

# Compensation framework review: response to feedback and next steps

**Feedback Statement**

FS22/5

December 2022

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# 1 Summary

- 1.1** In December 2021, we published a [Discussion Paper \(DP21/5\)](#) to seek views from stakeholders as part of our review of the compensation framework within which the Financial Services Compensation Scheme (FSCS) operates.
- 1.2** Our review was established in the context of increasing concerns about the cost of compensation liabilities falling to the FSCS. Accordingly, our review aims to ensure that the compensation framework (for the aspects of the framework that the FCA is responsible for) continues to provide appropriate and proportionate consumer protection with costs distributed across industry levy payers in a fair and sustainable way.
- 1.3** We are grateful to stakeholders for engaging in the review positively and constructively and for their responses to our discussion paper. We received 67 responses from both consumers and representatives of different parts of the financial services industry providing us with a helpful array of ideas and perspectives. In light of this feedback, we have now considered our next steps for the review.
- 1.4** The prevailing feedback from stakeholders was that the high cost of compensation liabilities falling to the FSCS is not a feature of the compensation framework itself, but have occurred because of the harms from certain markets that give rise to FSCS liabilities. Stakeholders felt the most effective way to bring down the cost of claims falling to the FSCS was for firms to improve their conduct to minimise the liabilities in the first place and to be more financially resilient. There was no clear appetite to bring the costs down in other ways such as removing aspects of consumer protection provided by the FSCS. It was acknowledged that this would merely shift the burden of the costs to the consumer, who would be unprotected if a firm failed.
- 1.5** Many of the claims that the FSCS is dealing with today relate to misconduct by firms occurring several years ago. It takes time for mis-selling or misconduct to come to light following the original advice, for the firm to fail as a consequence and for consumers to refer claims to the FSCS. So, these liabilities are already 'baked in' to the pipeline of liabilities that are likely to ultimately fall to the FSCS to deal with. We therefore need to recognise that liabilities from historic misconduct issues will continue for the time being to fall to the FSCS, before costs will start to come down. In the meantime, it is paramount that we prevent further costs becoming baked into the FSCS in the future. Part of this will be how we authorise, supervise and enforce against firms in markets, and another part will be how the regulatory regime in different markets ensures firms deliver good consumer outcomes and are financially resilient. We need to consider what the future scope of FSCS protection should be in light of this.
- 1.6** Therefore, the next steps for the Compensation Framework Review have four aims:
- Those liabilities that are already baked into the system are dealt with effectively and efficiently.
  - The funding model for existing and future liabilities continues to apportion costs in the most proportionate way.
  - Compensation limits are appropriate given the type of claims we currently see – and may see in the future.

- The scope of FSCS protection is adapted over time in the context of workstreams looking at the way sectors, including the retail investment markets, are regulated.

### 1.7 So this feedback statement sets out:

- How we are already taking forward our strategy to tackle the underlying causes of FSCS redress liabilities. This is a key element of our strategy for 2022 to 2025, with its focus on reducing and preventing serious harm in line with our approach to be a more innovative, assertive and adaptive regulator. Our Strategy sets out how we will work to stop firms with inadequate harm-prevention controls from entering our markets. At the same time, we are targeting those firms that are already authorised that carry the greatest potential to cause consumer detriment with the aim of preventing harm happening in the first place. We are focusing our work on particular markets, such as through our Consumer Investments Strategy – to which we have published a recent 1-year update.
- To ensure that FSCS compensation costs continue to be allocated amongst firms in a fair and sustainable way, we will set out plans to review the current funding arrangements, to ensure the funding class thresholds remain at an appropriate level. We plan to start this work during 2023. We have also highlighted to Government the strong calls for using monies from financial penalties (imposed further to Enforcement investigations) to fund FSCS compensation costs.
- Our plans to review compensation limits in 2023, to ensure the limits continue to provide an appropriate level of protection for consumers, including for pension claims.
- Over the medium term we want to consider the appropriate scope of protection. We will do this both for sectors that we currently regulate, particularly investments – and also new sectors that we may regulate in the future. For both existing and new sectors and activities, we want to ensure that appropriate safeguards are in place to protect consumers, before determining the appropriate level of protection for that activity. We will undertake research to inform this work, to fully understand the impact that the availability of FSCS protection has on consumers and the incentives it creates for firms. Our work will also be informed by the updated principles for protection that we set out in Chapter 5.

## Who this affects

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**1.8** These issues have direct implications for consumers – who may benefit from the protection the FSCS provides – and for industry levy payers – who are required to fund the FSCS. The issues discussed also have wider implications for the financial services industry more generally, in terms of the benefits that the FSCS brings, particularly by maintaining consumer and market confidence in the industry.

**1.9** This feedback statement will be of particular interest to:

- consumers
- groups representing consumers' interests
- regulated firms, including FSCS levy payers
- trade bodies for regulated firms

## The wider context of this feedback statement

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- 1.10** The Compensation Framework Review was launched in the context of increasing claims liabilities falling to the FSCS in recent years. Total compensation costs have increased from between £200 and £300 million between 2011/12 and 2014/15 (excluding the Major Banking Failure Levy paid up to 2017/18) to £717 million in 2021/22. Notably, in recent years, the FSCS has seen increasing numbers of claims about pension products, with pension claims representing around 86% of total investment claims paid over 2021/22.
- 1.11** These increasing compensation costs have led stakeholders to question how the FCA is tackling the cause of recent high FSCS costs – and how we are ensuring that excessive costs are avoided in the future. Questions have also been raised about who and what the FSCS protects and to what level. Regulated firms which are required to contribute to the FSCS levy have also raised concerns about the impact of the FSCS levy on their businesses and the fairness of how costs are apportioned between firms.
- 1.12** In this context, we wanted to hear from stakeholders about ideas for addressing these concerns – in relation to the issues we see impacting the framework today in respect of historic liabilities, and the issues and opportunities we expect to see in the future. When we began the review, we recognised that groups would have different, potentially competing, views on how to improve the framework. For example, stakeholders may have differing views on whether we should expand or reduce protection and competing financial interests on how compensation costs should be shared across sectors. These different opinions have been borne out in the feedback we received.
- 1.13** The Compensation Framework Review focuses on the aspects of the compensation framework that we are responsible for. Under the Financial Services and Markets Act 2000 (FSMA), the FCA and the Prudential Regulation Authority (PRA) are each responsible for making rules in relation to the FSCS. The PRA is responsible for rules on claims in connection with deposits, insurance provision and dormant accounts. The FCA is responsible for claims for all other relevant types of financial services activities that are protected by the FSCS. The rules which we are responsible for are set out in the Compensation sourcebook (COMP) and Chapter 6 of the Fees Manual (FEES) in our Handbook.

## How it links to our objectives

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- 1.14** All 3 FCA operational objectives are relevant to the Compensation Framework Review:
- Consumer protection: We want to ensure that there is an appropriate level of protection to protect consumers if an authorised firm that they deal with goes out of business and is unable, or likely to be unable, to meet claims against it.
  - Market integrity: We want to ensure that funding is available to cover the cost of claims falling to the FSCS, with costs distributed across industry levy payers appropriately and sustainably. We also want to ensure that the existence of this protection helps to maintain consumer confidence in the financial services industry and encourages consumers to continue to do business with financial services firms.
  - Competition: We want to ensure that the FSCS framework helps to promote effective competition in the interest of consumers, by not creating conditions which unduly affect competition or create barriers to entry to or exit from markets.

## Summary of feedback and our response

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**1.15** We received 67 responses to the discussion paper, including 24 responses from consumers, 26 from firms and industry representatives, 12 from trade bodies, 3 from FCA panels, 1 from a charity and a response from the FSCS.

**1.16** There were 3 key themes arising from this feedback:

- Respondents frequently gave the view that the key to stabilising and bringing down the FSCS levy is to tackle the causes of harm, for example by strengthening the authorisation and supervision of firms and by improving firms' resilience.
- We received differing views on the appropriate scope of FSCS protection. Some stakeholders supported expanding FSCS protection with others suggesting that the scope of protection should be reduced. Most respondents considered that the FSCS provided consumers with important protection.
- Levy paying firms and their trade bodies generally felt the impact of FSCS compensation costs on firms had a detrimental effect on businesses, and that the application of cross subsidies through the Retail Pool was unfair. However, we received mixed views about whether changes to the current funding arrangements or a move to a different funding structure would be beneficial.

**1.17** We give further detail of the feedback received and our response in subsequent chapters.

## What we are changing

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**1.18** This feedback statement sets out plans for the following:

- Ongoing work to **tackle the underlying causes of high FSCS compensation costs** to bring down the compensation costs falling to industry levy payers. This involves tackling past misconduct issues and anticipating future issues and opportunities. This is in line with the Consumer Investments Strategy's aim to act to stabilise the cost of claims falling to the investment funding classes by 2025 and to target a year-on-year reduction in these classes from 2025 to 2030. See Chapter 2.
- Our future work will be shaped and informed by consumer and firm research to **improve our understanding of the impact of FSCS protection on consumer decision making, confidence and behaviour**, and the effect of FSCS protection on **firm behaviour and incentives**. This research will help us develop future policy proposals (by helping to understand the impact of potential policy interventions on consumers and firms) and help to demonstrate the value of the FSCS to market participants. See Chapter 2.
- To consider the appropriate **scope of FSCS protection** and how best to communicate the availability of FSCS protection as part of several ongoing connected workstreams designed to reshape the regulatory framework for consumer investments. See Chapter 3.
- To **review compensation limits** to consider whether they remain at an appropriate level for different types of claim. This includes considering introducing a process for the periodic review of compensation limits. See Chapter 3.
- To **review funding class thresholds** to consider whether the class thresholds remain at an appropriate level and to consider introducing a process to periodically review class thresholds. See Chapter 4.

- 1.19** We expect to largely complete these actions over the next financial year, 2023/24, with some aspects continuing over the medium term – particularly our consideration of whether to revise the scope of protection.

## Outcome we are seeking

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- 1.20** The Compensation Framework Review's objective is to ensure that the framework continues to provide appropriate and proportionate consumer protection with compensation costs distributed across industry levy payers fairly and sustainably.
- 1.21** If we consult on specific policy proposals on these actions in the future, we will specify outcomes and success measures for the specific interventions.

## Equality and diversity considerations

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- 1.22** We have considered the equality and diversity issues that may arise from our review of the compensation framework.
- 1.23** Overall, we do not consider this feedback statement adversely impacts any of the groups with protected characteristics, ie age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment.
- 1.24** We will continue to consider the equality and diversity implications of the issues raised in this feedback statement throughout our review of the compensation framework.

## Next steps

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- 1.25** We will progress the key actions set out in this Feedback Statement over the next year. We expect to consult on any proposed changes to the compensation rules during 2023/24 with a view to confirming any changes by the end of that financial year.

## 2 The FSCS as a 'fund of last resort'

**2.1** In our discussion paper, we sought views on how best to ensure FSCS is seen as a true 'fund of last resort' by tackling the causes of high claims costs falling to it. We also proposed 2 key principles for protection and considered the fundamental purpose of the FSCS, how it fits into the wider regulatory framework and the benefits of having an appropriate and proportionate compensation framework.

### Principles for protection

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**2.2** In our discussion paper, we proposed the following 2 principles for protection to give context to the purpose of the compensation framework and frame the discussion:

#### **Principles for protection – proposed in DP21/5**

##### **Principle 1 – the FSCS is a fund of last resort and should not be the first line of defence for protecting customers of authorised firms from harm:**

The FSCS is the UK's statutory compensation scheme for customers of authorised financial services firms carrying out certain regulated activities. This means that the FSCS represents a backstop to protect consumers from financial harm in the event that other mitigants are not sufficient. The first resort to protect consumers is the governance, conduct and financial resilience of authorised firms.

##### **Principle 2 – FSCS protection for a particular regulated activity and category of individual should increase consumer confidence in the financial services sector. The availability of protection, and the benefits it brings to consumers, should be commensurate to the benefits to financial services markets:**

The availability of FSCS protection adds value to the overall financial services sector, by reassuring customers that it is safe to do business with authorised firms that are protected by the FSCS, assisting competition in the interests of consumers and supporting the growth of the UK financial services sector by maintaining market integrity. However, the FSCS does not automatically protect all regulated activities or categories of customer and FSCS protection should only be extended in cases where the risk of harm could prevent consumers from participating in those markets and where losses could result in significant harm to the consumer.

**2.3** Most respondents agreed with the proposed principles. However, some respondents argued that the FSCS is not currently operating as a true fund of last resort and more should be done to stop liabilities falling to the FSCS. Others acknowledged that a zero-failure regime would not be desirable, that firms should be allowed to fail in some situations with the FSCS representing an essential safety net to protect consumers.



Many respondents were keen to ensure that, where possible, the 'polluting' firms which give rise to liabilities should meet the cost of those liabilities, to avoid the costs needing to be picked up by other firms through the FSCS levy.

**2.4** We received some differing views on Principle 2 and whether the availability of protection should aim to increase consumer confidence in financial services. Several respondents made the point that, while the availability of protection should help to reassure consumers when transacting with firms, the availability of FSCS protection in itself cannot be expected to increase confidence. This can only be realistically achieved through strong regulation and the sound conduct of firms. Some respondents also questioned whether it was appropriate to balance the benefits to consumers from the availability of FSCS protection with the benefits to the wider markets, as set out in the proposed principle.

#### **Our response:**

We understand why several respondents considered that FSCS is not operating as a true fund of last resort, and we consider that a key part of our upcoming work should involve tackling this view. We maintain that the FSCS does represent a fund of last resort - in that it only steps in once other mitigants to protect consumers have failed - but recognise that in many cases the FSCS is not perceived to operate in this way. For example, in cases where firms and their directors are seen to be avoiding their responsibilities to their customers or seeking to escape their liabilities. This is exasperated by the significant historic misconduct issues which are currently giving rise to high FSCS costs, such as liabilities relating to pensions advice and claims against self-invested personal pension (SIPP) operators. As these historic liabilities are 'baked in' to the pipeline of redress liabilities that will fall to the FSCS over coming years, it fuels the perception that the FSCS is not operating as a true fund of last resort.

In the next section we say more about the work that is already underway to address historic misconduct issues, and to avoid future issues arising, and to ensure that the firms that are responsible for misconduct meet the cost of that misconduct - to ensure that 'polluters' pay. In time this work will help ensure that FSCS is widely seen to represent a true fund of last resort.

We consider that it is necessary to ensure that an appropriate balance is struck between maintaining an appropriate level of protection to benefit consumers with the benefits that that protection provides to the wider financial services markets. We believe that having comprehensive protection for consumers does benefit firms, for example, by maintaining consumer confidence and encouraging consumers to transact with firms.

Considering feedback received, we will change the wording of Principle 2 from 'FSCS protection for a particular regulated activity and category of individual should increase consumer confidence in the financial services sector' to '...help to maintain consumer confidence...', on the basis that other regulatory protections will serve to increase confidence.

We set out our updated principles in Chapter 5.

## Tackling the underlying causes of high FSCS compensation costs

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**2.5** A consistent theme of the responses was that we should do more to tackle the causes of high claims costs falling to the FSCS. There was a recognition that the high cost of compensation paid by the FSCS – a cost met by industry levy payers – was not caused by the FSCS itself but was a consequence of the conduct and resilience of authorised firms which have gone out of business.

**2.6** We received many views and ideas for how to tackle this issue, including:

- more effective supervision and enforcement, targeting those firms which cause consumer harm and by better identifying emerging issues
- increase capital requirements to make firms more resilient, particularly for personal investment firms, and prevent firms from dissipating assets to avoid liabilities
- stronger powers to allow us to recover assets from failed firms and to take action against the directors and other individuals who benefit from misconduct by increasing personal accountability
- maximise the opportunities from the new Consumer Duty to improve conduct standards
- robust approach to authorising firms, and to tackle instances of 'phoenixing' whereby firms seek to avoid their liabilities by restructuring their businesses
- require product providers to take greater responsibility for the conduct of their intermediaries
- routine analysis of the cause of firm failure to learn lessons
- restrict the ability of authorised firms in dealing with unauthorised introducers who may be responsible for transactions involving non-standard assets
- improve Professional Indemnity Insurance to ensure it provides appropriate cover
- improve whistle blowing procedures to better identify problems in firms
- introduce mandatory compliance audits of firms, to identify conduct issues

### Our response:

We fully acknowledge the need to tackle the causes of high claims costs falling to the FSCS.

Ultimately the liabilities that fall to the FSCS are due to the conduct and actions of authorised firms, representing market failures. But, as conduct regulator, we have an important role in addressing market failures and maintaining an effective regulatory regime which minimises customer harm which leads to liabilities that some firms cannot meet.

While firms going out of business is a feature of a normal functioning market, it can harm consumers, the effectiveness of markets, and overall confidence in the financial system. Accordingly, while we cannot stop all firms going out of business, we aim to help minimise disorderly firm failures which cause serious harm to both consumers and markets.

This was a key element of our [3-year strategy](#) published in April which sets out our programme of work towards becoming a more innovative, assertive and adaptive regulator. As part of our work to reduce and prevent serious harm, we set out commitments for:

- dealing with problem firms
- reducing harm from firm failure
- improving oversight of appointed representatives
- reducing and preventing financial crime

Both directly and indirectly, these interventions will help to bring down the cost of claims falling to the FSCS in the future.

In line with our strategy, we have launched several workstreams over the last year which directly aim to tackle this issue – and address many of the ideas put forward by respondents to our discussion paper about what more we should be doing.

We recently published a [1-year update](#) on our Consumer Investments Strategy. The 3-year Strategy was launched in September 2021 to address harms in the consumer investments market. One of its target outcomes is to act to stabilise the Life Distribution & Investment Intermediation and Investment Provision funding classes by 2025 and target a year-on-year reduction in these classes from 2025 to 2030. In our update we warned that, while compensation costs for investment claims decreased from 2020/21 to 2021/22 (and are set to decrease further in 2022/23 according to the latest [FSCS Outlook](#) publication), there is a risk that compensation costs could increase in upcoming years.

Figure 1 provides examples of the work underway to tackle the issue of high FSCS compensation costs. These build on the changes we've made to how we operate so we act faster, protect more consumers and, where we can, prevent harm before it happens. These actions aim to ensure that:

- consumers transact with confidence in the market and can access and identify investments that suit their circumstances and attitude to risk
  - emerging issues are identified, and action taken to avoid future harm
  - polluting firms meet the cost of misconduct
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**Figure 1 – Tackling the underlying causes of FSCS compensation costs**

<p>We have continued our work to review the <b>prudential regime</b> for non-MIFID investment advisers. This work aims to ensure that firms that create redress liabilities are better able to pay them. In doing so we are seeking to promote access to suitable advice and reduce the burden of the FSCS bill on the broader adviser population.</p> <p>We plan to set out further details on this next year, as we explore solutions to the key drivers of harm in the market.</p>	<p>We have strengthened our <b>authorisation gateway</b>, so firms need to meet a higher standard before we authorise them.</p> <p>At the gateway we work to prevent ‘phoenixing’ by firms – which is the deliberate avoidance of liabilities. If we receive applications either for individuals or phoenixed firms, we will give them significant additional scrutiny and challenge. This includes applications to cancel. Action then taken may include using past business reviews, deed polls and/or special requirements to ensure that past liabilities to consumers are met.</p>
<p>In April 2022, we introduced a temporary <b>asset retention requirement</b> for certain firms subject to the proposed British Steel Pension Scheme consumer redress scheme.</p> <p>This requirement will help make sure the firms responsible for redress liabilities meet the cost of those liabilities, rather than the costs falling to other FSCS levy payers, and ultimately being passed on to consumers.</p> <p>We confirmed the final rules for the consumer redress scheme in November 2022. We also consulted on a proposed extension to the temporary asset retention rules, so that they will apply until firms have resolved all scheme cases, and other relevant cases outside the scheme.</p>	<p>We are focused on <b>preventing future misconduct in relation to pensions</b>.</p> <p>On defined-benefit pensions advice, we are using data to identify high-risk firms and target our supervisory action.</p> <p>On SIPPs, we are using data to identify firms that offer non-standard investments and assessing their due diligence on recent business.</p>
<p>In August 2022, we announced that we will introduce a new <b>Consumer Duty</b> from August 2023. The duty will set higher and clearer standards of consumer protection across financial services and require firms to put their customers’ needs first.</p>	<p>The new Consumer Duty will introduce <b>further obligations for all firms in the distribution chain</b> to take responsibility for retail consumer outcomes.</p> <p>This will help ensure that product providers take a greater responsibility for the conduct of intermediaries they work with.</p> <p>We also confirmed new rules to make authorised firms more responsible for their appointed representatives.</p>
<p>We take <b>enforcement action</b> against firms and individuals that are not authorised or exempt under FSMA but who carry on regulated activities in breach of the legislation or who disregard restrictions on financial promotions.</p> <p>For example, in February 2022, we announced that we had stopped AJH Financial Services Limited, a firm that advised on transfers from the British Steel Pension Scheme, disposing of assets without FCA permission.</p>	<p>We continue to invest in improving our <b>whistle-blowing</b> capability and function. Over the last 12 months this has included supporting communication with whistle-blowers by introducing a webform, which is now the most popular route for whistle-blowers to submit their disclosures to us.</p>

## The incentives created by FSCS protection

**2.7** We heard a range of differing views on the impact of FSCS protection on consumer confidence and the behavioural incentives created by the existence of FSCS protection - for firms, consumers and the FCA. However, we received little hard evidence underpinning these views.

- 2.8** Some respondents considered that the availability of FSCS protection would encourage consumers to take excessive risk, or to have less regard for risk when transacting with firms. This led to some respondents suggesting that if FSCS protection was reduced consumers would be encouraged to undertake better due diligence. However other respondents felt that, although the availability of protection is likely to give consumers some comfort when transacting with firms, there was no evidence that its existence encourages excessive risk taking. This is the case when considering the sequence of events that would need to occur between a regulated transaction occurring and FSCS paying compensation for the consequences of that transaction.
- 2.9** Some respondents considered that firms might be incentivised to give bad advice knowing that customers could receive compensation from the FSCS in the future. However, others took the view that it was unrealistic to expect that the actions of 'bad actors' was influenced by the protections available to their customers. A few respondents also suggested that FSCS protection could cause the FCA to avoid taking certain actions, knowing that consumers would be protected through the FSCS. These respondents felt that, if protection was not available, we would be incentivised to tackle issues at an earlier stage.

### Our response:

Given the differing views and limited evidence available, we consider more work needs to be done to fully understand the impact of the availability of FSCS protection on consumers and firms. We are therefore proposing to, in conjunction with the FSCS, develop a programme of consumer and firm research to improve our understanding of the impact of FSCS protection on consumers' decision making, confidence and behaviour, as well as on firm behaviour and incentives. This research will build upon previous research both we and the FSCS has undertaken on awareness of the availability of protection. For example, in 2016, we published a [feedback statement](#) about Smarter Consumer Communications which discussed how to raise awareness of FSCS protection, and the FSCS has this year published consumer research about awareness of its protection for [pensions and SIPPs](#).

This new research will go further to help us develop future policy proposals, by helping to understand the impact of potential policy interventions on consumers and firms. It will also help in demonstrating the value of the FSCS to market participants. This evidence would help ensure we maintain a compensation framework that remains proportionate and delivers demonstrable benefits to the markets. We expect to carry out this research over 2023.

On calls for us to take greater accountability for reducing the cost of claims falling to the FSCS, we consider that we have demonstrated our plans to tackle the issue of high FSCS compensation costs, reflecting our ambition to bring down the cost of FSCS levies and to tackle the causes of those compensation costs. This includes through our work on the Compensation Framework Review and Consumer Investments Strategy.

## 3 The scope of FSCS protection

**3.1** In our discussion paper we explored what the appropriate scope of FSCS protection should be – in terms of the activities that should be protected, who should be eligible to claim compensation, and the maximum amount of compensation that should be payable to an eligible claimant. We framed this aspect of the discussion with reference to the proposed principles for protection, considering both the current scope of protection and issues stakeholders had raised with us.

### Reducing the scope of activities protected by the FSCS

**3.2** In our discussion paper we explained that the scope of the FSCS protection is broad – covering claims relating to deposits and insurance (under the Prudential Regulation Authority’s rules) and investment business, home finance intermediation, insurance distribution, debt management and – from July this year – funeral plan business. The scope of activities protected by the FSCS is broader than similar compensation schemes in other jurisdictions. However, despite this broad scope, the FSCS does not protect some regulated activities.

**3.3** Overall, we did not receive many calls for significant changes to the scope of FSCS protection (in relation to the rules that the FCA is responsible for). For example, few respondents supported removing protection for investment advice, even though compensation schemes in other jurisdictions do not typically cover claims for investment advice. Respondents saw that protection for investment advice represents an important aspect of consumer protection which benefits consumers and the wider financial services sector in the UK.

**3.4** However, many respondents were supportive of us considering a reduction in the protection available for certain non-standard or high-risk investment types or the activities associated with them (eg distribution and advice). These respondents believed that such claims are contributing to a high proportion of overall FSCS compensation costs and were an indicator of the harm being caused by firms providing bad advice to consumers to invest into non-standard assets. As discussed in the previous chapter, some respondents also considered that because the FSCS can protect claims for non-standard assets in certain circumstances, consumers may potentially be encouraged to take excessive risk when deciding to invest.

#### **Our response:**

After considering the feedback received, we remain open to exploring further opportunities to restrict the scope of protection to potentially exclude certain activities or product types in the future. However, we are clear that before we can make any such changes, we need to ensure that all the appropriate regulatory safeguards are in place to protect consumers from harm.

For example, there may be benefits in exploring restricting protection to exclude certain non-standard asset types, which we do not consider are suited to typical consumers. This could potentially align with the recent changes to our financial promotion rules for high-risk investments. These changes introduced strengthened rules for firms when communicating or approving financial promotions relating to high-risk investments - to be classified as 'Restricted Mass Market Investments' and 'Non-Mass Market Investments' from 1 February 2023. However, without further additional safeguards, there is a real risk that consumers could continue to be negligently advised to invest into non-standard or high-risk investments, without the safety net protection of the FSCS if the firm responsible goes out of business.

So we will continue to consider the question of the appropriate scope of FSCS protection as part of connected workstreams to reshape the regulatory framework for consumer investments. This includes work underway on the Government's Future Regulatory Framework Review. We are particularly keen to build on work already undertaken around high-risk investments and explore opportunities to revise regulatory requirements around different investments.

As part of the Consumer Investments Strategy, we issued a Consultation Paper on 30 November 2022 on proposals to introduce a new core investment advice regime for consumers to receive appropriate support for investing new money into a stocks and shares ISA wrapper. The consultation will remain open until 28 February 2023, and we will look to publish a final policy statement with finalised rules and guidance in spring 2023.

To the extent that this work aims in part to reduce inappropriate consumer exposure to 'non-standard' or 'high-risk' investments, this may affect our consideration of FSCS protection. Once we have decided on what that new landscape looks like, we can consider to what extent the scope of FSCS protection complements our wider regulatory objectives.

The consumer research referred to in the previous chapter will also be directly relevant to this work, as it will help us better understand the impact of potential changes to the scope of FSCS protection on consumer decision-making. For example, whether reducing protection for non-standard assets would discourage consumers from investing in these products.

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## Extending the regulated activities protected under the FSCS

- 3.5** Some respondents also called for the scope of FSCS protection to be expanded. For example, some respondents suggested that consumer credit activities should be fully protected by the FSCS, in addition to the current protection for certain debt management activities, and that Electronic Money institutions and payment institutions should also be protected.

### Our response:

We considered FSCS protection for consumer credit activities in 2016 and introduced protection for certain debt management claims. Our view then was that, as consumer credit firms do not hold client money or assets, their activities are unlikely to give rise to significant financial loss to consumers. Since then, whilst we have seen several consumer credit firms fail, we are not persuaded that the introduction of FSCS protection is appropriate. Consumer credit protection would likely need to be funded by all lenders, including prime lenders. This could increase costs and lead to a tightening in the availability of credit and thus drive negative outcomes for consumers. Furthermore, we do not consider the availability of protection for consumer credit would influence consumer confidence in that sector, in the way we consider it likely does for other sectors.

On protection for Electronic Money institutions and payment institutions, the Government is currently considering the regulatory regime at large for payment firms as part of its Future Regulatory Framework Review.

## Territorial scope considerations for investment funds

- 3.6** We asked whether we should make any changes to the territorial scope of FSCS protection for investment fund claims.
- 3.7** In our discussion paper, we explained that, for investments, FSCS protection is usually linked to regulated activities carried on by an authorised firm from an establishment in the UK, regardless of the location of the client or the relevant investment. However, there are some exceptions for funds. In cases where a UK-authorized firm carries on the activity of 'managing a UK UCITS,' 'managing an AIF' or 'establishing, operating or winding up a collective investment scheme', then generally FSCS coverage only applies to UK-authorized or domiciled funds. However, where firms are carrying on the activity of 'managing investments' or 'safeguarding and administering investments' there is no geographic restriction on the fund's location provided the activity was carried on from an establishment in the UK.
- 3.8** Future marketing of overseas investment funds to UK retail investors will primarily be through the Overseas Funds Regime (OFR). The Government consulted on proposals to extend FSCS coverage to funds recognised under the OFR but decided it was disproportionate to extend FSCS coverage to failures of an OFR fund's operator or depository. This was due to a lack of evidence of significant risk of consumer loss from the failure of authorised UCITS funds.
- 3.9** Some respondents were in favour of excluding regulated activities in relation to all non-UK domiciled funds from the scope of FSCS protection, in addition to current exclusions regarding territorial scope of protection. However, a greater number were against such a change, arguing it would penalise certain customers of UK authorised firms and would further complicate messages about FSCS protection for funds. Since FSCS protection is currently available for some regulated activities carried out in relation to some non-UK funds, there was concern that a change could make those



funds less attractive to some consumers, which could affect the business models of some UK authorised firms. More generally, there was a concern that such a move could represent a material reduction in the protection available to consumers which could detract from the high regulatory standards available in the UK.

#### **Our response:**

Based on feedback received, we do not propose to make any immediate changes to the territorial scope of protection for investment funds. However, we will consider this point further as part of the ongoing work to consider the scope of FSCS protection and which will be informed by the consumer research we will carry out next year.

## **Issues at the perimeter and giving consumers clarity**

- 3.10** In this section we discussed the complexity of determining what is protected under the FSCS and how best to make consumers aware of the protections available.
- 3.11** Most respondents acknowledged the importance of the provision of clear information to consumers about what is protected under the FSCS. However, many recognised that there are inherent complexities involved in describing what is protected in a straightforward way, which creates a risk that further disclosure requirements could be introduced – which would create additional costs to firms – which would not necessarily give consumers the information that they want and need. Whilst some respondents considered that firms should make clear when protection is not available, others considered this would be challenging and could deter consumers making a claim to FSCS about another authorised firm involved in the transaction. Some respondents considered that steps should be taken to simplify the scope of protection first before updated disclosure requirements were introduced. There was some support for very straightforward information about the availability of FSCS protection, similar to the 'FSCS Protected' badge that is used by some authorised deposit takers to signal that FSCS protection is available.

#### **Our response:**

We recognise the importance of ensuring that there is clear information available to consumers about the protection available to them from the FSCS. We consider that our current disclosure requirements for firms are adequate (such as COBS 6.1 and COBS 6.1ZA in our Conduct of Business rules). We have also recently strengthened risk warnings on high-risk investments, which include warnings that consumers are unlikely to be protected if something goes wrong. We will consider whether we need to adapt our disclosure requirements in light of any scope changes as a result of our ongoing consideration of the scope of protection discussed earlier in this chapter.

## Opportunities for refining FSCS's eligible claimant criteria

- 3.12** We explored whether changes should be made to the 'eligible claimant' rules which determines which category of person is able to claim compensation from the FSCS. For example, we asked whether it might be appropriate to exclude 'high-net-worth' or 'sophisticated' customers from being able to claim compensation.
- 3.13** We received limited support for the idea of excluding 'high-net-worth' or 'sophisticated' customers. One respondent suggested that such individuals would have greater awareness, knowledge and experience and would have other legal remedies available to them. However, a greater number of respondents objected to the suggestion that such individuals should be excluded. Respondents considered that 'high-net-worth' individuals may not necessarily have the resources to absorb losses or means to take their own civil action to recover losses. Some respondents objected to any suggestion that high-net-worth individuals would have any greater appreciation of the risks of transacting with authorised firms. Excluding 'sophisticated' customers would introduce challenges in judging to what extent an individual's sophistication in a particular field is pertinent to the claim for compensation. More generally, respondents considered that introducing such an exclusion targeted at certain groups would be unfair and unreasonably exclude certain individuals who may be experiencing vulnerable circumstances.
- 3.14** A couple of respondents suggested that only vulnerable individuals should be allowed to claim compensation. Further respondents suggested that customers living outside the UK should not be allowed to claim compensation from the FSCS. Some suggested that non-UK consumers are unlikely to expect to be protected by the UK's compensation scheme.

### Our response:

After considering the feedback we received, we do not propose to make any changes to the eligible claimant rules. In particular, we do not consider there is a strong case for excluding 'high-net-worth' or 'sophisticated' customers. This would penalise certain individuals while complicating messages about who is protected by the FSCS, with no discernible benefits, including to the markets.

We do not consider it would be appropriate or practical to restrict protection to only individuals in vulnerable circumstances, particularly considering that vulnerability is transient. As a consumer may not be in vulnerable circumstances at the point of sale but may be so at the point of claim, or vice versa. This tension would be difficult to resolve, would lead to operational challenges and likely result in unfair outcomes. There may also be consumers that, under such an exclusion who, although not in vulnerable circumstances, would be adversely affected by not being able to claim compensation.

Non-UK consumers only represent a small proportion of FSCS claimants (around 4% of FSCS claimants in 2021/22 with investment claims resided outside the UK). Nonetheless, we do not consider that it is appropriate to remove protection for non-UK based consumers.

We consider it is a positive benefit of doing business in the UK that consumers, wherever they live or move to, benefit from the protections available, including relevant access to the FSCS.

However, we do not have any evidence of the importance of the availability of FSCS protection to non-UK consumers when deciding to transact with UK authorised firms. Our planned consumer research may therefore help to understand more about how FSCS protection influences decision-making. In any event, if a consumer who transacts with a UK authorised firm also has access to compensation from an overseas compensation scheme for the same loss, in certain circumstances, our rules allow the FSCS to postpone payment of compensation to allow the customer to claim from the overseas compensation scheme.

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## The collective investment scheme 'look-through'

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**3.15** We received mixed responses on the Collective Investment Scheme (CIS) 'look-through' provisions. We introduced this rule in April 2018 which allows the FSCS to treat participants in a relevant fund as having a claim, instead of the CIS, operator, trustee, manager or depositary who is the actual claimant. Some respondents considered the provisions represent important consumer protection, to enable individual consumers to claim compensation in the event of the failure of a fund, portfolio manager or depositary. Others argued that the risk of such failures was low, non-UK consumers wouldn't expect FSCS protection, and it generates disproportionate costs for asset management firms. This is especially the case for some firms who lack the relevant information about end investors to calculate eligible income, which results in some firms overestimating it.

### Our response:

We do not plan to make any changes to the CIS look-through rules at this time. These rules provide important protection for consumers if an operator or depositary fails. Without the look-through rules, underlying investors may not be able to claim for losses that they incur in relation to CISs against authorised firms that are protected by the FSCS. The look-through policy therefore ensures consistency across the protection provided by the FSCS by addressing a gap in the protection available, whereby an investor would not otherwise have a claim against the authorised firm which could potentially cause them to suffer a financial loss, due to the indirect nature of the investor's contractual relationship with that authorised firm (e.g. if portfolio management is delegated by the fund). While the risk of such a failure may be low, it is not unfeasible, including in the event of fraud or mismanagement which could result in widespread consumer losses, and the availability of protection in such scenarios is consistent with FSCS's role as a 'fund of last resort'. Furthermore, similar look-through rules exist in the case of certain trusts and pensions, therefore the CIS look-through helps maintain consistency in the protection available.

We have not previously considered it relevant whether consumers expect to be compensated in such scenarios, although the planned research introduced in Chapter 2 may help to evidence consumers' expectations for protection for investment funds. We consider that firms should seek solutions to the difficulties some face in estimating and reporting eligible income. We also remain open to ideas for alternative metrics that could create a fairer distribution of costs amongst firms in the Investment Provision funding class. We say more about our plans to review the current funding classes in Chapter 4.

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## Potential changes to compensation limits

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- 3.16** In the fifth chapter of our discussion paper, we considered the limits on compensation payable by the FSCS. We wanted to explore whether stakeholders considered that current FSCS compensation limits provide appropriate protection for consumers. The current limit is £85,000 for most types of claim covered by the FCA's rules, for each category of protected claim that an eligible claimant has against the relevant person in default or, where applicable, a successor. We also asked whether it may be appropriate to introduce a periodic review of compensation limits, to ensure that the limits remain at an appropriate level over time.
- 3.17** Respondents who commented on the appropriate level of compensation payable by the FSCS were roughly split evenly between those who considered limits should be increased and those who felt they should be maintained. Few respondents suggested that limits should be reduced.
- 3.18** Several respondents called on us to review current limits for claims about pension products. They highlighted that a material proportion of pension claims dealt with by the FSCS are not compensated in full, and stressed the importance of pension savings for consumers' financial wellbeing. From those who called for an increase in limits for claims about pensions, there were mixed views on by how much. Some respondents suggested that pensions-related claims should be compensated in full, with no limit. Others argued that a separate limit for pension claims should be introduced that covers the majority of claims, matches the Financial Ombudsman Service maximum award limit (currently £375,000) or matches the lifetime pensions allowance (currently £1.073 million).
- 3.19** Those respondents who considered that no changes were necessary to the compensation limits typically suggested that the limits were already at a reasonable level as they covered the majority of claims received, and that the appropriate limit had to be balanced with consideration of the impact on levy payers who fund the FSCS.

### Our response:

While we consider that the current compensation limits are set at a reasonable level for most types of claim, we believe that it is appropriate to consider further the protection available for claims about pensions.

Our analysis of FSCS data shows that, in 2021, 30.1% of pension claims exceeded the compensation limit, compared with 6.2% of overall investment intermediation claims falling to the Life Distribution & Investment Intermediation funding class. Between 2019-2021, the number of pension intermediation claims where the value of the claim exceeded the compensation limit increased from 1,477 to 2,461 – pointing to a growing number of customers who are not compensated in full.

Our work on advice to transfer out of defined benefit pension schemes – particularly in the context of our consumer redress scheme for unsuitable advice to transfer out of the British Steel Pension Scheme – highlights the significant impact that bad pensions advice can have on consumers' wellbeing. We have seen some cases where individual's losses total several hundred thousand pounds, meaning that, if the advising firm responsible for the bad advice goes out of business, the impacted consumer would not be able to recover all their losses from the FSCS.

Given this, we think there is merit in looking specifically at whether the increase in the proportion of pension claims that involve losses in excess of the FSCS's compensation limit seen in 2021 was a short term 'blip' or points to a longer-term trend, and whether higher limits for pension claims might be appropriate.

We therefore plan to commence a review of the current compensation limits in 2023, particularly to consider whether it would be appropriate to increase compensation limits for certain pension claims.

As any increase in compensation limits would increase potential claims costs falling to FSCS levy payers, we will carry out the review of compensation limits alongside work to review the current funding classes, set out in Chapter 4.

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## Introducing a periodic review of compensation limits

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- 3.20** The suggestion that compensation limits should be reviewed on a periodic basis was generally well received, with most respondents in favour.
- 3.21** Respondents felt it was important that compensation limits are adjusted in line with an appropriate economic measure. Some respondents also suggested we should take account of the proportion of claims with losses which exceed the compensation limit – which may be an indicator that the limit is too low. Some respondents considered that it would be important to consider the impact on levy paying firms of introducing such a change. Some respondents suggested the limits should be adjusted in line with inflation, although a few suggested that changes would only be necessary if inflation became very high. There were different opinions about the frequency of a review, with some respondents suggesting the limits should be reviewed annually with others suggesting up to every 5 years.

**Our response:**

We agree that it would be appropriate to carry out further work to develop a process for the periodic review of compensation limits. This work would aim to ensure that compensation limits remain in line with current prices, to avoid the real value of FSCS protection reducing over time. As with the review of compensation limits, this work will be considered alongside a review of the current funding classes.

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## 4 How the FSCS should be funded

4.1 In the sixth chapter of our discussion paper, we considered how the compensation framework should be funded.

### Proposed principles for funding

4.2 In our discussion paper we proposed the following 2 principles for funding:

#### Principles for funding – proposed in DP21/5

##### **Principle 3 – the funding model should be robust, be adaptable to a changing external environment, economical and practical to implement:**

We want to ensure that the funding model can respond to differing levels of levy liabilities that can reasonably be expected (eg based on historic volumes and future forecasts) – while also being able to respond to unexpected spikes in costs (eg a sudden failure which could not have been foreseen) – while apportioning costs appropriately and fairly across funding classes.

##### **Principle 4 – funding classes should provide sufficient funding for compensation while remaining sustainable, therefore some degree of cross subsidy may be needed in practice:**

By allocating FSCS compensation costs to different funding classes, it means that, as far as possible, firms are paying for the cost of the failure of firms carrying out similar business (eg investment firms are paying for the cost of investment claims). Class thresholds help ensure that the model is sustainable by capping costs at a level that the overall class can afford. Consequently, if costs exceed the class they will need to be shared by a wider pool of firms, which ensures that consumers remain protected and the overall financial services sector benefits from the confidence in the market that is maintained.

4.3 Overall, respondents agreed with Principle 3, but some respondents disagreed with Principle 4. They argued that cross subsidies were unfair and contrary to a 'polluter pays' goal. Some respondents suggested that the principle should reflect the view that riskier firms should meet a greater share of the costs.

#### **Our response:**

We recognise that many firms are unhappy with the impact of cross subsidies, which have been needed several times in recent years when costs have exceeded a funding class's funding threshold. However, we consider that cross subsidies are a key component of the current funding model, and critical to ensuring that the funding arrangements remain sustainable, particularly for extreme situations where funding is required

beyond the level that an individual class can afford. We consider there are benefits to all firms across the industry of maintaining the FSCS, which justifies the mutualisation of costs across the industry in this way.

However, we also recognise that cross subsidies have been required several times in recent years. So below we set out plans for work to ensure that the funding arrangements are placed on a more sustainable footing, which aims to reduce the frequency of calls on the Retail Pool.

For these reasons, we do not propose to make any changes to the principles for funding.

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## Alternative funding models

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- 4.4** Several respondents advocated alternative funding models such as risk-based or product levies. Others considered a 'perfect' funding model was unrealistic, and that we should focus on addressing the causes of high compensation costs.
- 4.5** We also received a large number of responses suggesting that FSCS compensation costs should be met from monies raised through financial penalties imposed further to Enforcement investigations. Respondents considered that this would be closer to a 'polluter pays' model – where firms that are responsible for some misconduct or other failing (which led to them being fined by the FCA) are required to contribute more to the cost of failed firms.

### Our response:

We agree in principle with many firms' desire for riskier firms to meet more of the cost of FSCS claims, but there are practical difficulties with this. FSCS compensation costs typically arise from events several years in the past, making it hard to predict (with the certainty that would be needed to be the basis of risk-based levy calculations) which business models will give rise to future costs. The difficulties involved in doing this accurately means that it would not represent a 'polluter pays' model. Instead, it would represent a model that involves us trying to align current business models with the business models of historic firms – which would be an imperfect and likely contentious process. Further, where we suspect that certain business models are riskier, that should be something we address straight away – before the business causes harm – rather than anticipating harm that would give rise to future levies. So we consider that we should focus on dealing with riskier firms 'upstream', for example by improving the financial resilience of riskier firms. We provided further details in Chapter 2 about the work we are doing in this respect, including looking at prudential requirements for non-MIFID investment advisers.

We discussed these complexities when we last considered alternative funding models as part of the FSCS funding review over 2016-2018 (in particular, in our December 2016 consultation paper, '[Reviewing the](#)



funding of the Financial Services Compensation Scheme (FSCS)'), where we noted the difficulties of introducing a risk-based funding model, and also with other alternative models such as a pre-fund or a product levy.

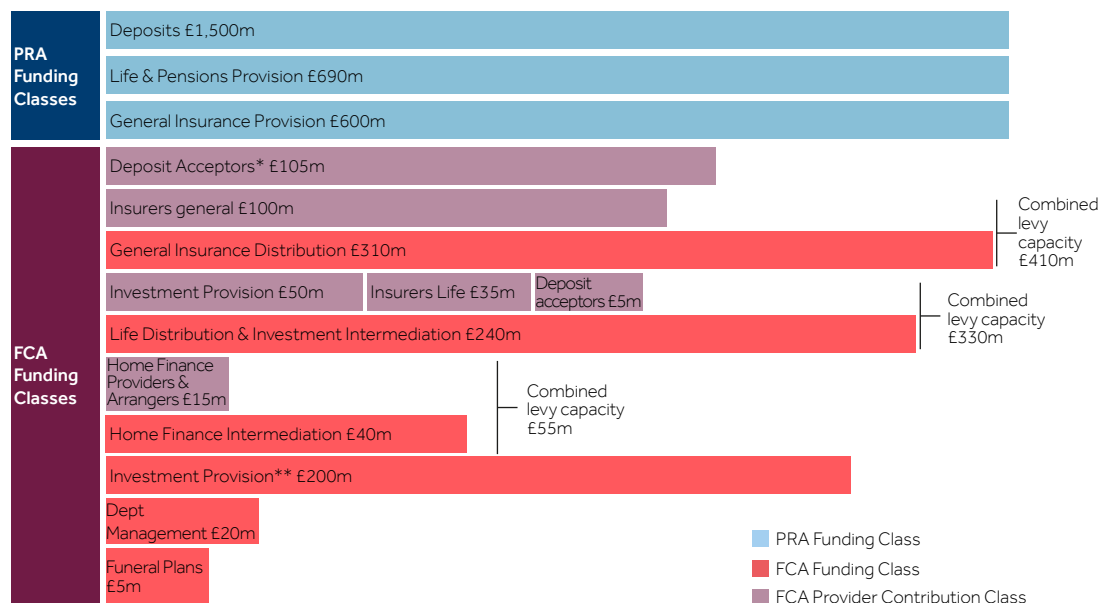
We therefore do not consider it appropriate to seek to introduce a risk-based funding model at this time. We have also not heard any views through the feedback received that other funding models, such as a pre-fund or product levy, would be preferable to the current funding arrangements.

We acknowledge that many stakeholders are in favour of the use of FCA financial penalties to fund FSCS compensation costs. Since 2012 monies raised through FCA financial penalties collected by the FCA have been paid to the Exchequer's Consolidated Fund. Therefore, how these monies are used is for the Government to determine. Accordingly, we have highlighted to the Government the strength of feeling on this matter.

## Changes in the current funding model

4.6 FSCS costs, including compensation costs and management expenses, are apportioned to different funding classes up to set class thresholds so that, as far as possible, firms are paying for the cost of the failure of firms carrying out similar business. As illustrated in Figure 2, each class has a levy limit or 'threshold', which is the maximum amount of costs which can be allocated to that class in a financial year, by reference to what each class can be expected to afford in a year. If costs exceed the threshold the costs are shared across the wider Retail Pool. This is based on the principle that firms in other funding classes benefit from the FSCS having sustainable funding and ensuring there is confidence in the protection provided.

Figure 2 – Current FSCS funding model



\* Deposit Acceptors only have to fund retail pool levies  
 \*\* Investment Provision firms can only be levied £200m in total

- 4.7** Many respondents were unhappy about the need to meet the cost of failed firms under this current funding model. This is particularly the case of firms which operate different business models or are involved in different types of business, whether in the same sector (eg different types of investment firm) or across sectors (eg instances where insurance, home finance or debt management firms have been required to contribute to the Retail Pool in relation to investment failures). So some respondents argued that we should review the funding class thresholds to minimise cross subsidies and the need for calls on the Retail Pool. Some respondents suggested that smaller funding classes may be preferable to the current classes, to help ensure that firms meet the cost of firms operating similar business models.
- 4.8** In contrast, a number of respondents considered that the current funding model, while not perfect, appeared to be a reasonable way of funding FSCS, and preferable to other models. These respondents felt the model should be given time to embed, considering the last changes were made only relatively recently, in April 2019.
- 4.9** Several product providers and their representatives considered that it was unfair that they were required to cross subsidise intermediary failures through product provider contributions. This was a change introduced in April 2019 whereby product providers are required to contribute 25% of costs from the General Insurance Distribution, Life Distribution & Investment Intermediation and Home Finance Intermediation funding classes. However, other respondents supported this aspect of the model and considered that it was right that product providers shared the cost of intermediary failures. Some argued that product providers were better able to identify issues arising from the activities of intermediaries than other intermediaries were able to. Some respondents considered that provider contributions should be higher than the current 25%.
- 4.10** We asked whether alternative metrics to annual eligible income could help to ensure that compensation costs in the Investment Provision class are distributed more fairly between firms in the class. While some respondents suggested that alternative metrics such as assets under management or a risk-based measure may be preferable, others considered that the current measure based on annual eligible income was the 'least bad' option. One respondent commented that the current measure was less likely to be gamed than other measures.
- 4.11** In the discussion paper, we also asked if it may be appropriate to introduce a periodic review of the funding classes, to ensure that the limits remain appropriate, considering external factors which will inevitably change over time and to help reduce the frequency of calls upon the Retail Pool. Most of the respondents who commented on this suggestion were in favour. Those respondents considered that it would help ensure that the allocation of costs across funding classes remains fair and equitable, by accounting for changes to the make-up of, and risks associated to, classes over time.

#### **Our response:**

We acknowledge that frequent calls on the Retail Pool in recent years and increasing FSCS compensation costs have exacerbated frustrations amongst levy paying firms. The Retail Pool has been triggered 4 times over the last 10 years, creating dissatisfaction among certain firms which have been required to fund the cost of failed firms which they do not associate themselves with. For example, in 2020/21, the General

Insurance Distribution funding class had to pay out £23 million for failures in the Life Distribution & Investment Intermediation as claims exceeded that class's £330 million limit, and the Home Finance Intermediation funding class had to contribute £3 million.

We agree with many respondents that there is a need to review the current funding classes to ensure thresholds remain appropriate and do not result in unintended unfairness. We will therefore carry out a review of the current funding classes to look at the constitution of classes, the ability of firms to meet costs, and the risks the classes are exposed to.

In this review we will consider whether product provider contributions remain at an appropriate level. We maintain that product provider contributions play an important part in ensuring the overall sustainability of the model and ensure that the firms that benefit from business conducted by intermediaries meet part of the costs from that type of firm. Provider contributions also aim to incentivise providers to design products that are well understood by intermediaries and that benefit end consumers, whilst encouraging firms to fully understand and exercise control over their distribution chains. Therefore, this policy is consistent with our new Consumer Duty, which will introduce further obligations for all firms in the distribution chain to take responsibility for retail consumer outcomes – helping to ensure that product providers take a greater responsibility for the conduct of intermediaries they work with.

An aim of this funding class review will be to ensure that the class thresholds remain at an appropriate level and to minimise the frequency of calls on the Retail Pool. This review will also consider the feasibility of introducing periodic reviews of the class thresholds so that we are clear and transparent in how and why these are set considering changing conditions over time.

Based on feedback received, we do not propose to make changes to the calculation of eligible income. Some respondents suggested that a measure based on the riskiness of firms' activities would be preferable to the current measure based on annual eligible income. However, we consider that such an alternative measure would present similar challenges to a risk-based model, as discussed earlier in this chapter. As explained at paragraph 3.15, we remain open to ideas for helping to address the reporting issues flagged by some firms in connection with the CIS look-through.

We plan to begin the funding class review in 2023, alongside the work on compensation limits discussed in the previous chapter.

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## 5 Conclusion and updated principles

- 5.1** We are very grateful to everyone who has participated in our review of the compensation framework so far and have contributed responses to our discussion paper.
- 5.2** Following careful consideration of the feedback received, we consider the main issue that needs to be addressed is the causes of high FSCS compensation costs which is putting pressure on the compensation framework and the firms that are required to fund it. We are focusing on addressing these issues through the programme of work set out in Chapter 2.
- 5.3** We do not consider that material changes are needed to the compensation framework at this time, but the next steps set out in this paper will help to ensure that the framework remains proportionate and provides an appropriate degree of protection for consumers with costs fairly distributed. In particular, we will:
- Keep the scope of FSCS protection under consideration as part of related workstreams.
  - Review the compensation limits. This will include considering whether it would be appropriate to introduce a compensation limit for pension claims and the benefits of introducing a periodic review of compensation limits.
  - Review the current funding classes and consider the benefits of introducing a periodic review of funding classes.
  - Carry out a research programme to better understand the impact of FSCS protection on consumers and firms.
- 5.4** This work will form the second phase of the Compensation Framework Review.
- 5.5** Considering the feedback received on the proposed principles for the compensation framework, we have made some changes to the principles (as explained in Chapter 2). We set out the final principles below. We will use these principles to inform our upcoming work on the framework.

### Updated principles for the compensation framework

#### **Principle 1 – the FSCS is a fund of last resort and should not be the first line of defence for protecting customers of authorised firms from harm:**

The FSCS is the UK's statutory compensation scheme for customers of authorised financial services firms carrying out certain regulated activities. This means that the FSCS is a backstop to protect consumers from financial harm if other mitigants are not sufficient. The first resort to protect consumers is the governance, conduct and financial resilience of authorised firms.

**Principle 2 – FSCS protection for a particular regulated activity and category of individual should help to maintain consumer confidence in the financial services sector. The availability of protection, and the benefits it brings to consumers, should be commensurate to the benefits to financial services markets:**

The availability of FSCS protection adds value to the overall financial services sector, by reassuring customers that it is safe to do business with authorised firms that are protected by the FSCS, assisting competition in the interests of consumers and supporting the growth of the UK financial services sector by maintaining market integrity. However, the FSCS does not automatically protect all regulated activities or categories of customer. FSCS protection should only be extended in cases where the risk of harm could prevent consumers from participating in those markets and where losses could result in significant harm to the consumer.

**Principle 3 – the funding model should be robust, be adaptable to a changing external environment, economical and practical to implement:**

We want to ensure that the funding model can respond to differing levels of levy liabilities that can reasonably be expected (eg based on historic volumes and future forecasts) – while also being able to respond to unexpected spikes in costs (eg a sudden failure which could not have been foreseen) – while apportioning costs appropriately and fairly across funding classes.

**Principle 4 – funding classes should provide sufficient funding for compensation while remaining sustainable, therefore some degree of cross subsidy may be needed in practice:**

By allocating FSCS compensation costs to different funding classes, it means that, as far as possible, firms are paying for the cost of the failure of firms carrying out similar business (eg investment firms are paying for the cost of investment claims). Class thresholds help ensure that the model is sustainable by capping costs at a level that the overall class can afford. Consequently, if costs exceed the class they will need to be shared by a wider pool of firms, which ensures that consumers remain protected and the overall financial services sector benefits from the confidence in the market that is maintained.

## Annex 1

### Abbreviations used in this paper

Abbreviation	Description
<b>AIF</b>	Alternative investment fund
<b>CIS</b>	Collective Investment Scheme
<b>COBS</b>	Conduct of Business Sourcebook
<b>COMP</b>	Compensation sourcebook
<b>DP</b>	Discussion paper
<b>DP21/5</b>	'Compensation framework review' discussion paper, published in December 2021
<b>FCA</b>	Financial Conduct Authority
<b>FEES</b>	Fees manual
<b>FSCS</b>	Financial Services Compensation Scheme
<b>FSMA</b>	The Financial Services and Markets Act 2000
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>OFR</b>	Overseas Funds Regime
<b>PRA</b>	Prudential Regulation Authority
<b>SIPP</b>	Self-Invested Personal Pension
<b>UCITS</b>	Undertakings for Collective Investment in Transferable Securities

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