Consumer and Retail Policy
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

By email

8 March 2022

Dear Sir/Madam,

FCA Practitioner Panel Response to DP21/5 Compensation Framework Review

The Panel's view is that the current funding structure for the FSCS is unsustainable and we support the FCA's desire to reinforce the principle that the FSCS is a fund of last resort. Any actions it can take to remove perverse incentives for bad actors (such as misconduct, knowing the fund will pick up the bill) and consumers (such as taking a greater degree of risk, again knowing the fund will pick up the bill) alike will receive our support. We therefore support the principles underpinning the compensation framework review.

With respect to good or bad incentives for market participants, we do not believe that it is the fund itself that creates incentives and do not imagine bad actors go into the market aiming to conduct themselves inappropriately safe in the knowledge the FSCS will compensate its customers. However, it does provide an inadvertent safeguard for firms which are ultimately incentivised by the low capital requirement which makes it easy for them to establish themselves. In short, it is not the motivation for, but it does enable, their poor behaviour along with the low capital requirements. We believe a capital requirement which is commensurate with the risk being taken would act as a better incentive to behave appropriately, which would in turn alleviate the strain on the FSCS. The Panel made this point earlier when responding to the HM Treasury Future Regulatory Framework Review[1].

We believe there are a number of levers that need to be pulled which will each have an impact on the FSCS. The key is dealing with the root cause of misconduct which is what ultimately leads to reliance on the FSCS. The DP lists a number of initiatives the FCA is undertaking to deal with those root causes, such as:

- The new Consumer Duty
- Consumer investments strategy
- Review of the Appointed Representatives regime
- Tackling phoenixing
- New prudential regime for investment firms
- Exploring a new prudential regime for non-MiFID firms (i.e. the majority of the investment advice market)

These are all initiatives we agree will play a part in reducing the levy, but the other key area is how the FCA approves and supervises firms. Both areas therefore need to be bolstered in terms of resources and skills to ensure that these policy changes are effective and thus actually have an impact on the FSCS burden.

[1] https://www.fca-pp.org.uk/sites/default/files/20210218_frf_review_-_practitioner_panel_evidence_final.pdf

Unregulated investments

In terms of what should be protected by the FSCS, we believe the issue of unregulated investments (where the advice itself is regulated) is one that needs resolving. We accept that the FCA does not set the perimeter, but there are ways to address the issues without legislative change. For example, although it would be difficult to carve this out via the FSCS rules, the FCA could explore how to ban regulated firms from providing advice on unregulated investments to retail clients. We do not believe the current capitalisation of these advisory firms reflects the degree of risk associated in advising on unregulated assets and therefore is a significant risk to the FSCS in the future. Another option would be to consider whether those with the means to seek compensation via the courts should not benefit from the protections of the FSCS – or, although noting this may be technically difficult, it should be explored as to whether High Net Worth, Professional and Eligible Counterparty clients who receive regulated advice on unregulated investments should be excluded from the scope of the FSCS. Such clients should be capable of understanding the risks of such investments, and therefore be able to accept a loss of that nature.

The importance of data

The FCA needs to get better at utilising available data from sources such as the FSCS and PI insurers to detect firms that are likely to fail. There also needs to be a 'look back' exercise – what are the common features of the firms that have failed and how should the FCA seek to identify those features in firms at authorisation and in the supervisory cycle?

We look forward to seeing the FCA's conclusions and how it intends to take the work forward.

Yours faithfully,

[Signed]

Penny James
Chair, FCA Practitioner Panel