

20 June 2007

Siân Thomas  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London  
E14 5HS

Dear Siân

**Financial Services Compensation Scheme – Funding Review: CP07/5**

IMA represents the UK-based investment management industry<sup>1</sup>. We welcome the opportunity to consider and respond to the FSA's proposals. Please find attached our response to the questions raised in CP07/5.

We are particularly concerned about the increase in cross-subsidy that is envisaged within these proposals, creating new contingent risks for firms, risks over which they have no control.

We are also concerned about the proposal to extend the forward view from 12 to 24 months. Our experience of this in the recent past has been that it is not possible to project that far forward with any accuracy, whether to the level of likely compensation, to the correct fee block or to the timing that compensation funds need to be available.

I trust that this response is self-explanatory but please do contact me if you would like clarification on any of the points in this letter, or if you would like to discuss any issues further.

Yours sincerely,

Angus Milne  
Senior Adviser, Retail Distribution

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<sup>1</sup> Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of nearly £3 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our members represent 99% of funds under management in UK-authorized investment funds (i.e. unit trusts and open-ended investment companies).

## **Appendix: Responses to FSA Questions.**

### **1. Do you have any comments on our analysis of the impact of our proposals in light of our principles of good regulation and our statutory objectives as described in the compatibility statement in Annex 2?**

We support the existence of the FSCS, and concur that it does have a part to play in maintaining market confidence. However, the statement in para. 2.11 that these proposals provide "*a better way of ensuring that the scheme is adequately funded than, for example, requiring the FSCS to borrow funds secured against future levies to pay eligible claims*" does not appear to have any supporting evidence in this document. This option should be further considered. Assuming that we accept the key identified risk, that "*the financial capacity of the scheme may be insufficient in the event of a significant failure*", it may be feasible to make provision for some compulsory levy in unaffected contribution groups in the forms of a loan to cover the peak of a failure in one other contribution group.

Such an arrangement would minimise the change in the extent of cross-subsidy, so reducing any adverse effect on competition (para.2.16).

There remains the concern expressed for the financial advisory sector, but we remain of the opinion that a remedy for this problem can be achieved without wholesale change of the type proposed.

### **2. Do our proposals strike the right balance between the various conflicting interests when applying the principle in section 213(5) of FSMA and having regard to the statutory objectives to which we have referred?**

We accept that, under s213(5), the FSA does have the ability to build in a degree of cross-subsidy. The legislation suggests that this should be kept to a minimum, and it is not clear that this has been fully taken on board; that proposals that may be less far-reaching in the scope may resolve the problems, and involve less increase in cross-subsidy.

## **The proposed model**

### **3. Are these proposals for the intermediation sub-classes appropriate?**

We have no fundamental objection to the Investment Class, with an Intermediary sub-class. The important issue then is the threshold (£430m) and the methodology involved in how this is split between the two sub-groups.

### **4. Do you agree with the special case, and the treatment, we propose for credit unions?**

We have no comment to make on this.

### **5. Do you agree that the home finance provision sub-class should be excluded from the general retail pool?**

We have no comment to make on this.

**6. Do you have any comments about the proposed model?**

We have significant concerns about the introduction of the General Retail Pool. We consider that there is considerable cross-subsidy already within the Investment Class, with a broad selection of business models. Firms within the sector do not necessarily see the broad affinity of interest upon which you base that decision. However, to then extend that concept to the whole retail sector removes any extent of "affinity of interest", and introduces potential contingent liabilities on to firms, creating risks for firms that they are powerless to mitigate.

Therefore, we do not support this Proposal.

**7. Do you agree with our proposed mapping of the existing contribution groups to the new structure?**

We have no issues with the proposal mapping per se, but this increases the relative significance of the tariff basis.

**8. Do you agree with the constitution of the proposed life and pensions intermediation sub-class?**

We agree that "investment" and "insurance" should be kept as separate contribution groups. Beyond that, we have no comment on the structures of the Insurance Class.

**9. Do you agree with the constitution of the proposed investment fund management sub-class?**

While we accept that a degree of synergy exists between the firms in the proposed investment fund management sub-class, the range of activities, types of fund management being undertaken, and likelihood of an eligible claim arising differ enormously between the various entities.

However, if change is to happen, and the number of contribution groups to be reduced, then these proposals are likely to be seen as a reasonable compromise. As stated previously, greater attention then falls onto the tariff basis.

**10. Do you agree with the constitution of the proposed investment intermediation sub-class?**

We have no additional comment about the creation or make-up of the investment intermediaries sub-class.

**11. Do you have any comments on our proposal to continue the existing arrangement in respect of claims relating to the intermediation of pure protection policies?**

We have no comment.

**12. Do you have any comments about our proposal to discontinue the A16 contribution group and for any future compensation costs to be paid for by the life and pensions intermediation sub-class?**

We have no comment.

**13. Do you think that the proposed levy raising structure is appropriate?**

We refer you to our response to Q.6. Similar objections would apply to the introduction of the wholesale pool.

**14. Do you agree with the proposal to give the FSCS discretion to levy up to a 24 months period, provided that this would not lead to a threshold being reached?**

We see no justification for this change. The FSCS already has the power to raise levies at any additional point during the year, and this should be sufficient. Our own sector has specific experience of an attempt to look forward. It was suggested, in January 2005, that a levy of £27m may be necessary for fee block A7 (fund managers). We managed to persuade FSCS at the time that this was premature. We are now over two years further along, and no levy has yet been necessary. Further, although it is foreseen that some levy may indeed be required before the end of 2007, FSCS has chosen to raise this via an interim levy nearer the time than as part of the annual levy. We should also point out that the compensation will fall to be met by fee block A9 (CIS operators), rather than A7 as originally suggested, which emphasises how difficult it is to look further into the distance with any accuracy.

**15. Do you agree that the last level of contributor should receive the first benefits of any recoveries made?**

We agree with the proposal – with the proviso of our concerns re the general pool.

**16. The costs of implementing the proposed model are discussed in the cost benefit analysis in Annex 1. Do you broadly agree with the conclusion we have reached in Annex 1?**

We broadly agree with the conclusion reached in Annex 1. However, the proposed general retail pool will introduce a new contingent risk for firms. Further, the introduction of this pool would be of particular concern to those firms who undertake both retail and institutional business. These firms currently contribute on the basis of total FUM, while a proportion of that business could not be subject to a claim. This part of the firm's business would not, therefore, meet the design principles.

We note that it is proposed that the tariff basis is considered further as part of the consultation on the wholesale pool. There does, though, appear to be a danger that no changes are made subsequently, providing an additional burden for these firms. However, any such change should be subject to normal consultative process. In the event of changes to the tariff data being implemented, we would suggest that some transitional provisions should also be created. Some firms would experience significant differences (increases and decreases) in their contributions.

## **Wholesale pool – discussion**

### **17. Do you have any practical suggestions for an appropriate tariff measure for a potential wholesale pool?**

We have serious concerns about the introductions of a wholesale post, and the setting of an appropriate tariff is just one of the issues that require considerably more thought.

### **18. In addition to the issues set out in this chapter of the consultation paper, are there any other issues we should consider in formulating our proposals?**

We have no other issues to raise at this time.

## **Thresholds**

### **19. Do you agree that thresholds should be based on considerations of affordability?**

We agree that the thresholds should be based on considerations of affordability. It is also important that these thresholds are set sufficiently high that they are breached only as an extreme exception.

### **20. Do you agree that basing financial size on estimations of the total income generated by a sub-class is a reasonable approach?**

We agree that it is reasonable to base financial size on the income generated in a sub-class.

### **21. Do you have any suggestions on a more appropriate method of judging affordability and setting thresholds?**

We have no further suggestions.

### **22. Do you agree that it is reasonable to set different thresholds based on different percentages of threshold size depending on whether a firm is a provider or a firm carrying on intermediation activities?**

We suggest that there is no reason to set different levels of threshold simply because one party is the provider, and the other is an intermediary. However, it might be reasonable to create a differential on grounds of affordability.

### **23. Do you agree that the approach taken for the home finance provision sub-class is proportionate?**

We have no comment.

### **24. Do you agree that the approach taken and threshold proposed, for the credit union sub-class is appropriate?**

We have no comment.

**25 Do you agree that the thresholds should be reviewed every 3 years?**

We agree that it would be sensible to review these thresholds after 3 years.

**Tariff measures**

**26. Do you agree that eligible income is a fair measure of determining each firm's share of the FSCS levy in the intermediary sub-classes?**

We have no comment as to whether, for intermediaries, eligible income is a fair measure.

**27. Do you agree that insurers' contributions to the funding of the FSCS should be based on a firm's eligible portion of its mathematical reserves or gross technical liabilities, as well as premium income, to take account of possible claims against insurers with little or no new business?**

We have no comment.

**28. Do you agree that the same tariff measure should be applied to firms on the basis of the activities they undertake in any sub-class?**

We feel that the option of introducing risk-based discounts is being dismissed too easily. While accepting that it increases complexity and cost, it may change behaviour, and lead to a reduction in overall cost which would be beneficial to firms and improve public confidence.

**Other policy considerations**

**29. Do you agree that there is not a case for any further special cases?**

We have no suggestions for additional 'special cases'.

**30. Do you agree that pre-funding is not an appropriate method of funding the FSCS?**

We support the decision that pre-funding is not an appropriate method of funding for the FSCS.

**31. Do you agree that a product levy is not a viable option?**

We agree that a product levy is not a viable option for the reason set down in paragraph 7.13.

**32. Do you agree with our approach to insurance for the FSCS?**

We support the approach being taken.

**33. Do you agree with our approach to borrowing for the FSCS?**

We support the approach being taken.

**34. Do you agree with our approach to the treatment of CTFs and ISAs?**

We agree with the approach being taken.

**35. Do you agree that advising and arranging in relation to all personal pension schemes should fall within the remit of the life and pensions intermediation sub-class?**

We agree with the approach being taken.

**Transitional issues**

**36. Do you agree that the proposals for the financial clean break are proportionate?**

We agree with the proposals.

**37. Do you agree with the proposal not to allow changes to firms' tariff data if submitted more than 12 months previously?**

We agree with the proposals.

**38. Do you agree with the proposed 75%/25% split of the FSCS levy according to premium income and mathematical reserves/gross technical liabilities?**

We have no comment on these proposals.

**39. Do you agree that it is reasonable to levy advisory firms on the existing approved persons tariff measure and allow firms to notify the percentage of business they undertake in each subclass for the financial year 2008/09?**

We have no comment on these proposals.

**40. Do you agree that gross income is a reasonable tariff measure for the fund management sub-class for the financial year 2008/09?**

We consider that this is a reasonable basis for moving forward. As explained previously (Q.16) we believe that there are issues about gross income vs. gross eligible income that deserve further consideration.

**41. Do you agree that the approach taken for proprietary traders where they are also registered as an approved person is proportionate?**

We have no comment on this proposal.

**42. Do you agree that this approach is appropriate given the need to maintain costs at a reasonable level?**

We support this approach.