

The balancing act of compensation

Data and insight from FSCS to support discussion on the future of financial services compensation in the UK

May 2022
www.fscs.org.uk

Foreword

Financial services is one of the UK's most vibrant, innovative and important industries. It makes a major direct contribution to the UK economy as a sector in its own right, plays a vital role in supporting the wider economy, and sits at the heart of the global financial system. I want to see the UK maintain its pre-eminent position in financial services and carve out new opportunities presented by technological and digital innovation as well as climate change.

In this context, I welcome the acknowledgement by many, including industry leaders, regulators and government, of the important role FSCS plays in protecting consumers and helping to maintain trust and confidence in the sector. The UK's compensation framework plays an important role in underpinning the UK's flourishing financial services sector, giving many consumers the confidence to engage with financial services. Ultimately, all financial services market participants benefit from this.

However, recent increases in the levy are putting pressure on many firms. This threatens to undermine the competitiveness of a sector of vital importance to the UK. Addressing the root causes of consumer detriment is, in my view, the only sustainable way to reduce the levy. This entails a two-fold approach – rooting out bad actors and poor practices amongst the small minority of firms who engage in such behaviour and educating consumers to make well-informed, appropriate and suitable choices.

The UK is uniquely well-positioned to take advantage of the opportunities presented by technological change. But this also brings risks and our shared goal must be to make sure that innovation works in the interests of consumers and that they have the confidence, skills and the safeguards of a strong regulatory regime to fully engage with this brave new world.

In recent years, FSCS has significantly powered-up its data and insight capability, which provides valuable information in terms of the identification of emerging trends and areas of consumer detriment. This unique perspective means that FSCS is ideally positioned to be at the heart of the debate on helping to address the root causes of consumer detriment and ensuring better consumer outcomes.

We fully intend to be an active voice in this important debate over the next few years. The data and insights we are sharing in this document support the important discussion on the future of financial services compensation in the UK, and I would welcome the opportunity to discuss these further.



Marshall Bailey OBE
Chair



Introduction

FSCS has a critical role to play in the financial services industry. The FCA's recent Compensation Framework Review (CFR) discussion paper rightly mentioned the value of FSCS in protecting consumers and maintaining trust and confidence in the financial services sector. This review is taking place against the backdrop of large increases in our compensation costs, and thus increases in the levy on the industry, over the past five years. This is placing pressure on levy payers, and we have discussed at length that the only sustainable way to reduce this pressure is through addressing the underlying causes of consumer harm that results in compensation being owed.

It is a widely known fact that the size of the levy is not within FSCS's control. It is the result of unacceptable levels of harm concentrated in particular sectors of the market, primarily resulting from poor advice given to consumers over many years. It is only by addressing the root causes of this harm that we will be able to sustainably reduce the levy, and better protect consumers, over the long term.

I must acknowledge the progress already being made. Increased co-operation between FSCS and others in the regulatory environment has led to tangible results in areas such as phoenixing, and contributed to effective calls for policy change on issues such as online safety and extortionate fees charged to consumers who come to FSCS or the Financial Ombudsman Service for help via a third-party.

Whilst we continue to make progress on these and other issues which will help shift the dial over the long term, it is right that changes to the levy funding model are considered today. It is important to find the right balance between affordable costs for the industry and appropriate compensation for consumers who have lost what can be their life's savings and financial stability, and find the combination of levers to pull to make the right changes at the right time. It may mean accepting a rise in costs over the short term in order to build the strong foundations needed for the future.

We have been told that being transparent and sharing our insights is useful for the industry, and this report sets out some of the data we included in our response to the CFR discussion paper, supplemented with additional case studies and views from the FSCS team and beyond.

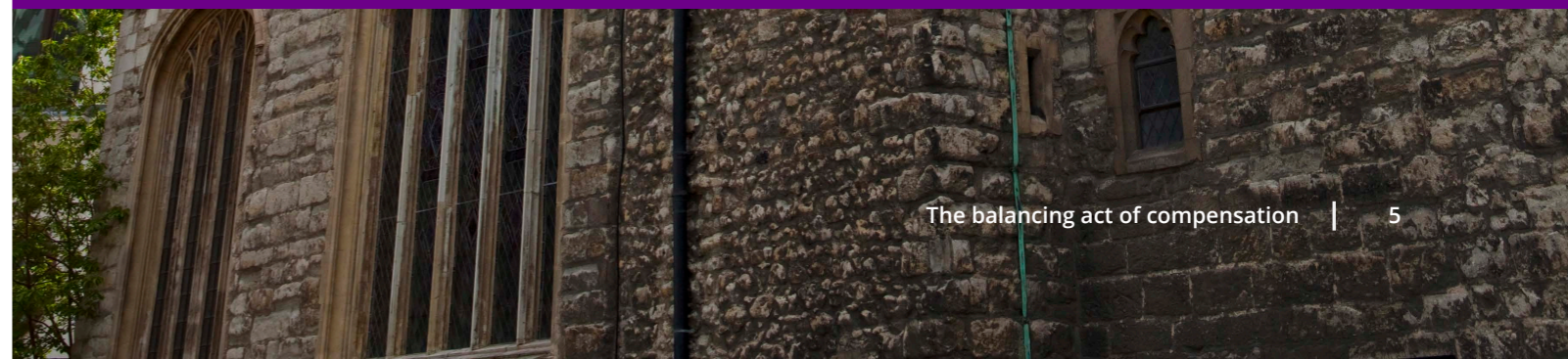
I hope what we have shared here is a useful contribution to the discussion on the future of compensation for consumers of financial services, and my team and I would welcome further conversations on any of the subjects raised here.



Caroline Rainbird
Chief Executive



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Compensation limits

FSCS believes that our current compensation limits remain appropriate for most products and activities covered by FSCS protection and continue to represent an appropriate balance between protecting consumers and the resulting cost to industry levy payers.

There is an important exception when it comes to pensions. In this specific area we believe that the FSCS compensation limit of £85,000 should be higher. We would like to see it reviewed, with a view to reducing the gap between FSCS's limit and the amount that the Financial Ombudsman Service can tell a business to pay, which is £375,000 as of 1 April 2022.

The history of FSCS compensation limits

When FSCS became a single compensation scheme in 2001, it was able to cover £31,700 of the money held by consumers in their bank or savings account and £48,000 for any investment business claims, which includes claims for pensions advice and switching, and the failure of SIPP operators.

The deposits compensation limit has risen three times since 2001, to £35,000, £50,000, and £85,000. The investment limit, which applies to most pension claims, has risen only twice, to £50,000 and then £85,000. Although today both limits are equal, they did not start that way. The deposit limit rise between 2001 and today has out-paced inflation, whereas pension protection is broadly worth the same as it was in 2001.

The limit for pensions and investments is now harmonised with deposits and most other FSCS limits, including products like Debt Management plans where losses are likely to be very small. Contracts of long-term insurance, such as annuities, are the only notable exclusion from the £85,000 limit for pensions, and a failure of a life

insurer offering these policies would see customers protected up to 100% of their claim with no upper limit.

Following consultation in 2018, the FCA announced that from 1 April 2020 onwards, the Financial Ombudsman Service's award limits would be automatically adjusted each year in line with inflation, as measured by the Consumer Price Index (CPI). On 1 April 2022 the maximum Financial Ombudsman Service award rose to £375,000. No such mechanism currently exists for FSCS's limits but we believe there is a strong case for it to be introduced.

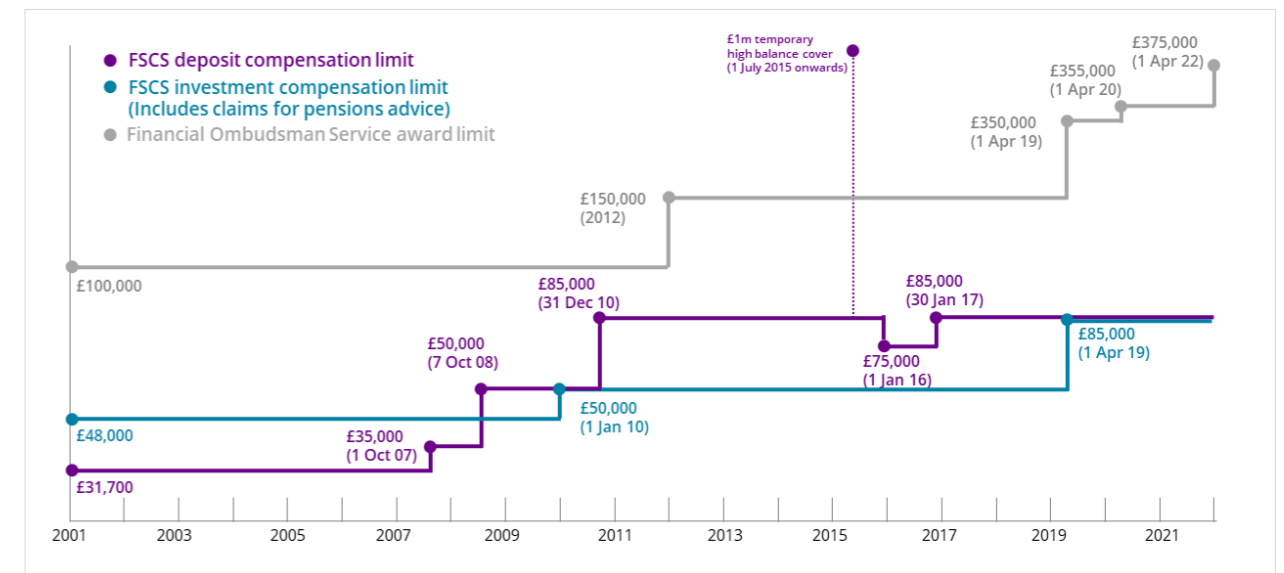
In the 2018 consultation the FCA said that 'while the number of 'high value' complaints is relatively small, there was a risk of very significant financial harm to complainants if they did not receive the full amount of compensation the ombudsman service considers due' and 'Complaints above the previous award limit typically involve insurance that protects consumers from a significant loss, advice on long-term investments that provide an income in retirement, or the investments themselves.'

We believe the same is true for customers who have a claim with FSCS.

During the consultation, the FCA did highlight the key difference between the Financial Ombudsman Service and FSCS – being that FSCS is a 'last resort' and does not require firms to pay for their own failings, instead relying on firms still active in the market to cover the costs of compensation. In the final policy statement, the FCA noted that the feedback they received included comments that their proposals would 'significantly increase the

existing discrepancy' but these respondents also 'tended to agree that the limits operated by the two organisations should not be aligned'.

The FCA also said in the final policy statement that the two organisations 'serve different purposes'. We don't believe that is a strong argument – particularly when you consider the volume of complaints that are passed from the Financial Ombudsman Service to FSCS when a firm is declared in default.



Compensation limit changes - 2001 to 2022 (to illustrate, not to scale)

"Helping consumers understand compensation limits is arguably easier when there is consistency – it does make our job simpler when we are explaining FSCS's protection.

But we do already have variation – insurance protection is set at a percentage rather than a fixed amount, and people understand other nuances such as temporary high balance cover.

I think consumers would much rather deal with a different limit for pensions, than face into a future where their retirement is no longer secure through no fault of their own, which is something we're sadly seeing every day with the limit as it is. It feels unfair that two people in virtually identical circumstances could receive radically different levels of compensation just because one dealt with a firm that has since failed."

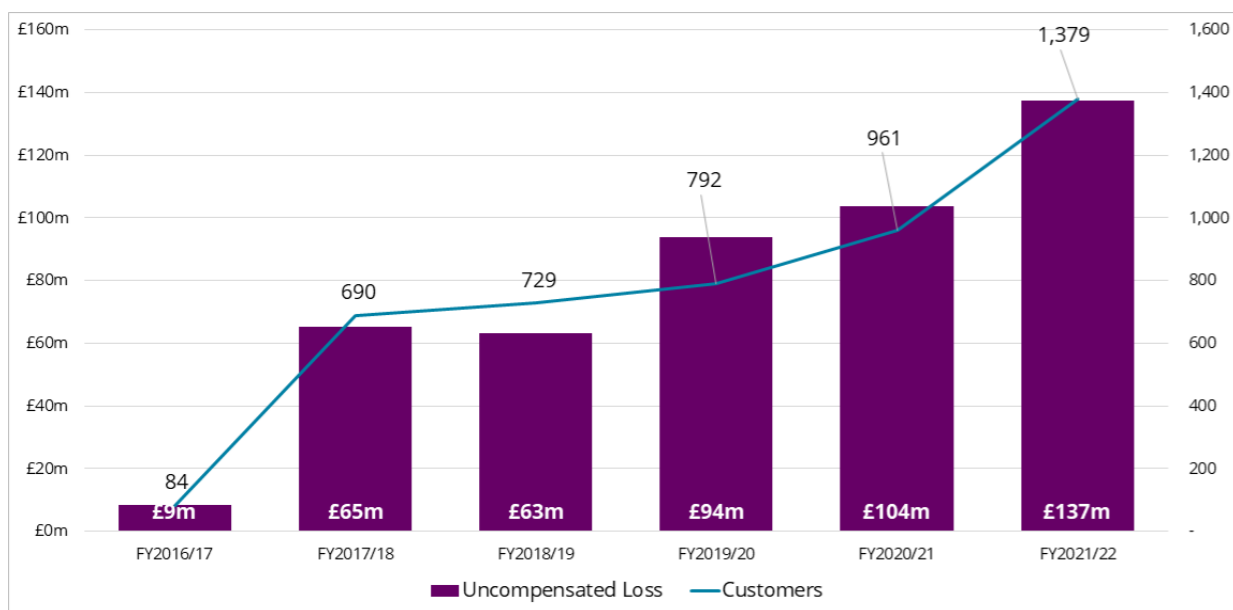
Emma Barrow, Head of Communications

The impact of customers' losses above FSCS's compensation limits

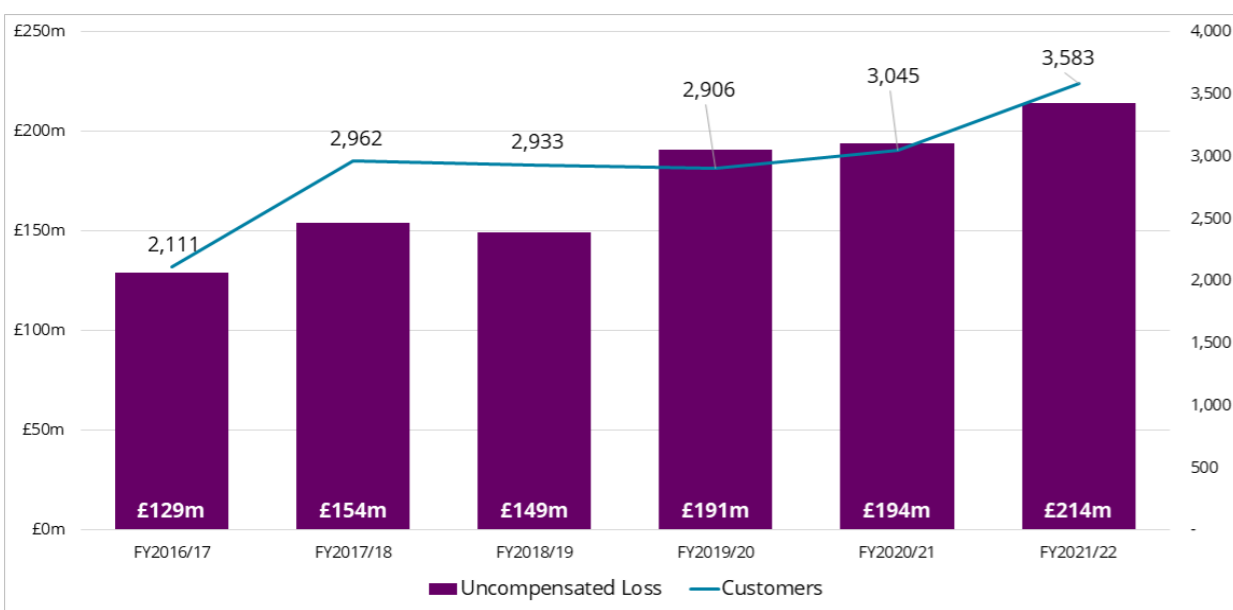
A key difference between pension claims and the other circumstances where FSCS can pay compensation to customers is the level of 'uncompensated loss', where the money we can return to customers is less than the total amount they lost due to FSCS's compensation limits.

For pensions advice claims, including pension transfers, the rise in uncompensated loss has been far steeper, and the average uncompensated loss per customer far greater than the average across all claim types.

The total number of claims where the customer's loss was over the relevant limit was almost 3,600 in the 2021/22 financial year that has just ended. This number has risen steadily over the past six years, and in that period has resulted in just short of £1 billion in loss not being paid back to customers as compensation.



Uncompensated losses for pensions advice claims - 2016 to 2022



Uncompensated losses for all claims - 2016 to 2022

Two successful claims, and still out of pocket

One of FSCS's customers originally made a claim in 2014, when they were 50 years old. They had worked for many years in Human Resources and three years earlier had received advice to transfer two existing workplace pensions from previous employers into a new SIPP. One element, a defined benefit scheme, had a transfer value of over £800,000 and valuable guaranteed benefits.

Once the transfers were complete, the firm advised the customer to invest around half of their total pot into three different funds within their SIPP – all high-risk, illiquid investments, and not in line with the customer's attitude to risk or within their tolerance for loss.

The customer lost virtually all their money, receiving some small amounts back from administration totalling a few thousand pounds. The customer noted that they knew there would be some risk involved in investing through a SIPP but that they didn't expect to be advised to invest with 'cowboys'. Their claim was upheld by FSCS and, as the firm failed before 2019, the customer received the maximum £50,000 in compensation.

In 2019, the SIPP provider itself failed, and the customer was able to make a second claim to FSCS against them – regarding their due diligence in accepting the high-risk investments into their SIPPs. Again, this claim was upheld and the maximum (this time £85,000) paid, enabling the customer to recover some of the uncompensated loss, but still leaving them significantly out of pocket and with a large hole in both their pension pot and retirement plans.

"The differences between the types of failure FSCS deals with are stark when it comes to how well we feel we are putting people back on track, and a lot of that is down to our compensation limits.

In recent years, most of the deposit failures we've seen have been credit unions. Very few of their customers were holding more than £85,000 in their accounts, and even if they had been, there is temporary high balance protection there to help in many cases.

When we declare an IFA in default, we see claims where customers have lost hundreds of thousands of pounds, life changing sums of money that we simply can't return due to the limits in place."

Simon Wilson, Head of Resolution

Improving consumer outcomes

When it comes to making financial decisions, the ability of consumers to access advice is an important part of the mix. It is extremely valuable to retail consumers and FSCS wants to see a vibrant financial advice sector in the UK.

We would support non-regulated firms and unauthorised introducers being excluded from the advice market for retail consumers. For example, they could be banned outright, brought within the scope of regulation or providers could be required to accept liability for these firms and their actions in the sales chain.

What should FSCS protect?

There is already a significant amount of work taking place in the industry and through regulation and legislation to support consumers with their financial decisions and improve outcomes. In the areas linked to FSCS compensation, this includes the FCA's Consumer Duty, a requirement on firms to promote PensionWise appointments, the Pensions Dashboards Programme and the FCA's Consumer Investments Strategy.

Whilst these initiatives are underway, they will take time to bear fruit, and we do not believe that FSCS protection for consumers against unsuitable advice should be removed in the meantime. Perhaps in the future protection may not be needed, but taking away our ability to pay compensation today does not feel like it would strike the right balance between protecting consumers and running an affordable service for the industry.

Advice is an area where the costs of compensation are rising, with around 78% of our claims linked to financial advice. We expect these costs to remain high for a number of years as most of our customers

come to us many years after the harm of poor advice took place.

Consumers now face a myriad of entry points to the financial services sector. Whether through a regulated firm, an appointed representative, or an unauthorised introducer. They are bombarded with recommendations and offers through cold calling, unsolicited emails, social media, online adverts, and 'finfluencers'.

FSCS has particular concerns about the role of the unregulated firms and unauthorised introducers - operating close to, and sometimes crossing over into, regulated activities - and believe it is open to abuse. These firms and individuals are operating in the UK, and abroad, and of course are not contributing to the FSCS levy so will not be concerned with rising costs of compensation.

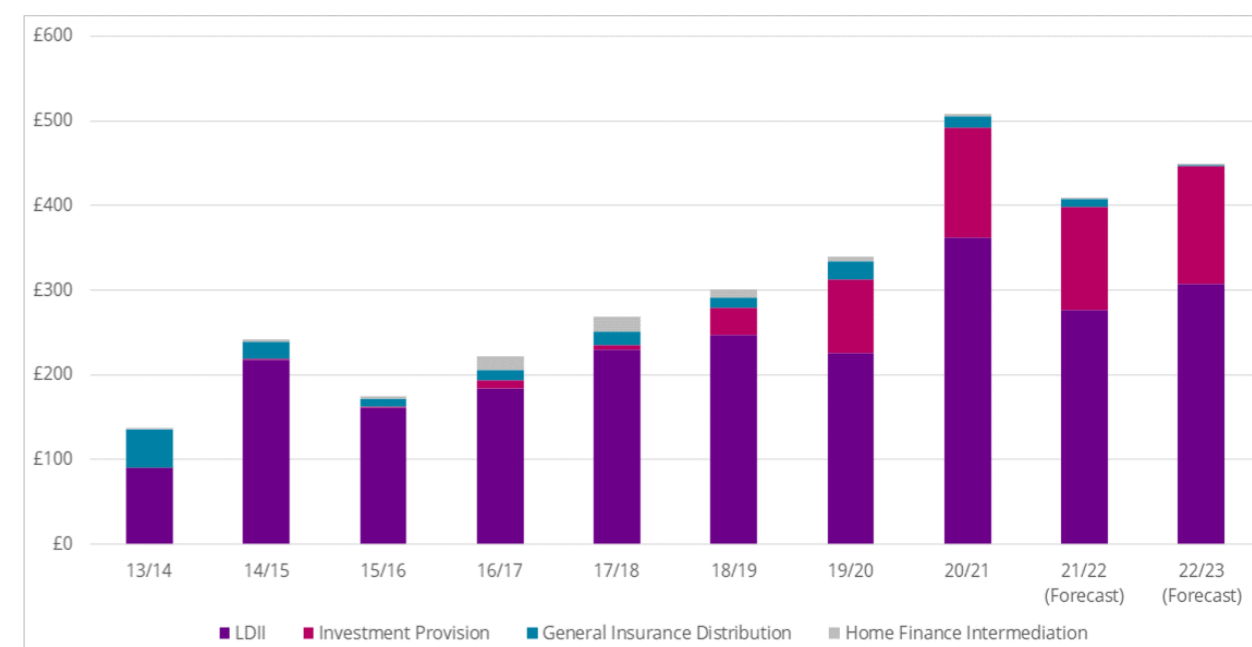
Consumers are facing a lack of transparency and are often not able to work out whether the role of unauthorised parties in the sales chain is something that is protected or not and may assume they are covered by the fact there is a regulated provider involved at the end of the chain.



"The 'advice gap' is something that worries me. Consumers who neglect or are not able to take regulated advice when making significant decisions about their finances, such as their pension, will likely end up with fewer protections and less chance of recovering any losses through compensation if something goes wrong.

Coupled with low-levels of financial literacy in the UK, it feels like we should be doing more to look at how poor practice and 'bad actors' can be eliminated from the industry, and under-served groups can be helped to access the advice they need."

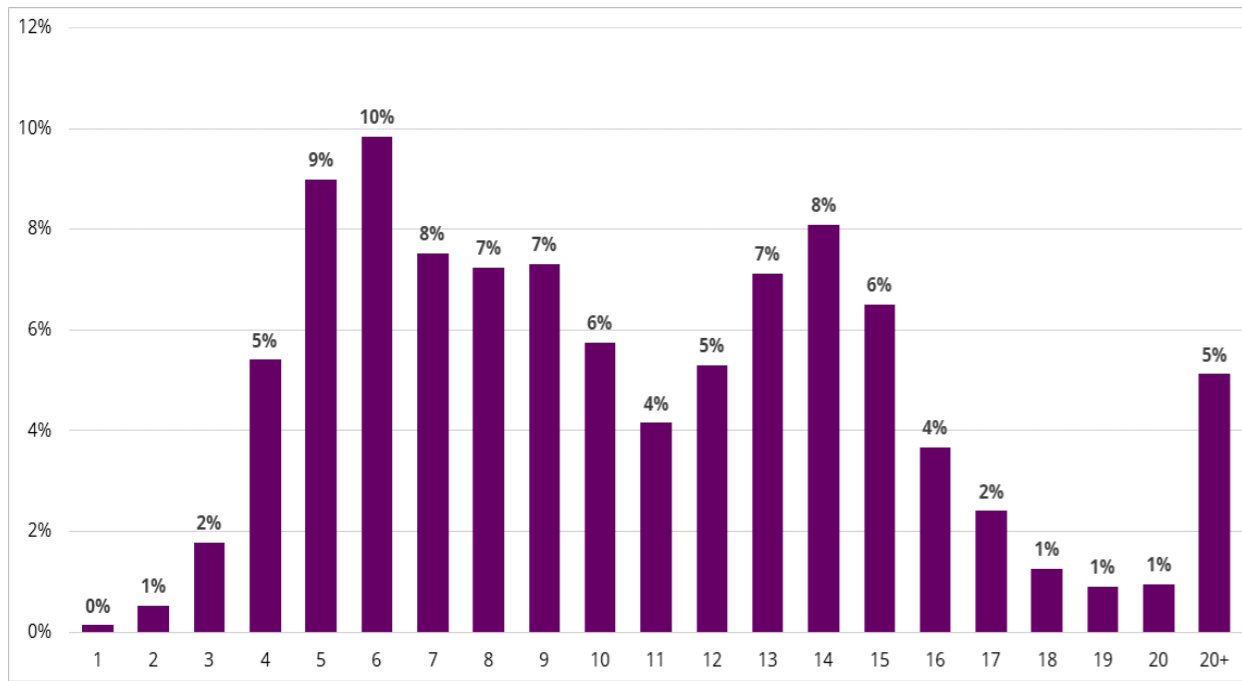
Jonathan Pallant, Head of Stakeholder and Public Affairs



Compensation costs for advice claims in £m - 2013 to 2023. Prior to 2019/20, figures shown for LDII are the sum of the old Life & Pensions Intermediation and Investment Intermediation funding classes.

An **appointed representative** is a person or firm who can undertake regulated activities, such as providing financial advice, but only as an agent of another firm who the FCA directly authorise. The directly authorised firm is known as the 'principal'.

An **unauthorised introducer** is a term FSCS uses to describe a person or firm who isn't able to undertake any regulated activities, as they are not authorised themselves nor are they an appointed representative of another firm.



Number of years between advice and claim - as a percentage of claims decisions made between 2018 and 2022

Who should FSCS protect?

We believe that the current framework is protecting the right groups of people and should be maintained. Eligibility is something which should be considered on an ongoing basis, to reflect changes which may take place in the financial services sector over time.

Our data tells us that removing eligibility for consumers based on categorising them as 'high-net worth' or 'sophisticated investors' would have a minimal impact on the compensation we pay. 95% of customers who have made a claim with us since 2018 earn a salary of less than £100,000, which is the current definition of a 'high-net worth' individual.

We also believe that many people who would be caught under these definitions would be unlikely to have the capacity to absorb the losses we see that they are experiencing, nor the resources to take private legal action.

Other ways of limiting individual eligibility have been proposed, such as focusing protection on consumers who were vulnerable at the time they dealt with the firm which they are claiming against, something that would be extremely difficult to define.

We believe that these types of restrictions would only serve to undermine the comprehensive nature of the UK's compensation framework and the key role it plays in encouraging consumers to use, and trust, financial services.

At a time when the FCA's Consumer Investments Strategy hopes to encourage more people to engage with suitable investment opportunities, we believe that any move to reduce the number of people eligible for FSCS protection may undermine these aims. We welcome the focus the FCA is putting in this area and we continue to collaborate with them.

Pressure to invest

This customer's initial claim to FSCS was rejected, as it was found that a firm still in business may be responsible for their losses. However, in 2019, the firm failed, and they were able to return to FSCS. By this time, they had lodged a complaint with the Financial Ombudsman Service which had been upheld.

The customer and her husband had attended a seminar about overseas investments. Neither of them were high-net worth or sophisticated investors. An unauthorised individual at the event introduced the couple to an adviser, who then referred them to a second adviser – as the first did not have pension transfer permissions.

The customer had modest retirement plans. She wanted to stop working at 65, with an income of roughly half her current salary. At the time, she was around 50 years old and earning £16,000 per year. She had a current defined benefit pension with a transfer value of just over £100,000 at the time of receiving advice. She was advised to transfer this value into a SIPP and make a number of high-risk investments.

The evidence shows that the customer and her husband had gotten 'cold feet' on more than one occasion, but the unauthorised party was instructed to speak to them to endorse the investments being suggested – overseas property in this instance.

FSCS was able to pay compensation of £85,000 in 2020. By this time, the estimated value of the original pension benefits was over £300,000 and the value remaining in the customer's SIPP (including withdrawals and incentive payments for some of their investments) was just £48,000. The customer's uncompensated loss was over £172,000.

"We analysed a sample of around 1,200 claims made against two large SIPP operators and looked at the named individuals and firms that customers told us about in their evidence.

71% of these claims involved an introducer who we believe is unregulated. 18% of the claims involved a regulated introducer, and 11% we were unable to identify. We're continuing to explore our claims data and share our findings with the FCA to support their work."

Tim McKeegan, Insight Manager

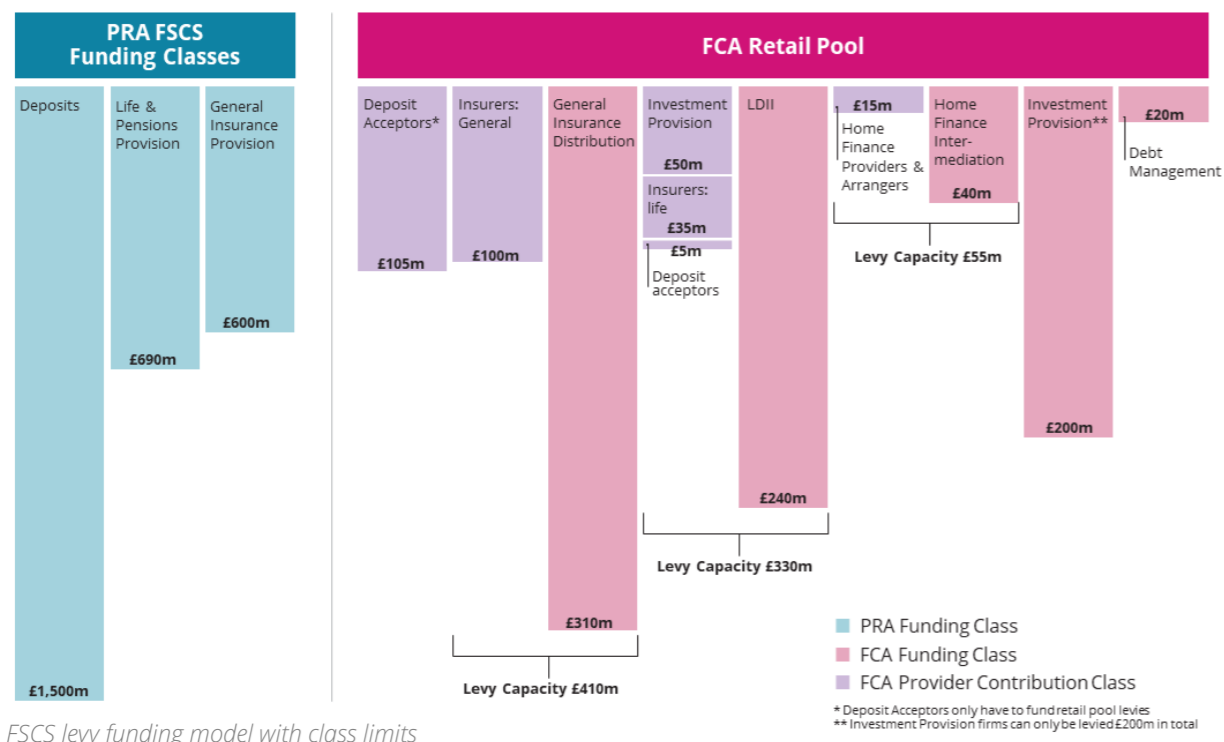
Compensation costs

We recognise that parts of industry do not support the current model of FSCS funding. Although a change to how the levy is paid will not solve the problem of high compensation costs directly, FSCS supports the exploration of alternatives to the current funding framework.

Any changes would likely alleviate the problem for some, whilst adding pressure elsewhere, so any options would require a lot of consideration and scrutiny from all angles.

FSCS's compensation costs are apportioned to different funding classes up to set class limits. This means, as far as possible, levy payers cover the cost of the failure of firms carrying out similar business. These classes are:

- **PRA Funding Classes:** Deposits, Life & Pensions Provision, General Insurance Provision
- **FCA Funding Classes:** Deposit Acceptors, General Insurance Distribution, Investment Provision, Life Distribution and Investment Intermediation (LDII), Home Finance Intermediation, Debt Management and Funeral Plans (from July 2022).



FSCS levy funding model with class limits

Levy limits and the retail pool

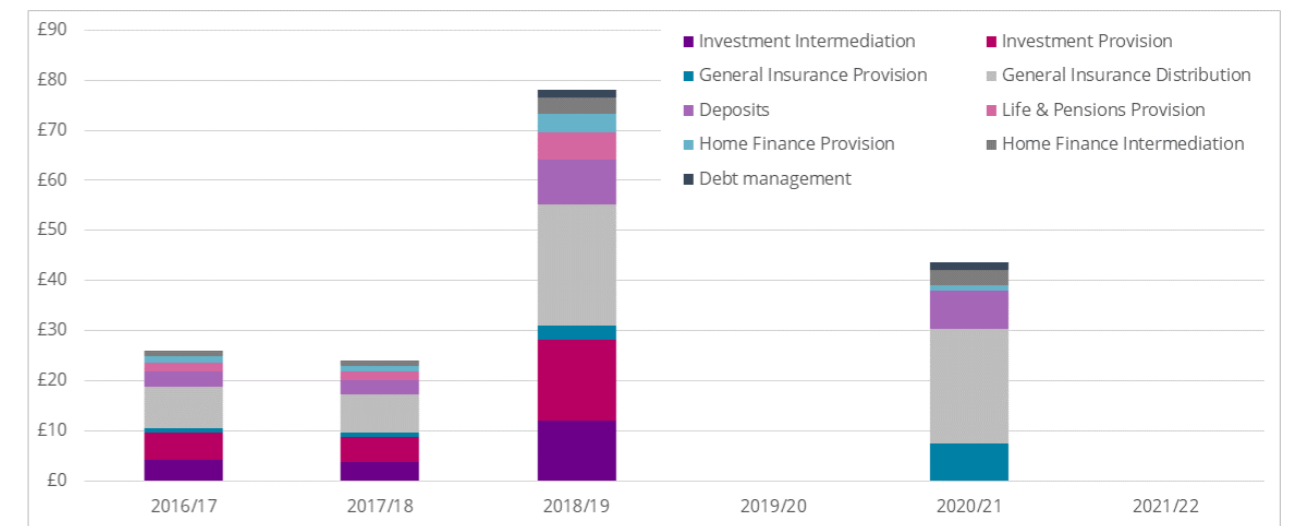
In the FSCS funding model each class has a levy limit or 'threshold' which is the maximum amount of costs which can be allocated to that class in a financial year. If costs exceed the threshold, they are shared across a wider retail pool.

The retail pool was introduced as a result of the 2006/07 funding review and was initially designed to fund a systemic crisis which affects the entire financial services industry, regardless of where the crisis occurs. It was subsequently recast as being used on the occasional breach of a funding class threshold. However, due to the rising costs of compensation, we have witnessed increasing

calls on the retail pool. Between 2016/17 and 2021/22 it has been used four times in six years.

The retail pool in particular is leading to calls for change from industry and trade bodies. BIBA's 2022 Manifesto makes this point clear when it states "The regulatory framework should never allow for a demand of many hundreds of percent of their actual levy requirement to be made on firms that are well managed, low risk and are not connected to the 'polluting' sector".

BIBA's members primarily pay levies in the General Insurance Distribution class. This class is particularly impacted when



Retail pool contributions by class in £m - between 2016 and 2022

contributions to the retail pool are required. For example, the total levy for this class was £12m in 2019/20 but rose sharply to £41m in 2020/21 - £29m of which was a contribution to the retail pool. This contribution mainly covered compensation for customers of firms who dealt with investments and pensions advice, not failed brokers or insurers.

FSCS believes that the concept of a retail pool remains valid. There must be a mechanism for compensation costs to be covered when it becomes unaffordable for a single class to pay, and as the industry as a whole benefits from the confidence and stability FSCS protection adds to the market, it is appropriate that it continues in some form.

However, we do believe it is being called upon too often and we acknowledge that how these costs are shared amongst the industry needs further consideration.

"We speak to the industry as often as possible about the work FSCS does, and the levy, through our publications and engagement with trade bodies across the different sectors.

Typically, comments challenging the levy fall into two themes - it's unaffordable, and it's unfair. The retail pool in particular clearly drives a lot of frustration for firms."

Tim Furness, Head of Finance

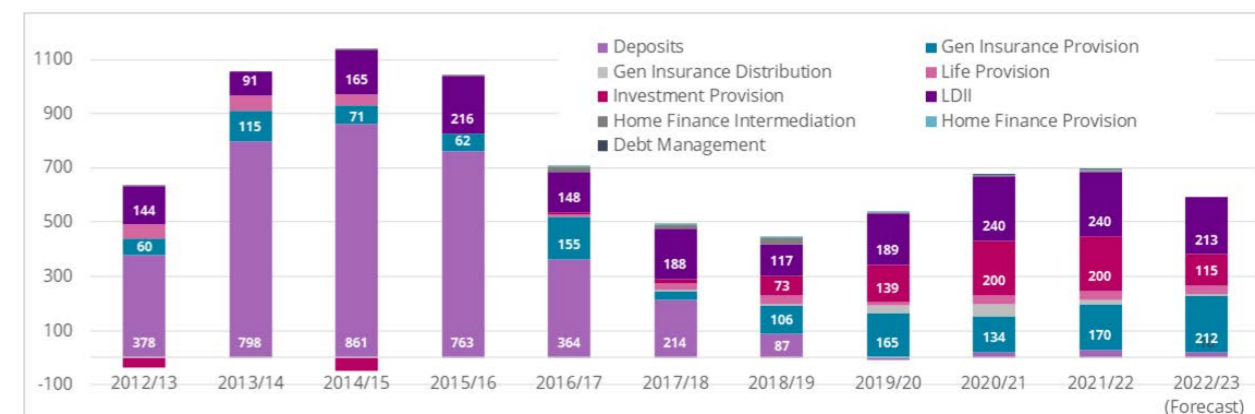
Influencing the cost of compensation

The sharp increase over recent years in overall costs has been driven primarily by claims arising from the two FCA investment related funding classes – Life Distribution and Investment Provision. These two classes together accounted for 66% of FSCS's total compensation costs in 2021/22 and LDII has seen compensation costs at or above its class threshold for the last three years.

Our forecasts suggest that costs in these classes are likely to remain high for several years. In part, this is because large numbers of consumers, approximately 80%, bring claims to us at least five years after the initial advice had been given.

This lag occurs for multiple reasons – many consumers do not realise they have been given unsuitable advice until years later, sometimes due to low levels of financial literacy or simply inertia. In the case of pensions, simply because it's often only when they retire, or are close to retirement, that many consumers look at the value of these assets and realise something is wrong.

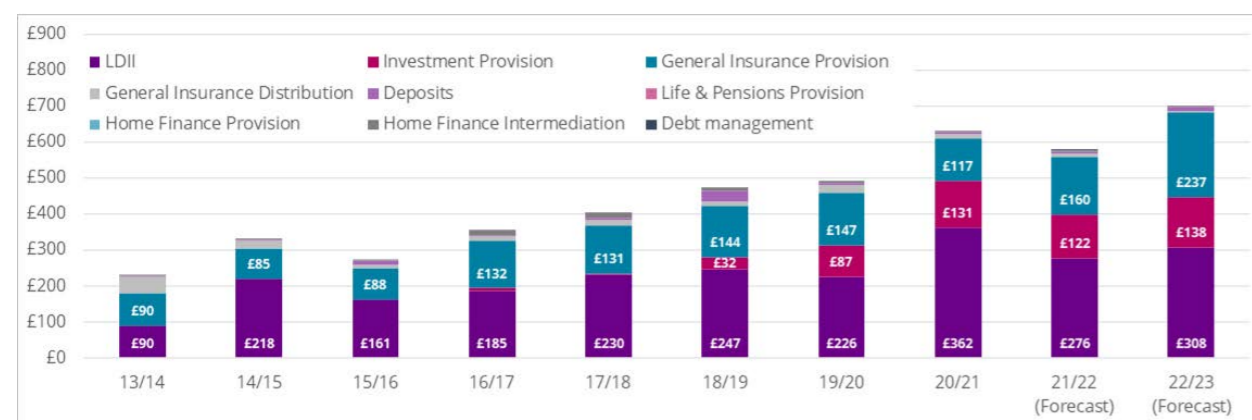
Additionally, firm failure often occurs slowly as does the completion of insolvency proceedings. We often find individuals who have made complaints to the Financial Ombudsman Service whilst the firm was in business which cannot be moved over to an FSCS claim until the firm fails.



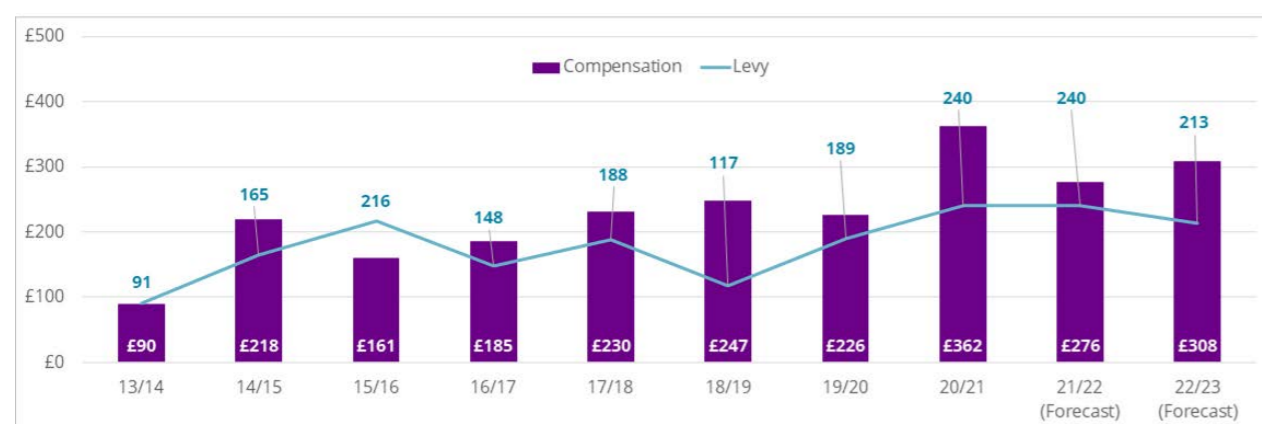
Levy paid by funding class in £m - from 2013 to 2023. Prior to 2019/20, figures shown for LDII are the sum of the old Life & Pensions Intermediation and Investment Intermediation funding classes.

FSCS is open to the FCA making changes to the current funding model, whether these be tweaks to the position today or more fundamental long-term changes. We are however keen that the debate around the levy does not become overly dominated by a short-term focus. Strengthening the UK's compensation framework and ensuring that it continues to effectively fulfil its role within the UK financial services eco-system, on an effective and sustainable long-term basis, should be the ultimate goal.

We would support further analysis of alternative funding models and believe that the FCA and industry should work together to analyse the merits and feasibility of these options. Coming to a consensus on potential solutions may well be difficult, as any changes will likely lead to a new set of 'winners and losers' across the industry as a whole.



Compensation paid by funding class in £m - from 2013 to 2023. Prior to 2019/20, figures shown for LDII are the sum of the old Life & Pensions Intermediation and Investment Intermediation funding classes.



Compensation and levy for the Life Distribution and Investment Intermediation (LDII) class in £m - from 2013 to 2023. Prior to 2019/20, figures shown for LDII are the sum of the old Life & Pensions Intermediation and Investment Intermediation funding classes.

"Stabilising the levy and moving into a space where it is sustainably decreasing is a tough ask. We could resort to blunt instruments such as lowering compensation limits or removing certain groups of customers from protection, but that would just be masking the real issues.

Our data doesn't tell us that measures like these will make any significant dent in the costs today, especially as we know we have harm that has already happened waiting to come through as claims.

"What we need is reform. This is already beginning, with the Future Regulatory Framework review, the Compensation Framework Review, Online Safety Bill, and countless other avenues where progress is being made. Focusing on these opportunities and making sure every voice is heard during the consultations and debate is key."

Jay Sheth, Head of Policy

About FSCS

The Financial Services Compensation Scheme (FSCS) can pay compensation when authorised financial firms go out of business. It is independent, provides a completely free service for consumers and is funded by the financial services industry.

FSCS is best known for protecting deposits held in banks, building societies and credit unions. It can also pay compensation for insurance, investments, investment and pension advice, home finance advice, PPI and debt management plans. From July 2022 it will also protect funeral plans.

FSCS's mission is to provide a trusted compensation service which helps to raise public confidence in the financial services industry.

FSCS is the statutory UK compensation scheme to protect consumers of financial services, set up by parliament under the Financial Services and Markets Act 2000 (FSMA). FSCS can step in when a regulated firm is unable to meet its customers' claims. This year we are celebrating our 21st birthday.

Our service is free to the individuals and businesses who need our help. By providing this service, FSCS contributes to market confidence, supports financial stability and protects consumers.

FSCS is operationally independent but accountable to the Bank of England (PRA) and the Financial Conduct Authority and operates within the rules set by the regulators.

Since the scheme began on 1 December 2001 FSCS has declared more than 4,200 firms in default, paying out £26.5bn in compensation to 6.5m customers who lost money as a result.

In addition to paying compensation to customers of failed firms, FSCS also makes recoveries where it is cost-effective to do so to offset the costs levied on the industry. Since 2015 we have recovered more than £280m from the estates of failed firms and third parties, such as professional indemnity insurers.

You can find out more about FSCS and our strategy on our website at www.fscs.org.uk/about-us/



FSCS submitted an extensive and detailed response to the FCA's Compensation Framework Review (CFR) discussion paper.

If you would like to discuss any aspect of this report or our response to the CFR discussion, please speak to your usual FSCS contact, or you can email us at **communications@fscs.org.uk**

