Personal Finance Society
Standards | Professionalism | Trust

Consultation Response

31 March 2017

FCA CP16-42: Reviewing the funding of the Financial Services Compensation Scheme

- The Personal Finance Society welcomes the review of FSCS funding and the implicit recognition within the consultation that the current system is unfair to Financial Adviser intermediaries.
- We encourage the FCA to take this opportunity to broaden the parameters of the review, to help find a long term viable solution that addresses the fundamental issues of a growing pool of legacy risk, a growing number of potential claims being met by a reduced collective of contributors, driving some away from regulated activity and deterring new entrants to the market.
- We encourage the FCA to consider the widest range of single or multiple solutions, including a consideration of the future role that professional indemnity insurance has to play and its interaction with the FSCS.

About the Personal Finance Society

The Personal Finance Society is the largest professional body for the financial advisory profession in the UK, with 36,690 members of which 5287 are Chartered Financial Planners (as at October 2016). We promote the highest standards of professionalism for technical knowledge, client service, culture and ethical practice across the entire financial advice community for the ultimate benefit of the public, engendering confidence and trust in our profession. Our mission is to serve the public by guiding the financial advice community towards higher levels of professionalism. This is exhibited through ethical and behavioural standards, interpersonal and business skills and technical knowledge. We support our members with achieving this goal through a wide programme of activities, including advocacy, good practice guidance, continued professional development (CPD) events, publications and related tools.

The Personal Finance Society is part of the CII Group and therefore we share the CII mission and Royal Charter to secure and justify public confidence and trust in our members and the sector more broadly.

For further comment please contact:

Keith Richards
Chief Executive
The Personal Finance Society
keith.richards@thepfs.org
Tel: 07786 023033

Our overall views

Summary

When looking at the funding of the FSCS, all options should be considered, including a product/investment levy, a pre-funded system and a risk-based or pooled risk levy. We would like to see a solution that creates improved consumer protection, scheme sustainability, transparency, costs aligned to risk and a greater degree of certainty and predictability for the advice profession.

Ultimately, in the continuing absence of a product levy, the preferred funded solution should address all three major shortcomings of the current system:

a) It must ease and smooth cost pressures on firms, which will in turn make financial advice more affordable and accessible;

b) It must reduce the unpredictability of levies; and

c) The charging mechanism must better reflect the relative risk-profiles of adviser firms, so that the cost of funding the system is borne more by those who are likely to cause compensation payouts from the scheme.

Furthermore, contributions should come from organisation and/or sectors that don't currently contribute into the FSCS but have an impact on and benefit from a well functioning market.

A public interest perspective

Following the Personal Finance Societies engagement with both HM Treasury and FCA during 2016, through which we sought support for a review of the Financial Services Compensation Scheme from a public interest perspective, we welcome the FCA Consultation Paper CP16/42.

The current funding system is fundamentally flawed from a consumer perspective on a number of levels:

- It is opaque, with the FSCS (as well as regulation and public guidance) appearing to many to be free – the public deserve greater transparency and consistency in line with the spirit and principles of both recent regulation (eg. The Retail Distribution Review) and government intervention (eg. Pension Freedoms);
- With the increasing cost of each bundled into adviser charging structures, it is making financial advice look disproportionately expensive; and
- It is a contributor to the advice gap, not just in terms of increasing the cost of advice but specifically driving firms from the regulated market, discouraging new entrants and driving the sector towards non-regulated activities.

These factors fail to service and protect the best interests of the public, government reforms or the advice profession.

PII and the FSCS

We welcome the questions being asked about the future role that professional indemnity insurance has to play within the consultation. Given the link between Professional Indemnity Insurance (PII) and the FSCS, and the dynamics of how insurance works in relation to the legacy liability of regulated advice, it makes sense to address the shortcomings of both.

Currently PII insurers can mitigate liability or over-exposure to risk by amending or even withdrawing cover, potentially exposing advisers to the full cost of unforeseen compensation claims. Whilst firms are being asked to set aside additional capital in support of potential claims, many simply don't have the balance sheet strength to do so. In some cases, such financial pressures will force firms into administration, with any resulting liabilities falling on the FSCS.

The Personal Finance Society has proposed a potential solution of combining first and second line protection within a single central fund, Personal Finance Compensation Scheme (PFCS). We believe this would offer up the potential for a more effective overall solution and the certainty of a single annual payment from each firm. A central fund would have the financial capacity to not only protect advice firms, but also protect consumers from advice firm failures. It could also address common PII exclusions and high excess charges that result from limited competition in the PII marketplace. A combined fee would also provide greater certainty to advisers who are currently exposed to the highly unpredictable costs of the FSCS.

A single contribution to a non-commercial 'pooled risk' fund, with an excess applying similar to PII, is likely to be lower than the current dual contributions. In terms of better predictability, a single annual contribution could be based on a combination of FSCS known 'base costs', a projection of FSCS anticipated 'compensation costs' (with actual costs incurred being smoothed over a number of years) plus the cost of a market PII policy. We understand this proposal would require a radical overhaul of the FSCS, as well as parliamentary approval, but we need to capitalise on the once-in-a-generation opportunity for reform provided by the Financial Advice Market Review and the implementation of the Insurance Distribution Directive (IDD).

Whilst we welcome the proposed review of the PII market in 2017, separate solutions to both FSCS and PII market may ultimately be sub optimal – we need a solution that combines the two. Whilst greater competition in the PII market and consistent cover should be sought, we cannot see how this can be mandated or be enforceable.

Product levy

More radical thinking may not be the answer to all problems, but we suggest it should form part of the broadest possible review covered by this consultation. In this respect we are disappointed that the idea of a product levy 'falls outside the remit of this review, partially as it is deemed 'a tax issue' which seems on the face of it to be a case of semantics.

The introduction of a savings and investment premium tax (SIPT) similar to Insurance Premium Tax (IPT) would be a fairer and more transparent way forward and help alleviate the financial pressures on regulated firms and their clients. SIPT would also be simpler than risk rating firms, with the link to risk maintained through risk rating products and changing the quantum of the tax.

SIPT might also allow HM Treasury to generate additional revenue from a much broader source of contributors, which could additionally be directed to improve financial awareness and capability, as well as help fund services such as public guidance.

This is suggested as a supplement to industry contributions, which should be set at a fairer and capped annual level.

Responses to specific questions

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

We are disappointed that the idea of a product levy 'falls outside the remit of this review', partially as it is deemed 'a tax issue' which seems on the face of it to be a case of semantics. We believe a product levy is far simpler than risk rating advisers, with the quantum varying dependent upon the risk rating of the product. It would also have the inherent advantage of educating consumers (many of whom see the current funding system as opaque, with regulation, the FSCS and Public Guidance all appearing to be free) and promoting the existence of the FSCS which would further enhance consumer confidence.

In the continuing absence of a product levy, we agree the preferred funded solution must better reflect the relative risk-profiles of adviser firms, so that the cost of funding the system is borne more by those who are likely to cause compensation payouts from the scheme. As such, a risk-based levy would redress some of the current imbalance in the system.

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?

Yes. It would seem appropriate that risk-based levies be apportioned in direct relation to:

- the extent to which firms distribute products considered 'higher risk' with reference to past FSCS claims;
- The extent to which firms distribute products already subject to restrictions e.g. CoCos; and
- The extent to which business is placed with unrated insurers.

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

We agree it is important to consider whether and how the relative responsibilities of providers and distributors (intermediaries, FinTech services and platforms) are reflected in FSCS funding.

Where large compensation bills are incurred because of poorly designed products, the industry should also be encouraged to look at its product governance processes and the regulator to use its product intervention powers more often.

Whilst the argument against product providers subsidising compensation from advisers will likely stem from a basic RDR principle, namely that advice and product provision should be kept separate, we believe it is appropriate that providers pay additional contributions over and above those that reflect their increasing intermediation activities due to:

- provider firms product governance responsibilities, including those highlighted within the Markets in Financial Instruments Directive (MiFID) II and the IDD;
- the vast majority of historic claims on the FSCS relating to a financial product; and
- the reality that everyone in the sector suffers if the reputation of the sector is damaged by customers not receiving the compensation they deserve.

A balanced and considered approach to this issue is needed; one that also reflects the assumption that reasonable FSCS funding over time might ensure providers use their market knowledge to stop problem firms creating liabilities at an earlier stage than at present.

Finally, any increased contribution from product providers should not simply increase the scope of funding and/or compensation limits of the FSCS, but lessen the burden on the advice profession so that advice is more affordable and accessible.

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?

We agree that PII cover isn't reliably performing one of its roles of preventing adviser firms going out of business. Furthermore, it is not by experience always reliably performing its role as the first line of consumer redress before the FSCS is involved.

Currently PII insurers can mitigate liability or over-exposure to risk by amending or even withdrawing cover, potentially exposing advisers to the full cost of unforeseen compensation claims. Whilst firms are sometimes asked to set aside additional capital in support of potential claims, many simply don't have the balance sheet strength to do so. In some cases, such financial pressures will force firms into administration, with any and all resulting liabilities falling on the FSCS.

Whilst we welcome the proposed review of the PII market in 2017, separate solutions to both FSCS and PII market is likely to be sub optimal – we need a solution that combines the two. Failing this, we hope as a minimum aspiration, greater competition in the PII market is achieved through the current review.

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?

Mandatory and comprehensive PII cover is like to result in some existing providers exiting from the market, reducing competition and increasing costs.

The Personal Finance Society has proposed the alternative idea of combining PII with the FSCS within a central fund, most recently to both HM Treasury and the FCA, offering up the potential for a more effective overall solution and the certainty of a single payment from each firm. A central fund would have the financial capacity to not only protect advice firms, but also protect consumers from advice firm failures. It could also go some way to address common PII exclusions, limitations, a lack of run- off cover and high excess charges that result from limited competition in the PII marketplace. A combined fee would also provide greater certainty to advisers who are currently exposed to the highly unpredictable costs of the FSCS. It could also address some of the issues advisers face around indefinite liability and a lack of long-stop.

A single contribution to a non-commercial 'pooled risk' fund, with an excess applying similar to PII, is likely to be lower than the current dual contributions. In terms of better predictability, a single annual contribution could be based on a combination of FSCS known 'base costs', a projection of FSCS anticipated 'compensation costs' (with actual costs incurred being smoothed over a number of years) plus the cost of a market PII policy. We understand this proposal would require a radical overhaul of the FSCS, as well as parliamentary approval, but we need to capitalise on the once-in-a-generation opportunity for reform that FAMR has provided us with.

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 have previously expressed our concern about the current shortfalls of PII, and we are pleased that the FCA has acknowledged these by proposing restrictions on policy excess levels and restricted use of exclusions. However, as previously stated, mandatory and comprehensive PII cover is likely to push some existing providers out of the market, reducing competition and substantially increasing costs.

Whatever the outcome of this consultation, it is imperative that it at least results in greater competition in the PII market.

Q7: Would you support an increase to the FSCS compensation limit in relation to any or each of the investment provision, investment intermediation and life & pensions intermediation classes? If so, do you have any views on what those limits should be?

It is important the principle of effective consumer protection is maintained (especially were a clear movement in the market has been seen) and that limits are updated in respect of inflation and market changes. This said, such changes need to be balanced against any increases in overall cost and ultimate sustainability of the scheme.

In the case of the Pension Freedoms, with more consumers of the life, pensions and long-term savings sector investing in drawdown products as opposed to pension annuities, a degree of revised consistency in compensation limit would seem appropriate.

Q8: Would you support a proposal to differentiate between investment provision and investment intermediation, and to introduce higher limits for either? If so, do you have any views on what those limits should be?

No comment.

Q9: Would you support a proposal to seek to make a distinction between pensions-related investment business and non-pensions investment business, and apply higher limits for pensions-related investments? If so, do you have any views on how the distinction might be made and what those limits should be?

We believe making an accurate distinction would be challenging and from a consumer perspective difficult to communicate.

Q10: Do you have any comments about the possible risks to investors posed by crowdfunding and whether these might justify introducing FSCS protection?

While overall, crowd funding platforms appear to have gained investors' trust and are building a sound reputation, there are nevertheless potential risks and liabilities associated with it. For example:

- Risk of fraud/scams;
- The crowding out of other forms of financing e.g. angel, venture capital etc;
- Ideas may be great and well received but they may not be easily commercialized or established on a sound financial or market position;
- Investor over-optimism might apply;
- Problems with technology, IT security or the internet; and
- Systems failures, for example, could delay or prevent the sale of investments on a secondary market.

Some crowd funding activity, such as donation or reward-based crowd funding, is not regulated by the FCA, some is regulated by the FCA, and some is exempt from regulation.

We understand that from April 2016, 'FCSC may be able to compensate eligible investors in relation to unsuitable advice they receive about the merits of investing in Peer-to-peer lending via loan based crowd funding, dependent upon individual circumstances. (source: www.fscs.org.uk/what-we-cover/questions-and-answers/qas-about-investments/#question17)

From 6 April 2016, FSCS may be able to compensate eligible investors in relation to unsuitable advice they receive about the merits of investing in peer-to-peer lending via loan-based crowdfunding platforms.

Depending on individual circumstances, FSCS may be able to provide compensation of up to £50,000 in relation to investment advice.

A peer-to-peer advice claim would need to meet all of the following criteria:

a) The advice you received to buy the investment must have been given on or after 6 April 2016;

b) the firm that advised you must have been authorised by the appropriate regulator to do so at that time;

c) you must have lost money as a result of the advice you were given; and

d) the firm (or its principals) no longer has sufficient assets to meet claims for compensation from April 2016.

Whilst it remains an important principal that customers of advisory firms have recourse to the FSCS to protect them against failures by authorised advisory firms, is important for the regulatory framework is proportionate, especially while the market is young and growing. Widening the FSCS remit at this stage would impose additional regulatory costs, which may be quite significant and disproportionate. Furthermore, funding would likely fall on others, given that crowd funding firms alone would be unlikely to form a sustainable funding class.

Firms should ensure that investors understand the risks involved.

Q11: Do you have any comments about the scope of the FSCS and whether promoting financial products, or any other activities, should be included within its coverage?

We agree that in the absence of significant evidence to justify extending FSCS protection to the activity of promoting alone, the scope of the FSCS should not be extended to cover this 'risk'.

Q12: Do you agree that it would not be justified for the FSCS to utilise a credit facility to further smooth levies, given the costs involved?

Firms are concerned about both smoothing/eradicating volatility in levies, transparency, and the overall costs involved. Based on the costs of a revolving credit facility as detailed in 7.5, we do not believe the smoothing benefits that would arise from this route justify the cost.

As mentioned in our preface, we encourage the FCA to look at all funding options, including a product/investment levy, a pre-funded system and a risk-based or pooled risk levy. We would like to see a solution that creates improved consumer protection, scheme sustainability, transparency, costs aligned to risk and a greater degree of certainty and predictability for the advice profession.

Q13: Do you believe that we should seek to reduce the number of funding classes, in order to reduce volatility of FSCS levies?

Whilst reducing the number of funding classes, and increasing provider contributions will potentially reduce volatility, it will do little to align cost to risk. We look to the FCA to be ambitious in its search for a comprehensive solution that does more that reduce volatility and cost (albeit important considerations).

Q14: What are your views on the different funding classes we have set out here? Do you have any alternative proposals?

No additional comments, beyond reaffirmation that the preferred funded solution must address the three major shortcomings of the current system:

- It must ease and smooth cost pressures on firms, which will in turn make financial advice more affordable and accessible;
- It must reduce the unpredictability of levies; and
- The charging mechanism must better reflect the relative risk-profiles of adviser firms, so that the cost of funding the system is borne more by those who are likely to cause compensation payouts from the scheme.

Q15: Do you agree with our intention to keep the current class thresholds for intermediary classes, merging the thresholds if appropriate to adopt a revised class structure?

See answer to Q14.

Q16: Do you agree with our intention to keep our current class threshold of £200m for the investment provision class?

See answer to Q14.

Q17: Do you have any views on the idea of a fixed levy for smaller firms?

We do not believe a fixed levy for smaller firms alone is appropriate, given the calculation that 82% of smaller forms would pay more than they have over the past six years and the fact that it would not address the cost of funding the system borne more by those who are likely to cause compensation payouts from the scheme.

Q18: Do you have any comments on the mechanism by which we would propose to incorporate product provider contributions into the intermediary claims classes, for the various different class structure options described?

No.

Q19: Do you agree with our proposals to include protection for client money for debt management activities within the scope of FSCS protection and our proposed funding arrangements?

Yes.

Q20: Do you have any views on whether or not coverage should be extended to negligent advice provided by debt management firms?

We do not see a case for extending coverage to include negligent advice in this sector.

Q21: Do you agree with our proposals to extend FSCS protection to structured deposits intermediation and to fund it through the Investment Intermediation and Investment Provision classes?

Yes.

Q22: Do you agree with our proposed approach to provide FSCS protection for claims relating to fund management?

Yes.

Q23: Do you agree with our proposed new approach to Lloyd's of London?

Yes.

Q24: Do you agree with our proposal for a new reporting requirement on higher risk products in the RMAR?

Yes.

Q25: Do you agree with our proposal to remove the rule relating to paying FSCS levies by quarterly direct debits or should we consider other options?

Yes.

Q26: Do you have any comments on our proposed class threshold and tariff measures for the new debt management claims class?

No.

Q27: Do you have any comments on our proposed tariff measures and metrics for calculating the deposit taker contribution for direct sales in relation to structured deposits?

No.

Q28: Do you have any comments on how, in future, we might calculate any provider contributions required from deposit-takers, in relation to structured deposits, if we were to consult in detail on this approach?

No.

Q29: Do you have any comments on our decision to maintain the current tariff measures, except for life and general insurers?

No.

Q30: Do you have any comments on our proposal to bring the tariff bases for insurers into line with the PRA's approach?

No.

Q31: Do you agree with our proposal to require firms that must pay some of their FCA/PRA levies on account to also make a payment on account in respect of their FSCS levy?

No comment.

31 March 2017