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On 20 May 1997, the Chancellor of the Exchequer announced that the Government proposed to bring forward legislation to transfer responsibility for banking supervision to the Securities and Investments Board (SIB), and to replace the current system of self-regulation under the Financial Services Act by a new and fully statutory system, in which the SIB would become the single regulator. On 23 July 1997, the Chancellor of the Exchequer announced that the insurance supervisory functions carried out by the Insurance Directorate of the Department of Trade and Industry and the functions of the Registry of Friendly Societies, the Building Societies Commission and the Friendly Societies Commission would also be transferred to the new single financial regulatory body.

The new single regulator will be the Financial Services Authority (FSA), as the SIB has been renamed. This consultation paper is published by the FSA on behalf of the FSA and all the bodies for whose activities it will become responsible.

Comments are sought on the proposals set out in this consultation paper.

Comments should be made in writing to:

The Consultation Office
The FSA
Gavrelle House
2-14 Bunhill Row
London
EC1Y 8RA

They should arrive by **18 February 1998.**

The FSA will assume that your response is not confidential unless you indicate otherwise.

Introduction and summary

Introduction

1 The Government has said that the protection of consumers of financial services will be one of the statutory objectives which are to be set for the Financial Services Authority ("FSA") in the new legislation. Effective compensation arrangements for consumers where individual firms authorised by FSA are no longer able to meet their liabilities to these consumers will have a key role to play in achieving that objective.

2 The purpose of this document is to seek views on the compensation arrangements which should apply to firms authorised by the FSA once the proposed financial regulatory reform bill comes into force, probably in late 1999. This date is referred to in this document as "N2 date."

3 In Part II of this paper we set out our view of the objectives for compensation arrangements. This consultation exercise needs to be set in the context of those objectives.

4 A number of compensation schemes currently exist, covering a wide range of business falling within the FSA's scope. They are listed in Part III of this paper. The creation of the FSA provides an opportunity to review these schemes, to see whether a different structure would be appropriate and whether more harmonisation is possible in the arrangements for different industry sectors. Ministers have provided initial indications of how they would like to proceed and this paper discusses, against that background, how the existing arrangements should be rationalised.

5 As described in "Financial Services Authority: an outline", published on 28 October 1997, the FSA will acquire its powers in two stages. First, the Bank of England Bill will transfer from the Bank to the FSA responsibility for supervising banks, listed money market institutions and related clearing houses. This is likely to happen in about April 1998. Second, the proposed financial regulatory reform bill will create a new statutory regime under which the FSA will, in broad terms, acquire the regulatory and registration functions

currently exercised by the bodies listed in Part III below. This will take effect on N2 date.

6 The proposals in this paper relate only to the period after N2 date. We do not anticipate any changes to existing arrangements prior to that date (subject to some changes which will take place to meet existing legislative plans, such as the implementation of the EC Investor Compensation Directive in autumn 1998).

Summary of main issues

7 The Government has indicated its desire to see a single scheme with a single board and harmonised administrative arrangements. With this in mind, the FSA makes the following proposals in the paper:

Scope

(1) We propose that compensation arrangements should operate in respect of business within the FSA's scope of authorisation carried on by firms properly authorised by the FSA (paragraphs 35-47).

(2) We propose that compensation cover for negligence claims should remain as at present, and that there should be no further harmonisation of the amounts payable under complaints-handling and compensation arrangements (paragraphs 48-60).

Structure and governance

(3) In line with Ministers' views, we propose that there should be a single compensation scheme and that the scheme should be independently managed, but accountable to the FSA (paragraphs 61-74).

(4) Within that structure there would be three sub-schemes, dealing with the three main business sectors of deposit-taking, insurance and investment. We believe this structure would provide optimum flexibility for funding arrangements (paragraphs 75-82).

Harmonising the definition of eligibility

(5) We propose making some changes to the various elements which currently define the eligibility of claimants to ensure that the compensation arrangements focus more directly on private individuals and smaller firms (paragraphs 83-89).

Limits on compensation payments

(6) We propose a full review of the different limits which currently exist as to the maximum which can be paid to claimants, to see whether harmonisation is possible and/or whether changes in the levels are appropriate (paragraphs 90-100).

Funding

(7) We propose a "pay as you go" system for funding, and arrangements for collecting funds from authorised firms to provide resources for the scheme, which will aim to be fair, as well as financially viable. We envisage further detailed consultation with the industry on how allocation of liabilities would work in practice (paragraphs 101-129).

Transitional arrangements

(8) The FSA will need to develop transitional arrangements for the funding of compensation payments relating to claims in process within existing schemes at N2 date, and those arising after N2 date which relate to pre N2 date failures (paragraphs 130-131).

Consultation process and timetable

8 The responses to the proposals and questions set out in this paper will be taken into account in formulating compensation arrangements in the new regulatory structure after N2 date. They will also, where appropriate, inform the content of the forthcoming legislation on regulatory reform.

9 We envisage that there will be further consultation during 1998 when the financial regulatory reform bill is published for consultation.

10 The FSA is also carrying out a separate but simultaneous consultation exercise on "Consumer Complaints." As noted later in this paper, some aspects of complaints and compensation are interrelated.

Objectives of compensation

11 The provision of compensation to consumers where firms fail to meet their liabilities is integral to the protection of investors, depositors and policy-holders, and plays an important part in promoting confidence in financial institutions as well as in the financial system as a whole. The justification for establishing compensation schemes is that individual investors, depositors and policyholders are not generally in a position to make an informed assessment of the risk that the firm to which his or her funds are entrusted may fail. As well as providing protection in the last resort for consumers, the existence of compensation schemes also helps to reduce the systemic risk that a single failure of a financial firm may trigger a wider loss of confidence in the rest of the financial sector concerned (e.g. through a run on deposit-taking institutions).

12 Subject to the overall statutory objectives for the FSA which are expected to be set in the financial regulatory reform bill, the FSA envisages that compensation arrangements post-N2 date will, as now;

- 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.

13 It is worthwhile taking a closer look at the high level objectives set out above, and in particular the overall purpose of compensation.

14 It would be possible to structure compensation arrangements as a complete safety net for all consumers. Such a provision would be more in the nature of an indemnity for consumers, providing total protection for anything that goes wrong. It could undermine the encouragement which we would otherwise wish to give to individuals to enter into transactions in financial services only after proper consideration, to the best of their ability, of the balance of risk and reward.

15 The Government has recognised the need to strike a balance between "caveat emptor" and consumer protection in the overall objectives for the FSA. Compensation arrangements should also achieve a balance between a level of protection which is reasonable, given the nature of the consumer and the nature of the transaction, and the need to encourage consumers to act responsibly. We therefore think it is relevant that individual compensation payments should be subject to appropriate limits, and we also believe there is a continued rôle within compensation arrangements for an element of "co-insurance" i.e. where individual consumers bear part of any financial loss themselves. This is reflected in the way in which limits on individual compensation payments to consumers are currently calculated (for example deposit protection arrangements pay 90% of any claim, up to a maximum of £18,000).

16 In deciding an appropriate level of compensation for individual consumers, and for what loss or damage should they be compensated, a number of considerations play a part.

17 Consumers use financial services for a variety of reasons, and the nature of the products and services reflect different levels of risk and different needs for protection arising in the various industry sectors. It can be argued, for instance, that the purchase of insurance is primarily defensive (and in some cases – e.g. car insurance – compulsory), which in itself can justify a high level of protection when the firm writing the business fails. The placing of deposits creates a debtor/creditor relationship, where the risk could be seen to be the straightforward obligation of the deposit-taker to return the consumer's funds. In the investment sector, it is widely accepted that consumers should not be compensated in respect of market movements – such losses are part of the risk and reward relationship in business in that sector. However, the level of protection here needs to take into account the damage to a consumer which can occur when he or she is poorly advised on products which are, by their nature, often complex and long-term.

18 More generally, there are demographic and economic influences to take into account, and the effect of these on the consumption and savings patterns of individuals, and on different sectors of the population as a whole. There is also a mix of "proactive" consumers, who take a lively interest in financial services and their different characteristics, and those who are more passive in their approach. Some consumers will be more knowledgeable, more risk-aware, more able and willing to accept risk, than others.

19 Accordingly, we must recognise that individual consumers will not all have the same level of understanding about the transactions they enter into. Indeed they may also be constrained by the structure of products and services (for instance because of financial penalties for transferring business from one sector or product to another) from arranging their financial affairs for optimum security.

20 The issue of risk also arises in funding arrangements. Should the way that compensation costs are allocated for payment by regulated firms be determined by the inherent risk of the activities carried on by those firms? This approach could produce a compensation scheme and a system of funding which might be able to tie more closely the firms "responsible" for the compensation costs with those that pay those costs.

21 Whilst this is a concept which could merit further development, there would be some way to go and some sizeable technical obstacles to overcome before we could produce a compensation system based on a comprehensive application of this principle. It also needs to be remembered that significant compensation costs are generated by sectors which are not necessarily perceived as inherently risky (for example, the sale of life insurance and unit trust products via intermediaries). In these circumstances, we do not think the time is right to develop this concept substantively within the current exercise (though we anticipate returning to the subject at a later point).

22 These issues will re-emerge in the more detailed aspects of compensation arrangements discussed in the rest of this paper. We acknowledge there are no easy answers, but overall we think our aim must be to achieve a balance between caveat emptor and complete protection.

23 Finally in considering these objectives the FSA believes that the arrangements for providing compensation should be:

- transparent in their structure and operation, and clear both to claimants and to the regulated firms which will provide the funding;
- easily accessible to claimants and potential claimants;
- fair in their application both to claimants and contributors;
- efficient and responsive in operation;
- simple and cost-effective.

24 These objectives provide the basis for the proposals set out in this paper.

1 1 1 The current position and the opportunity for change

Existing arrangements

25 From N2 date the FSA will combine the regulatory and registration functions of the following bodies:

Building Societies Commission	Building Societies
Friendly Societies Commission	Friendly Societies
Insurance Directorate of the Department of Trade and Industry	Insurance
Investment Management Regulatory Organisation (IMRO)	Investment management
Personal Investment Authority (PIA)	Retail investment business
Registry of Friendly Societies	Credit unions' supervision (and the registration and public records of building societies, friendly societies, industrial and provident societies and other mutual societies)
Securities and Futures Authority (SFA)	Securities and derivatives business
Financial Services Authority (formerly the Securities and Investments Board)	Investment business (including responsibility for supervising exchanges and clearing houses)
Supervision and Surveillance Division (S&S) of the Bank of England	Banking supervision (including the wholesale money market (s43 and s171) regimes)

26 Compensation arrangements now exist for all the main industry sectors to be brought within the FSA's scope. There are a large number of common elements to these arrangements, but a high degree of diversity as to how each scheme operates. These are differences in scope, eligibility, amounts paid to claimants and funding arrangements, as well as in the structure of the schemes themselves and how they derive their powers.

27 Broadly, the current situation is as follows:

(i) deposit-taking business is covered by the **Deposit Protection Scheme (DPS)** (if the failed deposit-taker is a bank) and the **Building Societies Investor Protection Scheme (BSIPS)** (if the failed deposit-taker is a building society). The maximum payment to a depositor is £18,000 or ECU 20,000 if greater, and is limited to 90% of the protected deposit;

(ii) insurance business written by most general and life insurance companies is covered by the **Policyholders Protection Scheme (PPS)**. There is different protection for different circumstances, but there is no absolute limit in cash terms on the claim: 100% of a claim may be paid in respect of compulsory insurance (such as third party motor insurance) and, generally, 90% on other types of insurance;

(iii) insurance business carried on by friendly societies is currently covered by the **Friendly Societies Protection Scheme** (but planned amendment to Friendly Societies legislation will in due course bring this business within the scope of the PPS). Existing limits are the same as those under the PPS;

(iv) investment business (as defined by the Financial Services Act 1986) carried on by firms regulated by the FSA (previously The Securities and Investments Board), IMRO, PIA and SFA is covered by the **Investors Compensation Scheme (ICS)**. Approved claims are paid in full up to £30,000 plus 90% of the next £20,000 – a total of £48,000. ICS covers claims for civil liabilities arising from breaches of conduct of business rules (to which we refer in this paper, for simplicity, as "negligence" claims) as well as theft or fraud;

(v) investment business carried on by professional firms currently certified by Recognised Professional Bodies (RPBs) is covered by individual schemes run by those bodies. The cover provided is designed to be at least comparable to that available under ICS.

Since its inception the ICS has paid out around £125 million in compensation, the DPS around £153 million and the PPS around £220 million. The BSIPS has never been brought into operation. Further details about the main schemes are given in Appendix 1 to this paper.

28 The existence of different arrangements reflects the diversity of business activities in the financial services industry. These individual schemes have been

established and have developed to take account of the individual characteristics of different industry sectors and different consumers. Their apparent lack of harmony, in terms of detailed operation, does not necessarily mean that the arrangements are inappropriate or inadequate; indeed levels of compensation available within the UK are well above the minimum levels set by relevant European Community legislation, and the fact that actual consumer claims (as noted later in this paper) largely fall within the limits established by existing schemes indicates that current arrangements are capable of meeting the current real needs of consumers.

The opportunity for change

29 Generally speaking, each of the existing schemes has operated successfully and compensation as defined by those individual schemes has been paid out in eligible cases.

30 But the growing diversification of business undertaken by any one type of organisation, and market developments generally, mean that it is likely to become increasingly difficult to "pigeon-hole" any one organisation in one particular compensation sector. Any new arrangements need to be able to deal efficiently with such cases, and to ensure that the complexity of business carried on does not in itself lead to difficulties in establishing regulatory responsibility for handling claims and problems in access for, and service to, consumers.

31 From the other side of the fence, the issue of the "good subsidising the bad" is of practical concern for industry. Compensation claims can be a considerable burden on the firms funding the arrangements, depending on the size and frequency of funding levies. In certain sectors, notably retail investment business, the incidence of compensation levies is of real financial significance for smaller firms. The existence of compensation arrangements has a stabilising effect for the industry (given the confidence instilled by the existence of the safety net), but the level of costs also can have a competitive effect on individual firms, sectors, or the industry as a whole. The FSA recognises the concerns expressed that costs should be contained within individual business sectors, to avoid contagion in the event of large failures, and to avoid the need for cross-subsidy between firms carrying on different activities (cross-subsidy is where firms in one business sector are required to contribute to meet the claims arising in another business sector even though they have obtained no commercial benefit themselves from that sector).

32 Overall, therefore, there is a strong case for reviewing the existing structure to see whether there is scope and need for change which would enhance the accessibility and transparency of the arrangements to consumers, while ensuring that costs to firms do not become excessive and are properly attributed.

Areas for consultation

33 We have considered five major aspects of compensation arrangements to see whether there is, or might be, a case for change:

- scope (i.e. the business to be covered by the compensation arrangements);
- governance and structure of any new scheme;
- eligibility of claims for compensation;
- individual limits on payments of compensation;
- funding by firms.

34 The arguments in each case can be summed up under the following headings:

- structural rationalisation: the extent to which the current variety of compensation arrangements can be standardised;
- operational harmonisation: the extent to which greater consistency can be achieved in operational detail.

IV a) Scope of compensation arrangements

Authorised business

35 The FSA's view is that the scope of compensation arrangements should be determined by the scope of the FSA's **authorisation** responsibilities. This would distinguish between firms where the FSA is responsible for regulation/supervision of the activities carried on (i.e. where the FSA **authorises** the business), and others where the FSA only has a responsibility to **register** the firm, without taking a further role in regulating/supervising its activities (for example as is the case with industrial and provident societies). We would therefore expect the compensation arrangements to cover:

- deposit-taking by banks and building societies (but not including the Cooperative Deposit Protection Scheme since this business will not be included in the scope of the FSA's authorisation responsibilities);
- insurance companies and friendly societies carrying on insurance business;
- investment business within the scope of the Financial Services Act 1986, which would include business carried on by firms currently regulated by the FSA, IMRO, PIA and SFA, and by those firms currently certified by RPBs which under the financial regulatory reform bill will need to be authorised by the FSA;
- any other types of authorised firm carrying on authorisable business.

36 The Deposit Guarantee Directive and (when it is implemented in autumn 1998) the Investor Compensation Directive set down minimum requirements for compensation arrangements of European Union Member States as regards, respectively, deposit-taking and certain kinds of investment business. A central feature of these Directives is that the authorisable activities of firms to which the Directives apply are covered by the compensation arrangements in their home states, although they may be able, and choose, to "top up" their arrangements (that is, increase the amount of cover) by participating in the scheme of any other EEA state where they carry on business, either via a branch or via cross-border services.

37 EEA firms falling within the scope of these Directives which carry on business in the UK will therefore be covered by the compensation arrangements of their home state, although they may choose to "top up" by participating in the FSA arrangements for compensation (in cases where the UK provides a greater degree of cover).

38 Where UK firms falling within the Directives' scope operate via branches or cross-border services in other EEA member states, the relevant business activity would be covered by the FSA arrangements to the extent envisaged by the Directives.

39 The scope and requirements of these Directives will need to be reflected in the new compensation arrangements. Overseas business conducted by UK authorised firms not within the scope of the ICD (for example, commodities firms and certain intermediaries) is currently not covered by existing compensation arrangements, and we would envisage this being the case under the new arrangements.

40 There is no corresponding compensation Directive for insurance companies. The cover under the PPS (including prospective amendments to the legislation for this scheme) will provide compensation cover in respect of relevant policyholders which have done business with branches of UK insurance firms established in other EEA member states, or UK branches of other EEA insurance companies. We propose this cover should generally be replicated under the new arrangements.

41 Firms from non-EEA countries carrying on authorised business in the UK would not be covered by the compensation requirements of the above Directives. We envisage that, as now, such UK business would be covered by UK compensation arrangements, but there would be no corresponding cover for overseas business carried on by such firms.

42 The FSA recognises that it will be important that the extent of compensation protection for consumers is made clear by all firms in relevant business and marketing documentation (reflecting EC legislation, where appropriate).

Authorised firms and unauthorised activities

43 We believe that compensation arrangements should operate for the authorisable business of authorised firms. Business carried on by firms not authorised by the FSA would thus not be covered. Moreover, if an authorised firm also carried on an activity which did not require FSA authorisation (for example, estate agency) that latter activity would not fall to be compensated in the event of the firm's collapse.

44 It is likely that under the new legislation there will be a single criminal perimeter around authorisable business (that is, there will be a criminal

penalty for carrying on authorisable business without being authorised by the FSA) and that authorisation by the FSA will be relevant for all authorisable activities within the FSA's scope. Once authorised, however, firms will likely be required to operate within particular categories of permitted business, as approved by the regulator.

45 The status of a firm (whether it is authorised or not) should be easily verifiable (by, for instance, contacting the FSA) and consumers will have an incentive to ensure they do business with authorised firms. However, we do not think that consumers can be expected to determine whether an authorised firm is in fact operating within the scope of its permission from the FSA. To do so would be likely to create disputes and confusion for consumers. It also fails to recognise that, as past experience in the investment sector indicates, some firms have operated with little regard for the detailed regulatory permissions required, and we do not think consumers should be penalised because of a lack of clarity or deliberate obfuscation by the failed firm concerned.

46 We therefore propose that where a business is authorised by the FSA and permitted to carry on certain activities, but nonetheless carries on other activities within the FSA's scope for which it has not received permission, the business "outside" the original permission should also be covered by the FSA compensation arrangements.

47 The implications for the funding of compensation costs arising from this proposed scope are discussed in Part IV(e) of this paper.

We would welcome comments on:

Q1 the scope of compensation cover, as proposed above;

Q2 in particular, the proposal that compensation should apply where a firm is authorised, even though the firm may have acted outside any specific permission given by the FSA.

Negligence claims

48 Firms currently authorised under the Financial Services Act 1986 are subject to specific "conduct of business" requirements requiring them, amongst other things, to give suitable advice. A firm which fails to meet these requirements may cause a consumer to end up with an unsuitable product for his or her needs.

49 The FSA believes that compensatable claims for negligence should continue to be restricted to those areas where statute provides that conduct of business rules should apply.

50 Where businesses are required to abide by an externally produced code of conduct the FSA is of the view that this should not have the effect of making any breach of that code compensatable in the event of a firm's default, unless

the application of the code of conduct was part of an established system of conduct of business regulation specifically recognised as such by the FSA.

Q3 We would welcome comments on retaining the existing scope of cover for negligence claims, as set out above.

Interaction with complaints-handling arrangements

51 There is a link between the complaints-handling arrangements and those covering compensation, since a liability to a consumer arising from a complaint may be outstanding at the point of a firm's collapse and may even have contributed to the collapse. (We are simultaneously issuing a separate consultation paper on "Consumer Complaints" which provides further information on proposals for the way that complaints-handling arrangements should be established by the Financial Services Authority.)

52 Under current arrangements an Ombudsman may make an award to a consumer based on a number of elements, reflecting the wide range of situations where redress may be appropriate. Some awards are based on breaches of conduct of business rules, whilst others are based on breaches of codes of conduct. Awards may also include redress for distress and inconvenience.

53 Compensation arrangements, by contrast, have a more limited basis for calculation of payments and in particular, as noted above, claims for negligence are only covered in the investment sector at present. Moreover, the limits on individual payments to consumers established under existing compensation arrangements tend to be much lower than those established by Ombudsman schemes.

54 Thus currently there will be occasions when a consumer may not receive from the compensation scheme the full amount of an Ombudsman's award where the firm collapses before he has received payment. This raises the question of how, if at all, the FSA's arrangements for dealing with complaints should dovetail with arrangements for compensation.

55 We think that the three main issues here are:

(1) whether complaints information and decisions reached by an Ombudsman prior to a failure should be available to the compensation scheme;

(2) whether an Ombudsman's awards should be automatically honoured – as to liability and quantum – by the compensation scheme; and

(3) whether the ceiling on individual claims should be the same in both areas.

56 As far as (1) above is concerned, we believe that it is desirable, in the interests of avoiding duplication of effort, for the work carried out by the Ombudsman in investigating a complaint to be available to the compensation scheme.

57 However, we are less convinced that it is appropriate to harmonise the complaints-handling and compensation processes in the way envisaged in (2) and (3) above. There are, we believe, significant differences between the two processes.

58 Complaints-handling arrangements are concerned with providing redress in relation to a "live" firm and the Ombudsman's awards are paid by the firm concerned. An award therefore needs to reflect the breadth of the relationship between the consumer and the firm, and we believe this justifies the wide scope available to Ombudsmen at present.

59 A compensation scheme has, on the other hand, a very different purpose. It provides cover when an authorised firm fails. As noted in Part II above, compensation cover is essentially designed as a back-stop, not a complete safety net, and we believe the wide scope that applies to Ombudsman arrangements is therefore not appropriate. A further distinguishing feature is that compensation claims are funded by firms other than the firm which collapses.

60 Because of these differences we believe that the narrower scope and lower limits for compensation awards noted above are justified. We therefore propose that, as far as possible, work done to determine complaints should be available to the compensation scheme. We also think the scheme should be able, where appropriate, to rely on an Ombudsman's awards, having due regard to differences in scope and the need for equity of treatment between claimants. Beyond this, however, we do not propose to harmonise the bases of calculation and the limits on individual pay-outs under the two processes.

Q4 We would welcome comments on whether compensation arrangements should continue to provide a final safety net and therefore be narrower in scope than complaints-handling arrangements. In particular, comments are welcome on our views that:

- **payments for losses arising through negligence under the compensation scheme should only be made in relation to areas subject to conduct of business rules;**
- **the limits on Ombudsman awards should remain distinct from those under the compensation scheme.**

b) Structure and governance

61 This section of the paper looks at the ways in which compensation arrangements can be structured and governed, and how these arrangements should interrelate with the FSA.

An independent scheme?

62 Arrangements for compensation could be:

- fully integrated with the FSA, without a separate existence;
- self-standing but closely related to the FSA; or
- independent of the FSA.

63 Most existing schemes operate largely independently of the regulatory structure, generally with powers laid down in statute. The notable exception to this is the ICS where there is a separate organisation with its own board but whose powers derive from rules made by the FSA under Section 54 of the Financial Services Act.

64 There are advantages with all these approaches. Full integration with the FSA would ensure maximum cohesion between the regulation and supervision of financial institutions and the payment of compensation when things went wrong. On the other hand, independence of the compensation arrangements from the regulator would avoid, for example, any suggestion of conflicts of interest and demonstrate clearly the impartiality of the compensation process. Where the compensation arrangements are separate but still closely related to the regulator (as in the current FSA/ICS relationship) this has the advantage of separating policy-making from the compensation arrangements, allowing the board of the scheme to concentrate on management of the claims process.

65 We see benefits in the creation of compensation arrangements which are independent, but we also see the need to establish clearly defined powers and accountability and to recognise the link between the regulation of the industry and the funding of compensation by the industry.

66 The powers of the scheme could be set out in the regulatory reform bill, but this may give rise to a lack of flexibility to respond to changing circumstances which current schemes have identified that they need. To counteract this, we expect the broad parameters to be set out in primary legislation, with the detail contained in rules made by the FSA.

67 Overall, we think flexibility of and accountability for operation would be best served by a structure which is independently managed, but which is accountable to the FSA. The compensation scheme would be a separate organisation from the FSA, but would be closely linked: we expect that the FSA would make rules under which the scheme would operate, would appoint the Chairman, subject to HM Treasury approval, and would appoint the members of the scheme's board.

68 In making arrangements for rules and procedures we will want to ensure that certain aspects of legislation covering existing compensation schemes concerning their own operational powers (for instance dealing with liquidators) are appropriately reflected in legislation for the new scheme.

69 As noted above, this overall structure of an independently-managed scheme would be akin to the current relationship between the FSA and ICS established under Section 54 of the Financial Services Act. The details of this arrangement are set out in a memorandum of understanding between the two organisations, covering matters such as information-sharing and the on-going review of ICS' operation by the FSA. We think this document could provide a model for the basis of the relationship between the FSA and the new compensation scheme. The text of the memorandum of understanding is set out in Appendix 2.

Q5 We would welcome comments on the governance arrangements proposed above.

Internal structure of the scheme

70 The FSA shares Ministers' view that there are clear operational advantages both for the industry and consumers in bringing the various schemes within a single organisation providing a clear single access point for consumers. The FSA also believes there are also strong practical reasons to continue to recognise the very different business sectors and consumers concerned.

71 There are two main ways in which the arrangements could be structured to take account of these different characteristics under a single board:

(i) **"All in one" scheme**
a single scheme could be created with the same terms in respect of all consumers and authorised firms;

(ii) **One scheme: different sub-schemes**
there could be a single organisational structure, which could contain, as "sub-schemes", arrangements for each of the different business sectors concerned.

72 The FSA believes that the new arrangements should aim for as much rationalisation as possible. At the same time practical considerations suggest that a degree of differentiation between industry sectors needs to be preserved. An "all in one scheme" (option (i)) might appear to enhance the financial viability of the scheme by spreading the cost of compensation payments over a wide base, but in practice this in itself would make it difficult to provide equitable funding arrangements. Moreover, this type of scheme would make it more difficult to reflect different business carried on in different sectors where this was relevant for the design of the compensation arrangements. For example, as explained in Part IV(d) below, the considerations applying to compensation for policyholders of failed insurance companies are different from those applying to people who suffer loss as a result of poor advice on an investment product.

73 By contrast a single scheme with different sub-schemes would be able to enhance the common application of compensation procedures across all business sectors, whilst at the same time allowing differences to be recognised and providing a flexible structure for funding arrangements.

74 We therefore think that the best structure for the new arrangements would be a single scheme, which would encompass several sub-schemes for different business sectors (option (ii)).

Q6 We would welcome comments on this approach.

Use of sub-schemes

75 It would be important to construct sub-schemes within this structure so as to provide a coherent set of business "constituencies" broadly covering the same activities, and produce a stable funding basis. However it is clear that the wider the scope of each sub-scheme, the weaker the community of interest amongst the firms covered by it and the greater the difficulties of producing a method of funding which is equitable between firms and avoids undue cross-subsidy. Narrow sub-schemes reduce these difficulties but increase the danger that the costs of a failure will do significant damage to the other firms within each sub-scheme, may leave funding deficits, and may provoke the need for cross-contribution.

76 The FSA believes there should be three sub-schemes, covering deposit-taking, investment business and insurance, though funding within each sub-scheme may need to be further differentiated (see Part IV (e) below).

77 We expect the various firms described in the scope section of this report (Part IV(a) above) would participate in these sub-schemes depending on the activities they carry on. This would indicate the following categories:

deposit-taking activities:	banks and building societies (as deposit-takers)
insurance activities:	life and general insurance companies, friendly societies carrying on insurance business;
investment activities:	firms currently regulated by the FSA, IMRO, PIA and SFA for investment business, certain firms currently regulated by RPBs, and others carrying on authorisable investment business.

Q7 We would welcome comments on the number of sub-schemes and their coverage.

Governance arrangements

78 It will be important in establishing the management arrangements for the new larger compensation scheme to ensure the efficient operation of the scheme and the consistent application of its procedures.

79 The compensation arrangements will cover a wide range of consumers and a wide range of businesses. We think it would be difficult to compose a board which would allow direct participation of representatives of all the sectors involved without the structure becoming unwieldy.

80 One way of dealing with this problem might be create separate boards for each of the sub-schemes. Whilst this would in theory have some attraction, we think that such a structure could make management decisions of common application to the arrangements as a whole very difficult to achieve in an efficient way.

81 Our current view is therefore that the compensation arrangements should be directed by one relatively small board. The directors would be appointed in the public interest (arrangements for appointment are discussed in paragraph 67 above) and would aim to blend industry experience with a wider consumer perspective.

82 Additional representation in respect of individual business sectors, as well as access to external expertise, advice or experience in a particular area, could be achieved through the use of management committees or panels to deal with individual sub-schemes or sectors within those sub-schemes. However we think that this is an area of operational detail which could be decided by the board once the scheme has been established and management priorities have been set.

Q8 We would welcome comments on proposals for the structure and composition of the board of the compensation scheme.

c) Harmonising the definition of eligibility

Claimants

83 We noted in paragraph 12 above that a general objective of compensation arrangements is that they should be focused in particular on "those consumers who are least able to sustain financial loss". We believe that in general cover should focus primarily on private individuals and smaller commercial entities. The definitions of eligibility set out in the Deposit Guarantee Directive and the Investor Compensation Directive provide good models for this and we propose to devise eligibility criteria which would adopt the main exclusions to compensation cover permitted by these two Directives (at the same time ensuring that the arrangements comply with EC law).

84 Broadly this would mean that "professional" consumers (such as banks, investment firms, insurance companies) and other large entities such as local government bodies would be excluded from cover. Subject to these general restrictions we wish to ensure that cover is available for small businesses, which can be just as vulnerable as private consumers, but believe larger undertakings do not need the same protection. We would therefore propose to exclude, as permitted by the two Directives, firms which do not meet two out of the following three criteria:

(i) a balance sheet total below ECU 2.5 million;

(ii) net turnover below ECU 5 million;

(iii) fewer than 50 employees.

85 In addition we would intend to exclude from the compensation arrangements directors, managers, partners and certain shareholders and other participants in the failed business, members of the same corporate group, and the statutory auditor.

86 These changes mean that the FSA's compensation arrangements would cover individuals, partnerships, unincorporated bodies and small companies. The

major change from current arrangements would be the exclusion of larger companies and local authorities from deposit protection cover.

87 Arrangements for insurance compensation would continue to cover all policyholders for specified compulsory insurance policies such as employers' liability and third party motor policies, regardless of the size or type of claimant.

88 We also believe that the eligibility of claimants should be restricted in the following ways:

- anyone who is judged to have had responsibility for, or profited from, the financial difficulties of the collapsed firm should be excluded from making a claim (this constitutes a change to insurance arrangements);
- claims arising through transactions relating to money laundering should be excluded, as set out in the relevant Directives (this is also a change for the insurance sector; the investment sector will change when the Investor Compensation Directive is implemented in autumn 1998).

Claims

89 The current investment and insurance schemes cover claims denominated in any currency. The deposit-taking schemes only cover deposits denominated in a European Economic Area currency or ECU. When these schemes were introduced it was reasonable to believe that small depositors were unlikely to hold deposits in a range of currencies (the DPS originally only covered sterling deposits) but we do not believe that it is now safe to make this assumption. Accordingly we think that the scope of deposit-taking schemes should be widened to cover deposits in all currencies.

Q9 We would welcome comments on these proposed changes.

d) Limits on compensation payments

90 Two of the fundamental objectives noted in paragraph 12 of this paper are that compensation:

- should be largely directed towards those consumers who are least able to sustain financial loss; and
- should be designed to provide substantial but not in all cases complete cover for loss.

91 Each of the existing schemes sets a limit (not necessarily in cash terms) on the amount of compensation which can be paid on any individual claim. For convenience we will refer to these restrictions as "individual limits" in the paragraphs below.

92 The following are the individual limits for the main existing schemes:

- ICS

  Maximum individual payout £48,000
  (100% of first £30,000, plus 90% of next £20,000).

- DPS/BSIPS

  Maximum individual payout £18,000 (or ECU 20,000 if greater)
  (90% of £20,000 or ECU 22,222).

- PPS

  100% of claims in relation to specified compulsory insurance policies and, broadly speaking, 90% otherwise, with no maximum limit.

(Schemes/Funds operated by individual RPBs either reflect ICS limits, offer greater limits, or are unlimited.)

93 The individual limits across different schemes vary, and have evolved over time. A feature of each of them is a recognition, through the element of co-insurance, of the importance of the consumer taking a share of the

responsibility for his or her own financial decisions. A further common feature is that there is an upper limit on the amount of compensation payable.

94 In the deposit protection area, the individual limit of £18,000 compares with a minimum requirement set under European legislation of ECU 20,000 (currently equivalent to about £12,200). The majority of claims on the DPS (the BSIPS has never been activated) have been in respect of small accounts (over 70% below £10,000 and over 80% less than £20,000).

95 In the investment sector, the Investor Compensation Directive also sets a minimum requirement of ECU 20,000 for loss of cash and securities (negligence is not covered). To date over 60% of claims on the ICS have been below £10,000 and over 80% below £20,000 – a similar picture to that seen in the deposit protection area.

96 Compensation arrangements for insurance business reflect a quite different approach. In the general insurance area, consumers would be significantly disadvantaged if any kind of absolute limit was imposed on compensation receivable – the issue is not necessarily a straightforward return of premiums (for example, claims arising from building and contents insurance policies). Generally the need is to ensure that appropriate cover can be continued. Where insurance is compulsory (such as motor insurance or employers' liability insurance) it is desirable that 100% cover is available.

97 In the long term (mainly life) insurance sector, 90% of cover is provided by the PPS. However, some products are designed more as investment vehicles than insurance. This could be presented as an argument for restricting the absolute amount of the cover available (in the same way that absolute limits operate for investments and deposits). However this approach would fail to distinguish the protective element of insurance cover provided by such products. Many are after all designed as longer term investments which allow one to "provide for the future". The use of life insurance policies within the personal pensions market underlines this fundamental link.

98 As part of the process of designing new compensation arrangements, the FSA believes various individual limits which currently exist could be reassessed, to see if they remain valid and, if not, how best they might be changed. Rather than automatically look for uniform treatment, in this exercise we think it is important to start by reaching a view as to what in fact would be a reasonable level of compensation in respect of different types of business. We also think it is important to note that there is no indication at present that the limits which exist are inappropriate, given the claims history to date, and therefore there is no obvious presumption of the need for change.

99 Bearing this in mind, the characteristics of each type of compensatable business activity and the costs of changing the elements of compensation which relate to that business need to be carefully assessed. We also need to

ensure the arrangements comply with the European legislation noted above. We would intend to take the following broad approach:

- we believe that limits on insurance cover should largely be left as they are (see paragraph 92 above), given the nature of the business and the different types of consumers and insurance risks which are involved;
- we intend to look at the pattern of claims in the deposit-taking and investment sectors and at the circumstances in which consumers enter into financial products and services to see whether existing limits reflect a realistic level of protection for those least able to sustain loss, or whether there is a need for change;
- we will look at the level of "co-insurance" (i.e. the amount of the loss which the consumer bears him– or herself) to see whether any change is appropriate and whether the right balance is being struck between the consumer's responsibility to act reasonably, and the need to provide protection;
- we intend to review the way in which existing cash limits (i.e. in areas other than insurance) might be updated, if required, to deal with the effect of inflation since those limits were set.

100 We intend that this review will be conducted separately from the current consultative exercise, probably later in 1998.

Q10 We would welcome comments on:

- **proposed elements of the review set out above;**
- **what individual limits should be set for specific types of business.**

e) Funding

101 It is important for the effective operation of compensation arrangements that they are properly and robustly funded, so that claimants can be paid out on a timely basis.

102 One of the basic criteria for compensation (set out in paragraph 12 above) is that it should be funded, as now, by the industry. Arrangements for this funding need to be equitable as between different sub-schemes and different types of firms within those sub-schemes, and need to ensure that the compensation scheme can be provided with adequate resources, without overburdening industry or making unrealistic or impractical demands on particular sectors.

103 This section of the paper therefore looks at what needs to be funded, as well as how funding can be achieved.

Limits on total payments to consumers

104 The FSA sees a strong argument on consumer protection grounds for there being no limit on the total which can be paid out to claimants in any period – to impose a limit unfairly disadvantages claimants in respect of defaults which happened later in any claims "year" rather than earlier. It is already established for compensation relating to business covered by the EC Deposit Guarantee Directive and, prospectively, by the Investor Compensation Directive that there should be no limit on the total amount of claims which can be paid out. We propose that no limit should exist within the new compensation arrangements generally (although individual limits on claims would of course continue to exist).

Q11 We would welcome comments on the above proposal.

Limits on individual levies on firms

105 There are currently limits within the funding arrangements for existing schemes on the amount which can be collected from firms. This is intended to give some reassurance to firms that there is a finite amount of contribution expected from them within a given period. It also helps to guard against systemic problems in sectors where compenstion levels are high. This does not restrict payments to consumers, as any requirement not collected in one year can be levied in the next. However, should that upper contribution limit need to be exceeded it would be difficult to adhere to the restriction. A ceiling on the total amount that can be levied from firms is therefore more perceived than actual.

106 The FSA recognises that firms have a valid concern that compensation levies made on them should not prove to be an unbearable burden, particularly in terms of cash flow. Whilst appropriate and fair levying procedures within the compensation arrangements should deal in large part with this concern, firms may welcome the inclusion of limits on the total compensation levies that can be called in any one period, on the understanding that any shortfall is levied in the following period. It is therefore proposed to introduce this kind of limit on levies during a set period (probably annual). The limit set would need to take account of likely demands for compensation funding in respect of any particular business sector. In addition, the feasibility of introducing such limits would ultimately depend on the compensation scheme being able to borrow on the necessary scale to ensure payments due to consumers were not delayed or scaled back due to a shortage of immediately available funds, whilst at the same time ensuring that funding was, overall, being achieved in the most cost-effective manner possible.

Q12 We would welcome comments on:

- **the principle of applying a limit on the total levies which can be called from firms over a particular period;**
- **whether such a limit should be available and would be appropriate to all sub-schemes, and to all business sectors within sub-schemes.**

Levy arrangements

107 There are two main methods of raising funding for compensation arrangements:

- to raise only as much as is needed in a particular period ("pay as you go"); or
- to raise in excess of what is needed (by regular annual contributions), which may build up a "buffer" of available funds.

These methods could be used in arrangements for individual sub-schemes, or across the scheme as a whole.

108 "Pay as you go" levies can be made either in anticipation of need or after the event. However, a prime consideration in any arrangement for funding is the need to ensure the scheme has sufficient liquidity in order to carry on day-to-day business efficiently and that eligible claims are paid on a timely basis. Clearly there is a balance to be struck between the optimum liquidity level for the scheme and that of firms which would be contributing the funding. A "pay as you go" scheme tends to favour the firms in this respect and does generate the need for the scheme to have adequate (preferably large) borrowing facilities.

109 The main disadvantage of the method requiring regular annual contributions is that calls may be made when the scheme has no need for the funds and a large reserve fund may be built up which in the event proves unnecessary. Moreover, particularly in the early days of a scheme, regular levies may not in any event meet the scheme's need for funding.

110 Whilst the arguments are reasonably balanced, the FSA believes that a "pay as you go" system is to be preferred, with a mixture of advance and retrospective calls possible to provide flexibility.

A standing fund

111 Where appropriate, a small standing fund can also be created which effectively provides up-front funding for the operational needs of the scheme.

112 The benefits of a standing fund include the administrative efficiency of being able to defray scheme expenses and deal with small failures without the need for a specific levy. This advantage has been particularly apparent in the case of the DPS. A standing fund is less relevant where a scheme is expected to make frequent calls, but may still be useful and reduce borrowing costs. The FSA is not proposing the establishment of such a standing fund, but believes the scheme ought to have the flexibility to do so, if circumstances make it desirable.

Product levy

113 A further possibility is the imposition of a product levy. This concept involves an additional charge or "tax" on individual transactions at point of sale, which would then be paid directly into the compensation scheme avoiding levies on individual firms. The costs of compensation would thus be clear to, and paid directly by, the consumer.

114 This potential method of funding has received considerable attention from the retail investment business sector, in particular independent financial advisers

(IFAs) who feel they are unable to pass compensation costs on to consumers and thus suffer the full weight themselves. There are some disadvantages to the method. A product levy would be likely to create timing difficulties in the receipt of funds and administrative difficulties in the calculation of the levy on individual products, as well as possibly increasing costs of collection. Moreover the method is not necessarily adaptable to all sectors (in many cases – for instance, advice – there is no product or transaction to form a basis for the levy), or across individual sectors, and could create competitive distortions between different businesses in the same sector, particularly between UK and EEA firms which would not be subject to such a levy.

115 However it is possible that a product levy arrangement might be able to provide one element of necessary funding for the compensation scheme and in due course we think it will be useful to consider further how this idea might be given practical effect.

The optimum funding structure

116 The FSA's current view is that the optimum structure for funding will probably be found in a combination of the funding methods mentioned above; that is, "pay as you go", with the possibility of the creation of a standing fund, and perhaps the use of a product levy for application to certain industry sectors. It will be important to ensure the compensation scheme has adequate borrowing powers to ensure funding arrangements can be operated as efficiently as possible.

Q13 We would welcome comments on:

- **the suggestion to use a combination of funding methods as noted above;**
- **the benefits or otherwise of the creation of a reserve fund;**
- **the areas in which a product levy could operate, how it would be administered in practice, and its competitive effects.**

Principles for the allocation of liabilities to individual sectors and firms

117 The FSA intends that funding arrangements will be fair and reasonable to the firms concerned. We recognise the strong feelings in the industry about the need to keep separate the compensation costs arising between or even within individual business sectors and hence avoid cross-subsidy. The need for this differentiation is one of the reasons why a structure involving sub-schemes within a single scheme (see paragraph 75 above) appears particularly appropriate.

118 However there are three other funding aspects to bear in mind. First, there is the need to establish viable funding arrangements. To achieve this there will inevitably be some degree of cross-subsidy, even within the same business sector, because of the different types of firms involved and their varying resources. Without it, levy constituencies could end up being constructed so narrowly that some constituencies would be unable to meet the liabilities to fund "their" sub-scheme.

119 Second, the idea of an element of cross subsidy from larger to smaller businesses, to maintain a healthy mix of firms in the market, has worked well in the retail investment sector, where product providers which use IFAs as a distribution channel contribute substantially to the funding of IFA compensation liabilities. It has been recognised in this arrangement that firms benefiting from such a cross-subsidy should not avoid liability altogether, and IFAs are required to fund the initial amount of any levy entirely. The FSA believes this general concept of shared responsibility within relevant sub-schemes could remain an underlying principle to any scheme.

120 Third, it has often been suggested that as all firms benefit from the confidence generated by the existence of the scheme, then all firms should contribute in some way to its on-going management (i.e. its day-to-day operational expenses), and that this funding should be kept separate from the funding of compensation payments.

121 The FSA therefore believes that compensation liabilities should be allocated to individual firms according to the following principles:

- **all firms pay an element of the general costs of running the scheme**

  we propose that, as a general principle, all firms within the scope of the compensation arrangements should make some contribution to the running costs of the compensation arrangements. This could be achieved by allocating fixed overheads across all business sectors (where a standing fund exists the costs can be charged to that fund; in other cases a levy on individual firms would be required);

- **compensation costs stay within individual sub-schemes**

  subject to the above point on general costs, we propose that particular costs in respect of the individual sub-schemes established within the compensation scheme should be met by firms within the relevant sub-scheme;

- **cross-subsidy will apply only where clearly identified and justified**

  compensation liabilities should be allocated as far as possible to the relevant business sector. We would not envisage cross-subsidy between sub-schemes. Within individual sub-schemes, the main determinant of how compensation costs should be allocated will be the need to ensure a viable funding base. Subject to this important requirement, it may in some cases be appropriate

to allocate costs to clearly identifiable sectors within a sub-scheme (see paragraphs 122-126 below). Where an element of cross-subsidy within individual sub-schemes is needed to deal with a particular set of circumstances (such as that currently in place between certain life companies and IFAs), and appears desirable and practical, the compensation arrangements should be able to permit this.

Q14 We would welcome comments on these principles

Allocation of liabilities between and within sub-schemes

122 Each of the three sub-schemes – deposit-taking, insurance and investment – will contain a number of different types of firm, each of which may carry on a variety of activities which cross sub-scheme boundaries.

123 We believe firms should participate in funding the compensation costs relevant to each of these sub-schemes by reference to the activities they carry on. Thus a firm could be required to participate in more than one sub-scheme (as is the case with existing arrangements).

124 On the allocation of liabilities within individual sub-schemes, we do not propose any particular method at this stage. There will need to be further, detailed consultation with firms on this matter. As noted in paragraph 121 above, in general we feel that compensation costs should be allocated as far as possible to the relevant business sector (representing an individual activity or group of activities), to avoid inappropriate cross-subsidy where a sub-scheme has a wide activity base. However, this aim must also be set against the need to ensure such sectors will be capable of bearing the burden of liabilities, without this creating financial problems for sector participants themselves.

125 Moreover we also recognise that the boundaries of these business sectors should be capable of change, and may well need to change, over time, as different types of firm become more alike in the way they carry on their business (an example of this might be the way that the business of banks and building societies is becoming increasingly closer in nature).

126 We intend to take all these factors into account in determining the allocation methods for liabilities for post-N2 date failures.

Q15 We would welcome comments on:

- **the proposition that firms should as now fund compensation liabilities on the basis of the activities they carry on (so a firm could be liable to pay levies into more than one sub-scheme);**
- **how, within individual sub-schemes, liabilities might be allocated amongst firms carrying on different activities.**

Business carried on without permission

127 In Part IV(a) of this paper on "scope" we proposed that business conducted without authorisation would **not** be covered by the FSA's compensation arrangements, whereas an authorisable activity carried on by an authorised firm but without the FSA's permission **would** be covered.

128 A further funding issue is how to allocate liabilities arising when this kind of firm fails. Should the liability for the activity outside the main permission fall to the sub-scheme appropriate to that activity, or should it fall to the sub-scheme which covers the **permitted** business of the firm? Alternatively could this cost be spread evenly across all sub-schemes?

129 The FSA's current view is that allocation of liabilities should fall to the appropriate sub-scheme for the type of business carried on. Thus firms within the sub-scheme where the failed business operated without permission would bear the compensation costs for that business.

Q16 We would welcome comments on these suggestions for funding such compensation costs.

Transitional arrangements

130 The processing of compensation claims in respect of the failure of an individual firm invariably takes a considerable time, and the practical effect of this will be that, in some cases, compensation costs will be paid over a period which is likely to cover both the current arrangements and those which will exist after N2 date.

131 We think it will be necessary to recognise within funding arrangements the different constituencies of firms contributing to funding this "tail" of compensation claims, allowing, if appropriate, compensation costs attributable to a particular industry sector before N2 date to be "ringfenced" within any new funding group which may be created for arrangements after N2 date.

Q17 We would welcome comments on this proposed approach.

Appendix 1

Details of the main existing compensation schemes

Appendix 1

Deposit Protection Scheme

The Deposit Protection Scheme ("the Scheme") was established by the Banking Act 1979 and continued under the Banking Act 1987 (as now amended, principally by the Credit Institutions (Protection of Depositors) Regulations 1995). The Banking Act sets out the terms of the Scheme which is administered by the Deposit Protection Board (DPB). The DPB is a statutory body, the members of which are drawn from the Bank of England and the banks. The Chairman of the DPB is the Governor of the Bank of England. There are currently four staff, of which two are part-time.

The Scheme is funded by contributions from banks. There is a modest standing fund which can be used to meet the costs of small bank failures and administrative expenses. The costs of larger failures are met by levying special contributions from the banks. The DPB also has powers to borrow.

The Scheme is triggered by the insolvency of a bank. Each protected depositor receives payment of 90% of his/her deposit up to a maximum payment of £18,000 (or ECU 20,000 if greater). The Scheme covers deposits made in the European Economic Area (EEA) currencies and ECU with branches of UK banks within the EEA, branches in the UK of banks from outside the EEA and, subject to special rules, branches in the UK of banks from other EEA member states where those banks have opted to participate in the Scheme as well as in the scheme of their home member state.

Not all deposits are protected under the Scheme. Exclusions include deposits by:-

(a) directors, controllers and managers of the bank and their close relatives;

(b) other group companies;

(c) credit institutions, insurance undertakings and other financial institutions;

and deposits which are:-

(d) secured;

(e) part of the capital of the bank; or

(f) made in the course of a money laundering transaction.

Any liability which a depositor has to the insolvent bank will normally be set-off against the deposit before calculating the protection payment.

When the DPB has made payment to a depositor, it is entitled to receive dividends from the liquidator of the bank until it has been repaid, in priority to the payment of dividends to the depositor.

The Scheme has been triggered by the insolvency of 29 banks. Payments to depositors total £153 million, of which £110 million has been recovered from liquidators etc.

Appendix 1

Building Societies Investor Protection Scheme

The Scheme was established by the Building Societies Act 1986. This was amended by the Credit Institutions (Protection of Depositors) Regulations 1995 (SI1995/1442) and by the Building Societies Act 1997.

The Chairman and First Commissioner of the Building Societies Commission (BSC) is the de facto Chairman of the Building Societies Investor Protection Board, which operates the Scheme. He appoints two other members of the BSC, one of whom becomes Deputy Chairman. Four other members are appointed by HM Treasury, after consultation with the BSC Chairman. Of these, three are to be, or to have been, directors, chief executives, or managers of Building Societies. Appointments to the Board (seven in all) may be held for up to two years. A member of the Building Societies Commission's staff serves as the Board's Secretary.

The scheme is funded by levies on Building Societies as required. There is no standing fund. The BSC pays administration costs whilst the Board has no money. The Board may borrow temporarily, the amount being limited to that which the Board may levy.

The Scheme is triggered by the insolvency of a building society or a determination by the Building Societies Commission that deposits which are due and payable cannot be paid. Each protected investor receives payments of 90% of the aggregate of his protected deposit (subject to liabilities having been set-off) up to a maximum of £18,000 or the sterling equivalent of ECU 20,000, whichever is the greater.

The scheme covers most shares and deposits in UK building societies and in any institution authorised in another EEA Member State which has joined the Scheme to provide top-up cover to depositors with its UK branches (for example, the First National Building Society, authorised in the Republic of Ireland and carrying on business in the UK, participates in the scheme in respect of its depositors at its UK branches).

To date the Scheme has not been triggered and there have therefore been no payouts.

Appendix 1

Investors Compensation Scheme

The Scheme was established under the Financial Services Act 1986. The rules of the Scheme are made under that Act by the Financial Services Authority. The Scheme operates as a separate company, governed by a Board composed of up to 11 individuals; an independent Chairman, five public interest representatives, four nominees of the self-regulating organisations established under the Financial Services Act, and the Chief Executive of ICS. There are approximately 130 staff.

The Scheme is funded by levies on regulated firms. This is generally on an annual basis, but ICS is also able to levy more frequently, and to incorporate some element of prefunding into the calculation of the levy. There is no standing fund. The Scheme also has borrowing powers.

The Scheme is triggered by the failure of a regulated firm to meet its civil liabilities, including negligence, in respect of investment business carried on under the Financial Services Act 1986. The civil liabilities must have arisen after August 1988.

Eligible investors are those defined as private investors by the FSA rules, (essentially private individuals and small commercial entities) and trustees other than unit trust trustees.

Each eligible investor is able to receive compensation of up to £48,000 (that is 100% of the first £30,000 of a claim, together with 90% of the next £20,000).

From the start of the Scheme (in August 1988) to 30 November 1997, 340 firms have been declared in default. Of these, 311 were regulated by FIMBRA*, 17 by SFA, 8 by IMRO, 3 by SIB and 1 by PIA. In all, 13,500 payments have been made to 10,500 investors. Approximately £125 million of compensation has been paid out in total, and around £14 million recovered from liquidators.

* the Financial Intermediaries, Managers and Brokers Regulatory Association

At present, overseas business carried on by investment firms is generally not covered by the ICS. The implementation of the Investors Compensation Directive in autumn 1998 will mean that business carried on in the EEA via branches or cross border services by UK firms falling within the scope of that Directive will be eligible for compensation. Relevant firms from elsewhere in the EEA carrying on business in the UK may also be able to participate in the Scheme in order to "top-up" the compensation arrangements of their home state. The overseas business of other investment firms will remain outside UK compensation arrangements.

Appendix 1

Policyholders Protection Scheme

The Policyholders Protection Scheme was established under the Policyholders Protection Act 1975 (as amended 1997 – yet to come into force). The Act provides for the protection of certain UK policyholders who may be affected by the inability of established insurance companies carrying on business in the United Kingdom to meet their liabilities. The Scheme is administered by the Policyholders Protection Board.

Benefits of protection are subject to tests on whether: an insurance company is an authorised company carrying on business in the UK; the policy issued qualifies (reinsurance, marine, aviation and transport insurance business does not); there is a qualifying private policyholder (i.e. individuals including natural persons, partnerships and unincorporated bodies, persons all of whom are individuals); and where the risk is situated. Lloyd's insurance policies and corporate policyholders are excluded.

Individual policyholders are compensated as follows:

- general business – 100% of liability where insurance is compulsory, otherwise 90%
- long term business – 90% of outstanding claims and arrangement of continuity of life insurance with benefits at 90%

There is no maximum limit on the payout by the Scheme.

Further, the Board has the discretion to provide assistance to an insolvent non-life insurance company to safeguard policyholders. This includes securing or facilitating the transfer of all or any part of the insurance business carried on by a company in financial difficulties.

The Scheme is funded by statutory levies on authorised insurance companies – separate levies are imposed on long term and general insurance business. The Insurance Directorate of the Department of Trade and Industry assists in collecting information about premium income on which the levies may be calculated.

Since 1975, 24 companies have received assistance. Not all required the payment of compensation to policyholders. Some £220 million in compensation has been paid out under the Scheme.

Appendix 1

Friendly Societies Protection Scheme

Friendly Societies currently operate a voluntary scheme to which all the major societies, accounting for over 98% of the sector's total assets, belong. The level of protection available is equivalent to that under the Policyholders Protection Scheme for comparable business. Additionally, the societies' scheme is an approved arrangement for the purposes of the Financial Services (Client Money) Regulations.

The Friendly Societies Act 1992 provides for the Policyholders Protection Scheme to be extended to cover friendly societies. These provisions are expected to be brought into force during 1998.

Memorandum of Understanding between the Securities and Investments Board* and the Investors Compensation Scheme Limited

General Structure

1 The purpose of this Memorandum of Understanding is to provide a framework within which the relationship between the Securities and Investments Board (the SIB) and the Investors Compensation Scheme (ICS) can operate sensibly in the public interest. Each of those bodies has its own separate functions to perform, but they need to co-operate and communicate constructively with each other in order to carry out those functions effectively.

2 The main function of the SIB is to act as the leader and manager of the regulatory system established under the Financial Services Act 1986 (the Act). The SIB is answerable, through the Treasury, to Parliament for the effective discharge of its functions (see sections 114-115 of the Act).

3 One of the functions of the SIB is, by subordinate legislative power, to establish and provide for the administration of a compensation scheme. The current rules establish ICS as the management company to operate that scheme.

4 ICS accordingly is the body endowed, pursuant to the SIB's rules, with the function of administering the scheme in accordance with those rules. In so doing, it is exercising a jurisdiction, and, accordingly, needs operational independence to take individual decisions on case work and on associated policy without any external interference.

* Now the Financial Services Authority

Objectives of ICS

5 With the agreement of the SIB, ICS has set the following objectives for itself –

(a) to process claims and deliver compensation fairly, efficiently and economically, in accordance with rules made by the SIB and, wherever appropriate, with due regard to any published guidance issued by the SIB or any relevant recognised self-regulating organisation (SRO);

(b) to ensure that the necessary resources are available to enable claims to be paid on a timely basis.

6 In carrying out these objectives, ICS, with the agreement of the SIB, aims –

(a) to operate impartially and objectively in carrying out the functions conferred on it by rule;

(b) to keep the interests of investors in mind;

(c) to keep the interests of contributors in mind, in particular, by ensuring that administrative costs are carefully budgeted and strictly controlled;

(d) to maintain strong and constructive relationships with the SIB, with the SROs and other relevant organisations, including the Treasury, in order to contribute to the efficient functioning of the regulatory system, and

(e) to ensure that information about its operation is made available to the SIB, the SROs and others as appropriate.

The relationship

7 The functions of the SIB and ICS are closely related, and they acknowledge that co-operation and communication are of the first importance: each needs access, wherever appropriate, to the information needed for the fulfilment of its functions, and each must operate with due regard to the need not to cause difficulties for the other, whether by failure to communicate or to identify a relevant consideration or otherwise.

8 As part of its own accountability, the SIB is answerable for the overall quality of the scheme for investor compensation put in place by its rules, and, for that purpose –

(a) expects to consider, from time to time, in consultation with ICS, whether the rules can in any respect be improved;

(b) expects to be kept informed (and, where appropriate, asked to offer advice and assistance) on issues of general principle or importance, and high profile cases, arising out of the exercise by ICS of its functions;

(c) arranges to review periodically, with ICS, the effectiveness, efficiency and promptitude of the delivery systems involved in the scheme, but

(d) will do so in a way which does not affect the autonomy of ICS in respect of decision-making and day-to-day management, and, accordingly,

ICS is correspondingly accountable to the SIB in respect of the discharge of the functions conferred upon it relating to a – c above.

9 The SIB for its part will discuss with ICS matters relevant to the exercise by ICS of its functions, in particular, those matters relating to the operation of the compensation rules.

10 As part of its system management role, the SIB aims to co-ordinate and facilitate flows of information on matters of regulatory concern, and, for that purpose, expects to be kept informed –

(a) of hazards to investors emerging in the casework of ICS, and

(b) of any conduct by any individual whose role in relation to any firm in default appears questionable.

11 The annex to this agreement sets out the detailed arrangements which have been set in place in order to achieve the purposes of this memorandum.

Memorandum of Understanding

The Arrangements

12 This annex sets out the detailed arrangements which have been set in place in order to achieve the purposes of the Memorandum of Understanding (MOU), with particular reference to the relationship as described in paragraphs 7 and 8 of the MOU.

13 These arrangements are designed to enable the SIB and ICS to operate their relationship in such a way that there are no surprises and each benefits from co-operation with the other.

14 The relationship: co-operation, communication and system management (ref. MOU para. 7)

14.1 The SIB and ICS agree that there is a need for each to have access, wherever appropriate, to the information needed to fulfil their specific functions.

14.2 ICS will give enough time to allow the SIB to provide considered comments on drafts of its:

(a) annual management plan including budget proposals;

(b) annual report and accounts.

14.3 In accordance with the rule made by the SIB under section 54 of the Financial Services Act (the "compensation rules"), ICS will provide to the SIB a quarterly report giving details of the exercise by ICS of its powers of management. ICS will aim to submit this report within six weeks of each quarter end. The report will cover aspects of the work achieved, in the format as agreed, both for the quarter just ended and cumulatively for the current financial year up to the end of that quarter. The report will include a commentary by ICS as to trends, and as to performance against its objectives (as set out in the MOU), its management plans and its budget.

14.4 ICS will provide the SIB with a briefing before and after each meeting of the ICS Board on issues relevant to the SIB's role as outlined in the MOU.

14.5 In addition, meetings are envisaged as follows:

(a) The SIB Chairman will meet the ICS Chairman half-yearly.

(b) The SIB Chief Executive and the SIB Head of Supervision and Standards (Regulated Businesses) will meet the ICS Chairman and ICS Chief Executive monthly.

(c) Executive staff will meet on an ad hoc basis, as necessary, to exchange information and to deal with problems, issues and intended actions.

14.6 ICS recognise that the SIB has a wider role as manager of the regulatory system, and as such has an interest in the identification of, and regulatory response to, hazards to private investors. Accordingly, ICS will do its best to inform the SIB in a timely manner of any perceptions it might develop, through its experiences in the handling of claims, about any potential hazards to investors caused by the abuses and mischiefs it identifies in the use of particular products or in investment business practices.

14.7 ICS will also provide the SIB, at an early stage, with information on defaults which contain matters suggestive of dishonesty, negligence or incompetence on the part of individuals, so that appropriate regulatory action can be taken; but this is subject to any exceptions agreed between the SIB and ICS.

15 The relationship: accountability (ref. MOU para. 8)

15.1 ICS will inform the SIB in a timely manner of any issues (including problems arising generally or in relation to particular cases) which may be significant in the context of the SIB's role as outlined in the MOU. These may relate to the interpretation and implementation of the compensation rules, or to the interpretation of any rules and regulations made by the SIB or the SROs or to FSA regulatory policy or to lawsuits either against or on behalf of ICS.

15.2 ICS will also keep the SIB informed, where appropriate, of any intended actions for dealing with such issues; for example, when seeking external legal advice or when making a public statement on compensation policy. ICS will do its best to give the SIB sufficient opportunity to comment on any such issues or intended actions so that the SIB's comments can be taken into account by ICS.

15.3 The SIB will discuss in a timely manner with ICS regulatory matters which are relevant to the Scheme's understanding and operation of the compensation rules and will discuss and consult with ICS on proposed changes to the compensation rules and the consequences of these changes for the administration of the scheme; this will include those changes necessary to comply with the implementation of EC Directives.

15.4 ICS will do its best to inform the SIB in a timely manner of all compensation issues and cases which are likely to become the subject of public or

parliamentary concern and each will provide the other with such further information on handling and other actions as may be necessary or requested.

15.5 The SIB and ICS will do their best to discuss and agree any mutually relevant press notices and/or briefings, in particular those likely to receive high media attention or parliamentary attention. The SIB and ICS will inform each other in a timely manner of correspondence from an MP or MEP or a member of the House of Lords which relates to a claim for compensation or a potential default.

15.6 ICS will inform the SIB in a timely manner of the nature of any meetings arranged with HM Treasury and where appropriate invite the SIB to attend.

16 Review of MOU

The SIB and ICS will review the operation of the MOU from time to time. This MOU will be effective from the date of its signature by the SIB and ICS.