

**EVALUATION OF THE INVESTMENT COMPENSATION SCHEME DIRECTIVE
DG INTERNAL MARKET AND SERVICES
EXECUTIVE REPORT AND RECOMMENDATIONS**

1. BACKGROUND

Directive 97/9/EC, known as the Investment Compensation Scheme Directive (the ICD), and the national measures implementing it in the EU Member States are important regulatory mechanisms. They aim to protect investors against the risk of losses in the event of an investment firm's inability to repay money or return assets held on their behalf.¹

The Directive establishes some basic principles, provisions and definitions and gives member States leeway to implement it in the way they find most suitable for their own situation. The directive lays down certain basic requirements for national investor compensation schemes in order to provide a harmonised minimum level of investor protection across the EU. It is left to each Member State to implement an appropriate scheme and to determine the most suitable way of organising and financing such schemes. Thus, while all EU Member States have implemented the ICD, the manner in which the directive has been interpreted and applied varies quite considerably.

The evaluation of the impact of the directive cannot therefore ignore the special features of the transposition of the ICD in national legislations. In fact, the evaluation focuses on how the basic principles, provisions and definitions of the ICD have modified the market and regulatory environment in the different member States and provided protection to investors throughout the EU. Then it examines to what extent these impacts have met the objectives of the ICD.

The evaluation required a significant field and desk research effort to examine the details of the transposition and market impact of the ICD in the Member States. Thus, the Commission decided to base this evaluation on the evidence provided by external consultants who could provide a comparative description and evaluation of the national compensation schemes with respect to their operating performance, financial position and ultimately, the level of protection they afford to investors.

Given the starting date of the evaluation, prior to the May 2004 accession date, the scope is limited to the EU 15. Nonetheless, an overview of the situation in the new Member States is provided as well.

The results of the external expertise conducted by OXERA, was the subject of internal assessment by the services responsible for the directive and the evaluation function in the Internal Market DG. This evaluation report summarises the evidence and conclusions of the OXERA report that is available upon request. The conclusions and recommendations of this exercise are presented in this executive evaluation report. In addition, a short action plan proposed and followed by the services is presented in the last section.

2. OBJECTIVES OF THE EVALUATION EXERCISE AND EVALUATION QUESTIONS

The directives gives considerable leeway to Member States in the establishment of the national compensation schemes while harmonising some essential elements such as the

¹ Investor compensation presents a further layer of protection in conjunction with conduct-of-business rules, prudential regulation, and organisational and operational safeguards.

definition of investment business, instruments and firms (identifying a list of exceptions), the minimum level of compensation (€20.000) and providing for some basic rules regulating the cross border activities of investment firms.

Therefore, the starting point for the assessment of the impact of the directive had to include an inventory of the situation resulting from the implementation of the directive in the different Member States. For this reason, the objectives of the evaluation exercise can be grouped as follows:

- First, to get a complete picture of the actual implementation of national investor compensation schemes and the way they have acted in different claims as well as identify the risk covered,
- Secondly, to assess the resilience of the different national schemes
- Finally, to assess to what extent the final outcome has effectively and efficiently achieved the objectives of the ICD.

To that end, the evaluation addressed the following questions:

1. *What is the current situation concerning investor protection as a result of the implementation of the directive?*

- Have all member states transposed the Directive 97/9/EC?
- Do the investor compensation schemes of all member states comply with the requirements of the Directive?
- What are the different choices made by member states about structure, governance, organisation, financing arrangements, membership, relationship with other protection schemes...

2. *Are national schemes performing in accordance to the objectives of the directive?*

- Have national schemes had problems in handling claims?
- Have been detected weaknesses in some of the national schemes?
- Are there ambiguities in the criteria for accepting or rejecting claims?
- Are non-resident investors treated in a different way?

3. *Are national schemes resilient?*

- Have member states established mechanisms to solve a possible shortfall in the schemes?
- To what extent the different schemes would be able to handle a crisis scenario?
- Can the resilience of national schemes be considered as proper?

4. *What is the level of coverage of the current system of schemes?*

- Which are the main types of risks retail investors are exposed to?
- Are these types of risks properly covered by national schemes?
- Are they covered by any other protection mechanism?

5. *Has the outcome of the process achieved the ultimate objectives of the directive?*

- Does the current regulation of national schemes in the different member states comply with the objectives of the Directive?
- Has the directive been a key factor to achieve the desired level of protection for investors?
- Are there significant differences in the level of protection of investors in the Member States
- Are new policy actions necessary?

In order to address these questions, consultants were asked to address the following issues in the terms of reference of an open call for tenders launched in 2003

- **To produce an inventory of the national investor compensation schemes**, i. e. to carry out a comparative description of the features of the national schemes in the EU 15 and the most important differences between them.
- **To analyse the operating arrangements of the national schemes and their performance**, examining past claims for compensation on national schemes and the performance of the schemes in handling claims and awarding compensation to investors;
- **To analyse the funding position and financial resilience of the national schemes**, to assess of the financial situation of the schemes and their capacity to withstand claims made by investors;
- **To analyse the risks for retail investors and the schemes' coverage of the principal types of loss event**: to evaluate the main types of risk for retail investors and the degree to which these are mitigated by the national schemes, both in isolation and in relation to alternative forms of investor protection.
- **To provide a brief description of the situation in New Member States**, giving an overview of the most important features of the schemes established in the ten Member States that entered the EU in May 2004

3. LOGICAL STRUCTURE OF THE EVALUATION

The table on the next page summarizes the logic underlying the evaluation. The minimalist approach adopted by the Commission was based on the assumption that different requirements across Member States regarding investor protection in investing services hampers the functioning of the Internal Market in retail financial services: if a minimum level of protection is not guaranteed, especially for small investors, they will not buy services provided by firms from other Member States as they buy from investing firms in their own domestic country. In addition, it is considered that Member States requiring membership of a NIC scheme to investing firms from other countries may be hampering the normal functioning of the Internal Market.

Requiring the establishment of national compensation schemes would provide a harmonised minimum level of protection. This is considered essential to ensure investors' confidence, especially in the case of small investors.

Summary log-frame of the evaluation

	Assumptions and risks	Sources of verification and impacts	Indicators	Intervention logic
Preconditions	<ul style="list-style-type: none"> • Supervision systems are not sufficient to ensure complete protection of investors • Member States requiring membership of a NIC scheme to investing firms from other countries may be hampering the normal functioning of the Internal Market 			<ul style="list-style-type: none"> • The lack of NIC schemes can have a negative impact on cross border financial activities as the level of protection is not harmonised for investors.
Actions	<ul style="list-style-type: none"> • Requirement to have an investor compensation mechanism in each Member State • Minimum harmonisation of coverage • Minimum harmonisation of definitions • No non-price competition based on investor compensation • Development of national investor compensation schemes leaving Member States freedom on the choice of elements other than the minimum harmonisation above 	<ul style="list-style-type: none"> • Description of the main features of the Directive • Analysis of operating arrangements • Analysis of funding position and financial resilience • Analysis of risk to retail investors and coverage of loss events 	<ul style="list-style-type: none"> • Number and description of the characteristics of newly created schemes • Limits of compensation • Evolution of compensation cases (number and value) • Impact and frequency of risks 	<ul style="list-style-type: none"> • There should be investor-compensation schemes in all Member States to guarantee a minimum level of protection throughout the Union • Small investors will now be able to purchase investment services from branches of Community investment firms or on the basis of cross border provision of services as confidently as from domestic investment firms
Results	<ul style="list-style-type: none"> • Increased participation of firms in National compensation schemes throughout the Union • Increased resources dedicated to investor protection 	<ul style="list-style-type: none"> • Inventory of the national compensation schemes • Review of laws, regulations and other publications • Questionnaires and country visits 	<ul style="list-style-type: none"> • Number of firms participating in national schemes • Increased staff for NICs • Increased funds for investor protection: compensation costs 	<ul style="list-style-type: none"> • Compulsory establishment of national compensation schemes and membership would increase investor confidence. • Increased resources invested in investor protection should increase investor confidence
Impacts	<ul style="list-style-type: none"> • Reduced risk to small retail investors • Avoid undue delays in the payment of compensations • Better coverage in case of loss events • No negative impact on competition • Increased cross border retail investment activity 	<ul style="list-style-type: none"> • Analysis of the arrangements of the national schemes and their performance • Analysis of the funding position and financial resilience of the national schemes • Funding sources of national investor compensation schemes 	<ul style="list-style-type: none"> • Evolution in the number of eligible claims • Changes in the level of coverage • Number and sources of failures experienced by NICs 	<ul style="list-style-type: none"> • Increased consumer confidence would foster integration of investment services • Ultimately, increased investor confidence should increase cross-border investment service activity.

The evaluation reviews first the Member states' response to the Community requirements by examining financial resilience of the established schemes, risk to retail investors and coverage of loss events and other essential features of national schemes.

4. MAIN EVALUATION CONCLUSIONS

4.1. Inventory of the main features of the investor compensation schemes established in the EU 15 after the adoption of the directive

The directive lays down certain basic requirements for the national investor compensation schemes, to provide a consistent minimum level of investor protection across the EU. The Member States are responsible for implementing appropriate schemes and determining the most suitable way of organising and financing them. Thus, while all EU Member States have implemented the ICD and established one or more statutory schemes to provide investor compensation in the event of failure of an investment firm, there are considerable differences across countries.

The differences identified relate to the following aspects:

- date of implementation and legal framework;
- organisational structure and governance;
- relationship with the national regulatory authorities;
- relationship with the national deposit guarantee schemes established in accordance with Directive 94/19/EC;
- participation requirements for investment firms, and number and types of firms participating in the schemes;
- definition of investors eligible to claim compensation;
- protected investment services and instruments;
- type of loss covered;
- compensation limits;
- operating arrangements and claims processing;
- funding arrangements.

4.2. Conclusions regarding the operating arrangements and scheme performance

Overall, there have been few cases of firm failure in the EU Member States that have triggered the operation of investor compensation schemes; in many countries, there has been no failure at all. As such, most schemes have no or very limited experience in handling compensation claims and awarding compensation to investors.

The exception is the UK investor compensation scheme: in 2003 alone, the scheme dealt with 164 cases of firm failure and 12,851 claims from investors. The main reason for this large volume of activity is that the UK is the only country that requires investment advisers to participate in the scheme and provides compensation for losses incurred by investors due to negligent investment advice, when the firm providing the advice is not able to compensate the investor itself.

Where failures do occur, the protection provided by an investor compensation scheme depends on the speed and quality with which investors' claims are handled and compensation paid. Although schemes aim to provide compensation as soon as possible,

difficulties can lead to delays in the process—in specific cases, and for reasons beyond the control of the schemes, investors had to wait several years before they received compensation following a firm failure. The principal difficulties relate to:

- delays in the declaration of default of an investment firm by the competent authority or court;
- notifying investors that a compensation event has occurred;
- lack of information required to establish a claim and calculate compensation amounts;
- delays in the legal process—in particular, if claims processing depends on the outcome of the insolvency proceedings against the defaulted firm.

Cases of firm failure that are very complex and that generate a large volume of investor claims impose considerable resource requirements on compensation schemes.

Staffing levels of the schemes differ considerably across the EU Member States, with permanent staff numbers ranging from 0 to 100. If firm failures are infrequent, it is not efficient to maintain high permanent staff levels. Instead, drawing in additional resources when required, or explicitly outsourcing parts of the compensation process to an external service provider, may be more cost-effective solutions. Nonetheless, such arrangements should be defined and put in place prior to a compensation event occurring.

4.3. Conclusions from the analysis of the funding position and financial resilience

Although alternative funding sources are available, the EU compensation schemes are principally financed by contributions levied from participating firms. There are considerable cross-country differences, in particular with regard to when contributions are collected; the degree to which the funds are pooled across participating firms; how contributions are calculated; and whether there are any limits on the amount that can be collected from firms in any one year.

The most important policy question is whether available funds are adequate. In relation to past compensation events, none of the compensation schemes in the EU 15 reported any funding shortfalls that resulted in compensation payments being delayed or not being made. However, there have been funding difficulties in some instances, in particular where compensation costs had to be financed soon after a scheme was established (such that no or low reserve funds were available), or where contributions had to be levied from a relatively small number of participating firms.

The current and past financial position of a compensation scheme is not a robust indicator of funding adequacy going forward: failures to date have in general been infrequent and of a comparatively small scale. Potential loss exposures are higher.

This is not to say that the compensation schemes should be able to cover all potential exposures, or that they should be considered inadequately funded because they are not able to cover these exposures. Rather, it suggests the need for a more rigorous assessment of the potential loss exposures and the likelihood of these losses occurring. Only a few EU investor compensation schemes appear to have undertaken such an assessment.

A range of methodologies to define and measure funding adequacy has been proposed in the literature, usually with reference to deposit guarantee schemes. The relevance of these techniques and their application to investor compensation schemes could be explored further.

Adequacy of funding arrangements depends on flexibility and, in particular, the availability of multiple funding sources. Unexpected large failures could impose more compensation costs than a compensation scheme had anticipated and participating firms would be able to cover. The scheme therefore needs back-up sources of funding.

One main source is borrowing. Most, but not all EU compensation schemes have borrowing powers, but few have explicit credit facilities in place. The supply of commercial credit may be limited, particularly in larger failures where the lender has no certainty about the capacity of the scheme and its participating firms to repay borrowed funds in the future.

This raises the question of whether a guarantee from the state or other forms of state funding may be required in these cases. Even if never activated, the existence of guarantees or similar arrangements can enhance the financial viability and credibility of a compensation scheme. Only a few EU Member States have explicit and irrevocable state guarantees provided under law to fund the compensation costs of a large loss event.

4.4. Conclusions from the analysis of risks to retail investors and coverage of loss events

Retail investors are exposed to a range of risks when engaging an investment firm to carry out investment services on their behalf. Investor compensation schemes provide important protection against the risk that, in the event of default, an investment firm is not able to return to investors the monies or investment instruments belonging to them.

The schemes therefore protect investors' assets against the risk of theft, embezzlement and other forms of fraudulent misappropriation. They may also provide protection where the loss of investor assets in the event of firm default has resulted from unintentional errors, negligence or breakdowns in the firms' systems and controls.

Investor compensation schemes provide only one form of protection against the various risk exposures for retail investors. Other protection mechanisms are in place: these either are prescribed by regulation (eg, prudential regulation, segregation requirements, other conduct of- business rules, supervision and enforcement), or emerge from institutional arrangements (eg, economic capital of investment firms, firm reputation, private insurance cover).

The better the protection provided by the alternative protection mechanisms, the lesser the need and resource requirements for the statutory investor compensation schemes. However, past case experience suggests that there have been instances where the alternative mechanisms have failed and investors would have incurred significant losses, had it not been for the existence of a statutory scheme. The national investor compensation schemes established in the EU therefore play an important complementary role in providing last-resort protection for retail investors.

Bad advice

There is a range of other risks that do not qualify for compensation cover under the ICD and national laws, or where compensation is not certain. In particular, with the exception of the UK compensation scheme, there is no compensation for losses arising from bad investment advice. The UK experience suggests that bad advice may be the most significant risk for retail investors, in terms of both frequency of occurrence and potential impact.

With the implementation of Directive 2004/39/EC on markets in financial instruments, investment advice will become a core investment service and, for the first time in many EU countries, a regulated activity. Combined with an expected growth in the market for independent financial advice in the EU, this could result in calls for greater regulatory protection.

Even if investment advisers were required to participate in a compensation scheme (which they may following the implementation of the 2004 Directive), as is already the case in the UK, current compensation rules under the ICD and in all countries but the UK would not provide this protection. Bad advice is not compensated by schemes that focus on compensating physical losses of investor monies and securities.

Third party losses

Another case in which the scheme does not provide protection with protection to the investors is when an investment firm holds investor funds at a bank or transfers the funds to another party, such as a broker, in order to undertake transactions on behalf of the investor, investors may not only be exposed to failures of the firm, but also to failures at the level of these third parties.

If the default of the third party holding the client assets triggers the default of the firm itself, compensation may be payable by the schemes. The other scenario arises when the third party defaults but the firm itself remains solvent. In particular, this may arise if the firm has applied due care and diligence in selecting the third party to which it transfers client assets. In this case, the firm may not be held liable for any losses of client assets arising if the third party defaults. The question is whether an investor can claim compensation for losses incurred at the third party, especially given that the investor may not have a direct contractual relationship with that party.

4.5. Investor compensation schemes in the ten new EU Member States

The ten new EU Member States have implemented the ICD and established investor compensation schemes, subject to certain transitional arrangements.

Most schemes have yet to experience a compensation event. However, the two countries that have had compensation events have experienced a relatively large number of firm failures. Although the individual failures have tended to be small, there have been problems in claims processing and in raising sufficient funds to pay compensation to investors. In both countries, an element of state funding was required to complement the funds that could be raised from firm contributions.

Further analysis may be required to gain a better understanding of the need and requirements for investor compensation arrangements in the new Member States.

5. MAIN PROBLEMS IDENTIFIED IN THE EVALUATION REPORT: RECOMMENDATIONS

The overall message is that the investor compensation schemes work fairly well and that they play an important complementary role in providing last-resort protection for retail investors.

However, there are some problems:

5.1. Delays in compensation

Some delays in compensation are inevitable and are due to factors other than the operation of the investor compensation schemes. For example legal delays and delays in the declaration of default of an investment firm are beyond the control of the compensation schemes.

However, some delays such as notifying investors that a compensation event has occurred may be caused by the operation of the scheme itself. In order to shorten delays in compensation the evaluation report suggests **outsourcing some resource-intensive and complex elements of the compensation process** to an external service-provider. Such arrangements should be defined and put in place prior to a compensation event occurring.

5.2. Funding and financial resiliency

The EU compensation schemes are principally financed by contributions levied from participating firms, though alternative funding sources are available. The most important policy question is whether available funds are adequate.

The evaluation report concludes that the most important consideration in relation to the funding of the compensation schemes is its flexibility. In particular, the existence of multiple sources of funding such as external borrowing is deemed to be valuable. Furthermore, it is suggested that government loan guarantees are likely to enhance the financial viability of compensation schemes.

Furthermore, the report indicates that improvements can be made in the management of the compensation schemes' funds relative to their risk exposure to possible compensation events. It suggests that, for example, methods for calculating risk exposure similar to those used under the new BASEL II accord could be used in order to have a more precise understanding of their potential loss exposure and funding adequacy.

5.3. Compensation in cases of bad investment advice

The inclusion of Investment Advice as one of the core services in the Markets in Financial Instruments Directive, poses the question whether compensation to investors for losses arising from bad investment advice could be funded by the compensation schemes.

Currently, only in the UK, bad advice is qualified for compensation cover from the Investor Compensation Scheme.

The UK experience suggests that bad advice may be the most significant risk for retail investors, in terms of both frequency of occurrence and potential impact.

Combined with an expected growth in the market for independent financial advice in the EU, this could result in calls for greater regulatory protection.

5.4. Third-party losses

In case of default of a third party holding client assets, when the investment firm can not be held liable for any losses of the clients, it is not clear if the investor can claim compensation for losses incurred at the third party, especially given that it may not have a direct contractual relationship with that party. This could result in situations of helplessness for investors.

6. ACTION PLAN PROPOSED BY DIRECTORATE G

The following options for action are available:

1. A legislative response aimed at addressing some of the main problems brought up by the study.
2. Publication of non-legislative communications or recommendations by the Commission.
3. Launching a debate at the level of the ESC among Member States and at the level of the national compensation schemes in order to consider the implications of the report's findings and promote best-practice.

Legislative response (Option 1) should be the policy tool used only as a last resort. This is not only because there are considerable differences across countries in the way ICD was implemented into their legal framework but also because a legislative response would be too lengthy.

Similarly, Option 2 should be considered only after proper discussion has taken place among Member States and the national compensation schemes.

We have therefore taken the first step in launching a debate and presented the report and its findings to the Member States (Option 3) in the ESC on 22 June 2005. Following the publication of the report, we invite Member States and the National Investor Compensation Schemes as well as any other interested parties to provide the Commission with their comments on the report, its conclusions and policy recommendations.