Compensation framework review

Discussion Paper
DP21/5

December 2021

How to respond

We are asking for comments on this Discussion Paper (DP) by **4 March 2022**.

You can send them to us using the form on our website at: www.fca.org.uk/dp21-05-response-form

Or in writing to:

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

Email:
dp21-05@fca.org.uk

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Contents

1 Introduction

1.1 The Financial Services Compensation Scheme (the FSCS) is the UK's statutory compensation scheme for financial services. It steps in to protect consumers when certain authorised financial services firms are unable, or likely to be unable, to meet civil claims against them. Bringing a claim to the FSCS is free to consumers, and it plays a critical role in both protecting consumers and ensuring confidence in financial services markets.

1.2 In recent years, increasing claims against failed firms have focused attention on the compensation framework within which the FSCS operates and have led to increasing dissatisfaction amongst industry levy payers that fund the compensation costs. These increasing costs have shone a light on aspects of the FCA's rules in respect of the compensation framework that mean it may not be working in a way that appropriately balances the benefits to both consumers and firms.

1.3 This paper aims to open a discussion with stakeholders on ways in which aspects of the compensation framework which the FCA is responsible for could be improved. We want to ensure the framework continues to provide appropriate and proportionate consumer protection and costs are distributed across industry levy payers in a fair and sustainable way.

1.4 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 relating to claims in connection with deposits, insurance provision and dormant accounts. The FCA is responsible for claims in connection with all other relevant types of financial services activities that are protected by the FSCS. This discussion paper is focused on the rules which the FCA is responsible for.

1.5 This review is not of the FSCS as an organisation. The FSCS, and its staff, have a strong track record of responding to financial services firm failures and paying compensation to eligible claimants in an effective way.

1.6 Through the FCA's Oversight Committee, the FCA's Board is assured of the capability and performance of the FSCS. In addition, the FCA has responsibility, along with the PRA, for scrutinising and approving the FSCS's operating costs. The FSCS is operationally independent of the FCA in carrying out its statutory functions.

The wider context

1.7 A well-functioning financial services market is one in which firms are competing for consumers' business and consumers are able to access and identify the products and services that suit their circumstances and meet their needs. Firms should consistently maintain high standards of conduct and treat their customers fairly in the provision of these services.

1.8 Where things go wrong and firms fail to meet those high standards of conduct, the firms responsible should have the necessary financial resilience to put things right for their customers, including paying appropriate redress when it is due.

1.9 However, in the event that a firm fails in the course of carrying out particular regulated activities, leaving behind redress liabilities for consumers, it is important for maintaining confidence in the financial system that these consumers have access to an appropriate level of protection by receiving redress for the harm caused by that firm's conduct. This protection should be proportionate in terms of both the protection it affords consumers and the way it is funded, with costs distributed fairly across the industry.

1.10 Such failures should be the exception, and the compensation scheme should be seen only as a last resort. Excessive FSCS compensation liabilities are a burden on firms – and therefore an extra cost to consumers who are likely to ultimately be required to meet these costs. They are also potentially a barrier to competition by, for example, discouraging new entrants with innovative product offerings from entering the market.

1.11 The FCA has committed to stabilising and reducing the size of the compensation levy over time. As explained in Chapter 2, much of the focus of our current work is on addressing the root cause of the current high compensation liabilities. We are doing this by taking steps to help improve the conduct of firms to prevent the harm from happening in the first place, and by seeking to improve the financial resilience of firms so that they are better able to meet their own redress liabilities and put things right for consumers. It will ultimately be through the improved governance, conduct and financial resilience of firms that compensation liabilities will be materially reduced over time.

1.12 In this context, we are seeking to open a discussion on the compensation framework itself and ask fundamental questions around the purpose, scope and funding of the FSCS. We are interested in identifying opportunities to improve the aspects of the framework which the FCA is responsible for, to ensure the framework remains appropriate and proportionate in order to benefit all market participants.

The compensation framework

1.13 The FSCS is operated by FSCS Limited, a body corporate established to run the compensation scheme. The FSCS was established in 2001 under FSMA as a unified compensation scheme and replaced several predecessor schemes which were focused on individual regulated sectors (including deposits, investments and insurance).

1.14 The FSCS is part of the wider 'regulatory family' of organisations, including the FCA, PRA, Financial Ombudsman Service and the Money and Pensions Service, which all play a key role in ensuring consumers are protected and have access to the information they need to participate in financial services markets.

1.15 Under FSMA, the FCA and the PRA are each responsible for making rules in relation to the FSCS. The rules which the FCA is responsible for are set out in the Compensation sourcebook (COMP) and Chapter 6 of the Fees Manual (FEES) in the FCA Handbook.

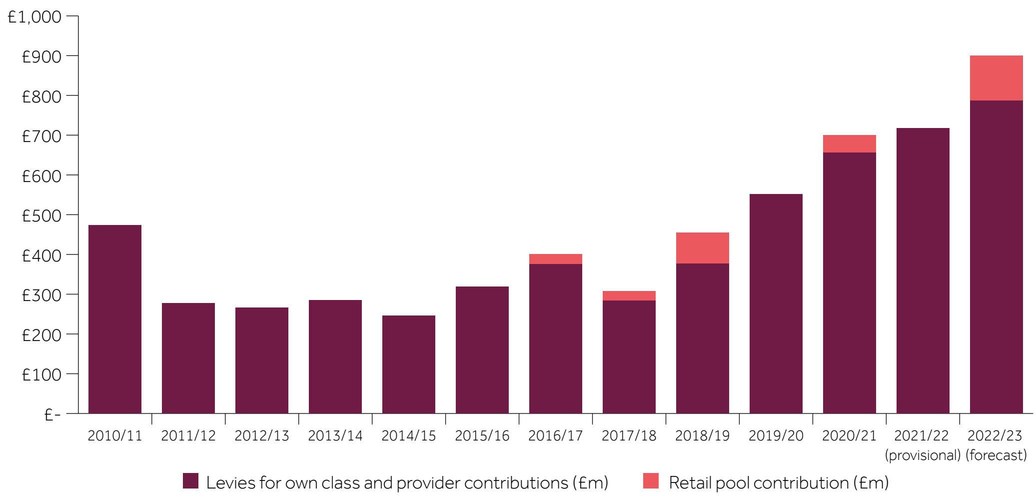
1.16 The FSCS is responsible for setting the amount of the levy raised by the FCA from firms each year based on its forecast of what the compensation costs (distinct from operating costs) will be in that year. The FSCS forecasts the number and cost of claims likely to arise against firms in a funding class (a group of firms carrying out similar regulated activities), and the FCA then raises that amount from those classes on the FSCS's behalf. This is so that, as far as possible, firms involved in related business to those that have failed meet the costs of those firm failures (e.g. firms involved in investment business meet the cost of investment failures). Each class has a funding limit beyond which the FCA cannot levy amounts that exceed the threshold in a given year. If a funding requirement for a class exceeds that limit, then this triggers the "Retail Pool". This is where firms in other classes are then required to pay the residual amount that the class that has exceeded its limit is unable to meet.

1.17 The compensation framework has been the subject of previous reviews by the FCA and former regulators, the most recent of which ran from 2016 to 2018 (see Annex 1). Previous reviews have typically focused on how compensation is funded by levy payers. Building consensus has been difficult because of differing views and the result of changes made often being a zero-sum game – with any changes to funding arrangements often benefiting one group of firms over another group of firms.

The need for a new discussion

1.18 Chart 1 shows how the overall FSCS levy has increased (in nominal terms) from between £200-£300 million between 2011/12 and 2014/15 and then rising steadily to the expected levy of £717 million for 2021/22 (excluding the Major Banking Failure Levy paid up to 2017/18). We have seen the Life Distribution & Investment Intermediation class and the former Life & Pensions Intermediation classes reach their class limits frequently in recent years, with the Retail Pool triggered four times in the previous five years. This has meant firms which are not affiliated to the failed firms which have given rise to the compensation liabilities have been required to contribute towards the costs.

Chart 1 – FSCS levies (or forecast levies), 2011/12 to 2022/23



1.19 The FSCS has recently announced in its Outlook publication on 11 November 2021 that the total levy for 2021/22 is expected to be £717 million, reduced from the original forecasted £833 million that was announced in May 2021. The FSCS also indicated that its provisional estimate for 2022/23 was a total levy of £900 million (subject to change), which would include a contribution of £113 million to be funded by the Retail Pool. This year's reforecast, and next year's provisional estimate, account for firm failures that were originally expected this year which are now being forecasted for the next financial year.

1.20 In the near-term, costs are likely to stay high before they are expected to stabilise and reduce. This is partly because we know that FSCS claims are typically made several years after the harm was caused and liabilities are still coming to light. It is also possible that, as we take an increasingly assertive stance with firms, we may see more harm discovered and more firms failing whilst owing consumers redress before things improve.

1.21 Every pound spent on compensation represents a monetisation of consumer harm resulting from misconduct and therefore the FSCS plays a critical role in protecting consumers and maintaining trust and confidence in the financial services sector. This benefits all market participants, by ensuring that markets function effectively, and consumers have the confidence to continue to do business with regulated financial services firms. However, every pound spent is then paid for by firms that typically have not directly caused those liabilities. We are aware of the increasing impact on levy payers and recognise that this needs to be addressed. However, we do not want this review to simply be a reaction to high compensation costs. Whilst the FCA is committed to taking steps which aim to bring down the costs, we recognise that costs could rise again in the future for reasons beyond our control and we need to ensure that the compensation framework is designed to respond to such an occurrence in an appropriate way.

1.22 First and foremost, and as far as possible, harm needs to be prevented from happening in the first instance. However, not all harm can be prevented, so where it does occur, generally and where possible, we consider it appropriate that the 'polluter' who caused the harm should pay for the liabilities rather than defaulting. Avoiding both harm and instances of failure due to redress liabilities arising in the first place are the primary means of stabilising and ultimately bringing down the compensation levy in the long-term, as it prevents costs falling to the FSCS in the first place. However, it is inevitable that some firms will fail whilst owing money to their customers, therefore the FSCS is necessary as a 'fund of last resort'. Once costs have fallen to the FSCS it means that the 'polluter' is no longer paying for the harm they have caused and, to maintain confidence in the overall financial system, those losses need to be met by other firms. We explore the role of the FSCS as a 'fund of last resort' further in Chapter 2.

1.23 Ultimately, where the FSCS provides protection, it should be proportionate to the risks that consumers accept when dealing with authorised financial services firms, and reasonably balanced with the risk to industry levy payers who fund the FSCS. Furthermore, given that risk is mutualised across the industry, it is important to ensure that the costs are met in a fair and sustainable way.

1.24 In this paper we propose four key principles for the compensation framework, which build upon previous reviews, contextualise the purpose of the compensation framework and help frame this discussion. In light of these proposed principles, we want to have a discussion with stakeholders about what is appropriate in terms of:

- the scope of protection (Chapter 3)

- eligibility of claimants (Chapter 4)
- compensation limits (Chapter 5)

1.25 We also want to have further discussion with stakeholders on how that mutualised risk should be funded (Chapter 6).

1.26 Any changes to these aspects of the compensation framework should be driven not as a reaction to high compensation costs, but with reference to the purpose and principles of the compensation framework. We invite stakeholders' views on how those principles should drive any necessary changes that would ensure we have a fund of last resort that continues to work for both consumers and firms in the future.

Our objectives

1.27 The main objectives for this discussion paper are:

- To explain the FSCS's role as the UK's statutory compensation scheme for customers of authorised financial services firms, within a wider regulatory system and in the context of work underway to tackle the root-cause of the high costs which are falling to the FSCS.
- To start a discussion about the purpose of the compensation framework and about the principles that should underpin the design of the framework that the FCA is responsible for.
- To explore opportunities for improving the aspects of the current compensation framework that the FCA is responsible for.
- To generate views and ideas that could be developed into specific policy proposals for future consultation by the FCA.

Who will be interested in this discussion?

1.28 These issues have direct implications for consumers – who may benefit from the protection provided by the FSCS – and for industry levy payers – who are required to fund the FSCS. Furthermore, the issues discussed 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.

1.29 It will be of particular interest to:

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

How the review links to the FCA's operational objectives

1.30 All three FCA operational objectives are relevant to the Compensation Framework Review:

1.31 **Consumer protection:** We want to ensure that there is an appropriate level of protection in place 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.

1.32 **Market integrity:** We want to ensure that funding is available to cover the FSCS's costs, with costs distributed across industry levy payers in an appropriate and sustainable way. In addition, we 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.

1.33 **Competition:** We want to ensure that the FSCS framework helps to maintain confidence in the financial services markets and encourages consumers to do business with firms, whilst not creating conditions which unduly impacts competition or creates barriers to entry or exit. We want to ensure that the FSCS framework helps to promote effective competition in the interest of consumers.

Equality and diversity considerations

1.34 We have considered the equality and diversity issues that may arise from this discussion paper.

1.35 Overall, we do not consider this discussion paper adversely impacts any of the groups with protected characteristics i.e. age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment.

1.36 We will continue to consider the equality and diversity implications of the issues raised in this discussion paper throughout our review of the compensation framework.

Next steps

1.37 We want to know what you think about these issues. Please send us your comments by 4 March 2022 using the online response form on our website or write to us at the address on page 2.

1.38 We will consider your feedback and publish a Feedback Statement during 2022, which will outline any further steps we intend to take. We also plan to engage with stakeholders directly during the first quarter of 2022, once we have had the opportunity to hear stakeholders' initial views.

2 The FSCS as a 'fund of last resort' and work to address the root cause of high compensation liabilities

2.1 In this chapter we propose two key principles for protection and consider 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.

2.2 The two principles are:

Proposed principles for protection

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.

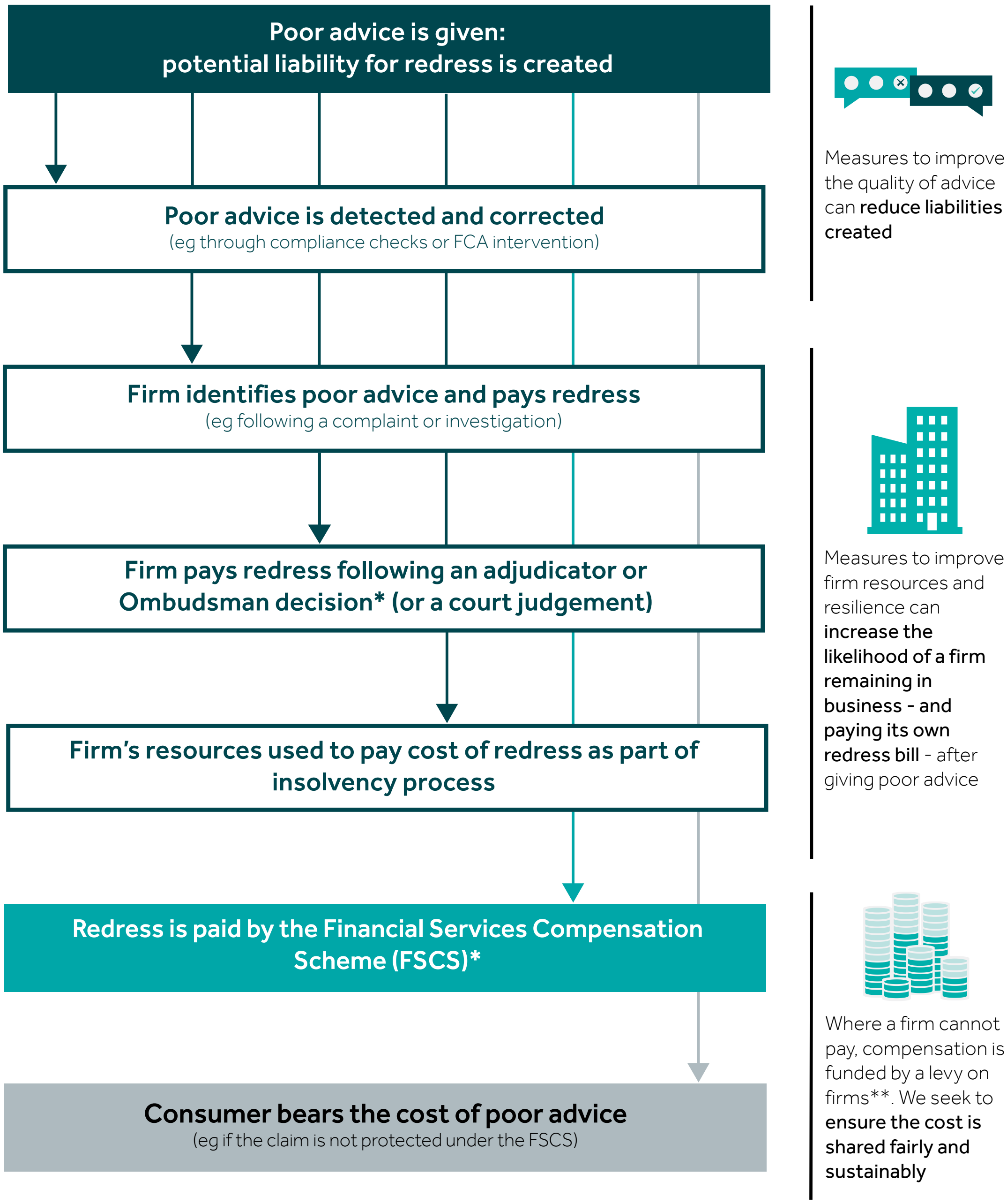
Principle 2 – FSCS protection for a particular regulated activity and category of individual should increase consumer confidence in the financial services sector. The availability of protection, and the benefits it brings to consumers, should be commensurate to the benefits to financial services markets: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

Ensuring that the firms which create the liabilities meet the liabilities

2.3 As set out in Chapter 1, in recent years, the rise in FSCS compensation costs have exacerbated perceived unfair outcomes for those firms that are having to meet the cost of liabilities for which they are not responsible, whilst the failed firms that are responsible pay little or nothing towards the FSCS liabilities that they create.

2.4 The infographic on the next page visualises this in respect to investment advice and highlights that the starting point in this dynamic is always the misconduct by a firm and the resulting harm to the consumer.

Infographic 1 – Illustration of how poor advice generates costs for FSCS, other firms and consumers



*Different limit exist on the awards that may be made by the Ombudsman and the compensation payable by the FSCS: in either case redress may not be paid in full.

**FSCS will seek to recover the cost of compensation paid (eg from the insolvent firm, an insurer or other third party) where reasonably possible and cost-effective to pursue.

2.5 The FSCS does not create the liabilities, instead it is a backstop before the consumer bears the cost of the original misconduct. However, the current level of costs falling to the FSCS highlights a risk that the FSCS may be perceived, in some respects, not to be functioning as a 'fund of last resort' but may risk becoming over-relied upon to deliver consumer protection.

2.6 Reliance on the FSCS in this way may create perverse incentives for both firms and consumers. For the former, it can lead to moral hazard to profit from misconduct as unmet liabilities are picked up by other firms. For consumers, the availability of FSCS protection is sometimes said to provide incentives to take more risk than they could afford to, or at a level which exceeds their risk appetite, on the assumption that, if the authorised firm fails, they will be compensated for losses. The result of this is that it could be seen to take away – for both firms and consumers – their 'skin in the game'. Although, we do not currently have evidence to demonstrate that a compensation scheme affects consumer incentives in this way, stakeholders often suggest that such incentives could exist.

2.7 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. However, consumers taking risk does not in and of itself lead to compensation liabilities. In a situation where there was no misconduct by a firm, then a consumer who lost money due to taking on such risk would probably not have a valid civil claim against a firm and therefore this is unlikely to result in a liability.

In accordance with proposed Principle 1, we want to get to a state where the FSCS is not over relied upon to deliver consumer protection, but instead acts as a final backstop to protect consumers in certain situations when all other mitigants have been exhausted.

2.8 Firms should be incentivised to run their businesses appropriately to avoid compensation liabilities arising in the first place. Authorised firms hold primary responsibility for protecting their customers from harm and firms need to ensure they have adequate governance arrangements, systems and processes in place to protect their customers. We expect firms to ensure that the conditions are in place such that consumers' biases are not exploited, they are able to make informed decisions, and are therefore able to take responsibility for the decisions they make following their dealings with authorised firms. Where harm does occur and redress is owed, it should be paid by the firm that caused the harm. Firms should therefore have sufficient resources in place to protect their customers. This includes having financial resources and, as appropriate, adequate insurance in place to meet the cost of liabilities that may arise. If a firm cannot continue to trade, we expect firms to wind down in an orderly way and pay all their liabilities rather than to fail and enter an insolvency process – and without the need for compensation from the FSCS where possible. The right incentives should be placed on firms to ensure firms are run in the interests of consumers and this should be reflected in firm culture, director remuneration and ownership structures.

2.9 However, the FCA does not run a zero-failure regime as we seek to encourage entry, innovation and spur growth in the financial services system for the benefit of consumers, markets and the economy. Accordingly, there will always be some degree of failures driven by market forces and the UK's statutory compensation scheme is there to meet unsettled claims for compensation in certain circumstances as a 'fund of last resort'. As set out in Principle 2, this final backstop is a benefit to the industry as it ensures that consumers have confidence to participate in financial services markets, including confidence to take an appropriate level of risk, and encourages consumers to continue to do business with authorised financial services firms. This purpose of the compensation framework should be the context for the discussion on what activities FSCS should protect, what categories of consumer are eligible to claim, and how much they should be able to claim for.

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)?**

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?**

Tackling the root cause of high FSCS costs

2.10 To ensure the FSCS is a true 'fund of last resort', we have several key workstreams underway, some of which are particularly focused on those markets which have seen firm misconduct recently give rise to liabilities they are unable to meet. In particular, the FCA's Business Plan for 2021/22 highlighted a number of priority initiatives which are relevant to the issues covered in this discussion paper:

The New Consumer Duty: Earlier this year we consulted on a new Consumer Duty (the Duty) which would set clearer and higher standards for firms' culture and conduct, to help ensure they put their customers' interests at the centre of their business models. It would require firms to ask themselves what outcomes consumers should expect from their products and services, and act to enable these outcomes and assess the effectiveness of their actions. Through the Duty, we would make it clear that we want firms to prioritise good consumer outcomes as an objective of their business priorities. We will continue to act where we see harm, but we want to see firms avoiding harm by 'getting it right in the first place'. Meeting these objectives should reduce the need for redress and compensation in the future. We will provide further details about the Duty in a second consultation that we expect to publish shortly, with a policy statement making any new rules to be published by the end of July 2022.

Ensuring people can choose appropriate pension products: We want to ensure that pension providers offer good value products, and that consumers can use guidance and support to help them make effective choices. Focusing on product design for those saving into a pension, we will:

- Seek views on how we can best increase value for money in pensions.
- Assess the effectiveness of our rules to help consumers make choices at the point of retirement.
- Implement a nudge to MoneyHelper's Pension Wise and support cross-government work to create pensions dashboards.

Consumer engagement strategy: We know that consumers do not always understand what 'FCA authorised' means and what protections apply. To address this challenge, we will improve how we engage with consumers. We are carrying out research into consumer awareness and understanding of financial regulation and protections and how this influences their behaviour. For example, what consumers expect from the labels 'authorised' and 'regulated' by the FCA, or from FSCS and/or Financial Ombudsman Service protection, and how their understanding influences their decisions. By better understanding consumers' beliefs, we can improve the information we give and how we give it to protect consumers from potential harm. We are also reviewing our current approaches to consumer engagement and how we work with our partners to protect consumers.

Consumer Investments Strategy: In September 2021 we published our Consumer Investments: Strategy and Feedback Statement, which sets out our three-year strategy for addressing consumer harm in the consumer investments market. The strategy includes measures to improve the quality of financial advice, reduce investment scams and the number of people investing in inappropriate high-risk investments who demonstrate characteristics of vulnerability or have a lower risk tolerance. We are drawing on the range of tools at our disposal: a tougher gateway, more assertive supervision and enforcement, adapting our rules where harm is developing, and innovative campaigns to warn consumers of risk. Ultimately, we want to see a consumer investment market in which:

- Consumers can invest with confidence, understanding the risks they are taking and the regulatory protections provided.
- They can access and identify investments that suit their circumstances and attitude to risk, only access higher risk investments knowingly and are protected from scams.
- Should they want advice or support to invest, they are able to get it.
- It is clear to consumers what happens if things go wrong and the cost of redress is met in a fair and sustainable way.

We want to prevent harms arising, which will lead to fewer disorderly failures resulting in liabilities falling to the FSCS, therefore reducing the burden on industry levy payers. We have said that, by 2025, our aim is that the FCA's interventions will help to stabilise the overall FSCS levy and then target a year-on-year reduction in the Life Distribution and Investment Intermediation and Investment Provision funding classes from 2025 to 2030. Later this year we will also consult on proposals to strengthen the rules for firms that approve financial promotions and we have recently launched a 5-year campaign – InvestSmart – to inform consumers about high-risk investments.

Coordination across regulatory partners: To help us to tackle harm in the consumer investment market, we continue to work closely with our regulatory partners including the Financial Ombudsman Service, FSCS and the Money and Pension Service, as well as other agencies such as the Home Office, the National Economic Crime Centre and law enforcement agencies. Alongside this existing engagement, we have created a 'consumer investment coordination group' involving FCA, FSCS, the Financial Ombudsman Service and the Money and Pension Service. This will identify areas of joint working to tackle harms in the consumer investments market and ensure efficient coordination on key workstreams.

Raising standards in the Appointed Representative regime: To ensure principals and appointed representatives are competent, financially stable and ensure fair outcomes for consumers, we are increasing our supervisory engagement to reduce the most significant risks from principals and appointed representatives across sectors. We have also published a consultation paper on improving the Appointed Representative regime alongside HM Treasury's Call for Evidence to gather views on the overall aim, scope, benefits and risks from the current regime.

Tackling phoenixing: At the Authorisations gateway we have a strong emphasis on preventing 'phoenixing' by firms – which is the deliberate avoidance of liabilities. For example, the directors of an existing authorised firm may seek authorisation for a new firm with the express intent, should they secure authorisation, of transferring their assets and running their business from the new firm, leaving the liabilities behind in the old firm (we refer to this as 'life boating'). This means that customers are unable to obtain full redress and the burden falls instead to the FSCS. We have been successful in identifying phoenixing attempts by focusing on connections between the directors and other individuals behind new applications and any existing or previously authorised firms. In addition, we are developing a framework for deterring 'life boating' attempts. A central plank of this will be to require applicants in certain scenarios to provide evidence of the suitability of advice given in an existing firm with any new authorisation application. There will also be a range of additional assurances that we can seek from firms.

Prudential regime for investment firms: When firms fail, we want to ensure they do so in an orderly way. In January 2022, our Investment Firms Prudential Regime will come into effect, including new requirements designed to try to ensure that firms are prepared for wind down. We will continue to strengthen our data-driven monitoring of the financial resilience of solo-regulated firms, targeting our interventions at firms with weak financial resilience and those whose failure is likely to cause material harm.

Prudential regime for non-MiFID investment firms: In the coming months, we will also review our prudential regime for non-MiFID investment firms, such as financial advisors, as part of our Consumer Investments Strategy. Our current prudential regime for these firms combines requirements relating to their financial resources with specific requirements to hold professional indemnity insurance (PII). We will explore whether there are ways to improve the different elements of our prudential regime – and whether this could, in turn, reduce the likelihood of firms failing and leaving behind liabilities for the FSCS.

2.11 In addition to the FCA's work, the FSCS is also committed to working with industry stakeholders to tackle the high cost of firm failures through the 'Prevent' strand of its strategy.

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'?**

3 What regulated activities should be protected under the scope of the FSCS?

3.1 In this section we discuss the question of what is the appropriate scope of FSCS protection. We do this with reference to the principles set out in chapter 2, considering both the current scope of protection and issues stakeholders have raised with us.

Current scope of protection

3.2 FSCS protection is currently broad in some sectors and covers a wide array of regulated activities. The broad categories of claim protected by the FSCS are:

- Deposits (subject to the PRA's Depositor Protection rules)
- Protected contracts of insurance (subject to the PRA's Policyholder Protection rules)
- Protected investment business (subject to COMP 5.5)
- Protected home finance intermediation (subject to COMP 5.6)
- Protected non-investment insurance distribution (subject to COMP 5.7)
- Protected debt management business (subject to COMP 5.8)

3.3 For the regulated activities covered by the FCA's rules, the relevant section of the Compensation (COMP) rulebook sets out the specific activities which are protected under the FSCS.

3.4 In addition, protected funeral plan business will become a further category of protected claim when we begin regulating the sector on 29 July 2022.

3.5 Despite the broad scope of FSCS protection, not all losses are protected by the FSCS, as the FSCS does not protect all regulated activities. For example, most consumer credit activities are not protected, and there is limited protection available for investment-based crowdfunding. Furthermore, the FSCS does not protect the activities of electronic money (E-Money) and payment institutions.

Protected investment business

3.6 There has been a large focus on the scope of protected investment business, which in recent years, has represented a large proportion of overall FSCS claims – with 78% of FSCS's total compensation costs of £584 million in 2020/21 (from the total levy raised of £700 million) relating to claims arising from the two investment related funding classes (Life Distribution & Investment Intermediation and Investment Provision).

3.7 The scope of the FSCS's protection for investment business covers many, but not all, of the activities specified in Part II of the Regulated Activities Order (some investment activities, such as investment-based crowdfunding, are not fully protected by the

FSCS). The wide breadth of protection available for investment business claims is highlighted by the variety of investment claims that the FSCS deals with, including those that are key drivers of recent costs, such as:

- Claims relating to negligent pensions advice, including advice to transfer out of defined benefit pension schemes.
- Claims relating to negligent advice to invest into self-invested personal pensions (SIPPs), sometimes including investments in non-standard assets.
- Claims against SIPP operators in relation to non-standard assets.
- Claims for the return of client money or custody assets.

3.8 A specific question has centred on why FSCS protection is more comprehensive than in other countries with investor compensation schemes, which typically protect only the non-return of investment assets and not claims for negligent advice (although the Australian government has recently introduced legislation to establish a scheme which would cover certain advice). Annex 2 summarises the protection for investments available under five example international schemes, to illustrate the different levels of protection available in different jurisdictions.

3.9 This disparity is driven by both historical factors and key differences in the investment markets in different jurisdictions. The former Investors Compensation Scheme (which preceded the FSCS), was established in 1988 under the Financial Services Act 1986. It had a similar broad scope for investments as is seen today under the FSCS. Schemes in the European Union were typically established much later than that in the UK following the requirements set out in the Investor Compensation Scheme Directive 1997. The Directive *"protects investors by providing compensation if an investment firm fails to return the investor's assets. Claims under the directive typically arise if there is fraud or other administrative malpractice or when an investment firm is unable to fulfil its obligations as a result of operational errors."* (the European Commission website).

3.10 When comparing protection with that available in other jurisdictions it is necessary to look beyond any *prima facie* differences and understand why those differences may have developed. Differences in FSCS scope for investments compared to comparator schemes are a reflection of the different levels of risk that consumers are exposed to when dealing with authorised firms in the UK market compared to that of other jurisdictions where investment markets are often structured differently. The broader scope reflects the multiple distribution channels seen in the UK and the prominent role of intermediaries (with around 5,000 advice firms and 27,000 regulated professionals advising on retail investments and pensions in the UK), compared to overseas jurisdictions where the distribution of financial services products is focused more on large banks and insurers (the bancassurance model). Considering the prevalence of small intermediary firms in the UK, there is arguably greater need for protection to cover the activities of the firms if they fail. This includes protection for advice provided, given how important that advice is for investment distribution in the market.

Possible changes to the scope of protection

3.11 We are interested in views from stakeholders on whether a change to the scope of FSCS protection – either serving to widen or reduce the scope of protection – may be appropriate. We invite stakeholders to consider proposed changes taking account of the discussion in Chapter 2 on the purpose of the compensation framework and in particular the proposed principle that FSCS protection for a particular regulated activity and category of individual should increase consumer confidence in the financial services sector, whilst remaining commensurate to the benefits to financial services markets.

3.12 Following on from the previous section, one option could be to align the scope of protection with that available in other jurisdictions. However, if the scope of the FSCS were to be reduced in this way, it may mean that consumers who do suffer financial losses following the failure of an investment intermediary would not be protected under the FSCS. The liabilities in relation to investment advice are currently very high (the FSCS expects costs arising from the Life Distribution & Investment Intermediation class to total £330 million over 2021/22) and this highlights that there is real and considerable harm suffered by consumers in relation to investment advice and other intermediation activities. These liabilities would not be protected in the future if the FSCS's scope was to be reduced to bring it into line with other jurisdictions.

3.13 Our current view is that such a reduction in the scope of FSCS protection could potentially impact the level of confidence that consumers have in financial services or may influence decisions consumers make about how they transact with authorised firms in the future. This is in the context of a consumer investment market within which consumers are increasingly responsible for making complex decisions about their financial future, including whether and how they invest. They have a greater choice of investment products and services than ever before and, whilst the increased choice has many benefits, the complexity increases the risk of things going wrong.

3.14 We are therefore interested in stakeholders' views on the impact that a reduction in FSCS protection may have on conditions in the financial services markets. For example, whether such a change would have implications for firms' business models, possible industry consolidation (such as a shift away from consumers seeking financial advice from small intermediaries to larger banks and insurance firms which may be considered by consumers to be more resilient) or the quality of financial services advice or other services. Furthermore, we would also welcome views on whether reducing protection in this way may conflict with the aim of our Consumer Investment Strategy for "a consumer investment market in which consumers can invest with confidence, understanding the risks they are taking and the regulatory protections provided."

3.15 Another option to ensure the scope of FSCS protection is proportionate could be to limit FSCS protection to exclude protection for certain investment products. This would mean that FSCS protection could be focused on mainstream investment products which are more likely to suit the needs of ordinary investors. We could then exclude certain particularly high-risk or alternative investments which are not typically suited to ordinary investors. For example, non-mainstream investments such as cryptoassets, unlisted securities or unregulated collective investment schemes could potentially be excluded from FSCS protection in certain circumstances. This may complement one of the objectives of our Consumer Investments Strategy by creating the right environment for consumers to invest, whilst encouraging firms to help consumers to identify and access investments that are suited to their circumstances and attitude to risk.

3.16 However, there may be certain challenges to limiting protection in this way. Firstly, we would need to clearly define the scope of "excluded" investment products before FSCS protection could be aligned to the new regime. The process of designating investment products within this category could be highly complex – both to set-up and then maintain on an ongoing basis – and likely contentious, with stakeholders likely to have different opinions of how investments should be treated. Furthermore, limiting protection in this way could also lead to undesirable outcomes, including whereby an individual, including someone who may be in vulnerable circumstances, could be negligently advised to invest in a high-risk "excluded" investment and would not be protected under the FSCS, although the activity itself would remain subject to FCA regulation. Finally, we consider that such a change could complicate the availability of FSCS protection, adding to confusion about what activities and products are protected by the FSCS.

3.17 Despite the challenges discussed above, we are interested to hear views of stakeholders on whether there may be overall benefits of limiting the scope of FSCS protection to some degree, in particular whether there may be benefits in not covering non-mainstream, speculative products.

> **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.**

> **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.**

Territorial scope considerations in relation to investment funds

3.18 FSCS protection is usually linked to regulated activities carried on by an authorised firm from an establishment in the UK (rather than linked to specific products or the location of funds), regardless of the location of the client. There are however some exceptions for funds.

3.19 Some industry stakeholders have said FSCS coverage should be limited only to UK authorised or domiciled funds and that it is not fair that UK authorised firms face significantly higher regulatory costs than overseas firms marketing their products to UK consumers, given the approach that the Government is taking to investor protection in the Overseas Funds Regime (OFR).

3.20 In cases where a UK-authorised 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-authorised 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. This difference came about following the implementation of the Alternative Investment Fund Managers Directive (AIFMD) where, following consultation, it was decided that a narrower territorial scope should apply for Alternative Investment Fund (AIF) and Undertakings for Collective Investment in Transferable Securities (UCITS) managers and Collective Investment Scheme (CIS) operators.

3.21 When the AIFMD was implemented, in CP13/9, the Financial Services Authority explained that it was its view that investors in an authorised fund would expect protections such as FSCS, regardless of where and by whom the fund is managed. The rules consulted on, and subsequently implemented, limited FSCS cover to cross-border fund management activities where the fund is an FCA-authorised fund. This meant that prior to the UK's withdrawal from the European Union, the FSCS:

- covered an EEA alternative investment fund manager (AIFM) managing a UK-authorised fund
- did not cover a UK AIFM managing a non-UK fund
- did not cover an EEA AIFM managing a UK-domiciled UCIS
- did not cover a UK AFM managing a non-UK UCITS since this activity is not protected investment business for the purposes of the Compensation sourcebook.

3.22 The OFR provides the post UK withdrawal from the European Union basis for marketing overseas investment funds to UK investors, including retail investors. The Government consulted on proposals for the OFR and subsequently decided that it was unnecessary and disproportionate to extend FSCS coverage to failures of an OFR fund's operator or depository, due to a lack of evidence of significant risk of consumer loss from the failure of authorised UCITS funds. Whilst FSCS cover may be available if UK investors invest through, or are advised by, UK-authorised intermediaries, UK investors would not be able to make a claim to FSCS about the mismanagement of the fund by the fund's operator, nor failures relating to the fund's depositary.

3.23 We see FSCS coverage as an important consumer protection mechanism and something that UK retail investors will expect to receive when dealing with a UK-authorised firm. If FSCS coverage for all regulated investment activities was limited to UK-authorised or domiciled funds, thought would need to be given to whether and how this could be effectively communicated to consumers and how this would further FCA objectives. If FSCS coverage for the activity of 'managing investments' were limited to UK products, this would mean that investors in, for example, an Irish retail fund managed by a UK-authorised delegated portfolio manager, would not have coverage where the UK portfolio manager did something unlawful that led to those investors suffering a loss.

3.24 We would also need to consider the impact of this approach on non-UK consumers and the possible impact this might have on UK consumers' ability to access appropriate compensation via international compensation schemes in the future.

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?**

Issues at the perimeter and providing clarity to consumers

3.25 There is a perceived complexity meaning that firms and/or consumers may not always understand the scope of protection. This issue can be illustrated by the types of investment which the FSCS can account for when calculating the compensation due as part of a designated investment business claim. Under COMP 5.5.1R, protected investment business includes (in addition to other activities) designated investment business carried out by the relevant person (e.g. the firm in default) with, or for the benefit of, the claimant. Designated investment business encompasses certain activities, specified in Part II of the Regulated Activities Order (Specified Activities) (RAO), which are carried on by way of business including, for example, advising on investments in relation to designated investments as specified in Part III of the RAO.

3.26 In cases where a valid claim is established, when calculating the financial loss suffered as a result of negligent advice given in relation to the designated investment, the FSCS may take into account losses that relate to non-designated investments. For example, the FSCS may consider that compensatable losses arising from negligent investment advice to enter into a SIPP (a personal pension scheme under article 82(2) of the RAO), include losses arising from investments placed into the SIPP, whether they are designated investments or not.

3.27 This position was reinforced in the case of Emptage v FSCS in 2013, in a case relating to designated home finance business. The court found that, in calculating what would be "fair" compensation, the FSCS should account for all relevant losses that arose from the negligent regulated home finance advice, including losses arising from a related overseas property investment purchased with the funds available under the relevant mortgage agreement, where the overseas investment was closely linked to the negligent advice given.

3.28 We hear from stakeholders that these cases result in liabilities that are not appropriate to be covered as claims involve investments outside the regulatory perimeter, and they therefore should be outside of scope and therefore give rise to levies that are not appropriate. However, the key factor here is the activity of advice and the harm that arises from poor advice that constitutes misconduct.

3.29 Related to this issue is the risk, flagged by the FCA's Perimeter Report 2020/21, that consumers may suffer harm if they believe they are dealing with an authorised firm or individual carrying out a regulated activity when this is not the case. Alternatively, they may believe they will be able to get protection through the FSCS (or the Financial Ombudsman Service) when this is not the case. This harm could occur if a firm carries out an unregulated activity and the consumer does not understand that this activity is not regulated and, in some cases, that the firm is also not authorised.

3.30 To help consumers understand how they may be able to access redress, we require most firms to provide customers with information about when compensation might be available from the FSCS (or another relevant compensation scheme) if the firm cannot meet its liabilities. For example, under our Conduct of Business (COBS) rules, certain investment firms involved in regulated investment business are required to provide information to clients about the amount and scope of protection provided by the FSCS or other relevant compensation scheme (see COBS 6.1 and COBS 6.1ZA). However, our rules do not typically require firms to warn customers when they are undertaking a financial services transaction where FSCS protection is not available.

3.31 The current disclosures prescribed in UK legislation and European Union regulation, as onshored, do not require firms to ensure retail investors are told clearly and prominently when UK compensation arrangements apply and, if not, whether and what equivalent overseas compensation arrangements might apply. Consequently, retail investors are unlikely to be aware when they buy funds managed overseas, via a UK distribution platform, that they are not receiving the same level of regulatory protections that they would if they had bought a UK managed fund. This could lead to some investors wrongly assuming that protection is available when it is not. We are currently considering options for mitigating this risk including enhanced risk warnings and requiring investors to acknowledge lack of protection in certain instances.

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?

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 firms ensure customers are aware of the lack of protection, through the fund's marketing materials or otherwise?

4 Who should be eligible to claim compensation from the FSCS?

4.1 In this section we look at who should be eligible to claim compensation from the FSCS.

4.2 We want to ensure that the scope of individuals (including, private individuals and entities such as small companies and charities in some instances) who are entitled to claim compensation from the FSCS is proportionate given the proposed principles for the compensation framework.

Who is currently eligible to claim from the FSCS?

4.3 The FSCS primarily protects private individuals, although small companies and charities are covered in some instances.

4.4 Under the Compensation (COMP) section of the FCA's Handbook, chapter COMP 4 sets out those categories of consumer who are able to claim compensation or benefit from the protection the FSCS is able to provide (different eligibility rules apply to deposit and insurance provision claims under the PRA's rules).

4.5 Rule COMP 4.2.2R sets out persons who are not able to claim compensation (unless certain exceptions apply, under COMP 4.3). The list of those not able to claim include certain authorised firms, directors of the firm in default, connected entities to the firm in default, large companies and large partnerships.

Should 'high-net-worth' or 'sophisticated' individuals be eligible to claim compensation?

4.6 It could be argued that individuals considered to be either 'high net worth' or 'sophisticated' should not be eligible to claim compensation from the FSCS in certain scenarios. This could be because a high-net-worth individual might be expected to have the means to absorb losses or take their own private action against a failed firm. It could also be because a 'sophisticated' individual (with particular financial services expertise, e.g. in investments) would likely have a greater understanding of the risks that they were undertaking when dealing with an authorised firm. Relevant to this issue, section 1-C-(2)-(b) of FSMA, in relation to our consumer protection objective, requires the FCA to have regard to the differing degrees of experience and expertise that different consumers may have in considering what degree of protection for consumers may be appropriate.

4.7 High net worth and/or sophisticated claimant definitions could be developed which apply solely to FSCS eligibility. Alternatively, such an exclusion could be linked to existing definitions, such as the definitions relevant to financial promotions set out in Schedule 5 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 ('the Order'). Aligning with the existing definitions in the Order would have the advantage of consistency and reduce the likelihood of consumer confusion if separate definitions were created specifically for the FSCS. However as set out in Chapter 6 of our Perimeter Report 2021/22, there are significant deficiencies with the current definitions. Therefore, using them may result in 'ordinary' consumers also losing protection. In addition, the criteria for being 'sophisticated' with respect to financial promotions related to unlisted securities may not be applicable to all circumstances where FSCS protection is available.

4.8 Notwithstanding the specific definition, there would be several considerations related to introducing such an exclusion for FSCS claimants. For example, whether the exclusion would apply to all types of protected claim, how the FSCS would determine whether the exclusion applied to a particular claimant (including if the information was not held in the firm's own records) and whether the FSCS would need to differentiate between different types of 'expertise' when considering whether a 'sophisticated claimant' exclusion should apply.

4.9 The FSCS has considered the possible effect of introducing such an exclusion in the future by looking at claims processed over 2020/21. Although the FSCS does not hold comprehensive data to be able to confirm whether claimants meet the current definition of 'high net worth' under the Order, its data indicates that 95% of claimants, whose claims were processed since 2018, earn salaries of less than £100,000. So, although this data does not cover all aspects of the current definition of high-net-worth individuals under the Order, it does suggest that introducing such an exclusion for future claims may only have a minimal impact on the number of eligible claims (although there would always be the prospect that a default could arise in the future where there is a higher concentration of high-net-worth claimants). The FSCS does not currently hold data which would indicate what proportion of claimants might have been excluded under a 'sophisticated investor' exclusion.

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?**

Are there other opportunities for refining FSCS's eligible claimant criteria?

4.10 There may be further opportunities to refine the FSCS's eligible claimant criteria to ensure that only the persons who are most in need of compensation from the FSCS are eligible to claim – for example, by focusing FSCS protection to a greater extent on those who were in vulnerable circumstances during their interactions with the firm whose actions resulted in them suffering detriment

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

Does the CIS 'look-through' remain appropriate?

4.11 FSCS compensation for a protected type of claim is generally only available if the claimant has a valid civil claim against the defaulting authorised firm. This could be a claim based on a breach of certain FCA rules or a claim under the general law such as breach of contract or negligence, for example where a firm has breached the terms of a client agreement with an investor. In certain circumstances, investors in a CIS may themselves not have a direct civil claim against the operator, fund manager, delegate fund manager or depositary and the right to make a claim may belong to the CIS itself or another person, e.g. its operator (which is not an eligible claimant for FSCS purposes).

4.12 In April 2018 we introduced a 'look-through' for CISs to enable the FSCS to treat participants in the relevant fund as having a claim, instead of the CIS, operator, trustee, manager or depositary who is the actual claimant.

4.13 We introduced the look-though rules to bring consistency to the circumstances in which the FSCS can compensate CIS investors. It was our view that confidence in the asset management sector could be threatened if the failure of an operator, delegate investment manager or depositary occurred, and the FSCS was unable to compensate some or all investors for reasons that may appear arbitrary, i.e. because the CIS or its operator is not an eligible claimant for FSCS purposes. There are similar look-through provisions in the Compensation sourcebook for cases involving bare trustees, nominee companies or trustees of certain types of pension scheme.

4.14 The FSCS does not provide protection for poor performance of an investment, but if a UK-authorised firm's acts or omissions have caused losses, investors are likely to expect to be protected by the FSCS. Before we introduced the look through, only some of the CIS activities of fund managers and depositaries could be compensated under our rules if the UK authorised firm did not have a direct contractual relationship with investors. It was our view that it would not be reasonable to expect investors to know when a claim for compensation against a UK authorised firm may or may not be covered in this way.

4.15 Some stakeholders have told us that the risk that a fund manager or depositary will fail leaving significant liabilities is low, so FSCS protection is not needed for CIS investors. Stakeholders have also said that non-UK investors are unlikely to be aware that they might be able to claim compensation from the FSCS and, even if they were, are more likely to seek compensation directly from other parties (e.g. the overseas fund or fund manager), meaning that the FSCS scheme that the UK delegate manager pays into is unlikely to ever be required to pay claims.

4.16 Whilst it could be argued that the risk that the operator or depositary failing is low in light of recent FSCS claims data, when we introduced the rules, we took the view that the potential impact on consumers if such a failure happened was significant enough to justify FSCS protection. That FSCS claims against particular types of firm have been low in the past does not necessarily mean that they will continue to be low in the future or that a large firm's future acts or omissions will not cause significant harm to consumers. We have seen cases in the past where asset managers have invested outside of their mandate. In that type of scenario, if the firm failed as a result of causing significant losses via outside of mandate investments, FSCS protection would appear to be appropriate and vital to protect consumers from harm.

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?

5 What is an appropriate level of compensation to be paid to an individual claimant?

5.1 In this section we consider the limits on compensation payable by the FSCS.

Current compensation limits

5.2 The current limits on compensation payable are set out in section 10.2 of COMP. The limits apply to the aggregate amount of claims in respect of each category of protected claim that an eligible claimant has against the relevant person (i.e. a firm in default) or, where applicable, a successor.

5.3 In the case of most claims covered by the FCA's rules, the compensation limit is £85,000, per eligible claimant, per firm in default. This includes claims in relation to investment, home finance and debt management business. In the case of certain categories of insurance claims (including claims against insurance providers and intermediaries), the amount of compensation payable is unlimited.

5.4 The level of compensation available under the FSCS can be contrasted with the amount of redress that can be awarded by the Financial Ombudsman Service, up to £355,000. This difference reflects the fact that the 'polluter' pays for the redress awards under the Financial Ombudsman Service.

Previous review of compensation limits

5.5 We last considered the compensation limits as part of the review of the FSCS framework over 2016-18. Ahead of that review, the limit for investment business and home finance intermediation business claims had been £50,000 since 2009, and between 2010 and 2014 the proportion of claims with losses above that limit had increased from 5% to 13%. We sought views on various options for changing the limits to ensure they were set at the right level.

5.6 In light of feedback we received following consultation in CP17/36, we confirmed in CP18/11 that the limits for investment and home finance business, and for debt management business (which became a new type of protected claim from April 2018), would be increased to £85,000. As part of our analysis set out in CP17/36, it was estimated that, if a £85,000 limit had been in place over 2015 to 2017, 94.4% of claims would have been fully compensated rather than 86.5% of claims that were actually fully compensated over that period based on the £50,000 limit which was applicable.

5.7 We explained in CP18/11 that the increase to £85,000 represented an appropriate balance between consumer protection and the cost to industry levy payers. Furthermore, it meant that the limits were at the same level as the limit for deposit claims under the PRA's deposit protection rules (while recognising that the limit for depositor protection could change in the future). This helped to avoid consumer confusion about the various limits which applied to different types of claim. The new limit applied to claims against firms declared in default from April 2019.

The impact of current compensation limits on the compensation paid by the FSCS

5.8 The FSCS has calculated the effect of the revised limits on investment, home finance and debt management claims processed against firms declared in default since April 2019, where the £85,000 limit applies.

5.9 The proportion of claims compensated where losses exceeded the £85,000 maximum is shown in Table 1. The table excludes claims paid in relation to firms that were declared in default prior to April 2019, when different limits apply. The table also excludes certain insurance claims where there is no limit to the compensation payable.

Table 1: Proportion of claims with losses which exceed the compensation limit applicable to firms declared in default since April 2019

Funding class (type of claim)	Compensation limit	Total number of claims paid	Number of claims paid where total losses exceeded FSCS limits	Proportion of claims paid where total losses exceeded FSCS limits
Life Distribution & Investment Intermediation (protected investment business)	£85,000	30,799	1,601	5.2%
Investment Provision (protected investment business)	£85,000	7,249	835	11.5%
Home Finance intermediation (protected home finance intermediation)	£85,000	1	0	0.0%
Debt Management (protected debt management business)	£85,000	110	0	0.0%

5.10 Table 1 shows that, despite the increase in the limit to £85,000, a proportion of claims exceed the compensation limit and are therefore not compensated in full (subject to any amounts successfully recovered by the FSCS, which may be paid to the customer in certain circumstances). Overall, around 6% of claims which fall to the two investment funding classes were not fully compensated. This proportion is consistent with the estimation referenced in CP17/36 that if a £85,000 limit had been in place over 2015 to 2017, 94.4% of claims would have been fully compensated.

Potential changes to compensation limits

5.11 Generally, we consider the current levels, which were only recently changed, represent an appropriate level of consumer protection, in that they are at an adequate level to cover a reasonable proportion of customers' claims. Furthermore, we consider there are clear benefits of maintaining consistency across limits where possible, to help simplify messages about FSCS protection. We consider that the availability of FSCS protection should be clear and understandable, such that it can be clearly communicated to consumers so they are aware of the scope of protection that may be available to them if the authorised firm they are dealing with fails.

5.12 However, the compensation limits are set at a fixed, nominal amount. Accordingly, the relative value of the applicable limit will change over time because of inflation; if inflation increases, the protection available from the FSCS will decrease over time. A possible option to ensure consumers are not disadvantaged by this would be to introduce periodic reviews of the compensation limit. For example, every three years a review of the compensation limits could be undertaken to consider whether they remain at an appropriate level or to consider whether changes are required. This review would be undertaken with reference to specific criteria (which would need to be developed) to help determine what an appropriate level of compensation should be. Any changes would apply to firms declared in default in relation to the relevant category of claim from the date that the rule change applies. We would need to ensure that any changes to the limits are clearly communicated (including to consumers and firms) to minimise the risk that there is confusion about what the applicable limit is.

5.13 We would be interested in hearing views from stakeholders on whether changes should be made to the level of compensation payable by the FSCS, perhaps through the introduction of a periodic review of the compensation limit.

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.**

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?**

6 Can improvements be made to how the FSCS is funded?

6.1 In the previous three chapters we have considered aspects of the scope of FSCS protection (particularly what activities should be protected, who should be eligible to claim and the limit on the amount of compensation payable) which address the type of compensation framework we want to have. In this chapter we turn to considering how that compensation framework should be funded.

6.2 Firms often challenge us to look at alternative ways of funding the FSCS, to avoid well-run firms continuing to meet the costs arising from the misconduct or mismanagement of failed firms – often for liabilities relating to different types of business that the levy paying firm is not directly involved in. Accordingly, in this chapter we will consider whether changes could be made to the current funding model, or whether there may be alternative funding models, which would ensure that FSCS compensation costs (for the classes which the FCA is responsible for) are funded in a fair and sustainable way and in line with our proposed design principles. Parliament has decided that the compensation framework should be funded by a levy on regulated firms, as set out in FSMA. Options for reform discussed in this section therefore focus on options for funding from regulated firms.

6.3 The proposed design principles (which build on principles established as part of the previous 2016-2018 review of the compensation framework) which are relevant to this aspect of this discussion about funding are.

Proposed principles for funding

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 (e.g. based on historic volumes and future forecasts) – whilst also being able to respond to unexpected spikes in costs (e.g. a sudden failure which could not have been foreseen) – whilst apportioning costs appropriately and fairly across funding classes.

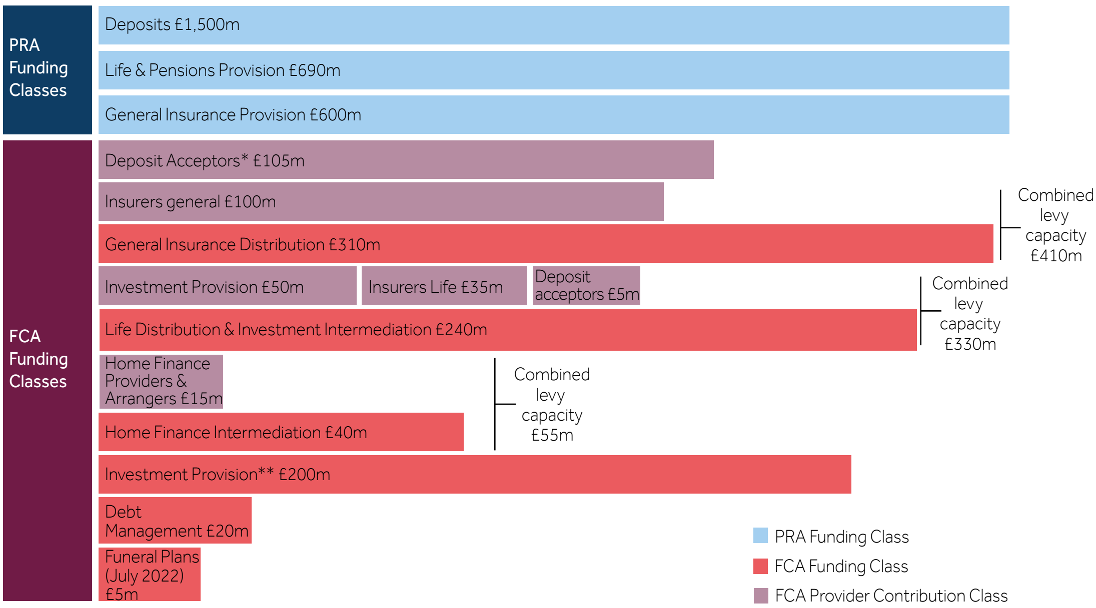
Principle 4 – funding classes should provide sufficient funding for compensation whilst remaining sustainable, therefore some degree of cross subsidy may be needed in practice: By allocating FSCS compensation costs to different funding classes, it means that, as far as possible, firms are paying for the cost of the failure of firms carrying out similar business (e.g. 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.

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?

Overview of the FSCS funding model

6.4 FSCS costs (including compensation costs and management expenses) are apportioned to different funding classes up to set class limits so that, as far as possible, firms are paying for the cost of the failure of firms carrying out similar business. A firm's compensation costs levy or management expenses levy for a funding class is usually calculated with reference to the size of its annual eligible income (e.g. the firm's income for the previous financial year in relation to a firm, class and category under the FEES rules) and the amount of FSCS compensation that its individual funding class will have to pay. The current funding model is illustrated at Chart 2.

Chart 2 – Current FSCS funding model



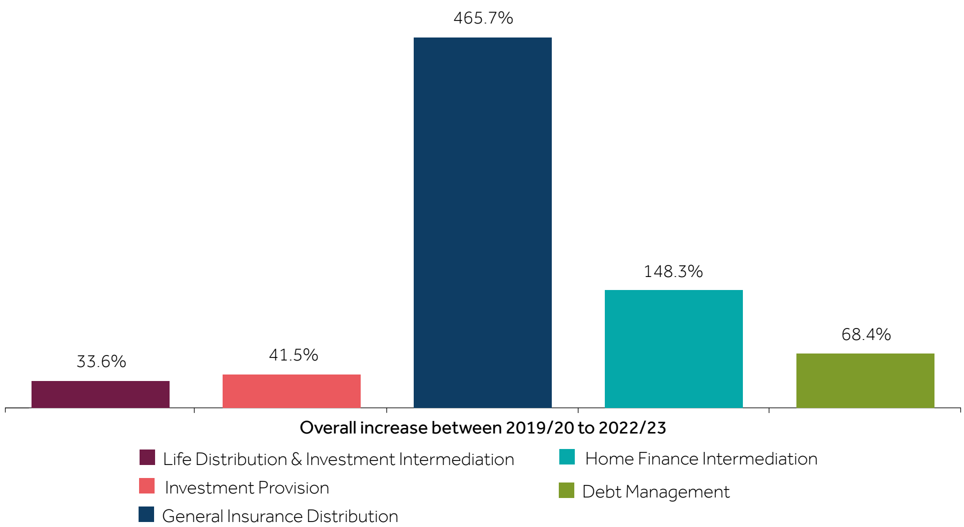
* Deposit Acceptors only have to fund retail pool levies
** Investment Provision firms can only be levied £200m in total

Cross subsidies and the Retail Pool

6.5 As illustrated in Chart 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.

6.6 As set out in Chapter 1, the Retail Pool has been triggered four times in the past five years. The consequence of cross subsidies can be seen in Chart 3, which show how the levy liability of an 'average' firm contributing to the main FCA funding classes has increased since 2019/20, with further increases expected for some classes in 2022/23 based on FSCS's provisional forecast for next year. For the purposes of this analysis, we have assumed the same population of firms will contribute to next year's forecast costs as for 2021/22. Furthermore, we have only accounted for the costs relating to the particular funding class (plus any Retail Pool contributions that the class was required to meet), and not the costs that a firm in the particular class may contribute to other funding classes in relation to other types of business.

Chart 3 – Percentage change in average firm funding class levy liability

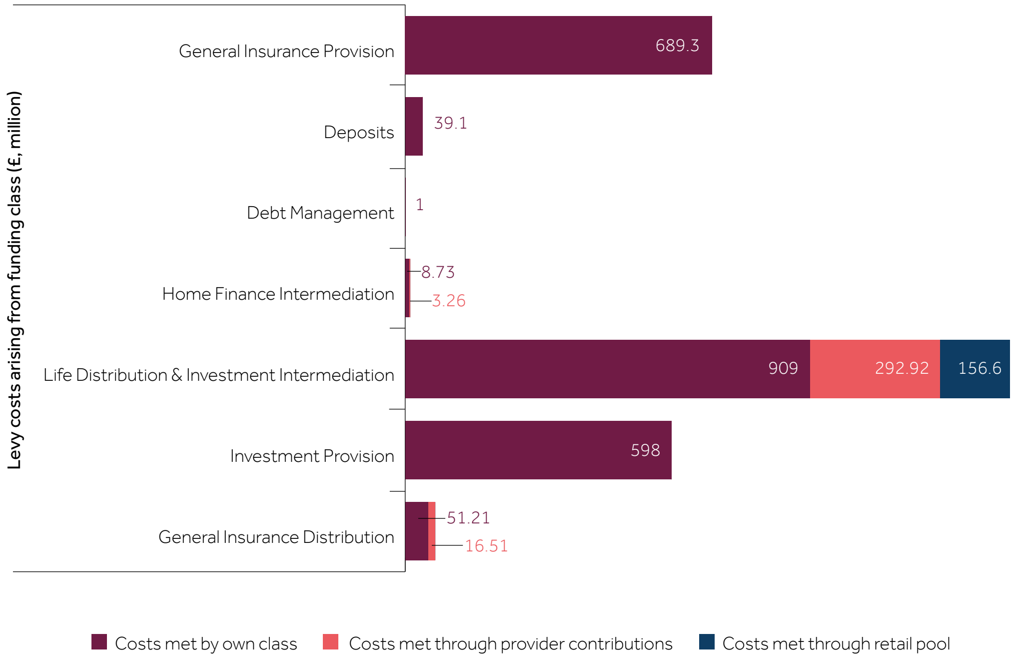


6.7 Chart 3 shows that while the average (mean) liability of firms contributing to the two investment classes is expected to increase by 34-41% over the four years up to 2022/23, the average cost to firms contributing to the General Insurance Distribution class, for example, is expected to have increased by 466% over that period, primarily as it is expected to be required to contribute to the Retail Pool in respect of costs arising from the Life Distribution & Investment Intermediation class in 2022/23. The Home Finance Intermediation and Debt Management classes are also projected to see increased levy costs next year, primarily due to the expectation, based on the FSCS's provisional forecast, that they will also need to contribute to the Retail Pool.

Where costs arise from and how the FSCS levy is distributed between firms

6.8 Chart 4 shows the originating funding classes where claims costs arise from, totalled for the four years between 2019/20 and 2022/23 (therefore including the provisional forecast costs for next financial year). This highlights how the majority of claim costs, other than costs arising from the General Insurance Provision class, arise from activities aligned to the two investment funding classes: Life Distribution & Investment Intermediation and Investment Provision. The chart also highlights how a sizeable proportion of the costs arising from the Life Distribution & Investment Intermediation class in particular, are met through contributions from other funding classes – either product provider contributions or through the Retail Pool.

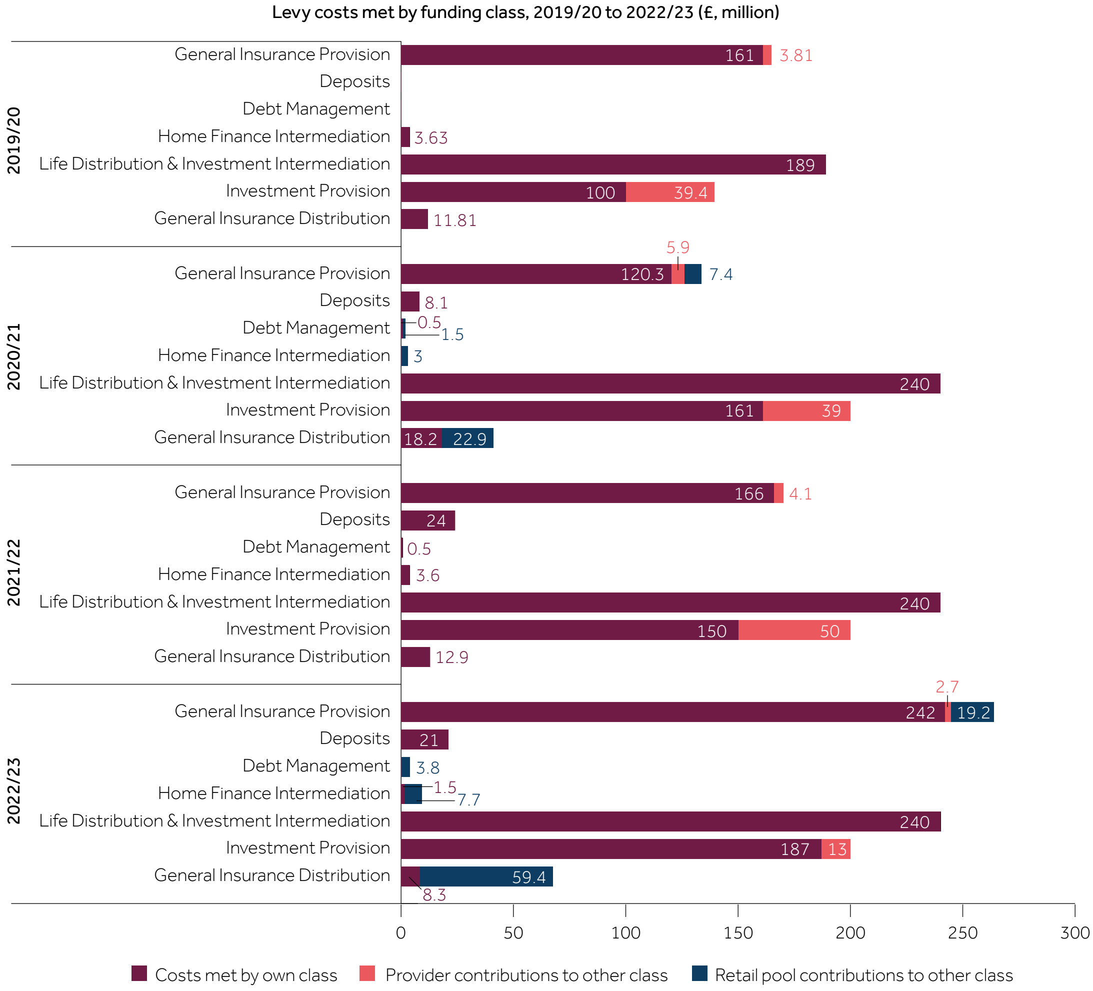
Chart 4 – Originating class of levy costs, combined view for 2019/20 to 2022/23



6.9 Chart 5 illustrates how these same costs have been allocated across (or are forecast to be allocated across) the seven funding classes over the same four years from 2019/20 to 2022/23 (including the provisional forecast costs for next financial year). In particular, the chart shows how the Investment Provision funding class has contributed a significant proportion of costs to other classes through provider contributions (as explained at paragraph 6.12, from April 2019, product providers have been required to contribute approximately 25% of the funding requirement for the insurance and investment intermediation funding classes), and the General Insurance Distribution class in particular has been, or is expected to be, allocated costs from other classes through contributions to the Retail Pool.

6.10 Other funding classes (including the Debt Management and Home Finance Intermediation classes) have also been exposed to costs arising from the Retail Pool, but to a lower amount due to the lower relative size of the funding class thresholds for those classes. This contribution to the Retail Pool is forecast to increase significantly in 2022/23, when the Retail Pool contribution is forecast to be £113 million (compared with a £44 million contribution in 2020/21).

Chart 5 – how costs have been (or are expected to be) allocated across FCA funding classes, 2019/20 to 2022/23



Please note the chart combines the General Insurance Provision and Insurers General funding categories for presentation purposes. It also does not include contributions paid by the Home Finance Providers, Deposit Acceptors, Insurers Life and Deposit – Structured Deposits classes. Levy for the Deposits class for 2019/20 shown as zero due to effect of refund paid to class.

Changes within the current funding model

6.11 When we last reviewed the compensation framework between 2016-2018, we made several changes to the funding model to ensure that the funding arrangements were appropriately distributed across industry levy payers, in particular to reduce the volatility of FSCS levies and to create sustainable funding classes (see Annex 1 for further detail).

6.12 Following the review and an industry consultation, from April 2019, to help reduce volatility of levies, the former Life & Pensions Intermediation and Investment Intermediation funding classes were merged into a new Life Distribution and Investment Intermediation funding class. This change aimed to ensure that the levy costs would be shared across a wider pool of firms. In addition, product providers were required to contribute approximately 25% of the funding requirement for the insurance and investment intermediation funding classes. This was considered appropriate as providers benefit from maintaining confidence in the overall market and the structures that exist for the distribution of products to consumers. Furthermore, it was considered that the additional funding requirement would incentivise providers to design products that are well understood by intermediaries and to understand and exercise control over their distribution chains.

6.13 The changes aimed to avoid small funding classes. Although small classes might mean greater symmetry between the activities of firms which contribute to the class, it would also increase the likelihood that the class limit would be exceeded and could jeopardise the sustainability of the class, increasing the risk that the Retail Pool is triggered.

6.14 We would welcome any suggestions for how the distribution of costs across funding classes could be improved. In particular, we are keen to hear suggestions for how to improve the Retail Pool funding mechanism, which ensures that funding remains available to cover costs when funding thresholds are met, whilst sharing costs in a fair and sustainable way.

6.15 In addition, some firms in the Investment Provision class have raised concerns that the tariff base for the class causes some firms difficulties. The definition of annual eligible income in our rules enables firms to either calculate it based on income attributable to business conducted with or for the benefit of eligible claimants, or if that is not possible, to include all annual income. Firms have told us that distributors rarely share details of underlying investors. This means that some firms have no choice but to report all annual income, which may result in them paying more towards the levy. We are interested in hearing views on alternative metrics to annual eligible income to ensure that compensation costs are fairly distributed amongst firms in the Investment Provision class.

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.**

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?**

Funding class levy limits

6.16 The funding class levy limits were last substantially updated in April 2013, following the Financial Services Authority's 2012-2013 funding review. While the limits were considered again as part of the 2016-2018 review, we confirmed in CP17/36 that, in light of an affordability analysis completed and consultation feedback, the class limits would remain largely unchanged.

6.17 Under s213(5) of FSMA, the FCA has a duty to take into account the desirability of ensuring that the amount of levies imposed on a particular class of authorised person reflects, as far as practicable, the amount of claims made, or likely to be made, in respect of that class. Furthermore, the effect of inflation since the limits were last materially changed may mean that the limits are not at the optimal level. Accordingly, it may be appropriate to revisit the class limits to ensure they remain at an appropriate level so that the compensation scheme remains sustainable and sufficiently funded. Appropriate considerations would include:

- The cost of claims made, or likely to be made, in respect of that class.
- The amount of costs that the class could afford whilst remaining sustainable.
- The ability of firms to 'pass through' costs to customers.
- Changes in the economic and regulatory environment which may impact the ability of a class to meet costs.

6.18 We consider there may be benefits to reviewing the funding class levy limits on a regular set cycle basis, for example, every three years. The limits could then be reassessed with reference to a set of established criteria. This would help to ensure the limits remain appropriate, in light of external factors which will inevitably change over time, and also help reduce the frequency of calls upon the Retail Pool.

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 criteria would FCA need to account for in such a review?

Alternative funding models

6.19 We would welcome the views of stakeholders on the merits of alternative models or sources of funding, including ideas for funding models which have not previously been contemplated (although, in light of the current funding provisions under FSMA, some potential alternative models may not be within the FCA's powers to deliver and may require statutory changes, which would be for the Government to consider). Models would need to be consistent with the proposed principles for the compensation framework in relation to funding set out at paragraph 6.3, or be subject to revised principles which the responder considers to be preferable.

6.20 In the past we have considered several alternatives to the current funding model that applies to the classes that FCA is responsible for, including:

6.21 **Risk-based levies:** In CP16/42, we considered whether firms should pay a premium on FSCS levies if they were involved in regulated activities or products that we considered to be higher risk. This would address one of the views often expressed by firms, that the firms engaged in higher risk activities (i.e. activities which are more likely to give rise to FSCS claims) should pay a higher proportion of FSCS levies. Firms that choose not to undertake any business involving 'higher risk' activities would be allocated a reduced share of the annual levy for their funding class, compared to firms that do. We recognised that the cost of the 'levy premium' would likely to be passed on to consumers. Therefore, firms would need to make a commercial decision as to whether it would be worthwhile continuing to engage in such activities or sell such products.

6.22 To help us to consider the feasibility and desirability of introducing risk-based levies, we introduced a new reporting requirement in relation to higher risk investments. From April 2018, firms were required to include details in their Retail Mediation Activities Return (RMAR) about the distribution of products sold that fell within a definition of 'enhanced reporting investment'. That definition linked to the list of investments subject to restrictions on retail distribution set out at COBS 9.3.5G. The data we have received since introducing the reporting requirement has helped identify firms involved in the distribution of higher-risk investments. However, this data has its limitations. It does not account for new types of higher risk investments which do not fall within the definition of 'enhanced reporting investment' and the definition would require ongoing reassessment to ensure it captures appropriate investment types. The data has not provided a suitable basis on which to develop a risk-based levy model.

6.23 Furthermore, despite the potential benefits, there remain apparent disadvantages to introducing risk-based levies:

- Firms could be disincentivised to distribute higher risk investments, where purchasing them could be in the consumer's interests (for example, where they are included appropriately as part of a diversified portfolio).
- Reporting requirements could act as an incentive for some firms to misreport if reporting such data led to increased levies and it could be difficult to identify which firms are not reporting correctly.
- A risk-based levies funding model could stifle innovation and competition and could act as a barrier to entry for new firms with innovative products.
- The risk-based funding model would need to be constantly refined, as the industry view of the riskiness of different activities changes.
- As there is often a long time lag between business being conducted by firms and liabilities being compensated by the FSCS, there may be a disconnect between the riskiness of activities being currently undertaken, and the activities which are giving rise to FSCS costs.

6.24 **Pre-fund:** Another alternative to the current model would be to enable the FSCS to build up a 'pre-fund' funded by industry levy payers – in excess of the costs required for a given period – which the FSCS could drawdown on as required. This could help to spread any high costs over a longer period. Such a model would likely require changes to legislation which would be for Government to consider. Nonetheless, when considered previously, we identified several drawbacks with such an approach:

- The fund would need to be built up over time and would inevitably require a contribution from firms in excess of their current levy contribution (i.e. to cover 'current' compensation costs and the future pre-fund element). As firms are already concerned about the impact of the FSCS levies, this option would add to the burden on firms.
- The pre-fund would mean that industry funds (paid by levy payers) will be held in a pre-fund, with no certainty that those funds will be fully utilised over the medium term. As firms would not have access to the funds – which may or may not be used to fund compensation – it may limit unnecessarily firms' ability to invest and grow.
- Arrangements would need to be made for firms entering and leaving the market, to ensure that firms pay a fair contribution to the pre-fund and receive a refund upon exit. The need to meet this contribution could present a barrier to entry, and in any event would complicate the administration of any such model.

6.25 **Product levy:** The FSCS could be funded by generic a levy on all financial services products sold – and this was an idea that a number of respondents to our recent Consumer Investments Strategy Call for Input suggested. For example, the cost of each financial services 'product' – e.g. an investment, insurance policy or mortgage – could include an additional levy cost to fund FSCS claims. As with the previous option for a pre-fund arrangement, a product levy would likely require changes to legislation which would be for Government to consider. However, we have previously identified the following drawbacks to introducing a product levy:

- Funding the FSCS through a product levy would present similar challenges to a pre-fund – as collecting a pre-determined amount upon the sale of a product would never equate to the levy costs required in a given year, therefore the product levy would need to form a pre-fund to be drawn upon when required by the FSCS.
- It is not clear that there would be a link between the products levied and the liabilities which give rise to FSCS claims. For example, low or no risk investments could be subject to the product levy, whilst regulated activities related to them are unlikely to cause losses to consumers. Furthermore, products purchased overseas, and included in an investment wrapper for example, may not be subject to the product levy – but could still give rise to FSCS protected losses.

6.26 **Insurance:** In the past we have considered whether FSCS funding could be met through insurance, whereby the FSCS takes out insurance to meet some or all funding requirements, and with the cost of that insurance to be met by industry levy payers (in a similar way that levy payers currently directly fund the levy costs). This approach may be a way of smoothing levy costs and to protect firms from a sudden increase in costs. However, we previously considered a commercial insurance arrangement is likely to be more expensive than the current model and not have significant benefits over the current arrangements.

Q18: **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.**

7 Proposed design principles and further opportunities for change

Proposed principles for the compensation framework

7.1 Throughout this document we have referred to four principles for the aspects of the compensation framework that the FCA is responsible for which we consider should underpin its design. The principles are:

- 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.
- 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.
- Principle 3 – the funding model should be robust, be adaptable to a changing external environment, economical and practical to implement.
- Principle 4 – funding classes should provide sufficient funding for compensation whilst remaining sustainable, therefore some degree of cross subsidy may be needed in practice.

Q19: 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?

Further opportunities for change

7.2 Through this discussion paper we have set out the key aspects of the compensation framework where we consider there may be opportunities for improvements to be made. However, we would welcome further ideas and suggestions for other aspects of the framework where improvements could be made.

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.

Annex 1
Previous reviews of the compensation framework

1. We last reviewed the compensation framework between 2016-2018 (publishing three consultation documents: CP16/42, CP17/36 and CP18/11), during which we made several changes which aimed to ensure that FSCS protection was at the right level for consumers to be appropriately protected and the funding arrangements appropriately distributed costs across industry levy payers.

2. The key changes relevant to this discussion paper are:

a. Since April 2018, the FSCS has been able to 'look-through' a claim by a fund (or any intervening fund operators, asset managers, depositaries or trustees) against a defaulting asset manager or depositary to protect collective investment scheme (CIS) investors. The rules were intended to bring consistency to the circumstances in which the FSCS can compensate investors in CISs.

b. From April 2019, the compensation limits for investment provision, investment intermediation and home finance intermediation claims were increased from £50,000 to £85,000. Protection for certain debt management claims was also introduced at this time, with a limit of £85,000. Whilst acknowledging that the revised limits could lead to higher compensation liabilities, it was considered appropriate to balance consumer protection with the cost to industry.

c. Since April 2019, product providers have been required to contribute approximately 25% of the funding requirement for the insurance and investment intermediation funding classes. This meant that investment providers were required to contribute towards investment intermediary failures. This was considered appropriate as providers benefit from maintaining confidence in the overall market and the structures that exist for the distribution of products to consumers. Furthermore, it was considered that the additional funding requirement would incentivise providers to design products that are well understood by intermediaries and to understand and exercise control over their distribution chains.

d. From April 2019, to help reduce volatility of levies, the former Life & Pensions Intermediation and Investment Intermediation funding classes were merged into a new Life Distribution and Investment Intermediation funding class. This change aimed to ensure that the levy costs would be shared across a wider pool of firms.

e. From April 2019, responsibility for funding pure protection intermediation claims was moved from firms in the former Life & Pensions Intermediation funding class to the General Insurance Distribution funding class. This change ensured that firms selling pure protection policies contributed to a class which was better aligned to their risk profiles.

3. In addition, as part of the 2016-18 review, we explored alternative funding options, including risk-based levies, pre-funded arrangements and a product levy, although we did not choose to implement such arrangements at that time as the proposals received minimal support from stakeholders and involved practical challenges which outweighed any benefits over current arrangements.

4. An earlier review over 2012-13 was initiated by the former Financial Services Authority (see CP12/16, CP13/1 and PS13/4) – ahead of the establishment of the FCA and PRA and their relative responsibilities. The review confirmed that a funding structure involving classes meeting costs aligned to relevant regulated activities should be maintained, but subject to revised funding class limits. The review introduced a revised 'Retail Pool' for FCA classes (whereby costs are shared across levy classes if the limit of a particular class is exceeded), to ensure that sufficient funding was available.

Annex 2
Protection available from example international investor compensation schemes

Compensation scheme	Scope of protection
1) Investor Compensation Scheme, Ireland	'The Investor Compensation Scheme (ICS) protects clients of an investment firm that goes out of business. The scheme pays compensation when an investment firm authorised by the Central Bank is unable to return money or investment instruments it owes to consumers who invested with it.' 'The ICS doesn't pay compensation if: – You incur losses due to receiving bad investment advice – Your investment is poorly managed – Your investment performs poorly due to market conditions or other economic forces.'
2) Investor Compensation Scheme, Germany	'Liabilities from securities transactions that are payable to customers are covered by the statutory investor compensation schemes. This includes funds owed to investors in connection with securities transactions (e.g. dividends, distributions or disposal proceeds). The schemes also protect your claims against your bank for the return of the securities held in custody for you. You are eligible for compensation if an institution has embezzled or misappropriated your securities or funds and is no longer able to return them. If your insolvent bank has misadvised you, however, the investor compensation schemes will not apply. You will thus not be compensated for any lost profits or losses incurred due to a misguided investment strategy.'
3) National Guarantee Fund, Australia	'The National Guarantee Fund (NGF) is the compensation fund for certain losses incurred by investors who trade in shares on ASX. The NGF applies only in specific circumstances and does not compensate investors for trading losses including those caused by market events or by investment choices based on poor advice.' In July 2021 the Australian Government published a consultation paper on a new compensation scheme of last resort. It proposed that the scheme would cover unpaid determinations made by the Australian Financial Complaints Authority, including in relation to personal advice to retail clients on relevant financial products.
4) Securities Investor Protection Corporation (SIPC), US	'SIPC protects against the loss of cash and securities – such as stocks and bonds – held by a customer at a financially-troubled SIPC-member brokerage firm.' 'SIPC protection is limited. SIPC only protects the custody function of the broker dealer, which means that SIPC works to restore to customers their securities and cash that are in their accounts when the brokerage firm liquidation begins. SIPC does not protect against the decline in value of your securities. SIPC does not protect individuals who are sold worthless stocks and other securities. SIPC does not protect against losses due to a broker's bad investment advice, or for recommending inappropriate investments.'

Compensation scheme	Scope of protection
5) Canadian Investor Protection Fund (CIPF), Canada	'CIPF provides limited protection for property held by a member firm on behalf of an eligible client, if the member firm becomes insolvent.' 'CIPF coverage is custodial in nature. CIPF does not provide protection against any other type of risk or loss.'

Sources:
1) https://www.centralbank.ie/consumer-hub/explainers/what-compensation-schemes-protect-consumers-of-authorised-firms
2) https://www.bafin.de/EN/Verbraucher/Schieflage/sicherungseinrichtungen_node_en.html
3) https://www2.asx.com.au/investors/learn-about-our-investment-solutions/shares/compensation-funds and https://treasury.gov.au/sites/default/files/2019-12/191220_cslr_discussion_paper.pdf
4) https://www.sipc.org/
5) https://www.cipf.ca/

Annex 3
Questions in this paper

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)?**

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?**

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'?**

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.**

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.**

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?**

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?**

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 firms ensure customers are aware of the lack of protection, through the fund's marketing materials or otherwise?**

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?**

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

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?**

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.**

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?**

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?**

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.**

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?**

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 criteria would FCA need to account for in such a review?**

Q18: **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.**

Q19: 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?

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.

Annex 4
Abbreviations used in this paper

Abbreviation	Description
AIF	Alternative investment fund
AIFM	Alternative investment fund manager
AIFMD	Alternative Investment Fund Managers Directive
AUT	Authorised Unit Trust
CIS	Collective Investment Scheme
COMP	Compensation sourcebook
CP12/16	Financial Services Authority consultation paper "FSCS Funding Model Review", published July 2012
CP13/1	Financial Services Authority consultation paper "FSCS Funding Review – feedback on CP12/16 and further consultation", published January 2013
CP13/9	Financial Services Authority consultation paper "Implementation of the Alternative Investment Fund Managers Directive", published March 2013
CP16/42	"Reviewing the funding of the Financial Services Compensation Scheme (FSCS)" consultation paper, published December 2016
CP17/36	"Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP16/42, final rules, and new proposals for consultation" consultation paper, published October 2017
CP18/11	"Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation" consultation paper, published May 2018
DIM	Delegate investment manager
DP	Discussion paper
FCA	Financial Conduct Authority
FEES	Fees manual
FSCS	Financial Services Compensation Scheme
FSMA	The Financial Services and Markets Act 2000

Abbreviation	Description
IFPR	Investment Firms Prudential Regime
MiFID	Markets in Financial Instruments Directive
OFR	Overseas Funds Regime
PRA	Prudential Regulation Authority
PS13/4	Financial Services Authority policy statement "FSCS funding model review – feedback on CP13/1", published March 2013
RAO	The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)
RMAR	Retail Mediation Activities Return
SIPP	Self-Invested Personal Pension
UCIS	Unregulated collective investment scheme
UCITS	Undertakings for Collective Investment in Transferable Securities

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