Consultation paper

24

Financial Services Authority

Consumer compensation: a further consultation

June 1999

FSA

Contents

The FSA invites comments on this consultation paper. It would be helpful if your comments could reach us by 10 September 1999.

Responses should be sent to:

Dean Brennan
Compensation Oversight and Policy
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Fax: 0171-676-9713
e.mail: dean.brennan@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection, unless the respondent requests otherwise.

1 Introduction and summary

Introduction

1.1 The Government has proposed that the Financial Services Authority ('the FSA') should have statutory objectives to maintain market confidence and to secure appropriate protection for consumers. It has also proposed a single compensation scheme to deal with claims in the event of the default of a firm authorised by the FSA and this will be an important element of the FSA's approach to meeting these statutory objectives. It is envisaged that these new compensation arrangements will come into operation once the draft Financial Services and Markets Bill ('the draft FSMB') comes into force, probably in 2000. For planning purposes, commencement is assumed to be in the second half of 2000. The new scheme will replace the various existing compensation schemes covering the financial services industry.[1]

1.2 In December 1997, the FSA published Consultation Paper 5: Consumer Compensation ('CP5'), which sought initial views on the proposal for a single scheme, including its governance and structure. This paper provides feedback on the responses received and describes how our policy has developed in the light of these and the provisions included so far in the draft FSMB. However, the main purpose of this paper is to consult on certain key aspects of policy relating to the new scheme's operations, which it is envisaged that the FSA will then establish through the rules that will govern the new scheme. A summary of the responses to CP5 is set out in the Annex to this paper.

Outline of the paper

1.3 Section 2 sets out our general approach to developing our policy in respect of the new scheme. It also provides an outline of the new arrangements as they

---

[1] The main existing compensation schemes that would be replaced by the new scheme are the Deposit Protection Scheme, the Building Societies Investor Protection Scheme, the Investors Compensation Scheme, the Policyholders Protection Scheme, the Friendly Societies Protection Scheme and the FSA's scheme covering firms authorised under s43 of the Financial Services Act 1986.

stand now, taking account of the provisions in the draft FSMB and the responses to CP5. Sections 3, 4 and 5 then set out proposals which develop this outline further and seek views on three specific areas:

- who should be an 'eligible claimant', able to claim compensation from the new scheme;
- what the limit should be on the amount of compensation payable on any single claim; and
- how the new scheme should divide up the actual costs of paying compensation and the administration costs that it incurs and recover these from firms.

Section 6 seeks views on two other issues: a joiners' levy and whether deposit protection should be extended to non-EEA currencies. Section 7 then summarises the FSA's work so far in establishing the new scheme manager.

Summary of main issues

1.4 The paper covers the following main issues:

- The FSA proposes that compensation cover should primarily be available to private individuals and small businesses. This would result in deposit protection no longer being available to large companies and policyholder protection being extended to small companies for the first time (see Section 3).
- The FSA is seeking views on where the limit on the amount that the scheme can pay out on an individual claim should be set. The FSA is proposing that this should be considered separately for the deposit and investment sub-schemes, and that as at present there should be no limit on the amount that the insurance sub-scheme can pay (see Section 4).
- The paper discusses the issue of 'co-insurance', where consumers eligible to claim compensation bear a share of any loss, which is a feature, to varying degrees, of the existing schemes. We are seeking views, in particular, on whether 100% cover should in future be provided for at least part of a claim on the deposit protection and insurance sub-schemes (see Section 4).
- The FSA is proposing further division of the 3 sub-schemes proposed in CP5 into 'contribution groups' of firms engaged in broadly similar activities and that the costs of paying compensation in respect of a default should fall on the firms in the contribution group of which the defaulting firm was a member. We are also proposing that all authorised firms contribute towards the 'base costs' of administering the scheme (see

Section 5). We propose that cross-subsidy between sub-schemes should not be permitted and that cross-subsidy between contribution groups should only occur if required for good reasons and after proper consultation.

- The FSA is not minded to require firms joining the new scheme to pay an up-front levy and is seeking further views on whether deposit protection should be extended to deposits in non-EEA currencies (Section 6).

1.5 The FSA is seeking views through a number of specific questions, which are highlighted in bold in the text. However, we welcome comments on any aspect of the arrangements set out in Sections 3 to 7 of this paper.

Next steps

1.6 The consultation period on the issues addressed in this paper will last three months. The FSA will review the responses and take these into account in developing the detailed rules for the new compensation scheme, which will also address other aspects of the compensation arrangements not covered here. We hope to publish the detailed rules in draft for consultation around the end of 1999.

2 The background to our detailed proposals

Our general approach

2.1 In the FSA's view, the creation of a single scheme, governed by a single board, will achieve an early and important advantage for consumers through the creation of a single point of contact on compensation in the event of a firm's default. However, CP5 has already recognised the difficulties in going further and creating a single approach to the provision of compensation that covers all sectors within regulated financial services, given the differences between the various sectors in terms of the products involved, consumers' behaviour, the risks faced by consumers, the ability of each sector to fund compensation and the differences in scope and practice. It sought to address some of these difficulties through the proposal to create three separate sub-schemes.

2.2 In considering whether it is desirable to create provisions that will apply across all three sub-schemes the FSA has been very conscious that we are not starting with a blank sheet of paper. Many of the provisions in the existing schemes relating to the amounts of compensation to be paid and who can claim compensation have developed to reflect the features of their particular sector of the financial services industry. These different sectoral approaches have each been the subject of debate over the years and now represent workable approaches which are broadly acceptable to all interested parties.

2.3 We have therefore decided not to seek harmonisation for harmonisation's sake. Our priority has been to seek to maintain the levels of consumer protection offered by the existing schemes and only propose to change these arrangements where we believe it is clearly justifiable. For example, we are not proposing that the new scheme should offer the same level of cover in all three sub-schemes.

2.4 It is also important to note that the FSA does not need to make once-and-for-all decisions on the issues addressed in this paper. As all the provisions are to be established through rules, the FSA will be able to review them when appropriate.

2.5 However, the FSA believes that in establishing the new scheme some changes to existing practice may be desirable – there are a few anomalies or features of the existing schemes which are not obviously justified in terms of the overall objectives for the new scheme and which may well become more obvious once the new scheme is established. But we see advantage in limiting change to these areas at this stage. A small number of changes have therefore been identified and this paper seeks to gauge the level of support for these. Otherwise, the paper explores various other possible options and seeks further views and information to support our decision-making, but does not propose significant departures from the existing arrangements.

Outline of the new arrangements as developed so far

2.6 The more detailed proposals set out in Sections 3 to 6 of this paper build on the framework for the new arrangements established through the draft FSMB and the FSA's policy work, as refined in the light of the responses to CP5 (see Annex for a summary of these). In summary, the new arrangements so far are as follows:

Governance

- There will be a single compensation scheme, operated by a scheme management company, which will be company limited by guarantee. It will be independent of the FSA in its day-to-day decision making, but accountable to it, in that the FSA will need to be satisfied that the scheme manager is at all times capable of exercising its functions.
- The scheme manager will have a board, whose members will be appointed by the FSA in the public interest, with the Chairman's appointment subject to Treasury approval.
- The FSA will have the power to establish the scheme and the details of its structure and operation through rules. As in all cases where it is exercising its rule making powers, the FSA will consult publicly on its proposals.

Scope

- The scheme will cover any authorisable business carried out by firms authorised by the FSA (i.e. it will cover situations where firms engage in activities for which they are not authorised by the FSA, providing that the activity is one which normally requires authorisation from the FSA).
- As at present, compensation in respect of claims for anything other than loss of money and assets, e.g. negligence or bad advice, will be restricted to those areas where the FSA exercises conduct of business regulation in accordance with a statutory power to do so.

Structure

- Within the basic single scheme structure, the scheme will be divided into three sub-schemes. One scheme will cover deposits taken by banks and building societies. The second will cover insurance policies written by insurance companies and friendly societies. The third sub-scheme will cover all authorisable business not covered by one of the other two sub-schemes, and is referred to throughout the rest of this paper as the 'investment' scheme, as convenient shorthand.
- Each authorised firm will participate in the sub-schemes according to the business it carries on, so a firm may have to participate in more than one sub-scheme, in the same way that a firm may have to belong to more than one of the existing schemes. A claimant with different types of claim arising from the same default (for example, a deposit and an investment) will be able to make a claim against more than one sub-scheme, if appropriate, but claimants will not be able to claim against more than one sub-scheme in respect of a single claim.

Eligibility

- In general terms, cover will be focused on private individuals and smaller commercial entities.

Funding

- The scheme will be funded, as now, by contributions from authorised firms in the form of levies.
- There will be no aggregate limit on the amount that the scheme can pay out in a given period, but there will be an aggregate upper limit on the amount that it can levy in a given period.
- The scheme will primarily be funded on a 'pay-as-you-go' basis. This means that the scheme will raise money as required to meet the costs of paying compensation. It is expected that levies will generally be made in arrears but the scheme manager will have the ability to levy in advance for identified future liabilities. Further consideration will be given to the viability of a joiners' levy.

Allocation of liabilities

- As a general principle, the amounts of compensation paid and the administration costs that can be attached to a particular default will remain within the sub-scheme of which the defaulting firm is a member. Further division of the sub-schemes into contribution groups is needed, in order to avoid cross-subsidy between firms engaged in dissimilar business activities.

- Cross-subsidy between contribution groups will only be allowed for good policy and practical reasons (for example, where there is a case for retaining a healthy mix of firms in the market) and only after the circumstances are clearly identified and the proposal has been the subject of consultation.
- All authorised firms should contribute to the costs of administering the scheme.

2.7 The issue of whether Lloyd's policyholders and members should be able to claim compensation from the new scheme has been the subject of separate consultation in the FSA's Consultation Paper 16. The results of that consultation exercise are now being assessed and will be reported in a feedback statement to be published shortly. Issues relating to Lloyd's are therefore not covered in this paper.

2.8 HM Treasury has been conducting a consultation exercise on whether credit unions should be regulated by the FSA and what form such regulation, including share protection arrangements, might take. Any consideration of how credit unions might be included within the new single scheme must await the outcome of the Treasury's consultation.

What next? – some constraints

2.9 The remaining sections of this paper expand upon some of the arrangements outlined above. It is worth recalling that in establishing the new scheme, the FSA is subject to certain constraints:

- The new arrangements must comply with the provisions of the draft FSMB and may need to be amended to reflect any changes that are made to these between now and the completion of the draft FSMB's passage through Parliament;
- They must also comply with the requirements of the EU Directives on Deposit Guarantee Schemes (the DGD) and Investor Compensation Schemes (the ICD).

2.10 In the short term, the costs of providing compensation have to be met by firms through payment of compensation levies. Any proposals affecting the levels of compensation to be paid by the scheme need to have particular regard to the effects on firms' cash flows and general considerations of affordability. Account also needs to be taken of the expense that firms will incur in providing information on which the provision of compensation or the collection of levies is to be based. (In the long term, compensation payments can be regarded as a transfer from customers of surviving firms to customers of failed firms, as firms tend to pass the costs of meeting levies on to their customers.)

3 Eligibility: who should be able to claim compensation?

General Approach

3.1 The draft FSMB requires FSA to have regard to the differing degrees of experience and expertise of consumers when securing the appropriate degree of protection for them. The responses to CP5 agreed that, in this context, this means that compensation cover should be largely directed toward those consumers who are least able to sustain a financial loss, namely private individuals and small businesses. This is broadly the approach already taken by the existing schemes, but a few changes may be appropriate to reflect the policy outlined in CP5.

3.2 The EU Directives, the DGD and the ICD, with which the new scheme must comply, define persons who are potentially eligible for compensation in respect of their deposits and investments through a range of compulsory and discretionary exclusions. Broadly, this means that 'professional' consumers (such as banks, investment firms and insurance companies) and other large entities, such as local government bodies, can be excluded (see Appendix A). The Directives also permit the exclusion of larger companies, defined as companies who do not meet at least two of the following criteria:

- A balance sheet total below euro 2.5m
- Net turnover below euro 2.5m
- Fewer than 50 employees.

3.3 Compensation arrangements for insurers are governed by the provisions of the Policyholders Protection Acts. The 1975 Act sets out the basic definition of eligible claimant. The 1997 Act (not yet commenced) refines this by, in general terms, limiting the geographical scope of the scheme to customers of UK insurers located in the UK and EEA, or to customers of insurers authorised in another EEA member state where the policyholder is located in the UK. Within the insurance sub-scheme, an 'eligible claimant' will, in certain circumstances, need to include beneficiaries who are not policyholders, (eg third party claimants under motor policies), and in the case of the transfer of long term insurance policies, to persons other than the policyholder, such as a liquidator.

3.4 A voluntary compensation scheme, approved under s141 of the Financial Services Act 1986, exists for friendly societies at present. It provides cover for contracts of insurance issued by friendly societies at a level equivalent to that of the Policyholders Protection Scheme for comparable insurance company business. The Friendly Societies Act 1992 provides for the PPS to be extended to cover friendly societies, but the provisions have not yet been commenced.

Deposit sub-scheme

3.5 Under the Deposit Protection Scheme (DPS), most types of deposit are covered at present (see Appendix B). However, deposits from banks, building societies, insurance companies and other financial institutions are excluded, as are secured deposits and deposits in non-EEA currencies. Deposits which do not qualify for deposit protection are excluded from the deposit base on which the bank is levied.

3.6 The Building Societies Investor Protection Scheme (BSIPS) offers similar cover to that offered by the DPS. To date, it has not been activated. However, were it to need to raise a levy, then this would be done on the basis of a society's total share and deposit base and unprotected deposits would not be excluded.

3.7 For the deposit sub-scheme within the new arrangements the FSA is considering adopting all the exclusions permitted by the DGD. The most significant effect of this would be to exclude deposits from larger corporate entities (as set out in para 3.2 above) from protection. Appendix C sets out an estimate of the amount of deposit protection paid out to *all* corporate entities in recent defaults which triggered the DPS. The DPS does not have sufficient information to enable us to identify separately the amounts paid to larger corporate entities.

3.8 If the deposits of larger corporates were to be excluded from protection, then this raises the related, but separate, question of whether these unprotected deposits should also be excluded from the deposit base which will form the basis for the calculation of any levy, reflecting the existing practice in the DPS. The argument for this approach is that the costs of funding deposit protection then fall on those institutions which gain commercial benefit from holding deposits which are protected.

3.9 While this may be attractive in principle, banks and building societies might incur significant expense in identifying protected and unprotected deposits, and there may be risks in relying on a reduced funding base. We estimate that excluding deposits of larger companies could reduce the current levy base by approximately one third (see Appendix C).

3.10 We are also aware that banks' and building societies' systems may not contain the information to enable them to distinguish between the categories of protected and unprotected deposits. For example, they may not hold the information that would enable them to identify those corporate depositors who do not meet two out of the three criteria set out in paragraph 3.2 above. It may be that the cost of providing this information would be so great as to outweigh any benefit to the banks and building societies of excluding larger corporate deposits from protection.

Q1 Do you agree that the deposits of larger corporates should be excluded from deposit protection?

Q2 Do you think that the exclusion of large corporates from protection should also be reflected in the calculation of any levy? Are there significant costs associated with such an approach and, if so, what might these be?

Investment business

3.11 Our proposals for the investment sub-scheme under the new arrangements do not result in any significant changes from the existing eligibility criteria used by the ICS, as these already largely reflect the exclusions permitted by the ICD. The exact drafting of the definition of an eligible claimant in this area, and the other sub-schemes, will depend on work going on within the FSA on the categorisation of customers. There will be an opportunity to comment on the definition as part of the consultation on the detailed rules.

Insurance sub-scheme

3.12 We propose to adopt in full the provisions of the Policyholders Protection Act 1997, limiting the geographical scope of the insurance sub-scheme.

3.13 Smaller companies are protected under the existing compensation arrangements for long term insurance but are excluded for non-compulsory general insurance. We propose to extend protection in respect of general insurance to small companies because any loss covered by a non-compulsory general insurance policy may have as significant an effect on a small corporate entity as on a private individual. For example, a small shop-keeper, whose business is incorporated, would suffer the loss of his livelihood if his shop were to burn down and the insurance company was not able to pay out on the claim. We would propose to distinguish small companies using the same criteria as outlined in paragraph 3.2 for the deposit sub-scheme. This would represent a significant increase in the protection provided to small companies.

3.14 The Policyholders Protection Acts already explicitly exclude reinsurance, marine, aviation, and transport insurance because they relate to commercial risks and we are not proposing to change these exclusions.

3.15 Under the current arrangements, compensation levies are made on all general insurance premiums, except for the excluded categories of marine, transport, aviation and reinsurance. The proposal to extend protection to an additional category of claimants would not require any change to this approach.

Q3 Should protection for claims on general insurance policies be extended to small corporate entities, to be defined using the criteria set out in paragraph 3.2 above?

3.16 We are not proposing to alter the existing scope of the protection for long term insurance policies. We propose that the new scheme should continue to protect all policyholders, including large companies. The scope of the existing scheme receives the support of the insurance industry and policyholders.

Partnerships

3.17 The treatment of large partnerships in respect of their eligibility to claim compensation differs in the existing schemes. Clearly, a large professional partnership is similar to a larger company and ideally should be treated as such when assessing a claimant’s eligibility for compensation. However, because of the special legal nature of a partnership, the DGD will not permit us to exclude partnerships from deposit protection, whatever their size or level of expertise. We are exploring how we might classify larger partnerships as ‘professional or institutional investors’ under the terms of the ICD and thus exclude them from eligibility to claim on the investment sub-scheme.

3.18 In the case of the insurance sub-scheme, this area is not constrained by EU Directives. The FSA proposes to define eligible claimant so as to exclude large partnerships from protection in respect of general insurance policies. The exact criteria to achieve this are still to be determined, but it may be possible to define a large partnership by reference to the number of partners.

Q4 Should large partnerships be excluded from eligibility to claim compensation, where this is permitted by legislation?

4 How much compensation should the scheme pay?

4.1 In CP5 the FSA suggested that we should carry out a review of the limits on the amount payable in respect of a single claim in the existing schemes, (referred to in the rest of this section as 'individual limits'). We also considered whether an element of co-insurance (i.e. the amount of any loss which the consumer bears him or herself) should apply to all or part of a claim. We took as our starting point the principle that the new arrangements should not result in a significant reduction in the overall level of protection available to consumers, when compared to that offered by the existing schemes.

4.2 We are only making three specific proposals at this stage, but we are also seeking views on a number of other possible ways forward in this paper.

4.3 Our specific proposals are:

a) That the overall maximum amount per claim that can be paid out under the new arrangements should be set separately in each sub-scheme and should not result in a reduction of the level of cover from that which is available under the corresponding existing scheme.

b) That each sub-scheme should pay 100% of at least part of a claim. The FSA is not making a firm proposal on the amount that should attract 100% cover in the deposit and insurance sub-schemes – this is explored later in this section.

c) That the individual limits and the co-insurance structure should be the subject of review and consultation within a period of five years from when the new arrangements are introduced.

The existing schemes' structures

4.4 The DGD and ICD require member states' deposit guarantee and investor compensation schemes to offer cover of at least 20,000 euro or at least 90% of a claim if it is for less than 20,000 euro. Providing the EU minimum is respected, there are no other restrictions on the level of co-insurance that can apply to a claim. So, for example, the level of cover available on a claim could taper, with 100% cover for the first tranche, 90% cover for the next tranche and a lower level of cover for the top-slice.

4.5 The ICS provides 100% cover for the first £30,000 of a claim and 90% cover for the next £20,000. The FSA is not minded to change this going forward.

4.6 In the insurance sector there are no EU constraints. The PPB pays 90% of claims in respect of non-compulsory insurance.

Co-insurance

4.7 In considering whether the new scheme should in future pay 100% of the initial band of claims on the deposit and insurance sub-schemes, there is a need to strike a balance between offering enhanced protection to certain consumers, who would be hit particularly hard by any approach which requires them to bear a share of any loss, and the desire to avoid providing a dis-incentive for consumers to make wise decisions about where to place their money or do business.

4.8 To provide 100% cover, even for part of a claim on these sub-schemes, would represent a significant departure from the approach adopted under the existing deposit protection schemes and the policyholder protection scheme in respect of non-compulsory insurance. A number of factors discussed further in paragraphs 4.13 to 4.36, have led us to conclude that while maintaining an element of co-insurance has been an important and widely-supported principle in the structure of the existing compensation schemes in the UK, there is a case for offering 100% cover for at least an initial band of every claim. These are outlined below. At this stage, the FSA is not making firm proposals on how much of a claim on the deposit and insurance sub-schemes should attract 100% cover, but expects that this cover is likely to apply only to the first few thousand pounds of a claim.

The maximum limit

4.9 The responses to CP5 recognised that individual limits had a role to play in setting an overall aggregate upper limit on the amount that the scheme can pay out and levy on the industry and that they may also have an effect on consumers' behaviour. There was no support for not having an individual limit in the deposit and investment sectors.

4.10 Our research has demonstrated that there has been little consistency underpinning the setting of individual limits in the deposit and investment sectors in the past. The factors set out below are those which we believe have some bearing on where individual limits should be set as well as on the extent to which there should be an element of co-insurance.

4.11 We are not persuaded of the case for having the same limit in the deposit and investment sub-schemes. We are not making firm proposals at this stage on where the individual limits should be set, other than they should be no lower than the limit in the corresponding existing scheme. This means that for the insurance sub-scheme we envisage that, as at present, there will be no maximum limit on the amount that can be paid out.

4.12 In the insurance sector, there is no individual limit under the existing arrangements and the FSA sees no case for introducing such a limit in the insurance sub-scheme.

Factors to consider in relation to co-insurance and individual limits

4.13 The FSA is seeking views on a number of questions relating to individual limits and co-insurance, which are set out at the end of this section.

Effects on consumer behaviour

4.14 The combined effect of individual limits and an element of co-insurance within the existing schemes is perceived to act as an incentive for consumers to take care about where they place their money or with whom they do business and reflects the principle that consumers should take some responsibility for their decisions. A number of respondents to CP5, mainly among the regulated firms, considered the co-insurance element to be particularly important in this respect. It is also argued that the publicity surrounding a default and the fact that not everyone gets all their money back acts as a warning to other consumers to take care. However, initial research suggests that consumers’ general awareness of compensation arrangements is very low and that it is not a factor to which consumers attach much significance when making savings or investment decisions or decisions about purchasing insurance cover, which might suggest that the incentive effect of the co-insurance element in the existing schemes is limited. The FSA is considering commissioning further research in this area.

4.15 Some argue that it is not appropriate to expect some consumers, especially among the private individuals and small companies on which we propose to focus compensation cover, to differentiate between authorised institutions and to understand why one institution is more risky than another. Even the most prudent and financially aware consumer does not have access to, for example, information on the relative soundness of firms’ financial positions. Even though the published lists of authorised banks and building societies contain a disclaimer, many consumers regard the stamp of authorisation by the regulator as guaranteeing the safety of their savings or investments or the continuity of the insurance cover; some indeed assume that they have a government guarantee.

4.16 It may be that if restrictions on the level of cover available under the new compensation scheme are to act as an effective incentive for consumers to take responsibility for their decisions, then there is a need to promote public awareness of the scheme and its provisions. This may be a difficult undertaking, given the complexity of the arrangements. The UK regulators have already introduced requirements on firms to ensure compliance with the provisions in the DGD and ICD which require that consumers are made aware of the existence of deposit protection or investor compensation arrangements.

Differences in the purpose of compensation in the three main sectors

4.17 For many people there is an intuitive difficulty, particularly in the context of a single compensation scheme, with offering a different level of cover, or having a different co-insurance level, in respect of products such as deposits, which are perceived as lower risk than investment products. This is reinforced when, for example, some banks and building societies offer deposit accounts with features that are more commonly found in investment products and in a climate where there are government-promoted products such as ISAs, which can have deposit, investment and insurance elements. Under the existing arrangements, each element of an ISA attracts a different level of compensation cover.

4.18 Others argue that there are fundamental differences between the deposit and investment sectors and that different levels of protection are therefore justified. Deposit and policyholder protection schemes aim to protect the value of an asset, whereas investor compensation aims to compensate for at least part of any liability arising in connection with investment business. Historically, deposit protection has been able to pay claims rather more quickly than the liquidator is able to pay dividends (although the schemes cannot pay out until the depositor has lodged proof of debt with the liquidator). An additional purpose is to maintain public confidence in the banking system at the time of a default. It is also argued that affordability for firms is a much bigger issue in the deposit-taking sector and that the existing level of cover more than adequately protects the majority of deposits made by private individuals and small companies.

4.19 By contrast, investor compensation claims are generally more complicated and the amounts involved are far more varied. Here, the purpose of compensation is to either restore an amount which should have been ring-fenced from the defaulting firm's own money or to enable the consumer to claim an amount which he would otherwise have sought through the courts or by pursuing a complaint through an Ombudsman.

4.20 In the insurance sector, there is no individual limit reflecting the special nature of insurance and policyholder protection. In long term insurance, the best way to protect policyholders is to arrange the continuation of cover. Actual cash payments to policyholders from the PPB are extremely rare. For general insurance, the absence of a limit reflects the nature of the transaction. The policyholder is purchasing a level of cover, often several million pounds worth, in return for a premium. This contrasts with the deposit-taking and investment sectors, where the consumer is generally placing a sum of money with an institution for savings or investment purposes.

Experience to date

4.21 For the DPS the individual limit was set at £7,500 (75% of £10,000) in 1979, rising to £15,000 (75% of £20,000) in 1987 and to £18,000 (90% of £20,000) in 1995 with the implementation of the DGD. At its introduction in 1986, the BSIPS could pay up to 90% of £10,000, rising to up to 90% of £20,000 in 1987. In 1995 the implementation of the DGD led to the removal of this element of discretion. Historically, the majority of claims on the DPS have related to small deposits (with 70% below £10,000 and 80% less than £20,000). Appendix C shows the detailed distribution for the most recent defaults. The BSIPS has never been triggered.

4.22 For ICS, the individual limit has remained at £48,000 since the scheme was established in 1988. The ICD requirement relevant here is also 20,000 euro for loss of cash and securities (the ICD does not require cover for other claims arising from investment business, e.g. negligence, to be provided). To date, over 60% of claims on ICS have been for less than £10,000 and over 80% have been for less than £20,000. Over the 10 years of ICS' operation, 96% of the claims paid have been accommodated within the existing £48k limit. Recent defaults have seen slightly more claims where the limit bites, as a result of claims arising in relation to pensions mis-selling, but the numbers are unlikely to rise as a result of phase 2 of the Pensions Review.

4.23 In the insurance area, there has never been an individual limit and there are no EU constraints. In cases where insurance is compulsory, e.g. third party motor insurance and employer's liability, the PPB has paid 100% of a claim. In non-compulsory cases, the scheme has paid 90% of the amount owing under the contract (i.e. 90% of the amount owing after the deduction of any excess to be met by the claimant). This generally only applies in the case of general insurance and in many of these policies an 'excess' often applies to any claim as well. In long term insurance insolvencies the focus is on securing continuity of cover for policyholders in a manner which ensures that they are entitled to at least 90% of the benefits to which they would have been entitled under their original policy.

Effects on the market for certain products

4.24 The view has been expressed that removing a co-insurance element in the deposit sub-scheme, even for part of a claim, and offering 100% cover instead, may lead to distortions in the market, with new products and services being generated solely as a response to the deposit protection arrangements. For example, firms could offer a service where they split up customers' deposits into amounts equal to the band for which 100% cover is provided and place these with different institutions. The FSA's preliminary view is that this is unlikely to happen if the 100% cover is restricted to a low level, but that the likelihood of this is greater as the extent of 100% cover increases. We shall be conducting further work on this aspect. Retaining an element of co-insurance would not provide an incentive for firms to act in this way.

Effects of inflation

4.25 The FSA is particularly aware of the effect of inflation on the individual limits used in the existing schemes. If the DPB and BSIPS limits of £20,000 had been indexed to reflect inflation since 1987, they would now stand at £32,000. The ICS limit of £48,000 set in 1988, would now be at £70,000. This suggests that the limits in the new scheme could be set at these levels.

Affordability

4.26 Whilst it is generally accepted that over, say, a 10 year timeframe, firms will tend to pass the costs of compensation on to their customers, there are important issues of short-term affordability. This is particularly important in the deposit taking sector, where systemic concerns may be exacerbated if the remaining institutions face large levy calls at such a time. Any pay-as-you-go, industry-funded scheme has a point at which it can no longer remain self-sustaining and it is important to consider whether any increase in the amount the scheme can pay on an individual claim might significantly affect this.

4.27 Any change to the co-insurance structure or the individual limit that represents any increase in the level of cover available also represents an increase in the short-term cost burden which may fall on the firms who have to meet any levy. Appendix C sets out the additional costs that would have been incurred by the DPB in the BCCI default if 100% cover had been offered at bands ranging from £1,000 to £10,000.

4.28 It is also important to consider the effect of any increase in the individual limits in terms of the firms' cash-flow position. In the investment sub-scheme, the levies are likely to be made annually and there will be the possibility of raising large amounts by spreading the levy as, for example, PIA does at the moment. Defaults in this sector tend to take some time to process. By contrast, the deposit sub-scheme needs to be able to process claims and pay out quickly. When a levy call is made the institutions, once levied, are required to pay within 21 days. The availability of short-term funds in this sector, in sufficient quantity to meet a levy call of whatever size, is therefore critical.

4.29 Appendices C and F show the increase in the amounts that would have been payable in respect of recent defaults if the DPB/BSIPS limit had been set at £30,000 and the ICS limit at £70,000.

Savings patterns

4.30 The Family Resources Survey 1996/97 shows that 57% of families have less than £1,500 of savings (excluding life assurance or funded pension provision). To lose 10% of a deposit can hit these consumers very hard. Other than not placing their money with a bank or building society, there is little they can do to insure themselves against this risk. Depositors who spread their risk by depositing small amounts with different banks or building societies may lose out in terms of the interest they can earn on their deposits.

4.31 To lose 10% of the value of a substantial insurance claim, on top of any excess that already applies can also hit consumers very hard, even though this is perceived to act as a counter-balance to the absence of an upper limit on the amount of such claims.

4.32 In all sectors, consumers still have to meet the incidental costs involved in making a claim, endure the worry of a default and, in some cases, face additional costs through not having access to their funds for some considerable time. This means that even if 100% cover is provided for any part of the claim, the consumer may bear some cost as a result of the default.

4.33 In considering the individual limit for deposit protection, the Family Resources Survey 1996/97 shows that only 12% of all families have savings of more than £20,000 (not including funds held in life assurance or funded pension provision). However, the same survey shows that 33% of pensioner couples and 15% of single pensioners have more than £20,000 of savings. A reasonable level of protection in the event of default is particularly important for pensioners with savings, as they are not in a position to work to replace these.

Comparisons with other countries

4.34 The practice in other countries varies, but a number of developed countries' deposit protection schemes offer 100% cover. However, it should be noted that in some cases this is in effect a government guarantee, as deposit protection arrangements are funded by the public purse, rather than by levies on banks and building societies.

4.35 In general terms, the level of protection offered in the UK in relation to deposits is somewhat below the level offered in other developed economies. However, when it comes to investor protection, the £48,000 limit applying to ICS is still significantly higher than that offered in other countries. Further details on the schemes offered in other countries are included in Appendix D. Very few other countries offer policyholder protection arrangements similar to those in existence in the UK.

4.36 The expiry of the so-called 'export ban' in the DGD and ICD, which will happen at the end of 1999 unless the EU Commission decides to renew it, may highlight the extent to which UK compensation arrangements differ from those in other member state of the EEA. At the moment, the ban means that the full scope of the ICS is not extended to firms operating in other EEA member states where the home state schemes' scope and cover is more restricted. Similarly, other member states with more generous deposit protection schemes cannot extend these to branches of their firms operating in the UK, where the DPS cover is lower.

Questions for consideration

4.37 The FSA would be interested in views on any aspect of these issues. You may wish to consider the following specific questions:

Q5 Of the factors outlined above, which are the most important for you in considering how any co-insurance element should operate or where an individual limit should be set? Are there any other factors which should be taken into consideration?

Q6 Do you agree that the deposit and insurance sub-schemes should offer 100% cover for part of a claim? If so, how much of a claim should attract 100% cover? What are your views on the co-insurance element that should apply to the rest of a claim?

Q7 Do you agree with the FSA's proposal that individual limits should be set separately for each sub-scheme?

Q8 Do you think that the individual limits in either the deposit sub-scheme or the investment sub-scheme should be retained at their existing levels or increased? If so, to what level and why?

Commitment to review in the future

4.38 Under the current arrangements, there has been no transparent mechanism for reviews of the limits on the amount that can be paid on a single claim or of the co-insurance structure. For example, the ICS limit of £48,000 was set 10 years ago and has not been formally reviewed since 1989. Even though only 4% of claims paid by ICS have been subject to abatement because of this limit, there have been those who argue that the limit must require an increase, because it is 10 years old. Under the new arrangements, these limits will be set by the FSA through the scheme rules. The FSA is therefore proposing that as a matter of good practice these elements of the scheme should be subject to formal review and public consultation within five years of the new scheme coming into effect.

Q9 Do you agree with the FSA's proposal for future review of individual limits and the co-insurance structure applied to claims?

5 Allocation of liabilities: who pays for what?

Division of sub-schemes into contribution groups

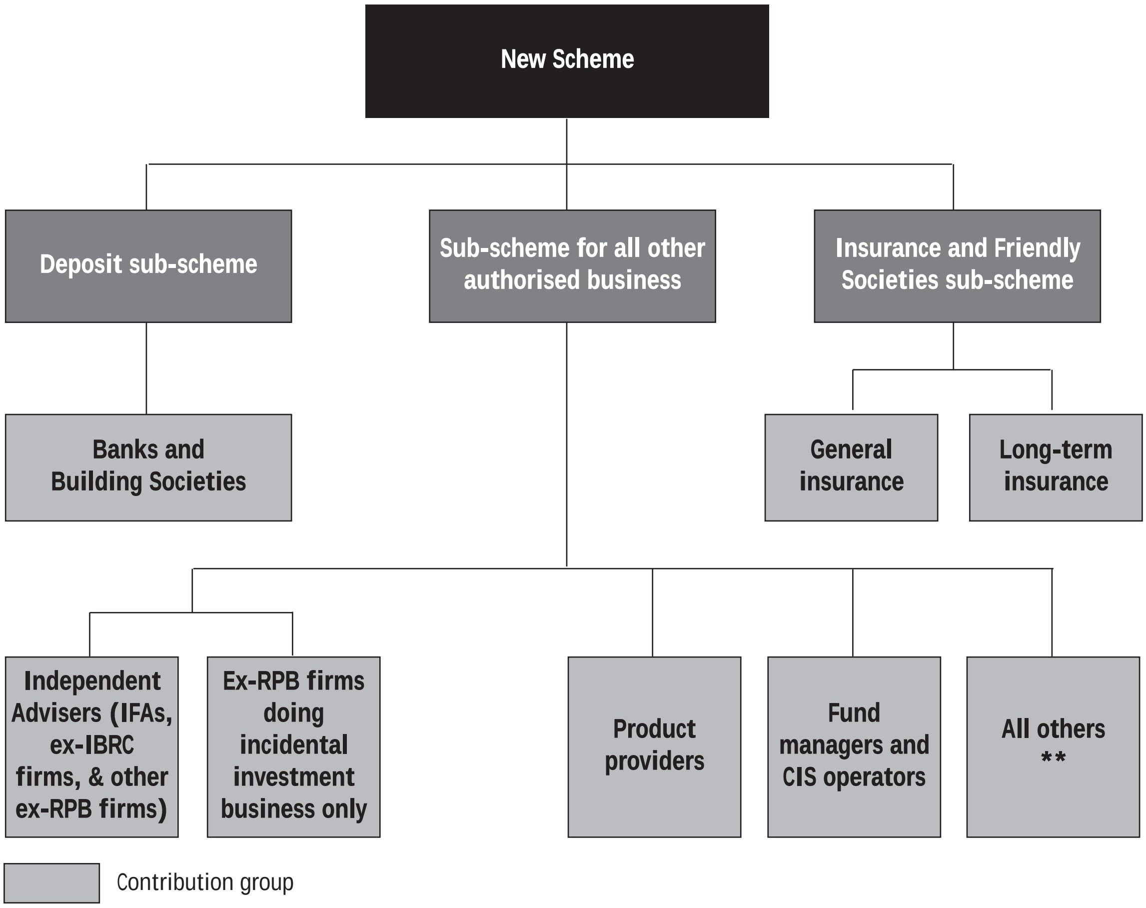
5.1 Responses to CP5 expressed concern that firms may be expected to meet the cost of claims arising from areas of business in which they do not participate. In particular, there was concern about the structure proposed for the investment sub-scheme and the absence of any equivalent to the SRO contribution groups in the existing ICS arrangements.

5.2 The chart on page 23 illustrates how this concern might be addressed, by dividing the sub-schemes further into 'contribution groups'. The contribution groups shown have been designed to cover business sectors with common interests, reflecting current market structures. In the case of the 'other regulated activities' sub-scheme, the contribution groups to a degree replicate the existing SRO contribution groups. We address each sub-scheme in more detail later in this section.

5.3 The contribution group descriptions in the chart are illustrative only at this stage. The exact definitions will depend on the final structure of permissions and authorisations to be developed by the FSA in accordance with the provisions in the draft FSMB. These will be included in the detailed rules to be consulted upon at a later stage.

5.4 We envisage that an authorised firm might need to belong to more than one sub-scheme, depending on the activities it is carrying on. However, within each sub-scheme, a firm would only belong to one contribution group. For example, a bank that took deposits and acted as a fund manager would belong to the deposit sub-scheme and to the fund management contribution group within the investment sub-scheme, just as at the moment it is required to participate in the DPS and the ICS. Each individually authorised legal entity will belong to a contribution group in its own right. The exact method by which a firm will be allocated to a particular contribution group will be set out in the detailed rules, but is likely to reflect its main business activity within each sub-scheme.

Outline structure for allocation of compensation liabilities



General principles for the allocation of liabilities

5.5 The proposals that follow are based on six general principles:

1 As a general rule, the costs of compensation attaching to a particular default (whether the actual amount paid or the administrative costs) will fall on the contribution group of which the defaulting firm was a member. Exceptions to this rule will only be made in clearly identified circumstances, after full consultation.

2 The rules will explicitly state that there should be no cross subsidy between sub-schemes.

3 The contribution groups will be constructed to reflect the market structure in order to avoid cross subsidy between firms carrying out dissimilar business activities. Wherever possible, the contribution group should be self-supporting.

4 All authorised firms will be required to contribute to the base costs of operating the scheme.

5 All other administration costs will be attached to a specific default and will then be met by the firms in the contribution group of which the defaulting firm was a member.

6 The allocation of liabilities to firms in a particular contribution group will be weighted towards those firms that do business with consumers eligible for compensation.

Types of cost

5.6 In our view, the scheme is likely to incur three main types of cost:

‘Base’ costs are not dependent on the level of activity and might include items such as, for example, the salaries of the Board and Chief Executive, some elements of premises and IT costs. They exist regardless of the level of activity, and cannot easily be allocated to a particular default.

‘Other administration costs’ are dependent on the number of claims and type of defaults and include the salaries of claims processing staff and other costs which can be allocated relatively easily to particular defaults.

‘Compensation costs’ are the actual amounts of compensation paid to a claimant.

5.7 Appendix E sets out what might be included in ‘base costs’ and a broad brush estimate of what these might be for the new scheme during its first year of operation. It is proposed that all authorised firms should contribute to meeting these costs. The FSA recognises that this means that building societies, insurance companies and friendly societies will, for the first time, be asked to make an explicit contribution to the costs of providing deposit and policyholder protection arrangements.

5.8 It is estimated that the total amount of base costs will be in the region of £2.5m, to be spread across the 10,000 firms that are expected to be authorised by the FSA, an average of £250 per firm. Given the small amounts involved, it may well be that the simplest way to achieve this is for the base cost elements of the new scheme to be recovered pro rata to the regulatory fees charged to each authorised institution. The FSA will be consulting at a later stage on the method to be used for the allocation of its regulatory costs. The FSA may need to give special consideration to the position of very small institutions, such as certain friendly societies.

5.9 The other administration costs and the actual costs of paying compensation would be met by the members of the contribution group of which the defaulting firm was a member, unless any special arrangements were in place. How these costs might be allocated to individual firms is discussed in more detail below.

Q10 What are your views on the definition of base costs and how these should be allocated across all firms authorised by the FSA?

The deposit sub-scheme

5.10 Our chart shows banks and building societies in a single contribution group, although it might equally well have shown them as two separate groups. The question is whether we should continue to recognise the historical separation of these categories of institution and put them in separate contribution groups, or regard them all simply as 'deposit-takers' and treat them as a single contribution group.

5.11 As more building societies convert to banks it is questionable whether the building societies will remain able to sustain a separate contribution group in the long term. But against this, it can be argued that the mutual structure, the legislative restrictions that apply to building societies, and their different risk profile set them apart from banks. The building society community is very aware that its protection scheme has never needed to be activated and is wary of being placed in the same contribution group as banks, which would mean that societies would be liable to contribute to the costs arising from the default of a bank.

5.12 However, it may be to the building societies' advantage to be grouped with banks in the longer term. We could therefore leave them in separate contribution groups now, but keep the flexibility to bring them together in due course. Or we could combine them now, but work towards a form of risk-based funding approach which sought to match more closely the funding an institution is required to contribute to its risk profile.

5.13 In considering how to structure the deposit sub-scheme the FSA will also need to take account of the results of the Treasury's consultation exercise on credit unions.[2]

5.14 The allocation of costs falling on this sub-scheme to individual firms is likely to be in proportion to the deposit base of each firm that is eligible for deposit protection (but see paragraphs 3.5 to 3.10 in Section 3 of this paper).

Q11 Do you think banks and building societies should be grouped together in one sub-scheme or divided into separate contribution groups?

The insurance sub-scheme

5.15 The insurance sub-scheme is split into two contribution groups for long term business and general business. We do not propose any further sub-division within the insurance sub-scheme. Friendly societies which are authorised by the FSA will be included in the appropriate group. Composite insurers who underwrite both long term and general business will be required to participate in both sub-schemes. We do not envisage any other circumstance, at this stage, where we may require an authorised firm to participate in more than one

[2] The Treasury's consultation exercise has sought views on whether credit unions should be regulated by the FSA and the form that such regulation might take, including share protection arrangements.

contribution group within the insurance sub-scheme. This approach is virtually identical to the existing arrangements under the Policyholders Protection Acts, although the provisions of the 1997 Act have not yet been commenced.

5.16 It seems appropriate for the new scheme to levy authorised insurers on the same basis as proposed in the 1997 Act, i.e. a share of gross premium income from those categories of insurance which are not excluded from protection under the scheme (i.e. premiums from marine, aviation, transport and re-insurance are not included in the levy base).

The investment sub-scheme

5.17 The investment sub-scheme's further division into contribution groups broadly reflects the market structure and the SRO contribution groups used to allocate existing ICS levies. Each group brings together firms engaged in similar business activities, although inevitably one of the groups (marked ** on the chart) has to include firms which do not obviously fall into one of the other groups. In our view, based on experience to date, all the contribution groups ought to be self-sustaining, apart from the 'independent advisers' group. This means that in order to maintain a healthy mix of firms in the market it would be necessary to continue the cross-subsidy from the IFA-using product-providers that exists under the present arrangements. At the moment those product providers which use IFAs as a distribution channel for their products broadly speaking meet 85% of the compensation liabilities which would normally fall on IFAs. However, we will review the terms of this arrangement at the time of establishing the new scheme and would propose to keep it under review going forward.

5.18 This structure means, for example, that institutional fund managers will not be expected to contribute to the cost of paying claims arising from negligent investment advice by a product provider's direct sales force or vice versa.

5.19 As the business that falls within the investment business sub-scheme is subject to conduct of business regulation, it will be the only scheme to provide cover for all civil liabilities, not just loss of money and assets.

Advisers

5.20 We propose to distinguish two groups of advisers. The first group would contain firms, at present primarily regulated by PIA, who act as independent financial advisers, and also the majority of those 2,000 or so firms formerly authorised by Recognised Professional Bodies (RPBs), engaged in offering independent financial advice as a key element of their business.

5.21 The second self-contained contribution group would be those firms, currently authorised for investment business by RPBs, but whose investment business is an incidental or subordinate part of the provision of a professional service. Such firms will not be advising clients directly on the selection of a packaged products and usually will have no readily identifiable investment business income. It is likely that the FSA will recognise, through its permissions regime, a distinction between such firms and firms carrying on mainstream investment business and FSA intends to indicate outline criteria as part of its forthcoming consultation on the future regulation of professional firms. It is not yet possible, however, to judge how many of these firms will eventually fall to be regulated by the FSA, as this depends on the final detail of secondary legislation, and we may have to re-consider this approach if such a group could not be self-sustaining.

5.22 A firm currently authorised by an RPB that carries on some form of investment business other than the giving of advice as a key element of its business would be place in the most appropriate of the other contribution groups.

5.23 The three law societies have suggested that, since the schemes that currently apply to firms regulated by them provide a level of cover for consumers which is expected to be greater than that to be offered by the new compensation scheme, firms regulated by them should be excluded from the new scheme. They argue that it would be less confusing for consumers to be covered by one scheme when doing business with, for example, a firm of solicitors, regardless of whether this business will be authorisable under the FSMB. The FSA proposes to explore these issues in more depth in our forthcoming consultation paper on the future regulation of professional firms.

The product providers

5.24 The product provider contribution group is likely to encompass those firms who currently sell regulated investment products direct or through either a direct sales force, appointed representatives, or IFAs.

Fund managers and operators of collective investment schemes

5.25 Fund managers and operators of collective investment schemes could form a single contribution group similar to the existing IMRO constituency. We consider fund management and the operation of collective investment schemes to be sufficiently similar activities to remove any need to split them further, although comments are welcomed on this point. Historically, the level of default in this sector has been low (see Appendix F).

‘All others’

5.26 The ‘all other’ contribution group broadly consists of the existing SFA community of broker/dealers, wholesale firms who participate in the existing S.43 scheme, and firms carrying on regulated activities that have not been categorised elsewhere. Historically, the level of default in this sector has been low (see Appendix F). We have not sought, at this stage, to divide the ‘all other’ contribution group any further, but would welcome comments on this and how liabilities could be allocated fairly within the group.

Q12 Is there any case for further sub-division of this group, bearing in mind the need for contribution groups to be large enough to be self-sustaining wherever possible?

Allocation of liabilities to individual firms

5.27 It is not feasible to develop one method of allocating the costs that fall to the investment business sub-scheme that will apply across the whole sub-scheme, regardless of the contribution group onto which the costs will fall. This reflects the varying approaches that are taken by the SROs in allocating ICS costs to their members, which are summarised in Appendix H. However, any methods proposed will need to have regard to the volume of business carried on by each firm and reflect the principle that the allocation should be weighted towards those firms that do business with consumers eligible to claim compensation.

Q13 With reference to the contribution group structure proposed for this sub-scheme, how should costs be allocated to individual firms within a group?

6 Other issues

A joiners' levy

6.1 There was almost universal support for the proposal in CP5 that the compensation scheme should be primarily funded on a pay-as-you-go basis with levies being collected as needed once a default has occurred.

6.2 However, a case can also be made for requiring all authorised firms to make an initial contribution to the compensation scheme when they join. A defaulting firm would then have made some contribution to the cost of meeting claims against it, on the clear understanding that a firm's initial contribution would be highly unlikely to cover the costs of providing compensation in the event of that firm's default. However attractive this might seem, there are a number of difficulties with operating such an arrangement in practice.

6.3 Only the DPS among the existing schemes has any form of initial or joiners' levy. The BSIPS has no joining fee or standing fund arrangements, as these were thought to be uneconomic in view of the likely level of claims on the scheme. If we were to require all authorised firms to pay a joiners' levy to the new scheme, those that have already paid an initial levy to the DPS might object unless the fact that they had already contributed to the DPS could be recognised by the new scheme. Those firms, such as building societies, whose existing scheme has never been triggered might well also oppose such a levy.

6.4 It would also be difficult to set a new joiner initial levy that reflected the risk inherent in the regulated business activity and to set an initial levy that reflected a firm's ability to pay. New joiners may be firms that carried on activities that were not authorised prior to N2, firms that carried on other business but now wish to carry on authorised business, or new firms created specifically to carry on an authorised activity. It is difficult to see how one might assess a firm's ability to pay on a consistent basis.

6.5 At this stage, the FSA is not minded to establish a joiners' levy as part of the new compensation arrangements, but would be interested to receive any views on this.

Q14 In the context of a scheme which primarily operates on a pay-as-you-go basis, do you think firms should be required to pay a joining levy? If so, at what level do you think this levy should be set?

Deposit protection for deposits in non-EEA currencies

6.6 In CP5, we proposed that the new deposit sub-scheme should cover deposits in all currencies, not just those in sterling and other EEA currencies. This proposal attracted very little comment, but those who did comment opposed the proposal, seeing it as an unnecessary extension to the existing arrangements. The FSA accepts that the scope of the DPS was extended beyond sterling solely to ensure compliance with the DGD and that the majority of private individuals and small companies hold their deposits in sterling. By contrast, the BSIPS protected deposits in all currencies until it was aligned with the DGD minimum requirement in this respect . The FSA is not yet persuaded that a private individual or small company that holds a deposit in foreign currency should be denied protection for that deposit on the grounds that holding such a deposit makes them a more sophisticated consumer. Appendix C shows that the level of non-sterling bank deposits held by UK-resident individuals at the end of 1998 was £1,566m against £325,634m sterling deposits, suggesting that the costs of extending this protection would not be that large. Extended protection to non-EEA currencies might also attract deposits to the UK. We are particularly keen to receive more views on this topic.

Q15 Should the deposit sub-scheme cover deposits in all currencies, or EEA currencies only? Please give the reasons for your answer.

7 The establishment of the new scheme manager

7.1 Following on from the responses to CP5 and the publication of the draft FSMB, the FSA has decided to establish a new company to act as the scheme manager for the new compensation scheme.

7.2 Work is now underway to draw up the Memorandum and Articles of Association for this new company, and we envisage that is will be established as a private company limited by guarantee later this year.

7.3 The draft FSMB provides for the FSA to appoint the members of the Board of the scheme management company and to appoint the Chairman with the approval of the Treasury. The FSA is proposing that all the members of the Board be recruited using Nolan-type procedures, inlcuding open advertisement and assessment of all candidates against the same criteria. They will all sit as public interest members, not as representatives of a particular group or industry sector. The FSA will have regard to the need for high-quality consumer and industry representation on the Board.

7.4 After discussions with representatives of the Boards of the existing schemes, the FSA proposes to recruit the new Board so that it is in a position to start work approximately six months before the assumed commencement date in the second half of 2000. We therefore intend to start the process of Board recruitment later this year.

7.5 After considering the responses to CP5 and discussions with Board members from the existing schemes, the FSA has concluded that it would be appropriate to recruit a relatively small main Board for the new scheme management company. However, we recognise the need to ensure that appropriate expertise in each sector of the financial services industry is available to the new scheme and that it may not be possible to ensure this with one small, mainly non-executive, Board. We therefore think it likely that the new Board will want to establish ‘management committees’ (their precise title is yet to be determined) for each of the three sub-schemes. We envisage that the committees would need to be very flexible, in order to reflect the level of activity in each sub-scheme. For example, it may only be necessary for the deposit and insurance committees to meet in the event of a default. We are now developing proposals on a possible split of responsibilities between the main Board and the management committees, the powers and responsibilities that the committees might have and on how members of the committees might be recruited. It is likely that links between the Board and the committees will be needed, perhaps in the form of a member or members who are common to both. We shall be discussing these further with representatives of the existing schemes and with the new Board of the main scheme, once they are appointed. The FSA is conscious of the need to avoid a top-heavy, inflexible structure for the scheme.

7.6 In appointing the Board of the new scheme and in establishing the management committees for the new sub-scheme, the FSA is aware of the need to provide for some continuity between the existing schemes and the new scheme. This will be important because, even when the new scheme is established soon after N2, it is likely that the bulk of its work at that stage will still relate to processing defaults which occurred before N2, in accordance with the 'old' arrangements prevailing at the time of default.

CP5: Feedback and subsequent developments in policy

1 CP5: *Consumer Compensation* was published in December 1997 and the consultation period closed on 18 February 1998. 130 replies were received. A list of those who responded is included at the end of this Annex.

General objectives for the new compensation scheme

2 CP5 set out three objectives for the new compensation scheme. These were that, as the existing schemes do, it should:

- be largely directed towards those customers who are least able to sustain financial loss;
- provide substantial, but not in all cases complete, cover for the loss incurred;
- be paid for by regulated firms.

3 The FSA also proposed that the new arrangements should be transparent in their structure and operation; easily accessible to claimants and potential claimants; fair in their application to both claimants and contributors; efficient and responsive in operation and simple and cost effective.

4 Respondents were generally supportive of these aims and objectives and provided detailed comments on a number of the FSA's proposals for making them a reality.

Scope of compensation arrangements

5 CP5 proposed that:

- compensation arrangements should cover authorisable business conducted by authorised firms, reflecting the proposal that there should be a single perimeter around authorisable business;

- the arrangements should cover authorisable business carried on by an authorised firm, even where this is outside the scope of its FSA permission; the paper also sought views on where the costs of compensation in respect of unauthorised business done by an authorised firm should fall;
- compensation for claims relating to civil liabilities other than the loss of money and assets should be restricted to situations where the FSA has the power to regulate conduct of business, or where codes of conduct are recognised by the FSA as part of an established system of conduct of business regulation;
- there are features which clearly distinguish compensation in the event of a firm's default from the awards made by an Ombudsman as part of a dispute resolution mechanism, and it is therefore justifiable for the compensation scheme to have a different scope and different limits on the amount that can be awarded.

6 All four proposals attracted broad support from across the full range of respondents. A number of detailed points were made relating to the recognition of codes of conduct. These are being considered further in the light of the draft FSMB's proposals relating to conduct of business regulation and FSA's rule-making powers. In particular, we feel that it may not be appropriate to extend compensation cover to areas where the FSA may be given the power to regulate conduct of business but chooses not to exercise it.

Structure and Governance

7 CP5 proposed that the new scheme should be independent of the FSA, but accountable to it, with the FSA responsible for appointments to the scheme Board. FSA would also appoint the Chairman, subject to H M Treasury's approval. The scheme would be directed by one small board, with the directors appointed in the public interest, blending industry experience and consumer perspective.

8 The paper also set out the FSA's preference that the broad parameters of the new scheme should be set out in primary legislation, with the detail in rules to be made by the FSA.

9 CP5 also recognised that a degree of differentiation between industry sectors needed to be preserved in the new arrangements. This would reflect the different risks and considerations in relation to consumer protection arising in the different sectors and provide a flexible funding structure. It proposed that there should be three sub-schemes, broadly covering deposits, insurance and investment business respectively, in which firms would participate depending on which activities they carry on.

10 The majority of respondents expressed support for the proposals. A number of respondents set out areas that they felt should be covered in legislation, rather than rules, including the sub-scheme structure. A small number of respondents argue that the scheme should be completely independent of the FSA.

11 Firms and their trade associations emphasised the need for specialist practitioner involvement on the board and on any panels established in connection with each sub-scheme. The consumer organisations emphasised the importance of credible consumer representation. A number of questions were raised on the boundaries of each sub-schemes and there were some proposals for additional sub-schemes or further division of the sub-schemes for funding purposes.

12 The draft FSMB proposes a scheme managed by a scheme manager which is independent of the FSA in its day to day operations and decision making on claims, but which is still accountable to it. The key elements of this accountability framework are:

- The members of the Board of the scheme manager to be appointed and to be liable to removal from office by the FSA;
- The Chairman to be appointed and to be liable to removal from office by the FSA, acting with the approval of the Treasury;
- The FSA to establish the scheme through rules, and the scheme rules may provide for the determination and regulation of matters relating to the scheme by the scheme manager;
- The scheme manager must make an annual report to the FSA on the discharge of its functions;
- The scheme manager must publish the report;
- The amount which the scheme manager may recover as management expenses is to be fixed through the scheme rules.

13 In recruiting the Board, the FSA will have particular regard to the need for practitioner and consumer representation of a high quality. Section 7 discusses how this might be achieved in more detail.

14 The FSA has taken forward the three sub-scheme structure. The need for further division of the sub-schemes for funding and claims purposes and the position of firms who do not do business with consumers eligible to claim compensation are addressed in the main body of this paper.

Harmonising the definition of eligibility

15 In CP5 we proposed that compensation cover should primarily be available to private individuals and smaller commercial entities. The new scheme would

adopt the main exclusions from cover required or available under the relevant EU Directives. Anyone judged to have had responsibility for, or profited from, the collapse would be excluded from cover, as would claims arising from money-laundering activities.

16 It was also proposed that the scope of the deposit-taking schemes should be widened to include all currencies, not just sterling and EEA currencies.

17 A wide range of respondents expressed support for these proposals, except that the proposal to widen the range of currencies covered attracted very little comment. A number of respondents from the insurance industry argued that small businesses and partnerships should not be eligible to claim. The FSA was asked to give further thought to whether large professional partnerships could be excluded from cover, similarly to large corporates.

18 The draft FSMB proposes that the FSA should be able to make rules limiting the claims that can be entertained according to the type of claim (e.g. whether it relates to a deposit, an investment or an insurance policy) and the type of claimant (e.g. whether the person making the claim is a private individual, or a company or a partnership). Section 3 of this paper explains how we propose to use this to achieve the aims set out in CP5.

19 Section 6 of the paper re-examines the issue of the extension of deposit protection to non-EEA currencies in the light of other related issues and asks for further views.

Limits on compensation payments

20 CP5 suggested that there needed to be a recognition of the importance of the consumer taking some responsibility for his or her own financial decisions, through an element of ‘co-insurance’, whereby the consumer is not guaranteed to receive 100% compensation for a loss in all circumstances.

21 CP5 also sought views on whether the limits which apply to individual claims in each of the main sectors should be reviewed as a separate exercise.

22 A considerable number of respondents, particularly financial services firms, expressed strong support for an element of co-insurance to be incorporated in the scheme’s structure. The proposal for a separate review of limits attracted the support of a majority of those who responded and was particularly popular with consumer organisations. Many took the opportunity to suggest where the limits should be set. Some (including the consumer organisations) proposed significant increases; others felt that they should be set at the permitted EU minimum, where applicable. A sizeable minority felt they should be left at their current levels.

23 Section 4 of this paper sets out the results of our review of this area and seeks further views on how we might go forward.

Funding

24 CP5 suggested that the funding arrangements needed to be equitable, as between different sub-schemes and different types of firm within the sub-schemes, and ensure that the compensation scheme is provided with adequate resources. It proposed that there should be no limit on the total amount that can be paid out to consumers in any period, but that a limit should be set on the amount that can be levied from an individual firm, or group of firms, during a period. This would depend on the scheme being able to borrow to cover any shortfall.

25 A considerable majority of respondents from all sectors agreed that there should be no limit on the amount that can be paid out to customers and there was a similar level of support for limiting the amount that can be levied in a period. It was recognised that these limits might differ between sub-schemes and contribution groups.

26 The FSA is not proposing to place an aggregate ceiling on the amount that the new scheme can pay out to claimants in a given period. We have also taken note of the strength of feeling in favour of a limit on the amount that can be levied from a firm or group of firms and the details of how this will be achieved will be reflected in the rules to be published later this year. The Memorandum and Articles of the scheme management company will permit it to borrow to fund any shortfall.

Funding mechanisms

27 CP5 suggested that the optimum funding structure for the new scheme was likely to be a combination of a 'pay-as-you-go' approach with the possibility of a small standing fund if needed. It also proposed that further consideration could be given to a product-levy as one element of a fund-raising mechanism, perhaps in part of the scheme.

28 This section attracted the widest range of responses. A number of respondents, particularly in the IFA community, supported the idea of a product levy. Others were opposed to it in principle. Opinion was divided on the need for a standing fund, but there was a significant level of support for the 'pay as you go' model, with an ability to levy in advance for identified future costs.

29 Ministers have since decided that the scheme should not be funded by way of a product levy and this approach has therefore not been pursued.

Allocation of liabilities

30 CP5 recognised the need to keep separate the compensation costs arising in different business sectors in order to avoid cross-subsidy. However, it also recognised that some element of cross-subsidy is inevitable in a 'pay-as-you-go' scheme covering a diverse industry. CP5 proposed that compensation liabilities should remain within the sub-scheme of which the defaulting firm was a member, and that as far as possible they should be allocated to the appropriate business sector within the sub-scheme, while recognising the need to ensure a viable funding base. The arrangements should permit an element of cross-subsidy where this is needed in particular circumstances, but this should be clearly identified and justified.

31 CP5 also proposed that all regulated firms should pay an element of the general costs of running the scheme. Otherwise, firms should participate in meeting the costs relevant to each sub-scheme and participation in a sub-scheme would be by reference to the activities carried on by a firm. CP5 promised further consultation on the details of the allocation of liabilities to individual firms within a sub-scheme.

32 There was general agreement that the costs of administering the new scheme should be spread across all firms. There was also support for the proposal that the costs of a default should fall within the sub-scheme of which the defaulting firm was a member and that cross-subsidy between sub-schemes should be avoided. However, it was recognised that sometimes cross-subsidy arrangements might be needed, particularly within sub-schemes, and that the new arrangements should contain sufficient flexibility to permit this.

33 Whilst responses to earlier questions demonstrated broad support for the three sub-scheme approach, responses to this section showed significant concern about the costs that might fall on firms in the wholesale markets, who do not deal with customers eligible to claim compensation. There was also specific concern about the structure of the investment business sub-scheme, in the absence of any further sub-division to produce the equivalent of the SRO contribution groups in the current ICS structure. A significant number of respondents suggested that the details of the sub-schemes and the allocation of liabilities within these should be spelled out in the legislation.

34 The FSA recognises the concern among respondents that they might be required to contribute towards meeting liabilities generated by the default of firms engaged in dissimilar business activities. The FSA also takes the view that to spell out the new scheme's structure in legislation would remove the flexibility provided by a rule-based approach, which permits a prompt but proportionate response to changing circumstances.

35 Section 5 of this paper explains our proposals for further division of the sub-schemes and how costs might be allocated to individual firms. There will be a

further opportunity to comment on the detail when the draft rules for the new scheme are published for consultation at a later stage. However, we do not envisage any major changes in the approaches used in each sector at the moment. Respondents to CP5 suggested a number of possible methods, including allocation on the basis of risk rating. The FSA takes the view that such an approach is not appropriate at the moment, when it is still in the process of bringing together the process of regulation previously carried on by nine different regulators into one body. However, this may well be an approach that we wish to examine in more detail in the future.

Transitional arrangements

36 There was general support for the proposal that compensation costs attributable to a particular industry sector before N2 should be ring-fenced separately from any new arrangements. This is a complex area, and detailed transitional arrangements are still under consideration.

Responses to CP5 were received from:

AITC Investment Trusts
Alliance & Leicester plc
American Banking & Securities Association of London
Assoc. of Private Client Investment Managers & Stockbrokers
Association of British Credit Unions Limited
Association of British Insurers
Association of Solicitor Investment Managers
Association of Unit Trusts & Investment Funds
AXA Equity & Law
Baillie Gifford & Co.
Bank Gesellschaft Berlin AG
Bank of England
Bankers Trust International plc
Barclays Plc
Billiton Metals Limited
British Aerospace
British American Financial Services (UK & Intl.) Ltd.
British Bankers' Association
British Health Care Association
British Venture Capital Association
Building Societies Commission

Cantor Fitzgerald International
Carr Sheppards Limited
Clarendon Friendly Society
Commercial Union Life Assurance Co. Ltd.
Construction Benefits Scheme Ltd.
Consumer Congress
Consumers' Association
Coopers & Lybrand
Credit Suisse Financial Products
Deloitte & Touche
Deposit Protection Board
Dove Insurance Brokers
Druids Sheffield Friendly Society
Fidelity Investment Services Ltd.
Foreign & Colonial Management Ltd.
Freemans Solicitors
Friendly Societies Commission
G H Financial Consultancy
General Accident Life Services
Greig Middleton & Co. Ltd.
Halifax Plc
Harlow Butler Group Limited
Hemmington Scott Publishing Ltd.
Holden Meehan
HSBC Holdings Plc
IFA Association
Indemnity Management Services Ltd.
Institutional Fund Managers' Association
Insurance Brokers Registration Council
International Consumer Policy Bureau
Investment & Life Assurance Group
Investment Management Regulatory Organisation Ltd.
Kauders Portfolio Management
Keith S Woodley
Lazard Asset Management Limited
Legal & General Assurance Society
Liberty Re Limited
Liverpool Victoria Friendly Society

London Investment Banking Association
M & G Life Assurance Co. Limited
M W Marshall (Financial Services) Limited
Manor House Healthcare
Middleton & Company
Midland Bank plc
Money Management Council
Moorgate House Plc
Morgan Stanley UK Group
National Association of Credit Union Workers
National Australia Life Co. Ltd.
National Consumer Council
National Provident House
Nationwide Building Society
NatWest Group
Norman Insurance Co. Ltd.
Norwich Union Plc
Office of Fair Trading
Old Mutual Life Assurance Co. Ltd.
Pearl Assurance plc
Perpetual plc
Personal Investment Authority
PIA Small Business Practitioners Panel
Prime Health Limited
ProShare (UK) Limited
Roland Walton Associates
Royal & Sun Alliance
Ruffer Investment Management Limited
Salomon Smith Barney
Save & Prosper Group Ltd.
SBC Brinson Limited
Scottish Amicable Life plc
Scottish Courts Administration
Scottish Equitable plc
Scottish Law Agents Society
Scottish Widows' Fund & Life Assurance Society
Securities Institute
Sedgwick Noble Lowndes Limited

Skandia Life
Suffolk Life
Sun Life International (IOM) Limited
Sun Life of Canada Group of Companies
Swiss Life (UK)
The Building Societies Association
The Equitable Life Assurance Society
The Federation of Insurance & Investment Intermediary Assocs.
The Futures & Options Association
The Grass Roots Consumer Watchdog
The Institute of Chartered Accountants
The Institute of Insurance Brokers
The Investors Compensation Scheme Ltd.
The Law Society
The Life Assurance Association
The National Association of Pension Funds Ltd.
The National Council of Women of Gt. Britain
The Oast House
The Prudential Assurance Co. Ltd.
The Royal Bank of Scotland Plc
The Society of Pension Consultants
The Wholesale Markets Brokers' Association
Thomas Financial Planning
Towry Law Financial Services Ltd.
Trade Indemnity
Tullet & Tokyo Forex International Ltd.
Universities Superannuation Scheme Limited
Virgin Direct Personal Financial Service Ltd.
W M Buttery & Co. Investment Services
WHA Healthcare
Worcester Hospital Contributors' Association
Yorkshire Building Society

Extracts from the EU Directives on Deposit Guarantee Schemes and Investor Compensation Schemes

EU Deposit Guarantee Directive (DGD)

Compulsory exclusions

Article 2 of the Deposit Guarantee Directive (94/19/EC) requires the following to be excluded from the protection of the Deposit Protection Scheme:

- deposits made by other credit institutions on their own behalf and for their own account;
- all instruments which would fall within the definition of ‘own funds’ in Article 2 of Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions;
- deposits arising out of transactions in connection with which there has been a criminal conviction for money laundering as defined in Article 1 of Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering.

Discretionary exclusions

Article 7(2) of the Deposit Guarantee Directive (94/19/EC) permits the following additional categories to be excluded from the protection of the Deposit Protection Scheme:

(1) Deposits by financial institutions as defined in Article 1(6) of Directive 89/646/EEC.

(2) Deposits by insurance undertakings.

(3) Deposits by government and central administrative authorities.

(4) Deposits by provincial, regional, local and municipal authorities.

(5) Deposits by collective investment undertakings.

(6) Deposits by pension and retirement funds.

(7) Deposits by a credit institution's own directors, managers, members personally liable, holders of at least 5% of the credit institution's capital, persons responsible for carrying out the statutory audits of the credit institution's accounting documents and depositors of similar status in other companies in the same group.

(8) Deposits by close relatives and third parties acting on behalf of the depositors referred to in seven above.

(9) Deposits by other companies in the same group.

(10) Non-nominative deposits.

(11) Deposits for which the depositor has, on an individual basis, obtained from the same credit institution rates and financial concessions which have helped to aggravate its financial situation.

(12) Debt securities issued by the same institution and liabilities arising out of own acceptances and promissory notes.

(13) Deposits in currencies other than:

– those of the Member States,

– euro.

(14) Deposits by companies which are of such a size that they are not permitted to draw up abridged balance sheets pursuant to Article 11 of the Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies.

Source: Council and European Parliament Directive (94/19/EC) 30 May 1994

Investor Compensation Directive (ICD)

Compulsory exclusions

Article 3 of the Investor Compensation Directive (97/9/EC) requires the following to be excluded from the protection of the Investor Protection Scheme:

- claims arising out of transactions in connection with which a criminal conviction has been obtained for money laundering, as defined in Article 1 of Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering.

Discretionary exclusions

Article 4(2) of the Investor Compensation Directive (97/9/EC) permits the following additional categories to be excluded from the protection of the Investor Protection Scheme:

1. Professional and institutional investors, including:
    - investment firms as defined in Article 1 (2) of Directive 93/22/EEC,
    - credit institutions as defined in the first indent of Article 1 of Council Directive 77/780/EEC,
    - financial institutions as defined in Article 1 (6) of Council Directive 89/646/EEC,
    - insurance undertakings,
    - collective-investment undertakings,
    - pension and retirement funds.

    Other professional and institutional investors.
2. Supranational institutions, government and central administrative authorities.
3. Provincial, regional, local and municipal authorities.
4. Directors, managers and personally liable members of investment firms, persons holding 5% or more of the capital of such investment firms, persons responsible for carrying out the statutory audits of investment firms' accounting documents and investors with similar status in other firms within the same group as such a firm.
5. Close relatives and third parties acting on behalf of the investors referred to in point 4.
6. Other firms in the same group.
7. Investors who have any responsibility for or have taken advantage of certain facts relating to an investment firm which gave rise to the firm's financial difficulties or contributed to the deterioration of its financial situation.
8. Companies which are of such a size that they are not permitted to draw up abridged balance sheets under Article 11 of the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3) (g) of the Treaty on the annual accounts of certain types of companies.

Source: Directive 97/9/EC of the European Parliament and of the Council of 3 March 1999 on investor compensation.

Appendix B

UK Deposit Protection Scheme

What limits apply to the Deposit Protection Scheme?

The Deposit Protection Scheme covers 90% of a bank's total liability to a depositor in respect of deposits made with EEA offices subject to a maximum payment to any one individual of £18,000 (or euro 20,000, if greater). A bank's total liability to a depositor is the aggregate of all accounts in the name of that depositor in the currencies covered including their share in any joint or clients accounts. A depositor's share of a joint account is calculated by dividing the total balance equally between the number of account holders. The trustees of a trust would normally be regarded as a separate depositor.

The limits shown above are those which will apply in the majority of cases. However, if a deposit is made with the branch of a UK bank in another Member State, the limits may be higher or lower than those shown above.

Does the deposit protection scheme cover deposits in all currencies?

The scheme ONLY covers deposits denominated in euro and deposits in the currencies of the following countries:

Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, United Kingdom.

Are all types of deposit covered?

Most types of deposit are covered, including current, deposit and savings accounts. Certain deposits are not covered by the scheme as follows:

- Deposits in currencies other than those of the countries referred to above;
- Deposits by directors, controllers and managers of the bank and their close relatives*;

- Deposits by a person who in the opinion of the Deposit Protection Board has any responsibility for or who may have profited directly or indirectly from the circumstances giving rise to the bank's financial difficulties;
- Deposits made in the course of a transaction in connection with which a person stands convicted of a money laundering offence or has been charged with such an offence but not yet tried;
- Secured deposits;
- Deposits by banks and building societies;
- Deposits by insurance undertakings;
- Deposits by other financial institutions;
- Deposits by companies in the same group as the bank;
- Deposits which form part of the capital of the bank.

* Directors, controllers and managers are defined in the Banking Act 1987. Close relatives are also defined in the Act as:

i) wife or husband;

ii) children and step children;

iii) parents and step parents;

iv) brothers, sisters, step-brothers and step-sisters;

v) the wife or husband of any person in ii) – iv) above.

If my deposits have earned any interest, will this be covered?

Interest earned on your account at the time when the deposit becomes due and payable will be protected, subject to the limits of the scheme mentioned above. In a liquidation, deposits cease to attract interest immediately whereas in other cases deposits will normally continue to accrue interest until they mature.

Will my deposits be covered if I have borrowed money from the bank?

In general, all loans, overdrafts and other amounts owing to the bank will be deducted when calculating the amount of the deposit on which compensation will be paid.

Source: Drawn from the Deposit Protection Board booklet "The United Kingdom Deposit Protection Scheme".

Appendix C

Supporting data relating to deposit protection

(1) Deposit Protection Board – claims to date

		BCCI	Wimbledon South West	Roxburghe	Mount	Equatorial
Date of failure		Jan-92	Feb-94	Apr-93	Oct-92	Mar-93
Number of claimants	Corporate	1,210	38	20	17	134
	Non-corporate	14,814	2,012	660	1,042	1,007
	Total	16,024	2,050	680	1,059	1,141
DPB payments	Corporate	£7.4m	£0.2m	£0.03m	£0.09m	£0.58m
	Non-corporate	£71.0m	£10.5m	£3.22m	£5.09m	£4.03m
	Total	£78.4m	£10.7m	£3.25m	£5.18m	£4.61m
Amount recovered in liquidation to date		£66.3m	£7.8m	Fully repaid	Fully repaid	Fully repaid
Percentage recovered in liquidation		84.50%	72.90%	100.00%	100.00%	100.00%
Average size of claim		£4,892	£5,219	£4,779	£4,891	£4,040

BCCI	Bank of Credit and Commerce International SA
Equatorial	Equatorial Corporation plc (formerly Equatorial Bank plc)
Mount	Mount Credit Corporation Ltd (formerly Mount Banking Corporation Ltd)
Rafidain	Rafidain Bank
Roxburghe	Roxburghe Guarantee Corporation (formerly Roxburghe Bank Ltd)
Wimbledon South West	Wimbledon & South West Finance plc

Source: data provided by the Deposit Protection Board

(2) Deposit Protection Board – default of the Bank of Credit & Commerce International SA

(a) Summary of claims (corporate & non-corporate)

	Claimants		Value of claimants' deposits		DPB payments*	
Size of deposit	No.	%	£m	%	£m	%
Less than £1,000	5,968	37.20	1,844,835	0.40	1,532,529	2.00
£1,001-£2,000	1,668	10.40	2,396,376	0.50	1,810,250	2.30
£2,001-£5,000	2,211	13.80	7,231,406	1.60	5,537,100	7.10
£5,001-£10,000	1,760	11.00	12,351,259	2.70	9,524,129	12.20
£10,001-£20,000	1,488	9.30	21,131,503	4.60	15,986,289	20.40
£20,001-£50,000	1,533	9.60	48,435,943	10.50	22,979,364	29.30
Over £50,000	1,396	8.70	370,026,678	79.80	21,014,952	26.80
Total	**16,024**	**100.00**	**463,418,000**	**100.00**	**78,384,613**	**100.00**

* At the time BCCI went into default, payments were limited to 75% of the first £20,000 of eligible deposits, a maximum of £15,000 per claim.

(b) Increased cost of meeting claims if BCCI depositors received 90% of the first £20,000

If BCCI depositors had received 90% of the first £20,000 in line with current arrangements rather than the 75% that applied at the time, the cost of meeting claims would have altered as follows:

Increase in payments	£15.7m
Total DPB payments	£94.1m

(c) Increase cost of meeting claims if BCCI depositors received 100% protection on a portion of their claim

The following table shows the payments that would have been made by the Board if 100% cover was extended to the band shown, and 90% cover applied to the remainder of the first £20,000.

100% cover for the first	Revised total payments (£)	Increase in payments over (b) above
£1,000	95.30	1.2
£2,000	96.20	2.1
£3,000	97.00	2.9
£4,000	97.70	3.6
£5,000	98.30	4.3
£6,000	98.90	4.9
£7,000	99.50	5.4
£8,000	100.00	5.9
£9,000	100.50	6.4
£10,000	100.90	6.9

(d) Impact on BCCI payments if the limit was increased to £30,000*

If BCCI depositors were paid compensation on the first £30,000 of eligible deposits, the cost of meeting claims would have altered as follows:

% of first £30,000 covered	Additional payments (£m)
75%	18.9
90%	22.6

* If the DPB limit had been increased in line with inflation, it would now stand at approximately £32,000.

Source: data provided by the Deposit Protection Board

(3) Sectoral Analysis of Bank Deposits from UK Residents: Q4 1998

	Sterling		Other		Total	
	£m	%	£m	%	£m	%
Individuals & individual trusts	325,634	68	1,566	8	327,200	66
Business & public sectors (excluding financial)	151,106	32	17,400	92	168,506	34
Total	476,740	100	18,966	100	495,706	100

Source: Bank of England: Monetary & Financial Statistics Q4 1998

Note: Figures are for UK residents only and include sale and repo arrangements

Comparative information on other countries' schemes

	COUNTRY	INVESTMENTS		DEPOSITS	
		Limit	Co-insurance	Limit	Co-insurance
ASIA	Japan	£51,000	100% cover: no co-insurance	£44,000	100% cover: no co-insurance
EUROPE*	Belgium	£40,000	Payment limit of £3.2m per failure	£13,000	90% cover per DGD
	Finland	£13,000	90% per ICD	Unlimited	100% cover: no co-insurance
	France	£248,000 for securities £50,000 for other assets £40,000 for cash	Payment limit of £19.8m per failure	£40,000	100% cover: no co-insurance
	Germany	Unlimited	100% cover from voluntary scheme	Unlimited	100% cover from voluntary scheme
	Ireland	£13,000	90% cover per ICD	£13,000	90% cover per DGD
	Italy	£13,000	90% cover per ICD	£372,000	100% of the first £74,400, 75% of remainder
	Norway	£16,000	Payment limit of £2m per failure	£161,000	100% cover: no co-insurance
	United Kingdom	£50,000	100% of the first £30,000 & 90% of the next £20,000	£20,000	90% cover for first £20,000
	Other EU states	£13,000*	ICD requires at least 90% coverage	£13,000	DGD requires 90% coverage
NORTH AMERICA	Canada	£104,000 for securities £25,000 for cash	100% cover: no co-insurance	£34,000	100% cover. Retirement a/cs treated separately.
	United States	£309,000 for securities £62,000 for cash	100% cover: no co-insurance	£62,000	100% cover: no co-insurance.

The figures above are in £ and give an approximate equivalent value of the level of protection provided by schemes outside the UK.

* From 31 December 1999, all EU member states must provide deposit and investment protection to at least 90% of the first €20,000 (approximately £13,000) of an eligible claim. Where an EU state has yet to fully implement the ICD and/or DGD, but has in place a scheme offering greater protection in certain areas than that required by the Directives, we have shown the higher figure.

This table is prepared on the basis of information available at 17 May 1999.

Appendix E

The likely 'base costs' of the new scheme

It is proposed that all authorised firms be required to contribute to the 'base costs' of operating the compensation scheme. These base costs would represent the fixed costs and operational overheads for the scheme. It is envisaged that they would include all costs which are not dependent upon the level of activity at the scheme or which cannot be allocated easily to a specific default. It is therefore likely that the base costs would include the following:

- directors' fees;
- staff costs relating to the senior executives of the scheme, including, for example, the Chief Executive, Company Secretary and Head of Finance, etc;
- staff costs relating to support functions such as HR, IT support and finance;
- premises costs;
- audit and other professional fees;
- depreciation costs;
- insurance payments and bank charges;
- 'one off' costs, such as IT development costs.

Initial estimates based on experience at the existing schemes suggest that the base costs for the new scheme are likely to be in the region of £2.5 million per annum as follows:

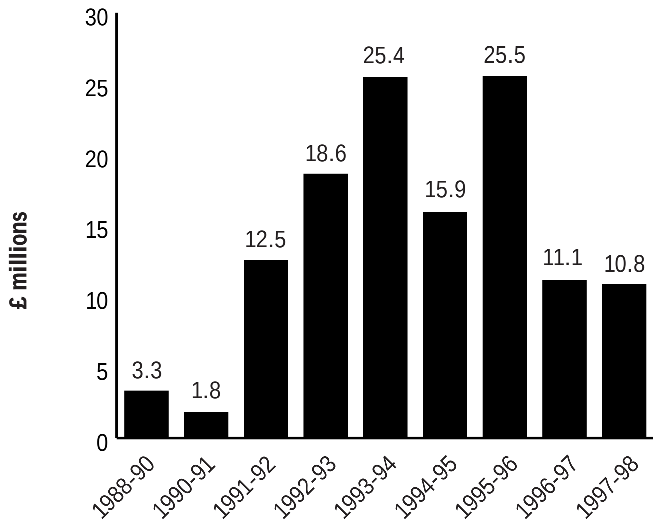
	£'000
Directors fees	300
Audit & professional fees	100
Other base costs	2,100
Total	2,500

It is estimated that there will be a total population of around 10,000 authorised firms. Spreading the base costs of the compensation scheme across the authorised population would therefore imply an average annual contribution per firm of approximately £250. Given the small amounts involved, the simplest approach may be for these costs to be recovered pro rata to the regulatory fees charged to each firm. The FSA will be consulting at a later stage on proposals for the allocation of its regulatory costs.

Supporting data relating to investor compensation

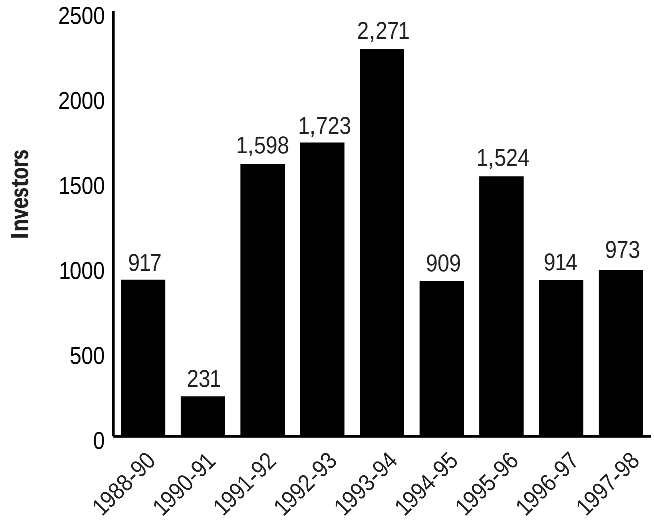
Compensation paid from 1988 to 31 March 1998

From 28 August 1988 to 31 March 1998, a total of £125m was paid in compensation to eligible investors.



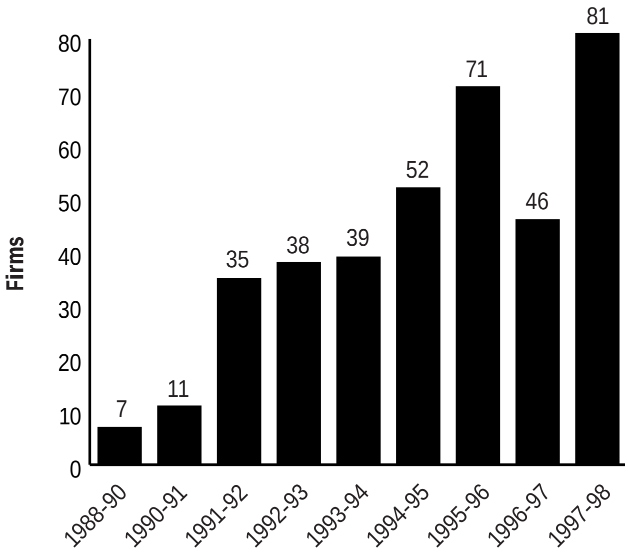
Investors compensated from 1988 to 31 March 1998

From 28 August 1988 to 31 March 1998, 11,060 investors received compensation from the scheme.

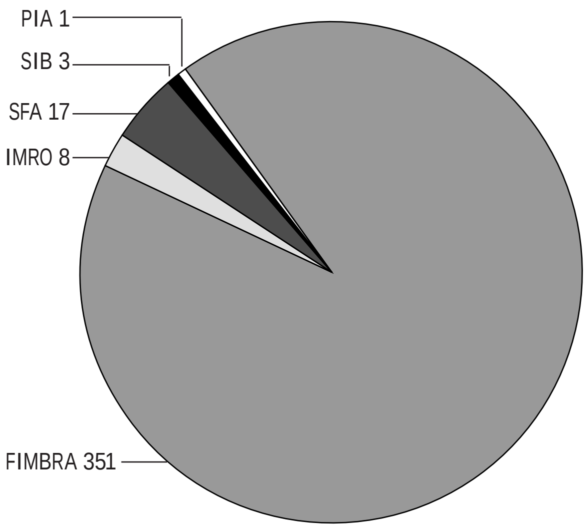


Number of firms in default from 1988 to 31 March 1998

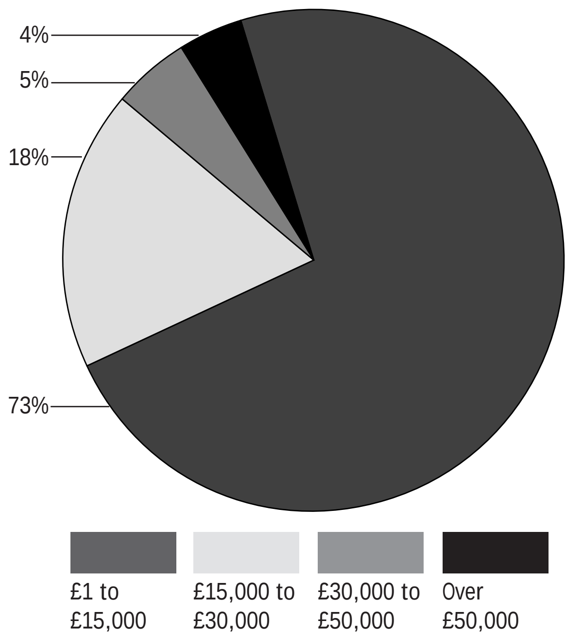
From August 1988 to 31 March 1998, 380 firms were declared in default.



Number of firms declared in default (by regulatory sector)



Eligible claims received from 1988 to 31 March 1998 (by size)



Source: data provided by the Investors Compensation Scheme

Increased cost of meeting claims if ICS limit was £70,000

This table compares the costs ICS have faced in meeting claims with those it would have faced had the individual limit been set at £70,000, the approximate present value of the existing £50,000 had it been linked to inflation.

Amount of total claim	Total no of claimants paid			Percentage of claimants in each band	Total eligible claim	Average Claim (£)	Less abatements		Compensation paid		Difference
£'000	To 31/3/97	1/4/97 – 31/3/98	Total		Total £'000		£50,000 limit	£70,000 limit	£50,000 limit	£70,000 limit	
					£'000	£'000	£'000	£'000	£'000	£'000	£'000
0-5	4,215	427	4,642	42%	8,421	2	-	-	8,421	8,421	-
5-10	1,746	181	1,927	17%	13,205	7	-	-	13,205	13,205	-
10-15	1,214	114	1,328	12%	15,094	11	-	-	15,094	15,094	-
15-20	937	81	1,018	9%	15,705	15	-	-	15,705	15,705	-
20-25	643	49	692	6%	14,419	21	-	-	14,419	14,419	-
25-30	442	50	492	4%	12,460	25	-	-	12,460	12,460	-
30-35	227	10	237	2%	7,091	30	85	85	7,006	7,006	-
35-40	136	8	144	1%	5,063	35	86	86	4,977	4,977	-
40-45	84	8	92	1%	3,736	41	114	114	3,622	3,622	-
45-50	105	8	113	1%	5,195	46	159	159	5,036	5,036	-
Over 50	338	37	375	3%	38,369	102	19,794	13,619	18,575	24,750	6,175
	10,087	973	11,060	100%	138,758				118,520	124,695	6,175

Supporting data relating to policyholder protection

Policyholders Protection Board – claims on general business policies

Accumulated net cost of assistance to protected policyholders since year ending 31 March 1993 to 28 February 1999.

Default	Payments (£)	Less recoveries (£)	Total (£)	Number of payments	Average payment (£)
Kwelm	208,769,789	27,266,518	**181,503,271**	1,086	**167,130**
Continental	595,568	0	**595,568**	647	**921**
Trinity	5,727,329	1,828,262	**3,899,067**	577	**6,757**
Bryanston	4,168,983	477,508	**3,691,475** (a)	500	**7,383**
MGI	31,384,614	0	**31,384,614**	1,164	**26,963**
Scan Re	226,417	22,743	**203,674**	29	**7,023**
Orion	3,376,233	708,053	**2,668,180**	353	**7,559**
Paramount	9,417,998	0	**9,417,998** (b)	4,379	**2,151**
English & American	2,116,086	231,083	**1,885,003**	12	**157,084**
Bermuda Fire	1,386,301	26,523	**1,359,778**	55	**24,723**
Anglo American	24,341	0	**24,341**	3	**8,114**
North Atlantic	5,850	0	**5,850**	1	**5,850**
Sovereign Marine	138,127	0	**138,127**	9	**15,347**
UIC	28,189	0	**28,189**	2	**14,095**
Black Sea & Baltic	740,753	0	**740,753** (c)	5	**148,151**
Builders Accident	1,674,476	0	**1,674,476**	118	**14,190**
Others	661,102	11,155	**649,947**	6	**108,325**
Total	270,441,156	30,570,845	**239,870,311**	8,946	**26,813**

(a) Includes Motor Insurance Bureau payments on behalf of the Policyholder Protection Board (£13,973,202)
(b) Includes refunds of Paramount premiums £2,071,993 (24,716 payments)
(c) Includes refunds of Black Sea premiums £707,807 (approximately 15,000 payments)

Policyholders Protection Board – claims on long term business

Accumulated net cost of assistance to protected policyholders since year ending 31 March 1993 to 28 February 1999.

Default	Payments (£)	Less recoveries (£)	Number of payments	Average payment (£)
Oaklife	1,038,957	0	708	1,467
UNAC	305,230	0	0	0
Total	1,344,187	0	708	1,899

Source: data provided by the Policyholders Protection Board

Allocation of ICS costs

PIA

Product provider and IFA liabilities are dealt with separately. Within these divisions the business is split into pension (transfer and opt out) liabilities and mainstream (all other) liabilities. The rules permit compensation liabilities arising from IFA defaults to be cross-subsidised by those product providers who transact business via IFAs. The product providers are responsible for meeting 85% of these costs and IFAs, the balance of 15%.

The allocation of product provider liabilities is calculated with reference to the level of new business written, as a proportion of the total. IFA firms' liabilities are allocated in proportion to the number of registered financial advisers as a proxy for the volume of business.

IMRO

With the exception of firms undertaking occupational pension scheme business, which are excluded, the compensation costs are charged to the firms in direct proportion to IMRO's membership fees.

SFA

The compensation costs are divided into two tranches, the first tranche being up to £5m and the second tranche, any amount in excess of £5m. The first tranche is levied on the firms in proportion to a weighted average of registered persons for each firm. The second tranche is charged to firms in direct proportion to the SFA's membership fees.

Existing compensation schemes

	Scheme	Members	Scope	Type of claim	Payment limit	Co-insurance	Claimants	Method of payment	EC Directive	Contribution ceiling	Activated	Triggers
Deposit taking	Deposit Protection Scheme (DPS)	UK authorised deposit takers EEA deposit takers topping-up	Sterling and EEA currency deposits	Claims against insolvent deposit taker for lost deposits only	£20,000	90% cover	All depositors	Cheque to depositor	Yes	0.3% of eligible deposit base	Yes	Court Order – provisional liquidation/ administration Liquidation FSA determines bank insolvent
	Building Society Investor Protection Scheme (BSIPS)	Authorised Building Societies	Sterling and EEA currency deposits	Claims against insolvent deposit taker for lost deposits only	£20,000	90% cover	All depositors	N/A	Yes		No	
Investments	Investors Compensation Scheme	Compulsory Scheme for authorised investment firms	All defined investments and investment activities	All civil liabilities arising in connection with investment business	£50,000	100% of the first £30,000 90% of the next £20,000	All investors except professional investors	Cheque to claimant	Yes	IMRO firms £100m SFA firms £100m PIA firms £200m	Yes	Firm in default and eligible claim
Money markets	s43 Scheme	Listed money market institutions undertaking investment business	All defined investments and investment activities	All civil liabilities arising in connection with investment business	20,000 ecu	90% cover	Private individuals and small companies as required by the ICD – no protection for professional investors	N/A	Yes	No levy in advance of claim. In the event of a claim being made, costs will be split among all participants in accordance with an agreed formula	No	Firm in default and eligible claim

	Scheme	Members	Scope	Type of claim	Payment limit	Co-insurance	Claimants	Method of payment	EC Directive	Contribution ceiling	Activated	Triggers
Insurance	Policyholders Protection Board	UK Authorised Insurers	UK insurance policies – three classes: compulsory, general, and long term				Policyholder means claimant on protected policies	Cheque must be payable only in liquidation. PPB can make payments to insolvency practitioner if reduces costs of meeting claims	No	1% of relevant premium income	Yes	Liquidation for compulsory duties. Discretionary duties triggered by liquidation, provisional liquidation, and scheme of arrangement
			Compulsory	All claims on compulsory insurance policies	No limit	100% cover	All claimants	Cheque must be payable only in liquid-ation. PPB can make payments to insolvency practitioner if reduces costs of meeting claims				
			General – excludes marine, aviation, transport, and reinsurance	Claims by private policyholders on policies of insurance	No limit	90% cover	Private policyholders – excludes companies	Cheque must be payable only in liquidation. PPB can make payments to insolvency practitioner if reduces costs of meeting claims				
			Long term	All claims on policies of insurance	No limit	90% cover	All policyholders.	PPB may reduce benefits of policy to 90% to help arrange transfer. Can make payment to IP or new insurer				
	Friendly Societies Protection Scheme	Voluntary scheme for auth-orised and unauthorised friendly societies	All policies	All claims against policies of insurance	No limit	90% cover	All policyholders		No	1% of relevant premium income	No	As PPB

Glossary

BSIPS	Building Societies Investor Protection Scheme
Co-insurance	That portion of any loss which claimants who receive compensation from the scheme must bear themselves.
CP5	FSA Consultation Paper 5: Consumer Compensation
DGD	EU Deposit Guarantee Directive (94/19/EC)
DPB	Deposit Protection Board
DPS	Deposit Protection Scheme
Draft FSMB	Draft Financial Services and Markets Bill
EEA	European Economic Area
EU	European Union
FSA	Financial Services Authority
ICD	EU Investor Compensation Directive (97/9/EC)
ICS	The Investors Compensation Scheme
IFA	Independent Financial Advisor
IMRO	Investment Management Regulatory Organisation
ISA	Individual Savings Account
PIA	Personal Investment Authority
PPA 75	Policyholders Protection Act 1975
PPA 97	Policyholders Protection Act 1997
PPB	Policyholders Protection Board
PPS	Policyholders Protection Scheme
RPB	Recognised Professional Body
SFA	Securities and Futures Authority
SRO	Self Regulating Organisation