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Financial Services Authority
**Financial Services
Compensation
Scheme Draft Rules**

July 2000



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Annex A: Feedback from CP24 'Consumer Compensation: a further consultation' and FSA's response.

Annex B: Draft Rules

The FSA would welcome comments on this consultation paper. Comments should reach us by 20 September 2000.

Please send comments by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/pubs/cp/58_response.html).

Alternatively, comments may be sent in writing to:

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

1 Executive summary

- 1.1 This consultation paper seeks comments on the draft rules for the new single Financial Services Compensation Scheme (the Scheme). The rules and guidance will apply to the Financial Services Compensation Scheme Limited (FSCS Limited), which the FSA has appointed as the Scheme Manager, and determine the amount of any compensation payable to consumers. They will also, insofar as levies are concerned, apply to firms authorised under the Financial Services and Markets Act (FSMA) and firms from the EEA which participate in the Scheme.
- 1.2 The draft rules and guidance are broken down into five main areas:
 - The powers and accountability of FSCS Limited, (the Scheme Manager).
 - The conditions to be met before compensation can be offered.
 - The basis for assessing how much compensation should be paid.
 - How the industry will fund the Scheme.
 - EEA firms' participation in the Scheme.
- 1.3 As explained in the introductory chapter, these rules are applicable to FSCS Limited. The rules are also relevant to authorised firms required to participate in the Scheme.
- 1.4 Chapter 13 of the rules will deal with the funding of the Scheme and recovery of costs from the participating firms. It is proposed that the levy contribution groups will take into account the FSA fee categories, which are currently the subject of a separate consultation paper. Therefore the detailed levy rules will be the subject of a separate consultation exercise later in the year.
- 1.5 Claimants may be interested in the chapters dealing with eligibility, calculating and paying compensation. The rules also provide for FSCS Limited to issue guidance. The FSA expect that FSCS Limited will seek to issue separate consumer guidance on the scope of, and access to, the Scheme in due course.

This is in addition to the general consumer information produced by the FSA's Consumer Education department.

1.6 The key policy changes compared with the existing compensation arrangements are:

Limits on compensation

- 100% cover to be available for the first £2,000 of a claim made to the deposit and insurance sub-schemes
- The amount of deposit that qualifies for protection to be increased to £35,000 i.e. a maximum payment of £31,700 (100% x £2,000 plus 90% x £33,000)

Eligibility to claim

- Large corporates are to be excluded from deposit protection
- Large partnerships are to be excluded from protection for claims on non-compulsory general insurance policies and cover is to be extended to small companies
- The deposit sub-scheme will cover deposits in all currencies

1.7 The new Scheme's limits are set out in the right hand column of the table below.

	Current limits	Proposed future limits
Deposits	£18,000 (90% of £20,000)	£31,700 (100% of £2,000 and 90% of £33,000)
Investments	£48,000 (100% of £30,000 and 90% of next £20,000)	£48,000 (100% of £30,000 and 90% of next £20,000)
Long-term insurance	at least 90% of value attributed to policy, including future benefits declared before date of default	at least 90% of value attributed to policy, including future benefits declared before date of default
General Insurance	<i>Compulsory:</i> 100% of valid claim/unexpired premiums <i>Non-compulsory:</i> 90% of valid claim/unexpired premiums	<i>Compulsory:</i> 100% of valid claim/unexpired premiums <i>Non-compulsory:</i> 100% of the first £2,000 of valid claim/unexpired premiums and 90% of remainder of claim

- 1.8 The policy in the rules reflects the results of two public consultation exercises, CP5 in 1997 and CP24 in 1999. It also takes into account the results of consumer research commissioned by the FSA in 1999 and meetings with representative bodies.
- 1.9 The FSA has decided that a review of the individual claim limits and co-insurance structure will take place within 3 years of N2 and at appropriate intervals thereafter. In carrying out the review, the FSA will take into account the type, nature and frequency of defaults, the risks to consumers and to consumer confidence, the impact on contributing firms and the merits or otherwise of further harmonisation of the limits.
- 1.10 The draft rules reflect discussions with the three existing operational schemes, the Deposit Protection Board, the Investors Compensation Scheme and the Policyholders Protection Board, and the views of the other schemes have been taken into account.
- 1.11 The FSA will be consulting on the rules dealing with the transitional arrangements and detailed funding issues later in the year.
- 1.12 The FSA seeks comments on these rules by 20 September 2000. We shall take account of the results of this consultation before publishing the final rules.

2 Introduction

Context

- 2.1 When the Financial Services and Markets Act (FSMA) comes into force, a new single Financial Services Compensation Scheme will replace the existing compensation schemes for investment business, deposits and insurance. This will create a single point of contact for consumers in the event of a financial services firm being unable to pay claims against it.
- 2.2 The Financial Services Compensation Scheme Limited has been established by the FSA as Scheme Manager for the new single compensation scheme. The Financial Services Compensation Scheme Limited is referred to throughout the paper as the 'FSCS Limited'. FSCS Limited was incorporated and its board of directors appointed by the FSA in February 2000. The Board is chaired by Nigel Hamilton, formerly an insolvency partner with Ernst & Young. The Board is now starting on its programme of work to establish the organisational structure of the Scheme. An important first step will be the appointment of a Chief Executive, expected in early Summer 2000.
- 2.3 In December 1997, the FSA published Consultation Paper 5: Consumer Compensation (CP5) which sought initial views on the Government's proposal for a single compensation scheme, including its governance and structure. Then, in June 1999, the FSA published a further consultation paper, CP24, with more detailed policy proposals and an outline of the new Scheme's internal structure (i.e. sub-schemes and contribution groups) taking into account the responses to CP5. In particular, the paper asked for comments and views on the limit on the amount of compensation payable on a single claim, who should be eligible to claim compensation and how the Scheme's costs should be allocated amongst authorised firms.
- 2.4 This paper is the next stage in the formal consultation process to create rules to govern the new single compensation Scheme. It also includes, in Annex A, a summary of the views expressed in responses to CP24 and the FSA's response to those views.

- 2.5 The draft rules take into account the European Directives on Deposit Guarantee Schemes and Investor Compensation Schemes (Directives 94/19/EC and 97/9/EC). The Directives are designed to provide a minimum level of protection to depositors and investors in their own state when banking or investing with a branch of a firm which under its home state ‘authorisation’ is able to carry on those transactions in other EEA states, using the Investment Services Directive (ISD) or Second Banking Coordination Directive (2BCD) passport rights. These firms are commonly known as ‘passporting’ firms.
- 2.6 The Deposit Guarantee Directive (DGD) requires EEA member states to have in place a compensation scheme for protecting consumers placing deposits with firms using a passport to carry on business in the EEA. The DGD requires EEA states to exclude certain categories of person (credit institutions and money launderers), and permits exclusion of other types of person, from the scope of the deposit guarantee scheme (principally large companies, financial institutions, government and municipal authorities, and persons connected with the failed firm).
- 2.7 Similarly the Investor Compensation Directive (ICD) requires EEA member states to have in place a compensation scheme for protecting investors of passporting investment firms. The ICD has no compulsory requirement to exclude particular types of person, but it grants states a similar discretion to exclude certain classes of person from the scope of the scheme.
- 2.8 The draft compensation rules set out the way in which the UK proposes to meet its obligation to provide compensation to consumers under the DGD and ICD.
- 2.9 The FSA is still considering its policy concerning compensation arrangements for customers of professional firms and is in discussion with the professions’ governing bodies on this issue. Similarly the subject of compensation for credit union customers will be addressed separately. The FSA is also considering the compensation arrangements for consumers purchasing stakeholder pensions and will consult later in the summer on the proposed regime.

The draft rule book

- 2.10 The FSA is consulting now on the draft rules and it intends, following this consultation, to make the rules for the new Scheme before Christmas. Following this, we understand that the Board of the new Financial Services Compensation Scheme will seek to put in place detailed procedures for the operation of the new Scheme by the time that the FSMA comes into effect. This date is known as N2.

- 2.11 The levy arrangements will form Chapter 13 of the rules and following confirmation of the FSA fee categories, will be the subject of a separate consultation exercise. This paper sets out the principles and approach we intend to adopt when drafting these rules.
- 2.12 The rules and guidance will apply to the Scheme and authorised firms but will also have implications for consumers applying for compensation as they will define the circumstances in which compensation is payable.
- 2.13 Section 4 provides a commentary on the draft rules. The text of the rules is contained in Annex B.
- 2.14 This draft reflects comments received from the existing compensation schemes, in particular the Deposit Protection Scheme, the Investors Compensation Scheme Limited and the Policyholders Protection Board. We have also received comments from representatives of the Building Societies Investor Protection Scheme, the S43 Scheme, and the Friendly Societies Protection Scheme. We are grateful for the comments provided.

Powers to make rules

- 2.15 Section 212 of the FSMA gives the FSA an express duty to establish by rules a scheme for compensating consumers in cases where relevant persons are unable, or are likely to be unable, to meet claims against them. Sections 213 to 215 list a number of provisions that may be made by the rules e.g. power to define eligible claimants and limits on compensation payments. The provisions in the FSMA provide the framework around which the rules, and the policy underpinning them, are based.
- 2.16 Sections 155(2)(a) and 157(3) of the FSMA require a cost benefit analysis to be provided in relation to proposed rules and guidance. Such an analysis is included in section 5 of this paper. Our conclusion is that the new single Scheme provides a significant improvement in the scope and level of protection available to consumers and small businesses, particularly in respect of deposit protection.

Text Reduction

- 2.17 The FSA is satisfied that the draft Compensation Scheme Rules meet the FSA's commitment that new rules made by it achieve a reduction in volume of over 30% from the rules and legislation they will replace.

Transitional arrangements

- 2.18 The FSA is now considering the arrangements for the transition from the existing compensation schemes to the new single scheme and will consult on this subject in due course.

Consultation process

- 2.19 The draft text of the Compensation Rules is available on the FSA's website (www.fsa.gov.uk). Responses should be sent to Dean Brennan at the FSA by one of the methods listed on page 2 of this paper. It is the FSA's policy to make all responses to formal consultations available for public consultation unless the respondent requests otherwise.
- 2.20 Comments should reach us by **22 September**. We plan to publish the final version of the Compensation Rules in early 2001. The operation of the new compensation arrangements in accordance with these rules will commence when the relevant provisions of the FSMA come into force.

3 Compatibility with the FSA's general duties under the Financial Services and Markets Act

- 3.1 This section sets out why the FSA believes the rules and guidance in the draft rules are compatible with its general duties under section 2 of the FSMA, and are also the most appropriate way of meeting those objectives. The requirement for such a statement is set out in sections 155(2)(c) and 157(3) of the FSMA.

Background

- 3.2 The FSMA requires the FSA to make rules establishing a single compensation scheme for the compensation of investors, depositors, and policyholders in the event of an authorised firm being unable or likely to be unable to meet claims against it. However, in making the rules, the FSMA gives the FSA discretion in a number of areas including who may receive compensation, how much they may receive, and the circumstances in which they may receive it.

The market confidence objective

- 3.3 The FSA is satisfied that the new compensation package, a mixture of new extensions and restrictions to the existing arrangements, will make a positive contribution to the achievement of the market confidence objective by focusing cover on those individuals and small businesses least able to sustain a loss. Retail consumers will be able to enter the market confident that, having taken reasonable steps to identify that a firm is authorised, they will be protected at least in part against the risk of their financial services provider becoming insolvent and being unable to meet claims against it.

The consumer protection objective

- 3.4 The FSMA requires the FSA to have regard to the differing degrees of experience and expertise of customers when securing the appropriate degree of protection for them. Accordingly compensation cover is to be largely directed towards private individuals and small businesses. Our research has

shown that it is these categories of consumer who have the lowest levels of experience and expertise in dealing with financial services providers, and are least able to sustain a loss should a firm be unable to meet claims against them.

- 3.5 The FSA has decided not to seek harmonisation of levels of cover as an automatic policy. Our priority has been to maintain the levels of consumer protection offered by the existing schemes and only change these arrangements where we believe it is clearly justifiable. For this reason, the three sub-schemes will not at this stage offer the same level of cover.
- 3.6 When selecting the level of cover that should be provided including the limit, if any, on the amount of compensation payable, and the portion of any loss claimants should bear themselves, the FSA also took into account the degree of risk involved in different transactions, the sums potentially at risk, and the level of cover provided by the existing schemes. These different sectoral approaches have each been the subject of debate over the years and now represent workable approaches that are broadly acceptable to all interested parties. Industry responses to CP24 have shown broad support for the current arrangements, while consumer research highlighted the need for a degree of 100% protection for deposits as the highest priority.
- 3.7 The FSA also considered the effect the provision of compensation may have on the behaviour of consumers and regulated firms when selecting the appropriate degree of protection to be provided by the compensation scheme. Section 5 – Cost Benefit Analysis explains why the FSA considers that the new compensation package minimises any negative effect on the behaviour of consumers and authorised firms. (See also CP24, paragraphs 4.13–24). The FSA considers that the new compensation package meets the requirements of the FSMA by securing the appropriate degree of consumer protection, taking into account the differing degrees of risk involved in different transactions and the general principle that consumers should take responsibility for their decisions.

The public awareness objective

- 3.8 FSCS Limited will have the power to issue guidance to the public about the operation of the Scheme and other matters that it considers relevant to the business of the Scheme. FSCS Limited also has a general duty to take reasonable steps to inform potential claimants as soon as possible, in a manner it deems most suitable, where a firm protected by the Scheme is unable to meet claims against it.
- 3.9 The draft Scheme rules will allow FSCS Limited to co-operate with the FSA and share its experience and knowledge. This will also assist the FSA in designing a consumer education programme that best contributes to the achievement of the public awareness objective.

The reduction in financial crime objective

- 3.10 Where permitted, FSCS Limited will be expected to pass to the FSA any evidence of financial crime uncovered by it when determining if a failed institution is unable to meet claims against it or verifying claims for compensation.

Compliance with General Duties

- 3.11 Section 2(3) of the FSMA sets out the matters to which the FSA must have regard in exercising its rule-making and general functions. The FSA's reasons for believing that the provisions of the draft compensation rules are compatible with having regard to those principles are set out below.
- (a) The need to use its resources in the most efficient and economic way*
- 3.12 The FSA will have little direct involvement in the administration of the Scheme; FSCS Limited will be independent of the FSA but accountable to it. The rules require FSCS Limited to have regard to the need to use its resources in the most efficient and economic way when exercising its functions. FSCS Limited must provide regular reports to the FSA on its use of resources and its financial budget must be approved by the FSA before the new financial year starts.
- (b) The responsibilities of those who manage the affairs of authorised persons*
- 3.13 The Scheme rules do not impose any additional controls or demands on those who manage authorised persons.
- (c) The principle that a burden or restriction should be proportionate to the benefits which are expected to result from the imposition of that burden or restriction*
- 3.14 Under section 213(3)(b) of the FSMA, the Scheme rules may make provision for the Scheme Manager (FSCS Limited) to impose levies on authorised persons for the purpose of meeting its expenses. Section 213(5) requires the FSA to take account of the desirability of ensuring that the amount of levies imposed on a particular class of authorised person reflects, as far as possible, the amount of claims made or likely to be made against that class of person.
- 3.15 An explanation of why the FSA considers the burdens to be proportionate to the benefits is contained in Section 5 – Cost Benefit Analysis (paragraphs 5.32–5.41). The FSA, when determining the amounts payable under the Scheme rules and the principles under which the Scheme should be funded, has also taken into account the costs the firms may incur in complying with the compensation rules, including the impact on the firm of any levy a firm

may have to pay. However, a final judgement cannot be made until later in the year, when the FSA will consult on the detailed rules for allocating compensation costs.

(d) The desirability of facilitating innovation in connection with regulated activities

3.16 The provisions in the draft Scheme rules should not stifle innovation in any material way.

(e) The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

3.17 The detailed provisions of the Scheme rules should not impede the ability of UK firms to carry on business outside the UK by putting them or their customers at a significant disadvantage relative to providers in other states, nor act as a deterrent to overseas business coming to the UK.

(f) The need to minimise the adverse effects on competition that may arise from any exercise of its general functions

3.18 When developing the policy and rules for the new Scheme, the FSA has taken account of the risk that the availability of compensation cover, and the manner in which such compensation is funded, may have an adverse effect on competition. Competition could be effected because the availability of compensation might influence the behaviour of consumers and authorised firms or because of the way compensation is funded. Section 5 – Cost Benefit Analysis explains why the FSA considers that the level of cover offered by the Compensation Scheme is unlikely to have anti-competitive effects by changing the behaviour of consumers and authorised firms. However, a final judgement on how funding may affect competition cannot be made until later in the year, when the FSA will consult on the detailed rules for allocating compensation costs.

(g) The desirability of facilitating competition between those who are subject to any form of regulation by the FSA

3.19 The FSA has taken account of the desirability of facilitating competition when considering the level of compensation to be provided by the Scheme. The FSA considered whether maintaining different levels of compensation cover for deposit taking, insurance, and investments would have a negative effect on competition where different products were effective substitutes but considers this is unlikely to have anti-competitive effects. Section 5 – Cost Benefit Analysis explains why the FSA considers that keeping the level of cover offered by the Compensation Scheme is unlikely to have anti-competitive effects by changing the behaviour of consumers and authorised firms. A final

judgement on how funding may affect competition cannot be made until later in the year, when the FSA will consult on the detailed rules for allocating compensation costs.

4 Commentary on the draft rules and guidance

Chapter 1: Introduction and Overview

Introduction

- 4.1 The introductory chapter explains that the purpose of the compensation rules is to set out the powers and functions of the Scheme Manager (Financial Services Compensation Scheme Limited). It also gives guidance on which sections of the rules are of particular relevance to potential claimants and authorised firms. This is re-stated in the guidance provided at the start of each section of the rules.

Scheme Manager

- 4.2 The rules are not the entire source of the powers of FSCS Limited. Sections 219 and 220 of the FSMA give FSCS Limited power to require authorised firms to provide information needed to fairly assess claims for compensation and to inspect records held by the liquidator of a former authorised person. FSCS Limited also has powers under section 221 to make an application to the courts to obtain this information, if necessary. (Section 222 of the FSMA confers immunity from prosecution under the FSMA on FSCS Limited and persons acting on its behalf in respect of any actions or omissions made in good faith.)

Claimants

- 4.3 Claimants may be particularly interested in the sections of the rules defining eligibility to claim under the Scheme, how claims are calculated and limits on the amounts that can be claimed. Table COMP 1.5(1)G provides a summary of the relevant rules.

Firms

- 4.4 Firms are likely to have a particular interest in the levies section of the rules which will be subject to a separate consultation exercise later in the year. This section will set out how compensation costs will be funded and these costs collected. There is also a section in the rules (Chapter 14) setting out the position of EEA firms who participate in the Scheme.

Chapter 2: The Scheme Manager

General effect

- 4.5 This chapter sets out the powers and duties conferred by the rules on FSCS Limited, the company which will operate the Scheme, and defines the terms of its relationship with the FSA.
- 4.6 The Scheme Rules, together with the Memorandum and Articles of Association of FSCS Limited, define the framework within which the company operates. In particular, the Scheme Rules enable FSCS Limited to:
- exercise the functions and powers of the Scheme Manager;
 - assess and pay compensation in accordance with the Scheme Rules;
 - impose levies on authorised persons in accordance with the Scheme Rules for the purpose of meeting expenses including compensation payments, expenses incurred in paying compensation and the costs of establishing the Scheme.
- 4.7 The Memorandum and Articles also provide that:
- FSCS Limited should co-operate with the FSA (and other bodies) in the operation of the Scheme;
 - the directors of FSCS Limited are to be appointed by the FSA on terms which secure their independence from the FSA in the operation of the Scheme. This is a requirement of section 212(5) of the FSMA.
- 4.8 FSCS Limited will be independent from the FSA in its day to day decision making but will be accountable to it. Accordingly, as required by the rules, FSCS Limited must satisfy the FSA that it is at all times capable of performing its functions in an effective and efficient manner, and report regularly on the operation of the Scheme.

The Scheme Manager

- 4.9 FSCS Limited must use its resources in an efficient and economic way in accordance with the requirements of these rules.

Powers of Management

- 4.10 FSCS Limited is to manage, hold and apply the funds held by the Scheme in accordance with the rules. In addition to its general powers under company law, FSCS Limited also has the power to publish information on the operation of the Scheme.

Co-operation between the Scheme Manager and the FSA

- 4.11 FSCS Limited is required to co-operate with the FSA and assist the FSA in the exercise of its functions.

Annual Report

- 4.12 FSCS Limited must produce and publish an audited report annually, within four months of the financial year-end of 31 March. This must include details of the assets and liabilities held by each sub-scheme fund and compensation costs allocated to each contribution group.¹

Three monthly report

- 4.13 FSCS Limited must make a three monthly report to the FSA with details of the business conducted by the Scheme and any other information requested by the FSA.

Report on particular events

- 4.14 FSCS Limited must advise the FSA in writing as soon as possible of the appointment of any person as chief executive, secretary or of any change in auditors.

Budget

- 4.15 The Scheme's financial budget must be submitted for approval to the FSA at least two months prior to the commencement of the accounting period. FSCS Limited will manage the Scheme in accordance with the approved budget.

¹ Sub-schemes and contribution groups will be defined in chapter 13 of the rules.

Record keeping

- 4.16 FSCS Limited must keep records of the Scheme's transactions to demonstrate compliance with the rules and these must be kept for 6 years. FSCS Limited must also keep claims records until such time as it reasonably believes they are no longer necessary.

Publication of defaults

- 4.17 When a firm is declared 'in default',² FSCS Limited must take steps to inform potential claimants that claims may be made for compensation, in accordance with the requirements of the rules.

Complaints

- 4.18 Effective procedures and service standards must be put in place for dealing with complaints about maladministration by the Scheme.

Chapter 3: Paying compensation, securing continuity of insurance and safeguarding policyholders of insurers in financial difficulties

Purpose

- 4.19 This chapter sets out the conditions to be met before compensation can be offered or in the case of insurance policies, where appropriate, insurance cover may be secured with another insurance company.

The qualifying conditions for paying compensation

- 4.20 Three conditions must be met before any payment of compensation is made:
- an eligible claimant must have applied for compensation;
 - the claim must relate to business covered by the Scheme conducted by an authorised or passported firm in default; and
 - where required to do so, the claimant must assign his rights in respect of the claim to FSCS Limited.
- 4.21 Full explanations of each of these requirements are set out in subsequent chapters. (Chapter 4: Eligible claimants, Chapter 5: Protected claims, Chapter 6: Relevant persons in default and Chapter 7: Assignment of rights)

² The definition of a 'default' is set out in chapter 6 of the rules.

- 4.22 FSCS Limited may make payment to representatives of persons who are, or would have been, eligible claimants. For example, personal representatives claiming on behalf of a deceased claimant and trustees claiming on behalf of beneficiaries.

Safeguarding policyholders of insurers in financial difficulty

- 4.23 When an authorised insurer (which includes a friendly society) providing long term insurance cover is declared in default by FSCS Limited, FSCS Limited must try to make arrangements to continue cover with another insurer if this is more cost effective than paying compensation. This may be by transferring the business to another authorised firm or arranging for substitute policies to be issued.

Securing continuity of insurance cover

- 4.24 Where FSCS Limited determines that an authorised insurer is in financial difficulties, it must try to arrange the transfer of the business to another authorised person or give financial assistance to the company to enable it to continue. Again such action must only be taken if it is more cost effective than paying compensation. A firm is defined as being in financial difficulties when:
- it is in provisional liquidation; or
 - it has been proved to be unable to pay its debts under formal insolvency proceedings; or
 - an application has been made to court to secure a voluntary creditors arrangement, but the firm is not yet in liquidation or being wound up.

Chapter 4: Eligible claimants

Who is eligible to claim compensation?

- 4.25 The protection offered by the Scheme is aimed at ordinary retail consumers i.e. private individuals and small businesses. This Chapter defines who is eligible to claim under the Scheme by reference to a table of exclusions. All persons are eligible unless they fall within an excluded category. Table COMP 4.2(1)R lists all exclusions and rule 4.3 sets out the exclusions applicable to different types of business.

Exceptions

Deposits

- 4.26 As set out in the introduction, the Scheme will need to comply with the Deposit Guarantee Directive (DGD), which defines persons who are

potentially eligible for compensation in respect of their deposits through a range of compulsory and discretionary exclusions. The DGD requires the following exclusions from the protection of the EEA deposit protection schemes:

- deposits made by banks and building societies;
- deposits connected with a criminal conviction for money laundering.

4.27 In addition, the DGD permits the following exclusions:

- deposits made by other firms carrying on regulated activities;
- deposits made by public authorities;
- deposits made by persons connected with the defaulting firms;
- deposits made by large companies;
- deposits in accounts where the identity of the depositor is not disclosed (i.e. numbered accounts);
- deposits secured on the assets of the firm;
- deposits denominated in non-EEA currencies.

4.28 The Cruickshank report³ recommended that all the exclusions permitted by the Deposit Guarantee Directive be adopted. The FSA has concluded that deposits by larger companies⁴ should be excluded from the scope of the Scheme. The decision to exclude deposits by larger companies means that the FSA will have met what it considers to be the main objectives of the exclusions permitted by the DGD, by focusing protection on those depositors less able to determine the security of their deposits or sustain a loss in the event of a failure.

4.29 Some FSA authorised persons who could have been excluded under the various professional or other institutional exclusions will continue to be eligible to claim in respect of deposits made by them provided that they are not excluded under the large company exclusion. This means that small credit unions and friendly societies will continue to be protected by the Scheme, as will smaller independent intermediaries.

4.30 As set out in Chapter 5 of the rules, the FSA has concluded that deposits denominated in non-EEA currencies should be protected by the Scheme. There is no evidence that these depositors are any more sophisticated than are ordinary depositors holding sterling deposits.

3 Competition in UK Banking. A Report to the Chancellor of the Exchequer. Don Cruickshank March 2000.

4 The definition to be adopted is that set out in the DGD i.e. a company which does not meet at least two of the following criteria:

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

Long term insurance

- 4.31 Policyholders of long term insurance policies, including large companies, will continue to be protected. Only those who, broadly speaking, are connected with the company will be excluded.

General insurance

- 4.32 Cover is to be extended for non-compulsory general insurance to small companies⁵ and large partnerships⁶ are to be excluded. This represents a significant increase in the protection provided to small companies.

Compulsory contracts of insurance

- 4.33 This section refers to contracts of insurance required under UK law e.g. third party insurance for car owners and employers' liability insurance. The Scheme will continue to protect all policyholders of these types of contract.

Designated investment business

- 4.34 The Scheme will also need to comply with the Investor Compensation Directive (ICD), which defines persons who are potentially eligible for compensation in respect of their investments through a range of discretionary exclusions. As with the existing Investors Compensation Scheme, all of the exclusions listed in table COMP 4.2(1) will apply to claims in respect of investment business. This means claims from large companies, financial institutions, government and municipal authorities and persons connected with the failed firm will be excluded.

Chapter 5: Protected claims

What is a protected claim?

- 4.35 This Chapter defines the claims protected by the Scheme. Claims can be in respect of a protected deposit, a protected contract of insurance or protected investment business. A claim must relate to a civil liability owed to the claimant by a relevant person.

Protected deposits

- 4.36 Protection has been extended to deposits held in all currencies. This follows the example of the existing investor protection arrangements, which compensate private customers for loss of money or assets regardless of the currency in which they are denominated.

⁵ A small company is defined, for the purpose of this rule, as a company with called up capital of less than £1m.

⁶ A large partnership is defined, for the purpose of this rule, as a partnership or unincorporated association with net assets of more than £1m.

Protected contracts of insurance

- 4.37 Contracts of insurance are protected only if the risk or commitment of the policy falls within the UK, another EEA state, the Channel Islands or the Isle of Man. This accords with the full provisions of the Policyholders Protection Act 1997. In addition, credit insurance is to be added to the list of excluded policies. This now means marine, aviation, transport, reinsurance and credit insurance are not protected by the Scheme. In addition, Lloyd's policies are also excluded as they are protected by the separate Lloyd's Central Fund.

Protected investment business

- 4.38 This definition mirrors that of the existing investment compensation arrangements. It includes investment business carried on by a FSA authorised firm or its appointed representative either in the UK or elsewhere in the EEA using an ICD passport. Again Lloyd's members are excluded from compensation in respect of Lloyd's business.

Chapter 6: Relevant persons in default

- 4.39 A relevant person is any firm covered by the Scheme. This chapter defines the firms covered by the Scheme and sets out the circumstances in which a firm is determined to be unable, or likely to be unable, to meet claims against it in respect of business covered by the Scheme.

Who is a relevant person?

- 4.40 A relevant person is defined as:
- an authorised firm (except an EEA firm which has a permission under the ISD or 2BCD);
 - an appointed representative of an authorised firm i.e. a person/firm contracted by the firm to act on its behalf;
 - a UK branch of an EEA firm which has a permission under the ISD or 2BCD and chooses to participate in the Scheme; or
 - an appointed representative of the above.

When is a relevant person in default?

- 4.41 A relevant person is 'in default' for the purposes of the Scheme when, in the opinion of FSCS Limited, it is unable or likely to be unable to meet claims against it in respect of business covered by the Scheme. Rule COMP 6.4.3R sets out a number of circumstances where FSCS Limited must declare the relevant person in default. Examples include the firm's insolvency or

bankruptcy. If the firm is still carrying on business, FSCS Limited must, before the default is publicised, send the firm a written notice summarising the reasons why FSCS Limited believes the firm is in default, and informing the firm that the default will be publicised unless the firm objects by a set date. If the firm disputes FSCS Limited's determination, and FSCS Limited remains of the view that the firm is in default, the firm may elect to have the matter heard by an independent third party (see Rule COMP 6.4.9).

Chapter 7: Assignment of rights

What is an assignment of rights?

- 4.42 When making an offer of compensation, the claimant may be required to transfer to FSCS Limited his rights to claim against any other parties. This allows FSCS Limited to maximise recoveries and prevents the consumer to whom compensation has been paid from taking action against other parties. This ensures that the consumer is not placed in a better position than he would have been had the default not occurred.

How does the assignment of rights work?

- 4.43 Once the claimant's rights are assigned to FSCS Limited, the liability of the firm in default to the claimant in respect of the assigned rights is replaced by a liability to FSCS Limited.
- 4.44 FSCS Limited must make such recoveries as it reasonably can and repay to the claimant any amount recovered which is over and above the compensation and interest paid. FSCS Limited is also able to correct any imbalance in the financial position between two identical claims where this arises as a consequence of one claimant accepting FSCS Limited's offer of compensation more quickly than the other.

Chapter 8: Rejection of an application or withdrawal of an offer

Rejection of an application for compensation

- 4.45 A claim may be rejected where there has been a material omission or inaccuracy in the claimant's application for compensation, unless FSCS Limited considers the information was provided in good faith.

Withdrawal of offer of compensation

- 4.46 If an offer is disputed or not accepted within 90 days, it may be withdrawn. FSCS Limited may also re-issue any offer withdrawn or vary it, if necessary.

Chapter 9: Time limits and postponements

When must compensation be paid?

- 4.47 Once a claim is assessed as valid, the general position is that compensation should be paid within three months, unless an extension for a further period of up to three months is granted by the FSA.
- 4.48 Payment in respect of non-ISD investment business claims may be postponed if FSCS Limited considers that the claimant should first pursue a claim for compensation against another party. For insurance claims, payment may be postponed where another insurer provides cover.
- 4.49 There is also provision for payments in respect of pension review claims to be postponed where it is not practicable to make payments within 90 days.
- 4.50 FSCS Limited may however still pay the claimant where it is expected that distributions may be made by a liquidator or trustee in bankruptcy and the consumer assigns his rights to FSCS Limited.

Type of claim	Level of cover	Maximum payment
Deposits	100% x first £2000 90% x next £33,000	Maximum payment £31,700
General Insurance	compulsory claims: 100% of valid claim/unexpired premiums non-compulsory claims: 100% x £2000 of valid claim/unexpired premiums 90% remainder of claim	Unlimited maximum payment
Long-term Insurance	At least 90% x value of policy, including future benefits declared before the date of the default	Unlimited maximum payment
Investments	100% x first £30,000 90% x next £20,000	Maximum payment £48,000

Chapter 10: Limits

- 4.51 Individual limits on the amount of compensation that can be paid will apply to each sub-scheme to reflect the differences between the sectors.

Limits on compensation payable

- 4.52 The limits on the maximum compensation payments are as follows:
- 4.53 The overall limit on the amount of protected deposits has been increased from the present £20,000 to £35,000, to broadly reflect the effects of inflation since the limit was last reviewed. (If increased for inflation, the DPB limit would now stand at £32,000.) The FSA's research identified a need to address the deposit protection limit as a priority. This was the area where consumers felt there was the greatest need for immediate action. The level proposed represents a significant increase in protection for those groups which tend to have higher balances with banks and building societies. Our research has shown that retired people are more likely to hold large sums on deposit, although the large majority of retired people have smaller balances. The higher limit will also assist claimants who ordinarily would not hold large balances, but who may, as a result of a one-off event (e.g. receipt of a legacy, redundancy payment, proceeds of house sale, etc) have significant balances with one institution. The increased limit also starts to move the UK closer to the levels offered in other developed economies and to close the gap between deposit protection and investor compensation.
- 4.54 The new rules see the introduction of a new 100% band of cover for the first £2000 of each claim to both the deposit and insurance sub-schemes. The current approach, with a universal element of co-insurance, is particularly hard on the least well off, especially in relation to deposits, where average balances are low. The rationale for the £2,000 tranche is that an average earnings level of around £400 gross per week suggests maximum balances of between £1,200 and £1,500 in current accounts in a normal month, and that we should seek to provide full protection to this 'working capital'. In addition, NOP research shows that the median level of balances in instant access accounts across the whole market is £1,082 and for those who only have one instant access account with a single institution it is £367 (for the 12 months to June 1999). Where a claim arises on a policy of insurance, the element of co-insurance borne by the claimant is applied in addition to any excess that may have applied under a policy. Thus the claimant bears a share of the loss under the terms of the policy, and loses an additional amount under the Scheme. This is particularly hard on the least well off.
- 4.55 However, the FSA recognises that an element of co-insurance should be retained as an incentive for consumers to consider carefully where they place their money, and co-insurance will continue to apply above £2,000.

Continuity of cover

- 4.56 When arranging continuity or transfer of cover for any contract of insurance, FSCS Limited is only required to ensure cover for 90% of any future benefit under the contract.

Chapter 11: Payment of compensation

Payment

- 4.57 This chapter sets out who FSCS Limited can pay and when it can pay them.
- 4.58 Payments relating to non-pension claims are to be made directly to the claimant or in accordance with his instructions. However, where a claim falls under the pension review, FSCS Limited must generally pay compensation to the occupational pension scheme or a pension provider. If FSCS Limited determines that exceptional circumstances apply, such as where a claimant has already retired, a cash payment may be made to the claimant or in accordance with his instructions.

Reduced or interim payments

- 4.59 If FSCS Limited is satisfied that a payment is due but there is any uncertainty about paying the full amount at that time, payments may be made on account or in part. Also payment in connection with claims not covered by the DGD or ICD may be reduced if there is any prospect of recovering monies from a third party or another compensation scheme.

Paying interest on compensation

- 4.60 FSCS Limited has discretion to pay interest on compensation payments as it considers appropriate. The rate of interest must be no higher than the clearing bank base rate for the relevant period.

Chapter 12: Calculating compensation

- 4.61 This chapter sets out the rules to be applied by FSCS Limited when calculating compensation payments.

Quantification of claims

- 4.62 In general, any claim against the authorised firm may be reduced by any liability owing by the claimant.

Overall net claim

- 4.63 FSCS Limited is also required to apply a test of reasonableness to any investment claim not covered by the ISD. This provides for any payment to be adjusted if the benefit to the consumer is greater than might reasonably have been expected. Also FSCS Limited may adjust payment to a trustee if any of the beneficiaries of the trust are not eligible to make a claim.

Quantification date

- 4.64 For claims relating to deposits and long-term insurance, the date on which the loss is calculated is the date that the firm is determined to be in default or (for deposits) when the deposit falls due to be paid. For claims relating to other insurance contracts, the loss is calculated on the date a claim is made. For claims relating to ISD investment business, the relevant date is the date of default. For claims relating to other investment business, FSCS Limited has the discretion to decide the relevant date on which the loss is calculated.

The compensation calculation

- 4.65 Where applicable, any compensation payment payable in connection with deposit or investment business carried on by the UK branch of an EEA firm must take account of any compensation payable by the home compensation scheme.
- 4.66 Compensation in respect of investment business claims will not take account of poor investment performance, failure to match a guaranteed level of performance or fluctuation in the value of an investment.
- 4.67 Claims covered by the pension review are subject to the investment sub-scheme limit and must also be assessed in accordance with the guidance issued by the FSA⁷ unless FSCS Limited considers it would not provide the claimant with fair compensation.
- 4.68 FSCS Limited is required to try to secure cover with another insurer for long-term insurance contracts before paying any claims. However, FSCS Limited would only secure cover with another insurer if it considers that this is likely to be more cost effective than paying compensation. Under certain circumstances, FSCS Limited may provide financial assistance to an insurer in financial difficulty to secure continuity of insurance.
- 4.69 FSCS Limited has the power to reduce payments in respect of claims on protected contracts of insurance and non-ISD claims if it considers the benefits to the claimant are greater than might reasonably have been expected or there is evidence of contributory negligence.

⁷ 'Specification of Standards and Procedures' issued by the FSA in October 1994, as supplemented and modified by subsequent guidance issued, in particular that of November 1996.

Quantification when seeking to maintain continuity of cover

- 4.70 Whilst seeking continuity or transfer of long term insurance contracts, FSCS Limited must ensure that any claim falling due to be paid to the policyholder is paid as soon as practicable after it would have been due under the original contract. Bonuses not yet declared under a contract of insurance at the time of the firm's insolvency will not be included in any offer of compensation.

Quantification: trustees and joint claims

- 4.71 Where a claimant is making more than one claim, on his own behalf and as a trustee, these will be treated separately. Where a claim is received on behalf of a bare trust, the beneficiary or beneficiaries are deemed to be the claimant(s).

Joint claims

- 4.72 A partnership is treated as a single claim. However, where two or more people have a joint claim, they are treated as having equal and separate claims unless there is evidence to contradict this.

Chapter 13: Levies

- 4.73 This chapter will contain the rules which govern the way in which the Scheme is to be funded and costs allocated and recovered from participating firms. **Detailed proposals will be the subject of further consultation later in the year.** It is not envisaged that there will be substantial changes from the current funding arrangements for the existing schemes.
- 4.74 The Scheme will be funded by levies on the industry and is to be funded entirely on a 'pay-as-you-go' basis. (Separate consideration is to be given to the handling of the existing funds held by the PPB and DPB – see part 6 of the paper which deals with the next steps to be taken.)
- 4.75 The rules for allocation of liabilities will be based on the following principles:
- As a general rule, the costs of compensation attaching to a particular default will fall on the contribution group of which the defaulting firm was a member.
 - The contribution groups will be constructed to reflect the market structure in order to minimise cross-subsidy between firms carrying out dissimilar business activities.
 - All authorised firms will be required to contribute to the base costs⁸ of operating the Scheme.

⁸ Base costs are not dependent on the level of activity and may include items such as the salaries of board members, some elements of premises and IT costs. These costs exist regardless of the level of activity.

- All other administration costs will be attached to a specific default and will then be met by the firms in the contribution group of which the defaulting firm was a member.
 - The allocation of liabilities to firms in a particular contribution group will be weighted towards those firms that do business with consumers eligible for compensation, e.g. levies are likely to be based on the amount of protected business conducted by the firm.
- 4.76 It is expected that the contribution groups will relate to the FSA post-N2 fee categories, which are themselves currently the subject of a separate consultation exercise. The FSA proposes to aggregate fee-payers into groups which offer similar products and services. This approach should ensure that costs reflect the different risks presented by the different entities, thus minimising cross-sectoral subsidies.
- 4.77 As part of the later consultation exercise, the FSA will also seek views on proposals for funding of the pre-N2 liabilities of the new Scheme.
- 4.78 This chapter will also set out the structure of the Scheme, which is divided into three sub-schemes: deposit taking, insurance and ‘all other’.

Participant firms

- 4.79 All firms authorised by the FSA are to be participant firms in the Scheme except the Society of Lloyd’s and firms which only carry on Lloyd’s business, as these firms participate in a separate Lloyd’s compensation scheme. The FSA is also discussing with the recognised professional bodies the future compensation arrangements for customers of professional firms carrying on investment business. An announcement will be made following the conclusion of these discussions.

The sub-schemes

- 4.80 Claims to the scheme will be divided into three different types: claims relating to protected deposits, protected insurance contracts, and ‘all other’ types of business. This section of the rules will establish the three sub-schemes that will handle the different types of claims.

The contribution groups

- 4.81 The sub-schemes will be divided into contribution groups of firms carrying on similar business. It will be through levies on firms who belong to particular contribution groups that FSCS Limited will fund compensation payments to claimants, or costs incurred in securing continuity of insurance.

Chapter 14: EEA firms

Introduction

- 4.82 This chapter relates to participation in the Scheme by UK branches of EEA firms using the ISD or 2BCD ‘passports’. (Other EEA firms i.e. insurance companies are required to join the Scheme in accordance with COMP 6.2.1(1)). To participate in the Scheme as a passporting firm, two conditions must be met:
- The firm must be carrying on business via UK branches using a European passport under the ISD and/or 2BCD.
 - The level or scope of compensation provided by the UK Scheme must be greater than that offered by the firm’s home compensation scheme.
- 4.83 In the event that an EEA firm becomes insolvent, the home state scheme in its member state is required to provide compensation in respect of ISD or 2BCD business conducted both in the home state and through branches in other EEA states. However, if an EEA firm meets the above conditions, it may apply to ‘top up’ the compensation payable in respect of ISD or 2BCD business conducted by the branch(es) of the firm elsewhere in the EEA.

Participation in the Scheme by EEA firms

- 4.84 FSCS Limited must accept an application to participate in the Scheme from a passporting firm if it meets the above conditions. Once an application is accepted, the firm must then be allocated to an appropriate contribution group according to the business to be carried on by the firm.
- 4.85 FSCS Limited is required to put in place an appeal procedure to allow the EEA firm to appeal against any rejection of an application or a decision to allocate the firm to a particular contribution group.

Co-operation between the Scheme Manager and the home state compensation scheme

- 4.86 Once an application from an EEA firm to participate in the Scheme is accepted, FSCS Limited must seek to put in place appropriate procedures in conjunction with the home state compensation scheme for dealing with compensation claims.

Termination of an EEA firm’s participation in the Scheme

- 4.87 FSCS Limited may terminate an EEA firm’s participation in the Scheme if it is advised by the home state compensation scheme that it no longer meets either of the conditions above.

4.88 An EEA firm participating in the Scheme is required to observe the rules in this sourcebook applicable to participant firms. If it fails to observe the requirements, FSCS Limited will report this to the FSA and the firm's home state compensation scheme. If the firm fails to meet its obligations for a period of 12 months, FSCS Limited may terminate its participation in the Scheme.

Resignation of an EEA firm from the Scheme

4.89 A firm may withdraw from participation in the Scheme by giving six months notice in writing to FSCS Limited.

Notice to customers

4.90 When an EEA firm ceases to participate in the Scheme, it must endeavour to notify all its UK customers within 6 weeks and confirm the amount of compensation now available to them. In addition, FSCS Limited must bring to the attention of the firm's UK customers the fact that the firm no longer participates in the Scheme.

5 Cost benefit analysis

- 5.1 Section 151 of the FSMA requires the FSA to publish a cost benefit analysis when it proposes to make Rules.
- 5.2 The FSA's views on the costs and benefits of the proposed policy to be implemented by the compensation rules, having particular regard to any changes from the existing arrangements, are set out below.

Background

- 5.3 Cost benefit analysis (CBA) provides a useful tool for policymakers when seeking to select the appropriate policy solution to any particular set of circumstances. CBA cannot determine which solution or possible outcome is the best in policy terms, but does allow policy options to be ranked in terms of their economic costs and benefits.
- 5.4 Ranking policy options can be a fairly exact science if the prospect of any particular event occurring can be predicted with reasonable certainty, and a monetary value can be ascribed to both the costs and potential benefits arising from a particular set of circumstances. But if the risk of an event or series of events occurring is unknown or unpredictable, a monetary value can only be ascribed to the costs incurred by one of the interested parties to such an occurrence, and the benefits are only measurable on a qualitative basis, then CBA is less exact, and the choice of any particular option is dependent on policy preferences. However, even if the benefits are only measurable qualitatively, the CBA still provides information that will help decision making by considering how the particular policy could affect behaviour, for example, whether consumers or firms will take more or less risk.
- 5.5 The peculiarity about CBA for the compensation scheme is that most of the costs are cancelled out by equal and opposite benefits. The main benefit of a compensation scheme is payments to customers of failed firms. The main costs are initially borne by firms who, in the longer term, are likely to pass it

on to their customers through higher charges. In total, the benefit to consumers is exactly matched by the costs to firms.

- 5.6 The existence of a compensation scheme may also affect the behaviour of consumers and firms e.g. consumers may derive confidence from the existence of a compensation scheme and hence be more likely to buy a financial product. Alternatively, the existence of a compensation scheme might distort competition by encouraging customers to place their money with weaker firms that offer better returns, since customers might reason that the compensation scheme would bail them out if the firm failed.
- 5.7 Thus, if one is considering various alternative compensation schemes that would all have the same administrative cost, the difference between total benefits and total costs depends only on how each option affects the behaviour of customers and firms, since the other elements of benefits less costs are the same for each option.

The policy options available to the FSA

- 5.8 There were four main policy options available to the FSA. They were:

- Option 1: To maintain the existing arrangements.
- Option 2: To construct a new compensation package having regard to the needs of consumers, the existing levels of cover and the differences between deposit taking, insurance, and investment business.
- Option 3: To reduce compensation to the minimum legally required by the EU Directives.
- Option 4: To reduce the level of compensation to a level somewhere above the minimum required by the EU Directives.

Approaching CBA for the compensation scheme

- 5.9 The nature of an industry funded pay-as-you-go default compensation scheme makes it difficult to quantify the benefits of the scheme, and any assessment of future costs can only be based on hypothetical events which may, but will not necessarily, occur in the future.
- 5.10 The frequency and size of defaults giving rise to claims are not easily forecast, so the demands on contributor firms in respect of levies payable by them are not always predictable. A ceiling on the amount a firm may be expected to pay in any year enables firms to take account of potential future liabilities, but this means there could be occasions where the value of claims exceeds the amount the scheme can levy. If this were to occur, the Scheme Manager could borrow to meet compensation costs, and recover any sums paid in the next

levy year. But even without a contribution ceiling, any pay-as-you-go industry funded scheme has a point at which it can no longer remain self-sustaining and it is important to consider whether any increase in the amount the scheme can pay out on an individual claim might significantly affect the scheme's ability to meet claims and contributor firms' ability to meet levies.

- 5.11 The quantification of the benefits is also problematic. Consumers who make a claim on the compensation scheme will never be as well off as those who have never had to make a claim, although they will be better off than if no compensation scheme existed at all. Where a firm fails, the claimant may incur costs associated with the time taken to make a claim, not having access to their capital, potential costs of borrowing to meet expenses where their assets (particularly when held in the form of deposits) are unavailable, and stress and inconvenience. Where co-insurance applies, the consumer must themselves bear that cost, in addition to the costs that arise because a firm fails.
- 5.12 But the benefits from the existence of a compensation scheme continue to accrue even when no claims are made, and at minimal cost to contributor institutions. In particular, any increase in market confidence, where consumers are aware of the existence of the scheme, or comfort gained from the belief that they will be protected in the event of a financial institution's failure where they are not aware of its existence, encourages participation in the financial services market giving benefits to both industry participants and consumers. And in the long term, the costs of providing compensation eventually fall to consumers so any costs to firms, where they occur, and although they may be significant in the short term, are temporary.
- 5.13 CBA allows an assessment of the difference between costs and benefits even where the risk of an event occurring, in this case the failure of a regulated firm, is low and the future costs, that is compensation costs, are unknown. It is with these factors in mind that we approached the CBA for the new compensation scheme.

The main costs and benefits of a compensation scheme

- 5.14 Assuming that a failure occurs and compensation is payable to persons protected by the scheme, the main benefit of having a compensation scheme is the payment of compensation to customers of the failed institution. The main cost is initially borne by the surviving firms that are liable to pay the levy. In the longer term these costs are likely to be passed on to the contributor firm's customers through either increased charges or reduced benefits (e.g. lower levels of interest, returns on investments or insurance policies etc). Where a firm uses an intermediary to sell its products or services, the commissions paid to the intermediary will tend in the long term to rise or fall depending on the level of expenses incurred by the intermediary, including the cost of meeting

compensation levies, and these costs are ultimately passed on to the consumer in the long term.

- 5.15 In terms of monetary values, the benefit to consumers who receive compensation exactly matches the cost incurred by those who pay the compensation levy. In addition to the costs of paying compensation, there are also administrative costs that are again met by firms in the first instance, and likely to be passed on to consumers in the longer term. Thus, the net effect is that the net monetary cost of providing a compensation scheme is independent of the actual level of cover provided by the scheme. But this is not the only factor to be taken into account. The potential impact that the existence of a scheme has on the behaviour of authorised firms and consumers, and the effect a levy can have on a firm's solvency, must also be taken into account.

Factoring in the unknowns

The risk of a failure occurring

- 5.16 In preparing a cost benefit analysis of the proposed policy for paying compensation if a regulated firm fails, it should be recognised that claims on default compensation are by their very nature unpredictable, being dependent on a regulated firm being unable to meet its liabilities, and the claim being made against it being protected by the scheme. This means that the only costs that we can say with any certainty will arise are limited to the minimum costs necessary to run the scheme if no claims were made. The costs that may arise are altogether different.

High risk/low impact failures v low risk/high impact failures

- 5.17 The differing probability of a failure occurring and the varying impacts a failure may have on consumers, both in terms of the size of loss and the number of consumers affected, give rise to potentially different levels of compensation costs, and the frequency at which levies to meet compensation costs are likely to be made. It can be useful to assess the impact on firms and consumers of different types of failures.
- 5.18 'High risk' and 'low risk' are used to signify the relative probability of a failure occurring. Firms that are required to hold high level of reserve capital (and thus significant sums in own funds) are less likely to fail than those that do not, as firms with higher capital reserves are more likely to be able to meet claims against them or repay customer assets when they become due and payable. Firms subject to conduct of business regulation will also give rise to different types of claim from those not subject to conduct of business regulation.

- 5.19 'High impact' and 'low impact' refer to the number of claims that are likely to occur. Thus the failure of a deposit taker with an extensive branch network and 200,000 customers would be a higher impact firm than an IFA with 500 customers, or an execution-only stockbroker with 10,000 customers.
- 5.20 However, it should be borne in mind that the number of failures and in particular the number of failures giving rise to claims on the compensation scheme is very low relative to the number of firms carrying on regulated activity in the UK and the numbers of people carrying on business with regulated firms. The fact that only a tiny fraction of consumers ever have to use the compensation scheme may help explain why consumer awareness is so low.
- 5.21 High impact/low risk events such as the failure of a major deposit taking institution or insurer potentially give rise to large costs in the event of a single institution's failure, but are very rare. In the deposit sector, the Deposit Protection Board last made a 'special' levy in 1992 following the failure of BCCI. Approximately 75% of the £81m levied on deposit takers has since been recovered and distributed to contributor institutions. The Building Societies Investor Protection Scheme has never been triggered.
- 5.22 In the general insurance sector, the failure of the KWELM group of companies in 1992 gave rise to potential claims summing to almost £180m, although claims have not crystallised as expected. The provisions of the Policyholders Protection Act 1997 changed the geographical scope of the Policyholders Protection Board, amending the definition of a UK policy, and excluding risks or commitments arising outside specified geographical areas. The new definition would exclude the majority of claims on the KWELM companies. The new Scheme will fully reflect the policy behind the PPA 97, and concentrate cover on private consumers and small businesses. This means that if a failure identical to the KWELM failure were to occur under the new regime, costs would be significantly lower. The customers of some 17 other general insurers have benefited from PPB intervention over the last 10 years giving rise to compensation costs of about £60m, but £31m of this is accounted for by one failure, and £9m by the next largest failure.
- 5.23 Since the PPB was established, only two life companies have required assistance from the Board at a cost of £4m.
- 5.24 Lower impact/higher risk events such as the failure of an independent financial adviser or appointed representative are far more frequent, and although they give rise to lower costs per failed institution, have in aggregate led to high costs in recent years. The Pensions Review has been the single most significant source of claims on the Investors Compensation Scheme since it was established – of the 28,335 claims notified to the scheme up to June 2000, 12,613 arose from the Pensions Review – and has given rise to

significant costs (approximately £70m). Issues such as FSAVCs and endowments, although detrimental to consumers in some cases, are not expected to give rise to the same level of claims on the compensation scheme as have arisen and continue to arise from the Pensions Review.

Affordability

- 5.25 Whilst it is generally accepted that in the long term contributor firms will tend to pass the costs of compensation on to their customers, there are important issues of short term affordability.
- 5.26 In a pay-as-you-go scheme, levies will be made as claims arise, although a facility is available to the Scheme to make levies in advance to meet the claims the Scheme has reasonable grounds to believe may arise. Those institutions that may be called upon to fund compensation in low risk/high impact areas, that is deposit taking and insurance, have, as a consequence of the nature of the relationship with their customers (debtor/creditor), access to significant sums in own funds (i.e. assets belonging to the company), but there is always a risk that systemic concerns, particularly in relation to the deposit taking sector, may be exacerbated if the remaining institutions face large levy calls at such a time. Any pay-as-you-go industry funded scheme has a point at which it can no longer remain self-sustaining and it is important to consider whether any increase in the amount the scheme can pay out on an individual claim might significantly affect this.
- 5.27 Those firms that may be called upon to fund high risk/low impact failures (that is failures of investment firms, and in particular financial advisers) tend to have an agent/principal relationship with their customers meaning that any client funds are held separately from the assets of the firms, and therefore the impact of a levy on a firm's cash-flow is greater and must be taken into account when developing the levy mechanism. In the investment sub-scheme, the levies are likely to be made annually. However, where a levy is likely to be large, and may cause unnecessary stress to contributor institutions in the short term, the scheme manager will be able to raise a levy by instalments (some in advance and some in arrears), spreading the levy across a number of months, similar to the way in which PIA operates at the moment. Defaults in this sector tend to take some time to process and the ability to levy by instalments allows levies to be made as compensation becomes payable to claimants. As the FSA is not proposing any significant change to the existing arrangements in setting the scope, payment limits and co-insurance, the impact on firms will be no different than at present.

Costs and benefits of adopting the FSA's preferred option

- 5.28 The FSA considers that Option 2, the adoption of a new 'compensation package', developed following previous consultations, represents the best

policy option, with significant improvements for consumers being achieved at minimal cost to contributor institutions. CBA was one of the factors the FSA took into account when selecting option 2 as the preferred option.

5.29 The FSA finds it useful to analyse the costs and benefits of its preferred option in terms of the following six categories:

- direct costs
- compliance costs
- quantity of goods sold
- quality of goods sold
- variety of products offered
- efficiency of competition

5.30 The last four criteria above depend crucially on how the proposal would affect the behaviour of consumers and firms.

Direct costs to the FSA

5.31 There is no difference between the various policy options and the impact on the FSA's direct costs. The FSA will still be required to monitor the effects of the compensation scheme and oversee the operation of the compensation scheme, ensure compliance with the rules, and assess their continuing suitability.

5.32 It is unlikely that the costs incurred by the Scheme in collecting levies will be any higher than at present. Under the present arrangements, both the PPB and DPB levy contributor institutions themselves so there will be no change there. The ICS currently levies the SROs who in turn levy their members. In future firms will be levied directly by the scheme, although the scheme can appoint an agent to collect levies on its behalf. The costs the SROs incurred in determining an individual firm's compensation levy will now be incurred by the new Scheme, but simplified levy rules, while maintaining the existing consensus concerning who pays, will, we believe, make the allocation and collection of levies simpler to achieve, and more cost effective.

Compliance costs to the firm

5.33 Excluding the levy itself, the effect on the compliance costs of regulated firms will be neutral. Regulated firms and their appointed representatives will be required to disclose certain information about the compensation arrangements in their documentation, but will be already changing documentation to comply with new the FSA regulations concerning information disclosure. Although the new Scheme comes into effect at N2, regulated firms will be

given time to ensure that their documentation complies with the new requirements, so the compliance costs they will face will be no higher than those they will face as part of the move to the new regulatory regime.

- 5.34 Levy returns will be simplified, and where possible, the FSA regulatory returns will be used to determine a firm's compensation levy.

The costs of funding compensation

- 5.35 Levies will be made in respect of the costs incurred by the Scheme. Costs will be split between base costs, that is the cost of running the Scheme if no claims were to be made, and default related costs i.e. the costs involved in verifying and meeting claims for compensation.

Base costs

- 5.36 Each participant firm will be required to make a contribution to the base costs of the scheme, which are estimated at £2.5m. Levies in respect of base costs are likely to be proportionate to the amount a firm pays to the FSA as a regulatory fee. Thus, if the base costs were £2.5m, a firm pays regulatory fees to the FSA of £1,500, and the total amount paid by regulated firms is £210m, it would be required to pay a levy of £17.86 in respect of the scheme's base costs. The base costs of the scheme are the same across all the options available to the FSA.

Default related costs

- 5.37 While it is impossible to forecast the likelihood of any future failure or the compensation costs that may arise (costs will vary depending on the frequency of failures, the business carried on by the failed firm, and the value of claims made) it is possible to try to establish the impact the proposed changes in payment ceilings would have had on past failures, had they already been in force.
- 5.38 In the deposit sector, it is useful to consider the amounts that would have been payable if 100% cover had applied to the first £2,000 of any claim in the BCCI failure, which is the most significant failure faced by the DPB. Full details of the distribution of deposits in BCCI are not readily available, but approximations can be made.
- 5.39 The introduction of 100% protection to the first £2,000 of each claim could have led to increased payments of £200 per claim, or approximately £3.2m. This assumes all claims were for more than £2,000, although almost 50% of BCCI claims were for less than £2,000. If the payment ceiling had been increased from £20,000 to £35,000, compensation payable could have increased by approximately £30.1m.
- 5.40 Thus the total amount payable by the DPB, funded by contributor institutions, could have increased by £33.3m from £81m to £114.3m, an

increase of about 41%. However this does not take into account the fact that almost 50% of claims were for less than £2,000, or that approximately 88% of claims were for less than £35,000, or that larger businesses who will be excluded from the new Scheme were eligible to claim. This is nonetheless a potentially significant increase in the amount payable by contributor institutions, but remains only a small fraction of the potential leviable deposit base at the time of approximately £1bn; and is unlikely to have affected the solvency of a contributor institution. (For a more detailed assessment of the BCCI failure, see Appendix C of the FSA CP24.)

- 5.41 In the insurance sector, the introduction of 100% cover for the first £2,000 of any claim would at most have increased the amount payable by the PPB by about £1.8m over the past 10 years. This assumes that every payment made benefited in full from the increased payment of £200 per claim. As a portion of the total sum levied of £239.9m, this represents an increase of about 0.75%. Policyholders will continue to be required to meet any excess specified under the terms of the policy. The FSA considers, on the basis of the evidence available, that the extension of general insurance cover to the smallest companies is unlikely to give rise to significant extra compensation payments. The exclusion of larger partnerships, who have been the biggest drain on the PPB resources in the past, means that if the KWELM failure were to have occurred after the new rules came into effect, the number of eligible claims and thus compensation costs are likely to be significantly less than those incurred in recent times. However, as stated above, the level and type of claims will vary from one default to another, and the type of firm that fails in the future will not necessarily be the same as that which has failed in the past.
- 5.42 By excluding larger businesses from the scope of the scheme, and focusing protection on private individuals and small companies, the levies made on contributor firms when funding compensation should be less or no greater than those they would have faced had a similar failure occurred under the old arrangements.

Quantity of the goods sold

- 5.43 The base costs of the scheme which the majority of authorised persons will be required to pay will be levied in proportion to the FSA regulatory fees and are unlikely to have any significant effect on firms' costs, and thus the price they will charge to the consumer.
- 5.44 The costs involved in meeting levies in respect of compensation actually paid by the scheme can have a substantial impact on a firm's cashflow, in particular smaller investment firms and IFAs. Firms may wish to make contingency plans, and make charges in anticipation of any levy in respect of compensation costs, but there is no reason to suppose that these costs will be

any higher than at present as the contribution ceilings will not have increased. This issue mainly arises in the investment area, that is investments that are not deposits or policies of insurance, and since no change is being proposed in this area, there should be no change from that which presently exists.

Quality of the goods offered

- 5.45 The existence of the compensation scheme could, in theory, encourage individual firms to offer lower quality products, in the belief that consumers will accept a lower quality product because they will receive compensation if the firm fails. The compensation scheme explicitly excludes claims relating to poor investment performance.
- 5.46 The effect compensation has on the quality of goods offered is considered by many particularly relevant to general insurance, and motor insurance in particular. There is a possibility that unregulated intermediaries who do not contribute to the scheme may use the existence of the scheme to encourage consumers to buy insurance at too low a price in the belief that they will continue to be covered if their insurer becomes insolvent. However, our research shows that security features very highly on consumer's list of priorities when selecting a financial services provider, so we consider it unlikely that most consumers, given the marginal savings available, would be prepared to accept such a risk. As stated above, there are costs incurred by the consumer when claiming compensation even when 100% is available. On balance we consider that competition in the market place should ensure no decline in the quality of products, and that although price competition will be a factor, it will not be the only basis on which firms compete for market share.

Variety of products offered

- 5.47 The costs involved in providing compensation are unlikely to have any significant influence on the variety of products offered.

Efficiency of competition

- 5.48 The obligation to pay compensation levies when a regulated firm carrying on similar business goes into liquidation may act as a barrier to entry in that there is a possible unknown future cost. To counter this, and allow contributors to take account of possible compensation costs in their future planning, the rules will provide for a maximum sum to be levied on contributor firms in a levy period. For participant firms in the deposit-taking sub-scheme, the maximum total sum leviable is likely to be a percentage of protected deposits, and for insurers a percentage of relevant premium income. The basis for calculating the contribution ceiling for investment firms will be different, and is likely to be set at the maximum figure that can be levied on a contribution group in any period.

- 5.49 For investment firms, and in particular financial advisers, the prospect of a large compensation levy being called at the end of any levy period may place a strain on a firm's cash flow, restricting its ability to compete or even remain in the market. The rules will make provision for levies to be made at intervals throughout the year – this should reduce the risk of temporary liquidity problems.
- 5.50 The compensation scheme will provide different levels of cover for claims in respect of investments, deposits, and insurance. In general, these three sectors meet different needs but there are certain products within those sectors that are substitutable, for example, unit trusts versus unit-linked life policies; unit trusts versus deposit accounts where the return depends on stock market performance; and deposit accounts versus cash unit trusts. However, as stated earlier, our research has shown that the level of compensation is not a significant consideration when investing in products. This means that, in practice, limits on the amount of compensation payable in respect of different types of product do not have an anti-competitive effect. Nevertheless, this is an issue the FSA would expect to examine as ceilings on compensation are reviewed in future years.

Impact on the behaviour of consumers and firms

- 5.51 It is the impact that compensation can have on the behaviour of consumers and regulated firms that is the area most eagerly debated when assessing default compensation. The impact on behaviour may of itself create costs or benefits depending on how behaviour is effected.
- 5.52 Consumers may derive confidence from the existence of the compensation scheme and thus be more likely to invest for the future. To the extent that this provides greater assurance at a price that consumers are willing to pay, this is a benefit. The fact that financial services are regulated and a compensation scheme exists if things go wrong acts as a positive incentive for consumers to consider long term savings and investment.
- 5.53 The downside is that the existence of a regulator and compensation scheme may create a moral hazard, acting as a disincentive to consumers to take care when making a financial decision or selecting a financial services provider, be that an adviser, a bank, or an insurer. This is a cost – it benefits neither consumers nor the industry if a consumer is reckless or careless when selecting a financial services provider. There may be short-term gains for the individuals concerned, but in the long run the industry loses through a loss of consumer confidence and lower participation, and the consumer potentially loses through uncertainty and not having access to their capital if a failure occurs.

- 5.54 It is often suggested that a compensation scheme discourages consumers from taking proper care when making financial decisions in the belief that they will be bailed-out, but we have no found evidence to support that this applies to any significant extent in the UK. Consumer research conducted by the FSA has shown that consumer awareness of the regulatory structure and the compensation scheme is very low. For those consumers who are aware of the existence of a compensation scheme, its existence is not a determining factor when making a financial decision. The financial security of the institution they are investing with is considered far more important than the existence of a safety net should a firm fail. Brand recognition and reputation seem to be the most important indicators of financial security at present, although this may change as the FSA Consumer Education programme starts to have an effect and consumer financial awareness and financial literacy improves. Consumers are happy to know a compensation scheme exists, but do not make financial decisions on the basis of its existence.
- 5.55 Indirectly the effect the existence of a compensation scheme has on consumer confidence should lead to an increase in, or at least maintain the existing levels of consumption of financial services. Under the existing arrangements, consumers could discriminate between holding their savings as deposits, investments, or policies of insurance, each of which were subject to a different regulatory regime. The majority of savings products now fall within the regulatory scope of the single FSA, so any dent in consumer confidence is likely to lead to a withdrawal from the financial services market altogether, with consumers spending on consumables rather than savings and investment products.
- 5.56 It is unlikely that the true effect of the payment limits and co-insurance selected by the FSA will be known before the FSA's Consumer Education programme has had time to take effect (i.e. some years), although if the frequency of failures in the future is similar to those which has occurred in the past (especially in the insurance and deposit taking sectors), the true impact may never be known. Nonetheless, the FSA considers it appropriate to have taken account of these risks when selecting the level of cover to be provided by the scheme, and the portion of any loss consumers will be expected to bear themselves.
- 5.57 The existence of a compensation scheme may arguably also act as a disincentive to firms to behave appropriately. Some believe that less scrupulous firms may gain a competitive advantage by relying on the compensation scheme to meet its liabilities in the event of its default. For example, a deposit taker may exercise less care when assessing the risk attached to its loans portfolio or accept higher levels of counterparty or market risk if it believes its depositors will be compensated if the firm fails. Or an insurer, particularly a weak insurer, may be encouraged to compete on price if consumers pay less attention than they otherwise might do to an

insurer's financial position and reputation. Or an adviser may give unsuitable advice in the belief that the compensation scheme may provide redress if the customer suffers a loss.

- 5.58 However, the existence of the FSA approved persons regime, prudential regulation, and in the future, risk based supervision means there are powerful disincentives to firms to behave in this way. Directors, managers, and controllers of a failed firm, and their close relatives, are also excluded from the scope of the scheme. This means they will be unable to receive compensation from the scheme for losses arising from that firm's failure, although they will be protected if a firm with which they have no connection were to fail. The FSA is satisfied that these measures address the disincentives to appropriate behaviour by firms that may arise from the existence of a compensation scheme.
- 5.59 The FSA has also sought to use market forces to encourage regulated firms to behave appropriately by excluding larger companies and financial institutions from claiming on the scheme. The FSA considers that large companies are in a better position than most retail consumers to assess if a firm is managed in a prudent manner, and to move their business elsewhere if they are not satisfied. The FSA also considers that a regulated firm is more likely to manage its business to avoid the risk of one or more large customers withdrawing their business from the firm, than if a similar number of ordinary retail customers took the same action.
- 5.60 The FSA has sought through a combination of measures to secure a realistic and appropriate level of benefit for consumers who have to claim on the scheme (which is always a second best option to not having incurred a loss in the first place) while minimising the costs to regulated firms and the risk of firms or consumers acting imprudently because the compensation scheme exists. As stated earlier, the actual costs of paying compensation are cancelled out by equal and opposite benefits to those who receive compensation.
- 5.61 The FSA also considered the effect reducing the level of cover would have on consumers and the industry (options 3 and 4 above). There is little to indicate that reducing the level of compensation payable by the scheme would alter the behaviour of firms. The costs to firms are unlikely to be significantly reduced if any reduction in cover was restricted to lowering the limit on the amount payable, given that the majority of claims are for small amounts relative to the maximum sums protected.
- 5.62 There could be a significant reduction in the costs to firms if the scope of cover in respect of investment business was limited to that specified in the ICD. This means that claims for negligence would no longer be covered by the Scheme. The practical effect of this is that contributor firms would no longer be required to meet claims for negligence, e.g. Pension Review claims. This

could lead to a significant reduction in costs; the £70m cost of meeting Pensions Review claims would not have arisen, nor would the majority of other claims paid by ICS.

- 5.63 However, our research has led us to conclude that any significant reduction in the scope or level of cover is likely to be mis-interpreted by consumers and lead to a loss of confidence in the financial system. Notwithstanding the low level of consumer awareness of the compensation arrangements at present, we believe that a significant reduction in the level or scope of cover would attract attention in the financial press and consumer media. Any loss of confidence would be almost directly proportional to the scale of the reduction, the implication being that if protection was being reduced the FSA must know something was amiss. It is our belief that such a reduction in cover could lead to a large-scale withdrawal from the financial system, with possible systemic effects. Should significant levels of withdrawals lead to failures and losses to consumers, the compensation scheme would face claims it might not otherwise have faced, with additional levies on the remaining participants in the industry as a result.
- 5.64 On balance, the FSA considers that its preferred option is the most practicable, taking into account the costs and benefits specified above, the potential impact on the behaviour of consumers and regulated firms, and the FSA's statutory objectives.

6 Next steps

Consultation on transitional provisions and levies

- 6.1 The FSA's aim is to effect a smooth transition from the various existing compensation schemes to the new Scheme. Transitional provisions will be made under the FSMA. Based on these provisions, the FSA will draft additional rules which will be the subject of further formal consultation in due course.
- 6.2 At the same time, the FSA will also consult on the levy rules for the Scheme and make proposals for the handling of the existing funds held by the Policyholders Protection Board and Deposit Protection Board.

Detailed operational procedures

- 6.3 In the period to N2, FSCS Limited will be working with the FSA and the existing schemes to establish the detailed operational procedures which will implement these rules.

Feedback from CP24 'Consumer Compensation: a further consultation' and FSA's response

Introduction

1. CP24 was published on June 9 1999 and the closing date for responses was Friday 10 September 1999. 94 responses were received; a list of those who responded, divided into 9 categories to assist with analysis, is attached. It represented the second stage in the consultation exercise concerning the new single compensation scheme.

Overview

2. The general response to CP24 has been positive and supportive of the general approach which the FSA is taking to the setting up of the scheme. Several respondents commented that in CP24 the FSA had addressed the concerns which they expressed in response to CP5, notably on the issue of cross-subsidy between firms in the investment business sub-scheme, engaged in dissimilar business activities. However, the FSA's Consumer Panel offered the view before publication that the FSA had missed an opportunity to make more radical changes. One point raised by many respondents from all categories is the need for increased public awareness of the existence of compensation and its limitations and we are considering this as a matter of priority.
3. Respondents displayed general agreement with our proposals concerning eligibility to claim on the new scheme. On the key issues of co-insurance and the limits that should apply in the deposit and investment sub-schemes, there was a wide variety of responses, reflecting the 'green' tone of the CP. There was support for an increase in the limits (particularly for deposit protection) and clear support for 100% cover to be available for the first tranche of a claim. Regulated firms and their trade associations were more receptive to the idea of 100% cover for part of a claim than had been expected.
4. Our proposals for further division of the sub-schemes into contribution groups were almost universally welcomed, particularly in relation to the

investment sub-scheme, as were our proposals concerning the definition and allocation of base costs. Wholesale market broking firms were the group that argued for their own contribution group, to reflect the fact that they do not generally deal with private customers. Opinion on whether banks and building societies should be grouped together or separately was divided, with most building societies arguing for separation.

New issues identified for consideration

5. The responses revealed a few new areas where further work has been needed. These were:
 - the appropriate contribution group for building societies which are appointed reps of life offices at present, but which will in future require permission from FSA to carry on this business, thus bringing them within the ambit of the investment sub-scheme;
 - the position of service companies;
 - the need for a review of the cross-subsidy arrangements between product providers and IFAs as part of the process of establishing the detailed methodology for the allocation of costs to individual firms;
 - how in determining eligibility we would operate the small/large company distinction based on the EU criteria for the preparation of accounts and the complexities of how this operates in practice;
 - the detailed implications of adopting all the exclusions from eligibility permitted by the EU directives, (e.g. directors, managers and their families and 'local authorities').

Research

6. During the consultation period, the FSA also commissioned qualitative and quantitative research on consumer awareness of compensation arrangements and their attitudes to limits, co-insurance etc. The results of this research have also been taken into account in formulating FSA's policies as set out in the body of this paper and the draft rules.

Questions 1-4: Eligibility to claim

- Q1: Do you agree that the deposits of larger corporates should be excluded from deposit protection?
7. There was widespread support for this proposal among respondents in all categories, who agreed with the principle that FSA should focus compensation on those least able to support a loss. The Deposit Protection Board (DPB), the BSA, the BBA and LIBA were all in support, as was the Board of the Building

Societies Investor Protection Scheme (BSIPS), which pointed out that further work was needed on how the criteria proposed for distinguishing between large and small corporates would operate in practice. The majority of individual banks and building societies that responded were also in favour.

8. The FSA's Small Business Panel argued that we should draw the net as wide as possible, not least in order to bolster confidence in smaller deposit takers.
9. ***The FSA's response:*** The EU criteria are such that only a small number of very large companies will be able to be excluded from deposit protection. It is therefore difficult to see how providing limited protection to them would enhance confidence in small deposit-takers. Furthermore, the FSA is required to have regard to consumers' differing degrees of expertise and experience and the principle that they should take responsibility for their decisions. Under these circumstances and given the wide support for the general principle on eligibility expressed in CPs 5 and 24, we do not consider it appropriate to pursue the SBP's line.

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

10. The responses to this question were mixed. Many respondents felt that those deposits which were not eligible for cover should on principle be excluded from the levy base, but many in turn recognised that there were considerable practical difficulties in doing this. No respondents provided any information on likely costs, although the Halifax stated explicitly that the costs of doing it would outweigh the benefits.
11. The DPB was in favour of exclusion, if it could be made to work in practice. The BSIPS re-emphasised their proposal in response to CP5 that the FSA examine a risk-based levy base. The BBA suggested that discretion be left to the FSA to permit exclusion in the future, if it proved practicable. The BSA suggested that easily identifiable non-eligible deposits could be excluded, such as those from other financial institutions.
12. No respondents felt that a reduced deposit base on which to base the levy was likely to prove problematic, given the history of defaults and claims in the deposit-taking area.
13. ***The FSA's response:*** We propose that unprotected deposits which can be identified from supervisory returns should in future be excluded from the deposit levy base. We recognise that stripping out other categories of unprotected deposit from the levy base may be difficult and therefore propose to continue the approach used by the DPB at present, whereby if the institution itself can identify the deposits in an unprotected category, then they

can request that they be excluded from the levy base. The FSA wishes to carry out further work on the feasibility of a risk-based levy, once the approaches to supervision of its 9 predecessor bodies have been brought together through the implementation of the Financial Services and Markets Act.

Q3: Should protection for claims on general insurance policies be extended to small corporate entities, to be defined using the criteria set out in the DGD and the ICD?

14. Responses to this question came mainly from the insurance industry and its trade associations and were mixed. The PPB did not feel it was appropriate for it to comment on this issue. The ABI opposes the extension of cover, but then noted that if the FSA still wanted to do this then we ought to examine the definition of a small corporate in this context and consider a turnover-based criteria. Of the 11 insurance companies who responded, 3 were in favour of extension, 3 others thought that they could support the idea if we re-examined the definition of a small corporate for these purposes or capped the level of cover, 3 were opposed and 2 did not respond to this question. The FSA Consumer Panel supported extension in principle, but also felt that using the EU criteria resulted in the definition of a small corporate being drawn too wide.
15. The ABI's arguments are that:
 - the costs of providing protection fall on the policyholder and that it would be inequitable for business policyholders to be protected at the expense of private ones;
 - that people who run businesses should see the need to seek professional advice in relation to the selection of insurance providers;
 - small businesses face very different risks from individuals and even relatively small companies can generate large liabilities, which could place large demands on the scheme.
16. ***FSA's response:*** There is no requirement on us to use the EU criteria in relation to policyholder protection eligibility – our proposal was driven by an attempt to ensure some degree of consistency across the various sub-schemes. We have therefore explored ways to cut back the threshold, so that a much smaller group of firms would be eligible for policyholder protection in respect of non-compulsory general insurance. Following discussions with interested parties, a small company, for the purposes of these rules, is defined as a company with called up share capital of less than £1m. A small partnership is to be defined as a partnership or unincorporated association with net assets of less than £1m.

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

17. Almost all of those who responded to this question were in favour of the proposal. The only outright opposition was from the Law Society of Scotland, who argued that as the EU required partnerships to be given deposit protection, they should also be offered investor and policyholder protection. (It is questionable whether the specific position of partnerships and their peculiar legal status in the UK was actually discussed when eligibility for deposit protection was discussed in the EU). No respondents offered any thoughts on how to define a large partnership.
18. *FSA's response:* The legal situation is that the EU legislation does not permit the exclusion of partnerships from deposit protection, but does permit their exclusion from investor compensation if we argue that they are professional or institutional investors. There is no specific EU legislation governing eligibility of partnerships in respect of policyholder protection. A number of non-EEA partnerships are likely to be excluded from eligibility on territorial grounds but we can in addition decide whether to exclude large EEA partnerships.
19. Given the strong support for the exclusion of large partnerships we propose to adopt the same criteria used to distinguish between small and large corporates for policyholder purposes (see above). Partnerships which do not meet the criteria will be regarded as 'professional or institutional' and therefore not eligible to claim investor compensation and policyholder protection.

Questions 5-9: How much compensation should the scheme pay?

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

20. Most industry respondents felt that some element of co-insurance in the compensation structure should be retained, and that limits in the deposit and investment sub-schemes were appropriate, as they ought to act as an incentive to consumers to think carefully about where they place their money or do business. However, many respondents agreed that they cannot work as an incentive if consumers are unaware that they may not get all their money back. There was strong support for the FSA to promote public awareness of compensation as a priority, both from industry respondents and from consumer organisations, including the FSA Consumer Panel.
21. A number of respondents felt that it was difficult to argue that consumers should be required to protect themselves by differentiating between firms if they do not have access to the information to enable them to do this. The FSA Consumer Panel stated:

'We accept that as a practical matter compensation limits (other than for insurance) are likely to be unavoidable. But as we have said, we dislike the term 'co-insurance'. Co-insurance has no legitimate place here. It assumes that consumers choose not to take care, or check the safety and soundness of a firm, because of the availability of compensation. We have seen no evidence of this. It is entirely unrealistic to expect most consumers to have the information, resources, or awareness to assess why one authorised firm is more risk than the other.'

22. Many respondents felt that savings and investment patterns were important in deciding where to set limits and co-insurance thresholds. The BSIPS suggested that it would be helpful for the future if the threshold for co-insurance could be linked to an objective measure of depositors' economic circumstances, and proposed average monthly earnings. A number of industry respondents said that affordability was an important factor, so that the compensation burden from a default did not put more firms out of business. The Small Business Panel felt that generous compensation arrangements enhanced the attractiveness of small firms and redressed the competitive balance which would otherwise lie with those firms perceived as too big to fail. A few respondents cited international comparability as important.

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

23. As in responses to CP5, there was no pressure to change the existing ICS arrangements, whereby investors receive 100% of the first tranche of a claim and 90% of the remainder, up to a maximum limit.
24. For non-compulsory general insurance claims, the ABI opposed 100% cover for the first part of a claim in principle, but indicated that they might be prepared to accept it for the first £1,000. BIBA opposed any level of 100% cover. The responses from individual insurance companies were mixed. Of the 11 firms who responded to the question, 5 opposed any level of 100% cover. Three indicated that they could accept it for a small slice of a claim, e.g. £1,000. Two suggested 100% cover for the first £10k and one 100% for the first £30k. The one bancassurer who responded suggested 100% cover for all insurance claims. There was very little specific comment on general insurance claims among other respondents.
25. The majority of comments in relation to co-insurance related to the deposit sub-scheme. There was substantial support for 100% cover for at least the first part of a claim, generally on the grounds that this would focus compensation cover where it was really needed, in enabling depositors to recover their 'working capital'. Suggestions from those who found the idea

acceptable as to where the threshold should be set ranged from £1,000 to £100k, including many points in between.

26. Responses from the banking industry and several of the key trade associations demonstrate a willingness to accept 100% cover for at least the first few thousand pounds of a claim. The FSA SBP and the Consumer Panel support 100% cover to a substantial level. The DPB, BBA and BSA could accept a threshold of £2k (the BSA tying their support for this to a separate building societies contribution group). LIBA opposed any degree of 100% cover. Among the 12 individual banks and building societies who responded, two did not respond to the question, but the other 10 all supported 100% cover to various levels. Two were not specific on the threshold, three suggested £2k, one £5k, one £10k, one £20k, one £30k and one 100% for the first 60% of the total claim.

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

27. Nearly all respondents answering this question agreed with the FSA's proposal. The Consumer Panel and three large firms said that the FSA should seek to harmonise the limits in the deposit and investment sub-schemes over time, to provide greater clarity to consumers, especially in relation to products such as ISAs. The Panel's response was part of a wider plea to FSA to recognise that the existing limits are an accident of history and that a 'full review' is required in order to develop an approach that has an underlying rationale. It is difficult to see what more we can do on this, given the analysis of the relevant factors in CP24 and our request for comments on these.

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

28. Again, the responses were mixed. Looking at all responses, a majority favoured an increase in the deposit protection limit. There was a lower level of support for an increase in the investment limit.
29. The Consumer Panel said '*We strongly recommend that individual limits are increased as a matter of priority*'. They were particularly concerned that with an increasing focus on consumer providing for their own retirement, there is a danger that careful, forward-planning individuals could be left in poverty. The Panel argued that the existing limits are not based on an underlying rationale and that one needs to be developed as a matter of priority for the future. The Consumers' Association argued that even those with the largest losses should receive full compensation.

30. The DPB supported the current £20k limit for deposit protection, while the BSIPS supports in increase to £30k. ICS and the PPB did not comment on this question.
31. The BSA and BBA want to stay with £20k in the deposit sub-scheme. Among banks and building societies there is a small majority among those responding for an increase in the deposit limit, but no agreement on how much – suggestions raise from ‘closer to other countries’ to ‘to current ICS levels’ to ‘increase for inflation’.
32. LIBA, FOA, the ABI and AUTIF want to retain the existing ICS limit in the investment sub-scheme. The FMA suggests this should be increased to £70k and APCIMS to £100k (but it ties this proposal to the removal of 100% cover to any level). Among retail investment firms, there was some support for an increase in the ICS limit, but the majority of firms felt that we should stay at the current level.
33. The issue of limits for deposit protection and investor compensation have also been considered in our consumer research.
34. *FSA’s response:* FSA has weighed up the wide range of suggestions received in response to the very open questions in CP24 and the results of the consumer research.
35. On co-insurance, the proposed rules provide for the Scheme to give 100% for the first £2,000 of a claim in the deposit and insurance sub-schemes. The investment business sub-scheme will offer 100% cover for the first £30,000 of a claim as the ICS does at present. 90% cover will be provided for the remainder of the claim in all cases, up to the maximum limit provided for in the rules.
36. On limits, the deposit protection limit is to be raised to £35,000, broadly reflecting the effects of inflation since the limit was last reviewed (i.e. 100% x £2k plus 90% of £33,000 giving a maximum of £31,700). The limit on investment claims will remain at £50k for the time being.

Q9: Do you agree with the FSA’s proposals for future review on individual limits and the co-insurance structure applied to claims?

37. There was general support for the principle of regular review of the limits applying to compensation claims. A few respondents questioned the wisdom of re-opening the co-insurance debate again, once the FSA has made decisions on this. The consumer sector also felt that five years from the start of the new scheme is too long to wait for the next review and that this ought to happen within three years of the start. One individual wanted annual reviews, as circumstances can change so fast.

38. *FSA's response:* If an element of co-insurance is to be retained in the new scheme, it will always remain an issue for debate. It is also extremely difficult to disentangle the issues of co-insurance and limits, so it is not realistic to say that we will review one without the other. However, we recognise that these issues are a key concern for consumers and practitioners and that our proposals on limits and co-insurance outlined above do not go as far as some respondents have suggested. We therefore think it would be appropriate for a review to take place within 3 years of N2.

Questions 10-13: Allocation of liabilities

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

39. There was considerable support across the full range of respondents for the FSA's proposals concerning the definition of base costs. On allocation, many respondents felt that to allocate them in proportion to regulatory fees would be fine. Others reserved their position until the FSA has published further proposals on fees. Other possible methods proposed for allocation included in proportion to the compensation costs to be borne by the firm or through a flat rate charge. However, the former means that many firms could end up paying nothing over a number of years and the latter discriminates in favour of large firms.
40. A number of wholesale firms argued that as they had no eligible customers, they should not contribute anything to the new compensation scheme. This goes against the general support for spreading such costs across all authorised firms that was secured through CP5, using the argument that the existence of a compensation scheme promoted market confidence and that a small contribution to the costs would be an acceptable part of the costs of doing business in UK.
41. *FSA's response:* FSA recognises the need to minimise the base costs of the scheme and proposes that those that do arise should be allocated to authorised firms in proportion to their regulatory fees. We shall be working closely with the FSA's Finance Department on the practicalities of calculation and collection of all elements of the compensation levy.

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

42. The DPB argued that banks and building societies should be brought together, if building societies agreed. The BBA, LIBA and ABSAL did not offer an opinion. The BSA favoured maintaining separation and only supported 100% cover for the first £2k of a claim if societies retained their own group.

43. The BSIPS discussed this question at some length. In the end, they concluded *'in view of the potential impact of any further conversion of building societies on the sector's capacity to sustain a separate contribution group, the Board considers that banks and building societies should form one contribution group from the commencement of the scheme.'*
44. The consumer groups tended to the view that too much ring-fencing could create difficulties for the scheme in sustaining funding, and that the number of contribution groups should be minimised as far as possible.
45. All building societies that responded, including the Nationwide, favoured separation, at least for the moment. The six banks which offered a response were equally divided.
46. ***FSA's response:*** In our view, the views of the existing Boards should carry greatest weight on this point. Creating a single group for banks and building societies from the start of the new Scheme enables the FSA to do this in a controlled manner, rather than when forced to do it as a result of further conversions or a series of defaults. It is also notable that the building societies argue for separation on the basis that there has never been a default in their sector. This is true, but the facts remain that some building societies have been near collapse but rescued through mergers etc, the level of default in the banking sector has been low, with no special levies raised since 1992, and in the majority of banking liquidations the DPB has eventually recovered and repaid a significant proportion of the compensation it has paid out. We believe that to retain separate groups would go against the FSA's message that deposit-takers will in future be regulated according to risk, regardless of their historic structure as bank or society.
47. We are therefore proposing to structure the new scheme so that banks and building societies effectively constitute one contribution group for the purposes of funding the new compensation scheme. Further work is continuing to determine how credit unions will be brought into the structure of the new Scheme.
- Q12: Is there any case for further sub-division of the 'all others' contribution group, bearing in mind the need for contribution groups to be large enough to be self-sustaining wherever possible?
48. The majority of respondents did not see a need for further sub-division and the Consumers' Association actively opposed it, as they felt too much division might undermine the funding capability of the scheme.
49. Specific responses highlighted the need to address the position of service companies in the new scheme and the position of building societies which were appointed representatives but which will now have to have permission to

carry on investment business in their own right. Further work is being done on these.

50. The s43 firms do not wish to be in a group in the new scheme with ex-SFA firms and other firms who were doing retail business. The Wholesale Market Brokers' Association argued that the fact that the FSA had seen fit to establish a separate compensation scheme for s43 firms to date suggested that we accepted this class of firms was capable of constituting a separate contribution group.

51. *FSA's response:* FSA is working on the levy rules and will consult separately on these proposals later in the year.

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

52. In general, respondents supported the principles set out in the CP to govern the allocation of costs to firms, noting that weighting the costs towards those firms that do business with eligible claimants was critical. However, a number of trade associations (BBA, LIBA, FMA,) remain concerned that the principles permit cross-subsidy between contribution groups within a sub-scheme, albeit only in clearly defined circumstances and after full consultation. They would like us to rule out such cross-subsidy completely. The individual firms that responded did not raise this issue, except that a number of product providers suggested that the IFA cross-subsidy should be reviewed as part of the exercise to prescribe the detailed allocation methodology for each group.

53. *FSA's response:* The FSA takes the view that to outlaw cross-subsidy between contribution groups is impractical and a step too far. Past experience demonstrates the need to retain the ability to continue the existing arrangements, whereby the IFA community's compensation liabilities are met in large part by the product providers who use IFAs as a distribution channel. Outlawing cross-subsidy between groups would render this impossible, without substantial re-drawing of the groups. Also, we cannot predict the future and it is possible to envisage circumstances where a different cross-subsidy arrangement might be required. Whilst it would be possible for FSA to change the rules we would then be going back on a principle set earlier. We have therefore felt it better to recognise, from the outset, the remote possibility that other cross-subsidy arrangements might be needed in the future, while offering reassurances that these will only be used as a last resort and after full consultation.

54. Given the practical need for this facility and the reassurances already offered we do not propose to change our position on this point.

Questions 14-15: Other issues

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

55. Among those responded to this question there was substantial opposition to a joiners' levy. The only significant support for it was from the BBA who felt that a low level of joining fee, similar to that applying to the DPS at present, would at least mean that new joiners had contributed something. Others felt that it was likely to be too complicated to administer and that determining an appropriate level was too difficult.

56. *FSA's response:* We do not propose to pursue the issue of a joining levy any further.

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

57. Responses to this question were mixed. Many non-deposit taking firms could not see a rationale for limiting cover to particular currencies in one sub-scheme, when investor compensation does not have regard to currency. The BBA, ABSAL and LIBA all opposed extending cover to non-EEA currencies, generally arguing that the scheme was extended non-sterling EEA currencies only so as to comply with the EU Directive and that a foreign currency deposit is indicative that a consumer is not 'vulnerable'. The BSA and BSIPS had no difficulty with extending cover. Of the 12 banks and building societies which responded 4 did not offer a view, 4 supported extension, 1 had no objection to extension and 3 opposed. The consumer organisations did not address this issue in their responses.

58. *FSA's response:* We remain unconvinced of the arguments for denying protection to foreign currency deposits and are particularly concerned that to do so could leave small depositors among ethnic minorities exposed. We therefore propose that the new scheme should protect deposits in all currencies.

Other issues raised by respondents

59. A number of firms of solicitors wrote in to argue that firms of lawyers that end up being authorised by the FSA should not be required to participate in the new scheme, as the Law Societies' schemes are already more than adequate.

60. A number of respondents to CP24, including the Consumer Panel, saw need for FSA to increase awareness of the compensation arrangements, reflecting their concern that consumers are not aware that 100% of their money may

not be protected. In the research, those who responded to the quantitative survey also felt that the FSA needed to make consumers more aware of the arrangements.

61. Some other respondents to CP24 saw increasing public awareness of compensation or consumer education initiatives as a means to get round the problem that co-insurance and limits are clearly not acting as an incentive on consumers to take care about where they place their money.
62. Other respondents, and members of the focus groups in the qualitative research who had an opportunity to give a more considered reaction recognised that public awareness campaigns on compensation might create panic and undermine the consumer confidence element of market confidence. Consumers might actually be deterred from placing their money with authorised institutions.
63. *FSA's response:* We need to ensure that consumers who are about to enter into transactions are informed of the compensation arrangements that will apply in the event of default. The means through which this will be achieved and the exact form in which the information will be provided is the subject of further work.
64. We need to ensure that clear information is available to anyone who contacts the FSA, the new scheme or authorised firms to ask about compensation arrangements (for example, we envisage that the new scheme will have a consumer-friendly website).
65. We believe that the costs and disadvantages of an extensive campaign to raise general public awareness of the compensation arrangements would outweigh the benefits. It is also accepted that consumer education initiatives are only likely to have an effect over a long period. We do not believe that an extensive public awareness campaign or consumer education initiatives are ever likely to put private consumers in a position to assess the relative riskiness of the firms which which they do business. We believe that a more effective way forward is to emphasise, through a variety of means, the need for consumers to check that the firm they are dealing with is authorised to do the kind of business in question (which will bring the consumer within the compensatable perimeter).

Responses to CP24 were received from:

Alliance & Leicester plc
Alliance Trust Savings Limited
American Banking & Securities Assoc. of London (ABSAL)
Assoc. of Private Client Investment Managers & Stockbrokers (APCIMS)
Assoc. of Solicitor Investment Managers
Association of British Credit Unions Limited
Association of British Insurers (ABI)
Association of Friendly Societies
Association of Policy Market Makers
Association of Unit Trusts & Investment Funds (AUTIF)
AXA Sun Life Services plc
Backhouse Independent Financial Services Ltd.
Bacon & Woodrow Friendly Society
Bank of Scotland
Barclays PLC
Barnett Waddingham Consulting Actuaries
Bloomberg L P
Brennan Neil & Leonard
British Bankers' Association (BBA)
British Insurance Brokers' Association (BIBA)
British Venture Capital Association
Building Societies Association (BSA)
Building Societies Investor Protection Board (BSIPB)
Capital Financial Services
CGU plc
Claredon Friendly Society
Consumers' Association
Countrywide Independent Advisors
Cripps Harries Hall
Deposit Protection Board (DPB)
Depositary & Trustee Association
Equitable Life Assurance Society
Faculty of Actuaries, Institute of Actuaries
Federal Deposit Insurance Corporation
Fidelity Investment Services Ltd.
Financial Services Consumer Panel
Financial Services Regulation Working Party
Flemings
Foreign & Colonial Management Limited
Forward Financial Planning Ltd.
Friendly Societies Commission
Fund Managers' Association (FMA)

Futures & Options Association (FOA)
Gaffney, Cline & Associates Ltd.
H M Treasury
Halifax plc
HSBC Holdings plc
Intercapital
International Securities Consultancy
Investors Compensation Scheme Limited (ICS)
Kent Reliance Building Society
Law Society
Law Society of Scotland
Legal & General
Liverpool Victoria Friendly Society Limited
Lloyd's
London Investment Banking Association (LIBA)
Lupton Fawcett Solicitors
Mercury Asset Management
Middleton & Company
National Association of Pension Funds
Nationwide Building Society
NatWest Group
Norwich Union
Pearl Assurance plc
Pensions Management Institute
PIA Small Business Practitioners Panel
Policyholders Protection Board (PPB)
Portman Building Society
Prebon Marshall Yamane (UK) Limited
Professional Partnerships
Proshare (UK) Limited
RBS Trust Bank
Royal & Sun Alliance Life & Pensions
Save & Prosper Group Limited
Securities Institute
Shuttleworth & Co.
Skandia Life
Small Business Practitioner Panel (SBP)
Solicitors for Independent Financial Advice Ltd.
Sun Life of Canada Group of Companies
Swiss Life (UK)
Taube Hodson Stonex Partners Limited
Thorntons Solicitors
Tradition (UK) Limited
Tullet & Tokyo International Securities Ltd.

Tullett & Tokyo London Ltd.
UBS Brinson Limited
University of Nottingham
Virgin Direct Personal Finance Service Ltd.
Wholesale Markets Brokers' Association
Yorkshire Building Society
Zurich Financial Services

Draft Rules

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1. Introduction and Overview

1.1 Application

- 1.1.1 G The chapter is relevant to:
- (1) *The Scheme Manager*;
 - (2) Those who might wish to make claims for compensation ('claimants'); and
 - (3) *Firms*.

1.2 Introduction

- 1.2.1 G Under section 212 of *the Act*, *the FSA* must set up a body corporate to exercise the functions that are conferred on that body corporate by part XV of *the Act*, dealing with compensation. Accordingly, *the FSA* has created Financial Services Compensation Scheme Limited, a company limited by guarantee.
- 1.2.2 G *The FSA* is also required, under section 213 of *the Act*, to make rules establishing a compensation scheme. These rules are set out in the remaining chapters of this sourcebook. *The Scheme* is to be managed by Financial Services Compensation Scheme Limited, '*The Scheme Manager*'.
- 1.2.3 G The rules in this sourcebook are directed at three categories of *person*:
- (1) *The Scheme Manager*;
 - (2) Claimants;
 - (3) *Firms*.

1.3 Purpose

- 1.3.1 G The rules in this sourcebook are one of the means by which *the FSA* will meet its regulatory objectives of securing the appropriate degree of protection for consumers and maintaining confidence in the financial system. By providing compensation at a level appropriate for the protection of *private customers* and small businesses, consumers can participate in the market place with the confidence that they will be protected, at least in part, should the *relevant person* with whom they are dealing be unable to satisfy claims against it.
- 1.3.2 G The provision of compensation also enables *the FSA* to adopt a less prescriptive regulatory approach towards disclosure of information by *firms* to consumers. This results in a reduced regulatory burden on *firms*, without diminishing consumer protection.

1.4 The Scheme Manager

- 1.4.1 G The rules in this sourcebook are principally relevant to *The Scheme Manager*. They set out the circumstances in which compensation may be paid, to whom compensation may be paid, and on whom *The Scheme Manager* may levy contributors to meet the costs of paying compensation (see in particular Chapters 3, 4, and 13). They also describe how *The Scheme Manager* is to calculate compensation in particular cases (see Chapter 12).

- 1.4.2 G However, while the rules in this sourcebook deal with the main powers and duties of *The Scheme Manager*, they do not provide the complete picture. *The Scheme Manager* has powers under company law: for example, to engage *agents* to act on *The Scheme Manager's* behalf; to rent accommodation; and to borrow money. In addition, *the Act* itself confers certain powers upon *The Scheme Manager*, such as a power to require *persons* to provide information or documents (section 219). Finally, the relationship between *The Scheme Manager* and *the FSA* is touched on at several points in this sourcebook, in particular in Chapter 2; but the details of that relationship are mainly to be found in a Memorandum of Understanding between the two.

1.5 Claimants

- 1.5.1 G Claimants and their advisers will be particularly interested in the sections of the rules in this sourcebook that deal with eligibility for claiming compensation, the way that *The Scheme Manager* calculates compensation, and how much they can claim. For convenience, the relevant rules are highlighted in a list of questions and answers in Table COMP 1.5(1)G.
- 1.5.2 G Claimants will also receive information about *the Scheme* from *The Scheme Manager*, should they make an application for compensation. They may also request information from *The Scheme Manager* at [address], or by telephone or fax ([numbers]), or by e-mail ([address]).

Table COMP 1.5(1)G Rules of particular interest to claimants		
This table forms part of COMP 1.5.1G		
Q1	What do I need to do in order to get compensation?	
A1	In order to get compensation, you must be:	
	1) An <i>eligible claimant</i> ,	COMP 4.3.1-2R
	2) With a <i>protected claim</i> ;	COMP 5.3-5.6
	3) Claiming against a <i>relevant person</i> ;	COMP 6.3.1R
	4) Who is in default	COMP 6.4
	In addition, if <i>The Scheme Manager</i> requires you to do so, you must assign your legal rights in the claim to <i>The Scheme Manager</i> .	COMP 7.3-7.4
	AND you must bring your claim to <i>The Scheme Manager</i> within a set time (normally within six years from the date of the claim).	COMP 8.3.4-5
	It is possible, in certain circumstances, for someone else to make a claim on your behalf.	COMP 3.3.4R

Q2	How much compensation will I receive?	
A2	This depends on whether your <i>protected claim</i> is a	
	1) protected deposit claim,	COMP 5.4
	2) protected contract of insurance claim, or	COMP 5.5
	3) protected investment business claim.	COMP 5.6
	Different limits apply to different types of claim.	Table COMP 10.3(1)R
Q3	How will the Scheme Manager calculate the compensation that is offered to me?	
A3	Again, this will depend on whether your <i>protected claim</i> is a	
	1) protected deposit claim	COMP 12.3.1R, 12.5.1R and 12.6.1R
	2) protected contract of insurance claim, or	COMP 12.3.1R, 12.5.2-3 and 12.6.10-18
	3) protected investment business claim	COMP 12.3.1R, 12.5.2R, 12.5.4R and 12.6.3-6
	Certain types of protected investment business claim require <i>The Scheme Manager</i> to use a particular method of calculation.	COMP 12.6.7-9
Q4	What happens if an insurer is insolvent?	
A4	If an <i>insurer</i> becomes insolvent, and you have a <i>long term insurance</i> policy with the <i>insurer</i> , <i>The Scheme Manager</i> will first try to secure continuity of insurance for you.	COMP 3.4 and 12.6.10R
	If <i>The Scheme Manager</i> achieves this, you will not necessarily receive any cash, but you will continue to be insured (though possibly with lower benefits than before).	COMP 10.3.4R and 12.7
	You will receive cash compensation only if <i>The Scheme Manager</i> cannot secure continuity of insurance cover or the cost of doing so would be unreasonable.	COMP 3.4 and 12.6.10R

	If you have a contract of <i>general insurance</i> with an insolvent <i>insurer</i> , <i>The Scheme Manager</i> will pay you cash compensation.	COMP 12.6.11R and 12.6.13R
	If the <i>insurer</i> is in 'financial difficulties', a situation short of insolvency, <i>The Scheme Manager</i> may try to arrange for another <i>insurer</i> to take over the <i>business</i> , or provide the <i>insurer</i> with financial assistance to carry on <i>business</i> . If this occurs, you will not receive cash compensation, but your policy will continue (though possibly with lower benefits from before).	COMP 3.5 and 10.3.5R

1.6 Firms

- 1.6.1 G *Firms* will be particularly interested in chapter 13, which deals with levies. [Each *firm* is allocated to a *contribution group* consisting of *firms* doing similar *business* (such as fund management, *deposit taking*, and *general insurance*). Depending on the type of *business* the *firm* carries on, it may be allocated to more than one *contribution group*.]
- 1.6.2 G [When a *firm* which is a member of a *contribution group*, or someone for whom the *contribution group* is responsible, is unable to meet claims against it, the costs of the compensation paid by *The Scheme Manager* in respect of those claims are allocated to that *contribution group*. If there is insufficient money in the *contribution group* accounts to meet these costs, *The Scheme Manager* raises a levy on the *firms* in that *contribution group*. The amount each individual *firm* pays depends on the type of claim for which compensation has been paid, and which *contribution group* is responsible for meeting the compensation costs.]
- 1.6.3 G *EEA firms* which are covered by their *home state deposit* guarantee or investor compensation scheme for their *business* from *branches* in the *UK* which is carried on under a *2BCD* or *ISD* 'passport' may become members of *contribution groups*. They are not required to participate in *the Scheme*. However, the *DGD* and *ICD* provide that if *the Scheme* offers a higher level of compensation for claimants than an *EEA firm's home state* scheme, or covers a wider scope, the *EEA firm* may choose to 'top-up' the *home state* coverage by participating in *the Scheme*.
- 1.6.4 G If an *EEA firm* 'tops-up', and then becomes insolvent, the *home state* scheme will pay compensation for claims up to the limit and scope of the *home state* scheme, with *The Scheme Manager* paying compensation for the additional amount in accordance with the rules in this sourcebook. The *DGD* and *ICD* require *The Scheme Manager* to make arrangements with the relevant *home state* scheme regarding the payment of compensation (COMP 14.4.1R).
- 1.6.5 G If an *EEA firm* becomes a member of a *contribution group*, it is responsible for paying compensation levies in the same way as any other member of the *contribution group*, though for the purposes of calculating the compensation levy *The Scheme Manager* will take account only of the *business* carried on from the *branch* in the *UK*.
- 1.6.6 G Chapter 14 contains further details of the position of *EEA firms* as participants in *the Scheme*.

2. The Scheme Manager

2.1 Application

2.1.1 R This chapter applies to *The Scheme Manager*

2.2 Purpose

2.2.1 G In order to carry out its functions and put into effect the provisions set out in chapters 3-14 dealing with determining whether compensation is payable, calculating the amount of compensation that should be paid, and making levies on *firms*, *The Scheme Manager* needs to have a variety of powers. The purpose of chapter 2 is to set out these powers, and the restrictions upon them.

2.2.2 G Chapter 2 also has a further purpose: to describe briefly the relationship between *the FSA* and *The Scheme Manager*. Further details are contained in the Memorandum of Understanding.

2.3 The Scheme Manager

2.3.1 G *The Scheme Manager* is responsible for the administration of *the Scheme* in accordance with the rules in this sourcebook

2.3.2 R *The Scheme Manager* must have regard to the need to use its resources in the most efficient and economic way in carrying out its functions under the rules in this sourcebook.

2.4 Powers of Management

2.4.1 R *The Scheme Manager* must hold, manage and apply the sub-Scheme Funds in accordance with the rules in this sourcebook, although the express powers given by the rules do not detract from nor restrict *The Scheme Manager's* general powers of management.

2.4.2 R Assets of the sub-Scheme Funds are to be invested from time to time as *The Scheme Manager* determines.

2.4.3 R *The Scheme Manager* may:

- 2.4.4
- (1) publish information on the operation of the Scheme, and
 - (2) agree to pay the reasonable costs of an *eligible claimant* bringing or continuing insolvency or similar proceedings against a *relevant person* (whether those proceedings began before or after a determination of default), if *The Scheme Manager* is satisfied that those proceedings would help it to discharge its functions under the rules in this sourcebook.

2.4.5 G *The Scheme Manager* also has general company law powers set out in its Memorandum of Association (see COMP 1.4.2 G).

2.5 Co-operation between The Scheme Manager and the FSA

2.5.1 R *The Scheme Manager* must co-operate with and assist **the FSA** in exercising its functions.

2.5.2 G The Memorandum of Understanding is also relevant here (see COMP 2.2.2 G).

2.6 Annual report

2.6.1 R *The Scheme Manager* must make and publish an annual report to **the FSA** on the discharge of its functions and on the operation of the Scheme, covering each financial year. The report must be made within four months of the end of the year reported on.

2.6.2 R The financial year must end on 31 March.

2.6.3 R The report is to give details of the exercise by *The Scheme Manager* of its powers of management , and must:

- (1) comply with the accounting and disclosure requirements of the Companies Act 1985 and with generally accepted accounting principles;
- (2) include a statement showing the movement within each sub-Scheme Fund during the year and a statement of assets and liabilities of each sub-Scheme Fund as at the end of the year;
- (3) include a statement allocating payments into and out of each sub-Scheme Fund during the year to the relevant **contribution groups**;
- (4) be accompanied by a report of *The Scheme Manager's* auditors as to whether, in their opinion, the statements have been properly prepared in accordance with the rules in this sourcebook.

2.6.4 G If the auditors think that proper accounting records have not been kept, or a sub-Scheme Fund's individual accounts are not in agreement with the accounting records and returns, or if the auditors fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit, they should state that fact in their report.

2.7 Three month report

2.7.1 R *The Scheme Manager* must also make a regular three-monthly report to *the FSA* within one month of the period reported on, giving details of the exercise by *The Scheme Manager* of its powers of management and such other information as *the FSA* may request from time to time.

2.7.2 G The three-monthly report need not be accompanied by an auditors' report.

2.8 Report on particular events

2.8.1 R *The Scheme Manager* must notify *the FSA* in writing of the appointment of any *person* as its chief executive or secretary, or of any change in auditors, as soon as possible after the event.

2.9 Budget

2.9.1 R At least two months prior to the commencement of a new financial year *The Scheme Manager* must prepare a draft financial budget for that financial year, and submit it to *the FSA* for approval.

2.9.2 R *The Scheme Manager* shall manage *The Scheme* in accordance with the financial budget approved by *the FSA*.

2.10 Record keeping

2.10.1 R *The Scheme Manager* must make and retain records which show and explain the transactions of the Scheme, and which will enable:

- (1) the financial position of *The Scheme* to be determined with reasonable accuracy at any time; and
- (2) *The Scheme Manager* to make the reports required by the rules in this sourcebook.

2.10.2 R Records required to be made and retained by COMP 2.10.1 R must be kept for a period of at least 6 years from the end of the financial year to which they relate.

2.10.3 R *The Scheme Manager* must also keep any records relating to claims made by *eligible claimants* until *The Scheme Manager* reasonably believes that the records will no longer be required.

2.11 Publication of defaults

- 2.11.1 R As soon as possible after becoming satisfied that a *relevant person* is unable or likely to be unable to meet claims against them in relation to *regulated activities* that constitute scheme business, *The Scheme Manager* must take reasonable steps to inform potential claimants how they can make a claim for compensation.

2.12 Complaints

- 2.12.1 R *The Scheme Manager* must ensure that effective procedures are established for the handling of any complaints of maladministration relating to any aspect of the operation of the Scheme.

- 2.12.2 R These procedures must include:

- (1) Nominating a *person* or *persons* employed by *The Scheme Manager* to be responsible for assessing all complaints of maladministration made against the Scheme, and for responding to the complainant;
- (2) Setting appropriate times for responses to *complaints*; and
- (3) Appointing a *person* who is independent of *The Scheme Manager* to enquire into and report on complaints which *The Scheme Manager* cannot resolve.

3. Paying compensation, securing continuity of insurance and safeguarding policyholders of insurers in financial difficulties

3.1 Application

3.1.1 R This chapter applies to *The Scheme Manager*.

3.1.2 G It is also relevant to claimants.

3.2 Purpose

3.2.1 G The purpose of this chapter is to set out in general terms the conditions that must be satisfied before *The Scheme Manager* can make an offer of compensation, secure continuity of insurance cover, or provide assistance to an *insurer* to enable it to continue *insurance business*. The qualifying conditions for paying compensation (claimant being an *eligible claimant*, with a *protected claim*, against a *relevant person* in default, and required to assign rights to *The Scheme Manager* if required) are set out in greater detail in chapters 4-7

3.3 The qualifying conditions for paying compensation

3.3.1 R *The Scheme Manager* may pay compensation if it is satisfied that:

- (1) An *eligible claimant* has duly made an application for compensation;
- (2) The application is in respect of a *protected claim* against a *relevant person* who is in default; and
- (3) Where *The Scheme Manager* so requires, the claimant has assigned his rights against the *relevant person*, or against any third party to *The Scheme Manager* in an appropriate manner.

3.3.2 G For the calculation of compensation, see Chapter 12. In certain circumstances *The Scheme Manager* will pay compensation only where it considers that this is essential in order to be fair to the claimant: see COMP 12.6.3R.

3.3.3 G For further details of what constitutes:

- (1) An *eligible claimant*, see Chapter 4.
- (2) A *protected claim*, see Chapter 5.
- (3) A *relevant person* in default, see Chapter 6.
- (4) Assignment of rights, see Chapter 7.

3.3.4 R *The Scheme Manager* may also pay compensation to *persons* who claim on behalf of another *person* if *The Scheme Manager* is satisfied that the *person* on whose behalf the claim is made

- (1) Is or would have been an *eligible claimant*; and

(2) **Would have been paid compensation by *The Scheme Manager* had he been able to make the claim himself, or to pursue his application for compensation further.**

3.3.5 G Examples of the circumstances where COMP 3.3.4 R would apply are:

- (1) Where personal representatives make a claim on behalf of the deceased;
- (2) Where *trustees* make a claim on behalf of beneficiaries (for further provisions relating to claims by *trustees*, see COMP 12.8);
- (3) Where the donee of an enduring power of attorney makes a claim on behalf of the donor of the power;
- (4) Where the Master of the Court of Protection makes a claim on behalf of a *person* incapable by reason of mental disorder of managing and administering his property and affairs;
- (5) Where an *eligible claimant* makes a claim for compensation but dies or becomes mentally incapable before his claim is determined.

3.4 Securing continuity of insurance cover

3.4.1 R Unless COMP 3.5.1R applies, where *The Scheme Manager* determines that a *relevant person* who is an *insurer* is in default, *The Scheme Manager* must, if it is reasonably practicable to do so, make arrangements to secure continuity of insurance for policyholders of *long term insurance* contracts with the *relevant person*, if

- (1) The policyholders would be *eligible claimants* under the rules in this sourcebook; and
- (2) In the opinion of *The Scheme Manager*, the cost of the arrangements is likely to be less than the cost of paying compensation under COMP 3.3.

3.4.2 G If the cost of securing continuity of insurance is, in *The Scheme Manager's* view, likely to be greater than the cost of paying compensation, COMP 3.3 will apply.

3.4.3 R If COMP 3.4.1 R applies, in securing continuity of insurance *The Scheme Manager* may take such measures as it considers appropriate:

- (1) To secure or facilitate the transfer of the *business* of the *relevant person* in default which consists of the carrying out of *long term insurance* contracts, or any part of that *business*, to another authorised *person*; and
- (2) To secure the issue of policies by another authorised *person* to *eligible claimants* in substitution for their existing policies.

3.4.4 G If any benefits under a *long term insurance* contract fall due to be paid to the policyholder while *The Scheme Manager* is seeking to secure continuity of insurance, *The Scheme Manager* will pay 90% of the benefit to the policyholder: see 12.7.1R.

3.5 Safeguarding policyholders of insurers in financial difficulties

- 3.5.1 R Where *The Scheme Manager* determines that a *relevant person* who is an *insurer* is in financial difficulties, and the conditions in COMP 3.4.1R are satisfied, *The Scheme Manager* may take such measures as it considers appropriate:
- (1) To secure or facilitate the transfer of the *business* of the *relevant person* which consists of the carrying out of *contracts of insurance*, or any part of the *business*, to another authorised *person*; and
 - (2) To give assistance to the *relevant person* to enable it to continue *insurance business*.
- 3.5.2 R In the rules in this sourcebook, a *relevant person* who is an *insurer* is in financial difficulties if:
- (1) It is a company in provisional liquidation; or
 - (2) It has been proved, in any proceedings on a petition for the winding up of the *relevant person* under the Insolvency Act 1986 or the Insolvency (Northern Ireland) Order 1989 for the voluntary winding up of the *relevant person*, (unless it is for the purpose of reconstructing the *relevant person*, or of amalgamation with another *insurance company*) nor has any order been made by the Court for the winding up of the *relevant person*; or
 - (3) An application has been made to the court under section 425 of the Companies Act 1985 or Article 418 of the Companies (Northern Ireland) Order 1986 for the sanctioning of a compromise or arrangement proposed between the *relevant person* and its creditors or any class of them and the terms of the compromise or arrangement provide for reducing, or deferring payment of, the liabilities or the benefits provided for under any of the *relevant person's* policies.

4. Eligible claimants

4.1 Application

4.1.1 R This chapter applies to *The Scheme Manager*.

4.1.2 G It is also relevant to those who may wish to bring a claim for compensation.

4.2 Purpose

4.2.1 G The purpose of this chapter is to set out the types of *person* who are able to claim compensation. A claimant needs to be an *eligible claimant* to satisfy COMP 3.3.1R(1).

4.3 Who is eligible to claim compensation?

4.3.1 R A *person* who does not come within any of the categories listed in Table COMP 4.3(1)R is an *eligible claimant*.

4.3.2 R A *person* who does come within any of the categories listed in Table COMP 4.3(1)R is not an *eligible claimant*, unless he can satisfy the relevant exception in COMP 4.4.

4.3.3 G The general effect of Table COMP 4.3(1)R and COMP 4.4 is as follows:

- (1) All *private customers* (other than companies or partnerships that are *large companies* or *large partnerships*) will be *eligible claimants*, whatever type of claim they have.
- (2) *Intermediate customers* will be *eligible claimants* where they claim compensation in respect of *long term insurance* contracts, or *liabilities subject to compulsory insurance*. In addition, *intermediate customers* which are partnerships can claim compensation for *deposits*.
- (3) *Market counterparties* are *eligible claimants* where they claim compensation in respect of *long term insurance* contracts, or *liabilities subject to compulsory insurance*. In addition, certain types of *market counterparty* (such as small authorised *persons*) can claim compensation for *deposits* and in respect of *general insurance* contracts. And authorised *persons* who are sole traders will be *eligible claimants* whatever type of claim they have, if the claim arises out of activity for which they do not have a *permission* from *the FSA*.
- (4) Customers with a connection to the defaulting *firm* (such as *directors* and managers of the *firm*, companies in the same *group*, and those whom *The Scheme Manager* judges responsible for the default) will not be eligible to claim compensation, whatever type of claim they have. The same applies to those whose claim arises from a transaction in connection with which they have been convicted of money laundering.

Table COMP 4.3(1)R Potentially ineligible claimants	
(This table forms part of COMP 4.3	
1)	Authorised <i>persons</i> (other than sole traders whose claim arises out of a <i>regulated activity</i> for which they do not

	have a <i>permission</i>)
2)	Overseas financial services <i>firms</i>
3)	<i>Collective investment schemes</i> , and anyone who is the operator or <i>trustee</i> of such a scheme
4)	Pension and <i>retirement funds</i> , and anyone who is a <i>trustee</i> of such a fund (except a <i>trustee</i> of a small self-administered pension scheme or an <i>occupational pension scheme</i> of an employer which is not a <i>large company</i> or <i>large partnership</i>)
5)	Supranational institutions, governments, and central administrative authorities
6)	Provisional, regional, local and municipal authorities
7)	<i>Directors</i> and managers of the defaulting <i>firm</i> (but this exclusion does not apply if all the following are satisfied: <ul style="list-style-type: none"> (a) The defaulting <i>firm</i> is a mutual association; (b) The defaulting <i>firm</i> is not a <i>large company</i> or a <i>large partnership</i>; (c) The <i>directors</i> and managers do not receive a salary or other remuneration for services performed by them for the defaulting <i>firm</i>).
8)	<i>Close relatives</i> of <i>persons</i> excluded by (7) above
9)	Companies in the same <i>group</i> as the defaulting <i>firm</i>
10)	<i>Persons</i> holding 5% or more of the capital of the defaulting <i>firm</i> , or of any company in the same <i>group</i>
11)	The auditors of the defaulting <i>firm</i> , or of any company in the same <i>group</i>
12)	<i>Persons</i> who in the opinion of <i>The Scheme Manager</i> are responsible for, or have contributed to, the <i>firm's</i> default
13)	<i>Large companies</i>
14)	<i>Large partnerships</i>
15)	<i>Persons</i> whose claim arises from transactions in connection with which they have been convicted for an <i>offence</i> of money laundering

4.4 Exceptions

DEPOSITS

- 4.4.1 R A **person** is eligible to claim compensation in respect of a protected deposit if, at the date of the **firm's** default
- (1) He came within category (14) of Table COMP 4.3(1)R; or
 - (2) He came within any of categories (1) – (4) of Table COMP 4.3(1)R, and was not a **large company** or a **credit institution**.

LONG TERM INSURANCE

- 4.4.2 R Any **person** is eligible to claim compensation in respect of **long term insurance** contracts if at the date of the contract commenced he came within any of the categories (1) – (6), (13) or (14) of Table COMP 4.3(1)R.

GENERAL INSURANCE

- 4.4.3 R A **person** is eligible to claim compensation in respect of a **general insurance** contract (other than in respect of a **liability subject to compulsory insurance**) if, at the date that the contract commenced:
- (1) He came within categories (1) – (4) of Table COMP 4.3(1)R; and
 - (2) He was a **small company** or **small partnership**.

LIABILITY SUBJECT TO COMPULSORY INSURANCE

- 4.4.4 R Anyone who comes within Table COMP 4.3(1)R is eligible to claim compensation in respect of a **liability subject to compulsory insurance**.

Designated investment business

- 4.4.5 R A **person** is not eligible to claim compensation in respect of **designated investment business** (other than **long term insurance** contracts, where COMP 4.4.2R applies) if, at the time the act or omission giving rise to the claim against the **relevant person** took place (or at any other date **The Scheme Manager** considers appropriate) he came within any of the categories in Table COMP 4.3(1)R.

5. Protected claims

5.1 Application

5.1.1 R This chapter applies to *The Scheme Manager*.

5.1.2 G It is also relevant to claimants.

5.2 Purpose

5.2.1 G The purpose of this chapter is to set out the various types of claim for which compensation may be payable. A claimant needs to have such a claim to satisfy the first condition in COMP 3.3.1R(2).

5.3 What is a protected claim?

5.3.1 R A *protected claim* in the rules in this sourcebook is:

- (1) A claim for a protected deposit;
- (2) A claim for a protected contract of insurance; or
- (3) A claim relating to protected investment business.

5.3.2 R In the rules in this sourcebook, 'claim' means a valid claim in respect of a civil liability owed by a *relevant person*.

5.4 Protected deposits

5.4.1 R A protected deposit is:

- (1) Any credit balance, denominated in any currency, which results from funds left in an account or from temporary situations deriving from normal banking transactions, and which the *relevant person* is under an obligation to repay under the legal and contractual conditions applicable;
- (2) Any debt evidenced by a certificate issued by a *credit institution*; or
- (3) Any share in a building society which is not of a capital nature.

provided the conditions in COMP 5.4.2R are satisfied.

5.4.2 R The conditions are:

- (1) The *deposit* does not come within COMP 5.4.4R;
- (2) The *deposit* was made at a time when the *person* who accepted the *deposit* had a *permission* from *the FSA* to carry on one or more *regulated activities* in the *United Kingdom*, or was otherwise lawfully able to do so; and

(3) The **deposit** was accepted in the **United Kingdom**, or, where the **person accepting** the **deposit** had a **permission** from **the FSA** to accept **deposits** in the **United Kingdom**, by a **branch** of that **person** elsewhere in the **EEA** under the provisions of the **2BCD**.

5.4.3 G **Deposits** made with **UK branches** of **EEA firms** which become **participant firms** in **the Scheme** can therefore be protected deposits, as these **firms** are lawfully able to accept **deposits** in the **United Kingdom** under their **home state** authorisation. For further information on **EEA firms**, see Chapter 14.

5.4.4 R The following are not protected **deposits**:

- (1) Bonds issued by **credit institutions** which are part of the institution's capital.
- (2) Secured **deposits**.
- (3) Building society deferred shares.
- (4) Non-nominative **deposits** (that is, **deposits** made without disclosing the depositor's identity).
- (5) Any **deposit** which, in the opinion of **The Scheme Manager**, was made in the course of a money-laundering transaction.

5.5 Protected contracts of insurance

5.5.1 R Unless COMP 5.5.2R applies, a protected contract of insurance is:

- (1) A **contract of insurance** issued by a **relevant person** through an establishment in:
 - (a) The **UK**
 - (b) Another **EEA State**, or
 - (c) The Channel Islands of the Isle of Man; or
- (2) A **contract of insurance** issued by an **EEA firm** through an establishment in an **EEA State**,

which relates to a protected risk or commitment.

5.5.2 R The following **contracts of insurance** are not protected contracts of insurance:

- (1) Any **contract of insurance** the effecting of which constituted the carrying on of **insurance business** falling within any of classes 6,7,8,12,13 or 15 of [Schedule 1 part I of the RAO] (aircraft, ships, goods in transport, aircraft liability, liability of ships or credit);
- (2) Any contract of reinsurance;

(3) *Lloyd's policies*.

- 5.5.3 R A risk or commitment is a protected risk or commitment for the purpose of *the Scheme*
- (1) In the case of a *contract of insurance* falling within COMP 5.5.1R(1)(a), if it is situated in an *EEA State*, the Channel Islands or the Isle of Man;
 - (2) In the case of a *contract of insurance* falling within COMP 5.5.1R(1)(b) or 5.5.1R(2), if it is situated in the *United Kingdom*;
 - (3) In the case of a *contract of insurance* falling within COMP 5.5.1R(1)(c), if it is situated in the *UK*, Channel Islands or the Isle of Man.
- 5.5.4 R In the rules in this sourcebook, the situation of a risk is determined as follows:
- (1) For insurance relating to buildings or to buildings and their contents (in so far as the contents are covered by the same *contract of insurance*), the risk is situated where the property is situated;
 - (2) For insurance relating to vehicles of any type, the risk is situated where the vehicle is registered;
 - (3) For *contracts of insurance* lasting four months or less covering travel or holiday risks (whatever the class concerned), the risk is situated where the policyholder took out the *contract of insurance*;
 - (4) In cases not covered by paragraphs (1) to (3):
 - (a) Where the policyholder is an individual, the risk is situated where he has his habitual residence at the date when the commitment is entered into;
 - (b) For a *contract of insurance* where the policyholder is not an individual, the commitment is situated where the establishment to which the commitment relates is situated at the date when the commitment is entered into.
- 5.5.5 R *The Scheme Manager* must also treat claims in respect of:
- (1) *Premiums* paid before the *contract of insurance* commenced, or
 - (2) Proceeds where a long-term *contract of insurance* has matured or been surrendered, or
 - (3) Unexpired *premiums* in relation to *general insurance* contracts;

as claims in respect of protected *contracts of insurance*.

5.6 Protected investment business

5.6.1 R Protected investment business is *designated investment business* carried on by:

- (1) An authorised *person* (but not an *EEA firm* carrying on *home state regulated activity* from a *branch* in the *UK* under the provisions of the *ISD*, unless (3) below applies);
- (2) A *branch* of a *UK firm* elsewhere in the *EEA*, under the provisions of the *ISD*; or
- (3) An *EEA firm* carrying on *home state regulated activity* from a *branch* in the *UK* under the provisions of the *ISD*, which has elected to participate in *the Scheme* in accordance with COMP14.3; or
- (4) An *appointed representative* of (1), (2) or (3).

6. Relevant persons in default

6.1 Application

6.1.1 R This chapter applies to *The Scheme Manager*.

6.1.2 G It is also relevant to claimants.

6.2 Purpose

6.2.1 G The purpose of this chapter is to set out the types of *person* against whom a claimant must have a claim in order to be eligible for compensation, and when those *persons* are 'in default' (generally, this occurs when they are insolvent or unable to meet their liabilities to claimants). A claimant needs to have a claim against a *relevant person* in default to satisfy the second condition in COMP 3.3.1R(2).

6.3 Who is a relevant person?

6.3.1 R A *relevant person* is a *person* who was, at the time the act or omission giving rise to the claim against him took place,

(1) An authorised *person* (but not an *EEA firm* carrying on *home state regulated activity* from a *branch* in the *UK* under the provisions of the *2BCD* or *ISD*);

(2) A *UK branch* of an *EEA firm* carrying on *home state regulated activity* under the provisions of the *2BCD* or *ISD* that is a *participant firm*;

(3) An *appointed representative* of (1) or (2).

6.3.2 G A '*relevant person*' includes a *branch* of an authorised *person* operating elsewhere in the *EEA* under the provisions of the *ISD* or *2BCD*. For *EEA firms* carrying on *home state regulated activity* covered by the *2BCD* or *ISD* as *participant firms*, see chapter [14].

6.3.3 G Section 213 of *the Act* requires *the FSA* to make rules which provide for compensation to be payable in respect of claims made against *appointed representatives*. However, *the FSA* would expect *The Scheme Manager* to require claimants with claims of this type to take them up in the first instance with the *principal* of the *appointed representative*, since the *principal* is responsible for the acts or omissions of the *appointed representative* under section 39(3) of *the Act*. For *The Scheme Manager's* power to postpone claims, see COMP 9.3.2R.

6.4 When is a relevant person in default?

6.4.1 R A *relevant person* is in default when he is, in the opinion of *The Scheme Manager*:

(1) Unable to satisfy *protected claims* against him, or

(2) Likely to be unable to satisfy *protected claims* against him.

- 6.4.2 G The fact that a *relevant person* is in default does not in itself mean that *The Scheme Manager* must pay compensation, secure continuity of insurance, or give assistance to *insurers* to enable them to continue *insurance business*. The remaining conditions in chapter 3 need to be satisfied before that can take place.
- 6.4.3 R Except where COMP 6.4.5R applies, *The Scheme Manager* must determine a *relevant person* to be in default if one or more of the following circumstances arise in relation to that person:
- (1) The passing of a resolution for a creditors' voluntary winding up;
 - (2) A determination of insolvency by the *home state regulator*;
 - (3) The appointment of a liquidator or administrator, or provisional liquidator or interim manager;
 - (4) The making of an order by a court of competent jurisdiction for the winding up of a company or partnership, the administration of a company, or the bankruptcy of an individual;
 - (5) The approval of a company voluntary arrangement or of an individual voluntary arrangement;
 - (6) *The Scheme Manager* is satisfied that the *relevant person* cannot be contacted at his last place of *business* and that all reasonable steps have been taken to establish a forwarding or current address, but without success;
 - (7) The claim is in respect of protected investment business, and there is no evidence that the *relevant person* will be able to meet claims made against it.
- 6.4.4 R In COMP 6.4.3R, references in paragraphs (1) – (5) to provisions of *UK* insolvency and bankruptcy law include similar provisions in other jurisdictions.
- 6.4.5 R Where the *protected claim* arises out of *ISD* or *2BCD* activity by the *relevant person*, *the FSA* shall determine whether the *relevant person* is in default, unless a judicial authority has made an earlier ruling that had the effect of suspending the ability of *eligible claimants* to bring claims against the *relevant person* (in which case the *relevant person* is automatically 'in default' under the rules in this sourcebook).
- 6.4.6 G COMP 6.4.5R is a requirement of the *ICD* and *DGD*, which provide that in the absence of a judicial ruling, it is for the Competent Authority, and not the manager of compensation or deposit guarantee schemes, to determine whether a *firm* is unable to meet *protected claims*.
- 6.4.7 R If *The Scheme Manager* is of the opinion that COMP 6.4.1R(1) or (2) is satisfied, but the *relevant person* is or appears to be carrying on *business*, or was at the relevant time a sole trader or partnership, *The Scheme Manager* must give the *relevant person* a written notice.

- 6.4.8 R The written notice must state:
- (1) That *The Scheme Manager* is of the opinion that the *relevant person* is in default;
 - (2) A summary of the reasons for that opinion; and
 - (3) That *The Scheme Manager* will publicise or take other steps to notify potential claimants that the *firm* is in default unless the *relevant person* makes representations to *The Scheme Manager* by a specified date (which must be no earlier than 21 days from the date of the notice).
- 6.4.9 R If the *relevant person* makes representation to *The Scheme Manager* under COMP 6.4.8(3)R and *The Scheme Manager* is still of the opinion that the *relevant person* is in default, he must send the *relevant person* a further written notice, stating
- (1) That *The Scheme Manager* is still of the opinion that the *relevant person* is in default;
 - (2) A summary of the reasons for that opinion;
 - (3) That the *relevant person* may elect to have the matter heard by a suitably qualified *person* who is independent of *The Scheme Manager*, the proceedings of which may be in public, if the *relevant person* so decides; and
 - (4) That if the *relevant person* does not so elect, *The Scheme Manager* will publicise the default by a specified date (which must be no earlier than 21 days from the date of the further notice).
- 6.4.10 R *The Scheme Manager* must make appropriate arrangements for any hearing under COMP 6.4.9(3)R, and shall take account of any decision reached.

7. Assignment of rights

7.1 Application

7.1.1 R This chapter applies to *The Scheme Manager*.

7.1.2 G It is also relevant to claimants.

7.2 Purpose

7.2.1 G *The FSA* anticipates that in most cases *The Scheme Manager* will make an offer of compensation conditional on the assignment of rights to it by a claimant. The purpose of this chapter is to make provision for and set out the consequences of an assignment of the claimant's rights.

7.3 What is an assignment of rights?

7.3.1 G Under COMP 3.3.1R, *The Scheme Manager* may make an offer of compensation conditional upon the claimant agreeing that all or any part of his rights against the *relevant person* should pass to *The Scheme Manager*. In addition, *The Scheme Manager* may require the claimant to pass to *The Scheme Manager* all his rights against any other *person* in connection with the claim. This procedure is known as an 'assignment of rights'.

7.3.2 G The purpose of the assignment is twofold. Firstly, it allows *The Scheme Manager*, by standing in the position of the claimant, to take up the claimant's rights against the *relevant person* or any third party should they turn out to have assets against which *The Scheme Manager* can claim. Any amount recovered by *The Scheme Manager* in this way will reduce the overall costs of *the Scheme*. Secondly, it avoids leaving the claimant in a better position than he would have been had the default not occurred. In the absence of an assignment he would still be able to take action against the *relevant person* for the amount of the loss, even if he had received 100% compensation from *The Scheme Manager*.

7.3.3 G The assignment will usually be effected by the claimant completing a form of assignment prepared by *The Scheme Manager*.

7.4 How does the assignment of rights work?

7.4.1 R *The Scheme Manager* may make any payment of compensation to a claimant in respect of a *protected claim* conditional on the claimant agreeing to assign, on such terms as *The Scheme Manager* thinks fit, the whole or any part of his rights against the *relevant person* and/or against any third party.

7.4.2 G In reaching an agreement with the claimant under 7.4.1R, *The Scheme Manager* may place any restriction it decides is appropriate on its ability to exercise the rights the claimant has agreed should pass to it.

7.4.3 R If a claimant, in connection with the payment of compensation, assigns the whole or any part of his rights against any *person* to *The Scheme Manager*, the sum paid to the claimant by *The Scheme Manager* extinguishes the liability of that *person* to the investor in respect of the rights so assigned.

- 7.4.4 R ***The Scheme Manager*** must make such recoveries as it reasonable can through the rights so assigned.
- 7.4.5 R Subject to COMP 7.4.6R, any amount received by ***The Scheme Manager*** under this rule COMP 7 is to be paid into the sub-Scheme fund from which the compensation was funded, up to the amount of compensation paid to the claimant, plus any interest on it that ***The Scheme Manager*** determines to pay. Any balance is to be paid to the claimant.
- 7.4.6 R ***The Scheme Manager*** must endeavour to ensure that a claimant will not suffer disadvantage arising solely from his prompt acceptance of ***The Scheme Manager's*** offer of compensation compared with what might have been the position had he delayed his acceptance.
- 7.4.7 G Take two claimants, A and B. Both have a protected investment business claim of £60,000 against an insolvent *firm*.
- 7.4.8 G In both cases, ***The Scheme Manager*** offers £48,000 compensation (the maximum amount payable for such claims: see COMP 10.3.2R). A accepts immediately, and assigns his rights against the *firm* to ***The Scheme Manager***. B delays acceptance. The liquidator then makes a payment of 50p in the pound to all creditors of the insolvent *firm*. A and B are therefore due £30,000 each. However, because A has assigned his rights to ***The Scheme Manager***, and ***The Scheme Manager*** has paid A more than £30,000, the £30,000 from the liquidator will be payable in full to ***The Scheme Manager***. A is thus left with a loss of £12,000, being the difference between his claim of £60,000 and the compensation paid by ***The Scheme Manager*** of £48,000.
- 7.4.9 G Contrast the position of B. Because B delayed accepted ***The Scheme Manager's*** offer, he is able to exercise his right against the liquidator. He therefore receives £30,000 from the liquidator. This reduces his *protected claim* to £30,000, which ***The Scheme Manager*** can pay in full (see COMP 10.3.2R). B therefore suffers no loss.
- 7.4.10 G COMP 7.4.11R thus enables ***The Scheme Manager*** to correct the imbalance between the position of A and B, and to pay to A any recoveries received.
- 7.4.11 R **If a claimant agrees to assign his rights to *The Scheme Manager*, and *The Scheme Manager* subsequently makes recoveries through those rights, those recoveries must be paid to the claimant:**
- (1) **To the extent that the amount recovered exceeds the amount of compensation paid;**
 - (2) **If *The Scheme Manager* considers that the disadvantage described in COMP 7.4.6R would occur if it did not do so; or**
 - (3) **If *the Scheme Manager* has not paid compensation to the claimant under COMP 9.3.3R.**

8. Rejection of application and withdrawal of offer

8.1 Application

8.1.1 R This chapter applies to *The Scheme Manager*.

8.1.2 G It is also relevant to claimants.

8.2 Purpose

8.2.1 G In some circumstances, it may be appropriate for *The Scheme Manager* to reject an application for compensation, or withdraw an offer of compensation. The purpose of this chapter is to set out when those circumstances arise.

8.3 Rejection of application for compensation

8.3.1 R *The Scheme Manager* may reject an application for compensation if it finds any material inaccuracy or omission in the application, unless this is considered by *The Scheme Manager* to be clearly immaterial or wholly innocent.

8.3.2 G A rejection under COMP 8.3.1R does not mean that the claimant cannot receive compensation. A rejected application may be resubmitted, with the appropriate amendments.

8.3.3 G A decision by *The Scheme Manager* to reject an application for compensation does not prevent the claimant from pursuing a claim against the *relevant person* directly.

8.3.4 R Unless COMP 8.3.5R applies, *The Scheme Manager* must reject an application for compensation if the liability of the *relevant person* to the claimant has been extinguished by the operation of law, or *The Scheme Manager* considers that a civil claim in respect of the liability would have been defeated by a defence of limitation at the date,

(1) *The Scheme Manager* determines the *relevant person* to be in default, or

(2) the claimant indicates in writing that he has a claim against the *relevant person*, if that is earlier than (1).

8.3.5 R As an exception to COMP 8.3.4R, *The Scheme Manager* may disregard a defence of limitation where *The Scheme Manager* considers that it would be reasonable to do so.

8.4 Withdrawal of offer of compensation

8.4.1 R *The Scheme Manager* may withdraw any offer of compensation made to a claimant if the offer is not accepted within 90 days of the date on which the offer is made, or if the offer is disputed at any time.

8.4.2 R *The Scheme Manager* may repeat any offer withdrawn under COMP 8.4.1R.

- 8.4.3 R *The Scheme Manager* must withdraw any offer of compensation if it appears to *The Scheme Manager* that no such offer should have been made.

9. Time limits and postponements

9.1 Application

9.1.1 R This chapter applies to *The Scheme Manager*.

9.1.2 G It is also relevant to claimants.

9.2 Purpose

9.2.1 G The purpose of this chapter is to ensure that compensation is paid to claimants as quickly as possible and that delays in paying compensation to claimants are kept to a minimum. *The Scheme Manager* may postpone payment of compensation only in strictly limited circumstances.

9.3 When must compensation be paid?

9.3.1 R Unless COMP 9.3.2 R applies, *The Scheme Manager* must pay a valid claim as soon as reasonably possible after it has calculated the amount of compensation due to the claimant, and in any event within three months of that date, unless *the FSA* has granted *The Scheme Manager* an extension, in which case payment must be made no later than six months from that date.

9.3.2 R *The Scheme Manager* may postpone paying compensation if:

- (1) In the case of a claim made against an *appointed representative*, it considers that the claimant should make and pursue an application for compensation against the *appointed representative's principal*;
- (2) In the case of claims relating to protected investment business which do not arise from *ISD business* conducted by a *relevant person*, it considers that the claimant should first exhaust his rights against the *relevant person* or any third party, or make and pursue an application for compensation to any other *person*;
- (3) In the case of claims relating to protected contracts of insurance, the liability to which the claim relates, or any part of the liability, is covered by another *contract of insurance* with a solvent *insurer*, or where it appears that a *person*, other than the liquidator, may make payments or take such action to secure the continuity of cover as *The Scheme Manager* would undertake;
- (4) The claim is one which falls within COMP 12.6.7R and it is not practicable for payment to be made within the usual time limits laid out in COMP 9.3.1 R; or

- (5) The claimant has been charged with an **offence** arising out of transactions in connection with money laundering, and those proceedings have not yet been concluded.

9.3.3 R Notwithstanding COMP 9.3.2 R (2), **The Scheme Manager** may pay compensation to a claimant in respect of assets held by a **relevant person** if a liquidator or **trustee** in bankruptcy has been appointed to the **relevant person**, and:

- (1) **The Scheme Manager** considers it likely that the liquidator or **trustee** would, in due course, distribute the assets to the claimant;
- (2) The claimant has agreed to be compensated for the assets on the basis of the valuation provided by **The Scheme Manager**; and
- (3) The claimant has agreed, to the satisfaction of **The Scheme Manager**, that his rights to the assets in respect of which compensation is payable should pass to it.

10. Limits

10.1 Application

10.1.1 R This chapter applies to *The Scheme Manager*.

10.1.2 G It is also relevant to claimants.

10.2 Purpose

10.2.1 G *The FSA* believes that in most cases it is appropriate for there to be a limit on the amount of compensation payable by *The Scheme Manager*. *The FSA* also considers that there should be some part of the claim which is not compensatable and for which the claimant must bear the loss. The purpose of this chapter is to set these limits out, as well as the limits that may apply when *The Scheme Manager* is ensuring that there is continuity of insurance cover, or is safeguarding policyholders of *insurers* in financial difficulties.

10.3 Limits on compensation payable

10.3.1 G There is a limit on the amount of compensation that *The Scheme Manager* can pay, depending on the type of claim.

10.3.2 R The limits on the maximum compensation sums payable by *The Scheme Manager* for *protected claims* are set out in Table COMP 10.3(1)R.

Table COMP 10.3(1)R Limits on compensation		
This table forms part of COMP 10.3.2R		
Type of claim	Level of cover	Maximum payment
Protected deposits	100% x first £2,000 90% x next £33,000	£31,700
Protected insurance contracts when the contract is a general insurance contract	Where the claim is in respect of a liability subject to compulsory insurance : 100% of claim In all other cases: 100% x first £2,000 of valid claim 90% of remainder	Unlimited Unlimited
Protected insurance contracts when the contract is a long term insurance contract	At least 90% of the value of the policy (including future benefits declared before the date of the default)	Unlimited
Protected investment business	100% x first £30,000 90% x next £20,000	£48,000

10.3.3 G *The Scheme Manager* will pay compensation for protected contracts of insurance only where *The Scheme Manager* is unable to secure continuity of insurance or decides not to take measures to safeguard policyholders (see COMP 3.4 and 3.5).

CONTINUITY OF INSURANCE COVER

10.3.4 R *The Scheme Manager's* duty to ensure continuity of cover for any protected **contract of insurance** which is a **long term insurance contract** extends only to ensuring that the claimant will receive 90% of any **future benefit** under his **contract of insurance**, subject to and in accordance with terms corresponding (so far as it appears to *The Scheme Manager* to be reasonable in the circumstances) to those which have applied under the **contract of insurance**.

SAFEGUARDING POLICYHOLDERS OF INSURERS IN FINANCIAL DIFFICULTIES

- 10.3.5 R Where *The Scheme Manager* takes measures under COMP 3.5.1R, in order to facilitate the safeguarding of policyholders in respect of *long term insurance* contracts *The Scheme Manager* may reduce, without the policyholder's consent, the claimant's interest in the policy to 90% of the amount which would otherwise have been payable under the terms of the policy. Any future *premiums* that the policyholder is committed to paying under the policy will be reduced by an equivalent amount.

11. Payment of compensation

11.1 Application

11.1.1 R This chapter applies to *The Scheme Manager*.

11.1.2 G It is also relevant to claimants.

11.2 Purpose

11.2.1 G In certain circumstances, it may be appropriate for *The Scheme Manager* to pay compensation to someone other than the claimant, or to make reduced or interim payments. The purpose of this chapter is to set out when those circumstances arise.

11.3 Payment

11.3.1 R *The Scheme Manager* must pay compensation to the claimant, or as directed by the claimant, unless

(1) COMP 3.4 or 3.5 applies, or

(2) COMP 11.3.2 R applies.

11.3.2 R Where a claimant has a *protected claim* arising out of the circumstances described in COMP 12.6.7R, *The Scheme Manager* must pay any compensation to

(3) The *trustee* of an *occupational pension scheme*, and/or

(4) A *personal pension scheme* or other *product provider*,

and not to the claimant, unless exceptional circumstances apply.

11.3.3 G The circumstances described in COMP 12.6.7R are those where the claim is covered by the Pensions Review. If, for example, the claimant has already retired and his claim is for 'actual loss', *The Scheme Manager* may determine that exceptional circumstances apply, and make a cash payment to the claimant in accordance with the Specification of Standards and Procedures issued by *the FSA*.

REDUCED OR INTERIM PAYMENTS

11.3.4 R If *The Scheme Manager* is satisfied that in principle compensation is payable, but considers that immediate payment in full would not be prudent because of uncertainty as to the amount of the claimant's overall net claim, it may decide to pay an appropriate lesser sum in final settlement, or to make payment on account.

11.3.5 R *The Scheme Manager* may also decide to make a payment on account or to pay a lesser sum if the claimant has any prospect for recovery in respect of the claim from any third party or by applying for compensation to any other *person*.

11.3.6 R COMP 11.3.4-5R do not apply where the claim arises out of *ISD* or *2BCD business*.

PAYING INTEREST ON COMPENSATION

11.3.7 R *The Scheme Manager* is to pay interest on the compensation sum in such circumstances as it considers appropriate.

11.3.8 R Interest must be paid at a rate no higher than the base rate of a clearing bank in the *United Kingdom* during the period to which the interest relates.

11.3.9 R Interest under COMP 11.3.8 R is not to be taken into account when applying the limits on the compensation sum payable in respect of a claim under chapter 10.

11.3.10 G If A has a protected investment business claim of £50,000, *The Scheme Manager* can pay A £48,000 compensation (see Table COMP 10.3(1)R). If *The Scheme Manager* decides that interest is payable, and the interest totals £5,000, the interest will be paid to A in full, along with the £48,000. It is not aggregated to A's claim to make a claim for £55,000 (on which £48,000 would be the maximum sum that *The Scheme Manager* could pay).

12. Calculating compensation

12.1 Application

12.1.1 R This chapter applies to *The Scheme Manager*.

12.1.2 G This chapter is also relevant to claimants, since it sets out how a claim will be quantified. (For the process of paying compensation, including the limits on the amount of compensation that can be paid, see Chapters 8-11).

12.2 Purpose

12.2.1 G The purpose of this chapter is to set out the different ways in which *The Scheme Manager* is to calculate compensation for various types of claim, and when, in calculating compensation, regulatory guidance should be followed.

12.3 Quantification of claims

12.3.1 R The amount of compensation payable to the claimant is the amount of his overall net claim against the *relevant person* at the *quantification date*.

12.3.2 R COMP 12.3.1 R is, however, subject to the other provisions of the rules in this sourcebook, in particular those rules that set limits on the amount of compensation payable for various types of *protected claim*.

12.3.3 G The limits are contained in Chapter 10.

12.4 Overall net claim

12.4.1 R A claimant's overall net claim is the sum of his *protected claims* against a *relevant person* in default, less the amount of any liability which the *relevant person* may set off against any of those claims.

12.4.2 R Where the claimant is a *trustee*, and some of the beneficiaries of the trust are *persons* who would not be *eligible claimants* if they had a claim themselves, *The Scheme Manager* must adjust the amount of the overall net claim to eliminate the part of the claim which, in *The Scheme Manager's* view, is a claim for those beneficiaries.

12.4.3 R Where COMP 12.4.2 R applies, *The Scheme Manager* must try to ensure that any compensation paid to the *trustee*

- (1) Is for the benefit of beneficiaries who would be *eligible claimants* if they had a claim themselves; and
- (2) Does not exceed the amount of the loss suffered by those beneficiaries.

12.4.4 G In calculating the claimant's overall net claim, *The Scheme Manager* may rely, to the extent that it is relevant, on any determination by:

- (1) A court of competent jurisdiction;
- (2) A *trustee* in bankruptcy;
- (3) A liquidator;
- (4) Any other recognised insolvency practitioner;

and on the certification of any net sum due which is made in default proceedings of any exchange or clearing house.

- 12.4.5 G In calculating the claimant's overall net claim, *The Scheme Manager* may take into account any payments to the claimant (including amounts recovered by *The Scheme Manager* on behalf of the claimant) made by the *relevant person* or any other *person*, if that payment is connected with the *relevant person's* liability to the claimant.

12.5 Quantification date

- 12.5.1 R For protected deposit claims, the *quantification date* is the date the *relevant person* is determined to be in default, or the date the *deposit* was due and payable, if later.
- 12.5.2 R For protected insurance contract claims relating to *long term insurance business*, and protected investment business claims arising from *ISD business* conducted by a *relevant person*, the *quantification date* is the date the *relevant person* is determined to be in default.
- 12.5.3 R For protected insurance contract claims relating to *general insurance*, the *quantification date* is the date the claim is made.
- 12.5.4 R For all other protected investment business claims, *The Scheme Manager* must determine a specific date as the *quantification date*, and this date may be either on, before or after the date of the determination of default.

12.6 The compensation calculation

PROTECTED DEPOSIT WITH EEA FIRM

- 12.6.1 R If the claimant has a claim for a protected deposit with a *UK branch* of an *EEA firm* which is a *participant firm*, *The Scheme Manager* must take account of the liability of the *home state* deposit-guarantee scheme in calculating the compensation payable by *The Scheme Manager*.
- 12.6.2 G Annex II of the *DGD* sets out 'guiding principles' which *The Scheme Manager* must follow when an *EEA firm* applies to become a *participant firm* in respect of its *home state* regulated *2BCD business*. For *EEA firms* as *participant firms*, see Chapter 14.

PROTECTED INVESTMENT BUSINESS – GENERAL

- 12.6.3 R ***The Scheme Manager*** may pay compensation for any protected investment business claim which is not
- (1) A claim for property held, or
 - (2) A claim arising from transactions which remain uncompleted at the ***quantification date***,
- only if ***The Scheme Manager*** considers that the payment of compensation is essential in order to be fair to the claimant.
- 12.6.4 R ***The Scheme Manager*** must not pay compensation for any protected investment business claim which relates to or depends on:
- (1) Failure of ***investment*** performance to match a guarantee given or representation made;
 - (2) A contractual obligation or promise to pay which ***The Scheme Manager*** considers to have been undertaken without full consideration passing to the ***relevant person*** or in anticipation of possible insolvency; or
 - (3) The mere fluctuation in the value of an ***investment***.
- 12.6.5 R If the claimant has a protected investment business claim against a ***UK branch*** of an ***EEA firm*** which is a ***participant firm***, ***The Scheme Manager*** must take account of the liability of the ***home state*** investor compensation scheme in calculating the compensation payable by ***The Scheme Manager***.
- 12.6.6 G Annex II of the ***ICD*** sets out ‘guiding principles’ which ***The Scheme Manager*** must follow when an ***EEA firm*** applies to become a ***participant firm*** in respect of its ***home state*** regulated ***ISD business***.

PROTECTED INVESTMENT BUSINESS – CLAIMS COVERED BY THE PENSIONS REVIEW

- 12.6.7 R If the claimant has a protected investment business claim relating to the fact that the claimant has:
- (1) While eligible or reasonably likely to become eligible to be a member of an ***occupational pension scheme***, instead become a member of a ***personal pension scheme*** or entered into a ***retirement annuity***;
 - (2) Ceased to be a member of, or to pay contributions to, an ***occupational pension scheme***, and has instead become a member of a ***personal pension scheme*** or entered into a ***retirement annuity***;

- (3) Transferred to a **personal pension scheme** accrued rights under an **occupational pension scheme** which is not a defined contribution (money purchase) scheme; or
- (4) Ceased to be a member of an **occupational pension scheme** and has instead (by virtue of such a provision as is mentioned in section 591(2)(g) of the Income and Corporation Taxes Act 1988) entered into arrangements for securing relevant benefits by means of an annuity,

The Scheme Manager must take the steps set out in COMP 12.6.8 R.

- 12.6.8 R If COMP 12.6.7 R applies, *The Scheme Manager* must, unless *The Scheme Manager* considers it essential to depart from the Specification in order to provide the claimant with fair compensation, follow the Specification of Standards and Procedures issued by *the FSA* in October 1994, as supplemented and modified by subsequent guidance issued by *the FSA* (in particular, that of November 1996), (the ‘Specification’) in
- (1) Assessing whether a **relevant person** has complied with the relevant regulatory requirements;
 - (2) Assessing whether non-compliance has caused the claimant loss; and
 - (3) Calculating the amount of compensation due (where *The Scheme Manager* may rely on calculations made by *the FSA* or any previous regulator of the **firm**).

PROTECTED INVESTMENT BUSINESS – EXCESSIVE BENEFITS

- 12.6.9 R *The Scheme Manager* may decide to reduce the compensation that would otherwise be payable for a protected investment business claim that does not relate to **ISD business**, if it is satisfied that:
- (1) There is evidence of contributory negligence by the claimant; or
 - (2) Payment of the full amount would provide a greater benefit than the claimant might reasonably have expected or than the benefit available on similar **investments** with other **relevant persons**; and
 - (3) It would be inequitable for *The Scheme Manager* not to take account of (1) or (2).

PROTECTED CONTRACTS OF INSURANCE

- 12.6.10 R *The Scheme Manager* must not exercise its powers to pay compensation for claims in respect of **long term insurance** contracts, until it has satisfied itself that it is not feasible to secure continuity of cover at a reasonable cost.

LIABILITIES SUBJECT TO COMPULSORY INSURANCE

- 12.6.11 R *The Scheme Manger* must pay a sum equal to 100% of any liability of a **relevant person** who is an **insurer** in respect of liabilities subject to compulsory insurance to the claimant as soon as reasonably practicable after the **relevant person** is in default.
- 12.6.12 G If the **relevant person** is in financial difficulties (see COMP 3.5.2R), then *The Scheme Manager* may take the measures listed in COMP 3.5.1R to safeguard policyholders in respect of liabilities subject to compulsory insurance, rather than paying compensation, provided that the costs of the arrangements appear likely to be less than the costs of paying compensation.

GENERAL INSURANCE

- 12.6.13 R Unless *The Scheme Manager* is taking measures under COMP 3.5.1R, or COMP 12.6.11R applies, *The Scheme Manager* must calculate the liability of a **relevant person** to the claimant under a contract of **general insurance** in accordance with the terms of the contract, and (subject to any limits in Table COMP 10.3(1)R) pay that amount to the claimant .

LONG-TERM INSURANCE

- 12.6.14 R Unless *The Scheme Manager* is making arrangements to secure continuity of insurance cover under COMP 3.4, *The Scheme Manager* must calculate the liability of a **relevant person** to the claimant under a **long term insurance** contract in accordance with the terms of the contract, and (subject to any limits in Table COMP 10.3(1)R and to COMP 12.6.16-18) pay that amount to the claimant.
- 12.6.15 R *The Scheme Manager* must not treat any bonus provided under a **long term insurance** contract as part of the claimant's claim unless it was declared before *The Scheme Manager* determined that the **relevant person** was in default.
- 12.6.16 R If *The Scheme Manager* considers that the benefits or **future benefits** provided for under a protected **long term insurance** contract issued by a **relevant person** are or may be excessive in any respect, having regard to the **premiums** paid or payable and to any other terms of the contract, *The Scheme Manager* must refer the contract to an actuary who is independent of the claimant and the **relevant person**.

- 12.6.17 R If *The Scheme Manager* is satisfied, following the actuary's written recommendation, that any of the benefits provided for under the contract are or may be excessive, it may treat the liability of the *relevant person* under the contract as reduced or (as the case may be) disregarded.
- 12.6.18 R *The Scheme Manager* may rely on the value attributed to the contract by the actuary when calculating the compensation payable to the claimant, or when securing continuity of cover.
- 12.7 Quantification when The Scheme Manager is seeking to secure continuity of insurance cover
- 12.7.1 R In any period when *The Scheme Manager* is seeking to secure continuity of cover for any policyholder of a *relevant person*, *The Scheme Manager* must secure that 90% of any *future benefit* under a *long term insurance* contract which would have fallen due to be paid to any of those policyholders during that period is paid to the policyholder in question as soon as reasonably practicable after the time when the benefit in question would have fallen due under the contract (but subject to and in accordance with any other terms which would have applied under the contract).
- 12.7.2 R A bonus provided under a *contract of insurance* is not a *future benefit* for the purposes of COMP 12.7.1R unless it was declared before the beginning of the liquidation.
- 12.8 Quantification: trustees & joint claims
- 12.8.1 R If a claimant's claims include a claim as *trustee*, he is treated in respect of that claim as if his claim as *trustee* were a claim of a different *person*.
- 12.8.2 R If a claimant has a claim as a bare *trustee* for one or more beneficiaries, the beneficiary or beneficiaries are treated as having the claim, and not the claimant.
- 12.8.3 R If a claimant has a claim as *agent* for one or more *principals*, the *principal* or *principals* are treated as having the claim, not the claimant.
- 12.8.4 R If any group of *persons* has a claim as *trustees*, they are treated as a single and continuing *person* distinct from the *persons* who may from time to time be the *trustees*.
- 12.8.5 R Where the same *person* has a claim as *trustee* for different trusts, the rules in this sourcebook apply as if the claims relating to each of these trusts were claims of different *persons*.

- 12.8.6 G If a *trustee* has a claim as *trustee* for different trusts, or where *trustees* of different trusts each have a claim in respect of the same default, *The Scheme Manager* should try to ensure, so far as it reasonably can, that no *person* who is, or may be, a beneficiary of more than one of the trusts benefits from the compensation paid by *The Scheme Manager* to a greater amount than the maximum compensation sum payable under Table COMP 10.3(1)R.

JOINT CLAIMS

- 12.8.7 R If two or more *persons* have a joint beneficial claim the claim is to be treated as a claim of the partnership if they are carrying on *business* together in partnership. Otherwise each of those *persons* is taken to have a claim for his share, and in the absence of satisfactory evidence as to their respective shares, *The Scheme Manager* must regard each *person* as entitled to an equal share.
- 12.8.8 G If a *person* has a claim and a *trustee* also has, in respect of the same default, a claim on that person's behalf or in which he may have or may acquire an interest, *The Scheme Manager* should try to ensure, so far as it reasonably can, that the total amount of compensation paid by *The Scheme Manager* to or for the benefit of the claimant does not exceed the maximum compensation sum payable under Table COMP 10.3(1)R.
- 12.8.9 R In applying the rules in this sourcebook to claims relating to a *UK firm* arising out of *business* done with a *branch* of the *firm* in another *EEA State*, *The Scheme Manager* must interpret references to *persons* entitled as personal representatives, *trustees*, bare *trustees* or *agents*, or references to *persons* having a joint beneficial claim or carrying on *business* in partnership, as references to *persons* entitled under the law of that state in a capacity appearing to *The Scheme Manager* to correspond as nearly as may be to that capacity.

13. Levies

For the reasons given in paragraph 4.73–4.81 of the consultation paper, *the FSA* has decided not to consult upon levy rules until it has finalised its regime for regulatory fees. *The FSA* anticipates that consultation on levy rules will take place in Autumn 2000. However, as stated in the consultation paper, *the FSA* would welcome comments at this stage on the general principles it is minded to follow in its levy rules, namely:

- (1) As a general rule, the costs of compensation attaching to a particular default will fall on the *contribution group* of which the defaulting *firm* was a member.
- (2) The *contribution groups* will be constructed to reflect the market structure in order to minimise cross-subsidy between *firms* carrying out dissimilar *business* activities.
- (3) All *participant firms* will be required to contribute to the base costs¹ of operating *the Scheme*.
- (4) All other administration costs will be attached to a specific default and will then be met by the *firms* in the *contribution group* of which the defaulting firm was a member.
- (5) The allocation of liabilities to *firms* in a particular *contribution group* will be weighted towards those *firms* that do *business* with consumers eligible for compensation.

¹ Base costs are not dependent on the level of activity and may include items such as the salaries of board members, some elements of premises and IT costs. These costs exist regardless of the level of activity.

14. EEA Firms

14.1 Application

14.1.1 R This chapter applies to *The Scheme Manager*.

14.1.2 G It is also relevant to *EEA firms* who carry on *home state regulated activity* covered by the *2BCD* or the *ISD*.

14.2 Purpose

14.2.1 G Under the *DGD* and *ICD*, *EEA firms* which carry on *business* from a *branch* in the *UK* in accordance with the terms of their authorisation under the *2BCD* or the *ISD* will not, generally speaking, be covered by *the Scheme*. Instead, their *home state* compensation scheme must provide compensation in respect of *business* conducted from the *UK branch* under the *2BCD* or *ISD* 'passport', in the event that they become insolvent.

14.2.2 G However, if the level or scope of compensation cover for this *business* is less in the *EEA firm's home state* than that provided by *the Scheme*, the *DGD* and *ICD* enable the *EEA firm* to obtain 'top-up' cover from *the Scheme*, up to *the Scheme's* limits (set out in chapter 10). If a *firm* with 'top-up' cover becomes insolvent, *The Scheme Manager* must liaise with the *firm's home state* compensation scheme regarding the payment of compensation (see COMP 14.4.1R).

14.2.3 G This chapter sets out how an *EEA firm* can obtain 'top-up' cover, and the ways in which that cover may be terminated. These provisions enable the *UK* to meet its obligations to *EEA firms* under the *DGD* and *ICD*.

14.3 Participation in the Scheme by EEA firms

14.3.1 R If the conditions set out in COMP 14.3.2 R are satisfied, an *EEA firm* may apply to *the Scheme* to become a *participant firm*.

14.3.2 R The conditions are:

- (1) The *firm* is carrying on *home state regulated activity* covered by the *2BCD* or *ISD* from a *branch* in the *UK*; and
- (2) The level of compensation available under *the Scheme*, and/or the scope of *the Scheme*, is greater than that of the *firm's home state* compensation scheme.

14.3.3 G *EEA firms* which carry on *business* from a *branch* in the *UK* for which they are authorised by *the FSA*, rather than regulated by their *home state regulator*, will in any event be *participant firms* in respect of their *FSA* authorised *business*.

14.3.4 G *EEA firms* which carry on *business* from a branch in the *UK* in exercise of an *EEA* right under the insurance directives are in any event *participant firms*: see COMP 6.3.1R (1).

14.3.5 R If both conditions in COMP 14.3.2 R are satisfied, *The Scheme Manager* must accept an application by the *EEA firm* to be a *participant firm*.

- 14.3.6 R When *The Scheme Manager* accepts an application, it must allocate the *EEA firm* to the *contribution group* (or groups) which seem to *The Scheme Manager* to be most appropriate, taking into account the nature of the *business* for which the *EEA firm* is seeking cover from *the Scheme*.
- 14.3.7 R *The Scheme Manager* must put into effect a suitable mechanism to enable an appeal by an *EEA firm* against
- (1) A rejection by *The Scheme Manager* of an application to become a *participant firm*, or
 - (2) A decision to allocate an *EEA firm*, once the *firm's* application has been accepted, to a particular *contribution group*.
- 14.4 Co-operation between the Scheme Manager and home state compensation schemes
- 14.4.1 R Where an *EEA firm* becomes a *participant firm* under COMP 14.3, *The Scheme Manager* must seek to establish with that *firm's home state* scheme appropriate procedures for the payment of compensation to claimants, following the principles set out in Annex II of the *DGD* or Annex II of the *ICD*, as appropriate.
- 14.5 Termination of an EEA firm's participation in the Scheme
- 14.5.1 R *The Scheme Manager* may terminate an *EEA firm's* participation in *the Scheme* where it is advised by the *firm's home state regulator* or compensation scheme that the conditions in COMP 14.3.2 R are no longer satisfied.
- 14.5.2 R If an *EEA firm* which is a *participant firm* under COMP 14.3 fails to observe any of the rules in this sourcebook which apply to *participant firms*, *The Scheme Manager* must notify *the FSA* and the *EEA firm's home state regulator*.
- 14.5.3 R In cases where COMP 14.5.2 R applies, *The Scheme Manager* must co-operate with the *EEA firm's home state regulator* so that appropriate measures can be taken to ensure that the *EEA firm* meets its obligations under the rules in this sourcebook.
- 14.5.4 R If the *EEA firm* fails to meet its obligations for a period of twelve months, *The Scheme Manager* may terminate its participation in *the Scheme*.
- 14.6 Resignation of an EEA firm from the Scheme
- 14.6.1 R An *EEA firm* which is a *participant firm* under COMP 14.3 may withdraw from participation by giving six month's notice in writing to *The Scheme Manager*.

14.7 Notice to customers

- 14.7.1 R Where an **EEA firm's** participation in **the Scheme** comes to an end under COMP 14.5.4R or COMP 14.6.1R, it must inform all its **UK** customers no later than six (6) weeks after the date that its participation ends that they are no longer protected by **the Scheme**, and of the level of compensation cover now available to them.
- 14.7.2 R If an **EEA firm** fails to comply with COMP 14.7.1R, **The Scheme Manager** must inform the **firm's home state regulator** of that fact.
- 14.7.3 R **The Scheme Manager** must bring the ending of an **EEA firm's** participation in **the Scheme** to the attention of customers by means of a public notice.

DEFINITIONS

Definition title	Definition wording
2BCD	Second Banking Coordination Directive: the European Council Directive of 15 December 1989 on the coordination of laws, etc, relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC (No 89/646/EEC).
accepting	In relation to a deposit, assuming the liability to repay the deposit.
agent	A person [including an employee] who acts on behalf of another.
appointed representative	<p>A person who:</p> <ul style="list-style-type: none"> (a) is a party to a contract with an authorised person (his principal) which: <ul style="list-style-type: none"> (i) permits or requires him to carry on business of a description prescribed in an exemption order; and (ii) complies with such requirements as may be prescribed, and (b) is someone for whose activities in carrying on the whole or part of that business his principal has accepted responsibility in writing; <p>and who is therefore an exempt person in relation to any regulated activity comprised in the carrying on of that business for which his principal has accepted responsibility, in accordance with section 39 of the Act.</p>
branch	<ul style="list-style-type: none"> (a) In relation to a credit institution, <ul style="list-style-type: none"> (i) a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions; (ii) for the purposes of 2BCD, any number of places of business set up in the same Member State by a credit institution with headquarters in another Member State are to be regarded as a single branch; (b) In relation to an investment firm, <ul style="list-style-type: none"> (i) a place of business which is a part of an investment firm, not being the principal place of business, which has no separate legal personality and which provides investment services for which the investment firm has been authorised; (ii) for the purposes of the ISD, all the places of business set up in the same Member State by an investment firm with headquarters in

	another Member State are to be regarded as a single branch.
business	In relation to a firm, commercial activities involving all or any part of that person's business, whether or not the part consists of or includes a regulated activity.
close relative	In relation to any person, <ul style="list-style-type: none"> (a) his spouse; (b) his children and step-children, his parents and step-parents, his brothers and sisters and his step-brothers and step-sisters; and (c) the spouse of any person within (b), as defined in paragraph 2(1) of the Regulated Activities Order [2000].
collective investment scheme	Any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income, as more fully defined in section 235 of the Act, and which is not excluded by The Financial Services and Markets Act (Collective Investment Schemes) Order [2000].
contract of insurance	Any long term or general insurance contract, including: <ul style="list-style-type: none"> (a) a fidelity bond, a performance bond, an administration bond, a bail bond, a customs bond, or any similar contract of (b) guarantee; (c) tontines; (d) capital redemption contracts; (e) when effected or carried out by a person whose permission covers the effecting or carrying out of any contract which is a contract of insurance apart from this sub-paragraph or sub-paragraph (c), a contract to manage the assets of pension funds (other than funds solely for the benefit of officers or employees of the person effecting the contract or carrying it out and their dependants or, in the case of a company, partly for the benefit of officers or employees and their dependants of its subsidiary or holding company or a subsidiary of its holding company); (f) contracts to pay annuities on human life; (g) any contract in accordance with which benefits are provided: <ul style="list-style-type: none"> i. for the relief or maintenance of any persons during sickness or when in distressed circumstances; or

	<p>ii. to meet the funeral expenses of any person;</p> <p>(h) contracts of a kind referred to in article 1(2)(e) of the First Life Directive; and</p> <p>(i) contracts of a kind referred to in article 1(3) of the First Life Directive;</p> <p>as specified in article 2(1) of the Regulated Activities Order [2000].</p>
contribution group	The group of participant firms who share the costs of funding compensation from claims arising from defaulting firms who carry on similar business.
credit institution	An undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account, as defined in article 1 of the First Banking Coordination Directive.
deposit	<p>A sum of money (whether denominated in a currency or in any unit of account defined by reference to the former European currency unit as that was defined in article 1 of Council Regulation No.3320/94/EC) paid on terms:</p> <p>(a) under which it will be repaid, with or without interest or a premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it; and</p> <p>(b) which are not referable to the provision of property or services or the giving of security;</p> <p>as more fully defined in article 2(1) and (2) of the Regulated Activities Order [2000], and subject to the exclusions in paragraph 2 of Schedule 4 to that Order.</p>
deposit taking	Accepting deposits.
designated investment business	<p>(a) a regulated activity in relation to a designated investment;</p> <p>(b) an ancillary activity in relation to a designated investment.</p>
DGD	The Deposit Guarantee Directive (Council Directive 94/19/EC).
director	<p>In relation to an unincorporated association or to a body corporate (whether constituted in the United Kingdom or under the law of a country or territory outside it), any person appointed to direct its affairs, including, in accordance with sub-section 417(1) of the Act,</p> <p>(a) a person occupying in relation to it the position of a director (by whatever name called); and</p> <p>(b) a person in accordance with whose directions or instructions (not being advice given in a professional capacity) the directors of that body are accustomed to act;</p>
EEA	See European Economic Area

EEA firm	<p>Any of the following if it does not have its head office in the United Kingdom:</p> <p>(a) an investment firm (as defined in article 1(2) of the Investment Services Directive) which is authorised (within the meaning of article 3) by its home state regulator;</p> <p>(b) a credit institution (as defined in article 1 of the First Banking Coordination Directive) which is authorised (within the meaning of article 1) by its home state regulator;</p> <p>(c) a financial institution (as defined in article 1 of the Second Banking Coordination Directive) which is a subsidiary of the kind mentioned in article 18.2 and which fulfils the conditions in article 18; or</p> <p>(d) an undertaking pursuing the activity of direct insurance (within the meaning of article 1 of the First Life Directive or of the First Non-Life Insurance Directive) which has received authorisation under article 6 from its home state regulator.</p>
EEA State	A State which is a contracting party to the agreement on the EEA signed at Oporto on 2 May 1992 as it has effect for the time being.
eligible claimant	A person who is eligible to bring a claim for compensation.
European Economic Area	The free-trade area established in 1992 which [at 31 March 1999] includes Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Liechtenstein, Luxembourg, the Netherlands, Norway, Portugal, Spain, the United Kingdom, Austria, Finland and Sweden.
firm	An authorised person.
FSA, the	The Financial Services Authority.
future benefit	Any benefit provided for under a long term insurance contract of a company in liquidation which has not fallen due to be paid before the beginning of the liquidation.
general insurance	All classes of insurance described under Schedule 1 Part I of the RAO other than marine, aviation, transport, credit, and reinsurance.
group	<p>In relation to a person ('A'), A and any person who is:</p> <p>(a) a parent undertaking of A; or</p> <p>(b) a subsidiary undertaking of A; or</p> <p>(c) a subsidiary undertaking of a parent undertaking of A; or</p> <p>(d) a parent undertaking of a subsidiary undertaking of A; or</p> <p>(e) an undertaking in which A or an undertaking mentioned in (a)-(d) has a participating interest; or</p> <p>(f) if A or an undertaking mentioned in (a) or (d) is</p>

	<p>a building society, an associated undertaking of that society; or</p> <p>(g) if A or an undertaking mentioned in paragraph (a) or (d) is an incorporated friendly society, a body corporate of</p> <p>(h) which the society has joint control (within the meaning of section 13(9)(c) of the Friendly Societies Act 1992);</p> <p>as defined in section 355 of the Act; including, for the purposes of the Regulated Activities Order, any body corporate in which a member of the group has a qualifying capital interest.</p>
home state	<p>(a) in relation to a credit institution, the Member State in which the credit institution has been authorised in accordance with the First Banking Coordination Directive;</p> <p>(b) in relation to an investment firm,</p> <p>(i) where the investment firm is a natural person, the Member State in which his head office is situated;</p> <p>(ii) where the investment firm is a legal person, the Member State in which its registered office is situated or, if under its national law it has no registered office, the Member State in which its head office is situated;</p> <p>(c) in relation to a market, the Member State in which the registered office of the body which provides trading facilities is situated or, if under its national law it has no registered office, the Member State in which that body's head office is situated.</p>
home state regulator	<p>(a) in relation to an EEA firm, the competent authority (as defined in the relevant Single Market Directive) of an EEA State other than the United Kingdom in respect of the EEA firm concerned;</p> <p>(b) in relation to an EU firm, the competent authority of the firm's home state for the purpose of its authorisation under the law of its home state to carry on the regulated activity in question.</p>
ICD	The Investor Compensation Directive (Council Directive 97/9/EC).
insurance business	<p>Business which includes</p> <p>(a) the effecting and carrying out, by a person not carrying on a banking business, of contracts for fidelity bonds, performance bonds, administration bonds, bail bonds or customs bonds or similar contracts of guarantee, being</p>

	<p>contracts effected by way of business (and not merely incidental to some other business carried on by the person effecting them) in return for the payment of one or more premiums;</p> <p>(b) the effecting and carrying out of tontines;</p> <p>(c) the effecting and carrying out, by a body (not being a body carrying on a banking business) that carries on business which is insurance business apart from this paragraph, of</p> <p>(i) capital redemption contracts;</p> <p>(ii) contracts to manage the investments of pension funds (other than funds solely for the benefit of its own officers or employees and their dependants or, in the case of a company, partly for the benefit of officers or employees and their dependants of its subsidiary or holding company or a subsidiary of its holding company);</p> <p>(d) the effecting and carrying out of contracts to pay annuities on human life, as defined in section 95 of the 1982 Act.</p>
insurance company	A person effecting or carrying out contracts of insurance.
insurer	An authorised person who can carry on or effect contracts of insurance in or from the United Kingdom.
intermediate customer	see CP43.
investment	Any investment, including any asset, right or interest.
ISD	The Investment Services Directive (the European Council Directive of 10 May 1993 on investment services in the securities field (No 93/22/EEC)).
large companies	A company which does not qualify as a small company under s247 of the Companies Act 1985.
large partnerships	A partnership or unincorporated association with net assets of more than £1.4m.
liability subject to compulsory insurance	<p>Any liability required under any of the following enactments to be covered by insurance or (as the case may be) by insurance or by some other provisions for securing its discharge:</p> <p>(1) section 1(4A)(d) of the Riding Establishments Act 1964 (or any corresponding enactment for the time being in force in Northern Ireland);</p> <p>(2) section 1 of the Employers' Liability (Compulsory Insurance) Act 1969 or Article 5 of the Employers' Liability (Defective Equipment and Compulsory Insurance) (Northern Ireland) Order 1972;</p> <p>(3) Part VI of the Road Traffic Act 1988 or Part VIII of the Road Traffic (Northern Ireland) Order 1981.</p>

Lloyd's policy	A contract of insurance written at Lloyd's.
long term insurance	All classes of insurance described under Schedule 1 Part II of the RAO.
market counterparty	See CP43.
occupational pension scheme	Any scheme or arrangement which is comprised in one or more instruments or agreements and which has, or is capable of having, effect in relation to one or more descriptions or categories of employment so as to provide benefits, in the form of pensions or otherwise, payable on termination of service, or on death or retirement, to or in respect of earners with a qualifying service in an employment of any such description or category.
offence	Any criminal offence including an act or omission that would be an offence if it had taken place in the United Kingdom.
participant firm	An FSA authorised person who is a participant in the compensation scheme.
permission	Permission granted by the FSA or given by a provision of the Act to carry on a regulated activity in the United Kingdom.
person	An individual, a body corporate, a partnership or an unincorporated association.
personal pension scheme	A scheme of investment as defined in section 630 of the Income and Corporation Taxes Act 1988.
premium	<p>Payments under a long term insurance contract:</p> <p>(a) (i) which are payable on dates that are certain or ascertainable at the time the contract is made; and</p> <p>(ii) which are payable over a period that exceeds one year in length; and</p> <p>(iii) assuming the policy evidencing the contract is not surrendered or otherwise terminated before the premiums fall due, will fall due on those dates without either party to the contract exercising any option under the contract; or</p> <p>(b) of which the first payment is an obligation under the policy, and subsequent payments, calculated according to an agreed formula, are payable over a period which exceeds one year in length under a collateral written arrangement with the insurance company or friendly society.</p>
Principal	A person conducting business on his own account.
private customer	See CP43.
product provider	A firm which is a life office, an operator of a regulated collective investment scheme, a friendly society or the manager of an investment trust savings scheme, or a firm carrying on any other type of investment business which in the opinion of the FSA makes it appropriate for the firm to be designated as a product provider.
protected claim	A claim for which compensation may be payable under the rules in the compensation sourcebook.
quantification date	The date a claim is quantified.

regulated activity	<p>An activity of a kind specified in an order made by the Treasury which:</p> <p>(a) relates to an investment of a kind specified in such an order; or</p> <p>(b) in the case of an activity of a kind which is also specified for the purposes of paragraph (b) of section 20(1) of the Act, is carried on in relation to property of any kind; as defined in section 20(1) of the Act;</p> <p>the following activities are specified in the Regulated Activities Order [2000]:</p> <p>4 Accepting deposits;</p> <p>5 Effecting contracts of insurance;</p> <p>6 Carrying out contracts of insurance;</p> <p>7 Establishing etc. a collective investment scheme;</p> <p>8 Making a market;</p> <p>9 Buying with a view to selling;</p> <p>10 Regularly soliciting the public to deal in securities;</p> <p>[continues below]</p> <p>11 Dealing as principal in contractually based investments;</p> <p>12 Dealing as agent;</p> <p>13 Arranging deals for another;</p> <p>14 Making arrangements enabling or facilitating deals;</p> <p>15 Safeguarding and administering investments;</p> <p>16 Sending dematerialised instructions;</p> <p>17 Causing dematerialised instructions to be sent;</p> <p>18 Managing investments;</p> <p>19 Certain investment advice;</p> <p>20 Advice on syndicate participation at Lloyd's;</p> <p>21 [Acting as] Lloyd's managing agents;</p> <p>22 Agreeing to carry on certain regulated activities; investments; certain investment advice; advice on syndicate participation in Lloyd's; Lloyd's managing agents; agreeing to carry on certain regulated activities.</p>
relevant person	<p>A person who was, at the time the act or omission giving rise to the claim against him took place:</p> <p>(1) an authorised person (but not an EEA firm carrying on home state regulated business from a branch in the UK under the provisions of the 2BCD or ISD);</p> <p>(2) a UK branch of an EEA firm carrying on home state regulated business under the provisions of the 2BCD or ISD that is a participant firm;</p> <p>(3) an appointed representative of 1 or 2.</p>
retirement annuity	<p>An individual pension policy effected by a self-employed person or a person in non-pensionable employment before 1 July 1998 and which is approved under Chapter III, Part XIV of the Income and Corporation Taxes Act 1988.</p>

retirement fund	The amount which will be available under the contract, at the date on which the investor retires, for the provision of benefits.
small company	A company with called up share capital or net assets of less than £1m.
small partnership	A partnership or unincorporated association with net assets of less than £1m.
the Act	The Financial Services and Markets Act 2000.
the Scheme	The compensation scheme established by the FSA under part XV of the Act.
The Scheme Manager	The Financial Services Compensation Scheme Limited.
trustee	(1) in relation to a unit trust scheme, the person holding the property in question on trust for the participants; (2) in any other case, the person holding the property in question on trust for the beneficiaries or objects of the trust; it includes a bare trustee (or if Scots law applies a nominee), a personal representative, an executor, a receiver, committee or curator bonis and an attorney under a power registered by the Court under section 6 of the Enduring Powers of Attorney Act 1985 or a power which (if Scots law applies and the grantor has become mentally incapacitated) continues to have effect despite the mental incapacity; it does not include a trustee of an implied, constructive or resulting trust of which the trustee is unaware.
UK	England, Wales, Scotland, Northern Ireland, but not the Channel Islands or the Isle of Man.
UK firm	A person whose head office is in the United Kingdom and who has an EEA right to carry on activity in an EEA State other than the United Kingdom
United Kingdom	England, Wales, Scotland and Northern Ireland, but not the Channel Islands or Isle of Man