

A RISING TIDE LIFTS ALL BOATS?

2020

A roadmap towards better
consumer outcomes and lower levies



PIMFA 

The Personal Investment Management & Financial Advice Association

Building Personal Financial Futures

FOREWORD

This is the second of a number of papers we plan to publish on the 'The Financial Services Compensation Scheme (FSCS)'. In our previous paper, we focused on the breakdown of trust between PIMFA members and the compensation scheme. Trust is something which takes time to build up but can be quickly broken and it follows logically that in order to restore trust this process will take time.

The recommendations that we set out in this paper are a recognition of that. Advocating singular solutions speaks to a misunderstanding of the complex issues at play here. Continued rises in FSCS levy payments are the result of a myriad of issues within the market – poor supervisory oversight, legacy issues of failure, poor adviser practice and yes, the construction of the levy - and there is no one singular individual or organisation responsible for it.

Over the past year in particular, my engagement with PIMFA member firms has revealed a frustration among them not just at continued levy rises, but a broader frustration at a failure among those responsible to recognise that this is a problem. Implicit in the recommendations that we set out today needs to be a recognition from all parties involved that the current situation is untenable. To their credit, the FCA's recent Call for Input speaks to a recognition of the problem but only seeks to address a symptom rather than the disease itself. We will of course be engaging with that particular paper through our own response, and in many respects, this paper can be read as our first intervention in that regard.

Beyond moves by the FCA to address some of the issues we raise in this paper, it is also incumbent on me to recognise much of the good work that both they and the FSCS do in the background. Much of the FCA's enforcement activity occurs without any public

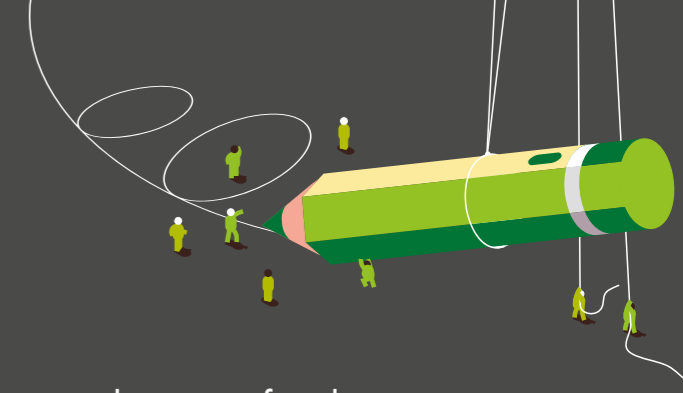
report and as is so often the case, we are drawn more often to stories about regulatory failure than we are to regulatory successes. The same is true of the FSCS who work diligently with various stakeholders in seeking to prevent firms from falling onto the Scheme. I cannot be clearer that our recommendations are made in the spirit of collaborative working rather than outright criticism. PIMFA wants to work together towards solutions and towards rebuilding trust.

Our desire to rebuild trust between this industry and the Regulatory system is ultimately rooted in a shared goal: we want consumers to be able to transact with confidence and with the adequate levels of support in a complex financial services market. The value our members provide to their clients is unparalleled in both inoculating them from harm and maximising the opportunities to both build and drawdown on their wealth. This is something that the Regulator knows and it is something that this and previous governments have recognised.

In turn, we recognise the value of the FSCS and remain committed to ensuring that consumers remain protected by it. But it remains the case that by definition, every single person who has had cause to call on the FSCS has had a bad outcome that it would be better to have avoided in the first place. It is for that reason that we are today reaffirming our commitment to work towards practical solutions with Government and the FCA to ensure that the FSCS and Regulatory structures can more effectively protect against harm; ensure the advice gap doesn't widen further and provide confidence and trust to both consumers and the firms which fund it.

Liz Field, Chief Executive, PIMFA

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EXECUTIVE SUMMARY

The Financial Services Compensation Scheme plays a vital role in UK retail financial services. It ensures that consumers can confidently participate in financial services knowing that malpractice or fraudulent behavior will not put their long term savings at risk, even if the firm in question stops trading. The existence of a compensation scheme that is able to meet its responsibilities is fundamental in ensuring that the UK can build a culture of saving and investment.

That being said, every person that has to utilise the compensation scheme has suffered a poor outcome that it would have been much better to avoid. Policy should be designed to minimise the need for the compensation scheme and protect consumers before the harm occurs, rather than allowing harm to occur and relying on the FSCS as a safety net.

PIMFA, the UK's trade body for the financial planning and wealth management industry, also retains significant concerns around both rising levels of payments arising through claims on the FSCS, market distortions related to the FSCS and the regulatory approach to certain risks, as well what we consider to be an inherent unfairness in the calculation of the levy itself. Broadly speaking, these can be summarised as follows:

The inadequacy of supervision carried out by the Regulator - As outlined in PIMFA's recent paper 'FCA supervision – fit for purpose?' we have identified a number of areas where we consider the Regulator's supervisory regime to be lacking. Failure to supervise firms adequately directly contributes to rising compensation costs for firms who are allowed to introduce harm into the market or fail without correct supervisory oversight.

Market distortion - the FCA's regulatory approach incentivises some firms to sell some assets and then fold their company to deliberately transfer risk to the FSCS. There are also issues with 'phoenixing' where advisors go out of business, transferring risk to the FSCS, before reemerging to provide advice via another entity.

The structure of the Financial Services Compensation Scheme – we are largely supportive of the current funding classes which make up its funding resolution, however we take the view that its current method of levying firms is too homogenous in its nature. It is unable to take account of both the activities of the firm and as a result the risk that any given firm presents to the market. By continuing with current funding approach, the FSCS levy continues to penalise prudent firms whilst in effect providing a no risk default environment for firms more willing to take risks or firms with no concern about their own prudence.



Continued increases in compensation payments allied to increases in ancillary fees have short and long term implications on firms and consumers. We are concerned that increasing costs will ultimately be borne by consumers and in the long run exclude more people from financial advice, leaving them unable to navigate the financial complexities of financial services more broadly. Further to this, we are aware of many firms considering an exit from the market altogether given their concerns around affordability.

It is, in our view, incumbent on government and the regulator to act quickly in order to ensure that the FSCS and the regulatory structures which feed in to it exist to provide confidence to both consumers as well as those who fund it. We are optimistic about the direction of travel set out in its recent Call for Input into the Consumer Investment Market although harbor some concerns that it seeks to address symptoms of a wider issue rather than the underlying problem itself. As a result we are calling for the following:

- 1 HM TREASURY TO REVIEW THE DRIVERS OF FSCS LEVY COSTS AND REVIEW THE REGULATORY PERIMETER AGAINST THIS.**
- 2 HM TREASURY TO REVIEW WHAT ALLOWS FIRMS TO TRANSFER RISK ONTO THE FSCS TO CAUSE MARKET DISTORTIONS INCLUDING PHOENIXING AND IDENTIFY WAYS OF LEGALLY LIMITING FIRMS ABILITY TO TRANSFER RISK ONTO FSCS IN FUTURE.**
- 3 FCA TO REVIEW ITS SUPERVISORY APPROACH AGAINST A RISK ASSESSMENT OF FIRMS ADDING COST TO FSCS AND REPORT AGAINST THIS.**
- 4 FSCS TO REVIEW INTELLIGENCE PROVISION AND PROVIDE AN ANNUAL ASSESSMENT OF WHETHER THE FCA HAS ACTED UPON IT.**
- 5 FCA TO REVIEW LEVY CONSTRUCTION AND CONSIDER A RISK-BASED ELEMENT AND HOW TO BOOST RECOVERY FROM THE ORIGINAL FIRM OR PRODUCT.**

ABOUT

The underlying principle of the FSCS is that its existence allows UK savers to invest or deposit their money with confidence. By protecting savers' money from malpractice, fraudulent behavior in the event of a firm closing, millions of UK savers are provided with a much needed safety blanket to encourage them to participate fully in financial services. In turn, providers and distributors covered by the FSCS are required to contribute to the upkeep of the scheme as well as compensation payments by way of an annual and supplementary levy. As above, the existence of the scheme provides savers with confidence. There is, in turn, benefit to those who fund the scheme through the levy. Without the existence of the scheme and the confidence

it confers, savers would be less likely to use the services of the providers and distributors who fund it.

Whilst it is both true that the scheme is valuable in ensuring consumer confidence which in turn allows firms to attract and retain business, it is equally the case that continued and rising claims upon the FSCS represent a bad outcome for consumers. Every person that has had to utilise the compensation scheme has suffered a bad outcome that it would have been much better to avoid. It is both the case that we can recognise the need for a scheme whilst believing that ultimately policy should be designed to ensure that individuals have little to no need for the scheme in the first place.

WHY IS IT A PROBLEM?

'Ever increasing levies represent a real threat to our business and therefore our ability to advise our clients. Levies of this scale undermine the integrity of the market for financial advisers'¹ PIMFA Member

The cost of regulation⁸- the 'cost of doing business well' – and in turn, the cost of potential compensation claims have risen exponentially over the preceding 5 years. For 45% of respondents to a PIMFA survey, FSCS costs have risen by over 100% whilst for PII premiums, 26% of respondents have seen a rise of over 100% in the same time period.

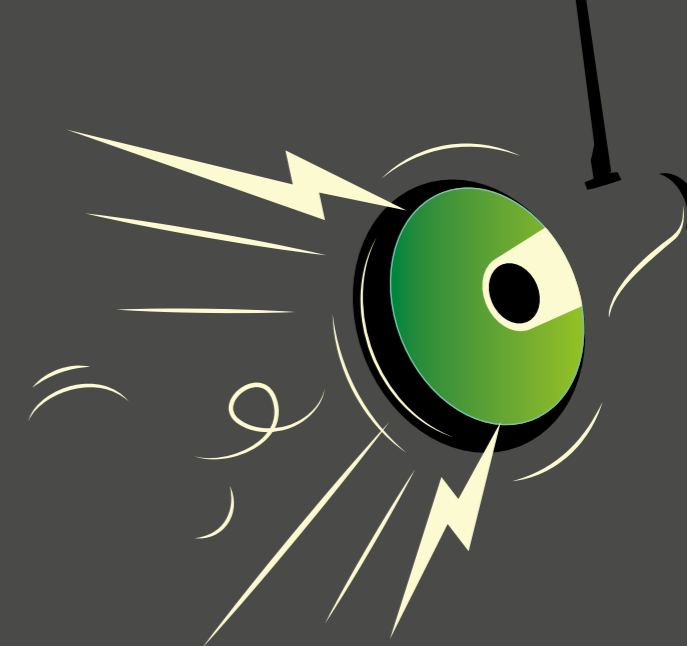
For the vast majority of firms we have surveyed, FSCS costs represent a sizeable proportion

of their costs once staff and accommodation costs have been accounted for – over 80% of respondents advised that it accounted for up to 20%. In any form of business, ancillary costs are inevitable whilst, in an industry as highly regulated as financial services sector in the UK, regulatory costs will always be high. However, these costs have to be met and increasingly these are being met either through levying additional charges onto clients, or disrupting business growth plans².

An absence of clarity

As we will set out below, the regulatory cost incurred by member firms would be tolerable if we had confidence that efficient, targeted regulation was in place to reduce the potential for consumer harm. However, FSCS costs continue to rise for member firms suggesting that harm continues to take place in the market. Whilst recent rises in adviser classes can be directly attributable to failures arising out of LCF and DB pension transfers, the exponential rise over the preceding 5 years is less clear to us. We have anecdotal evidence that the rise in FSCS compensation costs are directly attributable to claims on unregulated investments, but this has neither been corroborated by data provided by the FSCS or indeed, action from the regulator and government to seek to reduce the number of unregulated investments in the market either through enforcement activity or bringing them within the regulatory perimeter.

The need to rely on anecdotal evidence remains unavoidable. FSCS Class Statements⁴ make clear that SIPPs are the main driver



for cost in their sector. However, it appears that the main causes of SIPP compensation are the unregulated products and investments held within them (such as was the case with London Capital & Finance). Having examined FSCS Class Statements, PIMFA cannot find any explanation of what is driving the compensation to be paid or what is contained within the SIPP. We would strongly encourage the publication of more detailed and granular data focused on the cause of compensation rather than the type of firm that has failed.

However, beyond the provision of publicly available data, PIMFA would advocate a deep review and analysis of the drivers of costs placed upon the FSCS and whether these could have, for example, been prevented through an expansion of the regulatory perimeter. It is our deeply held view that if a product or service is subject to and qualifies for compensation claims, then it should both be within the scope of regulation and ultimately subject to the same levy obligation as other products and services.

¹ Throughout this document, PIMFA references the anonymised views of our membership which we gathered through a survey conducted earlier on in the year. These views are taken verbatim from our membership survey and do not necessarily reflect the views of PIMFA itself.

² In our response to the FCA's recent call for evidence on the impact of the Retail Distribution Review and Financial Advice Market Review we outlined that in the preceding 8 years (since the introduction of the Retail Distribution Review) average regulatory costs had increased by 30% for firms.

³ A Freedom of Information Request submitted by Professional Adviser magazine indicates that in the preceding 12 months, 252 advice firms have given up their authorization - https://www.professionalmagazine.com/news/4118653/revealed-advice-firms-giving-up-authorized-status-jumps-252-firms-medium-small&utm_content=medium&utm_campaign=FA_Update_BLI&utm_source=FA_DCM&utm_medium=email&utm_term=.01320612024&utm_term=PIMFA

⁴ <https://www.fscs.org.uk/globalassets/annual-reports-and-class-statements/fscs-class-statements-2019-20.pdf>

RECOMMENDATION 1:

HM Treasury to review the drivers of FSCS levy costs and review the regulatory perimeter against this.

'The basis of charging FSCS levies is no longer sustainable for firms and the FSCS has not altered the charging basis to take into account the interests of firms, their employers and wider stakeholders thereby creating a competitive barrier to entry within the sector.' PIMFA Member

'We can never accurately budget for an FSCS bill' PIMFA Member

Significant market distortions

Because a claim on the FSCS only arises at the point at which a firm is unable to meet its obligation either through PI or their capital reserves, we are seeing increasing evidence in the advice market that significant market distortion is occurring. By way of example, we are aware of a number of examples where firms have sought to fold in order to relinquish any tail liabilities they have on high risk markets and investments such as DB transfers. Firms are then phoenixing without tail liabilities whilst these liabilities fall on to the FSCS. It should not be the case that this is considered a viable business strategy for any firm, and we would question why – despite moves to address this – it continues to be reasonably prevalent across the market.

We have also received substantial feedback from firms whereby individuals or firms are 'phoenixing' as Claims Management Companies. In this construct, firms will 'dissolve' and resurface as a CMC advising and coaching former clients through the claims process. Due to the fact that the firm on which claims are levied will have been dissolved, in most cases these claims will fall onto the FSCS.

This is not conducive to nor indicative of a well-functioning market. In our view, more could and should be done by Government to review market distortions arising as a result of the FSCS and legally limiting firms' ability to transfer risk onto it.

RECOMMENDATION 2:

HM Treasury to review what allows firms to transfer risk onto the FSCS to cause market distortions including phoenixing and identify ways legally limiting firms' ability to transfer risk onto the FSCS in future.

Widening the advice gap

We are concerned that rising costs associated directly to potential compensation payments – FSCS and PII premiums – will widen the advice gap through driving up the cost of advice for consumers, as well as encouraging advice firms to leave the market. Whilst FSCS levies ultimately give due regard to firm revenue, PII renewals do not, and are becoming increasingly unaffordable for firms – only 18% of firms surveyed considered themselves very confident that they would be able negotiate a PII renewal on terms that were affordable⁵. It is already the case that firms are unable or unwilling to advise certain clients or provide certain services due to restrictions associated to their PII cover.

This should be of concern to government. There are already too few people accessing financial advice relative to those who could reasonably

afford to do so⁶ and government should be concerned about the potential further widening of the advice gap 4 years after seeking to put measures in to reduce it⁷.

Withdrawing professional support from individual's financial decision making will ultimately lead to further consumer detriment by virtue of the fact that the vast majority of UK retail savers do not currently have the tools to be able to navigate a complex financial services landscape. PIMFA remains highly supportive of government guidance services but we are cognisant of the limits of financial guidance in its current form. In order for people to be able to save with confidence and most pressing, manage their retirement incomes in a sustainable manner, it is imperative that individuals are provided access to financial advice, not excluded from it.

⁵ A number of firms we surveyed reported PII costs which were equal to or well above their annual FSCS levy. In the case of 1 firm, they reported PII costs which sat at 250% as a proportion of their FSCS bill.

⁶ FAMR Consumer research – the FCA estimates that around 4.5million people accessed financial advice in 2018 based on a broad assumption that individuals with investable assets of £10,000 and above could benefit from financial advice and/or planning

⁷ Financial Advice Market Review, 2015

Falling levels of trust

35%

Surveying its members, PIMFA found that only 35% trusted the FSCS to deliver fair outcomes for both consumers and firms.

39%

Over the preceding 5 years, 39% argued that their level of trust had changed (from a positive to negative sentiment).

Reasons for this ranged from a frustration that the FSCS is legally able to pay out on unregulated investments related to SIPP through to a consideration that the current construction of the levy is too homogenous by its nature and, as a result, inadvertently favours firms that are more likely to fail over prudent firms. More broadly, feedback suggests that there is a perception among PIMFA members, although PIMFA would stress that every claim is assessed within strict legal parameters, that where possible the FSCS seeks to find ways for consumers to be eligible for compensation.

Concerns around the FSCS levy

'It is not the FSCS but the FCA who are failing in their duty to regulate firms. Then the honest have to pay the failings of the dishonest and the regulator bears no burden' PIMFA Member

In our view, past criticisms of the construction of the FSCS levy have missed the underlying issue: not enough is being done to ensure that firms do not find themselves in a position where valid claims arise. The primary concern and the basis of any review of the FSCS should be why claims and levies continue to rise on a year on year basis. It is for this reason that we do not believe the current Call for Input goes far enough.

The size of the FSCS levy is currently equal to or more than the annual cost of funding the UK's Financial Services Regulator – the FCA. For the year 2020/21 – the annual levy for firms currently stands at £649m although it should be noted that this does not take into account

potential claims arising as a result of firm failings due to COVID-19.

For the year 2020/21 the FSCS expects significant claims arising as a direct result of claims being made due to mis-selling of DB pension transfers arising from the British Steel Pension crisis as well expected claims arising as a direct result of the failure of London Capital and Finance⁸. For the most part these claims fall onto the Life Distribution and Investment Intermediation class of which PIMFA members make up a significant proportion.

A failure of regulation

It is unreasonable to argue that firm failures and losses due to a lack of competence are not the direct responsibility of the firms and individuals who perpetuate it. The primary cause of rising FSCS levies are a direct result of poor practice, individual negligence and a lack of financial resilience to cover claims which fall on them. It follows logically that removing these firms from the market will in the longer term mitigate continued rises on claims on the FSCS and, as a result, rises in the levy. We are also sympathetic to the argument that because compensation claims arising from the FSCS are backwards looking, failure takes time to work its way through the system and the current levy may not be directly comparable to the current standard of supervision.

However, it is equally a case that these firms continue to exist in a regulatory environment which allows this sort of activity to go unpunished for too long. As we set out in our recent paper on UK supervision⁹, it is our view that the current regulatory and supervisory structure is unsuitable and allows poor practice in this industry to be perpetuated until it is too late to act. Better, more targeted supervision would, in our view, ensure that poor practice from firms would be addressed sooner and drive certain firms and individuals from the market not before time.

We recognise that implicit in the argument that the standard of supervision from the Regulator is deficient is a recognition of the

fact that better, targeted supervision will lead to an increase of failures and, as a result, claims on the FSCS. Whilst this is regrettable, it is our view that a short term increase in levy payments in order to secure a longer term reduction is preferable to the current situation whereby levies continue to increase – allied to ancillary regulatory and insurance costs - with no prospect of them reducing in the longer term. However, we would stress the need for this to be over the short term, recent public comments from the FCA's Chief Executive¹⁰ and private comments to PIMFA members point to a timeline of change which we believe to be unacceptable.

The current situation is unsustainable. Regulatory and compensation costs continue to rise and there are valid grounds to question whether either represents value for money from firms who are obliged to pay them. Whilst it may be the case that the Regulator is operating at optimum capacity, we consider that there are too many examples in recent history which suggests more could have been done sooner to mitigate future claims on the FSCS. A review into the effectiveness of the Regulator would go some way to building confidence that as much as possible is being done to mitigate future claims. More broadly, we would advocate an approach whereby if intelligence on potential harm has been provided by the financial services community and not acted upon, transparency should dictate that the Regulator advises why.

RECOMMENDATION 3:

FCA to review its supervisory approach against a risk assessment of firms adding cost to the FSCS and report against this.

⁸ An inquiry into the failure of LCF is currently ongoing. Whilst we have fed our views in privately, PIMFA members had previously raised concerns with the Regulator around the activities of LCF long before its eventual failure.

⁹ FCA supervision – fit for purpose? PIMFA, 2020

¹⁰ Treasury Select Committee Hearing, 4 November 2020

RECOMMENDATION 4:

FSCS to review intelligence provision and provide an annual assessment of whether the FCA has acted upon it.

'The apportionment of the levy is unfair on firms that have no interest in any of the investments that have caused the problem' PIMFA Member

Within the construct of the current levy configuration, it remains a point of enormous frustration among member firms that those who leave the market having defaulted clients into the FSCS do not bear a share of the resulting costs. As we have set out previously, PIMFA would favour a model whereby the funding of the FSCS is considered on a 'polluter pays' model rather than its current homogenous construction – more of which we will set out below.

Whilst we strongly believe that the current construction of the levy is unfair given that it favours firms who fail over prudent firms who pay for that failure, it may ultimately

be the case that upon review the current funding structure remains the fairest. However, consideration should be given to how more significant contributions can be made from firms to the cost of compensation which in the case of enforcement activity in particular cause clients to make claims on the FSCS.

PIMFA would advocate an approach whereby in the windup of businesses, value was extracted from the assets to contribute towards their cost of failure. More broadly, as we set out above, stricter measures should be put in place to prevent market distortions thus ensuring that individuals cannot re-enter the financial services profession through ownership of a new firm.

Not all firms should be treated equally

'We spend a lot of time, effort and money in getting our processes, monitoring training and capital in place to ensure we give the right advice...to then be charged for what appears to be all those who don't do that for no extra benefit to us or our shareholder. We are being fined for being a well-run business' PIMFA Member

As above, our primary concern is that the cost of funding the FSCS continues to rise year on year, and we take the view that consideration should be given to why that is and how it continues to happen. Of secondary concern is the make-up of the levy itself.

The structure of the levy is homogenous by its nature. As a result, firms which sit within the same class and have identical revenue would, in any given year, be required to pay the same levy to the FSCS. Such a levy payment would give no consideration to, for example, what the revenue sources for each firm were (provided

they sat in the same class) or whether or not they were in any way sustainable. This is the inherent contradiction in the construction of the FSCS levy – its homogenous approach to raising the levy in effect penalises prudent firms whilst, in effect providing a no risk default environment for firms more willing to take risks.

It should not be the case that a levy which exists to provide consumers with protection, in effect provides some providers with an incentive to offer products and services which consequently do the opposite. Whilst the consumer may eventually be compensated, and the firm bankrupted, the cost of servicing this contradiction ultimately falls on other, prudent firms who any given client would have been better using in the first instance.

The existence of a levy which continues to incentivise poor behaviour is something which clearly needs review. We accept that this has previously been considered by the FCA – although never outright rejected – however, without effective supervisory oversight, the construction of the levy in its current form will continue to in effect incentivise poor behaviour leading to poor outcomes for savers.

To this end, we are aware that in CP 18/11²² the FCA made a commitment to review the efficacy of Risk Based Levies. Instinctively, we believe that a risk based levy – provided

it properly took account of the risk a firm represented to claims on the FSCS – should be explored further. In setting a risk based levy we consider that FCA and FSCS could give due regard to risk posed by a firm either through capital buffers it holds against e.g. its Funds Under Management or a broader product based risk levy which gives due regard to the inherent riskiness of any product sold by a firm.

We would also encourage further investigation into how recoveries could be better pursued from failed firms. Whilst we understand that in some cases, recovery is expensive and there is a duty on the FSCS to only do so if it represents a worthwhile exercise in terms of value for money, the total recovery of our sector is extremely small as a proportion of the annual FSCS levy bill¹². The utility of a broader focus on recovery is twofold: it lowers the bill and also acts as a potential deterrent for firms. Unfortunately as things currently stand, in the vast majority of cases, no recovery action has been taken.

There are a number of different options available to the Regulator and we are confident that industry would willingly work constructively with the Regulator in finding a solution which is based upon principles of fairness; transparency and conducive to better outcomes for consumers.

RECOMMENDATION 5:

FCA to review the construction of the FSCS levy to consider a risk based element and how to boost recoveries from the original firm or product.

¹¹ From 1 April 2018, the FCA has expanded its RMA-J return to collect data on sales of high risk investment products with a view to developing risk based levies. The FCA argues that RBLs have a similar deterrent effect to holding funds in trust, can target riskier firms more effectively, and could be structured to adapt flexibly and quickly to emerging harms as they arise. The FCA made a commitment to consider the case for consulting on these levies in 2019 although to date no such consultation has been forthcoming.

¹² <https://www.fscs.org.uk/globalassets/annual-reports-and-class-statements/fscs-class-statements-2019-20.pdf>



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