

**SRA BOARD**

3 June 2015

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**Compensation Fund Contribution for 2015/16**

**Purpose**

1. To recommend the level of Compensation Fund Contribution for 2015/16 to the Law Society (TLS) Council.

**Recommendation**

2. The Board is asked to recommend that TLS Council approves the contributions to the Compensation Fund for 2015/16 totalling £8.5m, resulting in a level of Compensation Fund contribution for 2015/16 of:

- individual contribution - £32; and
- firm contribution - £548.

**If you have any questions about this paper please contact: David Middleton, Executive Director, Legal and Enforcement and Client Protection, [david.middleton@sra.org.uk](mailto:david.middleton@sra.org.uk) – 0121 329 6003**

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## **Compensation Fund Contribution for 2015/16**

### **Background and Approach**

3. The Compensation Fund pays discretionary grants to people who have lost money as a result of dishonesty or failure to account by solicitors or law firms. In 2013/14, the Fund paid out £23.8m in grants. It also has a fairly new jurisdiction to pay discretionary grants to people who cannot recover damages from a solicitor or law firm because of a failure to obtain indemnity insurance. That was put in place in view of the abolition of the Assigned Risks Pool which provided similar cover. Very little has been paid out under the new jurisdiction. It is referred to as “uninsured loss” in this paper.
4. Each year, the Board decides how much to raise from law firms and individuals to fund the Compensation Fund.
5. The proposed contributions this year are the same as last year:
  - individual contribution - £32; and
  - firm contribution - £548.
6. It is the long standing approach of the Fund, agreed by the F&RC and the Board, to maintain a minimum reserve fund as a contingency against unexpectedly high numbers of claims or unexpectedly large claims. In addition, our approach in recent years has been to look beyond the practising year in question to try to forecast contribution requirements over a three year cycle to avoid the position (which has occurred in the past) of the contribution spiking and then dropping significantly in consecutive years.
7. As the contribution paper last year pointed out, it would have been possible to have no contribution in the current practising year and still to have maintained a level of reserve well above the identified minimum. This remains the case for the next year.
8. However, a nil contribution in any year would mean that the level of contribution required in the following two practising years would then be significantly higher. Such peaks and troughs in the contribution make planning difficult for law firms. The figures show that no contribution is required to maintain the minimum reserve for the next year, but this would mean the requirement in 2016/17 and 2017/18 would be £9.2m and £17.8m respectively to maintain the minimum reserve, leading to much higher contributions.
9. In addition, a nil contribution model would not include any potential additional liability for the uninsured loss jurisdiction (above the sum provided for) and the contentious cases identified in the paper. As a result, the Fund’s reserves would reduce significantly creating a risk in the event of these, or other unforeseen liabilities, arising.
10. By taking an average of the required contribution across a 3 year period, we are able to smooth the impact of the contribution while maintaining a level of minimum reserves which can be used against potential liabilities arising from uninsured firms, contentious matters and so on. We therefore believe that this approach should be continued and this paper has been prepared on that basis.

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### **Position as at 31 March 2015**

11. Total grant payments for the practice year 2013/14 were £23.8m.
12. Forecast payments for this practice year are £16.2m as discussed further below.
13. The gross value of open claims<sup>1</sup> received as at 31 March 2015 was £45.5m. We forecast that of these, we will pay grants in the region of £4.9m, of which £4.2m will be paid in this practising year. It is normal for the gross value to be much higher than what is eventually paid.
14. The value of open claims has remained fairly consistent over the last 12 months as can be seen from Annex 1. A spike in claims in February 2015 was due to 3 claims with original claim values totalling £45.0m. These claims have been closed at the moment as the claimants are pursuing legal remedies. They are referred to briefly below.
15. The Board may recall that we previously separated out mortgage fraud claims but this is no longer necessary due to the very small number of them.
16. The introduction of eligibility criteria will protect the Fund against lender and other corporate claims although in a relatively benign conveyancing market, there are few such claims and so the financial impact at present is low. The categories of claimant who will now be ineligible were rarely successful with their applications as they were usually unable to show hardship. However, should there be, for instance, another sharp rise in claims from lenders due to mortgage fraud, then the new eligibility rules would have an impact.

#### Claims for uninsured loss

17. These are applications to the Compensation Fund (following closure of the ARP at the end of September 2013) for losses suffered as a result of the civil liability of a firm which failed to secure a policy of qualifying insurance against which claims could be made. Capita deals with these claims on our behalf because of their close relationship to formal negligence claims which they also dealt with as manager of the ARP.
18. As at 31 March 2015, there have been 71 claims in total, of which 44 are under investigation with a total claim value of £4.4m. The two largest open claims account for £3.3m. One of these is for £1.3m but the likely outcome is assessed at £135k. In other cases where the investigation is sufficiently advanced to make an assessment, the anticipated payment from the Fund is £291k. Some 27 claims have been closed with four payments having been made totalling £5.4k.
19. Last year £2.5m was included for expected payments for 2014/15 to cover possible payments for the open cases and associated defence costs. For 2015/16 £2.0m has been included.

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<sup>1</sup> Sometimes referred to as Original Claims Value (OCV) which after analysis is usually reduced to Revised Claims Value (RCV) which represents a more realistic estimate of the correct value of the claim. Claimants often seek much more “compensation” than is actually payable from the Fund.

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### Contentious Matters

20. Because the Fund is a fund of last resort, it will not pay if the defaulting firm's indemnity insurer should pay. The Board may recall the very high value dispute about this between the Fund and insurers in the Willmett case. There are a number of cases in which there is an ongoing dispute about whether the indemnity insurers are liable to clients. If not, then these claims may fall on the Fund. Willmett is the largest case and is in the public domain. Insurers could have liability in the tens of millions. The issue is whether they can rely on the aggregation clause in the minimum terms and conditions. The case is adjourned and the risk of substantial claims being payable by the Fund is mitigated by its discretionary nature.
21. There are other cases with similar issues but they are not sufficiently advanced to represent a serious risk to the Fund for 2015/16. The applications totalling £45.0m referred to in paragraph 14 above are also unlikely to impact on the Fund during 2015/16 and may also be mitigated by the appropriate exercise of discretion on the evidence when it is fully collected. They are part of a larger alleged fraud and further applications may be received.
22. We have therefore not included specific provision in the model for these cases as we think that the sum held above the minimum reserve would be sufficient to cover any potentially payable claims in 2015/16. This is explained in further detail below. There is an element of risk in this approach since whether or not applicants pursue their claims is outside of our control and this is the basis for the recommended contribution.

### Other Payments from the Fund

23. It has previously been agreed by the Board that the costs of interventions (in excess of the SRA budget) could be paid from the Fund.<sup>2</sup> That was in fact the case for many decades so far as the legislation allowed.
24. This has increased the total amount paid out of the Fund in recent years which has a consequent impact on the minimum reserve calculation. Increased costs are also being incurred for Capita in dealing with claims for uninsured firms (see para 17).

### **Calculation of Recommended Contribution for 2015/16**

25. As in previous years, the recommended contribution has been calculated by taking the opening balance of money held in the Fund and then taking account of:
  - calculation of the minimum reserve required (see paragraph 33)
  - forecast cash outflows (i.e. grants and costs – see paragraph 34)
  - forecast cash inflows (excluding the contribution – see paragraph 46)
26. This leads to the required contribution being identified as a balancing figure which is explained in Annex 2 and then as shown in the tables at Annexes 3 and 4. Annex 4

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<sup>2</sup> As expressly provided for in the Solicitors Act 1974 (as extended by the Legal Services Act 2007).

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shows the deliberate policy to reduce the balance held above the minimum reserve over the next few years to zero by 2017/18. Each of the above categories is considered in detail below.

Minimum Reserve

27. The calculation used in recent years for the minimum reserve produces the following figure for 2015/16:

$$\begin{aligned}
 & (1.5 \times \text{weighted average grants in previous 7 years}) + (3 \text{ months' costs paid} \\
 & \quad \text{from the Fund}) \\
 = & \quad (1.5 \times £17.1\text{m}) + (£2.7\text{m}) \\
 = & \quad \underline{\underline{£28.4\text{m}}}
 \end{aligned}$$

Cash outflows

See Annex 5 for detailed calculation of the minimum reserves for forthcoming years.

Cash Outflows

28. The Fund's main outflows are the payment of grants and of SRA and Law Society costs allowed by the legislation. The grants paid in the practising year 2013/14 were £23.8m as shown in Annex 6. The amount we expect to pay in grants for the practising year 2014/15 is forecast at £16.2m.

Future grants are forecast as follows:

2015/16 - £12.8m  
2016/17 - £15.0m

The value of claims and of grants paid is therefore expected to remain at a relatively stable level as shown in Annex 7. The trend in claims paid by calendar year is shown in Annex 8.

Future Claims and Costs

29. The main factors in forecasting grants are the numbers of current claims and expected future claims. The latter is in turn determined by the expected number of interventions.
30. For the purpose of this calculation, we have assumed that there will be 45 interventions in this and subsequent practising years, which represents the run rate to date this financial year.
31. Interventions also account for the bulk of the costs paid by the Fund. We liaise closely with Supervision on potential interventions to help forecast future intervention costs more accurately (as well as to prepare operationally). However, inevitably, this can only consider the position on investigations already underway which may lead to interventions in the coming months. Forecasting intervention numbers beyond that is very difficult.

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32. As was noted in last year's paper, we are seeing more interventions into firms which are closed in the sense of no longer having live client files but still hold client money and/or archived client files – often in very large numbers. An intervention into a “closed” firm with a large and disorganised archive can cost as much as an intervention into a live firm.
33. The SRA also continues to engage with some very large firms which are in financial difficulty. While intervention is unlikely in these cases, it remains a possibility.
34. Following the recent successful application to court on file destruction, cost savings are forecast to be realised from May 2016 onwards.

Future Grants likely to be paid in 2014/15

35. The total original value of open claims at the end of March 2015 is £45.5m. When looking at the revised claim value of open claims, the total as at the end of March 2015 was £17.8m. The total forecast for grants to be paid against these open claims is in the region of £4.9m, of this we forecast that £4.2m will be paid in this practising year.
36. The table below shows what we forecast to pay out in grants during 2014/15. The total is £16.2m made up of £8.2m actual grants paid out from November 2014 to the end of March 2015, £4.2m of grants in relation to current open claims, £2.6m on claims not yet received and £1.2m in relation to uninsured firms:

Actual grants paid to date (Nov'14 to Mar 15)	£8.2m
Forecast grants on open claims	£4.2m
Forecast for grants relating to future claims	£2.6m
Forecast for claims re uninsured firms	<u>£1.2m</u>
Total	£16.2m

37. Open claims have been evaluated to consider the likelihood of the claim being paid and when the payment is likely to be made. A possible future payout has been predicted based on historical payout rates, considering both the claim size and complexity.

Future Grants for 2015/16 onwards

38. All future estimated claims have been evaluated using the same methodology as in previous years. In addition, £2.0m has been included as future grants paid from 2015/16 onwards claims under Rule 5 relating to uninsured firms.

Costs paid from the Compensation Fund

39. The amount forecast to be paid from the Fund for 2014/15 is £10.3m based on the intervention costs included in the SRA budget. For 2015/16 the predicted recharge is £10.8m. This is made up of £7.0m intervention costs and the remainder is staff related costs. By way of comparison the costs in 2013/14 were £6.8m. The table at Annex 9 shows a breakdown of all costs recharged to the Fund.

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#### Cash Inflows

40. The main cash inflows to the Fund (excluding contributions) are transfers from Statutory Trust Accounts (STAs) through rights of subrogation and the transfer of residual balances.
41. Based on evidence of previously closed STAs and the ongoing work on live accounts, subrogated and residual funds are expected to total £11.1m in this year and £16.0m next year.

#### **Assumptions and Risks**

42. The following assumptions have been made in preparing this paper:
  - 45 interventions in this practising year and each year thereafter;
  - the costs payable from the Fund will be £10.8m of which £7.0m are intervention costs and the balance are staff related costs; and
  - rates of recovery from existing and future statutory trust accounts will not differ significantly from previous years.

#### Risks and Mitigation

43. Any departure from the assumptions above may result in lower than expected inflows to the Fund or higher than expected outflows, both of which would result in lower than expected reserves.
44. These assumptions are based on information available at the time of writing. The underlying assumptions surrounding the forecast are regularly reviewed to ensure that there have been no significant changes that will affect the Fund in the future. Overall, the risk to the Fund of increased outflows or reduced inflows is mitigated by maintaining a robust reserve.

#### **Recommended 2015/16 contribution**

45. By adopting the 3 year average there would be a required contribution of £9.0m, which represents an increase of £0.6m on the amount for the last practising year of (£8.4m).
46. For the purposes of calculating an individual and firm contribution it has been assumed that there will be the equivalent of 132,094 individuals paying a contribution and approximately 7,779 firms paying a contribution.
47. Based on these figures, a collection of £9.0m would result in an individual contribution of £36 and a firm contribution of £548, assuming that the current mechanism for collecting fees is retained (compared to £32 for individuals and £548 for firms last year). See Annex 10.

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48. However, it is recommended that we do not increase the individual fee by £4 this year and that the same fee is collected as last year. Overall this means we will collect £8.5m (£510k less than the £9.0m the model suggests), but we consider that this is low risk and manageable for the Compensation Fund. This move would also be perceived favourably by the profession in terms of the cost of regulation.
49. A comparison of year forecasts presented to the F&RC and SRA Board in recent years with actual position shows a significant favourable variance to forecast. For the three years considered by the 2011 forecast the actual position was £20.2m favourable, for the three years considered by the 2012 forecast the actual position was £13.8m favourable and for the three years considered by the 2013 forecast the actual is now expected to be £17.9m favourable.
50. This shows that the actual position has been significantly more favourable to forecast in each of the periods reviewed. The variances can be explained but show the general approach to forecasting has been cautious in previous years which should give the Board some comfort when recommending the proposed level of contribution.
51. On 30 April 2015 the SRA's Finance & Resources Committee (F&RC) approved the approach for the calculation of contributions to the Fund in line with the method used in previous years and at its meeting on 14 May 2015 the F&RC approved the recommendations in this paper.
52. Following the Board's decision in relation to the proposed funding levels for the 2015/16 Compensation Fund contribution, the matter will be considered by Management Board on 10 June 2015 and Law Society Council at its meeting in July 2015.

**Recommendation:** The Board is asked to recommend that TLS Council approves the contributions to the Compensation Fund for 2015/16 totalling £8.5m, resulting in a level of Compensation Fund contribution for 2015/16 as:

- **individual contribution - £32; and**
- **firm contribution - £548.**

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**Links to the Strategic Plan and / or Business Plan**

53. This paper relates to our strategic objective to “improve our operational performance and make fair and justifiable decisions promptly, effectively and efficiently” in the context of ensuring client protection through an effective and efficient Compensation Fund.

**How the issues support the principles of better regulation**

54. A properly run Compensation Fund provides transparency and accountability.

**What engagement approach has been used to inform the work (and what further communication and engagement is needed)**

55. The paper has been shared with Finance in Corporate Solutions.

**What equality and diversity considerations relate to this issue**

56. There are no equality and diversity considerations relevant to this paper.

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**Authors:** Clare Callan - Manager Claims Management & Recoveries, Client Protection

Tony King - Technical Manager, Client Protection

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**Date** 06 May 2015

**Annexes**

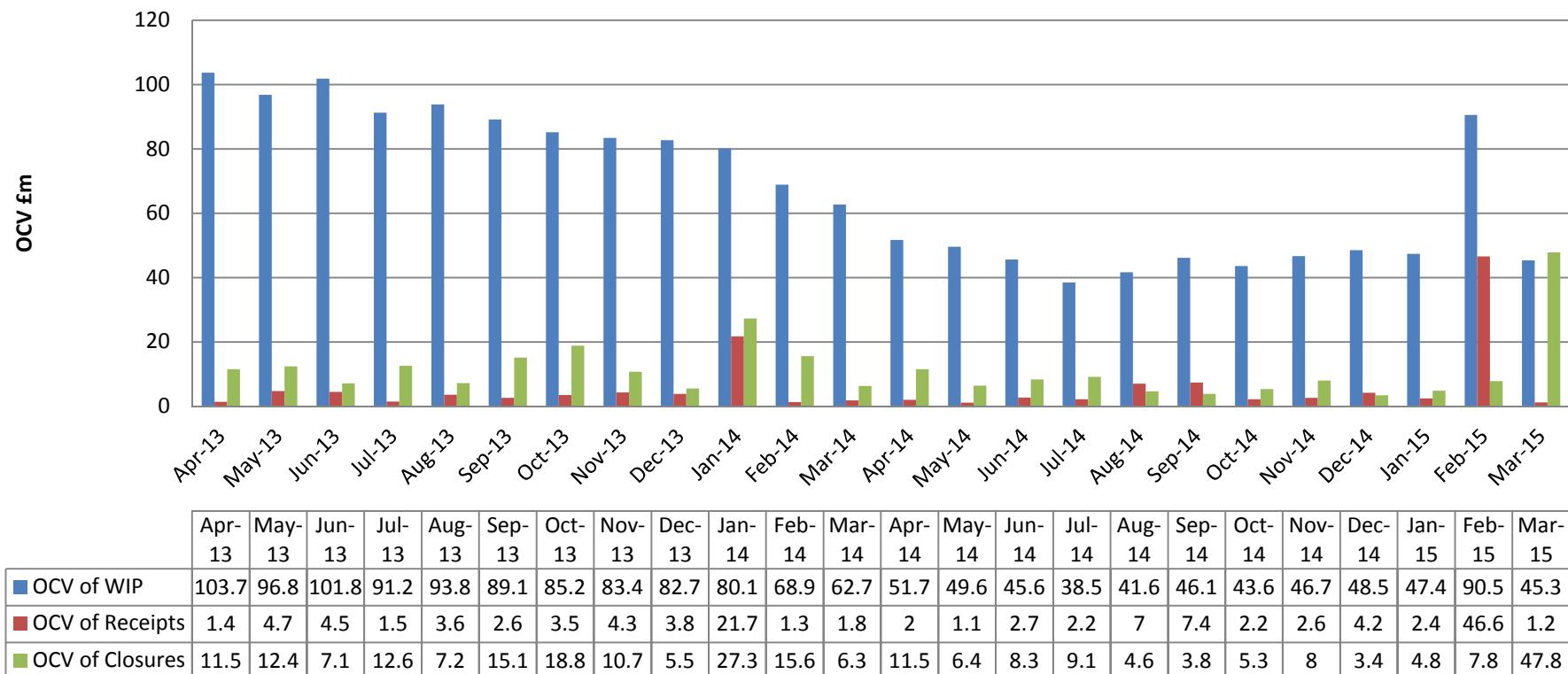
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|-----------------|---|
| <b>Annex 1</b>  | Original claim value (OCV) of work in progress (WIP), receipts and closures April 2013 - March 2015 |
| <b>Annex 2</b>  | Compensation Fund contribution shown as a balancing figure  |
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### Annex 1

#### Original claim value (OCV) of WIP, receipts and closures April 2013 - March 2015



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## Annex 2

### Compensation Fund contribution shown as a balancing figure

<b>Basis of calculation</b>	
<b>Opening balance</b>	As per accounts
<b>Less Cash Outflows:</b>	
Compensation Fund grants paid	Forecast based on work in progress, historical payout rates, expected future claims based on historical claim numbers and expected number of interventions.
Fees, taxes and other charges	Expected tax and audit costs
SRA support costs recharged	SRA budget / forecast figures
<b>Add Cash Inflows:</b>	
Subrogated claims	Expected receipts from existing Statutory Trust Accounts (STAs) based on historical distributions as well as forecast receipts from STAs in relation to future interventions.
Compensation Fund recoveries	Assumed to be broadly in line with previous years.
Residual funds	Expected receipts from existing Statutory Trust Accounts (STAs) based on historical distributions as well as forecast receipts from STAs in relation to future interventions.
Bank & investment income	Expected balances in the Fund and rates of return on investments
<b>Compensation Fund Contribution</b>	<b>Balancing figure</b>
<b>Closing balance = Minimum Reserve</b>	Calculation based on formula

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## Annex 3

## Compensation Fund budget and forecast 2014-2015

			PY 14-15		
2013/14 Actual	2014/15 Full Year Budget	Compensation Fund forecast 2014-2018 £000's	Actual November - March	Forecast April - October	Full year forecast
£72,037	£55,897	Opening balance as at 1st November	£56,010	£49,160	£56,010
<b>Cash Outflows</b>					
£23,787	£12,172	Compensation Fund Grants	£8,200	£8,042	£16,242
£38	£122	Fees, tax and other costs	£10	£22	£32
£10,611	£11,740	SRA support costs recharged	£3,828	£6,471	£10,300
£34,437	£24,034	<b>Total cash outflow in period</b>	£12,038	£14,535	£26,573
<b>Cash inflows</b>					
£6,246	£4,696	Subrogated claims	£2,363	£7,118	£9,481
£191	£142	Compensation Fund recoveries	£204	£98	£303
£1,785	£1,013	Residual balances from STA's	£188	£1,415	£1,603
£218	£293	Bank & investment income	£38	£127	£165
£8,440	£6,144	<b>Total cash inflow before contributions</b>	£2,792	£8,759	£11,552
-	-	<b>Net cash inflow / outflow before contributions</b>	-£9,245	-£5,776	-£15,022
£46,041	£38,007	<b>Balance before contributions</b>	£46,765	£43,384	£40,988
£9,970	£8,395	<b>Compensation Fund contributions</b>	£2,396	£0	£2,396
-	-	<b>Net cash inflow after contributions</b>	-£6,850	-£5,776	-£12,626
£56,011	£46,402	<b>NET BALANCE AFTER CONTRIBUTIONS</b>	£49,160	£43,384	£43,384

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Annex 4

**Compensation Fund forecast 2014-18**

	PY 14-15	PY 15-16	PY 16-17	PY 17-18
<b>Compensation Fund forecast 2014-2018 £000's</b>	<b>Full year forecast</b>	<b>Full year forecast</b>	<b>Full year forecast</b>	<b>Full year forecast</b>
<b>Opening balance as at 1st November</b>	<b>£56,010</b>	<b>£43,384</b>	<b>£45,295</b>	<b>£35,957</b>
<b>Cash Outflows</b>				
Compensation Fund Grants	£16,242	£12,811	£15,042	£16,571
Fees, tax and other costs	£32	£38	£38	£38
SRA support costs recharged	£10,300	£10,753	£10,806	£10,863
<b>Total cash outflow in period</b>	<b>£26,573</b>	<b>£23,603</b>	<b>£25,886</b>	<b>£27,472</b>
<b>Cash inflows</b>				
Subrogated claims	£9,481	£13,454	£5,888	£7,625
Compensation Fund recoveries	£303	£269	£269	£269
Residual balances from STA's	£1,603	£2,523	£1,124	£1,468
Bank & investment income	£165	£248	£248	£248
<b>Total cash inflow before contributions</b>	<b>£11,552</b>	<b>£16,494</b>	<b>£7,529</b>	<b>£9,610</b>
<b>Net cash inflow / outflow before contributions</b>	<b>-£15,022</b>	<b>-£7,108</b>	<b>-£18,357</b>	<b>-£17,862</b>
<b>Balance before contributions</b>	<b>£40,988</b>	<b>£36,276</b>	<b>£26,937</b>	<b>£18,095</b>
<b>Compensation Fund contributions</b>	<b>£2,396</b>	<b>£9,019</b>	<b>£9,019</b>	<b>£9,019</b>
<b>Net cash inflow after contributions</b>	<b>-£12,626</b>	<b>£1,911</b>	<b>-£9,338</b>	<b>-£8,843</b>
<b>NET BALANCE AFTER CONTRIBUTIONS</b>	<b>£43,384</b>	<b>£45,295</b>	<b>£35,957</b>	<b>£27,114</b>
variance from minimum reserve after contributions	£12,801	£16,874	£8,825	£0
<b>Calculated minimum reserve:</b>	<b>£30,583</b>	<b>£28,421</b>	<b>£27,132</b>	<b>£27,114</b>

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## Annex 5

### Minimum Reserve Calculations

<i>Minimum reserve calculation: grants paid last 7 years</i>	Contribution Year			
	2014/15	2015/16	2016/17	2017/18
Practising year ↓				
2008/09	£13.5 m	£13.5 m		
2009/10	£28.3 m	£28.3 m	£28.3 m	
2010/11	£15.4 m	£15.4 m	£15.4 m	£15.4 m
2011/12	£17.3 m	£17.3 m	£17.3 m	£17.3 m
2012/13	£15.8 m	£15.8 m	£15.8 m	£15.8 m
2013/14	£23.8 m	£23.8 m	£23.8 m	£23.8 m
2014/15 (forecast)	£16.2 m	£16.2 m	£16.2 m	£16.2 m
2015/16 (forecast)	N/a	£12.8 m	£12.8 m	£12.8 m
2016/17 (forecast)	N/a	N/a	£15.0 m	£15.0 m
2017/18 (forecast)	N/a	N/a	N/a	£16.6 m

Weighted average	£18.6 m	£17.1 m	£16.3 m	£16.3 m
Average * 1.5	£27.9 m	£25.7 m	£24.4 m	£24.4 m
3 months recharge	£2.7 m	£2.7 m	£2.7 m	£2.7 m
Minimum reserve	£30.6 m	£28.4 m	£27.1 m	£27.1 m

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**Annex 6**

**Compensation Fund year end balances and grants paid**

<b>Year</b>	<b>Grants paid</b>	<b>Year end balance</b>
2009-10	£28.3 m	£56.2m
2010-11	£15.4 m	£44.9m
2011-12	£17.3 m	£47.7m
2012-13	£15.8m	£72.0m
2013-14	£23.8m	£56.0m

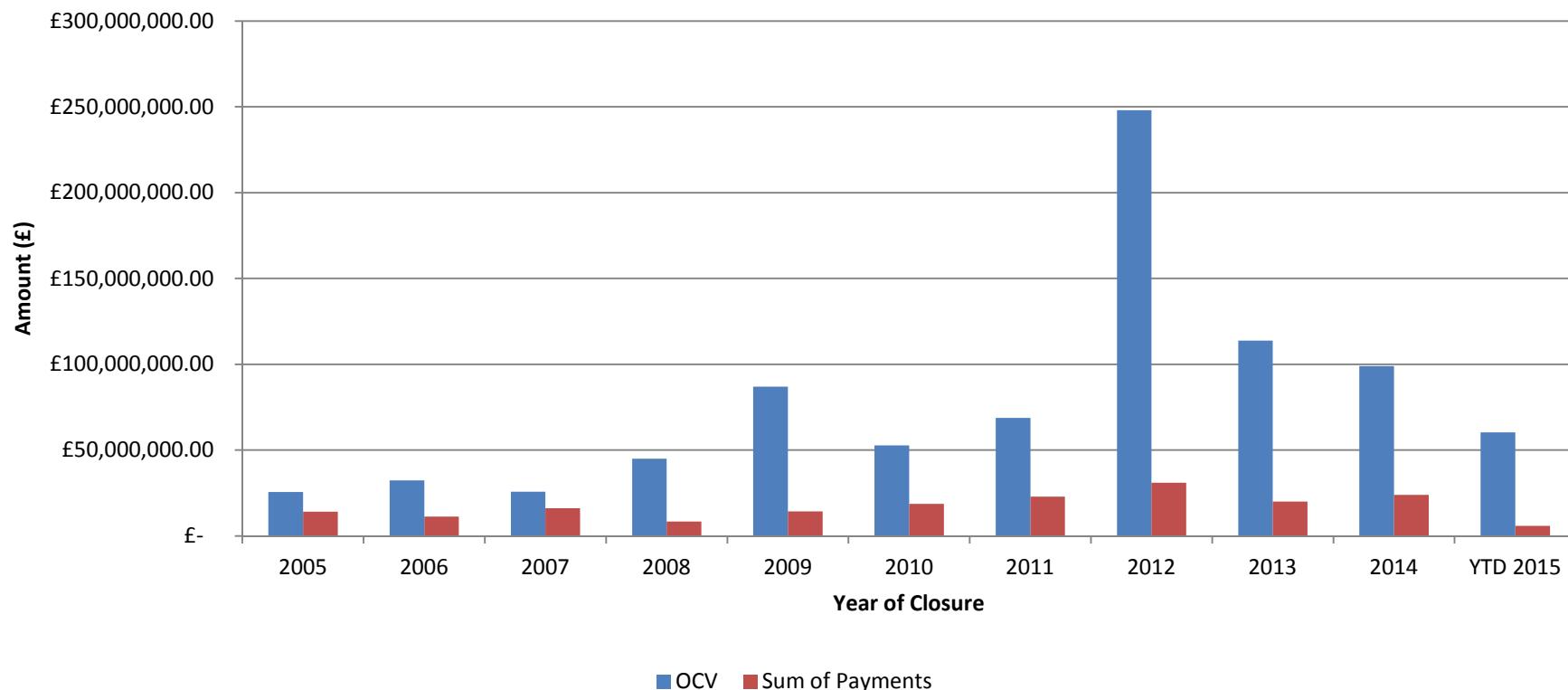


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**Annex 7**

**Original claim values and claims paid 2005-2014**

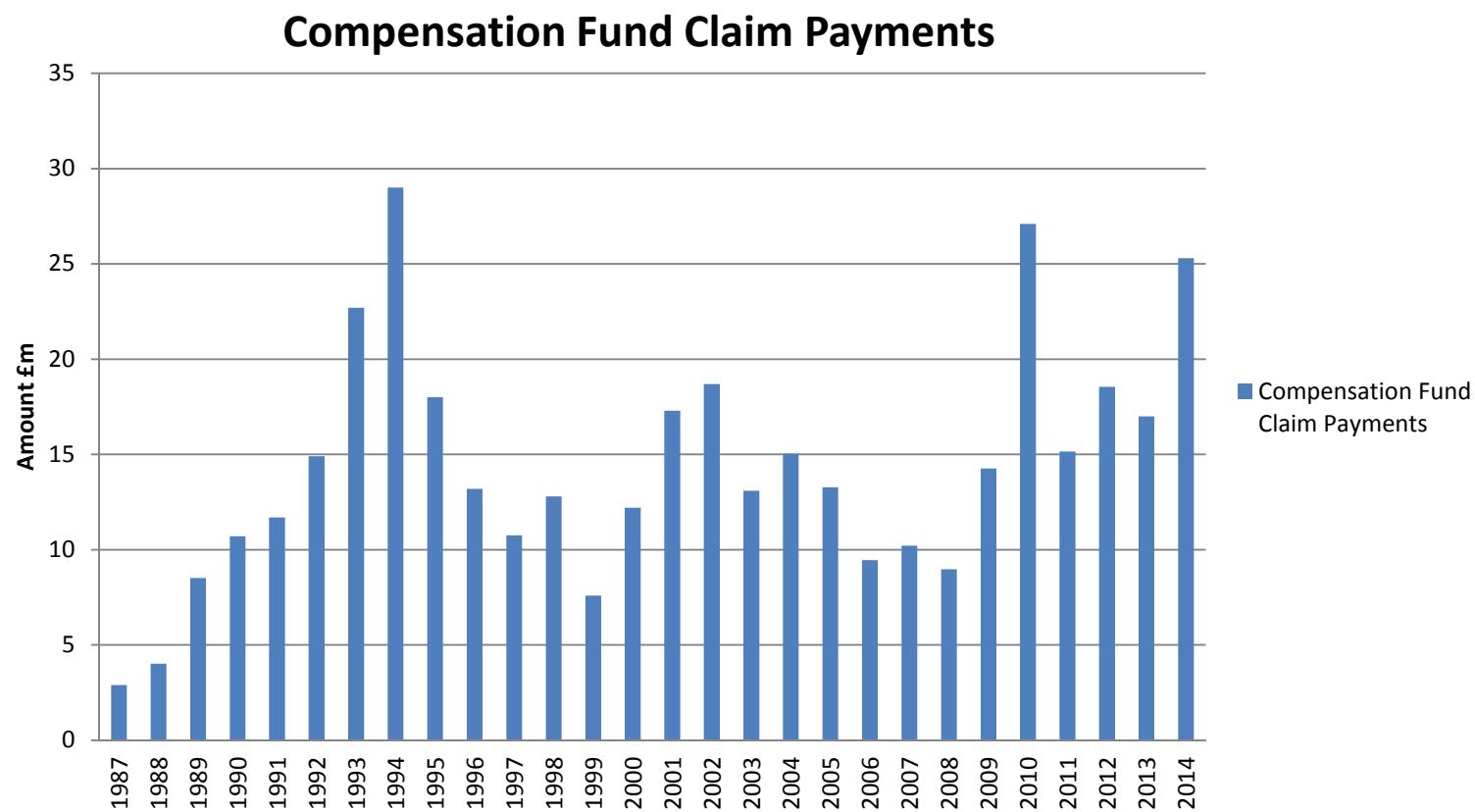




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Annex 8  
Compensation Fund claim payments by calendar year





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**Annex 9**  
**Costs recharged to the Fund**

	2015/16 (£000's)	2016/17 (£000's)	2017/18 (£000's)
Claims Management	1,027	1,053	1,082
Adjudication	48	49	51
Accounts Assessment	480	494	508
DSU	74	76	78
Contact Centre	100	100	100
Interventions	7,041	7,051	7,061
Shared service recharge	1,983	1,983	1,983
<b>Total</b>	<b>10,753</b>	<b>10,806</b>	<b>10,863</b>

	2015/16 (£000's)	2016/17 (£000's)	2017/18 (£000's)
Claims Management	1,027	1,053	1,082
Adjudication	48	49	51
Accounts Assessment	480	494	508
Directorate Support Unit	74	76	78
Contact Centre	100	100	100
Interventions	7,041	7,051	7,061
Shared service recharge	1,983	1,983	1,983
<b>Total</b>	<b>10,753</b>	<b>10,806</b>	<b>10,863</b>

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**Annex 10**

**Compensation Fund funding requirements and indicative contributions**

	Actual 2013-14	Actual 2014-15	2015-16 forecast	2016-17 forecast
Total contribution	13,445,450	8,378,322	9,019,000	9,019,000
Indicative individual Fee	£56	£32	£36*	£36
Indicative firm Fee	£836	£548	£548	£548
Firm / Individual split	50/50	50/50	50/50	50/50

\* It is recommended that the individual fee remains at £32 for 2015-16. Please note these are indicative contributions and may change if the number of firms/ individuals change.