Clare Vicary
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

January 2018

Dear Clare,

AFM Response to FCA consultation CP17/36:
Reviewing the funding of the FSCS

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

- comment on the proposals; and
- highlight our concerns that the proposals for provider contributions are unfair and not an appropriate solution to the FCA's need to address adviser failures.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £19.6 billion, and employ nearly 30,000 staff[1].

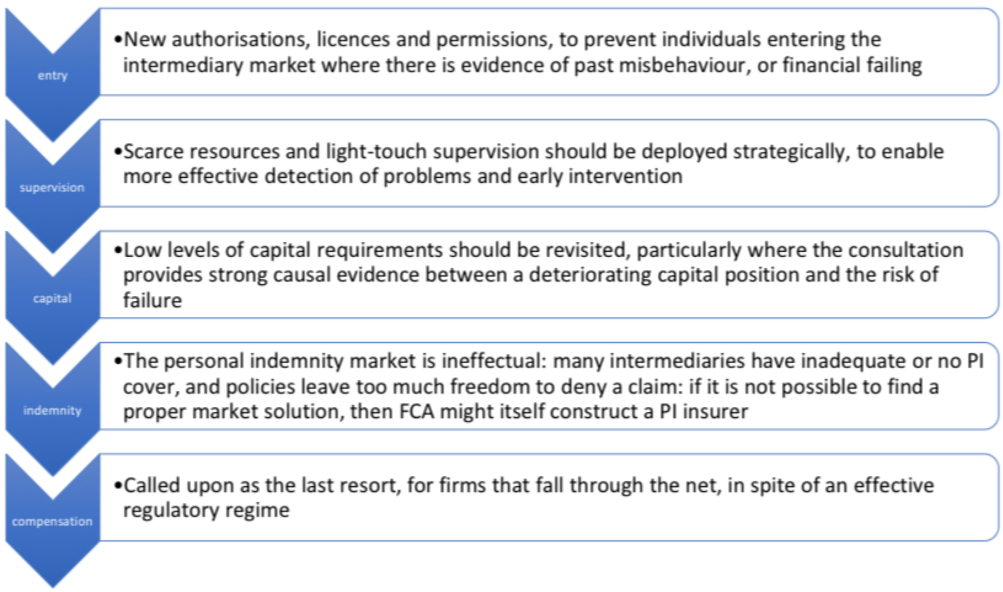
3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2].

4. In addition, the Bank of England and Financial Services Act 2016 now provides an additional Diversity clause for FiSMA, to require the PRA and

[1] ICMIF, https://www.icmif.org/publications/market-insights/market-insights-uk-2016
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted

FCA to take account of corporate diversity and the mutual business model in all aspects of their work[3].

5. We are pleased to respond to this consultation, having responded to the previous consultation (CP16/42), and contributed to various working group meetings. We share FCA's desire to ensure FSCS's activities are properly funded, and that the right solutions are adopted to minimise the impact of failing intermediary firms. As FCA has acknowledged in this consultation, and as we stressed in our previous response, FSCS must remain a last resort, and effective upstream intervention will reduce the number and impact of failures:



6. We accept that where FCA is committed to undertake more effective supervisory control, in the short term this might increase the number of disorderly failures. In our assessment, that mostly brings forward problems which may manifest in FSCS claims in future years, and is therefore a responsible action for FCA to take. We accept that may increase industry costs in the short run, but this is a possible consequence of too light touch an approach in the past.

7. FSCS plays a vital part in the UK regulatory environment, and more than that, in gives consumers faith that they can invest money safely and securely. All parts of the financial services sector will value that role and will naturally wish to see FSCS prosper. In our view, it is important to remember that without FSCS, players in the industry- be they providers, banks or brokers, would find it much harder to grow their business. It is regretful therefore that much of the debate on funding FSCS has been on self-driven interests, as observed in the consultation, with firms supporting proposals that reduce costs to their business, rather than to address the greater good. However, we consider that FCA would have known this, and might have considered how to create a

[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

debate that rose above partisan interests, and focused more on the sustainability of FSCS.

8. We consider that the role of FSCS in insurance should be about consumer protection and confidence just as much as it is about collecting reimbursement for failed businesses. At present much of FSCS's communication stresses its role in the recovery of funds: for insurance providers this is a much less relevant issue, given that all insurers must maintain very strong capital buffers and meet stringent regulatory tests under Solvency 2. It is also the case that FSCS has limited experience of dealing with failures of UK insurers, given that in most cases regulators can identify and act on issues early, and because the sector has long-embraced the concept of white knight support from strong businesses to those in the sector whose position has deteriorated.

9. Hence, we continue to be concerned that the FCA has largely disregarded concerns raised by insurance providers about being required to contribute from the first £1 to funding intermediary failures. This imposes an obligation on insurers which is not within their control to mitigate: for insurers, an intermediated purchase of insurance is essentially transactional rather than relational. Hence to be at risk of funding failures over which the insurer has little influence contradicts the FCA principles of business and more general concepts of fairness.

10. For many AFM members, who do not distribute their products via intermediaries, this is particularly unreasonable: as the table below shows, 31 of AFM's 48 members have built their business without third party distribution, and only one relies entirely on intermediaries. In other words, arguments of affinity do not apply in the case of two-thirds of AFM members.

Channel	Number of AFM members
Only sell through intermediaries	1
Sell direct and through intermediaries	16
Only sell direct/ through introducers	31

11. It is a particular feature of mutuals that their products tend to be simpler and lower cost, and often do not need expert salespeople for their distribution; their products are not attractive from a remuneration perspective for intermediaries. Where FCA therefore concludes there is no material differences in its plans for mutuals compared to proprietary models, it is overlooking the nature of many mutuals, for whom a cost benefit assessment of FCA's proposals would only generate cost and risk.

12. The FCA approach also appears to manifestly disregard the experiences of FSCS. According to recent comments by the Chief Executive of FSCS, 80% of claims it receives against financial advisers are for unregulated investment

sales, like forestry and storage pods[4]. This means there was no possibility of a fault of an insurance company, since they cannot offer unregulated products.

13. Hence the contention by the FCA Board that "*requiring product providers to contribute more to FSCS could incentivise them to create products which are better understood and benefit consumers more*"[5], is misinformed where most defaults occur in cases where the adviser did not sell a regulated product. Neither does this evidence that even in the 20% of cases where a financial adviser sold regulated products, that there was any failure in the design of the product. This seems therefore to be a case of a failure of authorisation and supervision first and foremost, that FCA has failed to address and instead of resolving that problem effectively, seeks to impose the costs of failure on insurers.

14. FCA's latest consultation also proposes changes to the retail pool, to widen it to include failures of investment providers. Hence, if an investment provider fails, insurers are included in the funding classes expected to contribute to compensating the failure. However, investment providers would be excused from funding a failure on an insurer. This appears to be a distortion to fair competition, and it is not clear why FCA concludes that for insurers, the door broadly swings one way, where notwithstanding the more conservative business model that Solvency 2 expects them to follow, they are forced to help resolve failures elsewhere.

15. We have responded to the questions raised in the consultation, and would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

[4] https://www.moneymarketing.co.uk/fscs-80-per-cent-claims-unregulated-products/?cmpid=pmalert_4411944&utm_medium=email&utm_source=newsletter&utm_campaign=mm_daily_news&adg=5F046092-B73F-4EF7-BE9B-629F071461B3

[5] https://www.fca.org.uk/publication/minutes/minutes-fca-board-18-and-19-oct-2017.pdf

Answers to specific questions in the consultation

Q1 Do you have any views on our proposal to prevent personal investment firms (PIFs) from buying PII policies which exclude claims when the policyholder or a related party is insolvent?

We consider policies with exclusions of this nature are entirely inappropriate, and we support the proposal to prevent their purchase by PIFs.

Q2 Do you have any views on the potential to require PIFs to hold additional capital in trust, for the purposes of contributing to any FSCS claims?

Q3 Do you have any views on requiring PIFs to obtain a surety bond?

We agree that intermediaries who distribute higher risk products have a greater likelihood of calling on FSCS in future, and should therefore be expected to pay a greater proportion of its costs. The same argument FCA uses here might be considered as an argument to exclude insurance providers, who don't use intermediary distribution, from proposals to require insurers to pay from the first £1 of every intermediary claim.

Of the two options set out (more capital or the holding of a surety bond), each has strengths and weaknesses; both potentially encourage good behavioural outcomes by intermediaries who would be incentivised for reducing risk, though both also increase costs.

In an ideal world, and as we have seen in insurance, high levels of capital support good risk management, but they also create barriers to entry and exit.

Q4 Do you have any comments on our proposal to merge the Life and Pensions Intermediation funding class with the Investment Intermediation funding class?

The proposal is likely to increase the number of claims each relevant funding class would be expected to pay; however, with more firms sharing the cost it is likely to reduce the absolute cost of each claim. From an intermediary perspective the question to weigh up is whether a larger number of smaller claims is better or not.

We do not think it is relevant that some intermediaries are in both funding classes currently; this argument is mainly relevant to the opportunity to reduce cost. Merging classes tends to mean that actions elsewhere to address concerns relating to firms who sell higher risk products are dissipated. Given concerns around NMPIs and the possibility of high claims for pension mis-selling in the future, we do not see there is a good argument for merging classes.

Equally, we continue to view the proposal, as set out in paragraph 4.22 that providers should contribute to every claim, as wrong. FCA indicates it received calls to explore legally whether this was appropriate in response to its previous consultation, and we consider FCA should publish any advice received.

Q5 Do you agree with our proposal to move pure protection intermediation from the Life and Pensions Intermediation funding class to the General Insurance Distribution funding class?

FCA highlights the contradictory approach between PRA and FCA on the treatment of pure protection, and that this is due to limitations in data collected. We suggest therefore that FCA and PRA consider this issue strategically to arrive at an aligned position.

In any event, there are material differences between long-term protection products, and short-term general insurance. In particular, the former has a long-tail of responsibilities and exposure that the latter do not. Protection products tend to be sold in the same way as investment products, whilst general insurances are not, and from an AFM perspective, where a number of AFM members provide Holloway products, which blend long-term income protection with a small element of savings and are therefore regulated under COBS, there is greater risk of market distortion.

Q6 Do you agree with our proposal to change the class thresholds for FCA product provider classes to represent 25% of the relevant intermediary claims funding class threshold? If not, what alternative would you suggest?

We do not consider that FCA has presented any new evidence to support this proposal, and we continue to oppose it.

The design of the current scheme was unpopular with our members when the retail pool was first introduced. That said, the levels are set at a reasonable level and had until this month only triggered one wider claim: though we were disappointed that the communications process by FCA and FSCS at the time was poor.

There is a presumption in the paper that insurance providers have deep pockets and this has driven the proposal for them to be included in the intermediary pool.

That is too simplistic a view though: most of the reserves that insurers hold are to meet regulatory solvency requirements. Insurers that transact via intermediaries hold extra capital to recognise the risks and cashflow implications- so the proposals here duplicate regulatory forces already in place.

With regard to AFM members, they do not have shareholders to bail them out of problems, or to fund unexpected calls on their finances such as a FSCS claim. To pay such claims, a mutual or not-for-profit insurer would have to take the money from policyholders' funds, which would increase the risks to their own business. Where regulatory costs have doubled since the introduction of Solvency 2, this is another unwelcome cost that will increase risks to the viability of some provider businesses.

The greater risk that FCA needs to resolve is that some intermediaries consider they can collect significant fees or commissions from clients and walk away from the consequences of bad advice or poor business management. Those risks of neglecting responsibilities will undoubtedly increase should FCA determine costs are levied onto providers as well.

Where FCA has asked for an alternative suggestion if we do not agree with the proposed 25% contribution from providers, we continue to believe a 0% rate is appropriate.

If the FCA policy team consider that they have already committed to the FCA Board that there will be some contribution by providers, then in light of recent FSCS comments as highlighted in our cover letter, we suggest FCA should explore more appropriate options. This must include more effective authorisations and supervision, as per our earlier flowchart. Where FCA can satisfy itself there is any further contribution to intermediary failures which are caused by (insurer) product design failures, it might also include:

- Setting a rate that better reflects the proportion of cases where regulated insurance products have been sold.
- Setting provider contributions from a different level to the first pound of claim. We consider a threshold should be established at 80% of the moving average cost of claims in the previous three years, in line with FSCS experience of unregulated investment advice, and once this threshold has been triggered, providers might be required to contribute. This will reduce volatility.
- Where providers exclude or mainly exclude intermediary distribution, they should be a lower or zero contribution to intermediary failures.

Q7 Do you have any comments on our proposal for how the retail pool will operate?

FCA suggests in paragraph 4.40 that 'all of the new funding classes will benefit from and contribute to the retail pool', with the exception of the deposit acceptors class, which is contributory only. We think this is misleading, as it is not clear how insurance providers might benefit from the retail pool. Nor has FCA explained why the investment provider class can benefit from the retail pool, where other provider classes are exempt.

We would appreciate greater clarity from FCA on why it is proposing to treat investment providers differently to insurance providers. It would also be helpful for FCA to clarify what benefits it believes insurance providers receive from the retail pool, given it has not identified any in the consultation or in its previous papers.

In addition, we consider it would be helpful if FCA avoided terms such as 'all funding classes', as its analysis does not include the PRA provider classes, and does not consider the contributions made by depositors and insurers to those classes. It would be helpful if FCA could explain whether its statement about how 'all funding classes benefit' makes the same differentiation between FCA's intermediary and investment funding classes, and the insurance providers funding class which falls to PRA. In this case, this would suggest that insurance providers are recognised as a contributory class only, as per depositors.

Q8 Do you agree that we should increase the FSCS compensation limit for investment provision, investment intermediation, home finance intermediation claims and debt management claims from £50,000 to £85,000?

We agree.

Q9 If you do not agree with the proposal above, do you have an alternative proposal?

(No response)