FCA
Practitioner Panel

Practitioner Panel response to CP16-42 – FSCS funding review

Q1: Do you agree with the introduction of risk-based levies? Should we also consider other regulatory responses?

and

Q2: Do you believe that risk-based levies could be appropriate in relation to: a) higher risk investment products; b) insurance brokers that choose to place business with unrated insurers; and c) any other types of specific products or services?

If risk based levies are introduced, they need to take into account the full range of risks, such as product risk, high risk business models, history of previously failed firms or numbers of complaints. For this reason, although we agree with the principle, which seems fair, we have reservations about how it can be implemented in practice.

Q3: Do you agree in principle that product providers should contribute towards FSCS funding relating to claims caused by intermediary defaults?

The Panel wishes to highlight two perspectives on this proposal.

One perspective is that as product providers already take responsibility for potential consumer detriment from intermediary default where they have risk transfer arrangements in place, and already contribute to the FSCS, it should not be a requirement for them to make further contributions. This view argues that if product design is at fault, the product provider should be held responsible but not if the fault lies with the sales or advice and it is the FCA's responsibility to regulate the client money arrangements of intermediaries and their prudential position, and not the responsibility of product providers.

There is, however, an alternative perspective which argues that product providers should contribute to claims caused by intermediary defaults as such providers benefit from participating in certain markets. Under a risk-based model, this view would logically extend to requiring distributors of higher risk products to pay a premium to the FSCS levy.

We therefore encourage the FCA to take both perspectives into account when considering whether the levy should be extended further to product providers.

Q4: Do you have any views about the current effectiveness, or otherwise, of PII cover including in reducing the number and cost of claims on the FSCS, and about the role of PII in providing compensation to consumers who have claims against failed firms?

and

Q5: Do you have any views or suggestions about the possible features of more comprehensive, mandatory PII insurance? Do you have any suggestions about other possible tools, remedies or approaches which could be used to reduce the scale of funding currently required by the FSCS?

and

Q6: Do you have any views on the impact of a requirement on PIFs to hold more comprehensive PII? For example, what would be its impact on the PII market, the financial advice market and on consumers in general?

We agree that the combination of FSCS and PII currently does provide a further barrier to the objectives of the Financial Advice Market Review in relation to reducing the advice gap. The absolute levels of the levy and its volatility are unhelpful in attracting and retaining advisers within the industry.

Conflicts of interest

A potential conflict of interest in protecting the customer arises in expanding the scope of PII as a solution to the funding issue. The insurer has a contractual obligation to indemnify the insured (the firm or individual holding the PII cover). During a claim, the insurer is therefore in opposition to the claimant (the customer). In addition, the customer will be forced to negotiate the legal liability system, which, due to its complexity and likely unfamiliarity, will leave them open to exploitation by claims management firms.

There also tends to be a higher frequency of insurer insolvency from liability business, compared to other sectors such as property insurance, due to the long tail associated with it.

Passporting

Issues arise from firms passporting in from other jurisdictions without understanding the specificities of the UK market. Non-UK insurers from Latvia, Iceland and Gibraltar (regulated outside the UK) using such rights to underwrite PI business have failed because they did not understand the business environment, underestimated the risks they were running and charged inadequate premiums.

Supply of PII cover

We consider that if the FCA were to go ahead with the proposed changes for PIFs/IFAs, there is a serious likelihood of undersupply in the PII market, leaving firms unable to buy cover. A change from a 'claims made' to 'losses occurring' basis as a way of underwriting cover would be a driver for this.

A 'losses occurring' method is used for losses being the result of an accident, such as third party injury or damage to property. PII differs in that it covers financial losses suffered by third parties due to neglect, error or omission. For an investment product in particular, where the value of the product will fluctuate and it will be ongoing, it is more difficult to determine when the loss happened. Where, as is currently the case, PII policies are issued on a 'claims made' basis, it is the insurer on risk *at the time it is made* that responds to it. This has the added benefit that it reduces other problems, such as the liability insurer being insolvent or difficulties in tracing the policy. Furthermore, the PRA may consider this would create a negative impact on capital holding requirements, which would in turn have a negative impact on premiums.

31st March 2017