

**Funding the Financial Services Compensation Scheme:
a submission from The SimplyBiz Group to the FCA's
FSCS review team**

Prepared by Ken Davy

Chairman of the SimplyBiz Group

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About the SimplyBiz Group

The SimplyBiz Group provides compliance and business support services to over 2,600 financial advisory firms directly regulated by the FCA, incorporating 6,000 plus individual advisers. As such, the SimplyBiz Group represents a significant proportion of all FCA regulated firms and the financial advice sector as a whole. In addition, through our not-for-profit New Model Business Academy (NMBA), we provide information, education and training support to several thousand advisers who are not users of our commercial support services.

Support for FSCS

The Financial Services Compensation Scheme (FSCS) is an essential element of the framework of consumer protections and is widely supported by the financial community, including the SimplyBiz Group. Its purpose is to compensate consumers who have suffered losses as a result of the actions of a firm which has subsequently gone out of business.

The Myth of Bad Advice

An analysis of FOS statistics clearly demonstrates that individually advisers have relatively few complaints. Put simply, in a 30 year plus career an adviser is unlikely to

have more than one complaint upheld against them, which we suggest is a record most professionals would envy. It is also unlikely in the extreme, that the cost of settling an upheld complaint will exceed £5,000. Against this reality even quite small advisory firms are being charged thousands of pounds per year to fund the FSCS caused by firms whose advice has been careless, reckless or dishonest and who have subsequently gone out of business.

In addition, many of the liabilities which have fallen on the FSCS have been a result of product failures and/or corporate fraud, rather than bad advice - Keydata and Arch cru, being high profile examples of regulated providers promoting regulated products which failed. Despite this, the bulk of the FSCS liabilities have continued to fall on the advice sector.

The Polluter Doesn't Pay

Inevitably, as the firm which created the liabilities no longer exists it is impossible for the "Polluter to Pay". Equally inevitably, this means that any funding mechanism is bound to be unfair as the cost falls, not on the polluter, but elsewhere.

An Unfair System and Economically Unsound System

It follows from the above that any funding method for the FSCS will be unfair, however the current method, where the costs fall entirely on the advisory sector, is so unfair as to be a grotesque injustice.

An honest advisory firm has no possibility of being aware of a 'problem firm' let alone influencing or preventing their actions. A 'problem firm', being a firm which is creating potential FSCS liabilities through being careless, reckless or dishonest in the advice they give to clients and/or the way they run their firm. When these liabilities do, in due

course, fall on the FSCS, they are paid for by the honest firms who again could not have possibly prevented or influenced the actions of the 'problem firms' which created the liabilities.

In addition to being unfair it is also an economically unsound model. It puts the cost of funding the FSCS onto the smallest and financially weakest cohort within the financial services sector and therefore on those least able to absorb it.

By way of example here are three actual FSCS amounts levied on small firms last year: Firm (a) with two advisers - £4,340; Firm (b) with 2 advisers - £9473 and Firm (c) with three advisers - £26,614.

A Risk Based Levy?

We have seen suggestions that a move to a more risk based levy is being considered where those conducting what is deemed to be higher risk business, make a larger contribution to the annual levy. Whilst superficially this may appear attractive and indeed it may have some part to play in a solution, it does not address the fundamental unfairness of the present funding method. It is inconceivable that a risk based levy could be set high enough to prevent those who, as 'problem firms', are careless, reckless or dishonest, from behaving as they do. Equally, whilst some high risk areas can be identified in advance, others only emerge with the benefit of hindsight.

Focus on Fairness

We understand that the FSCS is currently being reviewed and the Chairman of the FCA has stated that "making sure the FSCS levy is fair towards IFAs will be one of the focuses of this review" (Financial Adviser 16.05.16). The current fundamentally flawed

mechanism has been allowed to persist for far too long and we, along with the whole of the advisory sector, warmly welcome this comment by the Chairman of the FCA.

So who should bear the cost of the FSCS and how can it be made fairer?

We suggest the following key objectives:

1. It should be fair

Fairness is difficult to define, however the current funding method is manifestly unfair. Despite this fact, it has been allowed to continue for years as a significant and unfair burden on sound, well run, professional advisory firms.

2. It should promote market stability

Market stability is an important aspect of the FCA's role. It is clear that the current funding method of the FSCS places a wholly unreasonable burden on the advisory sector, creating potential market instability and limiting its growth.

3. It should have the widest possible collection base so that its unfairness is spread as widely as possible, in order that no contributor is unduly burdened.

Four Participants with a Natural Affinity

Within the advice process there are four parties with a natural affinity.

The regulator, the client, the adviser and the product provider.

(Please note the product provider may be an investment house, OEIC, or insurance company etc.) For convenience, we use the all-embracing term of “product provider” as it is rare, in the extreme, for the FSCS to award compensation which does not relate to some form of investment product).

The Regulator

Clearly, the regulator has the greatest likelihood of being aware of a problem firm and stepping in before the results of its careless, reckless or dishonest actions become too damaging. Equally clearly however, the regulator is not going to contribute to the FSCS and in any event the regulator is funded by those it regulates.

Clients

Clients could pay directly for the protection they enjoy under the FSCS via a product levy. This would be the fairest option however, it appears to have been ruled out at an early stage of the review. We see no logical reason for this stance as a product levy would:

- a. meet the test of collecting from the broadest possible population;
- b. operated very effectively in the General Insurance market from the 70’s until December 2001, when regulation passed from the Policyholders Protection Board to the FSCS;
- c. impact to only a tiny degree on any particular client, as it is estimated that to raise c£200m* a year would require a product levy of under 15 pence per £100 of new monies invested. This is surely a very small price for clients to have to pay for the

comfort and protection of the FSCS. (*The advisers' FSCS levies for the past five years being: £116m, £114m, £91m, £165m and £182m, an average of £140m p.a.)

We understand that a product levy would require legislation, however if it is the right solution the requirement to legislate should not be a reason to discount it.

Product Providers

Product providers have, or ought to have, significantly greater market intelligence, both individually and collectively, than any other market participant apart from the regulator. This extends far beyond their normal commercial relationships with advisers. For example: in relation to transfers or encashments, they write the cheques and/or receive the investment monies. Providers also have access to a wide range of additional market information and research, so are well placed to identify potential "problem firms" at an early stage, therefore preventing losses escalating.

On the assumption that a product levy is rejected, we believe it is essential that product providers become the primary funding source of the FSCS where its impact on any individual provider would be insignificant. Over the past 20 years product providers have increasingly outsourced the distribution of their products. This has enabled them to gather and accumulate assets and the continuing fees these sums generate, whilst avoiding the advice risks associated with accumulating these funds. The FCA estimates that the total sums invested with product providers now amount to some c£1.2 trillion, whilst the new monies invested annually are of the order of £180,000m.

Very importantly, placing the levy on the product providers would give them an immediate and continuing vested interest in the quality and integrity of the firms from whom they accepted business. This is an important element of the regulatory

framework which has been missing for far too long and will be a further significant benefit of a revised funding method of the FSCS.

There are various methods of calculating the amount of levy which would be required to generate c£200m of FSCS funding. These range from one measured by the new business placed with providers in any given year, or averaged on, say, a rolling three year period. To raise c£200m would require a levy of c15pence per £100 of new premium. Alternatively, if the levy was to be based on the total accumulated funds, which we understand the FCA estimate to be £1.2 trillion. A levy would only need to be some 0.016666% of £1.2 trillion to raise the required £200m; clearly the impact of this on any particular product provider would be extremely small.

Advisers

From the above it is obvious that:

- a. the current method of funding the FSCS via the Advice Sector is grossly unfair and should be changed;
- b. a product levy is the most direct and fairest solution;
- c. if a product levy has to be discounted because of the need for legislation the levy should be applied directly to product providers and investment houses in the widest sense. We believe this does not require legislation and that the impact on any particular provider would be insignificant.

Having said that we recognise that there is an argument that the Advice Sector enjoys some benefit from the existence of the FSCS. This benefit is not great, as few advisers,

if any, will use the existence of the FSCS as a relevant benefit when advising clients, nonetheless, we acknowledge the point.

With this in mind we would not argue against a restructured FSCS funding model, along the lines set out above, which incorporated a contribution of, say, 10% of the amount required being raised from the advice Sector.

Summary

- i. The current method of funding the FSCS is wrong and must be fundamentally reformed.
- ii. Tinkering with risk categories and the like will not fundamentally reform what is a grotesquely unfair system.
- iii. A product levy or provider levy will meet all the requirements of a fairer system and spread the cost so that no single client or provider suffers a material impact.
- iv. A contribution of up to 10% of the total required could come from the advisory sector and be incorporated into an overall solution.

Radical reform of the FSCS is critically important to the future of the advice sector and we commend this paper and its contents to you.

Ken Davy
Chairman
SimplyBiz Group

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