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

26 January 2018

Dear Clare,

AFM Response to FCA consultation CP17/36:
Reviewing the finding 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 the need for proposals- for provider contributions- and more generally, to be demonstrably fair and clearly appropriate to the issues FCA seeks to address: in this case that the incidence and value of adviser failures in excessive.

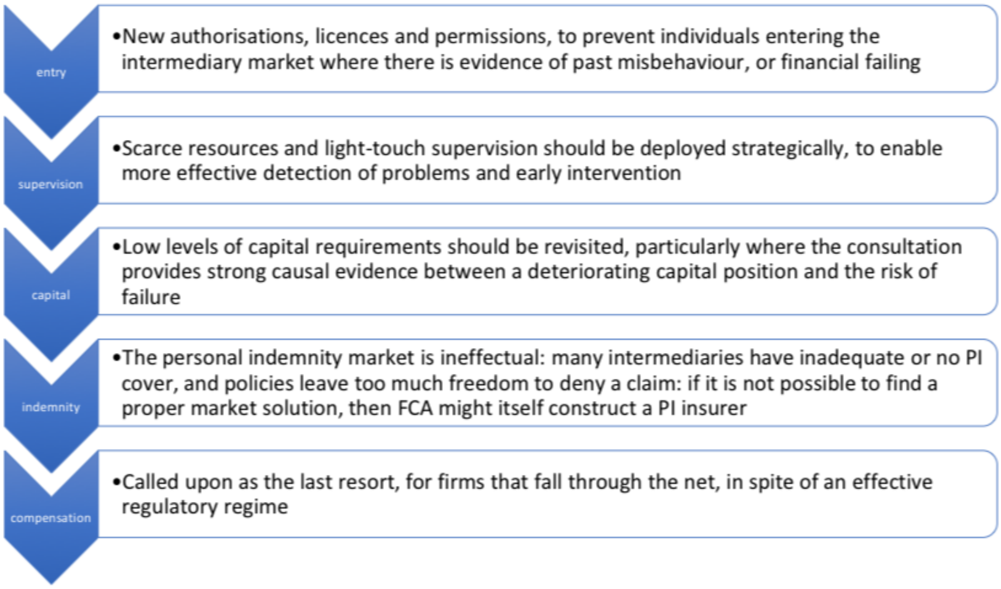
2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs 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 FCA to take account of corporate diversity and the mutual business model in all aspects of their work[3].

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

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 divisive and driven by self-driven interests, as FCA observes in the consultation, with firms supporting proposals that reduce costs to their business, rather than which help to address the greater good. We would like to see FCA frame future debates in a manner which rises above partisan interests, and which focus more on the sustainability of FSCS, and its proper place in the financial system.

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 UK 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. The most contentious issue in this consultation, for insurance product providers, is the expectation that in future they will be required to contribute to advisory failures, 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 the costs of failure, over which the insurer has little or no influence, appears to contradict the FCA principles of business.

10. In agreeing this approach, the FCA Board observed that "*requiring product providers to contribute more to FSCS could incentivise them to create products which are better understood and benefit consumers more*"[4]. We consider this view is misinformed, given that:

    a. 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[5];
    b. the incidence of UK product provider failures is very low, and given the approach taken within the sector, most provider failures are resolved by support within the sector and little recourse to FSCS; and
    c. data provided to use recently by the Financial Ombudsman Service, indicate that in the previous year they had received just 137 complaints about our members, and had upheld only a quarter, many of which related to historical products and advice.

11. As well as raising our concern here, we will separately challenge the sentiment expressed in the Board statement, and will ask FCA to produce evidence of product providers designing products today which fail to benefit customers, and are not understandable.

12. For many AFM members, who do not distribute their products via intermediaries, the proposal that they should contribute significantly more to adviser failures is particularly problematic. 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 between all providers and intermediaries are invalid 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

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

13. 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.

14. We are obliged to the FCA policy team for inviting us to talk further about the specific issues for our members, and also for requesting data which has provided some very helpful reassurance on the particular impact of the proposals on our members. Indeed, as explained above, as many of our members have permissions as intermediaries as well as providers, they may see an overall slight reduction in levy. These calculations indicate that for the average AFM member, FSCS levies for 2016/17would be £22,100 on the proposed basis, slightly reduced from £22,200 on the current basis (including PRA and FCA class contributions).

15. We welcome this outcome, though we anticipate there will be some exceptions, such as providers that do not have intermediary permissions. Further, overall the costs- for small companies as all our members are- demonstrate that the funding of FSCS remains very high, and that notwithstanding these proposals, there is still likely to be scope to improve cost efficiency.

16. 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

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 it 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 remain concerned that there is an absence of a compelling case for this proposal, and that, as described in our cover letter, the position taken by the FCA Board has not been properly established.

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 (relating to Keydata claims) 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- say- 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 offered a compelling rationale for why the investment provider class should benefit from the retail pool, other than to simplify the design requirements.

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. In our assessment, FCA should retract its current view, and clearly state that insurance providers are recognised as a contributory class only, as per depositors.

As an alternative in relation to investment providers, we suggest FCA explores alternative solutions for rectifying potential anomalies between the revised funding classes. This might include treating investment providers like other providers, ie as contributors only, or to opt for a less simplistic mechanism, such as a graduated arrangement or higher floor before benefits are payable. More radically, where the benefits of deposit acceptor and insurance provider classes are delivered by the PRA, whilst the benefits for intermediary and investment provider classes are delivered in FCA's classes, the artificial nature of separating classes between PRA and FCA is exposed, and we suggest returning to an aligned system would resolve this.

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.)