



## **PAPER 3: POTENTIAL IMPROVEMENTS TO EU ICS REGULATORY FRAMEWORK**

INVESTOR COMPENSATION SCHEMES WORKING GROUP (ICS WG)

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# 1. Executive Summary

The main aspects that this Paper discusses regarding potential improvements to EU regulatory framework for ICS, are the following:

- Progress in achieving harmonisation on clients, products, activities and entities covered by ICS within the EU.
- Facilitating the management of cross border cases within the EU, including cases of top-up, and making access to information and to actual cover for retail investors, easier.
- Helping to achieve more efficiency in the management of crisis, stressing the role of ICS in insolvency proceedings, guaranteeing access to information, and allowing ICS to effectively exercise their subrogation and recovery capacities.
- Improving communication to investors on ICS cover.
- Supporting efforts for the ICS to have the required ICS operational capacities and establishing minimum common rules on operational procedures.
- Reviewing potential updates of the ICSD to subsequent EU regulations.
- Reviewing what progress made on the DGS regulation field at EU level might be applicable to the ICS field, considering the different regulatory needs.
- Improving the current poor level of information that ICS and authorities receive to assess risk covered and ICS actual covering capacities.
- Exploring the potential role ESMA may play according to article 26 of Regulation 1095/2010, regarding these issues.

## 2. Introduction

1. - This paper intends to gather different views expressed by EFDI ICS WG members and can potentially be followed by an analysis of the specific Directive 97/9/EC text if necessary or an assessment of any other potential actions at EU level.

2. - This Paper is based on the experiences of ICS practitioners and seeks to leverage on the results of preparing for payout cases and executing payout cases since the commencement of Directive 97/9/EC ("Directive" or "ISCD").

3. - This Paper is the third of a collection of three papers prepared by the EFDI ICS WG on the current EU ICS regulatory framework and on potential improvements to it.

This is Paper 3, being Paper 1 an explanation of the current EU ICS regulatory framework, and Paper 2 an explanation of, and some reactions to, the proposed amendments of ICSD in 2010.

The audience for this paper is primarily EU focussed ICS practitioners, and those with an interest in understanding the ICS regulatory framework in the EU. The paper does not take positions on the ICS regulatory framework which is recognised as an area for political and legislative bodies within the EU. There may be other areas that practitioners or readers identify from their own experience, they will remain relevant and as appropriate can be captured in future revisions and updates to the paper.

### 3. Preliminary Considerations

4. - Expertise achieved from the enactment of the Directive, as well as the progress made regarding a better knowledge of EU ICSs within EFDI and also a better knowledge of other relevant securities markets jurisdictions' ICSs, have allowed to identify some priority elements that could benefit ICSs from the review of the current EU regulatory framework.

5. - Potential improvements in this respect, suggested in this paper are oriented to improve EU ICSs efficiency and to strengthen investors protection, following the experience gained and the new circumstances in which ICS coverage must be applied.

***These potential improvements are based on the following:***

- Putting in value for EU ICSs as a tool for retail investors' protection, having investors in the centre of EU ICS cover and regulation.***
- Maintaining financing resources at ICSs' disposal to discharge their compensation function.***
- Converging and coordinating cover across the EU, ensuring effective and easy access for retail investors in cross-border scenarios.***
- Increasing the efficiency of protection by adapting compensation procedures, judicial, insolvency and recovery processes to the needs of ICS members and investors.***
- Promoting better investor awareness of their cover, increasing confidence in securities markets and investment services providers.***
- Improving the information framework that authorities and ICSs receive to enable them to take informed decisions about risks, their coverage, and the financing of ICSs.***

***- Aligning EU ICSs regulation with other EU regulations enacted since 1997.***

***- Reviewing the alignment of retail investor protection with that of depositors and align where necessary, the regulation of ICSs with some aspects already regulated for DGSs, taking into account that they are different systems that require different regulations in some respects.***

***- Adequately clarifying the harmonising and convergence role assigned to ESMA by article 26 of Regulation 2010/1095.***

***In the EU, ICS organisation, financing and regulation are basically national. This has proved to be efficient to adapt the aim of the Directive to each national market specificities.***

***Article 26 of ESMA Regulation (Regulation 2010/1095) also charges ESMA with the role to contribute to strengthening the European system of national Investor Compensation Schemes (ICS).***

***Thus, this national characteristic of EU ICSs is a reference to take into account in the EU regulatory framework.***

## 4. Specific aspects to consider in terms of the main design elements of ICS's

### 4.1. Financing

6. - Financing is one of the most relevant issues regarding an ICS. The level of harmonization in this respect is very low in the Directive, and ICS financing has been solved on a national basis for each ICS.

7. - Financing of ICSs requires taking into consideration a number of issues. Among them:

- Ex ante or ex post or a combination of both: this is left today to each ICS to decide. Each ICS has a proper idea of the risks covered and the potential of ex ante or ex post financing capacities.

- Target size for ex ante ICS. According to EFDI survey there are a number of different criteria ICS use to determine or calculate the target size.

- Contribution criteria: EFDI survey shows that there are diverse criteria throughout the EU.

- Operational costs. Each ICS needs to have operational capacities which imply costs.

- Evaluation of risks: this will depend very greatly on a number of elements such as: past cases, risk profile of the covered entities, potential amounts of cash and/or financial instruments to cover in case of insolvency, general risk situation, etc.

- Investment rules for ICS funds. Investment of ICS funds may contribute to increase its funding capacities while require managing investment risks.

- Actual capacities of the ICS to recover after paying compensations. This is a very relevant issue for ICSs.

8. - While a majority of EU ICSs are ex ante or a combination of ex ante and ex post, since they have additional financing sources where they have to attend a case, some ICSs remain being financed ex post.

Criteria to determine target size in ex ante funds are different, and contribution criteria are also different in different ICSs, and they are under revision in some ICSs.

9. - To the best of EFDI knowledge, there has been no shortage of funding of an EU ICS when it has been obliged to cover a case.

Different financing arrangements for national ICSs seem thus to have been efficient in terms of adapting the Directive to specific domestic situations.

***There is not any specific common position among EU ICSs regarding harmonization of financing rules, particularly as regards ex ante or ex post, specific target size or contribution criteria.***

10. - The maximum cover amount ranges from 20.000 to 100.000 euros among different ICS.

11. - No mechanism exists in the Directive regarding different potential approaches to changing the maximum compensation limit which has resulted in different maximum limits in respect of which no open discussion on their grounds has taken place.

It has been proposed by some ICSs that it may be useful if a common mechanism could be provided for within a revised Directive to guide a common approach so that each EU member would retain the option to change the maximum limit (at a level above the harmonized minimum) if their own analysis make this advisable, potentially using a common way of consistent signposts and benchmarks.

12. - Other ICSs have proposed to discuss this on an open way so that progress towards 100.000 euros of maximum cover can be discussed.

13. - Other ICSs are of the opinion that the maximum cover of 100.000 euros has the effect of establishing the cover for investment at the same level of the cover for deposits, thus making compensation schemes cover neutral for retail investors deciding on deposits or investments.

14. - On the other hand, other ICSs mention that retail investors' positions in investments seem to be lower than their positions in bank

deposits. How current different cover influence this, remains unresearched.

15. - Additionally, the effects of changing the maximum cover on a potential increase of financing resources of the ICS may also be something to consider and assess potentially on a case-by-case basis.

16. - With all this, the lack of harmonization in these items has not been perceived as a hurdle for ICS operation.

***There is not a common view regarding the maximum cover and national discretion applies to change the limit upwards from the harmonized minimum.***

***Any revision of the current situation in the EU regulatory framework should be based on evidence and analysis of a sufficiently high-quality information, collected for this purpose by ICSs, NCA, ESMA and EU authorities, so that a robust assessment of risks and cover capacities may be conducted at national level as well as at EU level.***

***There are some aspects where clarification and potential harmonization of ICS EU regulation on financing could be positive, according to ICSs' opinions.***

***This is the case (i) for the establishment of common investment rules, or guides on them, (ii) the process for excluding an entity from the ICS in case the entity does not comply with the ICS rules where ICS regulation may look into current DGS regulation in this respect, and (iii) a clear regulation of the right of ICS to subrogate so that it can effectively recover in liquidation processes at the same level as other creditors.***

***According to the ICSD, ICSs should have at national level the right to subrogate and the capacity to recover amounts paid in the same position as other entities' creditors in the liquidation process.***

***The Directive provides for the recognition of subrogation in favour of the ICS, but it is far from clear how this right is recognised in some jurisdictions. In some cases, recovery capacities are in fact not recognised or are severely limited.***

***EU regulation should make clear that it considers subrogation and subsequent right to recover as an important source of potential recovery and financing for ICSs.***

## 4.2. ICS Cover

17. - The design of an ICS regarding the scope of its cover is an essential element for ICS definition.

18. - This includes defining in a clear and convergent manner at EU level, the risk and cases covered, as well as the entities, clients, activities, and products covered.

19. - As regards cases covered, according to the current regulation contained in the ICSD cover is triggered once the entity becomes insolvent irrespective of the reasons for that insolvency.

20. - As regards entities covered, in principle, the Directive and Mifid II and Directives 2009/65 and 2011/61 regulate it. However, different approaches have been taken in this respect by different national regulations.

21. - As regards clients covered, the Directive gives options to Member States to exclude some clients from cover. As a result of these options, a client may be covered in one Member State and not in another.

22. - In addition to this, ICS cover in the Directive is not aligned with the concept of retail investors as opposed to that of professional investors currently defined in Mifid II.

23. - As regards activities covered, the Directive, Mifid II and Directives 2009/65 and 2011/61 seem to make clear that the activities covered are investment services, provided that they result with the client to a situation where he/she cannot receive back his/her cash and financial instruments in case of insolvency of the entity providing investment services.

24. - As regards products, those listed as financial instruments in Mifid II should be covered. However, the appearance of new products and services, and the lack of experience as regards how specific products or situations (it could be the case for some derivatives) will be covered, valued, etc., gives room for an analysis and convergent approach in this respect.

25. - In addition, cover of cash in Investment Firms, in specific situations such as cash for collateral, cash in a currency other than that of the Member State, etc., are not clearly regulated at EU level.

However, these provisions have not been uniformly applied around the EU and EU regulation may serve to clarify this.

Finally, no EU ICS covers bad advice, as the UK FSCS does.

***EU regulation as well as the use of EU convergence tools would play a key role in helping to harmonize all these issues, and consequently harmonize ICS cover to investors in all the EU.***

***The appearance of new products or services offered to and acquired by retail investors require that EU ICS regulation have an effective procedure put in place to react and take a convergent approach as well to provide convergent information to investors throughout the EU regarding ICS cover.***

***This should also be combined with an adequate level of information that reaches all EU retail investors.***

***There is no appetite to extend EU ICS cover to bad advice.***

## 5. Key ICS efficiency elements in investors' protection interest

26. - For an ICS to be able to discharge its functions on an effective and efficient manner it should have at least, (i) adequate operational capacities, including communication capacities, (ii) efficient operational procedures that help to manage cases in the quickest and most efficient manner and (iii) good regulation both for the ICS and for legal proceedings including insolvency proceedings that impact very severely on ICS operation potentially leading in some cases to prejudice ICS cover.

### 5.1. Operational capacities

27. - The Directive does not provide specific rules regarding the adequate operational capacities an ICS should have. While this is the case for DGS, in relation with ICS stress test are not specifically regulated at EU level.

EFDI has made progress in identifying which capacities ICSs should have, always under the principle of proportionality through its *Non-binding guidance on Crisis Management guidelines for EFDI Investor Compensation Schemes*.

***EU regulation may help to fix common minimum standards regarding ICS operational capacities.***

### 5.2. Information to clients (Communication)

28. - ICSs are conscious of the importance that investors are aware of their cover by ICS. This reinforces their confidence in securities markets and in the investment services industry.

This is not only relevant at the point of contact between clients and the investment firms, but also information has to be available to investors and potential investors in general.

ICSs website could also play an important role in this respect.

***EU regulation and EU authorities may help to make progress in extending to EU retail investors information and putting in value the EU ICS cover vis a vis other securities markets or other investment services providers from outside the EU.***

***Ideally, this information would also enable retail investors to be able to identify which products are covered and which are not, even though they are acquired through a regulated entity, as could be the case for example with crypto assets.***

### **5.3. Operational procedures**

29. - Operational procedures in ICS include a wide range of activities such as calculation of clients' position, calculation of compensation amount, payment procedures, etc.

30. - The Directive contains some very high-level provisions on position calculation processes.

31.- However, the mandatory calculation of the client position on the date of bankruptcy established by the Directive prevents ICSs from considering subsequent processes that may be considered necessary prior to the client being compensated, such as derivatives, repos or other open positions' liquidation.

32.- It has been identified that there are differing interpretations as to whether the ICS should pay compensation for a client's loss, established as a statutory construct, or, on the basis of a client's actual loss (after closing out, as mentioned, certain live transactions such as repos / derivatives).

***While there are merits in leaving operational procedures to each ICS decision, some operational aspects could be also harmonized by regulation at EU level, such as (i) the inclusion of client's open positions liquidation results in the compensation calculation, (ii) the method to calculate the client's loss, (iii) the methods applied to pay compensation or (iv) the possibility to suspend compensation payments when there are suspicions of the client being excluded from cover.***

## 5.4. Need of adequate insolvency and legal proceeding regulation

33. - Evidences show that regulation plays a very important role in ICSs efficiency and consequently in retail investors effective protection.

34. - This is the case for specific ICS national regulations, but also and even more important, for legal proceedings that interfere ICS operations or within which, ICS activities must be discharged.

35. - In particular, a number of circumstances have been identified that are beyond the control of the ICS and that have the capacity to significantly affect the efficiency of ICS cover and that entail a worsening of their coverage:

(i) Insolvency proceedings are not always adapted to promote immediate repayment and to procure information to, and involvement of, the ICS in an adequate manner that would increase the efficiency and speed of these processes in the interest of investors.

(ii) In some jurisdictions, legal proceedings, not specifically insolvency proceedings, prevent the clients to be paid compensation until years later.

***Regulation should stress the importance of enhancing the role of ICSs in insolvency proceedings in a way that guarantee that the ICSs receive all the necessary information and can interact with the relevant court or insolvency administrators where necessary, in order to be able to provide for smoother and quicker processes.***

***ICS regulation could help to adapt other legal proceedings where retail investors interests are at stake.***

## 6. – Investors’ protection and ICS operation in cross-border cases within the EU

36. - ICSD contains a limited regulation concerning cross border issues and cases, particularly within the EU.

It basically foresees the possibility that a branch may join the host Member State ICS for completing the cover, and that ICS involved should establish agreements in this respect.

37. - The regulation of these agreements (MOU) is not extensive.

In particular, regulation of top-up agreements among ICSs, while different maximum cover among ICSs is maintained, is already foreseen by the Directive but in a less detailed way.

There are a number of items to pay attention too, that may affect the legal effect for this kind of MOU, and the efficient cross border crisis management, such as:

- How subrogation and recovery by the host Member State ICS can be made valid and recognized by Courts in the home Member State ICS’s jurisdiction.
- Establishment of a simple, easy, and standardised process for investors claiming compensation in these cases.
- Standardisation of information to be provided among ICSs.
- Permission under national law for the relevant ICS to act as necessary in case of a topping-up case.
- Whether and how costs are allocated among such ICSs.

***-It makes sense that ICS cover throughout the EU be established in a way that all retail investors are protected in a similar manner. By this, same cases, entities, activities, clients and products, would be covered around the EU. This is not the case today.***

***-In addition, all EU investors should have access to information regarding such protection, and have the capacity to access the necessary information as well as the effective cover in case of a cross border crisis in an easy and friendly form, including asking for compensation in their own language.***

***-It has been proposed by some ICSs that retail investors should have a clear contact point to establish the operators of national ICS's and should have more information regarding the cover provided by those different ICS operators and how to direct a compensation claim on an easy and friendly way.***

***-All this is particularly important in the current situation where digital platforms and digital provision of investment services allow for an increased provision of cross border services within the EU.***

***-It would also be an improvement that EU ICSs are able to better coordinate crisis cases in case the entity having a branch in another Member State is becoming insolvent.***

***-It has also been suggested that this potential coordination and collaboration be extended to cases where services in other Member State are provided on a free provision of services basis.***

***-The definition of the content of MOU among EU ICS particularly in the case of a top-up agreement, would be helped by additional EU regulation.***

***-EU regulation would play a role in achieving all these purposes.***

## 7. Adapting the Directive to later pieces of EU regulation

38. - A number of EU regulations issued after the Directive may demand that the Directive be adapted to them as regards references to new pieces of regulation and as regards new or differing legal concepts. EU capital markets regulations have been extensively amended along these 28 years since the enactment of the Directive.

39. - Some non-exhaustive examples of these new regulations and legal concepts are: investment services definition, professional client's definition, MIFID II in general, Investment firms' new prudential regulation, sustainable finance regulation, expiration of transitional regulations in the Directive, subsequent DGS regulations, subsequent AML regulations, etc.

40. - In addition to the above, it has been pointed out that the Directive or other EU regulation does not contain any provision on how ICS operation and EU resolution mechanism could interact each other.

***It seems that the ICSD requires to be updated in order to be aligned with other pieces of financial regulation enacted during these 28 years since the ICSD entering into effect.***

## 8. Alignment with DGS regulation

41. - EU ICS regulation was established at the shadow of deposit guarantee schemes and was originally aligned with DGS regulations.

42. - There are some relevant aspects that make an ICS case different from a DGS case. And these differences may require different regulatory approaches.

43. - Examples of the above are the following that apply in ICS cases and not in DGS cases:

- For an ICS to act it must first be identified the cash and the financial instruments belonging to each client.
- The cash, in the case of investment firms, and financial instruments, must be delivered back to the clients.
- The position that has not been able to be delivered back to clients must be valued.
- Clients' positions may evolve from the declaration of insolvency to the moment in which they are paid compensation. This would be the case of some derivatives, repos, securities loans, etc. Different approaches to this have been applied in different jurisdictions due to vagueness in the Directive.
- The ecosystem of entities involved in the crisis of an entity providing investment services is very specific and potentially complex, including sub-custodians, brokers, post trading agents, Central Securities Depositories, Central Counterparties, Asset managers, platforms, etc with which a number of arrangements may be needed in order to get cash and financial instruments delivered back to clients or in order to recover lost cash or financial instruments.
- All the above takes time, requires specific management, and can potentially in some cases, lead to long lasting legal procedures.

44. - EU DGS regulation has been developed and progress have been made regarding regulation and harmonization of a number of issues. This is the case, at least as regards:

- Financing. Including: ex ante, target size, contribution criteria, other financing sources, level of cover to 100.000 euros, payment modalities, and investment rules.
- Operational procedures: reference date, procedure to calculate clients' position and compensation amount, time for payment.

- Cooperation among DGSs: terms for collaboration in cross-border cases, potential loans among DGSs.
- Cover in third countries.
- Harmonization of what is covered and how it is calculated.
- Information to be provided to depositors.
- Information to be provided to the DGS by the covered entities.
- Clear subrogation and recovery regime in favor of the DGS.
- Stress test regime.
- Procedure for exclusion from the DGS of the entities not complying with the DGS rules.

***Taken into account the different regulatory needs for ICS and DGS in some respects, and without prejudice that further assessment can be made in this respect, some of the above progress made in the DGS harmonization field can also be of help in the ICS harmonization field.***

## 9. Other relevant issues

### 9.1. Information to ICS and authorities

45. - According to EFDI survey, there is a general perception that ICSs and authorities do not receive in all cases all the necessary level of information from entities to assess the ICS cover capacities, risks, etc.

***EU regulation could establish the necessary framework for all ICS and authorities to receive and use the information that may be considered needed.***

### 9.2. Role of ESMA

46. - Article 26 of Regulation 2010/1095 ("ESMA Regulation") says the following:

"Article 26

#### ***European system of national Investor Compensation Schemes***

*1. The Authority shall contribute to strengthening the European system of national Investor Compensation Schemes (ICS) by acting under the powers conferred to it in this Regulation to ensure the correct application of Directive 97/9/EC with the aim of ensuring that national Investor Compensation Schemes are adequately funded by contributions from the concerned financial market participants, including where appropriate financial market participants headquartered in third-countries, and provide a high level of protection to all investors in a harmonised framework throughout the Union.*

*2. Article 16 concerning the Authority's powers to adopt guidelines and recommendations shall apply to Investor Compensation Schemes.*

*3. The Authority may develop regulatory and implementing technical standards as specified in the legislative acts referred to in Article 1(2) in accordance with the procedure laid down in Articles 10 to 15.*

*4. The review of this Regulation provided for in Article 81 shall in particular examine the convergence of the European system of national Investor Compensation Schemes"*

47. - To the best of EFDI knowledge, article 26 of ESMA Regulation (1095/2010) has not been activated.

***It would require assessment the potential role that ESMA may play according to this article 26 under current EU ICS Regulation or in the future with a potential amendment of the Directive.***

***Some examples of this could be:***

- ESMA gathering information from ICSs and having a clear picture of the current situation of the European system of national Investor Compensation Schemes,***
- ESMA advising the European Commission regarding EU ICSs items,***
- ESMA helping in coordinating convergent approaches by different EU ICSs in cover in terms of clients, entities, activities and products,***
- ESMA promoting adequate operation of cross-border cases in retail investors interest,***
- ESMA helping to structure the information that NCA and ICSs should receive from entities in order to better discharge their functions.***

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