Smaller Businesses Practitioner Panel
Financial Services Authority

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RESPONSE TO FSA CONSULTATION PAPER 12/16

'FSCS FUNDING MODEL REVIEW' JULY 2012

09 OCTOBER 2012

Introduction

The Smaller Businesses Practitioner Panel has taken a great interest in the work to reform the FSCS Funding Model. In our view, budgeting for FSCS liabilities is one of the most significant challenges for many small firms today, and ensuring that the current system is made more affordable, predictable and fair should be a top priority for industry and the regulator.

Overall, we were disappointed that the paper as presented did not go further in considering more significant changes to the Scheme. In terms of pre-funding, we would have been interested in hearing more about this, but we recognise the FSA's stance that in relation to deposit takers, such a decision would be for HMT rather than the regulator. We will continue to monitor ongoing European level discussions around pre-funding with great interest. Our initial thoughts on this topic are that pre-funding appears to be a potentially sensible way to reform the system.

Our preferred option, as outlined below, is for the Scheme to introduce a product levy for investment products, and a risk-weighted funding system for deposit-takers. We recognise the FSA's concerns as outlined in the paper regarding especially product levies, but believe that these can be addressed. Our suggestions on how this can be done are outlined below.

In addition, the Panel has not chosen to comment on specific changes proposed to individual class threshold conditions. However, we would like to note the great importance of ensuring that this remains fair, and that any changes as a result of the reforms proposed do not impact any sector disproportionately.

Executive Summary:

- The Panel supports the introduction of a product levy for investment products
    - We recognise the FSA's concerns as valid, but believe these can be overcome
    - Concerns around ensuring advisers contribute to a product levy scheme could be addressed through a complementary 'advice levy'
- The Panel supports the incorporation of risk-weighting into the funding structure for deposit-takers
    - We support the Practitioner Panel response, in calling for further consideration of Schemes in other countries that already practice this

Detailed response:

Introducing a product levy for investment products

The Panel appreciates the concerns raised by the regulator with regard to introducing a product levy, but believe these are not insurmountable. We would encourage the FSA to re-consider the idea of introducing such a levy as an alternative to the current funding system for firms who originate and distribute investment products.

The FSA considers the idea of a product levy in the paper, but rejects this on a number of grounds. It states that its key concerns relate to (emphasis added):

a) Fairness considerations would suggest the need for risk differentiation of the various different types of products and transactions. However, it would be *difficult to objectively judge how to risk-adjust the rate of levies* accordingly
b) A product levy makes no differentiation between the activities of provision and intermediation, even though a significant volume of FSCS claims relate to advice given by intermediaries. *Intermediaries would appear to play no role in the funding of the FSCS* as the levy would be attached to the product and therefore the provider.
c) Those product levies that are often cited as successful (e.g. the investor compensation fund levy in Hong Kong or the transaction fee on equity securities in the US) tend to be levies that are collected to fund the costs related to the provision of products, not to their intermediation. *It is difficult to see how a comparable fee could be applied to the intermediation* rather than design/provision of a product.

The FSA notes that product levies have been used successfully elsewhere, but a key concern is the failure of a pure product-levy to appropriately attribute costs to advisors.

We strongly agree with the FSA that advisors should pay their fair share of costs to the compensation scheme. However, we believe this could be compatible with the introduction of a product levy, if this was complemented with an 'advice levy'. This could be charged in a similar manner to VAT on advice, where a percentage fee would be payable per hour of advice. This would be clearly labelled as an 'FSCS' fee. In order not to discourage the uptake of advice, or the uptake of savings products more generally, it should be appropriately labelled and explained to the consumer (e.g. in the manner of a mandatory insurance policy). It should also be made clear that this is something that many consumers would have contributed to implicitly in the past (as many advisors will have to price in the cost of contributing to the FSCS into the cost of advice).

An up-front levy payable on a product could be used to pre-fund future failures that would draw on the compensation scheme. In our view, advisors in well-run firms already have to budget for future FSCS levies, in addition to maintaining adequate capital and reserves to pay compensation claims not covered by PI Insurance. We believe the introduction of a new 'advisor levy', to complement a product levy, would also be beneficial in forcing poorly run advisor firms (who are also more likely to give rise to mis-selling claims) to pay into the compensation scheme prior to their collapse. This would address some of the moral hazards of the current system, whereby poorly run adviser firms take all the upside should a risk pay off, but where the FSCS and well-run firms pay for their mistakes.

It should also be noted that the introduction of a product levy would have a number of advantages over the current system. A product levy would mean that payments into the FSCS would become much more predictable for firms, and would make any contribution the customer currently makes towards the Scheme (which are costed into the price of advice) more transparent. Firms are currently operating in an environment where the Retail Distribution Review is radically changing the nature of how advisors are remunerated, with much greater transparency and openness in charging structures. Separating out FSCS costs within existing charges (insofar as costs are passed onto consumers) would therefore be in the spirit of other regulatory changes currently underway in the UK.

Creating an explicit charge for the FSCS fee would also have the advantage of highlighting to consumers that the purchase of an investment product will always come with a risk, and so may have the advantage of encouraging consumers to take greater responsibility for their investment decisions. This Panel has previously noted that although firms have a strong responsibility to provide clear and easily accessible information to consumers around the product they wish to buy, a consumer ultimately has to make the decision of whether to purchase. A product levy could then also serve as another reminder to consumers that any investment has an inherent risk, and that this should always be taken into account when investing.

We also appreciate that it could be difficult to decide how to risk-adjust the levies on different products. We agree that this could be one of the more challenging aspects of introducing a product levy. The Panel does not have specific suggestions on how this can be done, other than to note that to a certain extent a more pro-active and interventionist FCA will be making judgements on the riskiness of certain products in any case. In order for proposals to be practical, exactly how this should be done deserves further consideration – such as whether the majority of products attract a set fee, with particular exemptions/lower fees for products agreed to be low risk, and particular add-ons for products agreed to be higher risks, instead of risk weighting 'by product'.

Reforming the system for deposit-takers

The Panel recognises that a different system would need to be in place for deposit-takers. We welcome the proposals in the paper not to include the deposit-taking class in any cross-subsidy arrangements in the future. Cross-subsidy should as far as possible be avoided, in order to ensure that the class that originated the risk also pays for its crystallisation. Insofar as classes can be self-funding, as can the deposit-class, this should be encouraged.

However, the Panel was disappointed to note that the paper did not attempt to address the fact that different institutions pose significantly different risks to the Scheme. We strongly support the Practitioner Panel's response in this regard in calling for the introduction of risk-weighting in the funding arrangements for deposit-takers, noting that no less than seventeen other countries were running such Schemes in 2009[1]. We were surprised that these alternative Schemes did not appear to have been studied by the FSA for the purpose of this paper.

[1] Source: International Association of Deposit Insurers, 'Funding of Deposit Insurance Systems', 2009