Oxera

Funding of the Financial Services Compensation Scheme

Report prepared for The Financial Services Authority

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Summary of report

The Financial Services Compensation Scheme (FSCS) provides last-resort protection for retail customers of authorised financial services firms, awarding compensation if a firm is unable, or likely to be unable, to pay claims against it. The FSCS covers deposits, insurance, investments and, more recently, mortgage advice and arranging and insurance broking. The protection provided by the FSCS mitigates the consequences of firm failure for consumers and can thereby promote confidence in financial institutions and the sector as a whole. These benefits come at a cost.

FSCS costs are funded by levies on firms authorised by the Financial Services Authority (FSA). The current funding structure has been in place since December 2001 when the FSCS came into operation (this date is referred to as 'N2'), replacing the previous compensation schemes. Some industry sectors have expressed concerns about the current funding structure—in particular, in relation to the level of FSCS levies paid by some firms, the volatility and unpredictable nature of the levies, and the way in which they are allocated across firms.

The FSA announced its proposal to review the way in which the FSCS is funded on May 27th 2005, in conjunction with the publication of the final FSA fees and Financial Ombudsman Service (FOS) levies for 2005/06.[1] The overall aim of the FSCS Funding Review is to ensure that funding arrangements remain appropriate in light of the operation of the FSCS since N2 and going forward.

Oxera was commissioned by the FSA to provide independent analysis to support the Funding Review. The aim is to provide a systematic and objective evaluation of issues and options, using analysis of economic and factual data to stimulate an informed debate about FSCS funding. Oxera has engaged heavily with stakeholders to ensure that all viewpoints, arguments and options are taken into account and objectively analysed. The following summarises the main findings contained in this report.

Overview of current FSCS funding arrangements

The FSCS is industry-funded, with levies imposed on a pay-as-you-go basis to cover the projected costs of the scheme arising in a 12-month period. While all authorised firms make a small contribution to cover the basic administration costs of the FSCS, only firms whose defaults can give rise to compensation payments (ie, those with protected retail business) are required to fund compensation-specific costs.

For levying purposes, the FSCS is split into five sub-schemes (deposits; insurance; investments; mortgage advice and arranging; and insurance broking), with each sub-scheme containing one or more contribution groups. Firms participate in the groups according to their FSA permissions to carry out regulated activities, and FSCS costs arising from compensation in a group are allocated only to firms in that group.

The system of sub-schemes and contribution groups was intended to avoid cross-subsidy between regulated activities. It also follows the 'fee block' system established by the FSA for its own funding purposes, with a view to minimising where possible the administrative effort to calculate, invoice and collect levies.

[1] FSA (2005), '2005/06 Final Fees and Levies/Funding Review', FSA press statement FSA/PN/058/2005.

Impact of the current FSCS funding structure

FSCS costs have totalled around £200m in each of the first three years since establishment, including the considerable legacy costs arising from claims for compensation relating to pre-N2 failures of firms. There are considerable cost differences across sub-schemes and contribution groups, with compensation costs to date being concentrated in the insurance and investment sub-schemes.

Within the insurance sub-scheme, there have been failures of a few large general insurers that have imposed costs on other general insurers (contribution group A3). Within the investment sub-scheme, most costs have arisen in the ring-fenced Pensions Review contribution group (A16), but pension mis-selling costs are now phasing out. Instead, compensation costs have increased for firms in contribution A12 and A13 (advisory brokers with and without permission to hold client money), largely due to defaults of financial advisers triggered by claims relating to negligent advice on endowment mortgages, high-income bonds and other non-pension products.

The financial impact of the FSCS levy has been small in most contribution groups and for most firms. The exception is firms in A13 and in particular financial advisers, half of which paid levies in 2005/06 amounting to more than 1.5% of their income, with a non-negligible proportion of financial advisers (12%) having paid more than 5% of income. The calculations in this report do not include the forecast 2006/07 levy requirements published by the FSCS in February 2006, as these are indicative.[2] However, the trends in these expected levy requirements—in particular, an increase in the levy for contribution group A13—support the analysis in this report.

FSCS costs are inherently volatile and difficult to predict. Importantly, FSCS costs in the future may break historical patterns, arising in other contribution groups and being higher than those observed in the past. For the FSCS to meet its statutory obligations, the funding structure must be such that funds can be raised to meet compensation costs as they arise, even if these turn out larger than expected. FSCS funding arrangements should therefore be able to deal with less foreseeable shocks such as the failure of a major institution or problems in other sectors of the market. Most contribution groups appear large enough to afford more significant failures, including those that would require the FSCS levy to increase up to existing levy limits. However, the financial impact for some firms would be considerable. While most concerns about sustainability apply to A13, contribution group A9 (comprising operators of collective investment schemes and related firms) also appears less able to meet significant levy amounts.

The current contribution group structure is permission-based, so a significant number of firms participate in more than one contribution group (and sub-scheme) owing to the activities they are permitted to undertake. In 2005/06, around 40% of firms participate in more than one group, with multiple participation rising to 75% if the large number of general insurance brokers only participating in the new contribution group A19 are not counted. From the perspective of firms, this means that many are exposed to the compensation costs arising in different groups. Multiple participation also raises problems for the FSCS in cases of firm failure where losses cannot be easily attributed to a single activity and corresponding group.

Although uniform as regards permitted activities, there is a high degree of diversity within most contribution groups. Firms with the same permission are pooled together for funding purposes, although they vary in terms of their characteristics, such as type of firm (eg, bank, asset manager or financial adviser), or product market in which they operate. Hence, they differ in the risks they impose on the FSCS (eg, default, operational, or product risk). The

[2] FSCS (2006), *Outlook FSCS*, Issue 11, February.

current funding structure therefore involves a significant degree of cross-subsidy between different firms.

Options for changing FSCS funding and evaluation criteria

There are many dimensions along which the current FSCS funding structure could be changed, although the options for change fall broadly into one of the following four categories.

– **FSCS participation and contribution group structure**—contribution groups could be redefined to form narrower groups than under the current structure, similar-sized groups but with different participants, or broader groups whereby FSCS costs are shared among a larger pool of firms.

– **Ex ante versus ex post funding**—the allocation of FSCS costs could be changed over time, in particular by moving towards an ex ante system whereby levies are raised on a regular basis and in excess of what is needed in the following 12-month period, in order to achieve some degree of smoothing of levies and/or to build up a reserve based on an expectation of future compensation liabilities.

– **Tariff base and calculation of levies**—even if current FSCS participation and contribution group structure were maintained, the allocation of costs across firms could be changed by adjusting the tariff base that determines how much a particular firm contributes to meeting FSCS costs.

– **Other funding sources**—options are available that involve increasing the role of other sources of FSCS funding (eg, borrowing or insurance).

Within these four main categories, numerous elements of funding (or combinations of elements) could be changed, ranging from moderate changes in one detailed element to more radical changes that would fundamentally alter the funding structure.

Three distinct but related sets of criteria have been used to evaluate the main elements of options (including the option of maintaining the status quo), as summarised in the figure below.

Overview of options and evaluation criteria

FSCS participation and contribution group structure

Ex ante versus ex post funding

Tariff base and calculation of levies

Other funding sources

Evaluation criteria

Economic
- incentives
- competition
- risk diversification

Distributional
- sustainability
- ability to pay
- proportionality

Feasibility
- practicality
- legal/other constraints

Source: Oxera.

Some of the criteria are conflicting, and no single option meets all criteria. Deciding on the optimal balance between the criteria is ultimately a matter of policy. Nonetheless, and without unduly restricting the set of options, Oxera has adopted the following high-level principles in evaluating the options.

– From an economics perspective, it is desirable to design a funding structure that improves the incentives of participating firms, although other (regulatory) tools are available to achieve this. Incentives are improved if firms pay in accordance with the risks they impose on the system. A risk-based levy structure may also be considered consistent with the competition criterion.

– However, the benefits of a risk-based structure must be traded off against the objective of ensuring sustainability of FSCS funding, not just with respect to historical losses, but also going forward and taking account of the possibility of larger losses. Sustainability means that some consideration must be given to firms' ability to pay levies, bearing in mind that, ultimately, consumers pay the cost of FSCS levies.

– FSCS funding is not a regulatory tool that should be used to resolve problems in the market that could be more efficiently dealt with using other tools (eg, prudential rules or conduct of business regulation). At the same time, FSCS funding should also avoid introducing perverse incentives in the system and creating distortions in the competitive structure of the market.

– FSCS costs need to be borne by someone, and any reallocation of costs will have winners and losers. Outside a system in which the 'polluter' (ie, the defaulting firm that causes compensation claims) pays for the costs, which may not be feasible, 'fairness' of allocation is difficult to define objectively and cannot be addressed using economic tools of analysis. In such a system, the allocation of costs is a distributional decision to be made by policy. Allocations that are proportionate to the economic benefits that firms derive from the existence of the FSCS are likely to be considered fairer than others.

– Practicality is of concern, and some options can be ruled out because they are not feasible or would impose costs that far outweigh the likely benefits. In addition, legal requirements may restrict the options available for changing the structure of FSCS funding. These constraints are not addressed in the report; neither are developments at the EU level, or the specific funding issues that arise in the case of cross-border financial failures of firms.

FSCS participation and contribution group structure
The main options for changing FSCS participation and the contribution group structure include the following.

– **Narrowing contribution groups**—narrower contribution groups have conceptually attractive properties if groups are defined such that they contain firms that are homogeneous in the degree of risk they impose on the FSCS. Although the defaulted firms do not pay for the compensation costs they generate (unless pre-funding is introduced), allocating costs to groups of firms that carry a similar risk means that, on average and over time, firm levies would reflect risk differences between firms.

  Making higher-risk firms pay has desirable economic properties in terms of improving incentives, mitigating risks and reducing compensation costs going forward. However, the extent to which these benefits are emphasised does depend on policy decisions regarding the role of FSCS funding, and whether it is seen as an additional regulatory tool.

Narrower groups will result in an increase in compensation costs for some high-risk categories, which may lead to the exit of marginal firms. Firms unable to cover the costs they impose on the system may be considered not commercially viable and should exit the market; undue subsidies would distort the competitive process.

The question is whether it is possible to redefine groups in a way that captures more closely the relevant dimensions of specific risks of firms and activities than the current permission-based structure. Many risks that drive compensation events (eg, mis-selling, fraud) are not well understood and are difficult to measure.

Narrowing contribution groups raises concerns about firms' ability to pay and reduces the financial sustainability of the FSCS. High-risk groups are, by definition, those that are financially weakest, and a point could be reached where firms in the narrow group cannot afford further levies. Ability to pay would be less of an issue if levies were set to reflect economic markets, such that all firms competing in the market would be able to raise prices to pass on any cost increases they face.

– **Pooling along the vertical chain**—although the current funding structure does not explicitly recognise vertical links between firms, there are, or have been, examples of a sharing of costs in the retail investment sector, where product providers that use financial advisers as a distribution channel contributed substantially to the funding of compensation liabilities arising from failures in distribution. These examples include the ring-fenced Pensions Review group (A16) as well as the voluntary cross-subsidy arrangement that was set up to support financial advisers in contribution groups A12 and A13 until 2004/05.

While these provider subsidies present a specific form of 'one-way' pooling, costs could also be shared both ways, for example by creating a contribution group comprising product providers and distributors. Vertical pooling could also apply to other relationships in the industry.

The main argument for introducing vertical pooling is in terms of ability to pay and sustainability, and applies in particular to concerns that financial advisers may not be self-sustaining and able to meet the costs of compensation that arise. In addition, although sharing of compensation costs by providers may weaken incentives on the distribution side, in a second-best world where the polluter cannot pay, vertical pooling may have a positive effect on monitoring incentives along the vertical chain of relationships.

Pooling of firms that are commercially connected along the vertical industry chain may be considered 'fairer' or more proportionate than other forms of pooling, in particular if firms along the chain share a common interest in maintaining consumer confidence in the products manufactured and distributed by the chain.

The vertical pooling solution requires identification of the different chains of vertical relationships in the industry. While this may be straightforward in some cases (eg, financial advisers selling specific packaged investment products on a commission basis), it can be much more difficult in other areas where market structures are characterised by a complex net of links between firms.

The definition of the relevant vertical chain raises wider issues about whether firms should be participating in the FSCS with respect to their wholesale business. Using the economic criteria, the case for extending FSCS participation to the wholesale sector appears weak: wholesale firms do not impose a direct cost on the FSCS; the further away in the vertical chain from the polluter, the less scope or incentive there is to affect the behaviour of those that cause FSCS costs; wholesale firms operate in different economic markets; and, given the international nature of the UK wholesale sector, wholesale participation in the FSCS raises concerns about international competitiveness.

The case for FSCS contributions from wholesale firms largely rests on distributional motives. Extending the pool of funds available improves funding along the ability to pay and sustainability criterion. It may also be considered proportionate, provided there are wider market confidence benefits and wholesale firms benefit from a strong UK retail sector.

– **Pooling within and across sub-schemes**—the investment sub-scheme is currently divided into six contribution groups plus the temporary Pensions Review group, so a pooling option is to combine groups within the scheme. This pooling could be limited, for example combining A12 and A13 to create a single group of advisory brokers with or without permission to hold client money; alternatively, it could involve all groups within the investment sub-scheme.

While it weakens incentives, widening the pool of contributing firms improves sustainability, spreading risks more widely and reducing the financial impact on individual firms. Pooling across the investment sub-scheme may also be consistent with the proportionality criterion, provided that the benefits of market confidence are diffused across the whole investment market, rather than concentrated around single products and activities.

Creating a single investment pool can be considered practical. Many firms already have an interest in more than one funding pool due to their participation in multiple groups in the sub-scheme. Moreover, from the perspective of the FSCS, there would be less need to identify the activity associated with particular types of claim arising on a particular firm's failure in order to attribute costs to a specific group, or across groups if more than one activity is identified.

This pooling could be taken one step further to include life insurers (A4) in the pool, recognising that many life insurance products fall into the same broad economic market as other retail investment products. It recognises vertical links between firms in the investment sub-scheme and the life insurance group and, by capturing all 'product providers' (whether life insurers, CIS operators, etc), overcomes some of the practical problems associated with the pure vertical pooling solution.

If life insurers were pooled with firms in the investment sub-scheme, general insurers (A3) could be pooled with general insurance intermediaries (A19) using the same rationale and to ensure consistent treatment. The FSCS funding structure would then involve pooling firms or activities by broad commonality of markets—ie, long-term savings and investment (A4 and A7 to A14), general insurance (A3 and A19), deposits (A1) and mortgage advice (A18). These last two sub-schemes could also be pooled, although deposit-taking and mortgage advice can be considered sufficiently distinct markets, even from the perspective of consumers who may use the same bank or building society to provide the two types of service.

Sustainability could be further improved, and the financial impact on individual groups of firms reduced, if the pool were extended to include the entire FSCS—ie, creating a single pool of funds to cover all compensation costs in the UK retail financial services industry. Arguments for complete pooling appear less obvious. For example, the case for pooling across the investment sub-scheme rests partly on the fact that it may be difficult to define groups within the sub-scheme that reflect both the risks of participating firms and the economic markets in which they operate. The deposit-taking sub-scheme and the investment sub-scheme, however, seem sufficiently distinct to draw a line between them.

– **Pooling thresholds and other hybrid solutions**—while greater pooling reduces the financial impact of levies, in particular for the weakest firms, and improves FSCS funding sustainability, it implies losing desirable incentive properties and may also be seen as inconsistent with notions of fairness. There are options to deliver a funding structure that presents a compromise solution to the trade-offs.

  – Pooling thresholds could be established, whereby costs are first allocated to the narrowly defined group in which the failure arises, but only up to a threshold, beyond which costs are spread more widely across groups. There could be a single threshold, or several thresholds, with the pool of contributing firms expanding as the size of the failure increases.

  – Alternatively, within a broad pool, the tariff base used to allocate levies to firms could be adjusted to reflect risk differences between firms and activities. Thus, firms that impose, or are expected to impose, a greater cost on the FSCS pay a larger proportion of levies, but all firms in the pool make some contribution to meeting compensation costs. Such a risk-based approach to setting levies has been adopted by the Pension Protection Fund, for example, and is also observed among international deposit guarantee schemes.

  Both options are conceptually attractive because they provide a means of differentiating between firms, thereby limiting the distortions that might arise from pooling firms with different risk characteristics without differentiation. The options do, however, raise important practicality and implementation issues, and further analysis would be required to determine how to set appropriate pooling thresholds or introduce risk-weighted levies.

Ex ante funding

The current pay-as-you-go system for FSCS funding could be adjusted to introduce a stronger element of ex ante funding, imposing levies not only to cover actual compensation costs or those known to arise in the following 12 months, but any costs that might arise in the future. There is considerable international precedent of ex ante funding among deposit guarantee and investor compensation schemes in the EU and USA.

The main objectives for introducing an ex ante system can differ. In particular, it can be used to build up a sizeable standing fund to deal with very large failures, to force future insolvent firms to make at least some contributions to the compensation costs they generate, and to achieve some smoothing of levies over time.

While attractive for sustainability reasons, there are a number of arguments against building up a significant standing fund that covers the entire industry—eg, opportunity costs for firms relative to their cost of capital; practical difficulties for the FSCS in managing funds and determining the appropriate target fund size and annual levies needed to build up the fund; the existence of regulatory tools that limit the likelihood of very large failures occurring; and the availability of other contingency funding sources if such failures occur.

Ex ante funding may instead be viewed as a way of forcing firms to set aside capital to cover future compensation costs, and may also discourage poorly capitalised firms from operating. However, other regulatory mechanisms (eg, capital requirements) are likely to be more appropriate to achieve these objectives than the FSCS levy.

The case for ex ante funding does, on balance, seem strongest if introduced with an objective to achieve some smoothing of levies over time. Given the inherent difficulties in predicting the FSCS funding requirements, there are, however, limits to the degree of smoothing that can be achieved. Moreover, greater smoothing means, on average, higher levies for firms. It is therefore worth exploring whether other mechanisms (eg, alternative FSCS funding sources or internal provisioning by firms) can be used to achieve smoothing at lower cost.

Tariff base and calculation of levies
The choice of tariff base is more than a technical matter. It can greatly affect the amount of levy paid by an individual firm and the overall allocation of compensation costs across firms, even if the contribution group structure is unchanged. Under the current structure, levies in different contribution groups are allocated according to three broad types of tariff base: relevant income (A3, A4, A9, A18 and A19), client funds held by the firm (A1 and A7), and headcount (A10, A12, A13 and A14).

The income-based allocation method is most consistent with the ability-to-pay criterion; levy allocation according to protected deposits (A1) or funds under management (A7) is more consistent with risk-reflective pricing, at least in terms of impact (ie, potential exposure to loss given default); and the allocation based on the number of approved persons appears to be the most practical method (the information is readily available and verifiable).

There are other examples of inconsistencies in the current tariff base structure. In particular, for some contribution groups, the tariff base measures the volume of a firm's protected (retail) business, whereas for others the tariff base also counts the volume of business conducted for (wholesale) clients that are not eligible for compensation.

A separate question is what tariff base is appropriate if the current contribution group structure is redefined and greater pooling introduced. This requires the identification of a tariff base common to all pooled groups, or some other means of allocating costs across firms in the larger pool.

The economic criteria call for a tariff base that differentiates between firms according to the specific risks they impose on the FSCS. Risk-weighting on the basis of full expected loss pricing may be difficult to implement in practice, given the types of risk driving FSCS costs. Nonetheless, it may be possible to move towards a more risk-based differentiation between firms using simple proxy metrics. Further analysis is required to assess what the appropriate metrics are, and how feasible it would be to collect data for measurement.

Other sources of funding
The FSCS has available a limited range of alternative funding sources, such as borrowing between sub-schemes and a credit facility of £50m. The question is whether greater use should be made of available alternatives to cover large unexpected failures or to achieve some smoothing of levies over time, or whether new funding alternatives (eg, insurance) could be introduced. The arguments for and against these alternatives are outlined in the report. However, the FSCS is an industry-funded scheme under current legislation, so FSCS costs ultimately need to be covered by firms. The focus of the Funding Review and this report is therefore on the structure of FSCS levies.

Key considerations

– Different options for changing FSCS funding are subject to conflicting objectives, and, the choice between the options is therefore ultimately a policy matter. This report provides the relevant background for the analysis of the policy options, setting out criteria for assessing the options and how each one is likely to satisfy these criteria.

– The current funding structure involves a significant degree of cross-subsidy between different firms. The permission-based contribution group structure also implies that many firms are exposed to the compensation costs arising in different groups.

– Although over the last few years most costs have arisen in certain contribution groups, the funding structure will need to take into account the possibility that costs could be higher than in the past and could arise in other contribution groups.

- Most contribution groups appear large enough to afford larger failures than in the past, although the financial impact could be considerable and certain contribution groups (A13, A9, etc) appear most vulnerable.

- The report discusses some broad options for changing how costs are allocated across firms:

  - narrowing contribution groups;
  - pooling along the vertical chain of industry relationships;
  - pooling within and across sub-schemes.

- Narrowing the contribution groups would address current concerns that different types of firms are grouped together; that firms operate in the same product market but are subject to different levies; or that firms are in distinct product markets, but are included in the same contribution group and therefore pay a similar levy. In other words, this option could go some way towards defining groups of firms with similar risk characteristics.

- However, this option needs to be weighed against the potential difficulties of assessing the risk that different firms and activities pose on the FSCS, and the potential exacerbation of ability-to-pay problems that might arise if contribution groups were narrowed further.

- Vertical pooling improves ability to pay, funding sustainability and monitoring incentives along the chain. The vertical pooling solution requires identification of the different chains of vertical relationships in the industry. While this may be straightforward in some cases (eg, financial advisers selling specific packaged investment products on a commission basis), it can be more difficult in other areas where market structures are characterised by a complex net of links between firms.

- Pooling within and across sub-schemes improves sustainability and practicality, and avoids the need to attribute costs to a specific group or across groups if more than one activity is identified. However, it weakens incentives and may distort product market competition.

- Proposals to introduce a greater degree of pooling relative to the current structure should take into account the potential distortionary effects on incentives and competition. With this in mind, consideration should be given to how risk-based differentiation between firms and/or activities can be achieved, without undermining significantly the benefits of greater funding sustainability of such options.

- Options based on more narrowly defined groups should consider whether pooling thresholds could be established, whereby costs are first allocated to the narrowly defined groups in which the failure arises, but only up to a threshold, beyond which costs are spread more widely across groups.

- While the case for building up a large contingency fund seems weak overall, there may be a case for pre-funding to achieve some smoothing of levies over time. Given the inherent difficulties in predicting the FSCS funding requirement, there are, however, limits to the degree of smoothing that can be achieved. Moreover, greater smoothing means, on average, higher levies for firms. It is therefore worth exploring whether other mechanisms can be used to achieve smoothing at lower cost.

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1 Introduction

The Financial Services Compensation Scheme (FSCS) provides important last-resort protection for customers of authorised financial services firms, awarding compensation if a firm is unable, or likely to be unable, to pay claims against it. The scheme covers deposit, insurance, and investments, and, more recently, also protects mortgage business and advice and arranging on general insurance policies. The protection provided by FSCS mitigates the consequences of financial failure for consumers and thereby encourages confidence in financial institutions and the sector. These benefits come at a cost.

FSCS costs are funded by levies on firms authorised by the Financial Services Authority (FSA) and whose failures can give rise to compensation payments. The current funding structure has been in place since December 2001 when the FSCS came into operation, replacing the compensation schemes that existed prior to N2.

Concerns have been expressed by some industry sectors about the current funding structure—in particular, about the level of FSCS levies paid by some firms, the volatility and unpredictable nature of the levies, and the way in which they are allocated across firms. The FSA announced its proposal to review the way in which the FSCS is funded on May 27th 2005. The overall aim of the FSCS Funding Review is to ensure that funding arrangements remain appropriate in light of the operation of the FSCS since N2 and going forward.

In September 2005, Oxera was commissioned by the FSA to provide independent analysis to support the Funding Review, focusing on the following three areas of analysis:

– what is the FSCS funding requirement?

– what impact has the current funding structure had?

– what options for change are available to secure appropriate funding going forward?

The aim is to provide a systematic and objective evaluation of issues and options, using economic and factual data analysis to stimulate an informed debate about FSCS funding. This will facilitate policy decision-making to create a funding regime that is and remains adequate for the long run.

Oxera has no pre-conceived views about the outcome of the Funding Review, and has engaged heavily with stakeholders to ensure that all viewpoints, arguments and options are taken into account and objectively analysed. Stakeholder involvement has been enlisted through an Industry Advisory Group (involving the relevant trade associations as well as the Financial Services Practitioner Panel, the Consumer Panel and the Small Business Panel) and an Internal Working Group (involving FSA and FSCS staff). Oxera also conducted a series of interviews with industry practitioners, and is grateful for the support we received during the research period.

This report summarises Oxera's assessment of current FSCS funding arrangements and an evaluation of options for change, and is structured as follows:

– section 2 provides background information about the FSCS and the way the scheme is currently funded;

– section 3 presents an overview of FSCS funding requirements to date and going forward, summarising the sources and cost levels that need to be funded for the FSCS to fulfil its statutory obligations;

– section 4 presents the results of the analysis conducted to assess the impact of the current funding structure in terms of the allocation and financial consequences of FSCS levies on participating firms;

– section 5 provides an overview of the main options for changing the funding structure. It also sets out the evaluation criteria applied by Oxera to analyse the merits of particular options. This section presents the conceptual framework for the evaluation contained in the following sections, 6 to 8;

– section 6 considers the options that relate to changing the allocation of FSCS levies between firms. It sets out the main arguments for and against particular allocations, and illustrates the financial impact of these alternatives in a variety of scenarios;

– section 7 explores the advantages and disadvantages of moving towards a system that introduces a stronger element of pre-funding than the current system;

– section 8 addresses possible changes in the tariff base used to calculate FSCS levies, including risk-weighting of contributions. It also provides a brief discussion of options relating to sources of FSCS funding other than firm levies.

The appendix provides a summary of the funding structure of other schemes that may be seen as comparators for the FSCS.

2 Overview of the FSCS and the Funding Review

This section provides the relevant background information. It presents an overview of the role of the FSCS and the current funding structure. It also sets out the aim of the Funding Review and the scope and content of Oxera's research and analysis conducted to support the Review.

2.1 What is the FSCS?

The FSCS is the UK's statutory fund of last resort for customers of authorised financial services firms. Created under the Financial Services and Markets Act 2000 (FSMA), the FSCS became the single compensation scheme on December 1st 2001 when FSMA came into force, replacing predecessor schemes.[3]

FSCS can pay compensation if a firm is unable, or likely to be unable, to pay claims against it. In general, this is when a firm has stopped trading, and has insufficient assets to meet claims, or is in insolvency. The scheme covers regulated business conducted by firms. European firms (authorised by their home state regulator) that operate in the UK may also be covered.

The FSCS protects:

- deposits;
- insurance policies, including Lloyd's policies since January 1st 2004;
- insurance broking (for business on or after January 14th 2005);
- investment business (for business on or after August 28th 1988); and
- mortgage advice and arranging (for business on or after October 31st 2004).

Compensation can only be paid if a claim is eligible, as set out in the rules of the FSA Handbook ('Redress, Compensation'). In particular, the FSCS was set up mainly to protect private individuals, although smaller businesses are also covered. Larger businesses are generally excluded from compensation, although there are some exceptions to this for deposit and insurance claims. FSCS pays compensation only for financial loss, and does not pay for distress or inconvenience. There are limits to the amount of compensation that can be awarded. The compensation limits, which are currently under review, depend on the type of claim and are set out in Table 2.1.[4]

[3] The former schemes included the Building Societies Investor Protection Scheme, the Deposit Protection Board, the Friendly Societies Protection Scheme, the Investor Compensation Scheme, the Personal Investment Authority Indemnity Scheme, the Policyholders Protection Scheme, the Section 43 Scheme (which covered business with money-market institutions), and the arrangements between the Association of British Insurers and the Investor Compensation Scheme for paying compensation in relation to Pensions Review cases.

[4] Different limits may apply to failures under pre-existing regimes.

Table 2.1 Maximum level of compensation (£ per claim)

Type of claim	Compensation limit (£ per claim)	Details
Deposits	31,700	100% of the first £2,000 and 90% of the next £33,000
Investments	48,000	100% of the first £30,000 and 90% of the next £20,000
Mortgage advice and arranging	48,000	100% of the first £30,000 and 90% of the next £20,000
Long-term insurance (eg, pensions and life assurance)	unlimited	100% of the first £2,000 and 90% of the remainder of the claim (including return of premiums)
General insurance	unlimited	Compulsory insurance (eg, third-party motor): 100% of the claim. Non-compulsory insurance (eg, home and general): 100% of the first £2,000 and 90% of the remainder of the claim or return on premiums
General insurance advice and arranging	unlimited	100% of the first £2,000 and 90% of the remainder of the claim. Compulsory insurance is protected in full

2.2 How is the FSCS funded?

2.2.1 Levies from firms

The FSCS is funded by levies on the financial services industry. The scheme operates on a pay-as-you-go basis, as follows. Levies are raised to cover the projected costs of the scheme in a 12-month period (ie, administration expenses and forecast claims based on claims trends). The levies are announced at the beginning of each financial year. Further levies can be raised if compensation payments exceed those anticipated or if there is a major new default in that financial year. The levy rules are contained in the FSA Handbook of rules and guidance (‘Fees’). The levies are collected, on behalf of the FSCS, by the FSA, which issues a single invoice that covers firms’ fees for the FSA, the FSCS and the FOS.

While all authorised firms make a small contribution to cover the basic administration costs of the FSCS, only firms whose defaults can give rise to compensation payments (ie, firms with retail business) are required to fund compensation-specific costs.

For levying purposes, FSCS is split into five sub-schemes: accepting deposits; insurance business; designated investment business; mortgage advice and arranging; and general insurance mediation. Each FSCS sub-scheme contains one or more contribution groups for funding purposes. Firms are allocated to the groups according to their FSA permissions to carry out regulated activities. A firm could be allocated to one or more contribution groups (and sub-schemes) by virtue of its permitted activities.[5]

Within this structure of sub-schemes and contribution groups, FSCS costs are categorised and allocated across firms as follows.

- *Management expenses*, which are split into two categories:
  - *base costs*—the core costs of running the scheme that are independent of the level of activity of the scheme. All authorised firms contribute to the base costs in proportion to the periodic fees they pay to the FSA, irrespective of whether they conduct business that can give rise to eligible claims;

[5] Participant firms must submit statements by the end of February each year showing the contribution groups to which they belong and the total amount of business they conducted in relation to each of these groups, as at December 31st of the previous year.

- *specific costs*—the costs of assessing compensation claims and making payments in relation to specific compensation cases. They are allocated to the relevant contribution groups in which the relevant defaulting firms are members. The tariff base for calculating specific costs and allocating them to individual firms within the contribution groups corresponds to that for compensation costs.

– *Compensation costs*—the costs incurred in paying compensation to claimants. The costs are allocated to the relevant contribution group, in line with the tariff base for that group. Table 2.2 summarises the sub-schemes and contribution groups, and the tariff base according to which compensation costs are allocated to individual firms in the groups.

The system of sub-schemes and contribution groups was intended to avoid cross-subsidy between activities. It also follows the 'fee block' system established by the FSA for its own funding, with a view to minimising where possible the administrative effort on regulated firms, the FSA and the FSCS in collecting data, and in calculating, invoicing and collecting levies.

Table 2.2 Overview of sub-schemes, contribution groups and tariff base

Sub-scheme	Contribution group		Tariff base
Accepting deposits	A1	Deposit takers	Protected deposits
Insurance	A3	General insurers	Relevant net premium income
	A4	Life insurers	Relevant net premium income
Investment	A7	Fund managers	Funds under management
	A9	Collective investment scheme (CIS) operators and depositaries	Gross income
	A10	Principal dealers	Number of traders
	A12	Advisory brokers holding either client money or assets	Number of approved persons
	A13	Advisory brokers not holding either client money or assets	Number of approved persons
	A14	Corporate finance advisors	Number of approved persons
Mortgage advice and arranging	A18	Mortgage advisers and arrangers	Annual eligible income
General insurance mediation	A19	General insurance intermediaries	Annual eligible income

In addition to the contribution groups set out in Table 2.2, the investment sub-scheme contains a temporary group (IFA Pensions Review—A16) to deal with the specific and compensation costs arising in relation to IFA Pensions Review claims.

There are no aggregate limits on the amount that the scheme can pay out, but there are limits, laid down in the funding rules, on the amount that the scheme can levy in a financial year (see Table 2.3 below). These limits are binding for the FSCS, but, by changing the rules, could be amended by the FSA. The management expenses levy is also subject to an annual limit, following annual consultation by the FSA as required by FSMA.

Table 2.3 Limits on FSCS levies

Sub-scheme	Levy limits
Accepting deposits	No more than 0.3% of a participant firm's protected deposits, cumulative
Insurance business	No more than 0.8% of a participant firm's net premium income on protected policies
Designated investment business	The total levy must not exceed £400m in any one financial year
Mortgage firms	No more than 0.8% of a participant firm's annual eligible income
General insurance intermediaries	No more than 0.8% of a participant firm's annual eligible income

2.2.2 Other sources of funding

The FSCS is a fully industry-financed scheme. For example, it does not receive any contributions from the state, and does not benefit from any guarantees or provisions by the state to meet obligations in the case of funding shortfalls.

Although the FSCS is primarily funded on a pay-as-you-go basis and ultimately financed by industry, there can be a difference between annual FSCS levies and costs incurred. If there is a shortfall, this can be met by temporary funding sources other than levies from firms participating in the relevant scheme or group.

– The FSCS took over the assets of its predecessor schemes and has used these funds to cover costs incurred after N2.

– The FSCS is also able, in general, to recover some of the compensation costs following the liquidation of firms, and the recovered funds can be used to reduce future levy requirements in the relevant sub-scheme and contribution group.

– More generally, positive fund balances in any year (including excess funds if levies were raised beyond what was required to meet costs in the year) can be used to meet FSCS costs and compensation payments in the following year. A refund may be made at the FSCS's discretion. For example, £42m was refunded to firms in contribution group A3 (general insurers) during the financial year 2005/06, due to larger than anticipated recoveries being made by the FSCS from the estates of insolvent insurers and a short-term reduction in the funding requirements for general insurance compensation claims in the sector.

– The FSCS may use existing fund balances of one contribution group to cover temporarily the costs of another. However, this requires that the creditor contribution group is not disadvantaged; for example, interest must be credited to the group and repaid in the next levy. Borrowing across sub-schemes is also possible, although the rules envisage that borrowed funds are repaid as soon as possible. Thus, sharing of costs is possible on a temporary basis when there are shortfalls of funds in a particular contribution group or scheme. Ultimately, however, costs are allocated to firms according to the sub-scheme and contribution group structure described above.

– The FSCS also has the powers to borrow externally. It has a credit facility in place of £50m, to be used, as necessary, for the funding of the scheme. This borrowing facility applies to the FSCS as a whole.

3 The FSCS funding requirement

The funding of the FSCS must be such that the scheme is in a position to fulfil its statutory obligations of paying compensation to consumers when firms are unable, or likely to be unable, to satisfy claims against them. The Funding Review takes as given the current arrangements for compensation, including types of loss covered and amount of compensation.

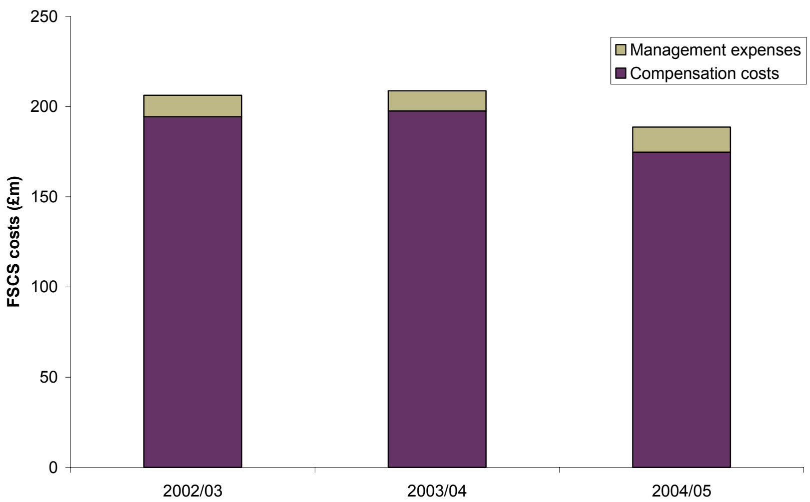
This section presents an overview of the FSCS funding requirement, summarising the costs incurred since the scheme was established and the main sources of FSCS costs. It also discusses why any new funding structure should be designed based on a forward-looking assessment of FSCS funding needs, but taking into account historical experiences of defaults in the industry.

3.1 FSCS costs since N2

Aggregate FSCS costs in the first three full financial years since N2 have been around £200m (see Figure 3.1). Of the total costs, more than 90% is made up of the costs that result from compensation payments, with the remainder arising from management expenses.

The financial year of the FSCS closes in March, so the final costs for the current financial year will not be available in March, as they need to be audited. They will be published in June in the FSCS Annual Report.

Figure 3.1 FSCS compensation costs and management expenses, 2002/03–2004/05



Source: FSCS.

The stability of costs at aggregate level conceals the substantial differences in costs across sub-schemes and contribution groups, as shown in Figures 3.2 and 3.3 below.

Figure 3.2 demonstrates that compensation costs have been concentrated in the insurance and the investment sub-schemes.

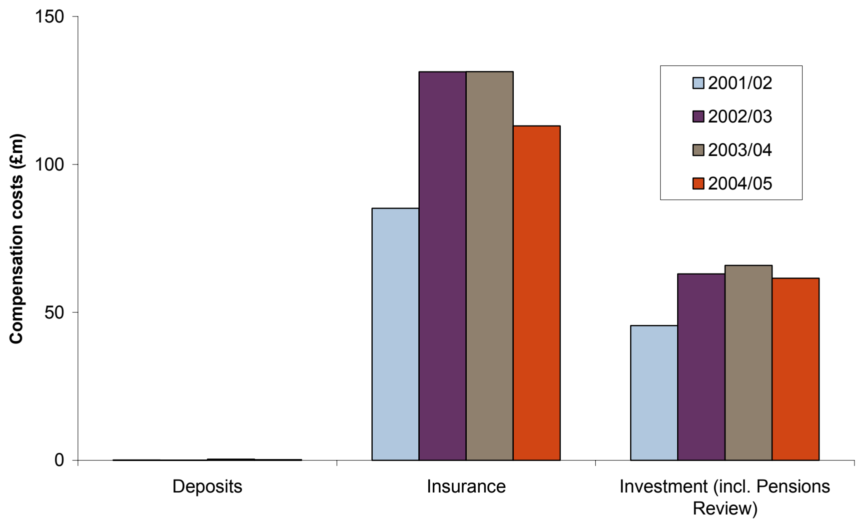
Within the *insurance* sub-scheme, there have been failures of a few large general insurers (eg, Independent, Chester Street) that have imposed costs on other general insurers participating in contribution group A3. Life insurers in A4, however, have not given rise to significant compensation costs since the establishment of the FSCS.

Within the *investment* sub-scheme, most of the historical costs have related to payments made for the IFA Pensions Review (A16). However, Pensions Review-related costs are declining and are expected to be phased out after the next financial year. Instead, compensation costs have increased in contribution groups A12 and A13 (advisory brokers with and without permission to hold either client money or assets). These costs mainly relate to defaults of financial advisors, triggered by claims relating to negligent advice on high-income bonds, endowment mortgages and other non-pension products. Compensation costs in this area also increased in 2005/06, although the final figures are not yet available.

Compensation costs in other contribution groups have been negligible or zero. There have been defaults of firms in the deposit sub-scheme (A1), but these concerned defaults of small credit unions and generated low compensation payments.

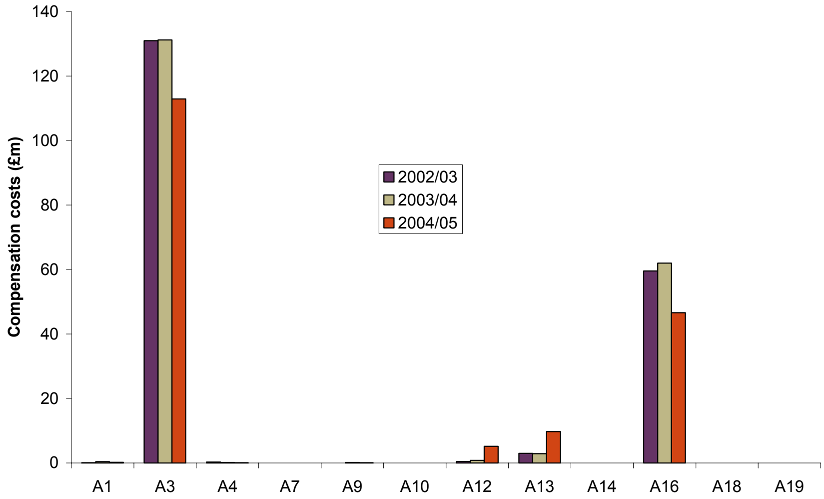
Mortgage advisors (A18) and general insurance brokers (A19) only joined the FSCS in October 2004 and January 2005, respectively. The charts therefore show zero compensation costs for these groups. In financial year 2005/06, while there have been no payments in relation to mortgage advice, a small number of general insurance brokers have failed and generated compensation claims, but the final compensation bill for the year is likely to be small.

Figure 3.2 Compensation costs by sub-scheme, 2001/02–2004/05



Notes: Compensation costs in 2001/02 are the sum of payments made by the predecessor schemes in the period between April 1st and November 30th 2001 and FSCS payments in the period from December 1st to March 31st 2002.
Source: FSCS.

Figure 3.3 Compensation costs by contribution group, 2002/03–2004/05



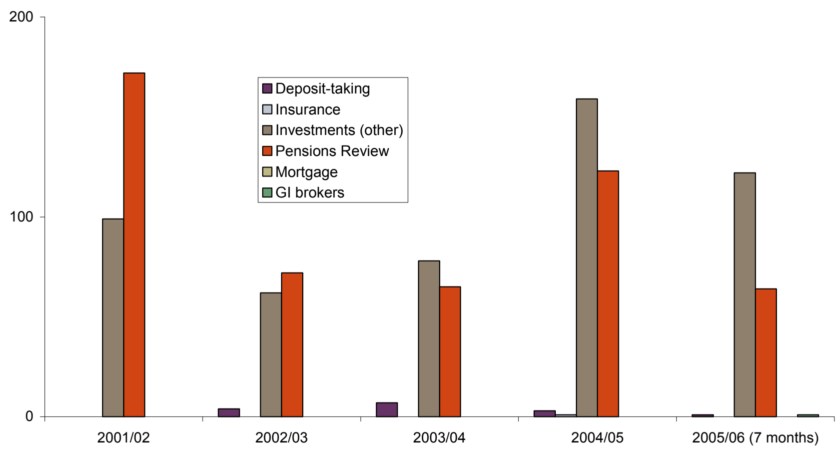
Notes: The contribution group structure did not apply prior to N2, so data for 2001/02 is omitted.
Source: FSCS

3.2 Sources of FSCS costs

FSCS compensation is only triggered in cases where a firm is unable (or likely to be unable) to meet claims against it due to its financial circumstances. If a firm is still trading and has sufficient financial resources to satisfy a claim, the firm is expected to meet the claim itself. Hence, the common driver of all FSCS compensation is the financial risk of default.

The probability of default varies across sub-schemes and contribution groups, depending on the type of participating firms and their required and actual capital resources. Figure 3.4 reports the number of defaults since the establishment of the FSCS in 2001 by sub-scheme. Within the investment sub-scheme, defaults that triggered Pensions Review claims are separated from other investment claims, although the same default may be counted twice if the default gave rise to both types of claim.

Figure 3.4 Number of defaults by sub-scheme, 2001–05



Notes: Includes defaults of firms since FSCS establishment to October 2005 that generated compensation claims against FSCS. There is double-counting where the same default generated claims in relation to the Pensions Review and other investment business.
Source: FSCS claims database and Oxera calculations.

Defaults are considerably more frequent among participants in the investment sub-scheme—mainly firms in the independent financial advice market that are smaller and have limited financial resources to meet claims against them.

Over the period examined, there have been 16 defaults by deposit-takers—as mentioned above, mainly small credit unions generating limited compensation costs.[6] The relative infrequency of compensation events is supported by the number of default declarations prior to FSCS establishment. During the period 1982–2001, 30 deposit firms were declared in default compared with the hundreds of smaller financial advisors and investment firms triggering compensation payments every year.

There have been no default declarations concerning insurance companies during the period, although the FSCS remains involved in the insolvency of 25 general insurers and two life insurers that occurred prior to N2.

The default history for the mortgage advice and general insurance intermediation sub-schemes is short. There have been no default declarations since mortgage advisers joined the FSCS in October 2004, and two default declarations relating to general insurance brokers during 2005/06. To the extent that these sub-schemes also contain a large number of small and less capitalised firms, including financial advisors that also carry out investment activities, the default pattern may be similar to that in the investment sub-scheme, so there is a clear risk of future costs, although it is too early to be sure about this.

FSCS costs depend not only on a default occurring, but also on the exposure or severity of loss given default. The types of claim upon default vary considerably across sub-schemes.

Within the investment sub-scheme, the main source for claims relates to losses incurred by investors from bad investment advice, generally associated with specific products that were mis-sold on a wider scale: pensions, endowment mortgages, precipice bonds, etc. Claims relating to failures where the firm cannot return investments or money owed to its customers make up only a small fraction of compensation costs in the investment sub-scheme.

Mis-selling risk also applies in the general insurance intermediation and mortgage sub-scheme where consumers are at risk of choosing an inappropriate policy or the wrong mortgage following poor advice.

Unlike in the deposit and insurance sub-scheme, customers' funds are protected, at least in principle, from firm default by rules that require firms to separate these funds from their own assets. However, the risk of losses arising from fraud, mishandling and misappropriation is common to all sub-schemes.

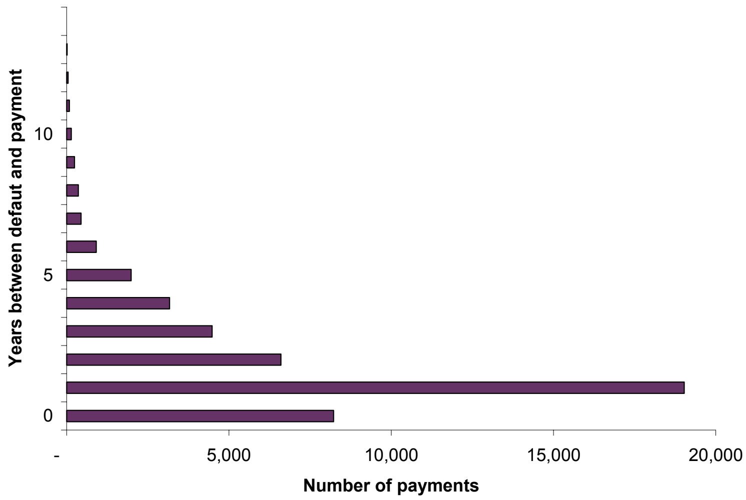
A substantial volume of claims and compensation costs to the FSCS arises from failures that occurred in the past, often before the FSCS was established.

Figure 3.5 shows the time lag between default declaration and payment of a claim for investment products, using data on claims made to FSCS and one of its predecessors, ICS. Although the majority of claims are paid within one or two years after default, the time lag can be much longer for some claims, for example because of delayed applications for compensation by customers[7] or the time taken in determining eligibility and amount of compensation.

[6] Credit unions were not covered by the FSCS until July 2002.

[7] There are no time limits to apply for compensation.

Figure 3.5 Time lag between default and payment of claim (investment sub-scheme)

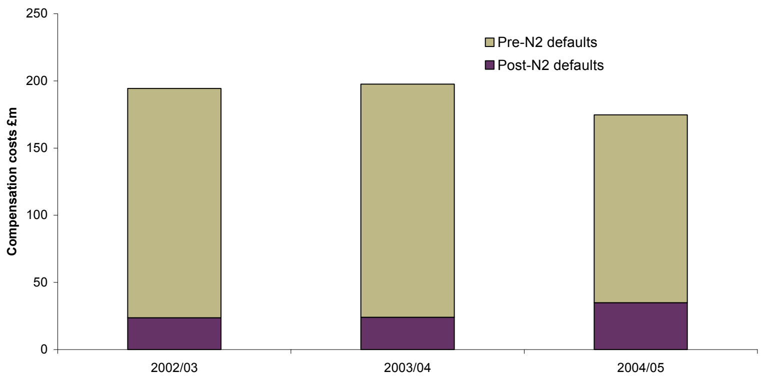


Notes: The data refers to all claims paid by the investment sub-scheme of the FSCS, as well as those paid by its predecessor, ICS. Claims data of other predecessor schemes is not included.
Source: FSCS claims database and Oxera calculations.

Figure 3.6 provides further information on the level of legacy costs arising to the FSCS. It shows the total costs of compensation paid by the FSCS in the three years 2002/03 to 2004/05, as well as the proportion that relates to payments for defaults that occurred before and after the FSCS was established.

The majority of FSCS costs in the first three full financial years since establishment arose from payment of compensation for defaults that were declared before the FSCS was established. In particular, the bulk of the costs refer to a few larger general insurance failures (eg, Independent, Chester Street) that occurred before N2 (see Figures 3.2 and 3.3), as well as some defaults in the investment sub-scheme.

Figure 3.6 FSCS compensation costs arising from defaults before and after FSCS establishment, 2002/03–2004/05



Notes: Total FSCS compensation costs are those reported in the annual reports. Based on claims payment data provided by FSCS, it was possible to identify payments that relate to defaults in or after financial year 2001/02 (labelled 'post-N2 defaults') and earlier 'pre-N2' defaults.
Source: FSCS annual reports, FSCS claims database and Oxera calculations.

Figures 3.5 and 3.6 do not show the full scale of the legacy costs as they only relate to the time lag between default and payment. The actual failure that gives rise to a claim may occur long before default is declared. For example, there may be many years between the point in time when a product was sold and when mis-selling is established and the firm declared in default. Claims relating to the Pensions Review are one example; the FSCS is still declaring defaults and paying compensation in relation to such claims.

These legacy costs raise questions about the design of the FSCS funding structure going forward. For example, policy decisions will need to be taken about the cut-off point between defaults or claims funded under the old arrangements and those to be funded under the new. Legacy costs also add to the complexities of forecasting FSCS costs.

3.3 Assessing compensation costs going forward

The FSCS forecasts its annual funding requirements in its Plan and Budget, which is published annually in January or February. These forecasts are updated by March of each year, when the initial levy for the year is generally set. Forecasts are largely based on work in progress and any information available from the FSA and/or industry sources, and are susceptible to unforeseen failures and/or unpredictable surges in the general levels of claims, as has been experienced recently with endowment claims.

Forecasts require estimates of the number of defaults, the number of claims per default, the uphold rate (ie, the percentage of claims that generate a payment) and the payment per claim. While predicting defaults may be problematic, predicting the number and likely value of claims that will need to be considered by the FSCS is difficult. The FSCS must also take into account potential recoveries and the timing of payments and recoveries.

In November 2005, FSCS had to update its forecast of claims relating to endowment mortgages. While uphold rates had remained constant at 39% and average compensation had fallen from £2,700 to £2,300 per claim, the number of forecast claims rose to 22,000 claims for 2005/06 compared with the 7,000 estimate provided half a year earlier.[8] It may be very difficult to predict with accuracy how many members of the public may choose to contact FSCS with a compensation claim.

It is beyond the scope of this study to review the forecasting process and assess FSCS costs going forward. What is clear is that forecasting FSCS costs is complex, and forecasts can only be estimated based on information available to FSCS at the time a forecast is made. This has implications for the FSCS Funding Review. In particular, concerns have been expressed about the unpredictable nature and volatility of FSCS levies. While a funding structure may be designed that seeks to smooth levies over time, there are limits to what a change in funding can achieve. Given the nature of the sources of costs, there is an inherent unpredictability in the FSCS funding requirement and consequently in FSCS levies.

What is also clear is that FSCS costs going forward may be very different from those observed historically, with further implications for the Funding Review:

First, although compensation costs have been concentrated in some sub-schemes and contribution groups, costs may arise in other areas in the future. For example, to date, FSCS compensation costs in the fund management (A7) and collective investment scheme (CIS) groups have been very small or zero. In its Plan and Budget for 2005/06,[9] the FSCS had announced the potential need for a levy on fund mangers amounting to £27m to cover expected costs of split claims. The levy was postponed due to uncertainty over the number and value of claims against Exeter Fund Managers, which is currently being considered by the administrators. No significant levels of claims in relation to splits were received during 2005. Nevertheless, the FSCS continues to expect a significant number of claims and resulting costs, with potential implications for the A7, A9, A12 and A13 groups, although the timing of the claims and potential costs is still unclear. Another firm, BFS Investments plc,

[8] FSCS (2005), *Outlook*, Issue 10, November.

[9] FSCS (2005), *Plan and Budget 2005/06.*

has recently gone into voluntary liquidation, which may give rise to split cap claims. The impact of this on FSCS (and therefore levy payers) is also currently unclear.

There may also be failures in the new sub-schemes for mortgage advice (A18) and general insurance intermediation (A19). The latter has already generated claims for compensation, and, given the size and capitalisation of many general insurance brokers in the market, it cannot be ruled out that more failures will take place in the future.[10]

Second, cost levels in the future could be higher than those observed. Despite being infrequent and of low probability, large-scale compensation events cannot be ruled out. A single default of a larger firm can give rise to significant volumes of claims and compensation costs, as is evident, for example, from the failure of Independent Insurance in 2001. At the date of appointment of the provisional liquidators, there were around 190,000 policyholders and in excess of 50,000 outstanding insurance claims. A further 41,000 insurance claims were received during the provisional liquidation. By May 2005, 60,000 insurance claims had been agreed, and the FSCS had paid £227m towards protected claims.[11]

Similar loss events can also occur in other sectors. For example, a prominent failure occurred in 1996 at Morgan Grenfell Asset Management, the UK asset management arm of Deutsche Morgan Grenfell and part of the Deutsche Bank Group.[12] Asset management failures could have imposed significant losses on a large number of investors who had invested in the firm’s mutual funds; however, no compensation event was triggered as investors were fully compensated by the firm and its parent, with total costs amounting to more than £210m.[13] Nonetheless, the failure raises the question of what would happen if a similar failure occurred and there were no parent to bail out the firm and compensate investors. Another example comes from the banking sector. Compensation payments in relation to the Bank of Credit & Commerce International SA (BCCI) started in 1992 and involved the largest banking default in the UK to date, with total payments amounting to more than £78m.[14]

Any such high-impact events may have a very low probability. Nevertheless, if they occur and the FSCS is triggered, sufficient resources need to be in place for the scheme to meet its statutory obligations. Short of an assessment of what FSCS costs will look like in future, it will therefore be useful to 'stress test' the current funding structure and alternative funding options under a number of loss scenarios.

3.4 Summary

FSCS costs have totalled around £200m in each of the first three full financial years since establishment, but there are considerable differences across sub-schemes and contribution groups, with costs to date concentrated among general insurers, the ongoing (but phasing out) Pensions Review, and mis-selling of endowment mortgages, precipice bonds and other investment products.

The FSCS is dealing with considerable legacy costs, paying compensation in relation to pre-N2 failures.

[10] Under the current rules, compensation cover for general insurance claims is unlimited and the cost implications, for example of a failure triggering claims from motor accident victims, could be large.

[11] See letter, dated May 2005, to creditors of Independent Insurance by joint provisional liquidator. Available at http://www.independent-insurance.co.uk/Articles.asp?id=1.

[12] The case is described in Oxera (2001), ‘Risks and Regulation in European Asset Management: Is there a Role for Capital Requirements’, a report prepared for the European Asset Management Association.

[13] Investment Management Regulation Organisation Ltd, press releases 05/97, 07/98, 01/99.

[14] FSA (1999), ‘Consumer compensation: A further consultation’, FSA Consultation Paper 24, June.

FSCS costs are inherently difficult to predict and volatile. Being an industry-funded scheme, there are limits to what the Funding Review can achieve in terms of smoothing FSCS levies paid by firms.

Although costs to date have been concentrated among certain activities and products, FSCS costs in the future may break historical patterns by arising in other sectors and being higher than those observed in the past. For the FSCS to meet its statutory obligations, funding must be such that funds can be raised to meet compensation costs as they arise, even if these turn out larger than expected.

4 The impact of current FSCS funding arrangements

This section examines the impact of the current FSCS funding structure, in terms of FSCS participation and the composition of sub-schemes and contribution groups, as well as the financial impact of firms in these schemes and groups. This description provides the benchmark against which alternative funding options will be evaluated in the following sections.

4.1 FSCS participation

In financial year 2005/06, the FSA regulated 27,359 authorised firms. While all firms contribute to the base cost of the FSCS management expenses, in proportion to the fees they pay to the FSA, not all firms are required to participate in the FSCS and make contributions to the specific costs of the management expenses—and, more importantly, the compensation costs. For example, wholesale firms without permission to conduct retail business are generally exempted from FSCS participation. There are also exemptions for other firms, such as mortgage lenders (fee block A2) or most EEA firms which are not required to join.

The total number of firms participating in the FSCS in 2005/06 was 24,194—ie, 88.4% of the regulated total. As explained in section 2, firms participate in FSCS sub-schemes and contribution groups according to their permitted activities and corresponding FSA fee blocks. Table 4.1 shows the number of participants per contribution group.

Table 4.1 FSCS participation, 2005/06

FSA fee block and FSCS contribution group	Number of FSCS participants
Deposit takers (A1)	831
General insurers (A3)	302[1]
Life insurers (A4)	265[1]
Fund managers (A7)	1,090
CIS operators, etc (A9)	325
Principal dealers (A10)	262
Advisers, brokers (A12)	975
Advisers, brokers (A13)	5,216
Corporate finance (A14)	625
Pensions Review (A16)	1,154
Mortgage advisers (A18)	7,212
GI brokers (A19)	18,495

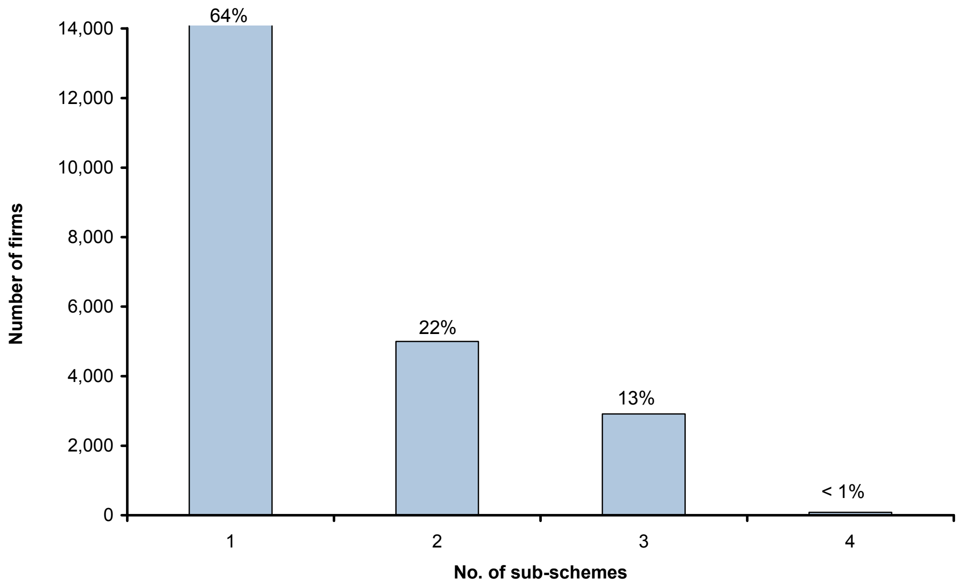
Note: This table shows the total number of firms participating in contribution groups. As multiple participation exists, the total number of unique firms is less. [1] More firms were participating in A3 and A4, but 302 and 265 firms reported non-zero tariff data (ie, eligible premium income).
Source: FSA data and Oxera calculations.

4.2 Composition of FSCS sub-schemes and contribution groups

4.2.1 What is the extent of multiple participation in sub-schemes and contribution groups? Depending on firms' permissions, they can participate in more than one sub-scheme and contribution group. Multiple participation is relevant to the extent that, from the perspective of an individual firm, there is exposure to failures in more than one group, affecting the total FSCS levy payable. It is also relevant from the perspective of the FSCS since a single case of firm failure may give rise to compensation costs in more than one group and requires (in some instances difficult) decisions regarding attribution of costs between groups.

The extent of multiple participation in sub-schemes is significant, Figure 4.1 suggests that more than a third of firms participate in at least two sub-schemes. This percentage increases to 66% if general insurance brokers that only belong to the insurance intermediation sub-scheme are excluded.

Figure 4.1 Multiple participation in sub-schemes, 2005/06



Source: FSA data and Oxera calculations.

Table 4.2 below shows how the multiple participation is distributed across sub-schemes. For example, around a fifth of deposit-takers are also participants in the investment, mortgage advice and general insurance broking sub-schemes. However, while many deposit-takers have a stake in other sub-schemes, the reverse is not the case. The same applies among the insurers: many insurers participate in the investment and, in particular, the insurance intermediation sub-scheme, but not the other way around.

There are also high levels of multiple participation between the investment, the mortgage and the general insurance broking sub-schemes. For example, 92% of mortgage intermediaries also undertake some general insurance intermediation activities, and 35% of general insurance broking firms also undertake mortgage intermediation—again, the overlap is not necessarily symmetrical.

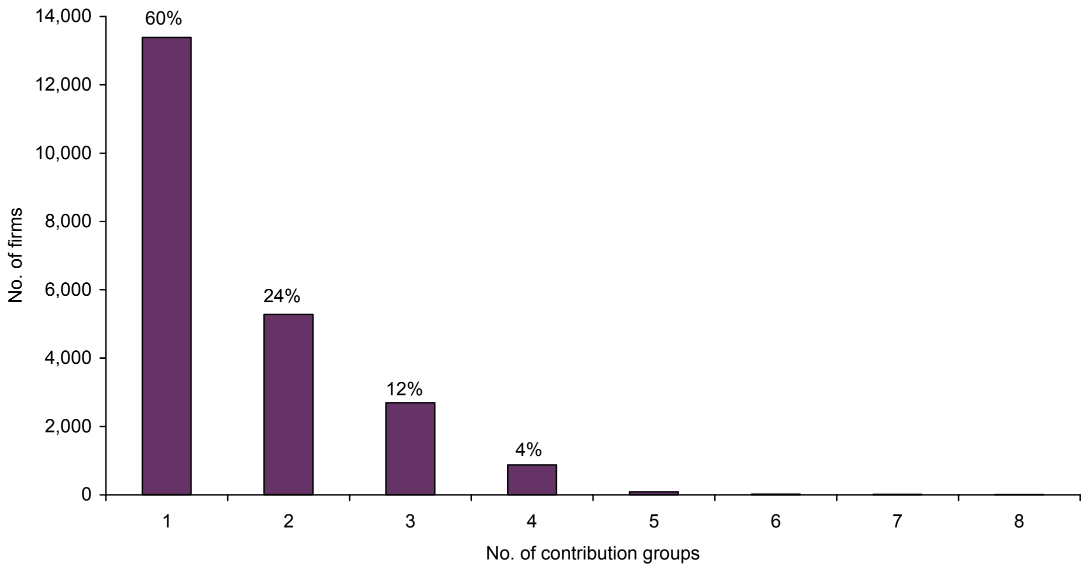
Table 4.2 Distribution of multiple participation in sub-schemes (%), 2005/06

	Deposit	Insurance	Investment	Mortgage	GI broking
Deposit	100	0	21	18	19
Insurance	0	100	15	1	41
Investment	2	1	100	43	59
Mortgage	2	0	42	100	92
GI broking	1	1	22	35	100

Note: The table show the percentage of firms in sub-scheme X (row) that are also participating in sub-scheme Y (column).
Source: FSA data and Oxera calculations

Multiple participation can also be examined by contribution group, as shown in Figure 4.2. Around 40% of firms participate in more than one contribution group. Again, if the large number of general insurance brokers only participating in A19 were excluded, this percentage would rise to 75%.

Figure 4.2 Multiple participation in contribution groups, 2005/06



Source: FSA data and Oxera calculations.

4.2.2 What is the degree of diversity within contribution groups?

The evidence on multiple participation by many but not all firms already indicates that there is a high degree of diversity in the types of firm participating in different sub-schemes and contribution groups. Assessing the degree of diversity is important because if firms within the same group vary in terms of characteristics (such as what type of firm they are—eg, their business model), they may pose very different risks (eg, default, operational, product), but are pooled together under the current structure. Thus, examining the degree of diversity allows assessment of the extent to which there is at present an element of 'cross-subsidy' between different types of firm.

Given the data available, one way to examine the diversity within groups is to use the FSA's categorisation of firms, which seeks to classify firms according to the primary activity they undertake.[15] In total, the FSA classifies firms into 39 primary categories (and 9 broad firm sectors). For example, deposit-taking is a sector, while credit unions and building societies are some of the primary categories associated with this sector.

Table 4.3 illustrates the diversity under the current structure, using three contribution groups as examples: fund managers (A7), brokers holding client money (A12) and brokers not holding client money (A13). These are the most diverse groups, but the reported results make a case in point. For example, within A12, 30.5% of firms can be classified as discretionary investment managers, and these are pooled with authorised professional firms (22.9%), financial advisors (13.5%), and so on. The A13 group is dominated by financial advisors, which make up 85.5% of the constituents, but other types of firm are also observed and their share would be larger if measured in terms of levy paid rather than by number.

Table 4.3 Diversity within contribution groups A7, A12 and A13 (%), 2005/06

Primary category	A7	A12	A13
Discretionary investment manager	54.8	30.5	2.5
Venture capital firm	8.0	0.3	0.0
Stockbroker	7.1	10.4	0.4
Financial advisor	6.8	13.5	85.5
Life insurer	5.5	0.7	0.0
Bank (other than wholesale only)	5.2	8.3	0.6
Advising and arranging intermediary	1.7	2.5	2.4
Non-discretionary investment manager	1.7	0.9	0.1
Authorised professional firm	1.4	22.9	4.4
CIS administrator	0.9	0.5	0.0
Wholesale market broker	0.7	1.6	0.1
Custodial service provider	0.7	0.8	0.0
Clearer/settlement agent	0.7	1.3	0.0
Corporate finance firm	0.6	1.5	0.4
Market maker	0.6	1.1	0.1
Other	3.4	3.3	3.4

Source: FSA, Oxera calculations.

The description by primary category does not reveal the full diversity within contribution groups. For example, the category of 'financial advisor' in itself is diverse, containing IFAs, networks of advisors, multi-tied agents, and others, who may also sell or advise on different financial products. Similarly, discretionary investment managers may engage mainly in institutional business, managing collective schemes or pension fund mandates, or instead concentrate their activities on private client business. Firms that engage in the same primary activity may also have very different capitalisation levels, be exposed to different operational risks, etc.

Given the data available, it was not possible to examine these issues in any detail. Nonetheless, the evidence appears sufficient to draw the conclusion that, overall, there is a high degree of diversity within most contribution groups. The type of firm (eg, a bank or

[15] The primary category should in general reflect the main activity undertaken by a firm. While this is straightforward for many firms, classifying firms with more than one business line can be difficult and in some cases involves a subjective assessment and discretion in the ultimate classification. In this report, primary category is only used for illustrative purposes as it was the best variable available to describe firms of different type.

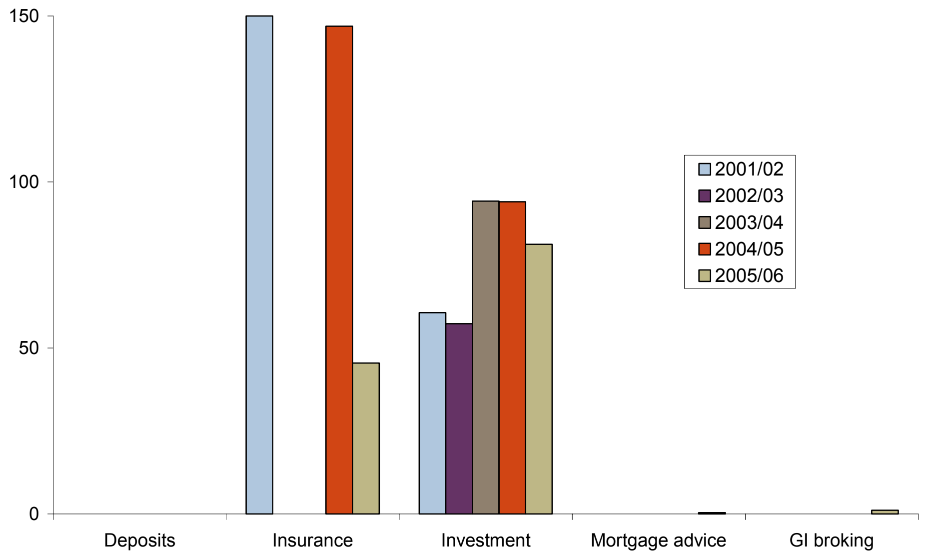
discretionary investment firm)—and, by assumption, the risks entailed—can vary significantly. This suggests that the current permission-based contribution group structure involves a degree of 'cross-subsidy' between different types of firm—ie, a pooling of a diverse set of firms that results from a poor definition problem rather than policy design.

4.3 The financial impact of levies on firms

4.3.1 Total FSCS levies by sub-scheme and contribution group

Reflecting the concentration of past compensation costs reported in section 3, FSCS levies have been concentrated within the insurance and investment sub-schemes including the Pensions Review. Figure 4.3 provides a breakdown of total levies paid by sub-scheme.

Figure 4.3 Total FSCS levies by sub-scheme (£m), 2001/02–2005/06



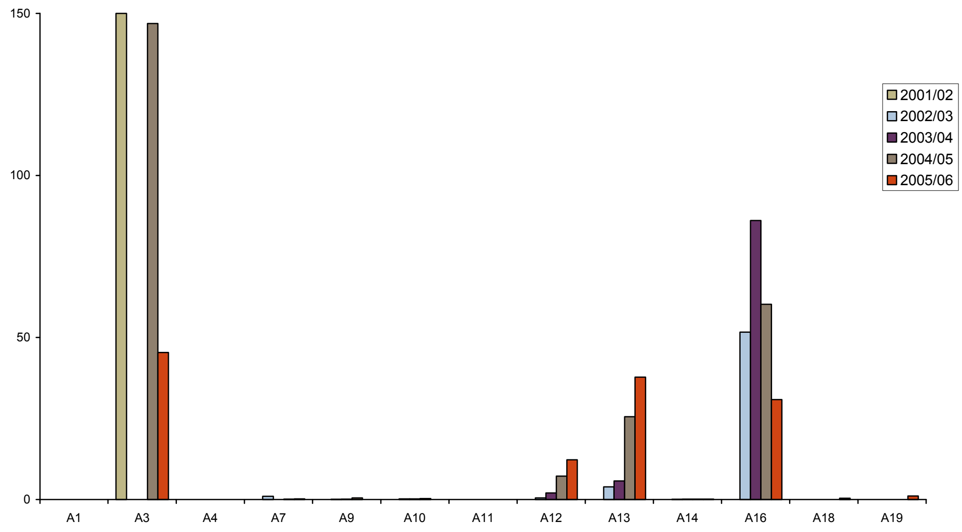
Notes: The 2001/02 levy includes £150m raised from general insurers by FSCS and the £60.6m raised by the ICS.
Source: FSA.

Within the sub-schemes, as shown in Figure 4.4, levies have been concentrated in A3 (general insurance), A12 (brokers holding client money), A13 (brokers not holding client money) and A16 (Pensions Review).

Figure 4.4 below also shows that, within a contribution group, levies change significantly from year to year. For example, while levies paid in relation to the Pensions Review have been declining considerably since 2003/04, the recent trend within A12 and A13 has been for levies to increase—eg, by 70% and 50% in 2005/06 to reach £12m and £38m in total. The effective increase for IFAs in the two groups was higher because, until 2004/5, they benefited from a voluntary subsidy from product providers.[16]

[16] The subsidy arrangement was set up to last for three years after N2. The amount of subsidy paid to IFAs in A12 and A13 by members of the Association of British Insurers amounted to £3m in 2002/03 and 2003/04 and £4.5m in 2004/05. The amounts do not include the cross-subsidy relating to Pensions Review costs (carried over from the Personal Investment Authority).

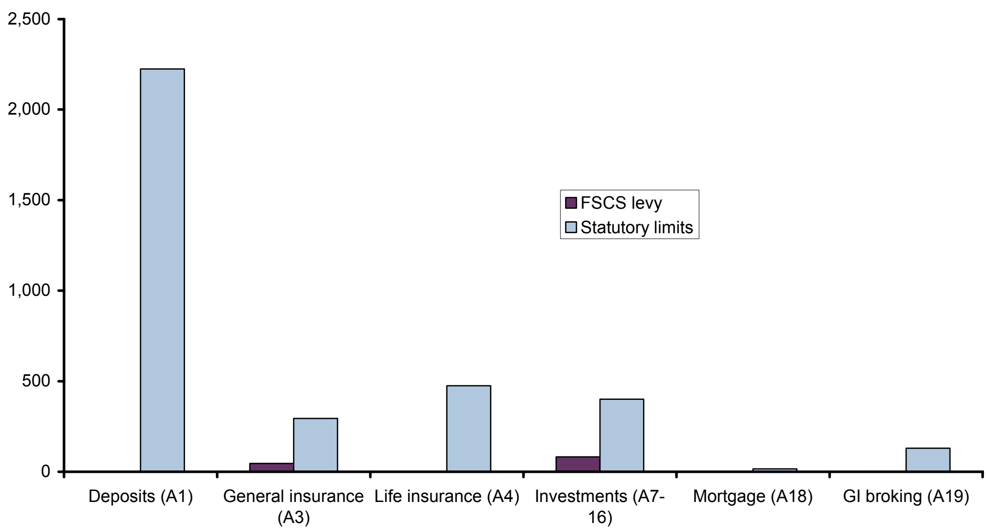
Figure 4.4 Total FSCS levies by contribution group (£m), 2002/03–2005/06



Notes: Contribution groups applied from December 1st 2001.
Source: FSA.

Figure 4.5 compares total levies against the regulatory limits that exist for the sub-schemes and specific contribution groups. Levies have been well below statutory limits, even in sub-schemes or groups where levies have been concentrated.

Figure 4.5 Total FSCS levies and statutory limits (£m), 2005/06



Notes: The levy limits are 0.3% of relevant deposits (cumulative) for the deposit sub-scheme, £400m for the investment sub-scheme and 0.8% of relevant income for the other sub-schemes. Other than for the investment sub-scheme, levy limits were calculated using the aggregate FSCS tariff data for 2005/06.
Source: FSA data and Oxera calculations.

4.3.2 The impact of FSCS levies on individual firms

Aggregate data on total FSCS levies paid does not provide information about the impact of the levies on individual firms. The following examines the impact of the FSCS levy on individual firms using financial data compiled by the FSA as part of its regulatory reporting requirements.[17] For each company within the sample, the FSA provided information on the FSCS levy, the FSCS tariff base, and firm attributes such as the primary category. Data was

[17] The names of the firms were not disclosed to Oxera and remained confidential.

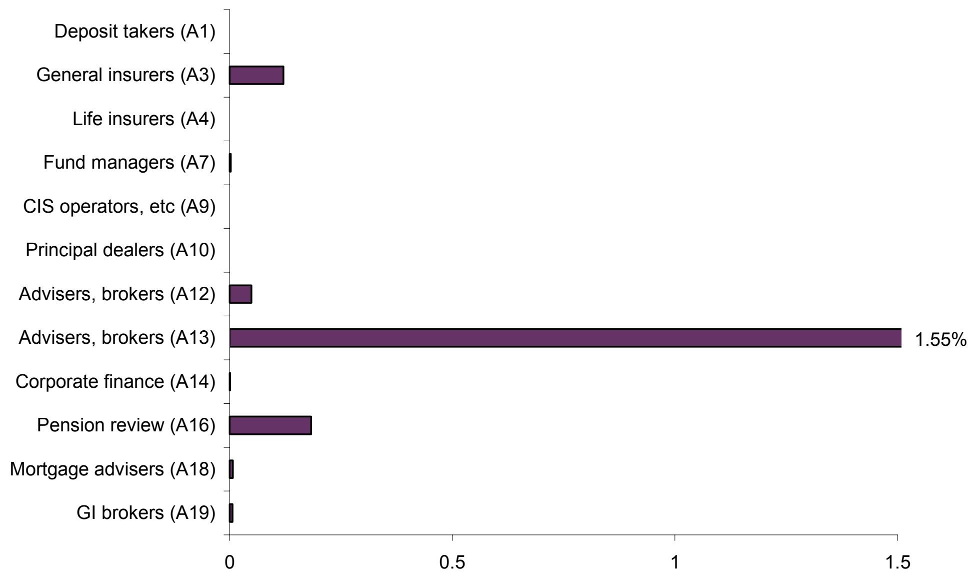
also provided on financial characteristics, such as income, although this was not as comprehensive as the data on FSCS levies.

While FSCS levies are specific to the activity a firm is permitted to carry out, with separate levies payable according to contribution group membership, the financial data, such as income, is only recorded at the company-wide level. The data has nonetheless been used to provide illustrations of the financial impact, and its distribution, by contribution group and at the firm level. Each of these is discussed in turn.

In general, the financial impact of the FSCS levy is illustrated by setting levies paid against a firm's income.[18] Although data was available on operating expenses and capital, the data was less complete and missing for more firms.

Figure 4.6 compares the impact of the 2005/06 FSCS levy on firms in different contribution groups. The results are reported in terms of the median, to reduce the impact of any outliers on the results. As the financial data is at the company level, the impact of the levy on, for example, A13 is measured in terms of the impact of the A13 FSCS levy on *total* income for firms participating in the A13 contribution group.

Figure 4.6 FSCS levy in 2005/06 in relation to income (%)



Notes: Reported ratio is the median in each group. The sample includes 3,456 firms in A13.
Source: FSA data and Oxera calculations.

The impact of the FSCS levy has been most significant for firms in A13, with half of the firms paying FSCS levies amounting to more than 1.55% of income. Either there is no impact on firms in other groups or it appears small in comparison.

Contribution groups contain different types of firm, and each firm can belong to, and pay a levy in relation to, more than one group. Table 4.4 below therefore examines the impact of

[18] Income relates to the entity regulated by the FSA and participating in the FSCS. The FSA provided Oxera with several datasets for different types of firm. The first dataset was sourced from the FSA's Integrated Regulatory Reporting (IRR) system, capturing total income of the relevant firms' Retail Mediation Activities Returns (RMARs) and Mortgage Lending and Administration Returns (MLARs). For personal investment firms not in the IRR, income refers to total turnover captured in annual questionnaires submitted by the relevant firms; for investment managers not in the IRR, the income data also comes from submitted annual questionnaires and contains commission, fee and other income. For banks, the FSA provided a separate dataset of income measured as net interest income plus fees and charges income. The income data for insurance companies was also provided separately, and refers to gross commission income plus investment income.

the levy, as a proportion of income, on a sample of different types of firm, classified using the primary categories as identified by the FSA.

Table 4.4 Total FSCS levy in 2005/06 in relation to income by type of firm

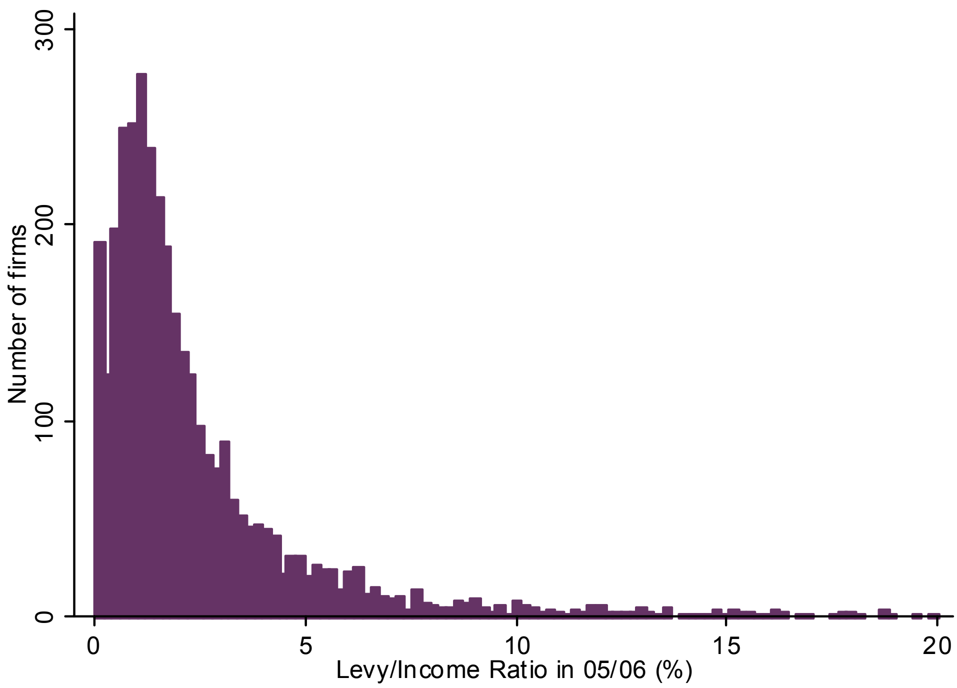
Type of firm	No. of firms in sample	Average ratio of levy to income (%)
Bank	113	0.00
Building society	62	0.00
General insurer	214	0.12
Life insurer	90	0.00
Discretionary investment manager	416	0.01
Non-discretionary investment manager	15	0.01
Financial adviser	3,491	1.59
Advising and arranging intermediary (other than financial adviser)	57	0.51
Mortgage arranger	808	0.04

Note: Firms are classified using the FSA primary category. Only a selection of primary categories is shown. The average ratio is the median of the total FSCS levy divided by income of the firm, taking into account payments in relation to more than one contribution group.
Source: FSA data and Oxera calculations.

The financial impact is most significant for financial advisers, at 1.59% of income on average, and advising and arranging intermediary (other than financial advisers) at 0.51%. Most financial advisers are within contribution group A13, consistent with the results shown in Table 4.4. The impact for other types of firms appears negligible in comparison.

The median ratio of levies to income hides the considerable variance in the financial impact across firms within the same primary category. Figure 4.7 below shows the distribution of the ratio for financial advisers. According to these statistics, more than 12% of financial advisers had a ratio of FSCS levy to income of more than 5%. This means that if these financial advisers had an operating profit of, say, 20% on average, the levy could account for more than a quarter of operating profits. This ratio would be lower if the operating profit margin were higher.

Figure 4.7 Distribution of levy to income among financial advisers, 2005/06



Notes: This figure shows the distribution of the ratio of the total FSCS levy to firm income, taking into account payments in relation to more than one contribution group. Financial advisers were identified using the FSA primary category.
Source: FSA data and Oxera calculations.

Does, for example, the size of impact of the levy on A13 or on financial advisers, of around 1.5% of income, have any implications for market structure? Even if it did, would that be a cause of concern so long as the costs and benefits were proportionate—after all, the higher levy reflects the higher compensation costs arising from activities in this group? These issues will be discussed in subsequent sections. What appears clear from this analysis is that the financial impact of the levy for firms within A13 and financial advisors, in particular, appears significantly greater than in other contribution groups. These firms have low levels of capitalisation and less internal resources to cover the FSCS levy. They are also less well diversified (eg, compared with other firms that have a stake in more contribution groups because they engage in different regulated activities); other things being equal, this suggests that changes to the FSCS levy in A13 have a larger total impact on these firms.

4.4 Looking forward: scenario analysis

The FSCS levy does not, overall, seem to have had a significant financial impact on most firms, with the exception of those within contribution group A13, and financial advisors in particular. Indeed, since the establishment of the FSCS, many contribution groups have not seen any significant failures and hence not paid any significant levies.

Looking forward, however, compensation costs could arise in other groups and could be higher than historical levels, for example, in the event of a very large, one-off failure, or an increase in the number of failures. As discussed in section 3, it is therefore useful to examine what the financial impact would have been under different loss scenarios. How sustainable is the current contribution group structure, and how robust is it in dealing with large loss events? It is difficult to ascertain what the threshold is for affordability or, put differently, at what point the level of the FSCS levy would itself jeopardise the financial viability of firms in a contribution group.

Tables 4.5 and 4.6 below consider a number of loss scenarios and illustrate what the financial impact of the corresponding levy would be on firms participating in the contribution groups.

Table 4.5 shows the average impact of the actual 2005/06 levy in relation to income of participating firms (corresponding to the results shown in Figure 4.6), and compares this with the impact under the assumption of a levy that would need to be raised under a £50m and £100m failure. For most groups, the average impact would remain well below 1% of income, with the exception of contribution groups A9 and A13—if a £100m failure had to be covered by firms in these groups, more than half of them would have to pay levies in excess of 3% of income.

Table 4.5 FSCS levy under various loss scenarios relative to income (%)

	2005/06 levy	£50m levy	£100m levy
Deposit takers (A1)	0.00	0.05	0.11
General insurers (A3)	0.12	0.13	0.27
Life insurers (A4)	0.00	0.01	0.02
Fund managers (A7)	0.00	0.17	0.34
CIS operators, etc (A9)	0.00	1.53	3.07
Principal dealers (A10)	0.00	0.06	0.12
Advisers, brokers (A12)	0.05	0.15	0.3
Advisers, brokers (A13)	1.55	1.89	3.79
Corporate finance (A14)	0.00	0.32	0.64
Mortgage advisors (A18)	0.01	0.43	0.86
GI brokers (A19)	0.01	0.14	0.28

Note: The median is reported.
Sources: FSA data and Oxera calculations.

There are limits to how much can be levied from the industry in any financial year. What would the financial implications be for individual firms if failures were so large that the limits were reached? Would raising the levy up to the worst-case scenario cross the threshold for affordability?

Table 4.6 compares the impact of the 2005/06 levy with what the levy would be if it were equal to the levy limit in each group. The levy limit of £400m in the investment sub-scheme applies to the scheme as a whole. As there are no group-specific limits, £400m could, in principle, be levied on each group (but not in the same year). The results in the table illustrate the impact.

Table 4.6 FSCS levy relative to income (%), assuming that the levy reaches the regulatory limit

	2005/06 levy	Levy if legal limit were reached	Regulatory levy limit (£m)
Deposit takers (A1)	0.00	2.42	2,220
General insurers (A3)	0.12	0.79	294
Life insurers (A4)	0.00	0.09	475
Fund managers (A7)	0.00	1.38	400
CIS operators, etc (A9)	0.00	12.27	400
Principal dealers (A10)	0.00	0.48	400
Advisers, brokers (A12)	0.05	1.19	400
Advisers, brokers (A13)	1.55	15.15	400
Corporate finance (A14)	0.00	2.55	400
Mortgage advisers (A18)	0.01	0.13	16
GI brokers (A19)	0.01	0.36	129

Note: The median is reported. The levy limits are 0.3% of relevant deposits (cumulative) for the deposit sub-scheme, £400m for the investment sub-scheme and 0.8% of relevant income for the other sub-schemes. Other than for the investment sub-scheme, levy limits were calculated using the aggregate FSCS tariff data for 2005/06. Source: FSA data and Oxera calculations.

Overall, the results suggest that, for most contribution groups, the average impact of the levy under this scenario remains relatively low, although profit margins could be squeezed considerably for many firms. Concerns about ability to pay and sustainability continue to apply to contribution group A13, where the impact is already high under actual levies. The other group where a large failure could have a significant impact is A9, where a £400m levy would require, on average, payments amounting to more than 12% of income.

The industry levy limits raise other issues in the context of the Funding Review. In particular, what would happen if a failure were so large that limits were exceeded but compensation costs needed to be funded? Compensation payments could be spread over several years (as they are at present—see section 3). In addition, the FSCS is able to borrow between sub-schemes. It could also draw from the credit facility, although the existing £50m facility, or any proportionate and cost-effective facility, may be too low to cover the costs of very large failures. Finally, the FSA could change the funding rules under exceptional circumstances and increase the existing industry limits. Ultimately, the costs would be borne by firms in the group in which the compensation costs arose.

4.5 Summary

The current contribution group structure is permission-based, and firms participate in the FSCS according to the activities they are permitted to undertake. A significant number of firms participate in more than one contribution group (and sub-scheme). From the perspective of firms, this means that many are exposed to the compensation costs arising in different groups and hence have a stake in different funding pools. Multiple participation also raises problems for the FSCS in those cases of firm failure where losses cannot be easily attributed to a particular activity/group.

Contribution groups show a high degree of diversity in terms of their composition. Different types of firm participate in the same group, with their different associated risks. This implies a cross-subsidy between very different firms that results from the permission-based definition of groups.

The financial impact of the FSCS levy has been small in most groups and for most types of firm. The exception is firms in A13 and in particular financial advisors, which have on average paid levies above 1.5% of income, with a non-negligible proportion of financial advisors (12%) paying more than 5% of income.

Going forward, levies may arise in different groups and be larger than in the past. Most contribution groups appear large enough to afford larger failures, including failures that would require the FSCS levy to increase up to existing limits. A9 appears less able to meet significant levy amounts than other groups. However, the main concern about sustainability relates to A13.

5 Conceptual framework for evaluation of funding options

This section presents the conceptual framework for analysing the options available for changing the FSCS funding structure. It sets out the main dimensions along which the funding structure could be changed (section 5.1) and the criteria available for evaluating the merits of various options for change (section 5.2).

No single option meets all evaluation criteria, and the ultimate choice depends on trade-offs between policy objectives and the weight given to the different, and often conflicting, criteria (section 5.3).

Section 5.4 provides a summary of the framework of analysis, and discusses how it has been applied in sections 6 to 8.

5.1 Overview of dimensions of funding structure

There are many dimensions along which the current FSCS funding structure could be changed, although the options for change fall broadly into one of the following four categories.

1) *FSCS participation and contribution group structure*—the current funding structure is built around contribution groups that comprise firms with permission to carry out particular activities. Going forward, this structure could be changed by redefining contribution groups and firms' participation in these groups with a view to changing the allocation of FSCS costs across firms. This redefinition could take the form of narrower groups than under the current structure; similar-sized groups but with different participants; or broader groups whereby FSCS costs are shared among a larger pool of firms.

2) *Ex ante versus ex post funding*—instead of reallocating costs across firms, a new funding structure could change the allocation of costs over time. Instead of levying firm contributions only when needed to cover the compensation costs of failures that have occurred (ex post), FSCS funding could move to an ex ante system whereby levies are raised on a regular basis and in excess of what is needed in the following 12-month period in order to achieve some degree of smoothing of levies over time and/or build up a reserve based on an expectation of future liabilities.

3) *Tariff base and calculation of levies*—even if current FSCS participation and contribution group structure were maintained, the allocation of costs across firms could be changed by adjusting the tariff base that determines how much a particular firm contributes to meeting FSCS costs.

4) *Other funding sources*—although the focus of the Funding Review is on the structure of FSCS levies imposed on firms, some consideration will need to be given to the other sources of FSCS funding available and options that involve increasing or reducing the role of these alternative sources.

Within the above four main categories, there are numerous elements of funding (or combinations of elements) that could be changed going forward, from moderate changes in one detailed element, to more radical changes that would fundamentally alter the funding structure.

Discussions with industry stakeholders confirmed the broad range of funding options that should be considered going forward (including the option of maintaining the status quo).

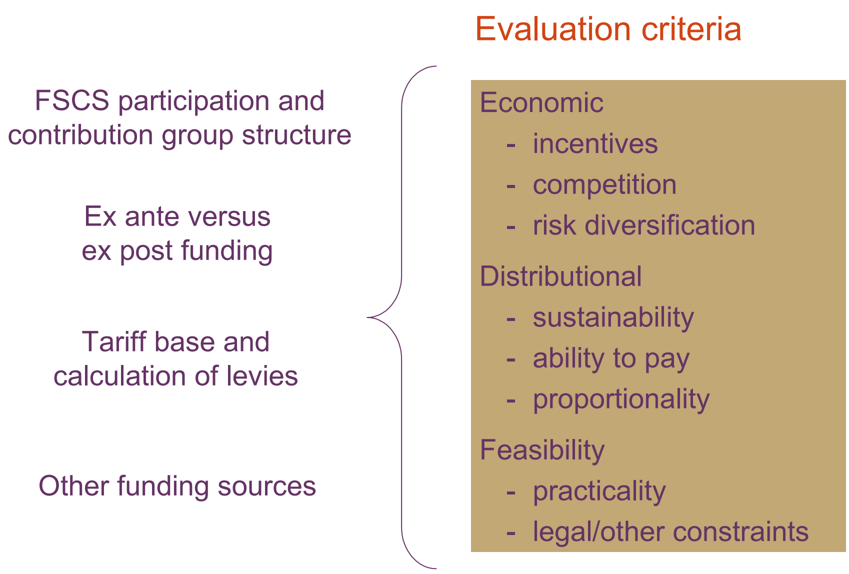
While industry proposals included changes in all the above four categories, the changes related mainly to adjustments to the current contribution group structure, with other changes in general being considered of less importance. The proposals have been, as far as possible, taken into account in the analysis.

The broad range of options for change is also apparent when considering the structure of funding of other schemes that have the same purpose as, or face funding issues similar to, the FSCS. This includes financial services compensation schemes established in countries outside the UK, as well as other protection schemes in the UK set up to cover against losses if participating firms cannot meet their obligations. Appendices 1.1–1.5 provide an overview of funding arrangements of investor compensation schemes established in other EU countries, the deposit guarantee and securities investment protection schemes established in the USA, the Pension Protection Fund (PPF) in the UK, and the Central Fund that covers the members of Lloyd's of London. These alternative structures for scheme funding have been taken into account, where relevant, in identifying and evaluating options for changing FSCS funding.

5.2 Overview of evaluation criteria and implications for funding structure

Given the multitude of potential options for changing the FSCS funding structure, it is important to establish a well-defined set of criteria to allow as systematic and objective an evaluation as possible. For the purpose of the Funding Review, three distinct but related sets of main criteria have been established to facilitate the evaluation. These include economic, distributional and feasibility criteria, as summarised in Figure 5.1. The following explains what is meant by each criterion and how it is interpreted when evaluating different options for the design of the funding structure.

Figure 5.1 Overview of evaluation criteria



Source: Oxera.

5.2.1 Economic criteria

Incentives

According to the incentive criterion, the funding structure should be designed so that it provides incentives for better behaviour of participating firms. In particular, requiring firms to pay for the specific costs they impose on the system provides incentives to reduce excessive risk-taking and other moral hazard problems. It also helps to overcome an externality problem: although firms have a collective interest in preserving the reputation of the industry or a particular business sector, they may base their actions on individual benefits that may work against the collective good. This problem can be overcome by imposing levies on firms that align incentives in the system and induce firms to internalise the costs of their actions on the FSCS and other participating firms.

Compared with the current structure, this criterion would suggest shifting the system towards contributions that are weighted according to the specific risks that firms impose on the FSCS.

Competition
Although a risk-based levy structure may raise market entry costs for some firms, it may also be considered consistent with the competition criterion. This criterion implies that funding should not distort market structure or influence the way in which companies compete. Hence, according to this criterion, firms should contribute to the FSCS in line with the expected costs they impose on the system.

Where the costs of a failure are borne by other firms, the competition criterion suggests the need to impose levies that do not affect the level playing field between firms. Put differently, the contribution group structure should take into account firms that operate in the same economic market (which may not coincide with the permission-based grouping under the current structure).

The criterion does not have to relate only to competition within the UK market. Where FSCS participants compete internationally, levies that are higher than those imposed on firms that compete in the same international market but are subject to a different regulatory regime and compensation framework may inhibit international competitiveness.

Risk diversification
There are economic benefits for participating firms in designing a funding structure that diversifies risks and spreads the costs of compensation across a diverse set of firms and activities. Depending on the nature of risks that are protected by the FSCS and the correlation between those risks, pooling of risks may lower expected costs for participating firms and the variability of levies.

The risk diversification criterion is consistent with introducing broader contribution groups than those currently in place, or, indeed, complete pooling of risks across the FSCS to achieve maximum diversification.

Importantly, the risk diversification argument applies most in relation to random events or risks that cannot be predicted and controlled for by firms. For risks that are specific to firms and controllable, the objectives of improving incentives and neutrality with respect to competition should take priority over risk diversification. That is, in the first instance, firms should pay in line with the expected costs they impose on the FSCS, as this has desirable incentive and competition properties. Where incentive effects fail to work, or where it is not possible to design a funding structure that reflects the specific risks of firms, pooling across risks is desirable from an economic point of view.

5.2.2 Distributional criteria

Sustainability
According to the sustainability criterion, the funding structure must be robust enough to meet the FSCS funding requirement, ensuring that sufficient resources are available for the FSCS to meet its statutory obligations and paying out compensation in accordance with the rules.

The structure must be sustainable going forward, being capable of covering FSCS costs even if the FSCS funding requirement turns out to be different or indeed larger than historical compensation cost levels suggest.

The larger the pool of funds available to the FSCS, the more sustainable the scheme will be. This points towards increasing the number of firms contributing to FSCS costs and defining broader rather than narrower contribution groups. Sustainability could be increased further by building up a standing fund over time to cover the costs of failures that may occur in the future. Furthermore, in addition to firm levies, it suggests the need to have available as many alternative funding sources, improving funding flexibility in particular in cases where firm levies are insufficient to cover costs.

Ability to pay

The sustainability criterion is connected with firms' ability to afford FSCS levies. If the levies imposed on firms, or specific groups of firms, are so high or volatile that they jeopardise the firms' financial viability, further firm defaults and compensation events may be triggered, which would have the counterproductive effect of increasing the FSCS funding requirement in the longer run.

Designing a funding structure around firms' ability to pay suggests broadening the pool of funds and sharing costs as far as possible. It also suggests that the tariff base used to calculate levies should be one that reflects a firm's ability to pay (rather than, say, the risk or expected costs the firm imposes on the FSCS). Ability to pay could also be improved if levies were spread over time rather than raised when needed, although building up a large ex ante fund could have adverse cost implications for firms.

Firms' ability to pay would be less of an issue if levies were set to reflect economic markets, such that all firms competing in the market would be able to raise prices to reflect any cost increases they face.

Proportionality

To the extent that FSCS funding is a zero-sum game, in that FSCS costs must be borne by some party, the issue is how to allocate costs across firms in a way that can be considered fair. There are different interpretations of what fairness means. Given the nature and insurance role of the FSCS, some unfairness is inherent in the system because those firms that cause the costs will never bear the full burden. The 'good' will always pay for the 'bad', but the funding structure can seek to mitigate the degree of unfairness.

A fair funding structure can be considered to be one that adheres to the principle of proportionality. First, firms should be charged FSCS levies in proportion to the expected costs they impose on the FSCS. This is consistent with the risk-based pricing principle discussed in the context of the incentive and competition criteria. Second, where other participating firms need to cover the costs of a firm failure, proportionality is taken to mean allocating costs to firms in proportion to the economic benefits they derive from the existence of the FSCS. These economic benefits may arise, in particular, from the confidence the FSCS promotes in the market, which means that the costs of a particular firm failure should be allocated to those firms that would be adversely affected, through a wider loss in consumer confidence, if the default were not compensated.

There are other dimensions of economic benefit. For example, economic benefits may arise from the ability of firms competing in the same market to take over the business of the defaulting firm and generate income going forward, which means that the costs of a particular firm failure should be allocated to those firms benefiting from the failure. Costs could also be allocated to firms that used to have a relationship with the firm in default and benefited in the past from the existence of those firms.

Allocating costs according to past, current or future economic interests may be considered fairer or more proportionate than other allocations. However, the choice about allocation is ultimately a distributional question for the policy-maker. Concepts of fairness cannot be addressed with economic tools of analysis.

5.2.3 Feasibility criteria

Practicality

The funding structure should be easy to implement and simple to operate, reducing the administrative burden for the FSA, the FSCS and ultimately participating firms.

In terms of practicality, proposals to redefine or narrow contribution groups are likely to cause more significant administrative costs than a system that abolishes any grouping and pools funds. Similarly, the introduction of an ex ante system would raise practical difficulties in terms of managing and investing fund assets that are avoided under the current system. This report discusses some of the main practicality issues, but focuses the analysis on the economic and distributional criteria.

Legality

Legal requirements may restrict the options available for changing the structure of FSCS funding that can be implemented without changing primary legislation. This report does not address legal constraints that may affect the design of the funding structure going forward.

Other

In addition to the constraints imposed by practicality and legality, there may be other factors that restrict the options available for changing the FSCS funding structure. For example, initiatives at the EU level may require changes to UK compensation arrangements. Moreover, there are specific cross-border issues that may affect the design of any national compensation scheme and its funding structure, which may become more relevant as retail markets in financial services become more integrated.[19] No consideration is given to these other constraints.

5.3 Trade-offs between evaluation criteria

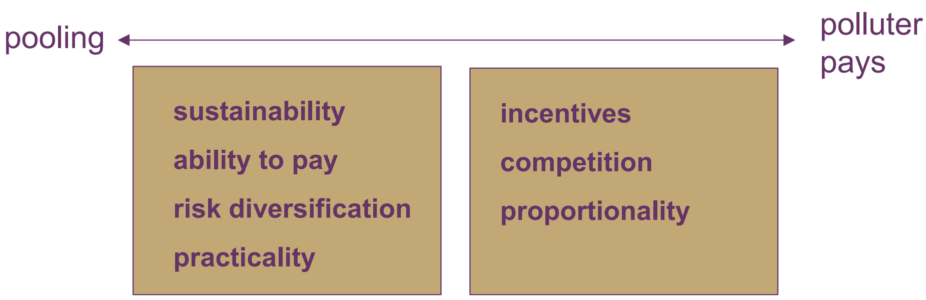
The evaluation criteria outlined above indicate different options for changing the funding structure of the FSCS, and the Funding Review must strike a balance between often conflicting criteria.

There is, for example, an inherent tension between the incentive criterion, on the one hand, and the sustainability and ability to pay criteria, on the other. While the former suggests a funding structure that reflects the specific risks firms impose on the FSCS (what may be described as the 'polluter-pays' principle), the latter indicates the need for a greater pooling of funds and sharing of costs. In other words, firms most likely to impose costs on the FSCS are precisely those with the least resources to pay levies, and relying on levies from the weaker firms may be destabilising and not sustainable in the longer run. Introducing a risk-based levy structure for firms also raises practicality concerns.

Figure 5.2 presents an illustration of some of the trade-offs that need to be considered in the Funding Review. A decision must be made with respect to the ranking or weights given to different criteria. This decision ultimately depends on the objectives determined by policy and regulatory preferences, and cannot be determined by economic analysis alone.

[19] For a discussion of cross-border issues and EU initiatives, see European Commission (2005), 'Review of the Deposit Guarantee Scheme Directive (94/19/EC)', Commission Services (DG Internal Market) Consultative Working Paper on Deposit Guarantee Schemes, July; and HM Treasury, Bank of England and FSA (2005), 'A Framework for Guarantee Schemes in the EU: A Discussion Paper', October.

Figure 5.2 Illustration of conflicting criteria and trade-offs



5.4 Summary of approach to evaluating options

The analysis presented in sections 6 to 8 discusses elements of options for changing the FSCS funding structure. The aim is to identify those elements of options (or combinations of elements) that are likely to best meet the different evaluation criteria.

Some of the criteria are conflicting, and no single option meets all criteria. Deciding on the optimal balance between the criteria is ultimately a matter of policy. Nevertheless, and without unduly restricting the set of options, some views on the ranking of the criteria is necessary to facilitate the analysis in sections 6 to 8 and help narrowing down the options. The high-level principles that have guided the analysis include (but are not restricted to) the following.

– From an economic perspective, it is desirable to design a funding structure that improves the incentives of participating firms, although other (regulatory) tools are available to achieve this. Incentives are improved if firms pay in accordance with the expected cost they impose on the system.

– A risk-based levy structure is also consistent with the competition criterion to ensure that firms cannot gain a competitive advantage by offering services at prices that are lower than those of their less risky competitors.

– However, the benefits of a risk-based structure must be traded off against the objective of ensuring sustainability of FSCS funding, not just with respect to historical losses, but also going forward and taking account of the possibility of larger losses.

– Sustainability means that some consideration must be given to firms' ability to pay levies, bearing in mind that, ultimately, consumers pay the cost of FSCS levies.

– FSCS funding is not a regulatory tool that should be used to resolve problems in the market that could be more efficiently dealt with using other tools (eg, prudential regulation or conduct of business rules).

– At the same time, FSCS funding should also avoid introducing perverse incentives in the system and creating distortions in the competitive structure of the market.

– FSCS costs need to be borne by some party, and any reallocation of costs will have winners and losers. Outside of a system in which firms pay in line with the costs they themselves impose on the system, 'fairness' of allocation is difficult to define objectively and cannot be addressed using economic tools of analysis. In such a system, the allocation of costs is a distributional decision to be made by policy. Allocations that are proportionate to the economic benefits that firms derive from the existence of the FSCS are likely to be considered fairer than others. One such potential benefit is the ability to take business from defaulted firms.

– Practicality is of concern, but should not be the overriding criterion for deciding in favour of a particular option. Nevertheless, some options can be ruled out because they are not feasible or would impose costs that far outweigh the likely benefits.

The discussion in sections 6 to 8 presents the case for and against different elements of options, taking the current funding structure as the benchmark. The qualitative discussion is supported by data analysis that illustrates the financial impact of different funding structures on firms, although data limitations did not always allow quantitative analysis to be conducted to illustrate all impacts.

The analysis has taken into account, as far as possible, the arguments put forward by the industry stakeholders that were consulted as part of the Review. In addition, information was gathered on the funding structure of other schemes in order to inform about options available for changing FSCS funding.

Section 6 considers the elements of options that relate to changing the allocation of FSCS levies between firms. Section 7 sets out the advantages and disadvantages of moving towards a system that introduces a stronger ex ante element of funding than the current system. Section 8 addresses possible changes in the tariff base used to calculate FSCS levies, including risk-weighting of contributions. It also provides a brief discussion of options relating to other sources of FSCS funding.

6 FSCS participation and the contribution group structure

This section examines the options available for changing the current participation and contribution group structure of the FSCS. The aim is to benchmark options against the current structure, using the evaluation criteria set out in section 5 and taking into account specific concerns about current arrangements. As described in section 4, these concerns relate in particular to the permission-based definition of contribution groups, the problems that can arise to the FSCS in attributing failures and costs to these groups, and the sustainability of groups in terms of certain firms' ability to fund group-specific compensation costs.

There are many ways in which it would be possible to reallocate FSCS costs between firms, but there are only two broad directions for change:

- narrowing contribution groups—section 6.1 evaluates arguments for moving towards a structure that narrows existing groups in a way that avoids the current pooling of different firms and activities in the same group;
- pooling of contribution groups—the alternative is to move towards a system where there is greater sharing of costs across firms, with more firms contributing to failures than under the current contribution group structure. Sections 6.2 to 6.5 consider the merits of options that introduce greater pooling.

Section 6.6 assesses some 'hybrid' solutions that contain elements of both the 'narrowing' and 'pooling' options. Section 6.7 provides a summary.

6.1 Narrowing contribution groups

Under the current structure, firms participate in the FSCS according to their FSA permissions and corresponding contribution groups. While practical, objective and easily verifiable, permission-based grouping results in contribution groups with a high degree of diversity in terms of participating firms, implying a cross-subsidy between potentially very different types of firm. Given the nature and purpose of the FSCS, some degree of cross-subsidy is inevitable, but the question is whether a different grouping—based on economic or policy criteria—would deliver preferable outcomes.

6.1.1 The economic rationale behind narrower groups

Narrower contribution groups have conceptually attractive properties if groups are defined such that they contain firms that are homogeneous in the degree of risk they impose on the FSCS. Although the defaulted firms do not pay for the compensation costs they generate (unless funding moves towards an ex ante system, as discussed in section 7), allocating costs to groups of firms that carry a similar risk means that on average and over time firm levies would reflect risk differences between firms. Firms with a certain level of risk would, over time, pay levies equal to the average compensation costs associated with that risk level. As such, narrow risk-based grouping can be seen as an alternative to the risk-weighted levy approach described in section 8.

Making higher-risk firms pay more has desirable economic properties in terms of aligning economic incentives. Any misalignment between FSCS levies and the underlying risk may induce firms to engage in excessive risk-taking and to carry out activities at a price that does not reflect the full cost on the system. If incentives are improved and risks overall mitigated, this also has the desirable property of reducing compensation costs going forward.

It is unclear how far the allocation of compensation costs to a group of similar firms will translate in practice into improved incentives of individual firms within that group. Although firms have a collective interest in keeping the compensation costs of the group low, individual incentives and collective monitoring of firms within the group may not be strong enough. Nonetheless, the smaller the group, the more likely it is to solve problems of collective action and free-riding of individual firms in the group. A narrowing of groups is therefore more likely to deliver improved incentives overall than any of the pooling options described below, which would result in further dilution of incentives.

Narrower groups will result in an increase in compensation costs for some high-risk categories, which may lead to the exit of marginal firms. If the increase is just a reflection of the higher risk that these firms impose on the system then firms unable to cover the costs are not commercially viable and should exit the market. Unduly subsidising such firms would distort the competitive process. At the same time, this exit process will probably lead to a temporary increase in compensation costs, and additional firms might suffer from financial distress as a result of higher levies.

The economic advantages of narrow groups do not apply to just any narrow grouping of firms or activities. Rather, they require a grouping that reflects the specific risks that firms pose on the FSCS. Any wrong grouping would have no benefits in terms of incentives and indeed could lead to distortions in the system, which would be amplified the narrower the groups and the higher the costs that are wrongly imposed on some firms but not others.

The current permission-based grouping is consistent with the fact that different regulated activities have different risk characteristics (eg, fund management activities carry different risks from corporate finance activities). However, it does not reflect risk differences between firms (eg, although banks and IFAs have permission to carry out advisory broking activities, the risk of a well-capitalised bank defaulting is lower than that of an IFA defaulting). The contribution groups therefore capture one dimension of relevant risks, but not others.

Poor definition of contribution groups can have an adverse impact on competition if similar firms that compete in the same economic market are allocated to different contribution groups and pay different levies that do not reflect differences in risk. Firms allocated to the more ‘expensive’ group will have higher costs and be at a disadvantage relative to those in the ‘cheaper’ group. A lack of an effective link between risks and costs may generate a distortion in competition.

There is some indication that the current system categorises similar firms and indeed similar activities into different groups. For example, pension fund management business is undertaken in both life insurance (A4) and fund management (A7) groups, so firms in the A4 and A7 groups are in competition for fund management business and differential levies in the two groups could have an impact on competition in this market. This issue has been addressed in previous consultations by adjusting the tariff base for pension fund management business in the A4 group.[20]

Another example is advisory brokers. Under the current structure, these are separated into contribution groups A12 and A13, depending on whether they have client money permission (A12 and A13). Financial advisors in the two groups engage in the same activity and share similar risks, the main risk being mis-selling of financial products. Failures related to endowment mortgage or precipice bond mis-selling, for example, have occurred in both groups, indicating that competition cuts across the two contribution groups. Financial advisers selling the same product can therefore be levied different amounts (to date, firms in A13 have paid more). Depending on the severity of the differential, this could have a distortionary effect on competition. Thus, although the current funding structure seeks to

[20] FSA (2003), 'Financial Services Compensation Scheme management expenses levy limit and other funding issues', Consultation Paper 209, December.

narrow groups, the narrowing based on the client money distinction does not appear to be the relevant one in terms of risk (in fact, misappropriation of client money can occur in both groups) and indeed could have a distortionary impact on competition. The funding structure could be improved in terms of the competition criterion if narrower but more homogeneous groups of firms in terms of risk were established.

6.1.2 How could narrower groups be defined?

Would it be possible to redefine groups in a way that reflects more closely the specific risks of firms and activities than the current permission-based structure. Is it possible to define homogeneous groups that truly reflect the risks imposed on the FSCS?

There are many dimensions of risk that need to be taken into account. The activities carried out by firms may capture some but not all dimensions. In particular, they do not capture the default risk of firms carrying out the same activity, nor does it capture the product dimension. For example, firms with an advisory broking permission in A12 or A13 do not all provide advice on a product provider commission basis for packaged investment products, and, although negligence can occur in relation to all products, historically failures have been concentrated in specific products.

To capture the default risk dimension, it may be possible to narrow further the current permission-based grouping according to the type of firm and/or the level of the firms' capital requirements or actual capitalisation levels.

The permission-based grouping partly reflects the operational risk dimension, but it may be necessary to narrow down regulatory activities further to capture in full the operational risks associated with different activities, taking into account the firms' business models, internal structures and controls, the nature of the relationship with customers, the type of customers, etc. This would most likely require considerable research since certain types of operational risk (eg, fraud, mis-selling) are generally not well understood and difficult to measure.

Since historical compensation costs have been concentrated in specific products, a case could also be made for a product-specific grouping of firms. That is, only firms involved with the products that gave rise to compensation costs would contribute to meeting the costs, such that higher-risk products would generate higher levies for the firms involved. A variant of this would be the introduction of a product levy, which involves an additional charge on individual transactions at point of sale, which would be paid directly into the FSCS, avoiding levies on individual firms.[21]

A funding structure that takes account of the product dimension is difficult to operate in practice: defining as many contribution groups as retail financial products in the market may not be feasible; innovation would lead to the continual creation of new contribution groups; product definitions can be blurred; information would need to be gathered on each firm's share in the relevant product market; etc. Product-specific grouping may be possible on an ad hoc basis—for example, to cover the costs of widespread failures involving a specific product. Although created for a different transitional purpose, the Pensions Review group (A16) can be seen as an example of this approach, and it may be possible to form similar groups as failures emerge in the future. However, such ad hoc solutions raise their own concerns about complexity. Moreover, these solutions only work where there is a specific product to form the basis for a group, which is not the case in all industry sectors and activities.

Overall, risk-specific grouping raises considerable issues in terms of practicality. There may be no practical solution to capture all dimensions of relevant risks in an adequate way,

[21] The introduction of a product levy was discussed in FSA (1997), 'Consumer Compensation', Consultation Paper CP05, October.

although it may be possible to use proxy measures to redefine and narrow groups according to some risks.

6.1.3 Illustration of financial impact of narrower groups and implications for sustainability

Any narrowing of contribution groups means that the financial impact of the FSCS levy is magnified for firms in those groups where failures arise. While consistent with risk-based pricing, this raises concerns about firms' ability to pay and reduces the financial sustainability of the FSCS. High-risk groups are, by definition, those that are financially weakest, and a point could be reached where further levies cannot be afforded by firms in the narrow group alone, triggering further failures within the group and requiring a wider sharing of costs to allow the FSCS to fulfil its function of paying compensation. If ability to pay and sustainability were the main and only policy criteria, narrowing of contribution groups can be ruled out as an option.

Table 6.1 provides an illustration of the financial impact that would apply if a narrow definition of contribution groups were adopted. Contribution groups A12 and A13 contain a diverse range of firms, grouping financial advisers with other firms that have the permission to advise on or arrange investments. Failures have been concentrated among financial advisers with low levels of capitalisation. What would be the financial impact if financial advisers were separated from other firms and costs allocated accordingly? Table 6.1 models the financial impact of varying levy amounts on three constructed narrow groups of financial advisers: the first contains financial advisers with client money permission (A12), the second financial advisers without client money permission (A13), and the third financial advisers irrespective of whether they hold client money (pooling financial advisers in A12 and A13).

Table 6.1 Illustration of financial impact of levies on narrow 'financial adviser' groups—average levy relative to income (%)

Constructed group	£10m levy	£50m levy	£100m levy
Financial advisers in A12	4.98	24.88	49.75
Financial advisers in A13	0.51	2.55	5.10
Financial advisers in A12 or A13	0.47	2.34	4.68

Notes: The reported ratios are medians for each group. The groups contain financial advisers, categorised using the FSA primary category, excluding other types of firm. The first two groups distinguish between financial advisers with client money permission (A12) and those without client money permission (A13); the third group pools all financial advisers in A12 and A13. The hypothetical levies of £10m, £50m and £100m are allocated to firms in the group according to their tariff data (ie, approved persons) for 2005/06.
Source: FSA data and Oxera calculations.

The first constructed group is the smallest in terms of number of participating financial advisers—even the relatively small levy that would need to be raised to cover the compensation costs of a £10m failure in that group would have a significant impact on firms (on average, 5% of income). The third group is the largest, as it pools across all financial advisers, irrespective of whether they hold client money. However, even that group may find it difficult to fund larger failures or the costs of many failures.

Moreover, the 'financial adviser' group may not be considered narrow enough. It only groups firms according to their primary activity, failing to take into account the risk differences that exist between different advisers (eg, product-specific risks, capitalisation levels, etc). Further narrowing would make the sustainability problem even more apparent.

The example illustrates the general sustainability problem of narrower groups, and is not specific to financial advisers. While some of the current contribution groups could be further divided without jeopardising the financial viability of firms in the group (see the results in section 4), there will always be a point at which a group may not be able to sustain itself if failures turn out larger than those observed to date. The question therefore is how to design groups that are reflective of the underlying risks, yet large enough to ensure sustainability.

6.2 Pooling along the vertical chain

Instead of narrowing contribution groups, the funding structure could be changed to a system where there is greater pooling and sharing of costs between firms. There are many ways in which current funding pools could be enlarged, one of which involves pooling along the vertical chain of industry relationships.

6.2.1 Examples of vertical sharing of costs

Although the current funding structure does not explicitly recognise vertical links between firms, there are, or have been, examples of a vertical sharing of costs in the retail investment sector, where product providers which use IFAs as a distribution channel contributed substantially to the funding of IFA compensation liabilities. Before N2, IFAs received a direct subsidy from product providers of 85%. Supporting the subsidy was mandatory for all product providers who did business in the IFA market, with their respective shares being based on IFA business volumes. The direct subsidy was not carried forward to the FSCS funding rules, with the exception of the ring-fenced Pensions Review group (A16), where product providers continue to contribute to compensation payments.

The industry did, however, set up a voluntary cross-subsidy agreement whereby product providers subsidised IFAs in relation to the FSCS levies in contribution groups A12 and A13. At the outset of the voluntary scheme in 2002, it was always intended that the scheme would operate for a limited three-year horizon to provide support to IFAs over a difficult period and in the run-up to depolarisation. Total subsidies paid by a group of ABI members amounted to about £3m (around 85%) in 2002/03 and 2003/04 and £4.5m (around 27.5%) in 2004/05.[22] Providers had planned to cap the final year's subsidy at 15% in 2004. However, this coincided with a significant rise in the FSCS levy, so ABI members agreed an additional subsidy of £1.5m (bringing the total to £4.5m).[23]

These arrangements provide examples of what is meant by vertical pooling. While provider subsidies present a specific form of 'one-way' pooling, costs could also be shared both ways—eg, by creating a contribution group comprising product providers and distributors. Subsidies could also go beyond the life insurer/IFA arrangements observed in the past to include other vertical relationships in the industry.

6.2.2 The rationale behind vertical pooling

The main argument for introducing vertical pooling is in terms of ability to pay and sustainability, and applies in particular to concerns that the IFA sector may not be self-sustaining and able to meet the costs of compensation that arise. This sector is at the end of the distribution chain, exposed to claims related to product mis-selling, and in general poorly capitalised. IFA failures have been frequent and have generated a substantial portion of compensation costs for both the FSCS and its predecessor. Concerns about IFAs' ability to pay compensation costs have been discussed in many previous consultations on compensation scheme funding. The subsidy paid from large to small firms (ie, from product providers to advisers) was seen as a tool to maintain a robust IFA sector and enhance competition and consumer choice in the market. This was considered particularly important given that the IFA sector, unlike other business sectors, was not normally able to pass the costs of levies on to its customers through charges.

[22] Information provided by the Association of British Insurers (ABI) and the Association of Independent Financial Advisers (AIFA).
[23] In addition, a number of ABI members provided subsidies to assist IFA contributions to their FSA fees.

The case for vertical pooling does not rest on ability to pay only; the pooling option also has merits in terms of the incentive and proportionality criteria. As regards incentives, although sharing of compensation costs by providers may weaken incentives on the distribution side, vertical pooling may have a positive effect on monitoring incentives along the vertical chain of relationships. In particular, knowing that they will have to share in the cost of mis-selling by advisers, providers may have a stronger incentive to select the channel through which they distribute their products.

Monitoring incentives may also work the other way (ie, with distributors more carefully monitoring and selecting the providers from which they choose products), so there may be a case for two-way pooling of costs rather than a one-way subsidy. However, the latter may appear more intuitive considering the 'deeper pockets' of product providers.

Other arguments for vertical pooling relate to the proportionality criterion. That is, pooling of firms that are commercially connected along the vertical industry chain may be considered 'fairer' than other forms of pooling for at least three reasons:

- product providers that do not own a distribution network have a direct interest in the stability of the distribution sector to protect their sale;
- shared responsibility may be considered fairer in cases where it is difficult to determine whether the failure and resulting compensation claims resulted from bad advice or product design;
- if confidence relates to products rather than just distribution activities, all firms along the vertical chain have an interest in maintaining consumer confidence in the products manufactured and distributed by the chain, and hence all firms should pay for this benefit.

6.2.3 Illustration of financial impact—provider subsidy and two-way vertical pooling

Figure 6.2 illustrates how a provider subsidy would alleviate the financial impact of FSCS levies for financial advisers in contribution groups A12 and A13. The subsidy is assumed to be at levels that applied, approximately, under the previous voluntary subsidy paid by ABI members to IFAs in the two groups. For example, without the subsidy, the FSCS levy paid by financial advisers in A13 amounted to 1.6% of income in 2005/06. Net of a 25% or 85% subsidy, the impact would have been correspondingly lower. The total costs to product providers would have amounted to an estimated £7.5m and £25m, respectively.

Table 6.2 Illustration of financial impact of provider subsidy to financial advisers

Constructed group	2005/06 levy	Net of 25% subsidy	Net of 85% subsidy
Financial advisers in A12: median levy in relation to income (%)	0.31	0.23	0.05
Financial advisers in A13: median levy in relation to income (%)	1.60	1.20	0.24
Implied amount of provider subsidy (£m)		7.5	25

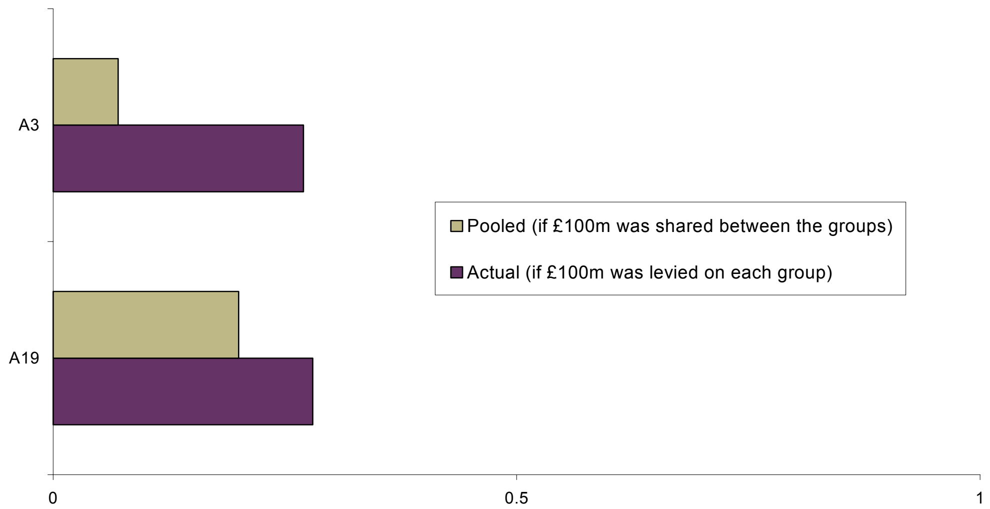
Notes: The table shows the actual 2005/06 levy in relation to income for financial advisers in A12 and A13, and the levy to income ratio after deducting a subsidy, assuming first a 25% and then an 85% subsidy. The amount of provider subsidy is estimated by applying the percentages to the total levies paid by financial advisers in the sample. Financial advisers are classified using the FSA primary category.
Source: FSA data and Oxera calculations.

Figure 6.1 illustrates the financial impact of a different vertical pooling arrangement. Instead of a one-way provider subsidy paid to financial advisers in the investment sub-scheme, it provides an illustration of two-way pooling in the general insurance market—ie, pooling general insurance providers in A3 with insurance intermediaries in the new contribution group A19. The rationale for adopting such a pooling in general insurance is the same as that outlined for the retail investment market above.

Figure 6.1 illustrates how the financial impact (measured in relation to income) could be reduced if an FSCS levy of £100m were shared between A3 and A19 rather than borne by one of the groups alone. For modelling purposes, under the pooling scenario, costs have been shared in proportion to the FSA fees paid by the groups. Any other method of sharing costs would yield different results.

Ability to pay in A19 appears to be less of a concern than among financial advisers in A13, with a £100m levy requiring the average firm to pay 0.3% of income. Moreover, many general insurers in A3 already participate in A19 because they have a broking permission and hence pay part of the levy even under current arrangements. Nonetheless, the financial impact could be reduced if the A19 levy were shared more widely. Given the two-way pool, the impact would also be lower if a £100m failure occurred in A3 and was shared between both A3 and A19.

Figure 6.1 Illustration of financial impact of £100m levy relative to income (%)—pooling between A3 and A19



Notes: The reported levy-to-income ratios are medians. 'Actual' refers to the FSCS levy under the current group structure, assuming a £100m levy for firms in each group. 'Pooled' results are obtained by sharing a single £100m levy between A3 and A19, in proportion to the total FSA fees paid by firms in the group. Within each group, the levy is allocated according to firms' 2005/06 tariff data.
Source: FSA data and Oxera calculations.

6.2.4 Limitations of the vertical pooling approach

The vertical pooling model requires identification of the different chains of vertical relationships in the industry. While this may be straightforward in some cases (eg, IFAs selling specific packaged investment products on a commission basis for product providers), it can be much more difficult where market structures are characterised by a complex net of links between firms.

The provider subsidy that used to be in place to assist IFAs (and that still exists in relation to Pensions Review payments) involved payments by life insurers that also participate in contribution group A4. While this group of firms includes the relevant providers of some products, IFAs sell products of other providers (eg, CIS). Thus, even in the case of IFAs, there is a question of how to define the relevant product provider. Moreover, IFAs can engage in services that are not product-specific (eg, financial planning), in which case the notion of 'product provider' loses some relevance.

These issues could become more important as depolarisation changes the advisory sector. Some firms may focus their business on advising and arranging packaged products, whether through a multi-tied or whole-of-market offering; others may adopt a business model that focuses on financial advice and planning. The vertical pooling approach in the form of a provider subsidy would be less suitable in an evolving market where there is less focus on packaged products and where other firms, such as fund managers and CIS operators, increasingly receive business from IFAs.

If a provider subsidy were introduced to assist IFAs (or indeed any other narrowly defined set of firms), account would need to be taken of the fact that the recipients comprise only a sub-set of an industry group which contains other firms undertaking similar activities. To avoid anti-competitive effects, the subsidy arrangements may therefore need to include other firms operating in the same economic market. A related point is that not all product providers sell through a network of IFAs, raising potential competition issues between different providers and distribution channels.

A sharing of compensation liabilities by product providers, no matter how these are defined, would mitigate the financial impact of FSCS levies on IFAs. However, it is not clear why the IFA sector should be singled out as the only beneficiary from vertical pooling. If there are more fundamental concerns about the level of IFA compensation liabilities and their financial capacity to pay required levies, there may be other, more efficient ways of addressing these concerns in the longer run than a provider subsidy.

If vertical sharing of costs were introduced for one segment of the industry, consistency may therefore require application of the same principle for all parts of the FSCS. The practical difficulties of determining who is the relevant ‘provider’ or what is the relevant vertical chain, however, become even more apparent when it comes to failures of other firms. Consider, for example, the failure of a fund manager in A7 who manages portfolios for private customers consisting of pension products, unit trusts, bonds, etc—all ‘provided’ by different manufacturers in transactions with different intermediaries. Similarly, in the general insurance market, it is not obvious which party is the relevant provider, given the many intermediaries that can be involved in a single general insurance contract sold to the end customer, including firms in the general insurance market which are currently not required to participate in the FSCS because they have no direct retail business.

The definition of the relevant vertical chain of relationships raises the wider issue about whether firms should be participating in the FSCS with respect to their wholesale business. Under the current structure, firms that carry out business exclusively for wholesale clients are not required to participate in the FSCS, other than through contributions to the base costs of the FSCS management expenses. Firms that have some retail business are required to participate, but the amount of levies they pay in general reflects the volume of their retail business only, excluding business conducted for wholesale clients. What is the case for extending contributions to the wholesale sector?

Using the economic criteria, the case looks weak. Wholesale firms do not impose a direct cost on the FSCS; they also operate in different economic markets. Moreover, the further away in the vertical chain from those firms that cause FSCS costs, the less scope or incentive there is to affect their behaviour. Importantly, given the international nature of the UK wholesale sector, making such firms contribute to the costs of failures in the retail market may also adversely affect their international competitiveness, depending on the amounts that would be levied.

The case for making wholesale firms contribute largely rests on distributional motives: extending the pool of funds available improves funding along the ability to pay and sustainability criterion. It may also be considered proportionate. In particular, if there are wider market confidence benefits and if wholesale firms benefit from a strong UK retail sector, it could be seen as only fair if they were to make a contribution to meeting FSCS costs. Analysis would be required to ascertain whether and how market confidence benefits flow through the system.

6.3 Pooling within and across the investment sub-scheme

Under the current funding structure, the investment sub-scheme is divided into six contribution groups plus the temporary ring-fenced Pensions Review (A16) group. One option would therefore be to pool within or across the investment sub-scheme. This could involve limited pooling of specific groups within the sub-scheme, or complete pooling across the sub-scheme.

6.3.1 Limited pooling within the investment sub-scheme

As regards limited pooling, a case could be made for pooling firms participating in the advisory broker groups A12 and A13. Firms in the two groups engage in similar activities and have in the past paid levies to cover the costs of mis-selling in relation to endowment mortgages, precipice bonds, and other products. As discussed above, the client money distinction between the two groups may not be the relevant one in terms of FSCS risks since client losses from misappropriation can occur in both groups, irrespective of whether a firm has permission to hold client money. The larger pool of advisory brokers would also improve funding sustainability and alleviate the impact of levies on individual firms in the group, in particular A13, which comprises a larger proportion of small financial advisers than A12.

Another limited pooling option would be to create a single contribution group of fund managers and operators of CIS, combining all or parts of the A7 and A9 groups into one. The underlying activities may be considered sufficiently similar to remove the need to distinguish between them.[24] There is also already a high degree of cross-participation between the two groups, with 27% of firms in A7 participating in A9 and 86% of firms in A9 participating in A7.[25] This means that many firms already have a stake in both funding pools. In addition, pooling A7 and A9 may have practical advantages for the FSCS in cases where it is difficult to attribute failures to one group or another and a decision about where the legal liability lies is required by reference to the activity giving rise to the claim. Moreover, as discussed in section 4, there are concerns about the sustainability of the A9 group in terms of its ability to cover the costs of larger failures. These would not apply under a single ‘asset management’ pool.

6.3.2 The rationale behind investment sub-scheme pooling

Instead of such limited pooling, it would be possible to take the sharing of compensation costs a step further and create a single pool of funds for the investment sub-scheme. Effectively, this would move the FSCS to a system with six funding pools corresponding to broad economic markets—investment, life insurance, general insurance, insurance intermediation, deposits and mortgage advice—although further pooling across these sub-schemes is also conceivable and discussed further below.

One key advantage of widening the pool of contributing firms is that it improves the sustainability of FSCS funding, spreading costs more widely and reducing the financial impact on individual firms.

On the downside, pooling weakens incentives since those firms that cause, or are likely to cause, more costs make lower contributions—ie, any form of pooling moves the structure further away from one where levies reflect the specific risks that firms pose on the FSCS. Arguably, however, such incentives are in any case not very strong, in particular as contributions cannot be fine-tuned to reflect in full the risks of firms and their activities.

[24] This was discussed in early consultations before the FSCS was established. FSA (1999), ‘Consumer Compensation: A further consultation’, Consultation Paper 24, June.
[25] Oxera calculations based on 2005/06 FSCS participation data provided by the FSA.

While, from an economic point of view, it is desirable to make firms contribute in line with their specific risks, there are common risks or risks that are not controllable by firms that are more efficiently dealt with through pooling. Risks that cannot be diversified (eg, common risks) should be pooled. The question here is whether it would be possible to separate out and measure specific risks, and make firms contribute directly for those, while pooling common and undiversifiable risks. Such a two-tier system, where firms or groups of firms pay for their specific risks while common risks are pooled, may be difficult to operate in practice.

If narrow risk-reflective groups cannot be defined and if positive incentive effects are in any case limited (or are achieved by other regulatory tools), the economic case for pooling is strong. Pooling means risk diversification—it would lessen the exposure of each group to risks, thereby reducing volatility and, on average, lowering levies.

In this context, it is also interesting to note that the contribution group structure within the investment sub-scheme is unique to the UK. Other EU countries have established investor compensation schemes in accordance with European requirements, but these do not draw a distinction between different types of investment business.[26] Rather, all investment firms contribute to the same pool of funds, irrespective of their activities. The issue of pooling may be less contentious in other EU schemes due to differences in market structures and, importantly, the fact that financial advisers are generally not required to participate in the compensation scheme and no compensation is provided for losses relating to negligent advice and mis-selling. The other EU compensation schemes only protect against the risk of fraud and misappropriation of client assets. These risks are common across all firms, making a case for pooling, at least for these risks, that applies for the international comparators as much as it does for the FSCS. However, the differences in market structure and scope of the UK and other EU schemes render further comparison difficult.

Removing the current contribution group structure and creating a single investment pool can also be considered practical. For example, from the perspective of the FSCS, there would be no need to identify the activity associated with a particular firm failure in order to attribute costs to a specific group or across groups if more than one activity is identified.[27] As already discussed in section 4, firms participate in more than one contribution group depending on their permissions, and this cross-participation is particularly prominent within the investment sub-scheme. For example, as summarised in Table 6.3, 48% of fund managers in A7 also participate in the advisory broker group A12. In addition to the practical difficulties this may impose on the FSCS, cross-participation also means that many firms in the investment sub-scheme already have an economic interest in more than one of the separate funding pools.

Table 6.3 Distribution of multiple participation in contribution groups, 2005/06 (%)

	A7	A9	A10	A12	A13	A14
A7	100	26	12	48	15	15
A9	86	100	9	38	10	20
A10	51	11	100	75	14	37
A12	52	12	20	100	4	18
A13	3	1	1	1	100	2
A14	27	10	15	29	20	100

Note: The table shows the percentage of firms in contribution group X (row) that also participate in contribution group Y (column) in 2005/06.
Source: FSA data and Oxera calculations.

[26] See Appendix 1.1.

[27] From a practicality point of view, the main disadvantage would be the need to identify and collect data on a common tariff base for firms in the investment sub-scheme (discussed in section 8).

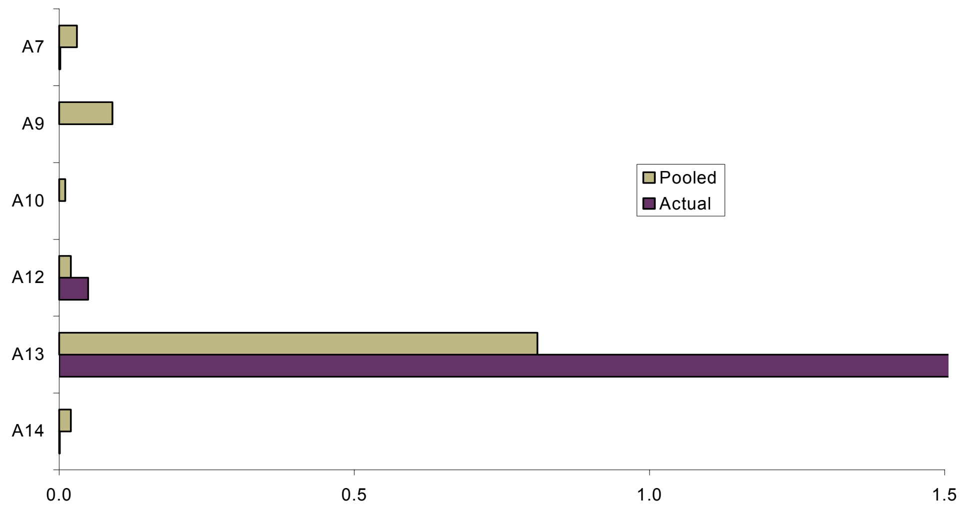
Pooling across the investment sub-scheme may also be consistent with the proportionality criterion, provided that investment firms derive collective benefits from market confidence. If benefits are concentrated around single products or business activities, wider pooling could be considered disproportionate or unfair. However, if the benefits of market confidence are diffused over the whole investment market, rather than concentrated around single products or activities, the proportionality argument would hold. It is likely that the benefits cannot be generalised and depend on the specific case of failure. For example, the implications of mis-selling of a particular product may be very different from those of a major case of fraud—the former is more likely to trigger losses in confidence in that product, whereas the latter may make consumers reluctant to transact with a particular type of firm. The benefits also depend on the scale and frequency of a failure, with large and widespread or recurring failures more likely to have wider implications for market confidence than smaller one-off failures. Further research would be required to understand the benefits of financial compensation and the way in which compensation events affect market confidence.

6.3.3 Illustration of financial impact—pooling across the investment sub-scheme

Figure 6.2 provides an illustration of the financial impact of the investment pooling option. It shows the impact of the 2005/06 FSCS levy, relative to income, allocated under current funding arrangements (as in section 4) and compares it with what the impact might have been if the levy had been shared across all groups. For modelling purposes, the levy has been reallocated between groups in proportion to the FSA fees paid by each group.

The main effect of pooling would have been to reduce significantly the financial impact for firms in those groups where levies have been concentrated in 2005/06 (ie, A12 and A13), but at the expense of the other groups. The other groups would also benefit from pooling in the event of firm failures in their group, such as in the loss scenarios described in sections 3 and 4.

Figure 6.2 Illustration of financial impact of 2005/06 levy relative to income (%)—pooling across investment sub-scheme



Notes: 'Actual' levy refers to the FSCS levy paid by group in 2005/06. The reported levy to income ratio is the median for each group. 'Pooled' results are obtained by spreading actual 2005/06 levies across all groups, in proportion to the total FSA fees paid by firms in the group. Within each group, levies are allocated according to firms' 2005/06 tariff data.
Source: FSA data and Oxera calculations.

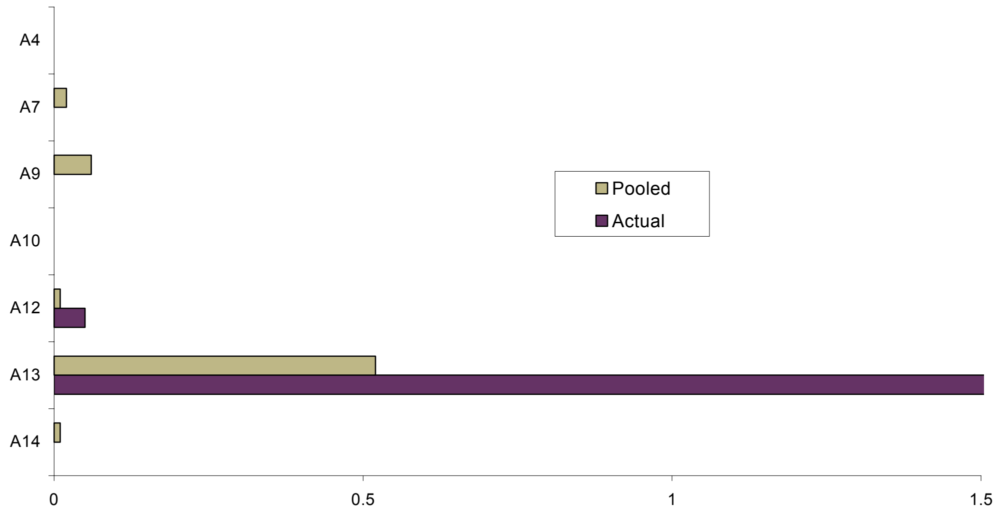
6.4 Pooling across the investment sub-scheme and including life insurers

This option takes investment sub-scheme pooling one step further and includes life insurers (A4) in the pool. This recognises the fact that many life insurance products can be considered to be in the same broad economic market as other retail investment products. The option would thus create one pool of funds to cover the broadly defined long-term retail savings and investment market in the UK.

Including life insurers in the pool also recognises vertical links between firms in the investment sub-scheme and the life insurance group, and thus contains elements of the vertical pooling option described above in section 6.2. All 'product providers'—whether life insurers, CIS operators, or others—would contribute to the compensation costs arising on the distribution side. This would ensure consistent treatment of different product providers and overcome some of the practical problems that characterise the 'pure' vertical pooling solution.

The financial impact of this extended pooling option is illustrated in Figure 6.3. With life insurers taking their share, the impact of the 2005/06 levy on firms in contribution groups A12 and A13 would have fallen further compared with the current arrangements and the investment pooling option described in Figure 6.2 above. Given the total amounts of funding required in 2005/06, the share of the levy that would have to be borne by life insurers would have had a negligible impact on the firms. It would also be small for the other groups in the investment sub-scheme. The broad pooling option therefore has attractive properties in terms of ability to pay and long-term funding sustainability, with the disadvantages being those that generally apply to any option that involves moving away from the narrow risk-reflective grouping.

Figure 6.3 Illustration of financial impact of 2005/06 levy relative to income (%)—pooling across investment sub-scheme and A4



Notes: 'Actual' levy refers to the FSCS levy paid by group in 2005/06. The reported levy to income ratio is the median for each group. 'Pooled' results are obtained by spreading actual 2005/06 levies across all groups, in proportion to the total FSA fees paid by firms in the group. Within each group, levies are allocated according to firms' 2005/06 tariff data.
Source: FSA data and Oxera calculations.

If life insurers were pooled with firms in the investment sub-scheme, general insurers (A3) could be pooled with general insurance intermediaries (A19) using the same rationale and to ensure consistent treatment. The FSCS funding structure would then involve pooling firms or activities according to a broad commonality of markets—ie, long-term savings and investment (A4 and A7 to A14), general insurance (A3 and A19), deposits (A1) and mortgage advice (A19). There is the possibility of further pooling the latter two sub-schemes, although deposit-taking and mortgage advice may be considered sufficiently distinct markets, even from the perspective of consumers who may use the same bank or building society to provide the two types of service.

6.5 Pooling across the entire FSCS

Sustainability could be further improved, and the financial impact on individual groups of firms reduced, if the pool were extended to include the entire FSCS—ie, there could be a single pool of funds to cover all compensation costs in the UK retail financial services industry.

Arguments for complete pooling are weaker. For example, the case for pooling across the investment sub-scheme partly rests on the fact that it may be difficult to define groups within the sub-scheme that reflect both the risks of participating firms and the economic markets in which they operate. The deposit-taking and the investment sub-schemes, however, seem sufficiently distinct to draw a line between them. Moreover, as the financial impact illustrations above have shown, many concerns about ability to pay and sustainability are largely dealt with by the more limited pooling options.

There is some international precedent of pooling between deposit-taking and investment activities, but most schemes in the EU as well as in the USA draw a distinction and operate separate deposit guarantee and investor compensation schemes (see Appendix). Also, most EU countries do not at present provide compensation for the other activities covered by the FSCS, so the question of complete pooling between deposit-taking, investment, insurance, and mortgage business does not arise.

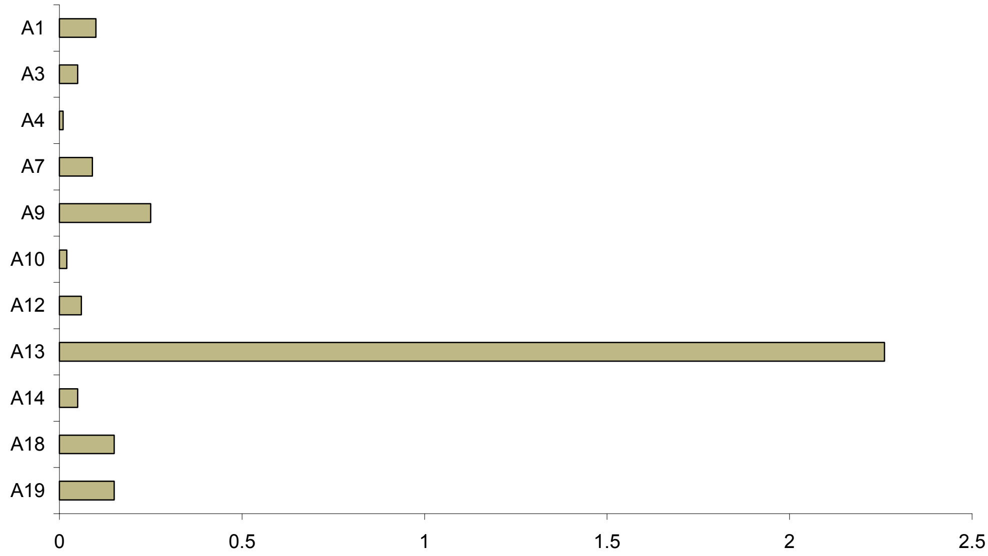
Complete pooling may be considered practical—any compensation costs that arise would simply be funded from a single pool of funds. Moreover, some firms such as the banks in the deposit sub-scheme already participate and contribute to the cost arising in other sub-schemes, as was described in section 4.

Complete pooling may also be consistent with a broad view of a single UK market in retail financial services—ie, all participating firms have a certain commonality of interest in ensuring confidence in the ability of the financial sector to compensate consumers in the case of insolvency. This argument may have particular merits when considering the impact of very large failures that are more likely to have wider market confidence implications.

Figure 6.4 illustrates the financial impact of FSCS levies on firms, assuming that the cost of a larger failure (£400m) would be spread across all FSCS participants. The £400m levy is allocated to firms using the existing contribution group structure, with each group paying in proportion to its share of FSA fees paid in 2005/06. Other allocations are possible, and the chosen method was adopted for modelling purposes only. As discussed in section 8, pooling may raise practical difficulties as it requires identification of a tariff base that is common for all firms, or some other means of allocating levies across firms in the pool.

If a £400m failure were to be funded under the current structure and hence allocated to the single group in which the failure had occurred, the financial impact would be significant for some groups, as was illustrated in section 4. For example, the average firm in A9 would have paid more than 12% of income (as reported in Table 4.6); but under the pooling model shown in Figure 6.4, the impact falls to less than 0.5% for firms in A9 as the levy is shared by other groups. This illustrates again that one of the main advantages of pooling relates to ability to pay and funding sustainability—spreading costs reduces the exposure of individual firms or groups to risks, and limits the financial impact if failures occur.

Figure 6.4 Illustration of financial impact of a £400m levy relative to income (%)—pooling across the entire FSCS



Notes: Pooled results are obtained by spreading the cost of £400m across groups, in proportion to the total FSA fees paid by firms in the group. Within each group, levies are allocated according to firms' 2005/06 tariff data. The average levy to income ratio is the median for each group.
Source: FSA data and Oxera calculations.

6.6 Hybrid solutions—pooling thresholds or risk adjustments in the tariff base

The pooling options described above have a number of attractive properties. Importantly, they reduce the financial impact of levies, in particular for the weakest firms, and hence enhance sustainability of FSCS funding. At the same time, greater pooling means losing desirable incentive properties. It may also be seen as inconsistent with the principle of proportionality and notions about fairness.

There are two main approaches to deliver a funding structure that presents a compromise solution to these trade-offs, as follows.

– *Pooling thresholds*—costs are first allocated to the narrowly defined group in which the failure arises, but only up to a threshold. Once the threshold is reached, costs are spread more widely across other groups. There could be a single threshold beyond which pooling takes effect, or several thresholds, with the pool of contributing firms expanding as the size of the failure increases.

  This approach recognises that firms should not avoid liability altogether with respect to the compensation costs their activities impose, or are expected to impose, on the FSCS. At the same time, it recognises that some sharing of risks and costs may be required from the ability to pay and sustainability perspective. The concept of an expanding net is also consistent with the view that the larger the failure, the more likely it is that the market confidence benefits of compensation apply more widely than in the group in which the failure arises.

  A funding structure whereby costs are shared once a threshold is reached existed under the early ICS funding arrangements (until 1994)—each self-regulatory organisation (SRO) contributing to the ICS paid towards its own costs up to a capped level beyond which cross-contributions between SROs are instigated.[28] The principle also applied

[28] Securities and Investments Board (1994), 'Investors Compensation Scheme Funding', Consultative Paper 79, February.

under previous subsidy arrangements paid to IFAs (and still applies in relation to Pensions Review payments)—ie, product providers shared responsibility, but IFAs were required to fund the initial amount of levies entirely.

A system of pooling with thresholds could be built around the current definition of contribution groups, or could be introduced with a different and potentially narrower definition of groups, taking account of the discussions in section 6.1. Pooling can be done vertically (section 6.2), across broad markets (sections 6.3 and 6.4) or covering the entire FSCS (section 6.5), and policy decisions would be required about what type of pooling is desired.

– *Risk-adjusting the tariff base*—within a broad pool, the tariff base is adjusted to reflect risk differences between firms or activities. Thus, firms that impose, or are expected to impose, a greater cost on the FSCS pay a larger proportion of levies, but all firms in the pool make some contribution to meeting compensation costs. The degree to which levies are based on risk can be adjusted, as considered appropriate, to take account of concerns about ability to pay. For example, it would be possible to introduce a combination of flat-rate and risk-weighted contributions, such as the approach proposed for funding the PPF where not all but 80% of the levy is based on risk.[29] Risk-weighted contributions are further discussed in section 8.

Both options are conceptually attractive because they provide a means of differentiating between firms. This could limit distortions that might arise from pooling firms with different risk characteristics without differentiation.

The options do, however, raise important practicality and implementation issues, which would require further analysis. For example, the expanding net option requires a setting of thresholds beyond which costs would be pooled. This requires decisions about the appropriate trade-off between ability to pay and incentive/fairness, although it may be possible to set ad hoc thresholds that are considered most practical (eg, by implementing a rule which triggers pooling once firms in a particular group have paid FSCS levies that exceed the group’s FSA fees by some fixed factor). Risk-weighting also raises practical difficulties in terms of identifying and measuring firms’ risk, as further discussed in section 8.

6.7 Summary

There are alternative structures for allocating costs across firms, which can be designed to meet different evaluation criteria and improve upon the current permission-based contribution group structure accordingly. However, there are trade-offs, and the choice between options is ultimately a matter for policy, depending on the weight given to the various evaluation criteria and underlying policy objectives.

Pooling options are attractive from an ability-to-pay and sustainability standpoint, but raise concerns about distorting incentives; they also have distributional implications that may be considered unfair. That said, no pooling might be considered unfair by some if it implied that firms were able to benefit from the activities (eg, distribution of financial products) of other firms without proportionately contributing to costs. Narrower groups have desirable economic characteristics if designed to reflect underlying risks.

Compromise solutions could be achieved through a mix of options that improve upon the current system by introducing greater pooling, while differentiating between firms in a way that reflects the risks that firms or activities impose on the FSCS. While conceptually attractive, further analysis would be required to determine whether implementation of these is feasible.

[29] See Appendix 1.4.

7 Ex ante funding

The FSCS is funded on a pay-as-you-go basis. Firm levies are set on the basis of expected compensation costs, although there is no requirement for the levy to be equal to expected compensation costs in any particular year as other limited sources of funding exist (for example, recoveries).

This structure could be changed by introducing a stronger element of pre-funding, whereby levies are set not only to account for actual compensation costs or those expected to arise within the immediate future, but any compensation costs that *might* arise. The main objectives for introducing an ex ante fund could differ. For example, the principal objective could be to provide a source of finance if a large failure, which would otherwise threaten the financial viability of the contribution group or the scheme itself, occurred. However, a greater element of pre-funding could be introduced with the view to smoothing fluctuations in levies over time.

This section provides a discussion of the ex ante funding option.[30] It sets out the international precedent for ex ante funding and then describes the advantages and disadvantages of such a funding structure against the evaluation criteria set out in section 5.

7.1 Precedent set by other compensation schemes

There is considerable international precedent of ex ante funding. Table 7.1 categorises deposit guarantee and investor compensation schemes established in the EU 15 and the USA according to whether they have a strong element of pre-funding.[31] One of the advantages of an ex ante system is that it facilitates the levying of risk-weighted contributions, so Table 7.1 also indicates whether risk-weighting is in place.

The majority of international schemes reported are pre-funded and levy regular annual contributions from firms. Ex ante funding has also been the preferred system of funding among the ten new EU Member States.[32] Risk-weighting is common among the deposit guarantee schemes, but not for investor compensation.

Although ex ante funding is common, there are considerable international differences in the size of the standing fund and operation of the ex ante system. For example, many of the EU ex ante schemes to compensate investment claims have standing funds amounting to less than €10m. The Irish investor compensation scheme had a target reserve of €20m to be reached by July 31st 2007 but, due to larger than expected failures, has already recognised that it may take longer to establish this reserve.[33] The size of Belgium's standing fund was €639m at the end of 2003, and was the largest among all EU investor compensation schemes, but this fund was used to pay for both investor compensation and deposit guarantee claims.

[30] The issues are also discussed in Roy, J. (2000), 'A preliminary analysis of deposit insurance funding issues', paper prepared for the International Association of Deposit Insurers; and HM Treasury, The Financial Services Authority and the Bank of England (2005), 'A framework for guarantee schemes in the EU: A discussion paper', October 2005.

[31] The EU 15 refers to the Member States of the European Union before its expansion in membership to 25 countries on May 1st 2004.

[32] These are not reported in the table but described in Oxera (2005), 'Description and assessment of the national investor compensation schemes established in accordance with Directive 97/9/EC', Report prepared for European Commission (Internal Market DG), January.

[33] The Investor Compensation Company Limited (2005), Annual Report, p. 11.

The standing reserves of the US Federal Deposit Insurance Corporation (FDIC) exceed $44 billion. The reserves' target is fixed as a proportion of insured deposits (1.25%).[34] When reserves exceed this, as they do at present, deposit premiums may be low or even zero for most participating companies. Should the reserve ratio fall below the required 1.25%, the FDIC must raise premiums to bring it back to the minimum within a year, or must charge at least 23 basis points until the reserve ratio meets the requirement. If it is not brought back to the ratio within a year, the FDIC must establish a schedule to return it to the required minimum within 15 years.

Table 7.1 Prevalence of ex ante funding in international compensation schemes

	Deposit guarantee		Investor compensation	
	Ex ante	Risk-weighting	Ex ante	Risk-weighting
Austria				
Belgium	✓		✓	
Denmark	✓		✓	
Finland	✓	✓	✓	(✓)
France	✓	✓	✓	✓
Germany	✓	✓	✓	(✓)
Greece	✓		✓	
Ireland	✓		✓	
Italy		✓		
Luxembourg				
Netherlands			✓	
Portugal	✓	✓	✓	
Spain	✓		✓	
Sweden	✓	✓		
USA	✓	✓	✓	

Notes: The funding of investor compensation schemes in the EU 15 is summarised in Appendix A1.1. The classification of EU deposit guarantee schemes is based on National Bank of Poland (2005), 'The Polish deposit insurance system compared to arrangements adopted in other EU countries', Paper No. 34. Funding arrangements in the US schemes are described in Appendices A1.2 and A1.3.

7.2 Evaluation—a large standing fund

A large standing fund has clear advantages. Once in place, it provides the compensation scheme with a safe and liquid source of funds. In terms of sustainability, collecting funds in the stronger part of the business cycle could prevent the requirement to levy substantial amounts when most needed and when firms are least able to pay for it.

Moving towards a greater element of pre-funding can also have advantages in terms of the economic criteria proposed in section 5. In particular, according to the incentive criterion, the funding structure should be designed such that levies are risk-weighted and levied ex ante to ensure that firms pays in proportion to the expected costs they impose on the system. However, ex ante funding by itself (eg, without risk-weighting) would be unlikely to improve firms' incentives compared with the current structure. It may nevertheless be considered 'fairer' to ensure that those firms that cause costs make at least some contribution to the system, even if this contribution does not fully reflect risks.

[34] See Appendix A1.2.

At the same time, raising levies ex ante to build up a large fund raises important concerns. If the levies are set too high and the accumulated standing fund were too large, the financial impact on firms could be significant—in particular, in the transitional period when the levy would need both to meet current compensation costs and to help build up the fund to pay for future costs. The latter is particularly important given the evidence presented in section 3 on the high level of legacy costs arising to the FSCS.

Thus, although ex ante funding can be easily implemented in principle by adding a fixed percentage to the current pay-as-you-go levy, decisions about the optimal size of the levy and target reserve would have to be made, as well as about the time period over which to achieve the target. This would place greater emphasis on accurate compensation cost forecasting, which, as already discussed, is inherently inaccurate.

There is a considerable body of literature on how to estimate the optimal fund size, in particular in the context of deposit guarantee schemes, using techniques that are similar to the credit risk modelling applied by banks and financial institutions.[35] Although it is beyond the scope of this project to apply such techniques to the FSCS, it is nevertheless possible to present some illustrations about the possible impact of ex ante levies on participating firms. At its very simplest, the impact on individuals firms is a function of the size of the target fund and how long the transition period is expected to be. For example, if the aim were to build a standing fund equal to average compensation costs over a five-year period, the levy would be 20% higher than the average. However, building a fund around average compensation costs in the past may not be considered sufficient to deal with large failures.

Alternatively, the rules adopted by the US deposit guarantee scheme could be applied. Applying the 1.25% target ratio of standing reserves to protected deposits to the FSCS deposit-taking sub-scheme would amount to a standing fund of more than £9.3 billion.[36] (For comparison purposes, recall that the annual limit on levies in the deposit-taking sub-scheme is 0.3% of protected deposits cumulative.) Shared across the 831 firms in the deposit-taking fee block, this would imply an average stake of more than £11m, which could be spread over, say, 10 years. In recent years, deposit-takers have not paid any levy. Although the impact analysis in section 4 suggests that they could afford payments of this size, such a change would be significant and raise particular concerns if the target were set inappropriately and too high compared with expected losses in the UK deposit-taking sector.

The costs imposed on firms (and ultimately consumers) do not only amount to the actual cash levies paid, but include the returns that firms could have earned on the funds instead of the funds being retained by a compensation scheme. This raises the general issue of how a surplus fund should be invested. If funds are invested in safe assets, this is likely to increase the opportunity costs to firms relative to their cost of capital. However, if the fund is invested in risky assets, the fund would be exposed to market risk, and, depending on which assets were purchased by the fund, possibly also credit risk. Compensation costs may also be correlated with market movements, exposing a fund that was invested in marketable securities to the risk that an increase in its liabilities could coincide with a fall in the value of its assets. These issues would require the scheme to employ investment professionals to manage the fund, and define and design an investment strategy that meets the sustainability criterion without imposing too high an opportunity cost on firms.

If a target fund size were set, there is the question of what to do once the target is reached. One option is to let the standing fund grow, even if no failures occur. The alternative is to cease imposing the industry levy once the target is reached. The former could exacerbate concerns about opportunity costs to firms; the latter could result in periods when no levies are collected, making it difficult to adhere to the principle of making firms pay in line with the expected costs they impose on the system.

[35] For a discussion by the FDIC, see FDIC (2000), 'Federal Deposit Insurance Corporation – Options Paper', August 2000.

[36] Based on 2005/06 data on protected deposits.

There are ways to overcome these difficulties. For example, it would be possible to introduce a rebate system whereby the target fund is capped and funds above the cap rebated in proportion to the firms' stake in the fund. Similarly, new firms could be made to pay an entry fee to join the fund, with corresponding repayments if a participant leaves the market. Entry fees would allow a small fund to build up without the need for a specific levy, although high initial fees may raise concerns about market entry barriers.[37]

The opportunity cost to firms could be reduced if participating firms were allowed to carry contributions to the fund as assets in their books, making pledges or guarantees to make cash payments as the need arises. Any of these options raise issues about practicality and are likely to increase the administrative burden of operating the scheme.

A very large ex ante fund that is disproportionate to expected costs may also raise questions about legality under primary legislation. Another constraint is whether ex ante funding would have tax implications. In particular, would firms be disallowed from deducting the ex ante element of the levy from their tax bill if the advance payments to the FSCS were treated as provisions rather than tax-deductible expenses? These feasibility issues would require further analysis if ex ante funding were to be considered as an alternative to the current FSCS funding structure.

Overall, the move to a funding structure with a large ex ante element is likely to impose significant practicality issues, which would require further analysis prior to implementation. Levies under pre-funding would be higher than under the current system, in particular for the transitional period when the standing fund is build up. Pre-funding is consistent with the polluter-pays principle. However, unless combined with a risk-based contribution structure, it would not deliver any desired incentive effects. High upfront levies may be considered fair by making firms that ultimately create costs to contribute towards covering them, but if the levies fail to differentiate between firms, they have adverse effects on individual firms (and their consumers) and may distort market structure more generally. These problems increase the stronger the element of pre-funding and the larger the target fund size.

The main advantage of a large standing fund is improved liquidity and long-term sustainability of funding. The case for a radical change to the current pay-as-you-go structure for the FSCS as a whole therefore rests on the weight given to the sustainability criterion and the likelihood of significantly larger failures occurring, combined with a significant weakening of the financial position and stability of the industry. It also depends on the availability of alternative funding structures that can be used as a contingency if failures are too large for the industry to meet in any year.

7.3 Evaluation—pre-funding to target specific firms or reduce volatility

For the reasons set out above, it may therefore not be considered desirable to build up a significant FSCS standing fund that covers the entire industry. Nevertheless, pre-funding has some desirable features that could be implemented in part, first to target specific firms only and, second, to smooth levies over time.

Ex ante levies could be imposed on firms in those sectors where failures occur, or are expected to occur, regularly. Forcing certain firms to pay upfront may require them to set aside internal resources to pay for compensation and, indeed, discourage them to operate in the market, thereby preventing failures of such firms in the first place. This argument has been put forward in the context of IFAs and the mis-selling costs they pass on to the FSCS. However, there appear to be more appropriate tools to deal with any problems in the advisory market than raising barriers to entry and forcing exit via a high and upfront FSCS levy. If the levies required in contribution groups such as A13, and the impact this has on

[37] Entry and exit fees and, more generally, the advantages and disadvantages of moving towards an ex ante system with a large fund are also discussed in HM Treasury, Bank of England and FSA (2005), op. cit.

IFAs, are a sign of a wider problem in the UK retail distribution market, the Funding Review is unlikely to be the most appropriate way of addressing these problems. FSCS levies can, at best, be designed to provide additional incentives to reduce problems in the market which may be addressed more effectively through capital adequacy, commission structure, provider responsibility, availability of professional indemnity insurance, and other issues that are already under review. Singling out one type of firm or sector for the purpose of raising ex ante contributions may also raise practical and legal concerns.

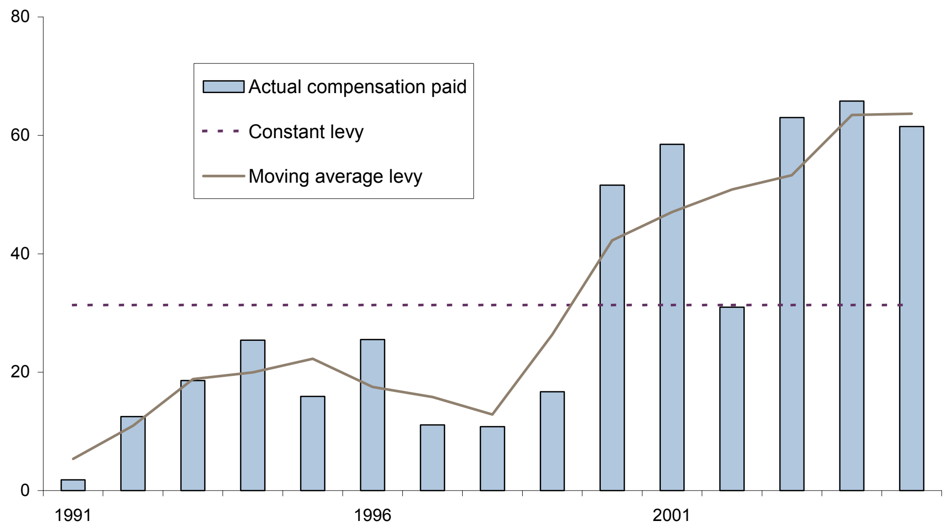
Instead of aiming to build up a significant FSCS standing fund to deal with large loss events, an element of pre-funding could be introduced to smooth fluctuations in the levy. Although this would require, on average, somewhat higher levies, most of the adverse effects of a large standing fund could be avoided.

The main distributional impact of introducing an element of pre-funding is to redistribute costs across time, which, from a firm's perspective, means spreading costs in periods where claims are high, to periods when they are lower than average. There may be some redistribution across firms (over and above the redistribution under the current pay-as-you-go system), since firms leave and enter the market, as well as during the transitional period when current firms would be required to pay for both the current compensation bill and towards building up the fund used for smoothing purposes. However, this effect may be small if only modest smoothing were introduced.

How much smoothing would be possible? In the limit, the most smoothing possible would be to have a constant levy, as volatility would be reduced to zero. Such a degree of smoothing may not be necessary, and, in a world of uncertainty, could correspond to a funding system with a large standing fund.

For illustrative purposes, Figure 7.1 shows the time-series of compensation costs in the investment sub-scheme and its predecessor, the ICS, during 1990/91 to 2004/05. What smoothing could have been achieved if levies had to be raised to correspond to annual compensation costs? Compensation costs during the period averaged £31m and, with perfect foresight, the levy could have been set at this average level to achieve maximum smoothing. Instead, the levy could have been based on a moving average, for example, the average compensation cost of the previous, current and next year, as illustrated in Figure 7.1. The greater the ability of the FSCS to forecast average compensation cost levels, the more smoothing can be achieved. There are inherent difficulties in achieving this.

Figure 7.1 Illustration of smoothed levies to cover investment claims



Source: ICS and FSCS annual reports and Oxera calculations.

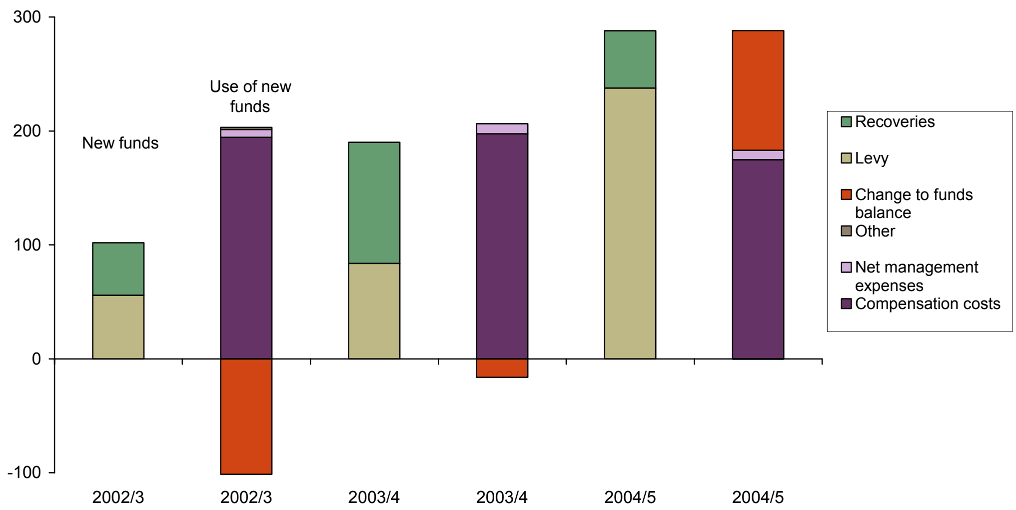
If smoothing is the main objective for moving towards a system with an element of pre-funding, the question is whether alternative mechanism would be available to deliver a similar outcome. Two such mechanisms come to mind.

– *Smoothing by firms*—instead of implementing a system whereby the FSCS achieves a smoothing effect by collecting levies ex ante, firms themselves have tools available to achieve the same outcome internally—for example, by making provisions for future levy increases. This would give firms flexibility. Rather than asking all firms to pay somewhat higher than average levies to deliver smoothing, firms could decide, depending on their degree of risk aversion, whether to make higher internal provisions or to accept volatility. Internal smoothing by firms could be facilitated if FSCS forecast of costs were communicated on a clear and timely basis, and looking further ahead than a one-year period. However, the further ahead the FSCS tries to forecast, the less accurate those forecasts are likely to be.

– *Smoothing using alternative FSCS funding sources*—as summarised in section 2.2, the FSCS has a number of other funding sources available, including existing fund balances, recoveries following liquidations, and borrowing (either between schemes and groups, or the credit facility arranged with a commercial bank). FSCS levies could be smoothed by making greater use of these alternatives—for example, borrowing at times when compensation costs exceed the average, with repayments made during times when costs are low.

The possibility of a greater use of FSCS funding sources to help smooth firm levies can be illustrated by considering the sources and uses of funds by the FSCS in the first three full financial years since N2. Figure 7.2 shows that total FSCS costs have been around £200m on average (see also section 3), but total levies in any year differ considerably from costs, and change year on year. The difference can be attributed to receipt of recoveries and changes in existing fund balances.

Figure 7.2 Difference between FSCS costs and firm levies, 2002/03–2004/05



Source: FSCS data, Oxera calculations.

Under the current system, the objective of existing fund balances and recoveries is not to smooth levies. Rather, levies are largely determined as the residual between expected FSCS costs, and existing fund balances and potential recoveries, although the levy calculation process is considerably more complicated that this.[38] The illustration in Figure 7.2 may

[38] Determining the levy amount is the last part of the forecasting process. For each contribution group, FSCS looks at the likely costs for the financial year, and the required funding up to the date of the next levy collection. After taking into account the

suggest that levies could have been smoothed, if so desired, through a different use of existing fund balances and accumulated recoveries.

For example, in 2002/03 FSCS levies were significantly lower than compensation costs, largely due to a running down of the fund balance of the insurance sub-scheme that was available from previous years. Compensation payments in relation to general insurance (A3) failures continued in 2003/04 and 2004/05 at similar levels, but until 2004/05 no levy was raised from general insurers, as existing fund balances continued to be available and recoveries were received. In 2004/05, FSCS imposed a levy on A3 amounting to £147m (from zero in 2003/04). Fund balances for A3 at the end of the year were in significant surplus.

In addition to changing the way in which existing fund balances and reserves are used, FSCS has the option of borrowing, which could, at least in principle, be used to further smooth fluctuations temporarily.

In practice, the use of alternative funding sources to smooth FSCS levies over time depends on the extent to which costs can be forecast—indeed, part of the discrepancy between costs and levies reported in Figure 7.2 is due to compensation costs and recoveries turning out higher or lower than expected. The concern about forecasting is common to all smoothing options, whether to be achieved through alternative funding sources, introducing pre-funding, or internal smoothing by the firm. FSCS costs are volatile and inherently difficult to predict, meaning that there are limits to the degree of funding that can be achieved using pre-funding or other means.

Overall, moving towards an ex ante fund can help to achieve some smoothing of FSCS levies over time, thereby addressing concerns expressed by parts of the industry about the volatility of levies. More smoothing means, on average, higher levies for firms. Other mechanisms may be available to achieve greater smoothing, and it may be worth considering further the extent to which these could be used instead.

7.4 Summary

Ex ante funding has a number of attractions. It is consistent with, and develops at the aggregate level, the principle of firms themselves making provisions for future events, and ensures that future insolvent firms have at least made some contribution to the compensation costs they generate. While ex ante funding does not significantly reallocate levies across participating firms, and therefore does not make existing groups more sustainable in the short term, it does reallocate levies across time and improves funding sustainability in the longer term. Ex ante funding may be conducive to risk-weighting of levies, with desirable potential incentive effects.

However, companies may themselves make provisions for future FSCS levies (including any supplementary levies in the event of a large failure). While ex ante funding may be viewed as a way of forcing firms to set aside capital to cover future compensation costs, and may also discourage poorly capitalised firms from operating, the FSCS levy does not seem to be the appropriate regulatory tool to achieve such objectives. The main argument to establish a sizeable standing fund is that it could deal with large failures or provide a contingency fund. However, other limited contingency sources of funding exist, although there may be a case for reviewing these to see whether they can be improved.

In some sectors the levy has been volatile. The case for ex ante funding would therefore, on balance, seem to be stronger if it refers to a fund with an objective to smooth fluctuations in

forecast fund balances for each contribution group at the start of the levy period, estimated interest receipts, and potential recoveries, FSCS considers resources needed to handle claims and pay compensation. The required levy amount is then calculated to ensure that the forecast fund balance at the end of the financial year is sufficient to cover the required funding until the date of the next levy collection.

the levy, rather than to help establish a significant standing fund to deal with large failures. Nevertheless, it is worth exploring whether smoothing could be achieved at a lower cost using other mechanisms.

8 Risk-weighting, tariff base and other sources of funding

This section presents an overview of options relating to changes in the tariff base that determine how much firms contribute to FSCS costs in a specific contribution group, focusing on the introduction of risk-weighted contributions. It also briefly considers options relating to funding sources other than firm levies.

8.1 Risk-weighted FSCS levies

Each participating firm can be considered to have an expected FSCS compensation cost, based on the probability of the firm becoming insolvent, and the exposure or level of compensation costs arising if default occurred. This expected FSCS compensation cost may change over time as the firm's activities and risks evolve. One approach to funding a compensation scheme would be to risk-weight levies such that each firm's contributions were equal to the expected FSCS compensation cost. Firms assessed as posing greater risks of triggering FSCS compensation costs would be charged a higher levy.

There is a body of literature that discusses approaches to such expected loss pricing, developed in particular in the context of funding deposit guarantee schemes.[39] Risk-weighting is observed among international deposit guarantee schemes (see Table 7.1), and has been adopted in the proposals for funding the PPF.[40]

Approaches to risk-weighting can differ. On the one hand, a 'bottom-up' approach to risk-weighted contributions would be to set levies equal to expected losses, irrespective of current funding requirements. This implies that if the resulting revenue were insufficient to fund current compensation costs, other sources of funding would be required, and if levies raised exceeded the current funding requirement, the excess would accumulate to a fund to cover future costs. On the other hand, a 'top-down' approach would first determine the appropriate level of aggregate funding and then allocate this to firms on the basis of risk. Risk-weighting can therefore work under either an ex ante or ex post funding system.

Risk-weighting approaches also differ in the degree to which they aim to achieve expected loss pricing. For example, the PPF, in its latest proposals, has increased the number of risk bands of scheme sponsors from ten to 100, with a view to increasing the precision of risk-based contributions.

8.1.1 The economic rationale behind risk-weighted levies

Risk-weighting levies has a number of economic advantages. These advantages have already been discussed in the context of options that seek to define contribution groups according to risk. Rather than, or in addition to, having narrow risk-reflective groups, risk-weighting would work within a wider funding pool and set levies that differentiate between firms in that pool.

Risk-weighted levies are generally seen as having desirable incentive properties. Risk-weighting may encourage firms to control their own risks, potentially alleviating moral hazard problems associated with fixed size-based contributions. Risk-weighting may also facilitate more precise risk measurement of firms, which can also help to control risk.

[39] See, for example, Federal Deposit Insurance Corporation (2000), 'Options Paper', August.

[40] See Appendix 1.4.

Moving towards a more risk-based approach to setting FSCS levies must be evaluated in the context of the wider regulatory framework. For example, if the funding structure were designed to produce strong incentives, this could duplicate other rules that may be designed with the same effect (eg, conduct of business rules or prudential regulation). Put differently, if FSCS funding is not seen as an additional regulatory tool, setting risk-weighted levies to improve incentives may be less important.

Not risk-weighting FSCS levies implies that there will always be an element of cross-subsidy between firms, with low-risk firms paying for the costs of high-risk firms. This subsidisation also applies across time, a feature that is implicit in the 'pay as you go' nature of FSCS funding arrangements. In particular, 'high-risk' activities were carried out in the past at too low a price, subsidised by the contributions from current FSCS participants to cover the legacy costs arising to the FSCS. This subsidisation would be limited if levies were raised according to the risks, or expected compensation costs, of firms and their activities.

8.1.2 Sustainability considerations and feasibility of introducing risk-weighted levies

The introduction of risk-based levies raises concerns about funding sustainability, as discussed in section 6. Firms may not be able to afford to pay the full economic cost they impose on the FSCS. If this were the case, collecting levies from the weakest firms would further weaken their financial position, possibly triggering further defaults and generating new compensation claims. Since the resulting costs would then have to be collected from the stronger firms in one way or another, cross-subsidies would ultimately not be avoided.

Concerns about ability to pay and sustainability have, for example, been raised in the context of the recent proposals for a risk-based levy of the PPF.[41] The latest proposals introduce a cap on levies of 0.5% in relation to pension scheme liabilities, down from the initial cap of 3%, with a view to limiting the financial impact on the weaker pension schemes.[42]

Feasibility issues are arguably the most important obstacles to moving towards a risk-based levy structure. As discussed above, risk-weighting levies requires, under expected loss pricing, an assessment of the probability of default, and exposure or severity of compensation costs in the event of default. This necessitates detailed firm-specific information, which the FSA or FSCS may not have, and which would be difficult and costly to collect, possibly in particular for small firms or those with lower reporting requirements.

FSCS levies could be based on, or built around, FSA risks, as measured by the FSA's Arrow risk framework. For example, the risk-weighting approach adopted by the US deposit guarantee scheme (FDIC) is based on composite ratings that the regulator assigns to banks.[43] However, the types of risk that drive FSCS costs (eg, failures of small firms, mis-selling, fraud, etc) are very different from those that drive, for example, the setting of the prudential regime for banks, or that are relevant for other FSA supervisory purposes.

The main risks for the FSCS are also very different from those that drive the compensation costs of other schemes that have introduced risk-based levies, such as some of the international deposit guarantee schemes or the PPF. For example, while protected deposits or the degree of pension scheme underfunding may provide adequate proxies for loss exposures in the event of the default of deposit-takers and pension schemes, respectively, FSCS compensation costs that arise from fraud or mis-selling may be more difficult to proxy. There is little existing research on these types of risk.

[41] For a discussion, see, for example, McCarthy, D. and Neuberger, A. (2005), 'Pricing Pension Insurance: The proposed levy structure for the pension protection fund', *Fiscal Studies*, **26**, 471–89.

[42] See Appendix 1.4.

[43] See Appendix 1.2.

It may be useful to conduct detailed analysis of past compensation cases, looking at the characteristics of the firms involved, their underlying products and activities, the sources of failure, and resulting compensation costs. This could provide a better understanding of FSCS risks and could be used to place firms or activities into different risk categories. However, there are limitations to backward-looking analysis and drawing inferences about the future based on a potentially very short time-series of data.

Risk measurement may instead focus on the probability of default, leaving aside those risks that determine exposure or compensation costs in the event of default. One approach to evaluating the probability of default would be to use market-based information, such as that on the firms' equity or subordinated debt, or its credit ratings. Such information would not be readily available for many firms participating in the FSCS. In principle, however, it would be possible to task a credit rating agency or similar to measure and rate the solvency risk of participating firms. For example, the PPF has tasked a business information provider to rate pension scheme sponsors' default risk rather than carrying out such assessments itself or using the ratings of the Pensions Regulator.[44]

Other approaches for measuring default risk could be based on the regulatory capital requirements for different firms or calculated using firm-specific data on capital or financial ratios more generally (eg, the ratio of available to required capital may provide an indicator of solvency).

Overall, risk-weighting on the basis of full expected loss pricing may be difficult to implement for the FSCS. Nevertheless, it may be possible to move towards a more risk-based differentiation between firms using simple proxy metrics. Such a differentiation has economic advantages and would be considered 'fairer' from a distributional perspective, in particular if the FSCS funding structure moved towards greater pooling of activities and firms than under current arrangements. Further research would be required to assess what the appropriate risk metrics are, and how feasible it would be to collect data for measurement.

8.2 Tariff base

If expected loss pricing and risk-based levies are not feasible or ruled out for other reasons, the question remains of how to allocate levies to individual firms. Under the current structure, levies in different contribution groups are allocated according to three broad types of tariff base: relevant income (A3, A4, A9, A18 and A19), client funds held by the firm (A1 and A7) and headcount (A10, A12, A13 and A14).

The income-based allocation method appears most consistent with the ability-to-pay criterion. Levy allocation according to the amount of protected deposits (for A1) or funds under management (for A7) is more consistent with risk-reflective pricing, at least in terms of impact (ie, potential exposure to loss, given default). The allocation of levies according to the number of approved persons of a firm appears the most practical method (ie, the information is readily available and easily verifiable).

While there is a rationale behind each tariff base, the question is what motivates the application of different tariff bases for different contribution groups. Practicality may be a key consideration, and the chosen tariff base may simply reflect the most practical or least costly method available for that contribution group.

If ability to pay were the key consideration, a case could be made for introducing an income-based tariff for all contribution groups. For example, under the current structure, the A13 levy is allocated to firms on the basis of the number of approved persons. Thus, an IFA with one approved person generating income of £100,000 pays the same levy as an IFA that generates only £10,000. This explains the large variation in levy to income ratios reported in

[44] See Appendix 1.4, which discusses the PPF in more detail.

section 4 (see Figure 4.7). Moving away from approved persons to income could therefore provide a solution to the relatively high levy paid by the weaker IFAs in A13—although this would be at the expense of the stronger and more profitable firms in the group.

An income-based allocation of levies is already applied for other advisory activities—ie, mortgage advice (A18) and general insurance intermediation (A19). This does not make the case for adopting income-based measures for A13 or other groups in the investment sub-scheme, but does suggest that such an approach is feasible. Importantly, it highlights that the way in which levies are currently allocated is not consistent across the FSCS.

There are other examples of inconsistency in the current tariff base structure. In particular, for some contribution groups, the tariff base measures the volume of a firm's business that can give rise to claims on the FSCS (ie, activities for retail clients). For other groups, the tariff base also counts 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 the relevant business carried out for eligible retail customers, the headcount tariffs in the investment sub-scheme do not.

Including all business in the tariff base, irrespective of whether it is retail or wholesale business, would improve FSCS funding along the ability-to-pay and sustainability criteria, whereas restricting the tariff base to include retail business only can be considered preferable under the proportionality criterion. The weight given to the conflicting criteria is a matter for policy, but it seems that the same criteria should, as far as possible, be consistently applied across the FSCS.

A separate, and more fundamental, question is what tariff base would be appropriate if the current contribution group structure were redefined and greater pooling introduced. The pooling options described in section 6 require a mechanism for sharing costs across activities and firms in the pool.

One approach would be to allocate costs according to the periodic FSA fees paid by firms in different fee blocks—eg, in the case of pooling within the investment sub-scheme, costs could be allocated to fee blocks A10 to A14 in proportion to the amounts of FSA fees paid by each fee block. Within each fee block, costs could continue to be allocated using the current tariff base (or any other tariff base).[45] This could be considered the most practical solution. In effect, it would correspond to the way in which the base cost of the FSCS management expenses is already allocated to individual firms. However, this solution may not be considered proportionate—the FSA's periodic fees are determined by the amount of FSA work required to address the risks that firms in the fee block may pose on the regulatory objectives, but these risks may bear little relationship to the risks firms pose on the FSCS. The allocation of FSCS levies to different fee blocks would not necessarily have to be in strict proportion to the FSA fees paid, and adjustments could be made or discounts introduced where considered appropriate while preserving some pooling and sharing of costs across groups.

An alternative approach would be to move away from the fee block structure for levy allocation purposes and identify a tariff base that is common for all firms or activities that are included in a pool. Compensation costs could then be allocated across firms or activities in proportion to that common tariff base. Considering the different types of firm and activity that may be pooled, the choice of a suitable tariff base measure is not straightforward. Income may be a potential candidate, although defining income on a consistent basis may be difficult. Income may also be a better candidate than other financial measures such as

[45] This approach was adopted for modelling purposes in section 6, where FSCS costs were allocated to the pooled contribution groups in proportion to the FSA fees paid by the group, and, within each group, were allocated to individual firms according to the tariff base for that group.

capital, in particular if less than complete pooling is envisaged and there remains a need to allocate FSCS costs to specific activities only.

Overall, the choice of tariff base is more than a mere technical matter. It can greatly affect the amount of levy paid by an individual firm and the overall allocation of compensation costs across firms. There are problems with the current tariff bases applied to different contribution groups, and new issues would arise if the current contribution group structure were changed and greater pooling introduced. Further analysis would be required to establish the appropriateness of different tariff bases, under both the existing and any new contribution group structure.

8.3 Other sources of funding

The FSCS has access to a range of alternative funding sources in the event of an unexpected increase in compensation costs that occurs after the levy has been set. These include using existing fund balances, the possibility of raising supplementary levies from firms, borrowing between sub-schemes, and drawing from the credit facility. This provides the FSCS with some flexibility in dealing with temporary funding shortfalls. As discussed in section 7, the alternative funding sources could be used to achieve some smoothing of levies over time.

Access to alternative funding sources is important since there is always a possibility of unexpected large failures that could impose more costs than the FSCS had anticipated and participating firms would be able to cover. It is also important in cases where the required levies would exceed the regulatory levy limit. The question is whether alternative funding sources could be strengthened to provide funding if large failures occurred and to enhance the overall sustainability of FSCS funding.

For example, the current credit facility allows the FSCS to draw funds up to a maximum of £50m, which is unlikely to provide a main source of funds to pay for a large failure. Thus, if sustainability were the key objective, a case could be made for extending this facility. However, the facility that has to be met by levy payers comes at a cost, and there are limits to which a commercial credit provider will be willing to extend the facility on similar credit terms.

Borrowing costs could be reduced if commercial loans were backed by the government. A number of comparator schemes in the EU benefit from a government guarantee or can borrow directly from the central bank or government. Such arrangements are in place in Austria, Denmark, the Netherlands, Spain, and Sweden, for example. State involvement also applies in some of the ten new Member States, such as in Hungary where the state made direct contributions to finance investor compensation cases, or in the Czech Republic where the investor compensation scheme negotiated a state loan when it experienced difficulties in raising sufficient funds to cover costs.[46] Similar government involvement in FSCS funding would enhance the financial viability of the scheme and in particular its ability to deal with very large failures. However, the circumstances in which state support may be required are limited, and general reliance on state intervention could have negative incentive effects and not be politically acceptable.[47]

As a more market-based solution, the FSCS could instead seek private insurance for future compensation costs. Such transfers of risk to a third party are routinely performed in the insurance business, and, at least in principle, could also be applied to compensation risks. For example, consumer compensation in the event of large failures possesses some similarities with catastrophic risks, in so far as it involves a fairly low probability of potentially

[46] See Appendix 1.1.

[47] The UK's position on state funding of compensation schemes is set out in HM Treasury, Bank of England and FSA (2005), op. cit.

high costs. The bankruptcy of a financial institution could be viewed as a financial rather than, say, a natural catastrophe, and (re-) insurance of such risks may be available.

Insurance has a number of attractive properties. For example, it would provide the FSCS with an alternative funding source, thereby improving sustainability. It could also improve the pricing of FSCS risks and help in setting risk-weighted levies. However, there may be problems in the supply of such insurance. One particular problem that has been observed for other catastrophic risks is the disruption of the insurance market after major loss events, when insurers react by raising prices, cancelling policies, placing limits on coverage, or even withdrawing from that particular line of insurance altogether.[48] Similar imperfections in the market could also apply for compensation risks.

The FSCS could also issue 'catastrophe bonds' or other instruments that have been used in property and casualty insurance to transfer catastrophic risks through securitisation. As with direct insurance, the major benefits would be access to additional funds and the potential improvement in the pricing of risks obtained via the market. Again, however, a number of market imperfections may present significant obstacles to this solution. For example, there are substantial costs to issuing securities such as catastrophe bonds; and bondholders could fear being at a disadvantage in terms of information relative to the compensation scheme and require high risk premiums to protect themselves. In addition, costs would be generated by the need to manage and invest the capital obtained from the issue.

These insurance solutions have been discussed in the literature,[49] but are not commonly observed among compensation schemes. The FSCS predecessor, the Investor Compensation Scheme, had insurance for compensation risks, and two of the EU investor compensation schemes also had an insurance contract in place. However, the insurance policies were either no longer available or dropped for being too costly.

[48] See, for example, Jaffee, D. (2005), 'The Role of Governments in the Coverage of Terrorism Risks', in *Catastrophic Risks and Insurance, Policy Issues in Insurance*, No. 8, OECD.
[49] See for example Roy, J. (2001), op. cit.

Appendix Funding arrangements of comparator schemes

A1.1 Investor compensation schemes in the EU

In accordance with the EU Directive on Investor Compensation Schemes (ICD) (Directive 97/9/EC), all EU Member States have implemented schemes that compensate retail investors for losses incurred in the event of default of an investment firm.[50]

The ICD lays down certain basic requirements for the national investor compensation schemes to provide a consistent minimum level of investor protection across the EU. Importantly, under the ICD, compensation is paid in the event that, upon default, an investment firm is not able to return money or investment instruments held on behalf of retail investors. There is no requirement to provide compensation for mis-selling or other negligent financial advice.

The FSCS is the only scheme in the EU that extends protection to bad advice, which explains why the scheme experiences a significantly higher volume of compensation cases than in other countries. Nonetheless, other countries have had cases of significant fraud, embezzlement and misappropriation of client assets that needed to be funded by the investor compensation scheme.

A1.1.1 Scheme participation and pooling

All investor compensation schemes are funded principally or exclusively by way of contributions from participating firms. There are important differences in participation requirements across countries. Compared with the UK, and given the more restricted loss coverage, other EU Member States do not require financial advisors to participate in the scheme. Ireland is the only other country that requires participation of financial advisors, although the scheme does not compensate investors for losses arising from bad advice.

Focusing on the EU 15, Austria, Germany, the Netherlands and Spain maintain separate compensation schemes for non-bank investment firms and credit institutions. They therefore avoid pooling between these two types of firm. However, the banking schemes do pool the funds for deposit guarantee and investor compensation purposes. The Danish scheme also maintains separate pools for investment firms and credit institutions, the latter to cover both deposit guarantee and investor compensation.

Belgium takes pooling furthest. The country has established a single fund for both credit institutions and investment firms, and combines deposit guarantee and investor compensation.

Although the other countries do not pool deposit guarantee and investor compensation funds, they generally pool the funds of all types of investment firm, including credit institutions, without distinguishing according to the type of investment business carried out by participating firms. The exception to this is Ireland, which maintains two separate funds: one for investment firms providing core investment services and the other for advisers, insurance intermediaries and tied agents.

[50] A detailed description and assessment of investor compensation arrangements in the EU, including scheme funding, is available in Oxera (2005), 'Description and assessment of national investor compensation schemes established in accordance with Directive 97/9/EC', report prepared for the European Commission, January. All information is based on this report and generally refers to arrangements in place in 2004.

Overall, the contribution group structure of the FSCS, which separates six different groups within the investment sub-scheme according to permissions, is therefore not observed elsewhere.

Firms without eligible retail clients are usually required to participate in the investor compensation scheme. In some cases, they pay lower contributions or contribute a minimum annual payment only. In Germany and the Netherlands, firms sought a judicial decision in the courts to exempt their business from participation. In the Netherlands, the suing firms can be described as market makers, which only conduct business for their own account. The Dutch court ruled in favour of the firms. Since the end of 2003, market makers in the Netherlands have not been required to participate, and the contributions paid by firms to the scheme were returned. In contrast, a German court decision ruled against a firm that sued for its right to be excluded from scheme membership because it had no eligible clients: firms without eligible clients were seen to benefit from the general increase in market trust and confidence resulting from the compensation scheme.

A1.1.2 Ex ante versus ex post funding

Among the EU 15, Austria, Italy, Luxembourg and Sweden fund their investor compensation schemes on an ex post basis, levying contributions as required. In the Netherlands, the scheme for credit institutions is also funded ex post, but the scheme for non-bank investment firms is funded ex ante. The single Belgium scheme collects ex ante contributions only for credit institutions and brokerage houses, but levies contributions ex post for asset managers and instrument-placing firms.

The other schemes are funded ex ante, and firms are required to make regular annual contributions. In some countries (Denmark, Greece and Portugal), the annual firm contributions take the form of pledges instead of, or in addition to, cash payments. By making pledges, firms guarantee payment in the event of failure. All ex ante schemes have the power to levy additional contributions if the accumulated reserve is not sufficient to cover compensation costs. Ex ante funding has also been adopted by all but one of the new EU Member States. However, the ex ante funds tend to be small, with the exception of those schemes that have a pooled fund to cover deposit guarantee claims as well.

A1.1.3 Tariff base, risk-weighting and levy limits

The national investor compensation schemes adopt a range of methods to calculate the level of contributions. Assessment bases include:

– investment and cash balances, typically counting only those held for eligible clients;
– turnover;
– number of eligible clients;
– capital;
– deposits (eg, used by the banking schemes in the EU which require banks to make a single contribution to cover compensation costs in relation to both deposits and investment costs).

Some schemes also incorporate a fixed element, requiring all firms to make an equal payment irrespective of size and business volume (eg, to pay for administrative costs). Others impose a one-off payment when first joining the scheme.

The compensation schemes in some countries require firms to make an initial one-off payment when first joining the scheme—eg, in the Austrian scheme for securities firms, this takes the form of a fixed subscription charge to the share capital of the scheme, whereas, in Germany, the initial charge depends on firm capital. In France, new firms are required to make supplementary contributions and purchase a certificate of association on joining, which pays annual interest and is remunerated at par value when the firms leave the scheme.

The French scheme aims to take into account explicitly the probability of default of a firm when setting the level of contribution the firm is required to make. Specifically, when calculating the level of a firm's contributions, the assessment base (investor assets held by the firm) is multiplied by a risk indicator that reflects the capital adequacy and operating profitability of the firm. No other scheme adopts a similarly explicit risk-weighting.

In some countries, contributions are set to take into account implicitly that some types of investment business expose investors to a greater risk of loss—eg, the German scheme for securities firms applies higher contribution rates for firms that are authorised to hold client assets and trade for their own account than those that are not. Similarly, in Finland, higher contributions are required for some investment services (eg, stockbroking or custody) than others (eg, portfolio management or own-account dealing). However, in most of the EU 15, contributions depend on the size or volume of investment business of participating firms, without further taking account of risks.

As regards levy limits, some schemes have introduced a cap on annual contributions that is expressed, for example, as a percentage of capital or net income (in many cases, 5–10%). Other schemes specify that special contributions that may be required cannot exceed more than twice what firms normally pay in any year. In contrast, no limit applies in France, Ireland, Italy, Spain and Sweden.

A1.1.4 Other sources of funding

Most investor compensation schemes in the EU have borrowing powers, but few currently have any external borrowing facilities in place. In 2004, the UK and Finnish schemes were the only ones that had arranged a binding agreement with a commercial bank to obtain credit if needed. In the Netherlands, the Central Bank gives the Dutch schemes interest-free advances on payments, which are ultimately repaid by firm contributions.

*S*ome countries, including the UK, with more than one compensation scheme and/or where the investor compensation scheme is separated from the deposit guarantee scheme, have arranged borrowing between schemes.

Explicit involvement of the state is observed in the EU 15. Schemes in Austria, Denmark, the Netherlands, Spain and Sweden are able to borrow either directly from the state or with state guarantee from commercial credit providers. With the exception of the Netherlands, borrowing is restricted to exceptional circumstances. State involvement also applies in some of the ten new Member States. For example, the Hungarian scheme has benefited from direct contributions from the state to finance past compensation cases, and the scheme in the Czech Republic negotiated a state loan when it experienced difficulties in raising sufficient funds to cover costs.

Both the Finnish and the Greek schemes have, in the past, taken out such insurance with a commercial insurance company, but, since the premiums were high, the policies were dropped as being too costly. None of the investor compensation schemes in the EU has any insurance cover in place.

As an additional source of funding, the compensation schemes in Portugal and France receive fines imposed on participants in breach of financial services legislation. Furthermore, like the FSCS, schemes are in general able to recover some of the compensation costs following the liquidation of firms that have defaulted and use recoveries for funding purposes.

A1.2 The Federal Deposit Insurance Corporation in the USA

Created in 1933, the Federal Deposit Insurance Corporation (FDIC) insures deposits in US banks and thrifts for up to $100,000 per depositor. Only deposits are covered by the scheme. Investments such as securities, mutual funds, etc, offered by banks and thrifts are not insured under the scheme. Total protected deposits amount to more than $3 trillion.

The FDIC is funded by premiums that banks and thrift institutions pay for deposit insurance coverage and from earnings on investments in US Treasury securities. The FDIC administers two insurance funds: Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF). Insurance coverage provided by both funds is identical, although assessment rates for the BIF and the SAIF are set separately.

A1.2.1 Ex ante funding

The FDIC Improvement Act of 1991 requires each fund to be maintained at a designated reserve ratio (DRR), which amounts to reserves of 1.25% of insured deposits. When a fund's reserve ratio (the ratio of its actual balance to insured deposits) falls below the DRR, the FDIC must raise premiums to bring it back to the DRR within a year, or must charge at least 23 basis points (bp) until the reserve ratio meets the DRR. If it is not brought back to the DRR within a year, the FDIC must establish a schedule to return it to the DRR within 15 years.

A1.2.2 Risk-weighting

The FDIC Improvement Act directs the FDIC to implement a risk-based insurance system. Banks are divided into risk classes based on capital levels and supervisory ratings. Three capital categories (well capitalised, adequately capitalised, and undercapitalised) are based both on leverage ratios and risk-based capital ratios. Three supervisory sub-groups (A, B and C) are based on a bank's composite CAMELS[51] ranking. Institutions ranked highest by CAMELS ratings are in group A; those ranked lowest are in group C. Overall, the highest-assigned banks are in category 1A and the lowest in 3C.

The nine-cell matrix below illustrates the premiums based on banks' risk rankings. Currently, both BIF and SAIF reserve ratios are above DRR.[52] Therefore, the premiums range from 0 for 1A companies to 27bp for 3C companies. In 1993, when the system was implemented, both the BIF and the SAIF were well below the DDR and the premiums ranged from 23bp for 1A institutions to 31bp for 3C institutions. Today, 92% of the industry does not pay for deposit insurance, and the more than 900 banks that were chartered within the last five years have never paid any premiums.

Table A1.1 Current assessment rates (bp)

	Supervisory group		
Capital group	A	B	C
1. Well capitalised	0	3	17
2. Adequately capitalised	3	10	24
3. Undercapitalised	10	24	27

Source: FDIC (2001), 'Recommendations for Deposit Insurance Reform 2001' and www.fdic.gov.

A1.3 The Securities Investment Protection Corporation in the USA

The Securities Investment Protection Corporation (SIPC) was established in 1970 to provide protection against loss to customers resulting from broker-dealer failure. SIPC is a non-profit membership corporation, with members who are, with some exceptions, all persons registered as brokers or dealers under Section 15 (b) of the Securities Exchange Act of 1934

[51] CAMELS is an acronym denoting a component rating assigned in a bank examination: Capital, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk

[52] BIF was 1.26% as at June 30th 2005. The SAIF ratio was 1.32% as at June 30the 2005. Source: www.fdic.gov.

and all persons who are members of securities exchanges. At present, SIPC has 6,153 members.[53]

Investments covered by SIPC include the cash and securities held by a customer at a financially troubled brokerage firm. Ineligible investments include commodity futures contracts and currency, as well as investment contracts (such as limited partnerships) and fixed annuity contracts not registered with the US Securities and Exchange Commission under the Securities Act of 1933. The limits of protection are $500,000 per customer; claims for cash, however, are limited to $100,000 per customer.

The self-regulatory organisations—the exchanges and the National Association of Securities Dealers, Inc—and the Securities and Exchange Commission (SEC) report to SIPC concerning member broker-dealers who are in or approaching financial difficulty. If SIPC determines that the customers of a member require the protection afforded by the Act, the Corporation initiates steps to commence a customer protection proceeding. This requires that SIPC apply to a federal district court for appointment of a trustee to carry out liquidation. Under certain circumstances, SIPC may pay customer claims directly.

SIPC does not provide the same blanket coverage as the FDIC. It replaces investors' missing funds and securities in situations where a member firm's liquid assets are insufficient to satisfy all customer claims (up to the predefined monetary limits) following a liquidation procedure.

A1.3.1 Ex ante funding

Funding sources of the SIPC are annual levies collected from SIPC members and interest earned on the SIPC Fund's investments in US government securities. The SIPC Fund, consisting of the aggregate of cash and investments in US Government securities, amounted to $1.29 billion in 2004. Members are charged a fixed amount of $150 a year. In 2004, member levies were $1.0m and interest from investments was $63.1m.[54]

As a supplement to the SIPC Fund, a revolving line of credit was obtained from a consortium of banks. In addition, if the need arises, the SEC has the authority to lend SIPC up to $1 billion, which it, in turn, would borrow from the US Treasury.

A1.4 The Pension Protection Fund

The Pension Protection Fund was established in the Pensions Act 2004 and became operational on April 6th 2005.[55] It has been designed to pay compensation to members of defined-benefit occupational pension schemes and the defined-benefit elements of hybrid schemes, when there is a qualifying insolvency event in relation to the employer on or after April 6th 2005 with no possibility of a scheme rescue, and where there are insufficient assets in the pension scheme to cover the PPF level of compensation.

Most private defined-benefit occupational pension schemes and the defined-benefit elements of hybrid schemes will be covered by the PPF, except for those that began to wind up or were completely wound-up prior to April 6th 2005. Other exempt schemes include unfunded public service pension schemes; schemes that provide pensions to local government employees; and schemes in respect of which a relevant public authority has given a guarantee. In addition, except in certain circumstances, schemes where a compromise agreement has been reached between the scheme trustees and the employer concerning a debt under Section 75 of the Pensions Act 1995 will not be covered by the PPF.

[53] Source: Fitch Risk Management (2003), 'Review of SIPC Risk Profile and Practices: The MJK Clearing Event, the Securities Lending Exposure, Risk Management Practices and Capital Requirements', www.sipc.org.

[54] Source: 'SIPC annual report 2004', www.sipc.org.

[55] www.pensionprotectionfund.org.uk.

As set out in the Pension Act 2004, the PPF is required to be self-financing. Compensation will be funded partly by the assets transferred from schemes for which the PPF has assumed responsibility, and partly by an annual levy raised on eligible pension schemes. Each year the Board will estimate the total protection levy to be collected in the following financial year based on the claims in the succeeding year and the variance of actual versus expected claims experiences from proceeding years. The Board will also consider its estimated total liabilities, the period over which it is appropriate and prudent to collect the funding for these liabilities, and the extent to which it aims to accrue a reserve for future large claims.

A1.4.1 Tariff base and proposed risk-weighting

The Pension Protection Levy consultation documents of July and October 2005 proposed that, in 2005/06,[56] the PPF is to be financed by an initial levy and an administration levy, payable by the trustees or managers of eligible schemes. The initial levy is a flat rate based on the number of members within a scheme, taking account of their status. £15 is payable for each active and pensioner members and £5 is payable for each deferred member. The administration levy for 2005/06 is based on the estimated initial start-up costs and ongoing administrative costs of the PPF for 2005/06. Schemes are banded according to the size of their membership. The amount to be paid per member depends on the band into which the scheme falls (subject to a minimum amount per band).

For 2006/07 and subsequent years the Pension Protection Levy is proposed to include a scheme- and a risk-based element, which will account for 80% of the Pension Protection Levy. This risk-based approach to the levy is prescribed by legislation, and is outlined in the July 2005 consultation paper, and confirmed in December 2005.[57]

The scheme-based element must take account of the level of a scheme's liabilities relating to its members. It may also depend on the number of members and the total amount of pensionable earnings within a scheme. The risk-based element is proposed to take into account the funding level of a scheme and the risk of an insolvency event occurring in relation to the sponsoring employer:

The risk based levy is described by the PPF as being equal to underfunding risk x insolvency risk x 80% x a levy scaling factor, where the underlying risk is 1.05 x liabilities – assets, except where the assets exceed 104% of the PPF liabilities, when the formula is different, and the assets include allowance for any special contributions and contingent assets. The levy scaling factor is assumed to be 0.53.[58]

The following changes were introduced to the levy as part of the final proposals to ensure affordability for weaker schemes and in the light of industry response to the July consultation:

- contingent assets, such as parental guarantees, letters of credit provided by third parties, and security over securities, are to be included in 2006/07 levy calculations;
- no risk-based levy is payable for schemes that are more than 125% funded on a PPF basis;
- the levy is capped at 0.5% to benefit weaker schemes;
- the risk bands are to be increased from 10 to 100, to increase precision;
- the PPF will also recognise special deficit repair contributions.

The December 2005 proposals reported the new levy estimate for 2006/07 at £575m.

[56] PPF (2005), op. cit. and PPF (2005), 'Pension Protection Levy Consultation Document—Update', October.

[57] PPF (2005), 'The Pension Protection Levy Consultation Document: December 2005'.

[58] PPF (2005), 'The Pension Protection Levy 2006/07', Factsheet 2/05.

A1.5 The Lloyd's of London Central Fund

Members of Lloyd's underwrite insurance business through syndicates. A syndicate is managed by a managing agent. Each member is required to delegate absolute discretion to the managing agent as to the risks that may be underwritten on its behalf. A syndicate may have a number of members who may be individual and/or corporate members. A syndicate does not have any legal status and is not a partnership. Each syndicate is an annual venture through which members participate for a specific 'year of account'.

A member does not have joint liability with any other member of a syndicate for risks underwritten through that syndicate, but is severally liable in respect of the proportion of each risk underwritten on its behalf as a member of the syndicate.

Claims are paid out of members' own resources, from the working capital they receive as premium and the funds they put up as capital to support their underwriting[59]. However a unique feature of the Lloyd's market is the existence of a substantial pool of central assets that may be used to meet underwriting liabilities if a member's resources are not adequate.

The central assets consist of the Central Fund, callable contributions and other central assets.

A1.5.1 The Central Fund

The New Central Fund is available, at the Council's discretion, to meet a member's losses once its funds at Lloyd's (FAL) and other assets have been exhausted. As at June 30th 2005, the Central Fund consisted of net assets of £650m.

The New Central Fund is funded by members' annual contributions; syndicate loans, the first instalment of which was paid into the New Central Fund in April 2005 (see below); and the subordinated debt issued by the Society of Lloyd's in November 2004 (see below).

The levy rate for annual contributions has fluctuated year by year, depending on demands on the fund. For the 2005 year of account, the level of annual contribution was 0.5%, with additional funding provided by syndicate loans (see below). For 2006 the contribution rate increased to 1%. The Council may also prescribe further special contributions, but these must have the approval of the members liable to pay them.

Member loans

In 2004, the Society decided to modify the funding arrangements for the New Central Fund by reducing the amounts payable by members as outright contributions, and instead introducing requirements for members to make subordinated loans to the Society via their syndicates, the proceeds of which will be held in the New Central Fund (the 'New Central Fund Syndicate Loans').

The New Central Fund Syndicate Loans came into effect on January 1st 2005 and require members to provide funding in the form of loans out of their syndicate premiums trust funds. The rights of members to repayment of such loans in the event of a winding-up of the Society will be subordinated to the claims of the holders of the Notes (see below). The amount of the loan will be determined by reference to a member's capacity for the relevant year of account (for the 2006 year of account, each member is required to lend an amount equal to 0.75% of its capacity).

The actual amount loaned by any particular member may therefore vary from year to year. There is no obligation on the Society to repay the loans other than in a winding-up of the

[59] The published annual accounts contain a helpful description of how members' resources are structured and the controls around them (see: http://www.lloyds.com/annual_report/pdf/09_Security_underlying_policies_issued_at_Lloyd%27s.pdf).

Society. However, in normal circumstances, it is expected that the arrangements will involve the 'rolling repayment' of a proportion of the debt. This repayment is expected to be funded out of the proceeds of a new loan on the same terms from the new year of account.

Subordinated debt
The Society issued two tranches of sterling and euro subordinated notes in November 2004, which amounted to £506m (the 'Notes'). The net proceeds from the issue of the Notes are held as part of the New Central Fund and may be used by the Society for any purpose for which the Central Fund is permitted or required to be applied from time to time.

The Notes are subordinated obligations of the Society. On the occurrence of any winding-up proceedings of the Society, payments on the Notes will be subordinated in right of payment to the prior payment in full of all other liabilities of the Society. Payments on the Notes will also be subordinated to: certain payments which may be made out of central assets, including payments made to discharge the liabilities of an insolvent member to any person (including policyholders) arising out of, or in connection with, insurance business carried on at Lloyd's by that member; and payments made in respect of the costs required by or under any insolvency procedure to which the Society or the Lloyd's market may be subject.

However, in the event of a winding-up of the Society, the claims of the holders of the Notes would rank senior to the Society's obligations to members under the New Central Fund Syndicate Loans and also in priority to the distribution of any central assets to members of Lloyd's generally (other than payments made to members in their capacity as senior creditors of the Society).

A1.5.2 Callable contributions

The Society also has the right to make a call on members of up to 3% of members' premium limits. These callable contributions can be drawn from members' premiums trust funds without the members' consent.

A1.5.3 Application of central assets

The New Central Fund is held and owned by the Society and, at the discretion of the Council, can be applied to discharge any liabilities of Lloyd's members that they are unable to meet in full. However, the New Central Fund may only be used to meet directly liabilities arising from 1992 or prior year insurance non-life business if the members of Lloyd's resolve in a general meeting to make the New Central Fund available in this way.

When a corporate member is unable to meet its liabilities, the Society would under normal circumstances give an annual undertaking to that member by which the Society agrees to use the New Central Fund to meet cash calls made on the member. The undertaking would have a duration of 12 months and would be subject to a financial limit. The undertaking is limited to moneys or other assets from time to time forming part of the New Central Fund. If the corporate member is in provisional liquidation, the Society will also provide a supporting undertaking which will ensure that in no circumstances will an insurance creditor of the member receive less than the amount it would have received in a winding-up commencing on the date of the provisional liquidation. The supporting undertaking is legally enforceable but it is not practicable to value it. While the Society is solvent, the likelihood of the supporting undertaking being called in is extremely remote.

When assessing the need for further annual undertakings, the Society reviews the most recent audited solvency returns prepared by managing agents of syndicates on which the corporate member participates. These returns will be supported by an actuarial opinion on the adequacy of the syndicate reserves. This enables the Society to form a view on both the level of future cash calls that may be made on the relevant member during the next 12-month period and to assess the total level of the member's underwriting liabilities.

The requirement to give undertakings reflects the likelihood that cash calls on insolvent corporate members will need to be funded by the Central Fund over the following 12 months in order to ensure that the insurance liabilities (including policyholder claims) of insolvent corporate members may be paid in full as and when they are due.

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