*Association of Mortgage Intermediaries' response to FCA DP21/5: Compensation Framework Review*

This response is submitted on behalf of the Association of Mortgage Intermediaries (AMI) and the Association of Finance Brokers (AFB). AMI is the trade association representing over 80% of UK mortgage intermediaries. AFB sits within AMI and represents second charge (formerly secured loan) brokers.

Intermediaries active in this market act on behalf of the consumer in selecting an appropriate lender and product to meet the individual consumer's mortgage requirements. AMI members also provide access to associated protection products. AFB members also provide access to unsecured products.

Our members are authorised and regulated by the Financial Conduct Authority (FCA) to carry out mortgage, insurance mediation and consumer credit activities. Firms range from sole traders through to national firms and networks, with thousands of advisers.

## Our view

We request the FCA's considers our comments in this section, alongside our response to the consultation questions.

As an industry we consider that the level of contemporaneous change being considered by the FCA to be visited on the industry as a significant challenge. To ask firms to finish embedding SM&CR; operate new ways of post-covid working; apply Operational Resilience measures; provide enhanced data for authorisations; complete ongoing Covid-19 financial resilience surveys; implement Consumer Duty as we are still completing the GI fair value work; review the AR regime and consider both the future regulatory framework and protect our customers from scams is applying a significant stress to trade bodies and the risk and compliance teams in firms who are all working on all of these projects. This will be added to by the work on Diversity and Inclusivity. We have yet to see the impact of SM&CR on distribution and FCA activity to measure how they consider the benefits of that fundamental shift have delivered the expected results.

It has been a challenge for a small trade body such as AMI to give adequate attention to the many interconnected consultations and implementations visited so close together. Accordingly, we may have missed some aspects that might need raising subsequently. The latest Regulatory Initiatives Grid acknowledged the burden, but we see no effort by the FCA to prioritise and address this.

The mortgage and protection advice and distribution sector does not recognise any of the harms that the FCA and others are citing to justify all these changes. Consumers in this sector have low inertia and the market is highly price and product competitive. It has low levels of complaints other than administrative, low FOS volumes, low FOS over-turn rates and one property scam through settled FSCS payments that is the majority of the sector costs.

AMI believes that the FSCS funding model needs a radical overhaul. It is not sustainable to levy large amounts for the retail pool levy at short notice upon firms who have no direct responsibility for or influence upon the areas in which the consumer harm is caused. We understand that the fee levy limits for each class are set to ensure that each class can tolerate the inevitable firm failure that will arise from this limit being reached, however, whether this has been extrapolated over a number of years to understand the cumulative effect that this will have on firms in each class is less clear, and we would welcome clarification on this.

Another principle needs to be re-assessed. Whilst FSCS must be a fund of last resort, two things need to have happened: a firm must have conducted itself so badly it has failed financially and it cannot meet its debts as they fall due and lacks liquidity. These are matters the PRA and FCA should be closer to than they have been historically. Then the firm also has to have either had toxic products or given bad advice. Again, these are supervisory matters.

AMI continues today to talk to our FCA contacts about firms and products and combinations of those that cause us concern. The time taken to "act" remains extended to a degree that means that consumers risk damage and firms may have to compensate. We are not convinced that the lessons of LC&F and Connaught are yet learnt or embedded. The FCA remains ponderous and out of touch with the markets it supervises. There are individuals within the FCA who recognise the risks, but claim both process and resource constraints limit their ability to act.

The funding of the compensation scheme needs a new approach. As a minimum, Treasury must allow FCA to retain all financial penalties to reduce the amount good firms are being asked to pay. The sequestration by Treasury was to avoid Banks that had created the 2007/8 financial crisis "benefiting" from the fines that were anticipated. This did not materialise, but HM Treasury has continued to benefit from other industry misdemeanours. We request that we return to the original "contract" with the industry so that the FSCS levy for the "innocent" is reduced by the fines on the "guilty". By making this change it would reduce the need for deeper structural change beyond a re-assessment of categories, limits and class inter-relationships.

The simplest solution to ensuring a more durable funding mechanism to compensate consumers would be a new product levy paid for by all consumers. This could follow the example set in the travel industry with ABTA and ATOL which is seen not as a tax on customers but as welcome insurance protection. We believe that the cost to the consumer would be circa 0.01% of their loan, which could be blended into the interest rate of the product taken by the consumer and collected by the product provider. Similarly, a fractional percentage of invested assets could be levied annually to provide consumer protection as delivered in the travel industry. This would also make it clear to consumers which products or services have "protection" and which do not. This would eliminate the uncertainty currently facing firms who know that a levy may be announced later in the year resulting in additional, higher invoices to compensate customers who have experienced harm in other sectors, unrelated to their own.

In previous reviews of the scheme the FSA and FCA have convened round-table review sessions with representatives of Treasury, PRA, FCA, FSCS, FOS and the main trade bodies to ensure that all possible avenues have been debated and assessed. These have previously been cited as exemplars of good regulatory consultation. Often these have seen as many as six rounds of debate to try to ensure optimum consensus on the outcomes. Ultimately Treasury, PRA and FCA will have to decide the best approach, but the significance they have on both consumers and the industry merits similar rigour on this occasion. Never has a review been as significant, therefore we consider that whilst this DP is an excellent starting point, face-to-face debate on the issues and potential solutions over the coming months is essential for us to achieve an outcome that the industry can fully support.

## Questions

**Q1: Do you consider that proposed principles 1 and 2 are the appropriate principles to underpin the design of the compensation framework (in relation to the aspects of the framework that the FCA is responsible for)?**

AMI does not think that we can commence this debate on such a first principle. Whilst at first read it is sensible and attractive, it requires a much deeper debate over the interaction of a range of interconnected aspects of the regulatory framework:

- Effective application of the authorisation process.
- Firms adhering to their granted permissions.
- The inter-relationship of capital and professional indemnity insurance.
- Timely and effective FCA supervision and enforcement.
- Timely and considered FOS decisioning.
- Purpose of the Scheme.

We do not consider that any of the current aspects of the regulatory infrastructure have been operating optimally therefore we are being asked to make decisions based on a flawed structure and performance.

The existence of the FSCS in its current guise does not inherently create any positive incentive for actors to perform better or worse. What it does however is create a position where consumers can use hindsight to recover funds lost for poor and/or risky decisions. Lawyers and CMC's can campaign to create liability where there is little chance of success but their activity creates significant overhead. This starts with DSAR activity which involves administrative costs with no specific complaint; having to register this with PII providers which creates open liability and increased premiums; implicit and explicit court claims rather than using the free FOS route; and use of loans and after the event (ATE) insurance which ensures the "lawyers" are paid but risks consumers enduring increased liability and harm.

The schemes as currently structured means that good actors work to adhere to the principles and rules, whilst bad actors ignore, obfuscate and avoid compliance. Upon failure the liability falls on those who continue to observe good outcomes and are vicariously penalised. This also damages the reputation of the industry.

Accordingly, whilst we can agree that "the FSCS is a fund of last resort and should not be the first line of defence for protecting customers of authorised firms from harm" this could be subject of further debate. The on-going issues with obtaining cost effective Professional Indemnity insurance (PII) makes this complex. Increasing excesses, exclusions on certain business lines and premiums which mean that some firms are effectively self-insuring merits deeper debate.

**Q2: What incentives, whether positive or negative, does the FSCS as a 'fund of last resort' create for market participants and what are the consequences of those incentives?**

The nature of the behaviour the "fund of last resort" drives is simply seen in the cash savings market. The last resort element does mean that consumers can place funds with riskier institutions, up to the cap, and receive higher rates of interest than other institutions can afford to pay. Those more stable, better capitalised, more risk averse firms cannot compete at that rate, pay less, but are inherently less likely to call on the scheme. However, if the higher risk firms fail, the lower risk firms have to bail out the depositors - a good consumer outcome, with unfair liability to better firms caused by the protection. This learned consumer behaviour is then replicated to other markets.

For good firms this acts as a penalty scheme over which they have limited control. The liability for "failures" rests too heavily on distribution rather than the product manufacturer. Within mortgages we have well-structured assessments by lenders over which distribution partner they are prepared to operate with. They also undertake on-going assessment of the quality of business submitted which can result in firms or individuals having their "franchise" removed. They will also provide structured data and feedback to distribution compliance teams to assist in their oversight of advisers. This structure is not replicated in other areas of the market and should be seen as a method to reduce poor conduct rather than leaving FSCS to pick up the pieces should distribution or product fail.

**Q3: Do you have any further suggestions on how to ensure the FSCS is not over relied on and represents a true 'fund of last resort'?**

When created, it was envisaged that FSCS was a protection for consumers where a firm failed financially due to more traditional issues – economic downturn; recession or issues in a particular geographic or market segment leading to firms' failures that might then lead to the need for compensation. What has evolved is that we see bad advice, scams and fraud through entities with or linked to authorised firms that following FCA or FOS action creates significant liability which then falls to the FSCS, as the firm held accountable cannot pay the compensation.

The history of PPI is of relevance. Lenders and insurers created a product with a premium that cross-subsidised cheap loans and provided a large income stream to lenders. Typically, a PPI premium would see 20% paid to the insurer and the "lender" taking the balance. If there was a distributor selling the MPPI/second charge/loan/charge card, then the distributor would receive 20% of the premium. In those cases, the distributor as adviser was wholly liable for the entire cost, plus interest as they were responsible for the advice. No distributor joined the lender or insurer in complaints that were escalated to FOS, as they were fearful of "action" by the lender to remove them from their "panel" if they did, so removing their current and future ability to earn. This was poor judgement, as events unfolded that the intermediary was then wholly liable – failed financially and the liability fell on the FSCS. The lender and insurer were insulated from the claims if there was a distributor. However, they were wholly responsible for the product construction, pricing and commission payments. Lenders were left to compensate if there was no distributor, but the insurers who made and priced the product were given immunity.

Consumer Duty is designed to address this asymmetry. However, it is too early to tell if this will be effective. More importantly it does not address the dominance that the manufacturer has in the process and still fails to fully isolate that the price setter should accept full liability in the event of complaint, failure and compensation. This may still fall on a distributor who is on skinny margins and is advising on whole of market to secure best price and terms.

We therefore consider that the 25% provider contribution to claims in the intermediary classes should be increased to 50%. This would ensure firstly that they take more responsibility for the products they market, but also who they market them through. It provides a proper shared liability in accordance with the policy objectives of Consumer Duty.

**Q4: Do you consider that a change in the scope of FSCS protection could be justified, whilst remaining in line with the proposed principles for protection at paragraph 2.2? If yes, please outline how and why you consider protection should be changed.**

From a mortgage and protection perspective we consider the scope to be fair. It is only the implications of the pooled risk and retail pool aspects that provide us with concerns.

Where a product is generated by an unregulated entity it should sit outside FSCS protection. Where it is brought to market by an authorised entity through advice then we can see why the consumer could feel the right to protection. Where the product is not advised on and the consumer has made their own choices, then it should sit outside. The complexity of the SIPP market where the SIPP provider is the catalyst for protection (not the product or the adviser) is tenuous, but the subject of legal review.

The Consumer Duty provisions cut across all of this, so until we see the final outcomes on that consultation it is difficult to judge fully.

**Q5: If you consider a change in the scope of FSCS protection could be justified, please set out the positive and negative implications of such a change in protection, for both consumers and the financial services sector more generally.**

See answer to Q4.

**Q6: Following the UK's withdrawal from the European Union, is the narrower territorial scope previously decided on for AIF and UCITS managers and CIS operators still appropriate? If not, what alternative options should we consider?**

As the mortgage intermediary trade body, we do not feel we are competent to comment on this technical issue.

**Q7: How can we make sure that consumers are provided with clear information about the availability of FSCS protection that equips the consumer to make effective and properly informed decisions about financial products and services, including those where FSCS protection is not available?**

All market participants should be required to always make clear in both their verbal and written disclosures whether or not both FOS and FSCS protection applies. The problem however is that good firms will be clear here and fraudsters or bad actors will obfuscate.

All firms using non-advised or execution only processes must be explicit about this. All parties in a transaction must be transparent over whether the protection is provided by them – so applicable to their funding class, or whether the protection is specific to only certain aspects.

Should we move to a product levy, then the application of the “levy badge” would give the consumer and advice firms total clarity. In the Complaints Commissioner’s recent reports[1] it highlighted consumer confusion regard to the lack of FSCS coverage in relation to certain aspects of consumer lending. In these instances, the absence of a “levy badge” (or a ‘flag’ to bring this absence to the customer’s attention) would have indicated to a consumer there is no FSCS protection on these products. This could have resulted in a more positive consumer outcome, as they are equipped with sufficient knowledge to make informed decisions.

Any firm found making such assertions that are incorrect should be immediately have their permissions suspended and taken promptly through enforcement proceedings.

**Q8: When distributing non-UK funds to retail investors in the UK, should firms be required to inform customers when FSCS protection is not available? If yes, how could firms ensure customers are aware of the lack of protection, through the fund’s marketing materials or otherwise?**

Whilst not our area of expertise, we consider this to be a sensible proposal. It should be in all documentation and disclosures.

**Q9: Do you consider that ‘high-net-worth’ and/or ‘sophisticated’ individuals should be excluded from being able to claim from the FSCS in certain circumstances? If so, should the exclusion(s) apply to all types of claim or just certain categories of claim?**

It is likely that the bureaucracy and administration of this would be greater than the potential benefit. It is not a proposal that has our general support.

**Q10: Do you consider any other amendments should be made to the current eligible claimant criteria?**

No comment

**Q11: Does the CIS look-through remain appropriate from a consumer protection perspective? If not, what alternatives should be considered to protect investors in CISs?**

We consider this to be outside our expertise.

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[1] https://frccommissioner.org.uk/wp-content/uploads/FCA001379-Issued-15-February-2022.-Published-01-March-20221.pdf
https://frccommissioner.org.uk/wp-content/uploads/FCA001402-Issued-15-February-2022.-Published-01-March-20221.pdf
https://frccommissioner.org.uk/wp-content/uploads/FCA001541-Issued-15-February-2022.-Published-01-March-2022.pdf

**Q12: Do you consider changes should be made to the level of compensation that is payable by the FSCS? Please provide justification for any changes you propose.**

The levels of compensation afforded must remain fairly balanced between compensating consumers and not delivering an unfair burden on levy payers.

We consider that the consistent £85,000 limit has been helpful. We would be strongly opposed to any proposal to bring FSCS compensation limits into line with FOS limits.

**Q13: Would you be in favour of the introduction of set periodic reviews of the compensation limits to ensure that they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?**

AMI would support a triennial review and consultation on compensation and class limits. These should take into account "inflation" and changes to the structure of the industry. We would welcome the opportunity to be involved in multi-lateral discussions for final comment around this before the production of a CP.

**Q14: Do you consider that proposed principles 3 and 4 in relation to FSCS funding are the appropriate principles to underpin the design of the funding arrangements (in relation to the classes which the FCA is responsible for)? If not, what principles would be preferable?**

Broadly, the principles make sense, but again we are starting from the wrong place in this debate. The benefits of a product levy and the support of "fines offset" would allow a better debate on the key principles.

Notwithstanding that principles 3 and 4 appear reasonable on the face of it, it is not these principles that will deliver the detailed rules and financial outcomes that actually make all this work. This requires cross- trade body workshops with the FCA and FSCS to hammer out acceptable solutions.

The need for a Retail Pool remains the most contentious. If a class cannot support the failure of firms who have delivered poor products or bad advice within its class, then should we be considering stronger controls over that market segment rather than spreading the costs of failure to other segments.

**Q15: How do you consider the current funding model (for the classes that the FCA is responsible for) could be improved, to ensure that costs are appropriately distributed and the impact on firms is proportionate? Please explain how your proposed changes represent an improvement on the current arrangements.**

Please see our previous answers re a product levy and repatriation of fines.

We do not agree with the FCA assertions on a product levy; it provides many transparency benefits and ensures the FCA and FSCS knows which products are covered and protected.

We consider the current pools to be appropriate.

The Retail Pool when created was considered within the consultation process to be an "occasional" once in a lifetime last resort. This is not now the case and needs to be reassessed. Given the likely calls on the pool in years to come we do not consider this to be fair or sustainable.

**Q16: Are there any alternative metrics to annual eligible income that would help to ensure that compensation costs in the Investment Provision class are distributed more fairly between firms in the class?**

We do not consider we should comment on this.

**Q17: Would you be in favour of the introduction of set periodic reviews of the funding class levy limits to ensure they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?**

Please see our answer to Q13. We consider that triennial reviews would be appropriate.

Assessments of turnover, profit and capital within firms, together with an assessment of the terms of PII contracts all need to be factored in. It might be that there is a need to consider that not all firms pay in equal proportions to turnover. It might be that larger firms have greater capacity to suffer loss. Product manufacturers must take a greater responsibility for themselves, their choice of routes to market and the policy and processes involved in distribution of their products. Consequently, their contribution should be moved from the current 25% to 50%.

In addition, the cap on classes might not be the correct approach. No upper limit might be appropriate where there is a "deeper" market.

**Q18: Do you consider that any alternative funding model would be preferable to the current funding model? Please describe the alternative model that you consider to be preferable and the benefits over the current arrangements.**

AMI has long advocated that a product levy would be a more equitable policy solution. A very small annual levy on each deposit balance, loan, mortgage, insurance policy, and investment fund would provide sufficient funds and ensure that products with such a levy are then clearly badged as protected.

**Q19: Do you have any overarching comments on the proposed principles for the compensation framework, or do you have any further principles that we should account for?**

Please see our previous answers.

**Q20: Are there further opportunities to improve the aspects of the compensation framework that the FCA is responsible for? Please describe the further changes which you consider should be made.**

In previous consultations and discussions on the Scheme the FCA and FSA were excellent in bringing the industry trade bodies together with representative from Treasury, PRA, FCA, FOS and FSCS in a series of roundtables to discuss the various aspects to deliver a restructured scheme. We feel that such engagement in addition to written responses is good regulation and essential in establishing that all avenues are fully explored and those who have to pay for the scheme can be satisfied that their voices are heard. It will also help to ensure that all parties move together towards an equitable solution.