1,568,086.8 | 31,361,735.3 |
| % of relevant net premium income ¹ | 3.14 | 3.14 | 3.14 |
| Amount of levy under current structure given contribution limit (£) | 4,000 | 400,000 | 8,000,000 |
| Intermediaries | Small: £50,000 annual eligible income | Medium: £1m annual eligible income | Large: £20m annual eligible income |
| Amount of levy under proposed structure (£) | 949.7 | 18,993.1 | 379,861.4 |
| % of annual eligible income ² | 1.9 | 1.9 | 1.9 |
| Amount of levy under current structure given contribution limit (£) | 400 | 8,000 | 160,000 |

Notes: ¹ The threshold is set at 7.5% of estimated net premium income after adjusting for claims and investment income, whereas the impact is measured with respect to net premium income. ² The threshold is set at 3.5% of the estimated relevant income; the discrepancy in the percentages is due to the fact that individual intermediaries' levies are modelled and allocated in proportion to 2006/07 tariff data (total reported eligible income of £10.3 billion), which is lower than the estimated relevant income (see section 3.3).
Source: FSA data and Oxera calculations.

Impact of large levy that triggers sub-class pooling

Tables 6.11 and 6.12 show the impact for levies of a size that would require the sharing of costs between providers and intermediaries.

Table 6.11 illustrates the impact of very large failures in the provider class that would require a £1.2 billion levy to meet compensation costs. Under the proposed structure, providers themselves would pay £1.045 billion, but intermediaries would have to pay £155m in total.

Amounts for providers under the current structure would be lower due to the current lower contribution limits. It is not clear how the excess costs would be funded in the current system, but intermediaries would not be required to pay the costs.

Table 6.11 Impact of £1.2 billion levy due to provider failure in general insurance class

| Providers | Small: £500,000 net premium income | Medium: £50m net premium income | Large: £1 billion net premium income |
|---------------------------------------------|----------------------------------------------|-------------------------------------------|---------------------------------------------|
| Amount of levy under proposed structure (£) | 15,680.9 | 1,568,086.8 | 31,361,735.3 |
| % of net premium income ¹ | 3.14 | 3.14 | 3.14 |
| Amount of levy under current structure (£) | 4,000 | 400,000 | 8,000,000 |
| Intermediaries | Small: £50,000 annual eligible income | Medium: £1m annual eligible income | Large: £20m annual eligible income |
| Amount of levy under proposed structure (£) | 754.9 | 15,097.1 | 301,941.2 |
| % of annual eligible income ² | 1.5 | 1.5 | 1.5 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |

Notes: ¹ Measured with respect to net premium income (ie, tariff base without adjustment for claims and investment income). ² The individual intermediaries' levies are modelled and allocated in proportion to the 2006/07 tariff base data, which may overestimate annual eligible income on an aggregate basis (see section 3.3). Source: FSA data and Oxera calculations.

Table 6.12 considers a pooling event where a £300m levy would need to be raised to cover the costs of intermediary failures. Under the proposed structure, costs of £105m that exceed the intermediary threshold (£195m) would be paid by providers.

Under the current structure, intermediary levies are limited to around £82m due to the current limit. Intermediaries would therefore pay less under this structure, and providers would not contribute. How the remaining £218m would be funded is unclear.

Table 6.12 Impact of £300m levy due to intermediary failure in general insurance class

| Providers | Small: £500,000 net premium income | Medium: £50m net premium income | Large: £1 billion net premium income |
|---------------------------------------------|----------------------------------------------|-------------------------------------------|---------------------------------------------|
| Amount of levy under proposed structure (£) | 1,575.6 | 157,559.0 | 3,151,179.1 |
| % of net premium income ¹ | 0.32 | 0.32 | 0.32 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |
| Intermediaries | Small: £50,000 annual eligible income | Medium: £1m annual eligible income | Large: £20m annual eligible income |
| Amount of levy under proposed structure (£) | 949.7 | 18,993.1 | 379,861.4 |
| % of annual eligible income ² | 1.9 | 1.9 | 1.9 |
| Amount of levy under current structure (£) | 400 | 8,000 | 160,000 |

Notes: ¹ Measured with respect to net premium income (ie, tariff base without adjustment for claims and investment income). ² The individual intermediaries' levies are modelled and allocated in proportion to the 2006/07 tariff base data, which may overestimate annual eligible income on an aggregate basis (see section 3.3). Source: FSA data and Oxera calculations.

6.3.3 Firms in the life & pensions class

The stylised illustrations of providers relate to firms with a current tariff base (net premium income) of £500,000 (small), £800m (medium) and £2.5 billion (large). The total levy paid by the provider sub-class in the new structure is allocated to individual providers on the basis of the current tariff base, irrespective of the proposed change in tariff base.

For intermediaries, and using the current tariff base for A12 and A13 to classify firms, a small firm is assumed to be one with one approved person; a medium firm has 25 approved persons; and a large firm has 500 approved persons. It is further assumed that each approved person generates around £50,000 of life & pensions-related relevant income, such that the total levy on the intermediary sub-class can be allocated to individual firms in proportion to their relevant income.

Impact of current FSCS levy

Table 6.13 shows the impact of the current (2006/07) levy under the new structure. The current levy amounts to a proportion of the total levy from A12 and, in particular, A13. No levy is raised from providers in 2006/07, and neither would providers have paid under the new structure.

Intermediaries in the life & pensions sub-class would also have paid for the levy under the current structure, but many would have paid less because the A12 and A13 levy was shared among a wider set of firms, including firms that would not participate in the life & pensions class. However, whether a firm would pay more (and how much more) depends on the proportion of life & pensions business carried out by that firm relative to other firms in the market; its income (ie, the proposed new tariff base) relative to the current headcount tariff; and whether the firm would otherwise have contributed to A12 or A13, etc. Moreover, firms would be liable to meet compensation costs arising in A12 and A13 with respect to investment claims, increasing the total paid in relation to advice.

Table 6.13 illustrates what the stylised intermediaries would have paid under the current structure. The amounts refer to the total 2006/07 FSCS levy in A12 (£1.4m) and A13 (£47.4m), not only the proportion (assumed to be less than half) that relates to life & pensions claims. Moreover, unlike under the current structure, costs are allocated to individual firms in proportion to their number of approved persons.³¹ Results are shown separately for current A12 and A13 participants.

³¹ The allocation does not take into account any minimum levies, fee bands or discounts. Each firm pays a share corresponding to the number of approved persons of the firm relative to the total in the contribution group.

Table 6.13 Impact of current FSCS levy in life & pensions class

| Providers | Small: £500,000 net premium income | Medium: £800m net premium income | Large: £2.5 billion net premium income |
|----------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------|
| Amount of levy under proposed structure (£) | 0 | 0 | 0 |
| % of net premium income | 0 | 0 | 0 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |
| Intermediaries | Small: one approved person, £50,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 520 | 13,012 | 260,240 |
| % of estimated relevant income | 1.04 | 1.04 | 1.04 |
| Amount of levy paid under current structure (for both life & pensions and investment claims)— A12 participant (£) | 31 | 786 | 15,716 |
| Amount of levy paid under current structure (for both life & pensions and investment claims)— A13 participant (£) | 1,434 | 35,844 | 716,878 |

Source: FSA data and Oxera calculations.

Impact of a £100m levy

Table 6.14 shows the impact of a £100m levy on the provider sub-class. Such a levy is well below the sub-class threshold (and the current contribution limit), so intermediaries would not be expected to contribute. The impact on providers would therefore be the same as under the current structure (leaving aside tariff base changes that may affect the allocation within the sub-class).

Table 6.14 Impact of £100m levy due to provider failure in life & pensions class

| Providers | Small: £500,000 net premium income | Medium: £800m net premium income | Large: £2.5 billion net premium income |
|---------------------------------------------|------------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------|
| Amount of levy under proposed structure (£) | 735.2 | 1,176,361.8 | 3,676,130.5 |
| % of net premium income | 0.15 | 0.15 | 0.15 |
| Amount of levy under current structure (£) | 735.2 | 1,176,361.8 | 3,676,130.5 |
| Intermediaries | Small: one approved person, £50,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 0 | 0 | 0 |
| % of estimated relevant income | 0 | 0 | 0 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |

Source: FSA data and Oxera calculations.

In Table 6.15 (in contrast to Table 6.14), the £100m levy is due to failures in the intermediary sub-class. Given the sub-class threshold of £70m, providers would have to pay £30m in total. Compared with the current structure, this significantly reduces the impact for intermediaries but at the cost of providers.

Again, the comparative amounts that would be paid by intermediaries under the current structure depend on multiple factors (the ratio of the new to the old tariff base of a firm relative to the ratio for other firms in the market, contribution limits, whether the firm would be A12 or A13, and the source of failure, etc).

The comparative amounts reported in Table 6.15 refer to failures in life & pensions advice among A13 participants. They are based on the assumed new/old tariff bases for the three stylised intermediaries reported in the table, with costs allocated to the firms in proportion to the old approved persons tariff. It is further assumed that the contribution limit is not binding (ie, the £400m limit is not used up by other failures), so the full £100m would be paid.

In this scenario, firms otherwise participating in A12 would pay nothing, but A13 participants would pay significantly more than under the new structure. If a £100m failure had instead originated in A12, and with other assumptions remaining unchanged, the A13 levy in the current structure would be zero and A12 firms would pay £2,245 (small), £56,128 (medium) and £1.12m (large).

Table 6.15 Impact of £100m levy due to intermediary failure in life & pensions class

| Providers | Small: £500,000 net premium income | Medium: £800m net premium income | Large: £2.5 billion net premium income |
|-------------------------------------------------------------------------------------------|------------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------|
| Amount of levy under proposed structure (£) | 220.6 | 352,908.5 | 1,102,839.1 |
| % of net premium income | 0.04 | 0.04 | 0.04 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |
| Intermediaries | Small: one approved person, £50,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large; 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 1,734.9 | 43,373.4 | 867,467.0 |
| % of estimated relevant income | 3.5 | 3.5 | 3.5 |
| Amount of levy under current structure assuming failure is in A13— A12 participant (£) | 0 | 0 | 0 |
| Amount of levy under current structure assuming failure is in A13— A13 participant (£) | 3,025 | 75,620 | 1,512,402 |

Source: FSA data and Oxera calculations.

Impact of levy up to sub-class thresholds

Table 6.16 illustrates what the firms would pay if failures in the two sub-classes were sufficiently large that thresholds were reached.

The current contribution limit for providers is below the threshold; firms would therefore be capped at a lower level under the current structure.

For intermediaries, the current limit is included in the £400m limit that applies to the investment sub-scheme as a whole, so the levy could be significantly lower under the new structure compared with the current structure. In principle, £400m could be levied against a single group of firms, but this depends on other failures occurring at the same time. The amounts paid under the current structure are therefore excluded.

Table 6.16 Impact of levy up to threshold in both sub-classes of life & pensions class

| Providers | Small: £500,000 net premium income | Medium: £800m net premium income | Large: £2.5 billion net premium income |
|----------------------------------------------------------------------|------------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------|
| Amount of levy under proposed structure (£) | 5,073.1 | 8,116,896.1 | 25,365,300.4 |
| % of net premium income ¹ | 1.01 | 1.01 | 1.01 |
| Amount of levy under current structure given contribution limits (£) | 4,000 | 6,400,000 | 20,000,000 |
| Intermediaries | Small: one approved person, £50,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 1,734.9 | 43,373.4 | 867,467.0 |
| % of estimated relevant income | 3.5 | 3.5 | 3.5 |

Notes: ¹ The threshold is set at 7.5% of estimated relevant income (see section 3.4), whereas the impact is measured with respect to net premium income (ie, the tariff base).

Source: FSA data and Oxera calculations.

Impact of large levy that triggers sub-class pooling

Table 6.16 above provided an illustration of a sharing of costs between intermediaries and providers—ie, in the event of a £100m levy due to intermediary failures, providers would pay £65m.

Table 6.17 therefore considers the other scenario where a provider failure is so large that intermediaries are liable to face costs. It is assumed that the required levy is £1 billion, of which, under the proposed structure, providers would pay £690m and intermediaries £70m. The remainder would be charged against the general pool, as illustrated separately below.

Under the current structure, providers would pay only up to the current lower contribution limits (around £544m), while intermediaries would not contribute.

Table 6.17 Impact of £1 billion levy due to provider failure in life & pensions class

| Providers | Small: £500,000 net premium income | Medium: £800m net premium income | Large: £2.5 billion net premium income |
|----------------------------------------------------------------------|------------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------|
| Amount of levy under proposed structure (£) | 5,073.1 | 8,116,896.1 | 25,365,300.4 |
| % of net premium income ¹ | 1.01 | 1.01 | 1.01 |
| Amount of levy under current structure given contribution limits (£) | 4,000 | 6,400,000 | 20,000,000 |
| Intermediaries | Small: one approved person, £50,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 1,734.9 | 43,373.4 | 867,467.0 |
| % of estimated relevant income | 3.5 | 3.5 | 3.5 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |

Notes: ¹ Measured with respect to net premium income (ie, the tariff base) and not estimated relevant income. Source: FSA data and Oxera calculations.

6.3.4 Firms in the investment class

The new structure proposes a change in the tariff base to annual eligible income for all firms. In the firm-specific illustrations, assumptions have therefore been made about the income earned. For firms in the fund management sub-class, including CIS operators and depositaries, the illustrations are based on annual eligible income of £500,000 (small), £35m (medium), and £100m (large). For firms in the other sub-class, the illustrations refer to financial advisers (rather than other participants). Assuming that the advisers earn £20,000 of relevant income per approved person (with other income being earned with respect to non-investment products), the illustrations refer to a small firm with an annual eligible income of £20,000 (one approved person), a medium firm with an income of £1.25m (25 approved persons), and a large firm with an income of £25m (500 approved persons).

Importantly, whether a firm pays more compared with the current structure depends largely on:

- its volume of relevant business (ie, FSCS-protected retail investment) compared with other firms;
- whether its income relative to the current tariff base (funds under management or headcount) is above or below average;
- where the failure originates—sub-classes would pay for their own costs (other than for large failures), as is the case in the current contribution group structure, but under the new structure A7 firms share costs in A9 (and vice versa). The same applies to the other sub-class.

The examples below cannot capture all these dimensions, so the impacts are illustrative only. For these reasons, and due to the significantly different structure of the investment class and changes in the tariff base introduced in the proposed funding option, comparable allocations of levies under the current structure are difficult to model. Nonetheless, some illustrations are provided.

Impact of current FSCS levy

Table 6.18 shows the impact for individual firms of the 2006/07 levy raised from the A7 fund management group and the A12 and A13 advisory broker group. For the latter, only a proportion is allocated to the investment class (£28.2m), with the remainder being paid by the intermediaries in the life & pensions class. Current A9 participants would be expected to share in the A7 costs in the same proportion (ie, based on annual eligible income) as current A7 participants. Similarly, A10 and A14 participants would pay, but only in proportion to their eligible income, to cover the costs associated with the A12 and A13 failures.

How do these amounts compare with payment under the current structure? The comparative amounts in Table 6.18 are based on the following assumptions.

- **Firms in the fund management sub-class.** It is assumed that the stylised firms engage in retail business only. Results are shown separately for A7 and A9 participants. For fund managers (A7), it is assumed that the three firms' current tariff base—ie, total funds under management—is £7m (small), £500m (medium), and £1.5 billion (large). This corresponds to an income/funds under management ratio of around 0.7–0.8% for all three firms. For CIS operators (A9), it is assumed that the firms' current tariff base—ie, gross income—corresponds to the new tariff base, and is £500,000 (small), £35m (medium), and £100m (large). Costs are allocated to individual firms in proportion to the total tariff base for each group. Note that firms with significant institutional business would pay significantly more.

Under the current structure, the amount paid by the three stylised fund managers is significantly less than under the new structure, despite the fact that A9 firms would share in the costs under the latter structure. This is due to the fact that, given the proposed change in the tariff base to annual 'eligible' income, institutional business would not make a contribution to the costs. Thus, firms with significant retail business (assumed for the three stylised firms) are likely to pay more under the new structure, all other things being equal, with the opposite being the case for firms that have additional business that is not FSCS-protected. This dimension of variation is not illustrated in the table.

- **Financial advisers in the other sub-class.** The assumptions (and results) are the same as those reported above for life & pensions intermediaries (see Table 6.13). The levy is the total A12 and A13 levy, not just the proportion that relates to investment claims.

Table 6.18 Impact of current FSCS levy in investment class

| Fund managers, CIS operators | Small: £500,000 eligible income | Medium: £35m eligible income | Large: £100m eligible income |
|----------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------|--------------------------------------------------------------------|------------------------------------------------------------------|
| Amount of levy under proposed structure (£) | 22 | 1,559 | 4,454 |
| % of estimated relevant income | 0.004 | 0.004 | 0.004 |
| Amount of levy under current structure— A7 participant (£) ¹ | 1 | 65 | 195 |
| Amount of levy under current structure— A9 participant (£) | 0 | 0 | 0 |
| Financial adviser | Small: one approved person, £20,000 eligible income | Medium; 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 217.6 | 13,599.3 | 271,986.8 |
| % of estimated relevant income | 1.09 | 1.09 | 1.09 |
| Amount of levy paid under current structure (for both life & pensions and investment claims)— A12 participant (£) | 31 | 786 | 15,716 |
| Amount of levy paid under current structure (for both life & pensions and investment claims)— A13 participant (£) | 1,434 | 35,844 | 716,878 |

Note: ¹ Costs are allocated in proportion to the firms' total funds under management, assumed to be £7m (small), £500m (medium), and £1.5 billion (large). The firms are assumed to have FSCS-protected retail business only; firms with institutional business could pay significantly more, depending on their total funds under management in relation to the A7 total.

Source: FSA data and Oxera calculations.

Impact of £100m levy

Table 6.19 shows how much the firms would pay if a £100m levy were raised due to a failure of a CIS operator. Fund managers (A7) and CIS operators (A9) would pay both in proportion to their eligible income, thus raising the cost for firms in the current A7 group and reducing it for CIS operators in A9. The opposite would apply if the failure originated in the current A7 group. Firms in the other sub-class would not pay.

The comparative amounts under the current structure are shown separately for A7 and A9 participants. The £100m A9 levy is allocated on the basis of the current tariff base—ie, gross income. As discussed above, for the purpose of the illustrations, the three firms are assumed to have retail business only, so 'eligible' income would correspond to total income. Firms with additional institutional business would pay more than those amounts. Two effects are at work when moving from the current to the new structure: first, for a given A9 failure, the levy for A9 firms should fall because A7 firms contribute to the cost; second, costs are allocated on the basis of eligible income only, so the costs for firms with significant retail business would be higher than currently.

Table 6.19 Impact of £100m levy due to CIS operator failure in investment class

| Fund managers, CIS operators | Small: £500,000 eligible income | Medium: £35m eligible income | Large: £100m eligible income |
|----------------------------------------------------------------------------|--------------------------------------------------------------------|--------------------------------------------------------------------|------------------------------------------------------------------|
| Amount of levy under proposed structure (£) | 11,134 | 779,398 | 2,226,850 |
| % of estimated relevant income | 2.2 | 2.2 | 2.2 |
| Amount of levy under current structure— A7 participant (£) | 0 | 0 | 0 |
| Amount of levy under current structure— A9 participant (£) ¹ | 13,757 | 963,017 | 2,751,476 |
| Financial adviser | Small: one approved person, £20,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 0 | 0 | 0 |
| % of estimated relevant income | 0 | 0 | 0 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |

Note: ¹ Costs are allocated on the basis of the firms' gross income, which is assumed to be the same as 'eligible' income for the three examples. Firms with institutional business could pay significantly more, depending on their income (eligible and non-eligible) in proportion to the A9 total.

Source: FSA data and Oxera calculations.

Table 6.20 illustrates the impact of a £100m levy to cover the cost of an investment advice failure. Firms in the sub-class would pay up to their threshold (£90m), with the remaining £10m charged against the fund management sub-class. As a result, financial advisers (at least those participating in the A12 or A13 group in which the failure originates) would pay less than under the current structure,³² and fund managers and CIS operators correspondingly more.

The comparative amounts of levy payable under the current structure are based on the same assumptions as those discussed for intermediaries in the life & pensions class, and the results reported are also the same—ie, costs are allocated on the basis of approved persons; the failure originates in A13 (so financial advisers in A12 would not pay); and the current contribution limit is not binding such that the full £100m is raised from A13 participants.

³² Under the current structure, the failure of £100m is below the contribution limit for the investment class (£400m); advisers could therefore be expected to cover the claims in full.

Table 6.20 Impact of £100m levy due to intermediary failure in investment class

| Fund managers, CIS operators | Small: £500,000 eligible income | Medium: £35m eligible income | Large: £100m eligible income |
|-------------------------------------------------------------------------------------------|------------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------|
| Amount of levy under proposed structure (£) | 1,113.4 | 77,939.8 | 222,685.0 |
| % of estimated relevant income | 0.2 | 0.2 | 0.2 |
| Amount of levy under current structure (£) | 0 | 0 | 0 |
| Financial adviser | Small: one approved person, £20,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 699.4 | 43,712.2 | 874,243.3 |
| % of estimated relevant income | 3.5 | 3.5 | 3.5 |
| Amount of levy under current structure assuming failure is in A13— A12 participant (£) | 0 | 0 | 0 |
| Amount of levy under current structure assuming failure is in A13— A13 participant (£) | 3,025 | 75,620 | 1,512,402 |

Source: FSA data and Oxera calculations.

Impact of levy up to sub-class thresholds

Table 6.21 illustrates what the individual firm levies would be if the sub-class thresholds were reached.

The current limit for the investment sub-scheme is £400m in total and, in principle, one contribution group could be charged this amount in full (assuming that there is no failure in the other groups). As such, the maximum amount payable by a sub-class in the new structure (£340m for the fund management sub-class and £80m for the other sub-class) could be less than under the current structure—depending on the incidence of failures and whether the limit is binding for any single group. The comparative amounts of levy that would be payable under the current structure are therefore excluded.

Table 6.21 Impact of levy up to thresholds for both sub-classes in investment class

| Fund managers, CIS operators | Small: £500,000 eligible income | Medium: £35m eligible income | Large: £100m eligible income |
|---------------------------------------------|--------------------------------------------------------------------|--------------------------------------------------------------------|------------------------------------------------------------------|
| Amount of levy under proposed structure (£) | 37,856.5 | 2,649,951.8 | 7,571,290.9 |
| % of estimated relevant income | 7.6 | 7.6 | 7.6 |
| Financial adviser | Small: one approved person, £20,000 eligible income | Medium: 25 approved persons, £1.25m eligible income | Large: 500 approved persons, £25m eligible income |
| Amount of levy under proposed structure (£) | 699.4 | 43,712.2 | 874,243.3 |
| % of estimated relevant income | 3.5 | 3.5 | 3.5 |

Source: FSA data and Oxera calculations.

6.3.5 Firms in the home finance (intermediation) class

The 2006/07 levy for mortgage intermediaries was small, and there would be no change in the way this levy would be allocated under the new structure. The impact illustration is therefore omitted. The illustration in Table 6.22 instead shows the result of a significantly larger failure—ie, a failure requiring a £100m levy.

The home finance intermediation participants would pay the levy up to the total threshold amount of £60m, and the resulting levy for home finance intermediaries of a different size is shown in Table 6.22. Note that the levy due would significantly exceed the current contribution limit—ie, the threshold is set at 3.5% of annual eligible income whereas the current limit is only 0.8% of annual eligible income. This explains the difference between amounts payable under the current and proposed structures as shown in Table 6.22.

Under the new structure, home finance providers would be expected to contribute the remaining £40m. The impact for individual home finance providers is not shown in tabular form. If the £40m levy were allocated among all 374 current home finance providers with regulatory permission in proportion to the current tariff base used to set FSA periodic fees (ie, the number of mortgages, which in 2006/07 totalled 8,978,584³³), a small home finance provider with 100 mortgages would pay £444; a medium lender with 50,000 mortgages would pay £222,752; and a large home finance provider with more than 500,000 mortgages would pay £2.2m.

³³ Information provided to Oxera by the FSA.

Table 6.22 Impact of £100m levy due to mortgage advice failure in home finance class

| Home finance intermediaries | Small: £50,000 eligible income | Medium: £1m eligible income | Large: £10m eligible income |
|---------------------------------------------------------------------|--------------------------------|-----------------------------|-----------------------------|
| Amount of levy under proposed structure (£) | 1,702.5 | 34,050.3 | 340,503.0 |
| % of estimated relevant income | 3.4 | 3.4 | 3.4 |
| Amount of levy under current structure given contribution limit (£) | 400 | 8,000 | 80,000 |

Source: FSA data and Oxera calculations.

6.3.6

Illustrations of firm-specific impacts for failures that trigger the general pool

Tables 6.23 and 6.24 illustrate what different firms would pay in the event of compensation costs that are sufficiently large for the general pool to be triggered. They show the amount levied from individual firms in the class in which the failure originates, as well as the levy on different types of firm in the other classes that contribute in the general pool. ‘Small’, ‘medium’ and ‘large’ firms of each type are classified as in the previous tables.

Table 6.23 uses as an illustration a £2 billion failure in the deposit-taking class. Given the specified thresholds, deposit-takers would pay a total of £1.84 billion, with firms in the other classes paying the remainder, as summarised in aggregate terms in Table 6.5.

Table 6.23 Impact of a £2 billion levy due to deposit-taker failure on deposit class and general pool, amount paid by different firms (£)

| Firms in deposit class | Small | Medium | Large |
|----------------------------------------|---------|-------------|---------------|
| Bank, building society | 4,536.3 | 2,268,145.7 | 113,407,284.0 |
| Firms in other classes in general pool | Small | Medium | Large |
| General insurance | | | |
| Provider | 982.9 | 98,286.8 | 1,965,735.6 |
| Intermediary | 59.4 | 1,188.3 | 23,765.7 |
| Life & pensions | | | |
| Provider | 316.1 | 505,835.6 | 1,580,736.1 |
| Intermediary | 109.1 | 2,726.3 | 54,526.5 |
| Investment | | | |
| Fund manager, CIS operator | 2,338.2 | 163,673.5 | 467,638.6 |
| Financial adviser | 46.6 | 2,914.1 | 58,282.9 |
| Home finance | | | |
| Intermediary | 227.0 | 4,540.0 | 45,400.4 |

Source: FSA data and Oxera calculations.

Similarly, Table 6.24 illustrates firm levies that would be raised in the event of a very large failure among life & pensions providers, requiring a levy of £1 billion in total. The life & pensions class would pay £760m in total, with other classes contributing to the remaining £240m, as summarised in aggregate terms in Table 6.5.

Table 6.24 Impact of a £1 billion levy due to life & pensions provider failure on life & pensions class and general pool, amount paid by different firms (£)

| Firms in life & pensions class | Small | Medium | Large |
|-----------------------------------------------|--------------|---------------|--------------|
| Provider | 5,073.1 | 8,116,896.1 | 25,365,300.4 |
| Intermediary | 1,734.9 | 43,373.4 | 867,467.0 |
| Firms in other classes in general pool | | | |
| | Small | Medium | Large |
| Deposit class | | | |
| Bank, building society | 299.5 | 149,771.6 | 7,488,578.8 |
| General insurance | | | |
| Provider | 1,035.4 | 103,538.7 | 2,070,774.9 |
| Intermediary | 62.8 | 1,256.5 | 25,129.3 |
| Investment | | | |
| Fund manager, CIS operator | 2,494.1 | 174,585.1 | 498,814.5 |
| Financial adviser | 46.6 | 2,914.1 | 58,282.9 |
| Home finance | | | |
| Intermediary | 244.0 | 4,880.5 | 48,805.4 |

Source: FSA data and Oxera calculations.

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