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Response to: Financial Conduct Authority consultation on Reviewing the Funding of the Financial Services Compensation Scheme (FSCS)

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Summary

- The FCA should address the disparity in protection provided to users of income drawdown compared to those who purchase an insurance based annuity in retirement.
- The FCA should therefore separate claims for pensions-related investments as distinct from those made for 'traditional' investments, and significantly increase the level of protection for pensions-related investments. Of the options the FCA proposes, we support an increase in the protection limit for pensions-related claims from £50,000 to £1m for both investment provision and investment intermediation covering pensions planning, accumulation and decumulation. We would be keen to discuss with the FCA how this option or other potential alternatives could be designed and implemented. The FCA should also periodically review any new limit.
- The increase to the pension investment protection limit should be introduced as soon as possible to prevent consumers losing out on their retirement savings. The pension protection limit should also be backdated to when the pension freedoms were introduced, to cover claims against firms that were declared in default since the new pension freedoms came into force.
- Where possible, the FCA should work with the PRA to harmonise other protection limits, to reduce unnecessary complexity in the scheme and help reduce confusion for consumers.
- The FCA and FSCS should consider the best way to communicate the protection limits to consumers to increase awareness and understanding. This clarity is

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essential in building and maintaining consumer confidence in the financial services market.

Introduction

We welcome the opportunity to contribute to the Financial Conduct Authority's (FCA) consultation on 'Reviewing the funding of the Financial Services Compensation Scheme' (FSCS). In particular, we are pleased that the FCA is considering updating FSCS compensation limits and activities in light of the pension freedoms. In March 2015, Which? published its *Better Pensions* report, in which we recommended that FSCS coverage of drawdown products should be extended. To avoid damage to consumer confidence, we called for greater protection to be afforded to users of income drawdown products as soon as possible. In July 2015, when new rules came into force increasing FSCS coverage of annuities, we reiterated our calls for the FCA to increase the protection for users of income drawdown products as well.

The focus of our response is therefore on the proposals to extend the consumer protection provided by the FSCS, and how changes should reflect how the pensions landscape has changed since the current FSCS protection limits were put in place. While we do not comment on the proposals for how the FSCS is funded, it is important that the FCA considers and monitors the impact that levies have on costs paid by consumers.

Increasing protection for pension investments

We welcome the FCA's decision to review the current limits for different products and services that can be used for saving for retirement or spending retirement funds, especially given the changes to the pensions landscape since April 2015. The FSCS protection limits need to be updated to reflect changes in how people are accessing their pension savings in retirement, and to keep up with how much people are saving for retirement.

A separate pensions limit

The FCA should separate claims for pensions-related investments as distinct from those made for 'traditional' investments, and should introduce higher limits for claims for investment arrangements or services used purely for retirement planning than for claims for non-pensions-related investments.

The potential for consumer detriment is far greater with pension investments, given the significant, and growing, importance of pension pots for sustaining retirement incomes for vast numbers of consumers. It is also important that consumer protections for pension savings do not undermine policies, such as auto-enrolment, that encourage and incentivise people to save more into a pension. In order to support efforts to get people saving more into pensions, it follows that pensions-related investments should be given greater protections.

We recognise that the FSCS would need to be able to identify the investments a consumer plans to use to manage their pension pot in retirement, and require firms to establish a clearly identifiable relationship between the pension pot and whatever investment is made, which could become complicated. However, pensions are already afforded special treatment in a range of different ways, including for tax relief, and it should be possible for pensions-related investments to be identifiable as such. Crucially, the industry would need to make it clear what



is a pension-focused investment and what is not. Clarity for the consumer is critical, not least so that consumers understand the difference in protection depending on the investment. The FCA should consider ways to ensure that FSCS protections are communicated to consumers at the point of investment, including the role of advisers, so that investors are aware of the protection they are getting.

Since April 2015, more consumers at retirement are choosing to invest their pension funds in drawdown products instead of insurance-based annuities. The FCA's own figures show that in the third quarter of 2016, around 41,000 consumers who accessed their pension pots for the first time purchased a drawdown product, compared to around 21,000 who purchased an annuity. However, unlike with annuities, users of income drawdown are not fully covered by the FSCS as cover for advice and provider failure related to income drawdown products is capped at £50,000. In retirement, consumers are unlikely to be aware that there is such a disparity between different compensation limits for income drawdown products and for insurance-based annuities. Increasing the protection limit for pensions investments - in both the accumulation and decumulation phases - and moving towards harmonising it with the protection for insurance-based annuities, would help to correct this imbalance.

An increase in the limit to £1m is our preferred option

Of the options that the FCA proposes for increasing the limit, Which? supports an increase in the limit from £50,000 to £1m. We would be keen to discuss with the FCA how this option or other potential alternatives could be designed and implemented. The FCA should also periodically review any new limit.

In August 2016, the ABI published statistics for the first complete year since the pension freedoms, which showed that the average amount invested in an income drawdown fund was £67,000, and therefore not fully covered by the existing FSCS compensation limit of £50,000. The FCA's data analysis shows that 33% of pension plans currently held are not fully covered, and indicates what share of currently held pension plans would not be fully covered for the other proposed protection levels: 24% at £75,000; 15% at £100,000; and 9% at £150,000. While the analysis does not show what percentage of currently held plans would be covered by the option of a £1m protection limit, between 2010 and 2014 there were only a handful of claims to the FSCS that exceeded this threshold.

A limit of £1m is clearly preferable to the other options, and should not add substantially to costs compared with a £150,000 limit. At this higher level, protection would be almost universal and would remain so for the foreseeable future. The FCA analysis shows that 9% of existing pension plans currently exceed £150,000, and this proportion is likely to increase. The Government has estimated that nine million people will be automatically enrolled by 2018, or will contribute more, increasing the amount that is being saved by around £15bn a year by 2019/20. A limit of £1m would avoid the need for regular updating to match expected increasing levels of pension savings, which would reduce confusion, whilst still limiting the potential costs for very high claims to the FSCS. The higher limit of £1m would also harmonise the level of FSCS protection with that provided for temporary high balances, as well as the pensions savings limit for tax relief under the pensions lifetime allowance. This could potentially make it easier to raise consumer awareness of the protection level.

Protection should cover intermediaries

The FCA should not differentiate investment provision from investment intermediation, but increase the limit for both. Most investment claims are for poor advice, so it is critical that the protection covers intermediaries. Between 2010 and 2014, the FSCS received only 36 claims in the investment provision class compared to around 52,000 claims for investment intermediation and around 12,900 for life and pensions intermediation. There also does not appear to be a major issue with the level of protection for investment providers. Only three of the claims against providers exceeded the £50,000 limit and none exceeded the limit by more than £25,000. This is likely to be because consumers may split investments across different providers thereby benefitting from protection up to £50,000 for each firm, but they are less likely to use more than one advice firm.

Backdating the changes to the protection limit

The increase to the pension investment protection limit should be introduced as soon as possible to prevent consumers losing out on their retirement savings. The new limit should also cover claims against firms that were declared in default since the pension freedoms came into force in April 2015 and up until the date when the new limit is introduced. A significant number of consumers have used their new freedoms to invest in drawdown products. They should not be penalised for having made these decisions earlier than other consumers. We recognise that this additional protection could add significant costs to the FSCS which may need to be funded via increased or extended levies, but we think that the benefit to consumers, who often ultimately bear the costs of industry levies, will outweigh the costs passed on to consumers.

Further harmonisation

The FSCS currently has three different maximum protection limits that apply to different categories (£50,000; £85,000; and £1m) as well as coverage of 100% and 90% depending on the type of insurance product. This adds unnecessary complexity to the scheme, and our research has found that consumer awareness of the different protection levels is extremely low¹. We found that while 67% of people know that deposits with a bank or building society are protected, 44% didn't know the compensation limit and only 23% knew it was £75,000 (at the time of the survey). Only 32% realised that investments also fall under the remit of the FSCS, and only 4% correctly identified the maximum level of compensation as £50,000 per investment firm.

Where possible, the FCA should therefore work with the PRA to harmonise protection limits. This could for example see the (non-pension) investment protection limit (currently £50,000) harmonised with the deposit guarantee scheme (currently £85,000), with both potentially increased to a new level that avoids the need to increase it in the near future. Communications should then be targeted at consumers to help increase awareness and understanding of the protection limits.

¹ Research conducted online with 1,692 members of the general public in November 2016.



Clarity, confidence and communication

Consumers need greater clarity on what is covered by the FSCS and what is not, as well as how much is protected. The FSCS plays a critical role in ensuring consumers can have confidence in the financial services market, and consumer confidence could potentially be undermined by confusion around the scope and limit of protection that the FSCS provides.

In February 2017, Which? highlighted case studies from members who had queries over the level of protection provided by the FSCS². We found confusion over the level of protection, which can differ significantly for similar investments, and uncovered the difficulties consumers can face when engaging with the FSCS or FCA to clarify what is covered. Whether a consumer is looking to deposit money, buy or invest in a product, or take advice, it is critical that they understand what protections are in place, and the specific circumstances when such protections apply.

Once the protection limits are set, and unnecessary complexities removed from the scheme, the FCA needs to consider how best to communicate this information to consumers. It is likely that significant communications activity will be needed to raise awareness and understanding with consumers. Building on the FSCS' concerted work to raise awareness of the deposit compensation limit, the FCA and FSCS should set out how they intend to increase consumers' awareness and understanding of the other protections that the FSCS provides.

Loan-based crowdfunding and debt management

Peer to peer lending has increased significantly in recent years. While investors should be made aware of the risks involved with this type of investment, and Which? welcomes the work to improve standards of disclosure, it is unclear what protection is offered to consumers, particularly in the event of a major failure of a crowdfunding platform. What is clear is that loan-based crowdfunding is not currently included within the scope of FSCS cover, which means that investors could not seek compensation from the FSCS if a firm operating a loan-based crowdfunding platform failed. FSCS protection is only currently available in this area in relation to money or assets held in a third-party account. There is therefore a strong case for the FCA to extend FSCS protection to loan-based crowdfunding, as this would serve to protect consumers and help maintain credibility and trust in this emerging market.

Which? agrees with the FCA's proposals to introduce FSCS protection for certain claims made for the debt management activities of debt counselling or debt adjusting, when they are undertaken as part of an individual entering into a 'debt solution' to discharge their debts. Given the substantial losses that the failure of a debt management firm could have on potentially vulnerable consumers, we support the extension of FSCS protection to these types of claims.

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² Which? Money, February 2017, p.26-29