



AIFA's response to CP 09/26 Regulatory fees and levies: policy proposals for 2010/11

The Association of Independent Financial Advisers (AIFA) is the representative body for the IFA profession. There are approximately 16,000 adviser firms that employ 128,000 people, and turnover is estimated at £6.5 billion (including £4.5 billion from life policies, £1 billion from fund management and £1 billion from mortgages and general insurance). Around 20% of the UK population regularly use an IFA, with c45% consulting one from time to time.

Membership is voluntary and IFAs currently account for around 70% of all financial services transactions in the UK (measured by value). As such, IFAs represent a leading force in the maintenance of a competitive and dynamic retail financial services market.

Introduction

We would like to thank FSA for facilitating a Trade Associations Briefing to discuss this consultation. It was a most informative and helpful meeting. As FSA is aware, the smallest directly authorised intermediary firms stand to pay reduced fees should FSA's proposals go ahead, the break-even point being roughly around firms with 5 Approved Persons (APs). However, larger firms will pay more to be regulated but without perceptible benefits to them or their clients. We would argue that this could lead to a degree of market disruption if such firms are forced to reorganise their proposition in order to meet an increase in regulatory fees. We would therefore have welcomed more in-depth analysis to accompany the proposals for increased transparency in the light of FSA's statutory objectives under FSMA 2000.

On top of the current difficulties caused by the recession and banking crisis, firms have incurred substantial costs complying with other regulatory initiatives such as TCF and the RDR. The new Prudential Rules for PIFs will impact significantly on some firms who are good regulatory citizens and who do not pose systemic risk. We would therefore urge FSA to take the wide view and consider fee policy changes in the light of other regulatory initiatives with which firms are currently engaged. If policy is now considered (not proven) to have been 'wrong', firms need to understand why.

Cost of regulation

We think an opportunity has been lost to examine the true cost of regulating the financial services community. The investment in on-line reporting facilities for firms has allowed FSA to collect good data cost-effectively and FSA now has a good record of firms' and sectors' histories and risk profiles. The fees regime governing principles (fair, risk-aligned, transparent, predictable, flexible, proportionate, legal) are to be welcomed. In the spirit of these principles, the strategic review should have borne in mind the absolute regulatory burden for firms. It is appreciated that concerns regarding value for money and accountability fell outside the scope of the review but the fees regime's governing principles would have provided an excellent guiding-light and we would have welcomed a review that took in the bigger picture.

Cost distribution

The cost burden incurred by smaller firms is disproportionate to the regulatory risk they present. They are paying too much for regulation. While banks account for 28.5% of FSA's 2009/10 annual funding requirement (AFR) the investment intermediary sector accounts for 16.5%. With the addition of Mortgage Intermediaries who account for another 2.7%, this means that the firms represented by AIFA and our sister trade body the Association of Mortgage Intermediaries (AMI) are generating 19.2% - almost one-fifth – of FSA's fees income. These firms do not present systemic risk. By comparison, the banking sector is paying remarkably little in fees and, according to Table 2.2 in the CP, not enough to cover the cost of the degree of regulation that is warranted by the systemic risk they present.

The manufacturing community – life companies and fund managers – are also paying disproportionately low fees (12.2% and 7.8% respectively) compared to intermediaries. FSA, in our view, must adjust its focus to where history tells us the risks are and apportion the cost of regulation accordingly. When the increased regulatory capital requirements are added to the picture for small firms (which in theory should lower their risk potential even further) we are not persuaded that FSA is taking sufficient account of risk-alignment.

We cannot therefore agree that the fee proposals are linked to risk and FSA activity.

Social Utility

The strategic review might also have considered the question of 'socially useful' activities in the light of the reference to the social utility of credit unions (4.17).

We agree that credit unions are socially useful but are eager to understand the criteria FSA uses to determine which firms are socially useful (does FSMA give a definition) and which are not.

Minimum fees

Our concern is that size is the only metric being used to define risk. If the cost of regulating small firms has decreased and hence the reduction in minimum fee, this is not explained or referred to in the CP. We do support the c£1,000 minimum fee and stress that firms will be planning and making decisions based on this figure; they can do little more than take their lead from FSA. The reference made to the final figure possibly being 'materially different' (1.32) contradicts the governing principle of 'predictability' so many firms will have an expectation that the minimum fee will not depart too far from the calculated approximation.

Compatibility

FSA rules relating to fees are excluded from the statutory requirement to conduct a Cost Benefit Analysis (CBA). We are nevertheless concerned that regulatory action is being considered without clear market failure having been identified; we do not believe that the onus should be on the industry to prove the *absence* of market failure. Annex 1 (para 14) refers to larger firms having a greater impact on FSA's statutory objectives. We cannot agree that size of firm is inevitably a more risky enterprise within the intermediary fee-blocks which do not share the same capacity for systemic risk as the banks in the A1 fee-block. In setting a fees policy, FSA should not ignore the significance of sector, before firm size, as specific sectors and models within sectors have been the cause of real detriment in recent years.

AIFA members and their clients are victims of the banking crisis, we would support whatever steps FSA deems it appropriate to take in order to mitigate the risk of reoccurrence. Our concern is the mapping across to other sectors, policy changes designed to fix problems with banks in the A1 sector.

'A' fee-block

Firms should pay the full costs of their authorisation (4.4) and we would question why FSA can envisage a situation where they believe it is unfair to charge firms the full cost of becoming authorised. A firm which cannot afford the cost is unlikely to weather the storm of a troubled market. We would like FSA to review this policy as, looking at the evidence, there are firms that have been allowed into the sector that have damaged the market's reputation because of this policy.

This ends up costing firms double – the cost of subsidising their authorisation and the reputational cost of them failing. We would also ask for clarification of the term ‘equally’ (4.5); does this mean all authorised firms divided by the number in the entire sector or based on those seeking authorisation by fee group or is there another measure?

Special Project fees

We are concerned that the regulatory cost-bar only seems to move upwards and believe that special project fees, (e.g. Payments Directive work) is a fair and appropriate way of ensuring regulatory fees are identifiable, accountable and in keeping with the Guiding Principles.

‘Straight-line’ recovery and economies of scale

The CP gives an historic view and we understand that when the rules were originally drafted, ‘moderation’ of the straight line recovery costs were not envisaged. FSA is to be commended on the way in which flexibility has been applied to the market. The application of rigid principles would not have served either the market or consumers well. It is expected that FSA would take into account the actual cost of regulating the firm in deciding its tariff.

FSA has made an exemption to the straight line recovery policy for deposit takers. Larger IFA firms should also qualify for an exemption because, following the argument that FSA is moving to straight line recovery because the market has changed and so have the risks (2.25), the risks posed by IFA firms to FSA’s statutory objectives have not only not changed but have actually reduced according to independent research by the ‘Trust Index’ compiled by the Financial Services Research Forum (FSRF)¹. Moreover, the higher capital requirements imposed on IFA firms mean that their risk profile should actually be perceived as having reduced.

Larger firms who are subject to the new ARROW approach should qualify for moderation because of the systems and controls that they have in place. Publication of premiums or discounts (2.28) is welcome and based on a solid rationale (5.3).

In our view, there are still economies of scale to be found in good, well structured and well managed large IFA firms and networks. Until the benefits of enhanced supervision are embedded and tangible, we would urge FSA to focus on the sectors where the risks actually are; mapping policy changes across in the way proposed could harm consumers. There is an assumption that all firms of the

¹ *Restoring Trust in Financial Services: Building on that which works*, AIFA, 2009

same size within a fee block take up the same level of resource and yet we see no evidence that this is the case.

We would like to have seen FSA produce some analysis and evidence as to why the economies of scale with regard to regulatory supervision are no longer deemed valid. Large firms are often asked to participate in thematic reviews which would indicate that economies of scale do exist. Larger does not inevitably mean higher impact and neither do all firms of equivalent size in the same fee block take up the same level of resource. A shift in FSA policy, in our view, warrants the presentation of evidence in support of the move irrespective of fees being exempt from the statutory requirement to produce a CBA. A model which shows how the introduction of the intensive supervisory approach mitigates the historic case for tapering-off fees for larger firms would have been helpful; in our view, the case for economies of scale stands and we are not persuaded of the need for change as no case has been made for it.

We cannot agree that the fees policy is targeted towards the most appropriate firms because good large firms who are meeting the needs of many consumers could be put to extra costs with no perceptible benefit for their clients by regulatory intervention and this cannot therefore meet any description of good regulation.

As always, change costs money and we would remind FSA that firms are operating during a recession while meeting the demands of the transitional RDR requirements and the concerns of other regulatory initiatives from both UK and Europe.

Regulatory Dividends

FSA's policy in setting fees should be risk-based and in-line with other FSA initiatives. We would also encourage FSA to use the tools at its disposal to reward firms that invest in their business and its people.

For example, regulatory dividends which could be linked to aspects of the RDR and could include altering FSA fees for advisers who are at or beyond QCF level 4. This would mitigate the costs of regulatory change for firms that have made the substantial effort to invest in their staff.

FSA could also consider other risk-weighted factors. Firms, whose advisers are voluntarily members of a professional body or a trade body, as evidenced by our sister association's (the Association of Mortgage Intermediaries) unblemished regulatory record, could legitimately require less direct regulatory scrutiny, which could again be reflected in FSA's risk profile and thus the firm's regulatory scrutiny.

AIFA strongly believes that no good firm should (and this is admittedly a worse case scenario) be put out of business by disproportionate regulatory intervention. The use of a more risk-based approach to fees policy would achieve a more equitable outcome for consumers and firms.

AIFA also believes that FSA should be aware of both the direction of travel of the Commission, and other areas of FSA work. For example, the Investment Compensation Scheme Directive explicitly insists on a risk-based approach to the levying of fees; this is then echoed in FSA's work on the FSCS Funding Model Review, which itself is considering the feasibility and role of risk-based tariffs, thus implying regulatory dividends, for some firms.

Transparency

We understand that the current minimum fee is based on the incremental cost of regulating the smallest firm and that anomalies within these costs have become apparent. We do not disagree that the new minimum fee, which will be used to recover specified regulatory costs, is an aid to transparency. With such increased transparency, however, comes greater accountability for FSA. When firms are aware that they are paying directly for specific functions, e.g. policing the perimeter, they will be better placed to hold FSA to account when firms who do gain authorisation and operate a flawed business model, sometimes over a number of years, fall over. Greater transparency will only be of benefit if it mitigates the risk of failures in the future; we perceive little value in transparency as an end in itself or as a driver of activity.

Execution only firms

We do not agree that execution-only firms are low risk (8.18). It is evidentially not the case.

Answers to specific questions

Q1: Do you agree with the inclusion of the regulatory function costs that we propose to recover through the new minimum fee?

The cost of the four functions specified and the number of firms available to meet these costs obviously fluctuates year on year and FSA will therefore need to be very clear should the minimum fee fluctuate significantly from year to year. It is helpful for firms to know exactly what they are paying for; although in practice they have been meeting the costs of these functions anyway but in a more opaque way.

Q2: Do you agree with our proposal to create an A0 fee-block into which all firms will contribute and the basis for calculating the new minimum fee?

We agree that the creation of an A0 fee-block will make clear what the minimum fee covers and why. However, we are aware that the new minimum fee amount will be based on FSA's 2010/11 budget and the number of firms authorised at that time and that this could be a very different amount to the £1,000 approximated. This would not be in accord with FSA's governing principles for fees. We agree that incoming EEA firms and Treaty firms should pay the same fee as UK based firms.

Regulated firms, however, will be more concerned about the size of their total fees payable rather than how they are calculated.

Q3: Do you agree with our proposal to treat smaller Credit Unions as an exception allowing them to pay a reduced minimum fee and the unrecovered minimum regulatory costs be applied to A.1 fee-block?

Credit Unions provide security to those consumers who are otherwise financially disenfranchised. We agree that it is equitable for A1 firms to subsidise Credit Unions as they benefit, albeit indirectly, from the assistance given to this band of consumers.

Q4: Do you believe there are any other firms that should be treated as an exceptional case? If so what is the basis for making them an exception and recovering the unrecovered minimum regulatory costs?

No comment

Q5: Do you agree with our proposed adoption of a straight line recovery policy?

We agree that banks in the A1 sector should pay a 'premium' above the straight line in acknowledgement of the greater risk they pose to FSA's objectives and the UK economy.

However, the impact of this policy will be felt very keenly by larger firms in the A12-A13 (A18) (A19) fee-blocks who do not present a systemic risk and the cost in the long run, inevitably, will be met by consumers. We must therefore declare reservations to the adoption of a straight line recovery policy due to the impact on consumers as well as firms. We do not agree that size is the appropriate metric for FSA to use. We do not object to high risk firms paying more than low risk firms but to risk-profile firms according to size is too blunt an instrument.

FSA has made an exemption to the straight line recovery policy for deposit takers. Larger IFA firms should also qualify for an exemption because, following

the argument that FSA is moving to straight line recovery because the market has changed and so have the risks (2.25), the risks posed by IFA firms to FSA's statutory objectives have not only not changed but have actually reduced according to independent research by the 'Trust Index' compiled by the Financial Services Research Forum (FSRF)². Moreover, the higher capital requirements imposed on IFA firms mean that their risk profile should actually be perceived as having reduced.

Larger firms who are subject to the new ARROW approach should qualify for moderation because of the systems and controls that they have in place. Publication of premiums or discounts (2.28) is welcome and based on a solid rationale (5.3).

We would like to see regulatory dividends being applied to promote good regulatory behaviour and to enable FSA to focus resource more acutely in a risk-based manner.

Q6: Do you agree with our proposed moderation framework and its operation to accommodate exceptional moderation from a straight line recovery?

Yes.

Q7: Do you agree with our proposal to treat A.1 (Deposit acceptors) as an exception applying a premium to the top two tariff bands (higher impact firms)?

Yes.

Q8: Do you agree with our proposal to amend the rules in FEES 4 Annex 7R to clarify that the valuation date for market capitalisation is the last working day of November in the previous financial year?

No comment.

Q9: Do you agree that the separate formulae for MELs for banks and building societies in FEES 4 Annex 1 should be replaced by the single amended formula, derived from the Bank of England's BT return, as the tariff-base for 2010/11? (Responses required by 7 December 2009).

No comment.

Q10: Do you agree that the formula in Item B of the Bank of England's ELS return should from January 2010 replace the formula on MELs for banks

² *Restoring Trust in Financial Services: Building on that which works*, AIFA, 2009

and building societies set out in FEES 4 Annex 1, providing the tariff-base from 2011/12? (Responses required by 7 December 2009).

No comment.

Q11: Do you agree that our policy clarification makes it clear that, in FEES 4 Annex 9, our intention is to measure the volume of trades, not the number of trades, and that the relevant contracts are the total number of contracts included in all trades?

No comment.

Q12: Do you agree that our proposed Guidance clarifies the way life insurance firms should treat assets transferred under Part VII in the calculation of their tariff data in fee-block A.4?

No comment.

Q13: Do you agree that an income measure along the lines discussed in this CP is in principle viable as a tariff-base for fee-blocks A.12 – A.14?

FSA's proposal to change the tariff base from approved persons (APs) to income based is more straightforward for FSA than for firms and increases the potential for mistakes to be made, albeit unwittingly. The AP measure is simple and certain and has been easy for FSA to monitor and, importantly, to collect. This is particularly relevant to large members such as networks where there is a continual stream of new entrants and leavers. In any firm where the regulatory fees are passed on to Appointed Representative (AR) firms or individual advisers, the cost of allocating the fees proportionately on an income basis will be higher.

We understand that difficulties have been caused to the fees regime by the merging of the different customer functions into the CF30 category when MiFID was implemented. Firms that have been authorised since the implementation of MiFID have only ever had CF30s, so we wondered how the fees regime has overcome the obstacle of dealing with firms without a pre-MiFID history.

A switch to income-based fees will have the perverse effect of penalising efficient firms, who in many cases have invested in better back office support and compliance staff or systems. It is this investment that allows them to generate the higher income per capita. One could also argue that firms with these tighter controls require less regulatory attention.

FSA's risk-based approach to regulation, we would argue that it is the scope of activity that is more relevant to the cost of regulation than the volume. In any

event, the AP measure by its very nature creates a natural ceiling to the potential volume.

On balance, the AP measure is more cost-effective and equitable.

Q14: Do you consider that the issues we have discussed in the CP are appropriate and/or are there any others you believe we should take into account when considering an income measure for fee-blocks A.12 – A.14?

We calculate that fees for the larger networks could increase by 38% and the impact of this would be to prejudice severely small firms who are members of networks. We cannot see why, we estimate, that it would cost around £0.5m more to regulate 1600 small network-member firms than the same number of directly authorised firms.

Q15: Do you support our suggested timetable for implementing an income measure from 2012/13 in fee-blocks A.12 – A.14?

We agree that a well constructed timetable is needed for firms to adjust to an income-based measure, should it go ahead, and that 2012/13 is the very earliest year in which this should happen. Nevertheless, the proposals still mean a sharp rise in some firms' costs to be anticipated while firms continue to trade through a recession; it should be noted also that as the payment of regulatory fees is a fixed expenditure so this measure would also impact on firms' capital adequacy requirements now that the expenditure based requirement has been expanded to firms in the A12 and A13 fee blocks. The demands of the new capital adequacy requirements on their own are causing grave concerns to a significant number of AIFA members; the proposed changes in fees policy on top of this could cause market disruption. We would reiterate our concern for FSA not to view changes in fees policy in isolation but to consider the overall impact of these proposals with other regulator programmes and initiatives.