

4th March 2022

Financial Conduct Authority
12 Endeavour Square
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Submitted via email to: dp21-05@fca.org.uk

RE: DP21/5: Compensation Framework Review

BlackRock¹ is pleased to have the opportunity to respond to the Compensation Framework Review, issued by the Financial Conduct Authority.

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this Discussion Paper and will continue to contribute to the thinking of the FCA on any issues that may assist in the final outcome.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

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¹ BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive summary

We welcome this Discussion Paper and the FCA's willingness to ask wide-ranging and fundamental questions about the Financial Services Compensation Scheme (FSCS). We are concerned that, because the cost of FSCS compensation is borne by the whole industry, it is not effectively addressing the specific sectors generating the failures. We believe it will be important to go back to first principles on the rationale for the FSCS and make fundamental changes to its structure and operation going forwards.

The total compensation costs are expected to reach £900mn in 2022/23, up from approximately £300mn in 2017/18.² This is a three-fold increase, and the Investment Provision levy is twenty times higher over the same period. Overall costs are expected to continue increasing up to 2025. This creates a significant and rising cost of doing business in the UK financial services industry and indicates an increase in misconduct or poor advice, combined with failure of authorised firms over recent years.

Publicly available data on what has driven the increase in compensation costs is limited. Levy payers do not receive information on how costs for their levy classes break down, or on where or how costs have been generated within their levy class. However, FCA and FSCS documents note that the 'protected investment business' has been a major driver of FSCS claims, accounting for 78% of claims in 2020/21. High-level statements from the FCA and FSCS suggest that major drivers of recent costs include negligent pensions advice, negligent advice to invest into self-invested personal pensions (SIPPs), claims against SIPP operators in relation to non-standard assets, and claims for the return of client money or custody assets.

The current design of FSCS funding classes implies a collective responsibility for the cost of misconduct and firm failure between all financial services firms. This includes firms, such as asset managers, who have little or no business links, insight, or control over the sectors that appear to be responsible for the issues. We believe this presents a significant moral hazard.

We strongly agree that retail investors should be protected from the potential costs of misconduct or poor advice. However, we do not believe that ensuring funding for compensation through cross-subsidy between different sectors necessarily enhances trust and confidence in financial services. Ultimately, consumers are eligible for redress if a) a firm is or was authorised by UK regulators; b) misconduct has been identified; c) the firm is unable to meet the cost of redress due to insufficient resources or failure; and d) the consumer successfully establishes a claim, often a multi-year process. Availability of compensation at the end of this process does not de facto enhance trust and confidence: compensation is a *consequence* of conduct failures, and it is the fact that conduct failures have occurred that reduces consumer trust and confidence, regardless of whether compensation is paid.

With this in mind, we believe the FSCS should be viewed primarily as an insurance mechanism, available if firms cannot meet their own compensation liabilities. The responsibility for consumer protection and preventing failures more broadly should rest with business and regulators. As such, the compensation framework should adhere strictly to the 'polluter pays' principle, and should therefore be fundamentally reformed to ensure that the costs of compensation are internalised by the sectors that generate them. This will require a comprehensive analysis of recent misconduct and failures, identifying the specific causes and business models that are at higher risk of failure.

In line with the 'polluter pays' principle, it is right that asset management firms cover any costs related to misconduct within the sector. However, any claims would be fundamentally

² Source: [FCA Compensation Framework Review Discussion Paper](#), page 6.

different to those that have been identified as the main drivers of recent costs. We therefore recommend that for the purposes of FSCS funding, the provision of investment management services should be separated out from unrelated financial services that pose a different set of risks to consumers. We have reason to believe that recent compensation costs arising from asset management are low and will continue to be low.

We recognise that narrowing funding classes in this way could risk insufficient funding for overall compensation costs, although the FCA is taking steps to tackle root causes and bring down costs over the medium to long term. However, pooling the cost between unrelated sectors is not the correct solution: it will generate perverse incentives and moral hazard. Instead, compensation costs exceeding class limits should prompt further focus on tackling misconduct or inability to meet the compensation costs within sectors causing the problems. The level of regulatory capital held by firms, particularly in those sectors which have seen the highest number of firm failures, should be genuinely sufficient to protect consumers and deter “bad actors” from entering the market in the first place. Professional Indemnity Insurance (PII) should also provide sufficient coverage in the event of failure, commensurate with the risk that an individual or firm poses.

Responses to questions

1. Do you consider that proposed principles 1 and 2 are the appropriate principles to underpin the design of the compensation framework (in relation to the aspects of the framework that the FCA is responsible for)?

We strongly agree with proposed principle 1: it is right that a form of last-resort protection should be in place to insure end-consumers against significant harm due to misconduct and failures outside of their control.

However, we do not agree with proposed principle 2: having a compensation scheme in place does not in itself increase confidence or trust in the financial services sector. FSCS compensation is provided if a) a firm is or was authorised by UK regulators; b) misconduct has been identified; c) the firm is unable to meet the cost of redress due to insufficient resources or failure; and d) the consumer has successfully established a claim, often a multi-year process. It is vital that consumers have confidence in their ability to receive compensation, but misconduct and failures will inevitably reduce trust and confidence in the financial services sector, regardless of compensation.

With this in mind, we believe the FSCS should be viewed as an insurance scheme in the event of firm failures; it cannot and should not be relied upon to maintain trust and confidence in financial services. That responsibility rests with financial services firms and regulators.

2. What incentives, whether positive or negative, does the FSCS as a ‘fund of last resort’ create for market participants and what are the consequences of those incentives?

The FSCS will create positive incentives to the extent that a) it is truly a fund of last resort; and b) the cost of the FSCS is fully internalized by the actors that generate them. The FSCS will generate perverse incentives for conduct and firm resilience in the wider industry as long as the costs are not borne by those sectors that generate them, or those most at risk of doing so, even if it functions effectively as a last resort for consumer redress.

At present, it appears that a significant and increasing cost of compensation is borne by sectors unrelated to those that are generating the costs, are at low risk of doing so, and which do not have material business links to those that are.

It has been suggested that this type of cross-subsidy is beneficial to end-consumers on the grounds that a) it ensures sufficient resources to meet compensation claims, thereby enhancing trust and confidence in financial services; and b) that it incentivizes monitoring of distribution and intermediation chains. We question each of these points. On the first, as noted under question 1, the availability of compensation does not in itself prevent failure and therefore cannot be deemed to enhance trust and confidence. On the second, it is difficult to see how this type of monitoring is achievable, given the very limited information levy payers receive on exactly where and how failures that generate compensation costs are arising. Without more transparency, it is difficult to see how industry can play more of a role in monitoring practices in the wider financial services ecosystem.

To generate incentives that are additive to market integrity, consumer trust, and confidence we believe it is imperative that the compensation framework is re-focused around the 'polluter pays' principle. As discussed under question 1, the FSCS should be viewed as an insurance policy; it is therefore critical that the cost of that insurance is borne in proportion to the risk of misconduct and failure.

3. Do you have any further suggestions on how to ensure the FSCS is not over relied on and represents a true 'fund of last resort'?

We support the FCA's aim of bringing down the costs of the FSCS by tackling the root cause of high costs – firm misconduct and failures – and are encouraged by the range of steps it has set out to do so.

Avoiding 'over-reliance' on the FSCS is fundamentally a question of first, reducing misconduct, and second, ensuring firms have the funding or insurance to meet any claims. In line with the 'polluter pays' principle, requirements for regulatory capital and professional indemnity insurance should be adjusted on an ongoing basis, informed by the regulator's view on which sectors post the highest risk of being unable to meet the costs of redress.

4. Do you consider that a change in the scope of FSCS protection could be justified, whilst remaining in line with the proposed principles for protection at paragraph 2.2? If yes, please outline how and why you consider protection should be changed.

We believe the current scope of protection could generate the potential for regulatory arbitrage and misuse of FSCS resources. Changes to its scope consistent with the need to protect retail investors include:

- Clarifying that unregulated products are out of scope, regardless of whether the wrapper is covered.
- Ensuring that products captured are suitable for retail investors, excluding unauthorised and esoteric products. Removing non-retail products would simplify the compensation scheme and be easy for investors to understand.
- Excluding funds that have a high entry limit, for example funds with a high minimum investment unlikely to be accessed by retail investors.

5. If you consider a change in the scope of FSCS protection could be justified, please set out the positive and negative implications of such a change in protection, for both consumers and the financial services sector more generally.

Narrowing the scope of the FSCS would result in a far simpler, fairer, and more transparent compensation scheme. The regulatory perimeter is arguably too widely drawn at present, and, as indicated in the Discussion Paper, the compensation scheme has extended coverage to products and investments not suitable for retail investors.

- 6. Following the UK's withdrawal from the European Union, is the narrower territorial scope previously decided on for AIF and UCITS managers and CIS operators still appropriate? If not, what alternative options should we consider?**

We agree that FSCS territorial scope should not be broadened. This issue was considered as part of HM Treasury's consultation on the Overseas Funds Regime (OFR), which concluded that it was not necessary to extend the jurisdiction of the FSCS to operators or depositaries of overseas funds under the OFR.³

- 7. How can we make sure that consumers are provided with clear information about the availability of FSCS protection that equips the consumer to make effective and properly informed decisions about financial products and services, including those where FSCS protection is not available?**

Currently, the complexity of establishing FSCS coverage for financial products and services can make it difficult for firms to comply with disclosure requirements. This in turn is likely to leave consumers unclear about the extent of their protection. We therefore believe that the scope of the FSCS should be narrowed (see question 4).

- 8. When distributing non-UK funds to retail investors in the UK, should firms be required to inform customers when FSCS protection is not available? If yes, how could firms ensure customers are aware of the lack of protection, through the fund's marketing materials or otherwise?**

No comment, see question 6.

- 9. Do you consider that 'high-net-worth' and/or 'sophisticated' individuals should be excluded from being able to claim from the FSCS in certain circumstances? If so, should the exclusion(s) apply to all types of claim or just certain categories of claim?**

This has the potential to add further complexity for firms who are calculating eligible income. It would be far simpler for firms to manage a model whereby funds which have a high minimum investment are excluded from FSCS protection on the basis that they would not include retail investors. See question 4.

- 10. Do you consider any other amendments should be made to the current eligible claimant criteria?**

No comment.

- 11. Does the CIS look-through remain appropriate from a consumer protection perspective? If not, what alternatives should be considered to protect investors in CISs?**

The look-through calculation is highly complex and requires data granularity that most firms' systems do not capture, and that has no use other than calculating eligible income for the FSCS levy. This has led to some firms over-reporting eligible income and, in some cases, contributing more to the scheme than required. It is not possible to identify the proportion of compensation paid as a result of the look-through based on the data that is made available to levy payers.

³ See HM Treasury, [Overseas funds regime: Summary of responses](#), paragraph 2.39 – 2.43.

As discussed under question 15, we ultimately believe that compensation costs arising from asset manager failures are low. We therefore recommend that for the purposes of FSCS funding, the provision of investment management services should be separated out from other financial services that are unrelated and pose a different set of risks to consumers. In the same vein, the look-through rule does not reflect the 'polluter pays' principle and should be removed.

12. Do you consider changes should be made to the level of compensation that is payable by the FSCS? Please provide justification for any changes you propose.

No comment.

13. Would you be in favour of the introduction of set periodic reviews of the compensation limits to ensure that they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?

Yes. However, we believe periodic reviews should not be limited to compensation limits; this should be part of a wider FSCS review programme that a) identifies where the major areas of risk and incidence of failures are; b) revises supervisory focus, levy funding requirements, and capital and insurance requirements accordingly; and c) links class compensation limits to inflation.

14. Do you consider that proposed principles 3 and 4 in relation to FSCS funding are the appropriate principles to underpin the design of the funding arrangements (in relation to the classes which the FCA is responsible for)? If not, what principles would be preferable?

See response to question 15.

15. How do you consider the current funding model (for the classes that the FCA is responsible for) could be improved, to ensure that costs are appropriately distributed and the impact on firms is proportionate? Please explain how your proposed changes represent an improvement on the current arrangements.

The FSCS funding model cannot be divorced from wider considerations as to whether the overall framework ensures that the FSCS is truly a last resort, whether it creates the right incentives, and whether it contributes to confidence, trust, and market integrity.

We do not believe that the availability of compensation in itself enhances confidence and trust in financial services. It is right that consumers should receive compensation if they are the victims of misconduct and firm failure, but by definition they are only eligible for compensation after these failures have occurred and often receive compensation only after a multi-year process to establish their claim.

The FCA has suggested that cross-subsidy between product providers and distribution is justifiable on the basis that it will help maintain "confidence in the overall market and the structures that exist for the distribution of products to consumers...[and] the additional funding requirement would incentivise providers to design products that are well understood by intermediaries and to exercise control over their distribution chains".⁴

We do not believe that this is the case, given that current funding classes contain a range of different sectors, many of which do not have material insight into, control over, or business links with one another. Moreover, the current level of transparency around the failures driving FSCS costs makes it very difficult for market participants to have clear oversight of or control over poor practices taking place elsewhere.

⁴ Source: FCA [Compensation Framework Review Discussion Paper](#), page 13-14.

We believe that the funding classes should be revised to ensure the costs of compensation are internalised by the highest risk sectors. This should be supported by a thorough analysis of where FSCS claims have arisen thus far, as well as ongoing monitoring and review of claims vs funding allocations over time.

As part of this reform, we believe provision of investment management services should be separated out from other financial services that are unrelated and pose a different set of risks. The primary type of claim that could be brought against an asset manager running investment funds or mandates is the provision of unclear, unfair, or misleading information, or negligence in managing investments in accordance with the prospectus, guidance, or mandate.

To generate an FSCS claim, an asset manager would also have to be unable to pay any redress owed or go out of business. The primary cause of asset management closures is a decline in AUM and revenue that leaves the firm unable to sustain itself. Asset managers do not use their own balance sheet to extend credit, and do not typically employ significant leverage on their balance sheets. Assets managed belong to clients and do not sit on the asset managers' balance sheet and are held in separate custody accounts.

We agree with the FCA that “if [an asset manager] failed as a result of causing significant losses [due to] outside of mandate investments, FSCS protection would appear to be appropriate”.⁵ The lack of granular information on what is driving the increase in costs in the Investment Provision class means it is difficult for industry to comment accurately on the risk posed by different sectors of the financial services industry, including asset management. However, we note that in the Discussion Paper the FCA states that “it could be argued that the risk that [an] operator or depository failing is low in light of recent FSCS claims data”.⁶

As such, we have reason to believe that any compensation costs arising from asset manager failures are low and will continue to be low. We also believe that the issues that the FCA has identified as key drivers of recent costs – negligent pensions advice, negligent advice to invest into self-invested personal pensions, claims against SIPP operators in relation to non-standard assets, and claims for the return of client money or custody assets – are fundamentally different types of misconduct than that which may arise in the asset management sector. We therefore strongly recommend that FSCS funding classes should be revised with this in mind.

16. Are there any alternative metrics to annual eligible income that would help to ensure that compensation costs in the Investment Provision class are distributed more fairly between firms in the class?

Alternative metrics will not solve this problem. The primary way to ensure costs are distributed more fairly is by reviewing and re-structuring funding classes, in line with the ‘polluter pays’ principle. See question 18.

17. Would you be in favour of the introduction of set periodic reviews of the funding class levy limits to ensure they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?

See response to question 13.

⁵ Source: [FCA Compensation Framework Review Discussion Paper](#), page 24.

⁶ Source: [FCA Compensation Framework Review Discussion Paper](#), page 24.

18. Do you consider that any alternative funding model would be preferable to the current funding model? Please describe the alternative model that you consider to be preferable and the benefits over the current arrangements.

A completely new funding model should be developed, based on the fundamental principle of ‘polluter pays’. FSCS levy funding classes should be reviewed, with the funding costs for different sectors closely mirroring the generation of compensation costs.

Under the current model the cost of firm misconduct and failure is pooled between firms that have very different business models, and often very little connection with one another. We note that from April 2019 the former Life & Pensions Intermediation and Investment Intermediation funding classes were merged into a new Life Distribution and Investment Intermediation funding class, alongside new requirements for product providers to contribute approximately 25% of the funding requirement for the insurance and investment intermediation funding classes. According to the FCA, this was done to “reduce the volatility of the levy”, and to “ensure that the levy costs would be shared across a wider pool of firms”; as well as to “avoid small funding classes”, which could “increase the likelihood that the class limit would be exceeded and could jeopardise the sustainability of the class”.⁷

While it may be the case that “greater symmetry between the activities of firms which contribute to the funding class”⁸ risks insufficient funding to meet compensation costs, we do not believe the correct solution is to pool the cost across business models that have little or no relation to one another. This risks generating perverse incentives and moral hazard. Instead, compensation costs exceeding class limits should serve as a prompt for further action to tackle misconduct or inability to meet compensation costs within that sector. The level of regulatory capital held by firms, particularly in those sectors which have seen the highest number of firm failures, should be genuinely sufficient to protect consumers and deter “bad actors” from entering the market in the first instance. Professional Indemnity Insurance (PII) should also provide sufficient coverage in the event of failure, commensurate with the risk that an individual or firm poses to the market.

19. Do you have any overarching comments on the proposed principles for the compensation framework, or do you have any further principles that we should account for?

See responses to questions 1 and 14.

20. Are there further opportunities to improve the aspects of the compensation framework that the FCA is responsible for? Please describe the further changes which you consider should be made.

No further comment.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Discussion Paper and will continue to work with the FCA on any specific issues which may assist in the ongoing review of the Compensation Framework.

⁷ Source: [FCA Compensation Framework Review Discussion Paper](#), page 34.

⁸ Source: [FCA Compensation Framework Review Discussion Paper](#), page 34.