

AIFA response to Consultation Paper CP 10/5 Regulatory fees and levies 2010/11

1. Introduction

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.

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.

We would like to thank FSA for meeting with us and RGL Forensics to discuss some of the modelling and theory behind the allocation of fees and for your cooperation with RGL. We wished to present FSA with a robust, evidence-based and economically sound response and attach a copy of RGL's report with recommendations which we trust will form the basis of a fairer way forward.

2. Executive Summary

In presenting this response we wish to set out that we believe FSA should be appropriately funded for the work it must undertake to protect consumers. The banking crisis has highlighted the problems caused by weak supervision of systemically important firms and we would encourage FSA to learn the necessary lessons of this episode and apply them to the relevant sectors. However, we must assert that advisory business were not the cause of the banking crisis and indeed, given the restricted access to credit as a result of the crisis (and the increase in costs of accessing available credit) have suffered as much as other smaller UK businesses. It is folly to then ask these firms to pay more for further regulation because of problems that were caused elsewhere and which we were not party to. Further, we note that FSA's responsibilities have increased to include the regulation of "everyday banking" yet we surprised by how little impact this seems to have had on FSA's budget. We believe that FSA should focus its attentions on those organisation that present greatest risk – and accordingly reduce the regulatory burden on IFA profession.

Following their detailed analysis, RGL have identified fundamental problems with the methodologies the FSA employs to charge fees to Independent Financial Advisers (IFAs). Firstly, the cost allocation model has not developed to reflect the changing nature of the FSA's work and needs an overhaul. Secondly the cost allocation method used to calculate fees should allocate costs in a way that is proportionate, and in a way that promotes competition. Thirdly, the FSA needs to consider the cumulative impact of increasing costs associated with regulation (in particular, the Retail Distribution Review (RDR)).

Based on RGL's calculations, the cost allocation model used to allocate the FSA's costs can only allocate 50% of the FSA's costs directly to fee blocks (which reflect the FSA's 'permissions' classifications'). It is not clear what the remainder of the costs relate to and what amount, if any, should be allocated to the IFAs' fee blocks. The cost allocation model arbitrarily allocates these costs pro rata to direct costs with the effect that the IFAs' fees represent double the amount of costs directly related to them. The FSA needs to overhaul its cost allocation model so that it reasonably allocates its indirect costs to the right activities and firms.

Financial intermediaries represent a very small proportion of the financial sector regulated by the FSA, but advisory activities represent upwards of 28% of the FSA's total costs. The IFAs (who contribute around 55% of the total fees to the intermediary fee blocks) are, therefore, burdened with a disproportionate and unfair share of the costs of regulation. This unfair burden is harmful to consumers.

The FSA has statutory objectives under FSMA which state:

- Public awareness: promoting public understanding of the financial system; and,
- Consumer protection: securing the appropriate degree of protection for consumers.

Under FSMA, FSA is required to have regard to 'principles of good regulation' and this includes:

- "The need to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate"

In order to achieve these objectives, the FSA should reduce the current unfair burden of regulatory fees amongst the financial sector on IFA firms and, in particular, consider the affordability of fees in the context of the entire value chain of products and timing issues in their affordability.

3. AIFA's Recommendations To FSA

This section is taken from RGL's report (see Appendix 1) and is underpinned by the detailed analysis contained in the report.

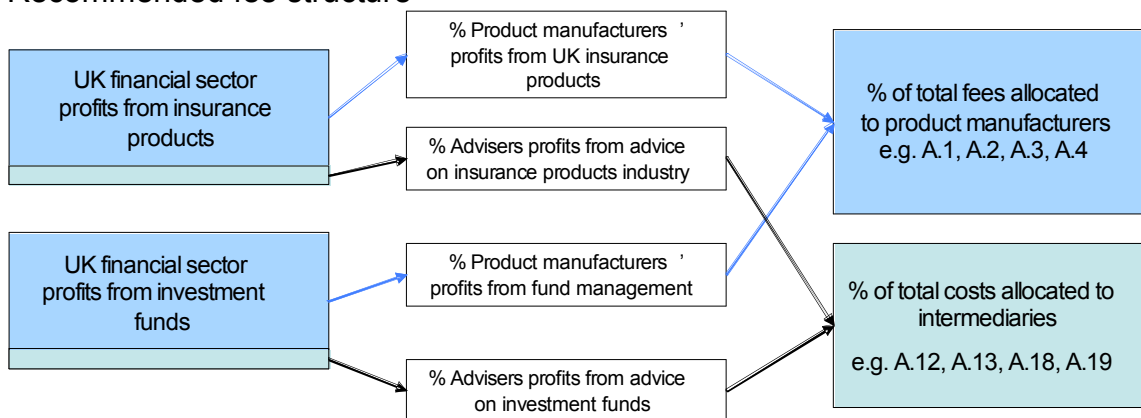
The existing methodology either does not or only weakly complies with RGL's proposed principles of cost allocation and fee calculation (these principles are set out in their report, see Appendix 1, and are drawn from a comparison of how other regulatory authorities approach these matters). RGL set out two recommendations with the aim of improving the way in which the current structure allocates fees.

1. Adjusted fee block system

One option is to retain a similar fee block structure but to adjust it in line with the principles proposed in RGL's report (See Appendix 1).

Under this regime, advice activities would pay an amount proportionate to their share of the revenues from different financial products e.g. investment products, insurance products etc. Revenues could be used as a proxy for profitability as profit data can have interpretation issues.

Recommended fee structure



Source: RGL analysis

As RGL has not been able to obtain adequate data to conduct this analysis (although they note that the FSA do collect turnover data for regulatory purposes), they calculated a range of estimates of the IFA revenues as a proportion of revenues in the UK financial sector. RGL recognise that the revenues are not robust estimates and note that the assumption that revenues are a proxy for profitability may need to be adjusted to reflect the business models of different firms (for example fund managers may earn annual management fees on the total amount under management but advisers take commission on annual premiums or fees for one off advice.)

In calculating estimates, RGL assumed the following:

- IFAs earn, on average, around 5.6%¹ commission on financial products. This is inclusive of trail commission.
- IFAs are involved in between 25% (low estimate) and 50% (high estimate) of consumption of financial products in the entire financial system (i.e. investment products pensions, current accounts, savings accounts, mortgages etc.)

Under these assumptions, RGL have calculated the following range:

Table 1 Range of fees payable by IFAs

% of all financial products sold by IFAs	25%	35%	50%
Average commission	5.6%	5.6%	5.6%
Revenues of sector	1.4%	2%	2.8%
Fees (£m)	6.4	9.1	12.7

Source: RGL analysis

RGL calculated a range of between 1.4% and 2.8% as a reasonable approximation of IFAs revenues as a proportion of the total revenues of the UK financial sector. Under these assumptions, IFAs should be paying between £6.4m and £12.7m (as opposed to the £70m that is currently expected of them).

Under this regime, a large part of the cost of regulating the risk in the financial services industry would be aligned with the source of the risk that is being regulated – the financial products.

2. A pragmatic solution for 2010/11

We maintain that the fee block structure as it currently stands requires a comprehensive overhaul and this should be done as soon as possible. However, we also recognise that the first recommendation represents a significant amount of work which may not be possible before the fees are due to be imposed later this year.

RGL make a second recommendation, therefore, to be used as a stop gap for 2010/11 until a more robust system is constructed. This is to reallocate indirect costs in a way which is more reflective of the principles of fee calculation.

¹ FSA estimate of average commission paid to IFAs per sale of pension; sourced from FSA PS 10/06: 'Distribution of retail investments: Delivering the RDR', March 2010, p A1:10

It is suggested that an approach which takes into account the distribution of benefits, where fees are set based on directly allocated costs plus an allocation of the indirect costs and overheads which is proportionate to profitability. Measuring profitability presents numerous practical problems and, therefore, a proxy is needed. For the purposes of allocating costs, revenues provide a useful proxy for profitability.

Due to an absence of data, RGL have used a high (6%) and low estimation (2%) of the revenues of IFAs as a proportion of the total industry earnings. In the table below RGL have set out their calculation of fees on this basis. RGL have included in the total fees to the four fee blocks an allocation of the fee block A.0. Their proportions of Direct, Indirect and Overhead costs are taken from their calculations set out in their report (see Appendix 1).

Reallocation of indirect costs

Cost category	Proportion	A.12	A.13	A.18	A.19	Total
	%	£m	£m	£m	£m	£m
Total fee for 2010/11 as per CP10/5		27.11	43.97	17.93	38.71	127.71
Direct cost	31%	8.44	13.69	5.58	12.05	39.75
Indirect cost	31%	8.44	13.69	5.58	12.05	39.75
Overheads	38%	10.23	16.60	6.77	14.61	48.21
Total Indirect and overheads		18.67	30.28	12.35	26.66	87.96
Proportion to allocate of indirect and overheads (High)		6%	6%	6%	6%	
Total Indirect and overheads allocated (High)		1.12	1.82	0.74	1.60	5.28
Proportion to allocate of indirect and overheads (Low)		2%	2%	2%	2%	
Total Indirect and overheads allocated (Low)		0.37	0.61	0.25	0.53	1.76
Total allocated (High)		9.56	15.50	6.32	13.65	45.03
Total allocated (Low)		8.81	14.29	5.83	12.58	41.51

Source: RGL analysis

On this basis RGL calculate that the fees that should be paid by fee blocks A.12, A.13, A.18 and A.19 are between £41.5m and £45m.

In the table below, RGL have calculated the costs to IFAs which are implied by these figures using information sent to them by the FSA:

Proposed fees to intermediaries

Cost category	A.12	A.13	A.18	A.19	Total
	£m	£m	£m	£m	£m
Total fee for 2010/11 as per CP10/5	27.11	43.97	17.93	38.71	127.71
% apportioned to intermediaries	2%	70%	48%	77%	55%
Total fee for 2010/11 to intermediaries	0.54	30.78	8.60	29.81	69.73
Total allocated to IFAs (High)	0.19	10.85	3.03	10.51	24.59
Total allocated to IFAs (Low)	0.18	10.00	2.80	9.69	22.67

Source: Information from FSA, RGL analysis

The above table points to a range of between £24.6m and £22.7m which should be payable by intermediary firms (as opposed to the £69.7m currently levied.)

RGL have set out below our assessment of this methodology in line with their principles of cost allocation (see Appendix 1).

Appendix 1 contains RGL's full report with the detail behind this response. We would welcome an opportunity to discuss this new approach with FSA. We firmly believe that FSA should adopt these recommendations as they deliver a more economically sound, and fairer, outcome for regulated firms.

3. Background Issues

The current fee structure dates back to 2001. Since then, the industry and regulation have changed fundamentally and, as Lord Turner has recognised, high impact firms must pay more. Intermediaries present little by way of systemic risk but now meet 20% of FSA's annual funding requirement (AFR) compared to the Banks 28% and the life companies 11%. It is now time for FSA to modernise and overhaul its fee structure. This must start with changing the basis for calculating IFAs' fees. We have identified fundamental problems with the current system and we call on FSA to review it:

- The cost allocation model has not developed to reflect the changing nature of FSA's work and urgently requires an overhaul. It is delivering poor outcomes for the firms who meet the regulator's fees.
- The cost allocation method used to calculate fees should allocate costs in a way that reflects the entire value chain and the "lifetime earnings" on a financial services product.
- FSA needs to consider the entire regulatory fee burden being levied on IFAs. Fees are just part of the regulatory costs jigsaw, which includes not just the RDR but also increased capital adequacy requirements, increased PII requirements and other regulatory costs which are forcing a radical overhaul of IFA business models at a time of economic uncertainty and upheaval.

The cost allocation model in use can only allocate 50% of costs directly to the fee blocks (these reflect FSA's permissions classifications).

It is not clear what the remainder relates to and what amount, if any, should be allocated to the IFA sector's fee blocks. The cost allocation model arbitrarily allocates these costs pro rata to direct costs with the effect that IFAs' fees represent double the amount of costs directly related to them. This must now be recognised as a historic anomaly which, in the interests of natural justice and sound principles of good regulation, must be corrected. We would therefore urge FSA to revamp the cost allocation model so that it more reasonably allocates the 50% of its indirect costs to the right activities and firms.

IFAs net revenues represent only a small proportion of the revenues of the financial markets regulated by FSA. However, advisory activities represent some 28% of FSA's total costs. IFAs are therefore burdened with a disproportionate share of the costs of regulation. It is now time for costs to be allocated in a manner which reflects the entire value chain and the "lifetime earnings" of an investment or other regulated financial services product.

Under FSMA, FSA is required to have regard to 'principles of good regulation' and this includes:

"The need to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate"²

This principle covers avoiding unnecessary regulatory barriers to entry, business expansion or the financial soundness of firms. In order to achieve this, FSA must reduce the current unfair burden of intermediaries' regulatory fees and, in particular, consider the affordability of fees so that consumers can continue to gain access to advice when they want it at a fair cost.

A key objective of the RDR is to move to adviser charging. However, by recovering a disproportionate amount of the costs of regulating the industry at point-of-sale, FSA is increasing the cost of advice and this is inevitably met by consumers. A fairer allocation will better enable consumers to access (and benefit from) regulated advice.

4. Social good and the 'value chain'

We do share FSA's view that it is appropriate for banks to subsidise the cost of regulating credit unions because of the social good they provide. Banks agree to do this because they can see how the function of credit unions assists their own role on the high street. We would add, though, that research shows access to advice improves consumer outcomes, and that this should be reflected in the level of fees they are asked to pay.

A Financial Services 'Trust Index' produced by the University of Nottingham on behalf of the Financial Services Research Forum (FSRF) found that

"Several research sources confirm IFAs are consistently the most trusted of all FSIs, both in terms of people trusting them to operate efficiently in their sector, as well as trusting them to have their best interests at heart. This trust in IFAs has increased over the past 5 years, despite the economic turmoil and challenges of

² <http://www.fsa.gov.uk/Pages/About/Aims/Principles/index.shtml>

recent times. However, the same cannot be said for other FSIs who have seen their levels of trust not only remain low, but in some cases decline even further”.³

IFA firms are meeting the cost of failed or toxic products which should in all fairness be shared with fee blocks A4 (life insurers) and A7 (fund managers) in particular. They also bear a disproportionately large portion of FSA’s AFR; 16.5% for A12 and A13 fee blocks compared with 12.2% for fee block A4. If social good is to be identified and accepted as a key regulatory driver, and we are persuaded of the case for this even though FSMA has nothing to say on the subject, then the burden of regulatory costs should surely be allocated further along the value chain, rather than just at point-of-sale.

5. Economies of scale

The thrust of the modern financial services marketplace is towards cost-efficiency and economy of scale. Regulation and increasing levels of customer awareness have led to significant reductions in charges and profit margins on each product and this has been to the benefit of consumers.

The reality of the increasingly efficient market that regulation has helped bring about should be mirrored in the cost of its regulation. The move to straight line recovery we believe risks diminishing firms’ potential to bring about ever-greater efficiencies and build on those that regulation and consumer pressure have helped bring about. Although this is a 2 and not a 3-star CP, consumers would inevitably suffer should some of the most efficient firms be forced to try to maintain current levels of service within more straitened circumstances.

We would urge FSA to consider risk metrics other than size. Large firms and networks in particular will see their regulatory costs rise despite their risk profile remaining unchanged. Networks will be obliged to pass on costs to their appointed representatives (ARs) who could subsequently find themselves at a competitive disadvantage with directly authorised firms of a similar size. This is an obvious competitive distortion in the market – and one that could not go unchallenged. The evidence of economies of scale can be seen in the on-line library of historic data on firms and sectors that has been collected via electronic returns. FSA should focus on the areas where the risks actually are until the benefits of the enhanced supervision programme are embedded and tangible. The assumption that all firms of the same size within a fee-block take up the same level of resource and present an identical risk is misplaced and could impact adversely, albeit unwittingly, on consumer outcomes.

6. Budget Process

³ *Restoring Trust in Financial Services: Build on that which works*, AIFA, 2008.

The budget process within FSA is not subject to a formal cost / benefit analysis. Rather a “top level” review is conducted in accordance with the Better Regulation Principles. However, we do not believe this to be sufficient for a budget now approaching half-a-billion pounds.

We therefore welcomed the announcement made last December that the National Audit Office (NAO) will review FSA’s budgetary process and conduct a yearly audit. Given the significant concerns raised in this response, we believe FSA should immediately ask NAO to review its budget process before proceeding with its proposed fee increases.

Questions

Q1: Do you have any comments on the proposed 2010/11 FSA fee rates for authorised firms and the premium applied to the rates in A1 (deposit acceptors fee-block)?

No

Q2: Do you agree with the proposal to treat smaller non-directive friendly societies as an exception allowing them to pay a reduced minimum fee and the unrecovered minimum regulatory costs be applied to A.4 (insurers – life) fee-block

No

Q3: Do you have any comments on the proposed 2010/11 FSA fee rates for fee-payers other than authorised firms?

Our concern is that fee-payers other than authorised firms meet the cost of their own regulation.

Q4: Do you agree with the proposed change to FEES 3, Annex 5, Part 2, Category 2 to reduce the fee for vetting equity registration documents to £3,520?

No comment

Q5: Do you support our proposals for the new FEES 7 chapter?

We fully support the principle of financial education and welcome the opportunity to discuss whether a new FEES chapter is the right way to meet the desired outcome of a better financially-educated populace. Until recently, unsustainably

high levels of personal debt were being encouraged. The consequences of this for those who have been hit hard by the recession and have perhaps lost jobs, are threatened with repossession of their homes and so on, are widely known. The lesson that now needs to be learned is that people must be encouraged (shown how if necessary) to live within their means and this will require a complete cultural sea-change. Credit needs to be no longer considered a mark of confidence in the future but recognised as a debt which must be repaid at a future date regardless of personal circumstances at that time. We completely support efforts to bring this change about; regulation can help 'nudge' people towards the right behaviours – helping them to help themselves – but new regulation alone cannot 'force' people to act more responsibly.

The Financial Services Bill was passed by Parliament on 8th April and a new Consumer Financial Education Body (CFEB) was established (albeit with amendment from original form of the Bill). Although this CP is concerned with that part of the CFEB's annual budget that is funded by 'fees raised from firms authorised under FSMA' it is important to consider proportionality; the proportion paid by authorised firms compared with

- "Public funds and dormant accounts, and
- Relevant consumer credit firms through the levies they pay to the OFT"

is a sensitive issue, particularly as the regulatory burden on firms is now higher than it has ever been and that firms are operating in economically difficult times. The CP refers to FSA contributing £32.9 million to the Financial Capability 2010/11 budget of £45.4 million but it is more correct to say that FSA *authorised firms* are making this contribution. 72% is a significant contribution by the industry. We therefore think it appropriate that CFEB's annual budget is subject to scrutiny discrete from the FSA approval that will be needed. We would like the scrutiny process to involve representatives of A-block fee-payers as the sign-off process as proposed is too remote from those who will actually have to pay the levies.

Consumers who use IFAs do receive a measure of financial education via their relationships with them. IFAs are also making a significant contribution to financial education through pro bono work with the general public as well as with their own client banks. For these reasons, their contribution to the Financial Capability programme must be proportionate and bear in mind the role they are currently playing in improving consumer outcomes.

The success or otherwise of CFEB will be difficult to measure but, nevertheless, it must be an accountable body and demonstrate value-for-money. We would like to know, therefore, how CFEB's objectives are to be measured and in particular the obligation in FEES 7.1.3 G to enhance

- “The understanding and knowledge of members of the public of financial matters (including the UK financial system); and
- The ability of members of the public to manage their own financial affairs.”
(*i.e., live within their means*).

These are noble intentions which we do support, but if money is being levied, they must be more than this; there must be measurable objectives and this involves setting out clearly how CFEB’s success will be identified and measured. CFEB must be accountable to those who fund it if it is to have credibility.

FEES 7 may be a step towards meeting CFEB’s objectives, but it should be kept under review (we would suggest regular NAO reviews). Its application should be proportionate as should the contributions made by all its ‘sponsors’.

Q6: Do you agree with our proposed £10 minimum levy for financial capability work/Consumer Finance Education Body?

We do not agree with the proposal. This should be a voluntary levy that firms can choose to opt out of if they wish. Firms with corporate social responsibility (CSR) budgets can use these to meet their contribution but otherwise, this will be seen as effectively a tax on all firms. FSA should, rather, encourage participation by emphasising the future benefits to be accrued to firms via the work of CFEB.

The proposed application of levies to activity group is uneven; for example the fixed sum levy payable by A12 firms is £31.57 per person whereas for A13 firms, it is £101.32.

The proposed minimum levy may be a starting point but while a sole trader A13 IFA will pay £10 only, a two-person firm will pay £10+£101.32 which is an incongruously large step. The notional minimum levy, if applied, should be £10 as proposed (it would be unfair to vary from this as firms can only plan on the basis of FSA’s proposals) spread across a wider range of firms until the CFEB is up and running and fee-payers know what *activities* are being funded and how these are being costed.

Q7: Do you agree with our proposed levies on periodic fees to recover the costs of financial capability work/Consumer Finance Education Body?

No. The overall burden of regulation is increasing exponentially and FSA cannot expect industry to bear above inflation linked increases

Q8: Do you agree that we should apply to CFEB the same discounts that we apply to FSA fees, apart from the discounts on financial penalties?

Yes.

Q9: Do you agree with the changes we are proposing to the way the IMAP SPF will be charged in 2010/11?

No comment.

Q10: Do you have any comments on the proposed non-IMAP SPF for the period 2010/11?

No comment.

Q11: Do you agree that our proposed amendment to FEES4 Annex 2 Part 5 reflects the criteria set out in paragraph 9.23 of this CP and the requirements of the Solvency II Directive?

No comment.

Q12: Do you agree with our proposal to reduce the discount offered on the variable periodic fees charged to inward-passporting EEA and Treaty firms in fee-block A.1 from 80% to 50%?

Our concern is that the cost of regulating these firms is met by them and reflects the full cost of FSA's work.

Q13: Do you agree with our proposal to reduce the discount offered on the variable periodic fees charged to inward-passporting EEA and Treaty firms in fee-block A.3 from 100% to 90%?

Our concern is that the cost of regulating these firms is met by them and reflects the full cost of FSA's work.

Q14: Do you agree with our proposal to offer a discount of 40% on the variable periodic fees charged to inward-passporting EEA fee-paying payment institutions in fee-blocks G.2 and G.3?

Our concern is that the full cost of regulating the COB of all passported-in payment institutions providing payment services in the UK is met by those firms in full.

Q15: Do you agree that the amendments we propose to insert into FEES 4 Annex 9 make our definition of the tariff base clear and unambiguous?

No comment.

Q16: Do you agree with our proposed glossary definition of securities derivative?

No comment.

Q17: Do you agree with our proposals for recovering the costs of setting up the regulatory regime for reclaim funds?

No comment.

Q18: Do you have any comments on the proposed 2010/11 FSCS management expenses levy limit figure?

Please see our earlier response to this question.

Q19: Do you have any comments on the proposed 2010/11 FOS general levy rates?

We are pleased to see that the percentage of FOS's total funding raised via case fees is on the increase, thus reducing the amount raised by levy. Applying the greater share of cost to those firms that pay case fees is a fairer method of funding the industry-wide service.

As the number of complaints against IFAs continues to fall, the freeze on the case fee is welcome news at a time when the overall cost of regulation is on the increase. Retaining the number of free cases at three for each firm is also positive; this effectively means that the vast majority of AIFA members will not incur case fees at all as, on the whole, they receive very few complaints.

We have raised the issue of the treatment of networks with FOS. As FSA is aware, effectively network appointed representatives (ARs) are a group of small firms working under one umbrella. ARs hold the same range of legal statuses as other directly authorised firms; sole trader, limited company etc, and pay the same levy per individual. They are, however, penalised as the network as a whole benefits from only three free cases a year. As the number of complaints received by FOS against networks is still relatively low compared to other parts of financial services, with only one network featuring in FOS's published complaints data, it would be interesting to see how extending free cases to ARs would affect FOS's overall funding model. We have already asked FOS to give consideration to this point.

Although we appreciate that complicated funding structures are difficult to implement, we have put the case to FOS for a "no wrong doing, no fee" applied to cases found in favour of the firm. IFAs represent a small percentage of complaints at FOS and the majority of those investigated are not upheld. The monetary and time resource cost of handling a complaint both in house and when presented to FOS, can be significant for small firms. Although only a small number of firms will be affected, we have said to FOS that in these

circumstances, reducing or even eliminating the case fee if a complaint is not upheld would be a welcome step.