



**Libertatem's response and  
recommendations to  
the Financial Services  
Compensation Scheme Review**

**16 million into 6 million  
DOES NOT GO!**

## Mathematics for beginners: 16 million into 6 million does not go

Conceptually, FSCS is an extension of the Policyholders Protection Act (PPA), which existed to protect Insurance company customers if their company failed. The policies of the failed company would be adopted by one firm with any shortfall being paid for by all the other firms on a pro-rata basis to the business sold.

This worked because it created a huge client insurance cooperative where every client paid within their charging structures a small additional fee for this cover. Sadly, it was not an explicit charge but it was a charge nonetheless and, most importantly, all the potential claimants paid into the Scheme.

The basis of insurance is that the fortunate many will pay for the unfortunate few. But the current FSCS scheme, as applied to adviser clients, is the opposite.

### The PPA Approach had several benefits:

1. The exposure to claims in any one year was limited to the failures in that year.
2. Insurance companies had access to the client's money making administration easy
3. All firms paid pro rata so there was no anti-competitive element to the process.

### The current FSCS Scheme is the obverse of the PPA Approach.

1. Every additional year the FSCS runs creates is an additional year of exposure.

This is unending because of the failure of regulation to obey the Limitations Act 1980 (Longstop). Consequently, all advice given since the passing of the Financial Services Act in 1986 has the potential to be a claim. That means a potential 16m claimants The Heath Report 2.

2. The invoices for the FSCS are sent to the thousands of advisers who have no access to clients' funds. The numbers make this difficult to administer and presumes that the advisers can cope with the violent spikes in funding demands recently seen.
3. The current FSCS Levy is profoundly anti-competitive and is depressing the appetite for financial advice.

The real cost of FSCS is visited only upon those clients who are accessed advice in the current year (currently around 6 million per annum.<sup>1</sup>)

The average Libertatem member has an actual cost of the compensation of around 10% of the fees collected, with other direct regulatory costs amounting to another 5%.

4. In addition to the train of misadvised clients from no longer trading advisory firms, the FSCS has been increasingly used as a claims dumping area for regulatory failures. FOS seems happy to accept claims from clients who have been defrauded – such as Connaught – and are keen to find ways of blaming advisers for actions beyond their control and knowledge.

## The Numbers Do Not Match

Both Gfk and the *Heath Report 2* showed that 16m clients have used the IFA sector. Each one has a potential FSCS claim. However, thanks to the drop-in adviser numbers and, more importantly, the halving of client/adviser ratio, only six million clients will take financial advice this year and, by so doing, will pay the FSCS claims.<sup>2</sup>

We therefore have two conflicting trends. Claims can only go up as the years extend; and the clients receiving advice will continue to go down if, as expected, firms continue to rationalise their client banks.

**The only way this circle can be squared is for all 16 million to pay and that means introducing some form of product or investment levy.**

## Risk Rating FSCS Payments: A Red Herring

The current thinking appears to risk rate those advisers deemed to have done more risky business. Remember the quantum remains the same, as does the number of contributors(at least initially). But the distribution differs based on "Risk".

This creates the following problems:

### Scale:

The difference in "risk" rated firms and "safe" firms would have to be significant to make the idea viable. Indeed, if there was only a minimal number of "Risk" firms, or only a small premium for falling into that category, the process would not be worth doing and it would only be window dressing for the status quo .

1. *The Heath Report 2*  
2. *The Heath Report 2*

## How is the FSCS going to assess “Risk”?

Libertatem’s PI Broker informs us that a complex PI case can take three people two days to come up with a premium. **As those hit by the additional risk charge are likely to be that type of adviser, where exactly will the FSCS recruit the talent to do this fairly?**

## How long would risk rating firms work?

In the long term, how does a “risk” rated adviser firm de-risk its exposure? They cannot undo the advice given. The client may even be delighted with the advice received from the firm, but if FSCS says that firm is “risky”, the firm will be hit with a significant extra charge in perpetuity. The potential for unfair outcomes is huge.

The risk rated adviser firm will have two choices: Continue to trade with high PI and FSCS costs which run the risk of destabilising the firm and making that firm less competitive. Or simply shut the firm down now, in good order and with no claims outstanding, and either phoenix elsewhere or retire.

This will result in the sector having less advisory businesses contributing to an increasing FSCS pot and the costs for the “good” firms will go up. Exactly the opposite of what FAMR wanted to achieve.

Take this through to its logical conclusion and the firms deemed “risky” will probably be a short-term phenomenon as they are likely to shut down in the face of rising costs and loss of business.

## It will also be counterproductive:

When a firm shuts down, the administrator does not keep the paperwork for six years or in perpetuity as the FCA now demands. Instead, the paperwork can be destroyed within six months.

So, every legal firm currently operating in the PPI arena will focus their efforts on those ex-firms as they no longer exist and cannot defend themselves. The FSCS is almost guaranteed to find for the claimant when faced with a failed firm without evidence.

So, the surviving firms will see not only FSCS increases created by the macro pressures above, but also additional pressures created by risk rated firms leaving the market, creating extra claims in the process. That will inevitably lead to a spiral of decline.

## Risk Rating Firms simply will not work.

## The solution is quite simple

Libertatem understands that there was a round table meeting in June of this year. At that meeting, the FSCS management decided to exclude any concept of “product levy” from their funding review. In so doing, they shut down the only logical solution to the FSCS funding problem.

## This decision must be reversed.

The solution has been obvious to those working within the financial services industry for 30 years. The failure to deliver this solution appears to be primarily political because it gives those with access to client funds power over the regulation of those who do not namely the Professional Adviser. Once again, this is anti-competitive.

## Product Levy

The phrase “Product Levy” is unhelpful and has become shorthand for a wider charging scenario. It presumes that this year’s product sales will pay for this year’s FSCS charge. This is only marginally better than the status quo as such a charge on new products only would be a disincentive to obtain new advice. It is also the wrong nomenclature as advisers no longer sell products.

Within the phrase is a presumption that the product provider would absorb the cost of such a levy within their overall costs. This would be unfair on them and creates unnecessary conflict.

## The solution is obvious

Advisers accrue huge amounts of “Funds Under Advice”. They have no way of accessing these funds themselves, but platforms and other investment houses can. We need a discreet charge on all investments that have been introduced through the Independent sector.

It should be a clear and discreet charge, disclosed to the client through his platform or provider.

The benefits are:

- We return to the original PPA concept. Far more of the 16 million potential claimants will pay into the scheme. It may not be perfect, as a few claimants may be claiming on non-investment bearing advice, but it far better than the current 6m/16m split.
- There would very few payees in comparison with the

current scheme. It would be far easier to administer. The ABI already has the statistical split of business achieved via advisers versus other distributions for each of its members

- Such FSCS payments would not anti-competitive.
- It would be a great advance for transparency. Consumers should know the costs of compensation and regulation.
- Advisers would not face a sudden hiatus in cash flow.
- A huge political issue would cease to exist.
- The cost of advice could drop significantly, allowing more consumers to take advantage of proper professional advice – a FAMR proposal.

We acknowledge that such a discreet charge may require legislation, but that could be introduced either via a Finance Bill or by a wider reforming package that will need to happen post Brexit.

## Conclusion

When Libertatem contributed to FAMR, we made the point that HM Treasury and the various regulatory bodies had to avoid being distracted by the attraction of new distributions based on Robo-advice or “guidance”

The primary need was to firstly preserve and then extend the existing Professional Advice market. Moving the FSCS levy to a charge on investments would an excellent start and would represent “low hanging fruit”.

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