



Consumer & Retail Policy
Financial Conduct Authority
12 Endeavour Square
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2 March 2022

AFM Response to FCA DP21/5, compensation framework review

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 in the review.

About AFM and its members

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 around £25 billion, and employ nearly 30,000 staff¹.
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 businesses² and to take account of corporate diversity³.

¹ ICMIF, <https://www.icmif.org/publications/market-insights/market-insights-uk-2016> with updates from EY and AFM

² Financial Services Act 2012, section 138 K: <http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted>

³ <http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted>

AFM comments on the proposals

4. We welcome the opportunity to respond to this discussion paper. The FSCS is a key part of the overall regulatory regime, and offers an important safeguard and assurance to consumers. It has however been the source of continued frustration to industry, due to its cost and the unpredictability of its demands.
5. We are surprised by the limited ambition of the paper, which appears to be a re-hash of past ideas, and suggests FCA is going through the motions to appease certain of its stakeholders. Whilst the alarming rise in the cost of FSCS is a reason for review, it is not clear what the purpose or terms of this review are, or how it will link with FCA's recently declared commitment to strengthening its authorisation and supervisory activities.
6. We have responded to the specific questions raised in the consultation below, and would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'MS', with a long horizontal stroke extending to the right.

Martin Shaw
Chief Executive
Association of Financial Mutuals

AFM response to selected questions raised in the paper

Q1: Do you consider that proposed principles 1 and 2 are the appropriate principles to underpin the design of the compensation framework (in relation to the aspects of the framework that the FCA is responsible for)?

We consider the first principle is deficit. The proper first resort for consumers is that the regulatory authorisations and permissions processes are effective, and that they protect consumers by preventing firms from undertaking regulatory activities where they are either intent on doing harm, or disregard proper standards.

We agree with principle 2.

Q2: What incentives, whether positive or negative, does the FSCS as a 'fund of last resort' create for market participants and what are the consequences of those incentives?

We remain concerned that for poorly run or undercapitalised businesses, or for those intent on doing harm, the FSCS acts as a safety net, and that historically there has been insufficient attention by the FCA to identifying potential problems and acting early. We are pleased that after many years of pleading the case, by AFM and others, for deeper regulatory engagement, FCA has now accepted that it needs to raise its performance, though until it begins to demonstrate success, the current onus on FSCS is greater than it should be.

We reject the notion that the presence of the FSCS encourages inappropriate behaviours by consumers. Consumers take comfort from knowing that the FSCS is supporting their interests behind the scenes, but have every reason to expect that a properly functioning regulator will prevent individuals or firms from gaining or retaining authorisation. Consumers also have a right to expect that the entry requirements for firms include that they have the capacity to resolve, from within their own resources, the nature of problems that may occur.

Q3: Do you have any further suggestions on how to ensure the FSCS is not over relied on and represents a true 'fund of last resort'?

The best defence against claims on FSCS is that firms have a strong capital position, or adequate indemnity cover against failure. Given problems in the latter, the onus must be in strengthening the financial resources required of firms at risk of failure, and/or allowing claims to be made against individuals in firms that mis-sell.

Q4: Do you consider that a change in the scope of FSCS protection could be justified, whilst remaining in line with the proposed principles for protection at paragraph 2.2? If yes, please outline how and why you consider protection should be changed.

Q5: If you consider a change in the scope of FSCS protection could be justified, please set out the positive and negative implications of such a change in protection, for both consumers and the financial services sector more generally.

We do not consider the scope of protection should be diminished: consumers would find it confusing to be told that protection may vary across a portfolio of products, or over time.

There are other regulatory options that should be pursued to avoid the risk that consumers purchase inappropriate products.

Q6: Following the UK's withdrawal from the European Union, is the narrower territorial scope previously decided on for AIF and UCITS managers and CIS operators still appropriate? If not, what alternative options should we consider?

Consumers have the right to expect that if a firm is authorised to operate in the UK, then the protections afforded to them are the same, regardless of whether they are an overseas firm. It was noticeable in the era before Brexit that most if not all insurance failures that have affected FSCS in recent years have been from overseas firms, who have been authorised to operate in the UK in spite of being based in a jurisdiction with lower prudential requirements.

We think that post-Brexit, a level playing field of access for consumers should persist, as well as a level playing field for prudential standards. Firms passporting in or selling through a branch should demonstrate comparable capital standards, and FCA should be more cautious about passporting in firms based in jurisdictions with lower standards.

Q7: How can we make sure that consumers are provided with clear information about the availability of FSCS protection that equips the consumer to make effective and properly informed decisions about financial products and services, including those where FSCS protection is not available?

Q8: When distributing non-UK funds to retail investors in the UK, should firms be required to inform customers when FSCS protection is not available? If yes, how could firms ensure customers are aware of the lack of protection, through the fund's marketing materials or otherwise?

We consider there should be additional risk warning to customers, if a product is outside the scope of FSCS by dint of investing outside the UK, and that these should be comparable to the risk warning for UK investments beyond the scope of FSCS. Consumers would rightly be surprised that this is not the case.

Q9: Do you consider that 'high-net-worth' and/or 'sophisticated' individuals should be excluded from being able to claim from the FSCS in certain circumstances? If so, should the exclusion(s) apply to all types of claim or just certain categories of claim?

We do not consider there should be an exclusion of this nature. The nature of fraud or mis-selling by a firm should not be excused by passing the problem onto consumers, however wealthy or experienced they are. Equally, such an exclusion would camouflage a problem, not solve it.

Q10: Do you consider any other amendments should be made to the current eligible claimant criteria?

No.

Q11: Does the CIS look-through remain appropriate from a consumer protection perspective? If not, what alternatives should be considered to protect investors in CISs?

We have no comments.

Q12: Do you consider changes should be made to the level of compensation that is payable by the FSCS? Please provide justification for any changes you propose.

Q13: Would you be in favour of the introduction of set periodic reviews of the compensation limits to ensure that they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?

We consider current levels are appropriate, and that it would be worthwhile having a set review period of five years.

Q14: Do you consider that proposed principles 3 and 4 in relation to FSCS funding are the appropriate principles to underpin the design of the funding arrangements (in relation to the classes which the FCA is responsible for)? If not, what principles would be preferable?

We had misgivings about the wider funding pool when it was previously consulted on, and were disappointed that the views of providers were unacknowledged and disregarded. A wider pool does not resolve problems with the incidence of firm failures, it merely pushes the problem across a wider range of firms.

Ineffective communication on the occurrence of claims that trigger the wider pool has done little to dispel the concerns previously echoed.

Q15: How do you consider the current funding model (for the classes that the FCA is responsible for) could be improved, to ensure that costs are appropriately distributed and the impact on firms is proportionate? Please explain how your proposed changes represent an improvement on the current arrangements.

Q16: Are there any alternative metrics to annual eligible income that would help to ensure that compensation costs in the Investment Provision class are distributed more fairly between firms in the class?

The retail pool is a blunt tool for raising funds, without pretending to allocate costs fairly or consistently. It seems this is inevitable however, and we consider the current arrangement is still relatively new, and would benefit from further assessment once improvements in the supervisory regime have been introduced and tested.

Q17: Would you be in favour of the introduction of set periodic reviews of the funding class levy limits to ensure they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?

We consider reviews should take place every five years. A lesser cycle would not allow an effective review of effectiveness over different cyclical conditions, and would be likely only to include a small number of business failures.

Q18: Do you consider that any alternative funding model would be preferable to the current funding model? Please describe the alternative model that you consider to be preferable and the benefits over the current arrangements.

Of the options included, we think a risk-based model is worth further consideration. This would ensure FSCS funding was more likely to reflect a 'polluter pays' approach.

Pre-funding, or product levies, create additional and unnecessary problems for firms, add costs which would need to be borne by consumers, and are more likely to shift the problem away from businesses that are most likely to give rise to claims.

Q19: Do you have any overarching comments on the proposed principles for the compensation framework, or do you have any further principles that we should account for?

Q20: Are there further opportunities to improve the aspects of the compensation framework that the FCA is responsible for? Please describe the further changes which you consider should be made.

We would have preferred to see the Discussion Paper had set out thinking more fully. The paper offers no new proposals, and given the reservoir of data and resource available to FSCS and FCA, this is disappointing. We would be wary of the next step in the review being a consultation, in the absence of workable proposals here: though it may be that FCA's aspiration is to demonstrate to stakeholders that it has initiated a review rather more than it has been to resolve tensions in the system.

For example, the paper does not reflect on the ongoing debate in Europe about the benefits of insurance guarantee schemes (IGS), or work on recovery and resolution. The recent study by JRC rightly points out that for insurance, continuity of cover is often a more relevant consideration in recovery than is compensation⁴.

The expectation that compensation is the main or only source of resolving a financial failure is not therefore relevant to insurance: the low incidence of failures amongst UK general insurers may have discouraged broader thinking about whether a different approach is needed for short-term insurance contracts, compared to investment-based products or the failure of advice firms.

We worry therefore that: (1) the risk of an insurer failure is very low, particularly since the introduction of Solvency 2 and the requirement to hold more capital⁵, and (2) the FCA/FSCS approach would be ill-equipped to resolve the failure of a large general insurer. As a result, a focus on monetary compensation means the main role insurers play in the current compensation framework is to subsidise costs for failures elsewhere.

⁴ <https://op.europa.eu/en/publication-detail/-/publication/36ade6ec-1b51-11ec-b4fe-01aa75ed71a1/language-en/format-PDF/source-231332618>

⁵ Even before Solvency 2, a recent report suggested that the probability of default across all UK general insurers was as low as 0.003 (<https://www.sciencedirect.com/science/article/pii/S0378426617301711>)