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By email: dp21-05@fca.org.uk

Dear Sir / Madam,

**Financial Services Consumer Panel response to the FCA's consultation on the Compensation Framework Review**

The Panel welcomes the opportunity to respond to the FCA's consultation on the Compensation Framework Review.

The Panel request the FCA consider the general comments made below:

- The consultation refers to what it calls 'perceived complexity' in the protection system 'meaning that firms and/or consumers may not always understand the scope of protection'. This is true, and the Panel would also say that the complexity goes beyond just a perception, it is real complexity that is hard-wired into the way the current system is structured as well as presented and signposted.
- Fundamentally, FSCS protection needs to be the last resort which is understood by the Panel however not understood by consumers. The FCA needs to do more work on ensuring consumers are educated and empowered on who does what within the regulatory family.
- When there is a choice between higher standards or something else, the Panel would always choose and encourage higher standards. A regime that delivers the highest consumer protection is preferable to any move to water down protection. This is crucial as a tool to support and build consumer confidence in the financial services market and this is particularly needed following the increases in consumer harm and decreased levels of confidence during the Covid pandemic.
- There's a question within the consultation around limits for different types of product. The panel would advocate consistency of the scheme across different products in a way that consumers can understand (and those levels of understanding should be regularly monitored).
- The FCA's rules do not usually require firms to warn customers who are transacting where FSCS protection is not available. The Panel are in strong agreement that this is a flaw as this information is highly likely to influence and inform the decisions consumers make and where consumers believed they were protected but in fact are not – this can have a major impact on consumer confidence in markets. The Panel strongly believe that customers should be made aware of the protections available to them based on their product and would encourage the FCA to explore how they can enhance consumer confidence and how they can encourage firms to do the same.
- As with its consultation on the New Consumer Duty, the FCA will hear lots of strong and loud voices from industry but comparatively little from consumers and consumer bodies. The Panel would ask the FCA to ensure they recognise and address that imbalance and push back on the industry-driven approach/perspective.
- The FCA needs to set this work in the context of everything it has recently been started or is ongoing – all of which is aimed at reducing consumer harm and, if successful will reduce

consumer losses that the FSCS would otherwise have to fund. To make fundamental changes to the FSCS scheme at this stage (apart from key improvements in awareness-raising, and consistency across markets etc.) without those other things being in place would appear to be the wrong approach and poor timing. The Panel believe it is best to improve those things that need improving with the current system and then engage in a wider review once NCD, Consumer Investments Strategy etc are in place and can be assessed.

- The essence of the NCD is to reduce some of the costs and risks that are set out in the consultation, so now is NOT the time to start thinking about reducing the coverage that consumers enjoy, or even the levels/limits of protection.
- Assuming the FCA strategy delivers in its key areas of focus, then the amount of new harm being caused will reduce over time. Under the current approach, the compensation being paid by the FSCS today is redressing historically caused harms. These will continue to feed through the system for a number of years to come. We would therefore support periodic reviews of the FSCS, alongside all of the FCA's current initiatives to ensure they deliver the outcomes expected in terms of the reduction of harm.
- In addition to the current funding model the FCA would propose that the revenue from fines issued by the FCA should be directed into the FSCS pool. This would offset levy payments by firms, increase the percentage of the pool paid by 'bad actors' and help in the funding of any transition from levy relating to claims to a levy relating to business written approach. The Panel would encourage the FCA to identify how this income could be allocated to protect consumers and reduce the overall burden on firms.

Our responses to the specific questions are included at Annex A below.

Yours sincerely,

Wanda Goldwag  
Chair, Financial Services Consumer Panel

## ANNEX A – Responses to questions

### **Q1: Do you consider that proposed principles 1 and 2 are the appropriate principles to underpin the design of the compensation framework (in relation to the aspects of the framework that the FCA is responsible for)?**

The Panel welcome the FCA's efforts in this area and believe that at this stage, it is important to ensure the principles are applicable and the purpose of them is understood. The Panel would encourage FCA action to ensure that there is a broad protection mechanism that will enable and underpin consumer confidence.

The Panel would be keen to see how the principles listed tie in with the developing New Consumer Duty and would emphasise that the principles need to be considered from a consumer perspective as currently, the consultation has a clear focus on the industry perspective. The principles must focus on offering consumers the best redress mechanism whilst being practical for firms to implement. It is important that the FCA strike the right balance here so that firms can be encouraged to enter the market and not view the redress regime as onerous and therefore a barrier. This is a key concern of the Panel as firms are likely to withdraw from the market, reducing competition, if they view the regime as too intense/resource heavy.

Please see below for the Panel's feedback in relation to Principle 1:

- The Panel agree with the wording of this Principle. However, we challenge the underlying assumption, as disclosed by the comment in paragraph 2.6 where the FCA discuss 'perverse incentives' for consumers to take 'more risk than they can afford to, or at a level that exceeds their risk appetite' on the assumption that if the authorised firm fails, consumers will be compensated for losses. The FCA admits that while 'stakeholders often suggest that such incentives could exist' it does not currently have evidence to demonstrate that 'a compensation scheme affects consumer incentives in this way.
- Paragraph 2.7 seems to exacerbate this dangerous assumption by stating that under FSMA, 'when considering the degree of protection for consumers that may be appropriate, the FCA should have regard for the general principle that consumers should take responsibility for their decisions. For example, consumers should not make speculative or reckless investment decisions if they are unwilling to take on the risk.'
- This demonstrates another reason for waiting to see the NCD implemented and evidence of the FCA's New Consumer Principle and related rules and guidance fully operational through the authorisation, supervision and enforcement regimes.
- The Panel believe broader legislative change is needed to support the NCD. For example, we note the FCA's statement that the cross-cutting rules do not negate consumer responsibility and we support the FCA's clear position that consumers can only take responsibility where firms deliver the different aspects of the NCD<sup>1</sup>. But unfortunately, the current legislation does not support this position.
- We therefore reiterate our view that the consumer responsibility principle (s3B(1)(d) FSMA 2000) should be amended so that consumers are only deemed able to take responsibility for their decisions where firms have met their own obligations under the NCD. This reflects the significant and ever-growing (especially with the increasing frequency and scope of digital interactions) power asymmetries between firms and consumers. It also helps create a regulatory framework

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<sup>1</sup> <https://www.fca.org.uk/publication/consultation/cp21-36.pdf> para 2.34

that properly upholds the aims and objectives of the NCD<sup>2</sup>. The FCA should call on HM Treasury to make this legislative change at the next available opportunity.

Please see below for the Panel's feedback in relation to Principle 2:

- The Panel agree with the first part of the wording of this Principle as it brings focus on the need to increase consumer confidence in the financial services industry. The Panel however sound a note of caution about the second part as it is unclear what those benefits are and how they are balanced with an increase in consumer confidence.
- Therefore, the Panel believe the second part of the Principle is not needed. We are unsure why the 'consumer benefit' needs to be weighed against the benefits for the financial services industry.
- In our view, the other proposed Principles already cover the affordability of the compensation scheme and we are unsure why the consumer benefit in this principle would need to be weighed against the benefits to the financial services industry. The Panel would appreciate further explanation and justification of this.
- The Panel does not feel that the benefits to industry should be linked with the principles for the compensation framework. It is about increasing the amount of consumer confidence in the sector and implicit in that is consideration of the benefit for the sector without having to make an explicit balancing with 'you [the consumer] only get protection if the financial services sector also benefits'.
- Within this Principle it should then be for the firms in that market to decide whether they improve and become better 'actors' which will lead to a reduction in their levy, or they decide to keep going the way they are which means that to ensure that consumer confidence is delivered through the protection scheme then the costs to firms in that class will go up. The Panel view is that this is a compensation framework and not a balancing of benefit framework.
- Both the FSCS and Professional Indemnity Insurance suffer from the fact that the levy (in the case of FSCS) and premiums (in the case of PII) are collected in year to cover claims arising from products sold in previous years (in some cases as far back as 20 years)  
This leads to a clear mismatch, both in terms of the levy/premiums and original income and, in the case of the FSCS, a mismatch in the firms involved, where the current year levy is paid by firms not only potentially un-associated with the cause of harm, but also potentially by firms that didn't even exist or operate when the issue arose.  
This mismatch may lead to firms questioning whether to remain in, or enter, certain markets. It also, in the case of PII, makes it harder for insurers to predict and value the level of risk exposure. The current approach seems to fall well short of the principle that the 'polluter pays'.
- The Panel understands that it is difficult to go from a scheme where the levy is funded from the point of claim to one where it is funded from the point of sale as, for a period of time, firms will be paying for both approaches. However the panel believes this fundamental change is necessary (and will become more so over time) and would encourage the FCA to start to execute this migration.
- We believe a more risk-based approach and pre-funding is possible. We acknowledge that this would need legislative change due to the constraints from FSMA on the FCA which can only raise

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[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1032075/FRF\\_Review\\_Consultation\\_2021\\_-\\_Final\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1032075/FRF_Review_Consultation_2021_-_Final_.pdf)

levies based on what they expect to pay out in a year, so it does not in principle allow for that kind of pre-funding.

- The Panel would like to see the FCA's ambition have a higher proportion of redress liabilities paid for by the firms that cause the issue, way before they have a propensity to fail. To achieve this requires the FCA to have better complaints data and insight on what firms were doing about those complaints, and the quantum of their redress liabilities much earlier on. Having this would help get to a better stage where the FCA can be more predictive based on an assessment of yearly developments that may indicate potential problems year on year if FCA does not take certain steps.
- The Panel view is that the FCA needs to be more proactive in identifying issues and flags early to minimise the risk of calls on the FSCS - in an ideal world the FCA would know and be in more control of what is likely to come to FSCS at any given point. This would also enable the FCA to ensure that firms set aside funds (either from revenue or capital) into the redress scheme before they fail or wind-up.
- Again, this underlines the link with the wider universe of other initiatives that need to deliver change – for example, can similar outcomes be achieved by altering capital requirements for firms operating in some markets, improving firms resilience generally so they can meet more of their own liabilities or fundamentally reviewing the role of PII?
- The target solution must be that the firm pays out to everyone without anyone needing to complain.
- The funding model must be robust – but the panel also believes prevention is key. If the FCA prevent the authorisation of, or weed out, the 'bad actors' early on then the FCA will reduce the extent to which those firms that haven't caused harm end up funding the redress caused by those firms that have.
- With regard to cross-subsidy and whether the different classes make sense, along with the consideration of the 'retail pool' so that when each funding class reaches their threshold the retail pool then comes into play and contributes. The panel understands the FCA's view that some large redress cases have triggered the use of the retail pool, this reinforces our opinion that prevention (through authorization, supervision and enforcement) is critical to the operation of a redress scheme that protects consumers and is 'fair' across firms.

**Q2: What incentives, whether positive or negative, does the FSCS as a 'fund of last resort' create for market participants and what are the consequences of those incentives?**

The Panel would challenge the FCA's underlying assumption in this area. As disclosed by the comment in paragraph 2.6 where the FCA discuss 'perverse incentives' for consumers to take 'more risk than they can afford to, or at a level that exceeds their risk appetite' on the assumption that if the authorised firm fails, consumers will be compensated for losses. The FCA admits that while 'stakeholders often suggest that such incentives could exist' it does not currently have evidence to demonstrate that 'a compensation scheme affects consumer incentives in this way.

According to past research, consumers are more likely to be attracted to riskier products due to the level of return on offer.

This suggests there is still a fair way to go before consumers understand protections.

The Panel believe there needs to be more obligation on firms to explain to consumers what protection is provided with products. Similar has been seen with the FSCS, proving that it is not easy for consumers to know when they are protected.

The FCA mentions that percentage awareness levels were really low. There are two separate risks in relation to this – the risk of putting money somewhere where consumers hope for a decent return.

There's also the risk of the firm going out of business, this is something that cannot be judged by consumers and is often misunderstood.

**Q3: Do you have any further suggestions on how to ensure the FSCS is not over relied on and represents a true 'fund of last resort'?**

The Panel agree that the FSCS should not be over relied on. In order to ensure this, the FCA needs to enhance consumer understanding of the regulatory family and their roles.

The FCA should also ensure that the FSCS is the last resort after (1) the firm's P&L, (2) the firm's capital, and (3) the firm's PII cover have been utilised.

**Q4: Do you consider that a change in the scope of FSCS protection could be justified, whilst remaining in line with the proposed principles for protection at paragraph 2.2? If yes, please outline how and why you consider protection should be changed.**

The consultation considers whether a change to the scope of FSCS protection – either serving to widen or reduce the scope of protection – may be appropriate. The Panel expect that industry may say the scope needs to be narrowed and that consumers should take on the risk if they are outside the parameters of the scheme. However, this is not easy for consumers to know if they are dealing with a regulated firm or if their product is regulated – consumers also do not currently understand what protections are available to them.

As such, the Panel would encourage the FCA to work on improving consumer engagement and understanding of the protections available.

The Panel believe the FCA should only consider any changes to the scope of FSCS protection in the context of the New Consumer Duty and ensure that any changes are in the spirit of and promote the New Duty.

The Panel believe that this comes down to what consumers understand – in most cases they are unlikely to choose on the basis of regulated v non-regulated but will consider the product, its features and benefits. The Panel believes it would be unfair to exclude certain products from the scope of the regime as customers will not understand the implications of this.

In relation to the scope of protection, the Panel would highlight two areas where FSCS cover is imperative to consumers. The first one being Funeral Plans, where the FCA need to ensure that consumers are protected in the event of firm failure and ensure continuation of cover (when applicable) – an application of appropriate capital rules would reduce the strain on the FSCS should any firms fail.

The second area is consumer credit. The Panel continue to press for FSCS cover or similar for mis-sold borrowers of existing firms. The Panel strongly believe that consumer credit should not be excluded from this scheme, this is due to the level of consumer harm that arises when a firm fails. The Panel believes the time is right for this question to be examined thoroughly alongside this review. The Panel would welcome being involved in a project to look at how outcomes can be improved for customers who have suffered harm at the hands of consumer credit firms:

- Levels of historic mis-lending remain persistently high, and the harm this causes is well understood
- Firms are choosing to exit the market, and currently this results in poor pay-outs for policyholders (often just a few p in the £)
- Delay simply advances the point at which the large majority of existing mis-selling has crystallised with bad consumer outcomes.

The Panel believes that there are two questions which need examining in parallel.

- 1) How can outcomes be improved for customers of existing firms with legitimate mis-selling complaints?
- 2) How can the regime better serve future customers through changes to legislation, FOS rights, and regulatory tools like capital rules and access to FSCS

**Q5: If you consider a change in the scope of FSCS protection could be justified, please set out the positive and negative implications of such a change in protection, for both consumers and the financial services sector more generally.**

The consultation considers whether a change to the scope of FSCS protection – either serving to widen or reduce the scope of protection – may be appropriate. The Panel expect that industry may say the scope needs to be narrowed and that consumers should take on the risk if they are outside the parameters of the scheme. However, this is not easy for consumers to know if they are dealing with a regulated firm or if their product is regulated – consumers also do not currently understand what protections are available to them.

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**Q6: Following the UK's withdrawal from the European Union, is the narrower territorial scope previously decided on for AIF and UCITS managers and CIS operators still appropriate? If not, what alternative options should we consider?**

The FCA are inviting comment on the fact that the UK has a particularly generous scheme, and the Panel has always said (particularly with Brexit) that where there's a choice between higher standards, or something else, we would always go with the regime with the highest standards of protection, and this would appear to be the current UK regime. As such we would not support a 'race for the bottom' approach following Brexit.

**Q7: How can we make sure that consumers are provided with clear information about the availability of FSCS protection that equips the consumer to make effective and properly informed**

**decisions about financial products and services, including those where FSCS protection is not available?**

It is crucial that consumers are provided with clearer and more consistent explanations of FSCS protection. This is highlighted by the fact that currently only deposit-takers are required to communicate the protection FSCS offers. If the industry is serious about protecting consumers, this requirement must be extended across a wider range of financial products.

The Panel strongly believe that customers should be made aware of the protections available to them based on their product and would encourage the FCA to explore how they can enhance consumer confidence and how they can encourage firms to do the same.

The Panel suggest consideration of the following:

- All products that come within the remit of the FCA should be labelled as either being covered by the FSCS or not being covered – with the level of cover clearly shown. There should be a requirement for this to have equal prominence to the key feature disclosed by the firm in relation to the product – namely the same prominence as the interest rate for savings accounts etc.
- What do consumers understand? They are not choosing between regulated vs non-regulated – what do they understand about this and the perimeter? Difficult to exclude certain products when we know consumers will not understand the implications of these products.
- Distinguish between UK/non-UK managed assets and products and claiming eligibility – something consumers would not know about; how would they know? Would they even check?
- Consistency in protections and level of protections
- Level of protection for pensions – auto enrolment – the limit should be higher and match maximum pensions
- The Panel has also said in the past that the level of protection for investments and pensions should recognise the fact that with auto-enrolment and defined contribution that the limits should be significantly higher and for pensions should match the max amount that consumers are able to put in there in the first place.
- Adopting a principles-based approach – consistent application of principles and consistent scheme across products that consumers can understand
- RAG status allocation discussion – can the FCA give ratings to these products?

**Q8: When distributing non-UK funds to retail investors in the UK, should firms be required to inform customers when FSCS protection is not available? If yes, how could firm ensure customers are aware of the lack of protection, through the fund’s marketing materials or otherwise?**

If a product does not come with FSCS protections, firms most certainly should be required to inform consumers. This is something the Panel believe strongly. (See our response to Q7)

**Q9: Do you consider that ‘high-net-worth’ and/or ‘sophisticated’ individuals should be excluded from being able to claim from the FSCS in certain circumstances? If so, should the exclusion(s) apply to all types of claim or just certain categories of claim?**

The above classification of individuals often relies on self-certification that the customer is opting out of protection. The Panel know from various T&C research that if a customer wants a product, they tend to accept all the Terms and Conditions listed in front of them.

Therefore, so long as consumers can self-certify, the panel would argue that they should be included in the FSCS coverage.

The Panel encourage the FCA to consider the following:



- The Panel has always taken the view that all consumers should be protected. A consumer's wealth does not mean they know how or what to invest in or that they won't be exploited by 'bad actors' – The Panel's stance is that all Consumer Duty related rules apply to all consumers.
- Consumers may not know if they would be classified as 'high net worth' individuals because the definitions differ, for example, if you're in the mortgage market versus a consumer investment market.
- Consumers' circumstances can change very quickly. Creating two-tier consumer protection would lead to confusion over where the boundary is? At what point in time would the protection boundary apply? What if someone's financial situation changes post investment (eg become 'high net worth' afterwards, or lose their 'high net worth' status...)?
- The FCA acknowledge (paragraph 4.9) that there are currently no reliable statistics to show that much of the payments made by FSCS are paid to 'high-net-worth' or 'sophisticated' consumers (or 'individuals' as the DP refers to them)

**Q10: Do you consider any other amendments should be made to the current eligible claimant criteria?**

No comment.

**Q11: Does the CIS look-through remain appropriate from a consumer protection perspective? If not, what alternatives should be considered to protect investors in CISs?**

In relation to consumer protection, the Panel would encourage the FCA to ensure consumer understanding of protections and suggest consumer testing in this area to identify the levels of understanding then action to enhance consumer understanding.

**Q12: Do you consider changes should be made to the level of compensation that is payable by the FSCS? Please provide justification for any changes you propose.**

The Panel suggest the FCA consider the pension market as an example of a need for a review of the effectiveness of FSCS protection in different sectors. We would also suggest the FCA looks at and applies any lessons learnt from the British Steel Pension Scheme in relation to redress.

The panel also believes that the application of compensation limits needs more consistency. In banking for example, the limit is per banking licence (in other words the Brand the consumer deals with) however when investing through a platform the limit is per Investment Firm, not the platform firm itself. This lack of consistency means that many investors will not be fully covered as their combined investment with an investment firm is in excess of the FSCS limit, even though it is spread through multiple platforms.

**Q13: Would you be in favour of the introduction of set periodic reviews of the compensation limits to ensure that they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?**

Yes.

**Q14: Do you consider that proposed principles 3 and 4 in relation to FSCS funding are the appropriate principles to underpin the design of the funding arrangements (in relation to the classes which the FCA is responsible for)? If not, what principles would be preferable?**

The Panel agree with pooling together different groups into one class. It would make sense to group them according to the level of risk and function of the different products.

**Q15: How do you consider the current funding model (for the classes that the FCA is responsible for) could be improved, to ensure that costs are appropriately distributed and the impact on firms is**

**proportionate? Please explain how your proposed changes represent an improvement on the current arrangements.**

Whilst firms may argue that the model for compensation is unsustainable, the Panel believe it is also for them to come up with the solution to protect what consumers are getting. Costs are reflective of the harm.

In addition to the current funding model the FCA would propose that the revenue from fines issued by the FCA should be directed into the FSCS pool. This would offset levy payments by firms, increase the percentage of the pool paid by 'bad actors' and help in the funding of any transition from levy relating to claims to a levy relating to business written approach

**Q16: Are there any alternative metrics to annual eligible income that would help to ensure that compensation costs in the Investment Provision class are distributed more fairly between firms in the class?**

No comment.

**Q17: Would you be in favour of the introduction of set periodic reviews of the funding class levy limits to ensure they remain at an appropriate level? If so, what**

Yes, we would definitely be in favour of periodic reviews.

**Question 18: Do you consider that any alternative funding model would be preferable to the current funding model? Please describe the alternative model that you consider to be preferable and the benefits over the current arrangements.**

In addition to the current funding model the FCA would propose that the revenue from fines issued by the FCA should be directed into the FSCS pool. This would offset levy payments by firms, increase the percentage of the pool paid by 'bad actors' and help in the funding of any transition from levy relating to claims to a levy relating to business written approach

**Question 19: Do you have any overarching comments on the proposed principles for the compensation framework, or do you have any further principles that we should account for?**

The Panel has no comment but would encourage the FCA to work to improve consumer understanding.

**Q20: Are there further opportunities to improve the aspects of the compensation framework that the FCA is responsible for? Please describe the further changes which you consider should be made.**

The FCA already has a lot of initiatives in the pipeline, which is going hopefully to target the risks, reduce the harms, increase the prevention – so the market will be a very different place to enter or trade in, but that is still some way off.

The Panel view is that the Principles really need to focus on offering consumers the best redress mechanism that can be made available, that's affordable, and some of the key issues are around the complexity and the level of understanding of consumers. These are the real issues that are going to be a struggle for the FCA – how to increase consumer awareness.

The Panel request the FCA consider the following:

- There are obvious issues around the uncertainty and unpredictability for the FSCS of the protection payments it will have to pay out annually. It is important to consider what other sources of funding can contribute to reducing the overall burden on the sector (and ultimately the consumer). The **fine income** of FCA is one where there is great scope for a more directional application to help reduce the industry levy and protect consumers more widely. The Panel view

is that this should be used for the benefit of consumers who have suffered at the hands of the industry. This is clearly attractive to support a more effective and affordable 'polluter pays' regime that leads to 'polluters' to pay for the broader sectoral pollution. We would strongly request the FCA to raise this in its discussions and representations to the Treasury.

- Misdemeanours in the industry (often uncovered through FCA supervision) can generate substantial if unpredictable levels of fine income. Currently this fine income goes to Treasury. We question whether this is fair and appropriate considering the FCA's consumer protection objective. We would expect this fine income to be used to help fund the kind of protection consumers need and expect. It would also reduce the need to call on the retail fund. This would contribute to protecting the FSCS funds, reduce the financial burden on the industry and contribute to maintaining the levels of protection consumers are entitled to and expect.