Peter Cardinali,
Fees Policy
Financial Conduct Authority
25 The North Colonnade,
Canary Wharf
London E13 5HS

19 December 2013

Dear Peter,

AFM Response to FCA Fees Review

1. I am writing in response to your request for input on fees policy, on behalf of the Association of Financial Mutuals.

2. Thanks you for setting out the policy options being considered for future fee collection in November. It was very helpful to see what stage this work has reached, and to be invited to offer views. We trust our comments are useful in the preparation of your discussion paper.

3. The Association of Financial Mutuals (AFM) represents 53 member companies, most of whom are owned by their customers. Between them, AFM members manage the savings, protection and healthcare needs of 20 million people, and have total funds under management of £100 billion. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In the context of fee policy, the FCA is expected through its underlying legislation, to assess where new or amended rules produce a materially different impact on mutuals.

General approach and principles

4. We note that as your general starting point, you have explored whether the fees charged by a regulator should be set based on either:
    a. Scale: the size of a regulated firm,
    b. Usage: fees related to the amount of work undertaking in regulating a firm, or
    c. Risk: related to the risk potential of an organisation.

5. We agree this are the most relevant dimensions, and we can see some merits and pitfalls in each approach:

    a. A revenue-based system is transparent, and provides stakeholders with a clear understanding of how fees are calculated. There is no need to adopt fee-blocks and to allocate firm activity between them. Where fees are fixed over three years, firms can plan in confidence for future fee levels, and see that these rise or fall depending on the success of the organisation. Where this approach is applied with a single and universal measure of revenue, applying the rules within FCA is easier.

       The dislocation of fees from other aspects of regulatory activity provides a clear message about the nature of the fee, ie they are not a supervisory tool or a policy outcome. On that basis, it is logical that the premium rate paid by depositors should disappear. More generally, the size of an organisation does not imply that the firm is a greater burden on regulators, or carries a more significant risk. This does mean that there is no chance for fees policy to incentivise good performance- instead they become more like a tax on operating in the UK, albeit a progressive one, scaled to size of business.

       The main advantage of this approach is simplicity for the regulator: it is not obvious to us that firms will regard easier comparison in itself as a virtue, and we explore further the nature of the proposed revenue approach below.

       The analysis of winners and losers proposes reducing the minimum fee to £100, and indicates that this would mean 87% of firms would be winners. This is not though on a like for like basis, as prior to 2013/14, the smallest firms paid a single fee to FSA of £1,000: today small dual-regulated will also be paying the PRA minimum fee, and single regulated firms will also pay an additional prudential regulation of these firms. The analysis though suggests prudential assessment of solo-regulated firms amounts to just 2.8% of total FCA fees, which is surprising low.

    b. Applying fees to reflect the amount of work undertaken on each firm/ block is a logical and attractive approach, and a fair form of apportionment- where the objective of the regulatory fees is to recover costs in relation to the amount of work expended.

       Our argument in the past, in responding to the FSA, was that the current, Usage based model, was not being properly applied, because there was insufficient correlation between the FSA business plan, and also that the regulator's internal systems failed to measure activity effectively. For example, in response to CP12/28 we stated: "*In the past, system limitations made it difficult for the FSA to demonstrate that the costs incurred in its supervision of specific cohorts of firms were in any way consistent with the fees charged. That always left an* *impression that fee-setting was approximated... Proper transparency should enable a better understanding by the new regulators and their stakeholders of the costs incurred."*

It would appear that this was not addressed, or dismissed, in the creation of the FCA. That being the case, the Status Quo option carries forward many of the limitations. Your notes suggest a number of refinements to the current approach, some of which also apply to the other options:

- We support the fixing of fees for three years. There is a difference of course between fixing the absolute fee and the fee rate and it is not clear what is proposed. We would hope that this does not leave scope for later adjustments, and that if there is a significant shortfall in one year due to specific circumstances, a special project fee can be applied to relevant firms.
- We do not consider that weighting fees in relation to complaints data will achieve anything helpful: firms with large numbers of complaints pay very significant case fees to FOS. There is also the risk of a perverse incentive to under-report the number of complaints.
- We are unclear on the effect of treating regular premium income the same as single premium for insurers, though potentially this would reduce fees for firms that do more regular premium business including many AFM members. However, this will need detailed assessment. AFM's approach to premiums assumes a single premium is spread over ten years to equalise with regular premiums, and we find this is generally seen to be fair.
- Moving the portfolio managers fee block from a measure based on assets, to income, appears sensible, though this will produce some winners and losers and needs to be mapped carefully.

c. The option of setting fees based on firm categorisation assumes each firm in a particular category (C1 to C4) pays in accordance with a revenue basis- such as that proposed in the first option- but that the fee rate varies in each segment. For example, C4 firms represent 92% of all FCA-regulated firms, but the proportion of total fees currently apportioned is 32%.

This solution appears to be a half-way house between the other two, in so far as it bases fees on a single measure of revenue, but also segments the fees, in this case based on perceived future risk rather than actual current workload.

We do not feel that this adds anything significant to the two other options, and it is likely to be inferior to one or other of the alternatives in each of the fee principles.

Insurance income

6. FCA's proposal for a revenue-based approach is based on applying a measure of income, drawing data from current regulatory returns. As FCA analysis already indicates, the proposed approach produces a significantly unwelcome consequence for insurers: FCA's analysis suggests the proportion of fees paid by insurers would rise from around 15% now to 48% (for friendly societies and non-friendly societies). We think that any measure of size other than premium would recognise that, for example, the banking sector is much bigger than the insurance one, so it is difficult to see how the proposed approach is fair.

7. The currently proposed definition of revenue assumes that income is capable of being compared on a consistent basis across all regulated entities. However this is not the case: a simple measure of income means different things for producers compared to distributors. To illustrate this, consider the automotive industry. A *car dealer* generates income based on the value of commissions earned for sales. Its main expenses to deduct from this before gross profit are staff costs and overheads. A *car manufacturer's* income reflects the price its vehicles are sold for, and gross profit will deduct the cost of manufacturing the car, commissions paid to dealers as well as staff costs and overheads. There is no reason to believe that the simple measure of income is consistent for car dealers and manufacturers, and this logic holds true in financial services, between brokers and insurers.

8. FCA suggests a fee rate of £0.58 per £1,000 income. In 2012 AFM members generated gross premium written (GWP) of £7.3 billion[1]. Applying the fee rate would results in fees for our 53 members of £4.25 million. This is an average of over £80,000 per member firm- and whilst this simple analysis ignores minimum fees and the indicative nature of the calculations, this is likely to increase fees paid by the sector by an order to two to three, and is therefore unwelcome.

9. This clearly fails the fairness principle, which in our opinion is by far and away the most important of FCA's fee policy principles. It also fails the test of proportionality, particularly for general insurance and healthcare, where premiums are very high in comparison to assets, due to the nature of the business which has high claims rates.

10. To illustrate the impact of creating a definition of income for insurers that equates more with brokers, a proxy to the nature of income in brokers for a producer might be: GWP- reinsurance - claims + operating expenses + other (realised) income. For AFM members in 2012 this would produce an income figure of £2.0 billion =(7.3- 1.1- 6.7 + 2.2 + 0.3), and fees of £1.2 million, which is close to the current levels, and treats income in a more equitable manner. We do not put this forward as a proposition (as on a firm level this produces some unusual results, particularly for closed life companies), but as

[1] Based on AFM key statistics: http://www.financialmutuals.org/advantage/key-statistics

an illustration of the practical challenges of trying to adopt a simple but comparable income figure.

11. We note that FCA is looking to appoint a consultant to undertake more detailed analysis, and we would be happy to provide support to them.

Conclusion

12. We have carefully considered the options put forward in the paper. Where we have seen a particular unwelcome impact for insurers of a particular approach, we have sought to test the principle first, rather than simply dwell on any apparently unjust outcome.

13. On that basis we give cautious support to the revenue-based approach. However our support is entirely contingent on identifying a fair basis for comparison: over the last five years in particular, the insurance sector has demonstrated that it is resilient and has presented a relative low risk to both conduct and prudential regulation. We see no evidence that the sector has underpaid its fair share in the past, and therefore no justification for an increase in fees now.

14. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals