CFA Society United Kingdom

Contents

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) is keen to share its views, ideas and observations on the important issue of how fees are raised from the industry. CFA UK welcomes this valuable opportunity to engage with the Financial Conduct Authority (FCA) on how it could reform the rationale for raising fees from the industry to cover its costs. This response has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC) and the CFA UK Board.

The PSMPC identifies and monitors key regulatory and best practice developments likely to affect CFA UK members.

Firm population and data

Table A shows that there are 17,936 'A' block firms that generate a total of £656.4 Bln in qualifying revenue (based on returns made by firms to the regulator). The annual funding requirement (AFR) allocated to these firms for 2013-14 is £381.2Mln out of a total of £646.3 Mln. The qualifying income of these firms ranges from £0 to £46Bln. While the average income is £36.6Mln, the median income is materially lower at £194,000.

Using the median provides us with the middle firm in the population and in this case is not the same as the average. Based on this information there are 8968 firms with income of £194,000 or less and about the same number of firms with income above £194,000. If one took the average and stated that half the population of firms earned income of £35.6 Mln and above this would be incorrect.

1) The population contains a very large number of smaller firms.

2) Using averages to determine how fees are levied will be distorted by the influence of the larger firms as measured by revenue.

Table A sets out the data provided to us by the FCA (FCA data)

Firm count	17936
Total Qualifying Income	£656,356,039,109
Maximum Income	£45,922,633,000
Minimum Income	£0
Average Income	£36,592,297
Median Income	£194,000

CFA UK welcomes the FCA's initiative in suggesting 3 methods to stimulate the conversation with the industry. Each method has its pros and cons but it is our opinion that all three overlook what should be the key consideration, and that is how to reflect the risks taken by, and conduct of, the firm when setting fees. While we recognise that these approaches have been put forward to stimulate discussion, CFA UK would like to take the opportunity to comment on each one of the FCA's suggestions for raising fees.

1) Fees are based on income of the firm – we have stated we will not support this approach as this does not take into account the risks and conduct of firms, let alone how the FCA allocates resources to regulate firms.

2) Status quo (segmentation) with refinements – this approach maintains the current fee blocks. The refinement of using revenue rather the assets under management is welcome. However, this approach does not take into account the conduct and risks of the firm let alone how the FCA allocates resources to regulate firms.

3) Categorisation – the FCA is already dividing firms into 4 categories, as this is how it supervises firms. We understand that C1 firms are the most complex, but are smaller in number than the C4 category; institutional asset managers mostly fall into C2 but retail advisers are likely to be in C4. Using this categorisation is a better approach in our opinion, as it relates to how the FCA allocates resources. However, we have the absence of the consideration of risk and conduct of individual firms.

All three approaches presented by the FCA aim for simplicity but may deviate from the FCA's recently stated principles for raising fees from the industry. However, in our view the way forward should take what the FCA is doing already and combine it with better data and incorporate a measure of the risk and conduct of individual firms. In doing so, we believe that there will be a solution that will align with the FCA's and our own principles of allocating the regulator's costs to the industry; demonstrate to the wider public that firm conduct is priority for the regulator, and show it is a thought leader as a standard setter.

CFA UK proposed approach[1]

We believe that the approach should be based on the following principles:

1) Appropriate – the level of fee should be suitable for the type and scale of regulated activity undertaken. For example, plain vanilla types of business should pay a lower fee than a more complex type of business or a firm that undertakes a variety of activities.

2) Risk aligned – The fee takes into account the risk the firm takes to generate revenues from each of its regulated activities.

3) Memory – Fees should reflect a firm's conduct over time. There should be higher fees for firms whose conduct has been inappropriate, ratcheting up for those that are either serial offenders or have undertaken conduct that results in severe breaches of the regulations. The more serious the offence, the greater the fee should be with it being calculated based on the activities of the firms concerned as well as the resources expended by the regulator plus some margin. These higher fees could be used to offset the fees of other firms that have not been involved with inappropriate conduct. In essence, firms would have a 'no claims discount' which would be lost if conduct was ever inappropriate.

   The points made in 2 and 3 above align with the FCA's emphasis on a firm's culture.

4) Transparent – it should be clear to firms how its fees will be calculated.

5) Moral hazard – the current system suffers from an element of moral hazard. This arises when inappropriate conduct by a firm is insufficiently penalised, leaving them with a financial gain while other market participants pay the cost of diminished trust in the market. Firms that knowingly take regulatory risks are usually only discovered after most of the damage has been done with the resultant 'clean up' costs being borne by the remaining participants in the market. The recent series of scandals in the banking sector involving a variety of regulated activities is a case in point. Hence, firms with poor conduct records and serial regulatory risk takers probably pay fees are not that much different from their better behaved counterparts undertaking the same regulated activities.

[1]CFA UK response to Fees and Levies 2013
https://secure.cfauk.org/assets/3372/CFA_UK_fees_and_levies_2013.pdf

6) Regulatory dividend - Initially CFA UK advocated for a regulatory dividend. Firms that act in the best interests of their clients should benefit from a 'no claims discount' via reduced fees and levies. These discounts would be sourced from the penalties, higher fees and levies imposed on firms that have not acted appropriately. We are aware that the FCA is not keen on this as it does not want fees to influence firm behaviour. However, the regulator is not averse to granting discounts for firms that have to pay financial penalties so there is an asymmetry and potential mixed message being sent out. With the Treasury now taking most of any penalties raised; the scope for rebates to firms has significantly been reduced. The Treasury would prefer firms to pay to be regulated so no matter how large the fines collected from other firms; we are unlikely to see the day when some firms do not pay any fee at all.

Strategic Approach

We propose the approach outlined below, which the regulator could move to over time or implement immediately. The approach we are advocating would involve the following steps to set the fees paid by each regulated firm.

1) The regulator calculates the AFR it requires for the following year
2) Firms with revenues at or below the median pay a flat fee of £1,000
3) Allocate the remaining AFR across the C1-C4 categories
4) Risk weight the remaining firms using the approach below for each of the regulated activities
5) Apply the risk weight to the AFR required for each regulated activity to obtain the fee for each activity and so the total fee for that firm.

This approach should not significantly add to the FCA's efforts because the C categories are how the FCA supervises firms. The FCA already uses fee blocks to identify regulated activity so this data is already available. All we are doing is combining the two and adding risk weights and some judgment. Two attributes the FCA are keen to convey in its messaging. In addition, the FCA is keen to hire a consultant to look at the data issues. Hence, we are proposing a hybrid approach that takes the form of a matrix as follows -

Illustration

Category (CFA UK view of AFR allocation)	Regulated activity*				
	Banking and Credit	Mortgages and home finance	General insurance	Life and Pensions	Investments
C1 (45%)	35%	25%	15%	15%	10%
C2 (30%)					100%
C3 (15%)			33.3%	33.3%	33.3%
C4 (8%)		25%	25%	25%	25%
Not categorized (2%)					

* For illustration purposes activities are grouped and reflect the categories used by the Financial Ombudsman. However, we could use the current fee block categories to segment regulated activity.

The total fee for the following year should be based on the current total fee adjusted by the risk posed by each firm for each of its regulated activities and the firm's conduct record for each of its activities. These factors would cover the risk premium associated with the firm's activity, a conduct premium that reflects previous enforcement actions and complaints upheld; there should be an adjustment which would be based on a surplus accruing to each category/fee block. The equation below presents what should take place. Please note that the factor weights we have used are for illustration purposes only to demonstrate the approach.

$$FEE = B\,(1 + \sum_{t=1}^{5} \beta_i E_{t-i} + \sum_{t=1}^{3} \theta_i C_{t-i}\ ) - S$$

Where

- B = Base fee is the fee the firm paid the previous year.
- R = risk factor determined by the FCA/PRA, for illustration purposes a large complex institution has a risk factor of 0.5, and a plain vanilla firm has no risk weighting.
- E and C = conduct premia

E = enforcement actions (UK only?) faced by the firm in the preceding 5 years. The factor weight (β) accorded to each year's action and would decrease as one went back in time. For example

AFR Year	Enforcement Action	Factor
2012/13	Yes	0.80
2011/12	Yes	0.60
2010/2011	Yes	0.30
2009/2010	Yes	0.15
2008/09	Yes	0.05

C= complaints upheld as a percentage of complaints for each regulated activity made weighted by a factor; and any court cases where the firm was found liable (this covers instances where the recompense exceeds the Ombudsman ceiling of £150,000). To count, the percentage of complaints upheld should exceed a threshold, for the purposes of our example we will use 30%.

To understand the threshold level please see the table below from the Financial Ombudsman that shows the percentage of complaints upheld against the top three firms when it comes to investments. For example HSBC in this case would only get uplift for complaints in the category of PPI and Investments as these are above the 30% threshold.

Ombudsman complaints upheld data Jan-July 2013 (top 3 by based on investments only)

			Regulated activity – complaints upheld					
Firm	Category	All Cases	Banking and credit	Mortgages and finance	General insurance (ex PPI)	PPI	Investments	Life, Pensions, decumulation
Barclays Firm Plc	C1	64%	38%	41%	46%	74%	56%	33%
HSBC Firm plc	C1	37%	25%	27%	5%	45%	53%	28%
Interactive Investor Trading Limited	C2	48%	i see below	i see below	i see below	i see below	48%	i see below

i Where no data is shown, either there were *no cases* or there were *fewer than 30 cases* and the percentage would not be statistically meaningful.

Complaints upheld factor weights (illustration purposes only)

AFR Year	Complaints Upheld >30%	Factor(θ)
2012/13	Yes	0.40
2011/12	Yes	0.20
2010/2011	Yes	0.10

S= 'Surplus ' or rebalancing item to firms that have relatively better conduct compared to firms that have a relatively poorer conduct record for the respective regulated activity. Better behaved firms would still pay to be regulated but much less than firms with poor conduct in the same fee block. In line with the Chancellor's desire to ensure that firms pay to be regulated appropriately.

Inflation uplift – while we recognize that the regulator's own cost base is likely to arise with inflation this should be factored in at some stage to ensure the regulator's resources do not decline in real terms over time. It may be useful to consider inflation adjustments for fees should the regulator face any shortfall in the AFR required. When considering an inflation uplift it should be automatic for firms with poor conduct. There should also be an automatic uplift if the FCA does not cover its costs for the following year using the above approach. Otherwise firms that have a good conduct record should have no inflation uplift.

Example of the application of approach: C1 firms[2].

Presume there are only two firms in this category each account for 50% of the revenue and also equally share the AFR allocation. Both undertake the same activities. For 2013/14 the AFR for this category is to rise by 10%

Firm	Income	AFR allocation 2012/13	AFR for 2013/14 is 10% higher
Firm A	£10Bln	£10Mln	£11Mln
Firm B	£10Bln	£10Mln	£11Mln
Total	£20Bln	£20Mln	£22Mln

However, the rise in fees does not take into account the characteristics of Firm A and Firm B. For illustration purposes Firm A has poor conduct, been involved with Libor manipulation, miss-selling

[2] Please note this is an extreme example to convey the approach in an accessible manner.

of PPI, and other products to retail clients. Faced enforcement actions over the last three years and has a high percentage of complaints upheld in the previous years. While B has been a model of appropriate conduct faced no enforcement actions in the last 5 years or had complaints upheld that exceed the threshold. Even though Firm A has paid penalties and compensation, its track record demonstrates that it has been willing to take regulatory risks to generate revenues. However, Firm B pays the same fee as Firm A. So how to allocate the fee for to reflect the difference in conduct for 2013/14?

Risk weight each Firm in the category that takes into account the complexity of the business and prior conduct using the above parameters.

Firm A risk measure = 0.5+1.7+0.7 = 2.9

1) C1 category firm risk = 0.5

2) Conduct premium
   - a) Enforcement (3 years in this case) risk weight is 0.8+0.6+0.3 = 1.7
   - b) Complaints premium exceeds 30% threshold for all types of business
     0.4+0.2+0.1 = 0.7

Firm B risk measure = 0.5

1) C1 category firm risk = 0.5

2) Conduct premium
   - a) Enforcement (none in last 5 years) risk weight = 0
   - b) Complaints premium = 0; does not exceed 30% threshold for all types of business

Using risk weights should see a different outcome in terms of how the AFR is allocated to each firm. The total risk measure for the C1 category is 3.4 of which 85% is represented by Firm A. We then apply this to the calculation of the fee for 2013/14. The table shows how Firm B benefits from poor conduct of Firm A (the 'S' term cited in the equation).

	Risk	Risk weight	Risk weighted AFR allocation for 2013/14 (£Mln)	Income based AFR for 2013/14 (£Mln)	Difference (£Mln)
Firm A	2.9	85%	£18.76	£11.00	£7.76
Firm B	0.5	15%	£3.24	£11.00	-£7.76
Total	3.4	100%	£22.00	£22.00	

<u>Benefits of CFA UK approach</u>

"So from the boardroom to point of sale and beyond, firms' behaviour, attitudes and motivations must be about good conduct." (Journey to the FCA)

The above approach provides the benefits to consumers, firms and the regulator in the following ways:

Consumers

- Helps contribute to the protection of consumers.
- Consumers have an accessible and easily understood metric to enable them to distinguish between firms based on their conduct track record.
- Consumers can see that the regulator will take into account and is aware of a firm's conduct history

Firms

- The fee incorporates the relative risk and quality of conduct of each firm
- Moral hazard with regard to fees is reduced
- The track record of appropriate conduct is rewarded and would make for good PR to use by firms, not to mention the regulator.
- Each firm pays a fee to the regulator in order to be appropriately regulated

FCA

- The FCA can obtain the resources it needs to cover its costs

- The approach aligns with how the FCA categorises firms and also the types of regulated activity firms conduct. The FCA already has firm level data and the fee block data provides the information about regulated activity.

- The regulator can also demonstrate to other regulators around the world that it is taking the lead on the key issue of how to raise fees from the firms being regulated.

This approach is not as simple as a pure income measure but is aligned with what the FCA is doing already. All the FCA needs to do is expend a touch more effort in this area and the benefits are likely to outweigh any additional costs with developing this approach. The regulator has the data. As a risk and judgment based regulator it can demonstrate that it is keen to ensure high levels of conduct to both consumers and firms. This is an excellent opportunity for the regulator to show how it can develop a consistent approach regarding culture and what better way than to start with fees.

Overview

CFA UK appreciates that fees and levies imposed on regulated firms are required to resource the regulator. Hence, it becomes essential that these charges are set appropriately to bring about apt outcomes in terms of providing the regulator with adequate resources while being applied fairly across the industry. These features of an appropriate set of fees and levies become even more crucial when applied to a heterogeneous set of firms operating in the UK financial services industry.

To provide the rationale for our response we will

1) Share our comments about the data and the population of firms.
2) Comment on the principles and methods proposed by the FCA
3) Suggest an alternative strategy that minimises the trade-offs of the FCA's suggested approach
4) Suggest a possible way forward when applying our approach to individual firms

We appreciate the assistance the FCA has provided to us so far. Given the confidentiality of the firm level data provided by the FCA, we would hope the FCA would engage with us in a dialogue to demonstrate how our suggestions would work in practice.

Firm population and data

Table 1 sets out the data provided to us by the FCA (FCA data)

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The table shows that there are 17,936 'A' block firms that generate a total of £656.4 Bln in qualifying revenue (based on returns made by firms to the regulator). The annual funding requirement (AFR) allocated to these firms for 2013-14 is £381.2Mln out of a total of £646.3 Mln. The qualifying income of these firms ranges from £0 to £46Bln. While the average income is £36.6Mln, the median income is materially lower at £194,000.

Using the median provides us with the middle firm in the population and in this case is not the same as the average. Based on this information there are 8968 firms with income of £194,000 or less and about the same number of firms with income above £194,000. If one took the average and stated that half the population of firms earned income of £35.6 Mln and above this would be incorrect.

3) The population contains a very large number of smaller firms.

4) Using averages to determine how fees are levied will be distorted by the influence of the larger firms as measured by revenue.

If one segregates the data according to how each firm is categorized; this provides more insight into how the distribution changes compared to the entire population.

In its paper "Journey to the FCA", the regulator set out how it would categorise firms. Four categories would be used and these are set out in figure 1. C1 firms are the largest and most complex institutions while C4 are less complex. The data in Table 2 shows the distribution of firms in each category and also notes that there are 234 firms that are not categorised but have a total income of £24.6 Mln. In each category the median income is materially below the average and so demonstrates the 'long tail' of firms in these categories. While C1 firms are considered to be the most complex, C2 generates the highest total qualifying revenue. However, C1 firms generate the highest median income of all four categories.

While this data is helpful we take note of the important caveat provided by the FCA about how the qualifying income is calculated. The FCA is seeking to get better insight into firm data and we hope this could be shared with us in due course depending on confidentiality. By doing so, the FCA can reconcile the income with the regulated activity and the risk of that regulated activity.

Table 2 – Distribution by category (FCA data)

Firm category	C1	C2	C3	C4	No cat	Total
Firm count	168	665	669	16200	234	17936
Total Qualifying Income (000)	£207,053,529	£323,595,290	£59,430,545	£66,251,820	£24,552	£656,355,739
Maximum Income (000)	£26,290,749	£45,922,633	£9,602,773	£7,375,524		
Minimum Income	£0	£0	£0	£0		
Average Income (000)	£1,232,461	£485,150	£88,835	£4,089		
Median Income (000)	£39,701	£12,357	£10,674	£178		

Figure 1 Four categories of firms

Source Journey to the FCA 2013

Comment on the principles and methods proposed by the FCA

The principles by which the FCA would like to apply to raise fees are set out in table 3. Please be aware that the FCA is not seeking to influence the behaviour of firms through how fees are raised although this does not totally align with its principles (and generates a significant paradox) as follows –

Table 3

FCA Principles	CFA UK view
Fair – justify basis for any shared costs	Agree although there should be no scope to cross-subsidise especially where firms undertake several regulated activities
Risk aligned – when effective to do so	Agree
Transparent – clear link between cost allocation, application of risk and level of fees	Agree
Predictable – firms can estimate fees for the coming year	Glad for views on this. Predictability may be more relevant for smaller firms?
Flexible – adaptable to changes in financial markets	Needs more explanation from the FCA
Value for money – fees methodology represents value for money for both dual and solo regulated firms.	Value for money should be based on how well the regulator regulates the industry. This principle may need refinement.

In our response to fees and levies we previously set out a slightly different set of principles and these have been modified to take account of where we agree with the FCA. I would suggest that the first three cited above should be where we have common ground and the following should also be considered as acceptable criteria -

- Appropriate – the level of fee should be suitable for the type and scale of regulated activity undertaken. For example, plain vanilla types of business should pay a lower fee than a more complex type of business or a firm that undertakes a variety of activities.

- Memory – Fees should reflect firm's conduct over time. There should be higher fees for firms whose conduct has been inappropriate, ratcheting up for those that are either serial offenders or have undertaken conduct that results in severe breaches of the regulations. The more serious the offence, the greater the fee should be with it being calculated based on the activities of the firms concerned as well as the resources expended by the regulator plus some margin. These higher fees could be used to offset the fees of other firms that have not been involved with inappropriate conduct. In essence, firms would have a 'no claims discount' which would be lost if conduct was ever inappropriate.

- Moral hazard – the current system suffers from an element of moral hazard. This arises when inappropriate conduct by a firm is insufficiently penalised, leaving them with a financial gain while other market participants pay the cost of diminished trust in the market. This situation is particularly serious where the offending firm goes out of business. Firms that knowingly take regulatory risks are usually only discovered after most of the damage has been done with the resultant 'clean up' costs being borne by the remaining participants in the market.

- Regulatory dividend - Initially CFA UK advocated for a regulatory dividend. Firms that act in the best interests of their clients should benefit from a 'no claims discount' via reduced fees and levies. These discounts would be sourced from the penalties, higher fees and levies imposed on firms that have not acted appropriately (the 'S' in our equation). The FCA is not keen on this as it does want fees to influence firm behaviour.

  As we have seen, the regulator is not averse to granting discounts for firms that have to pay financial penalties so there is an asymmetry and potential mixed message being sent out. With the Treasury now taking most of any penalties raised; the scope for rebates to firms has significantly been reduced. The Treasury would prefer firms to pay to be regulated so no matter how large the fines collected from other firms; we are unlikely to see the day when some firms do not pay any fee at all.

  Hence it may be preferable to take a different approach. Rather than propose firms with good conduct records get a rebate the alternative suggestion would be composed of two parts –

  1) No inflation adjusted increases for firms that have acted appropriately.

  2) Firms with poor conduct records should pay higher fees based on

     i. Above inflation increases.
     ii. Additional increases related to previous enforcement actions.
     iii. Further increases related to client complaints upheld by the Financial Ombudsman; court cases where the firm has been found liable.

FCA approaches

The FCA has provided us with 3 approaches to raising its fees and each has its costs and benefits. Fees under each approach would be fixed for three years to give the industry certainty. Fixing fees is a superficial comfort and may hamper the regulator from obtaining the resources it needs to be effective, e.g resources allocated to changes in financial markets or EU legislation. In addition the FCA would use complaints and enforcement data in options 2 and 3 to provide a risk metric to assist in the recovery of costs. The impact analysis has to be regarded as indicative as the data is far from the quality one would expect to make a valuable judgment let alone be considered a robust analysis of the changes being put forward. Limitations of the data include the inclusion of non-UK revenues and the reporting of non-regulated income.

Furthermore the fees the FCA raises cover both its direct and indirect costs. However, as can be seen below there are limitations to the FCA's ability to align indirect costs with the fee blocks currently being used to categorise regulated activity.

Direct costs: These are costs that the FCA allocate to individual fee-blocks, e.g., individual firm supervision and sector-specific policy development. These direct costs include people costs, to which it adds their overhead costs, such as accommodation, IT and other operational costs needed to support our staff.

Indirect costs: These are costs that the FCA cannot directly allocate to individual fee-blocks, e.g thematic supervision, non-sector-specific policy development, or the costs of a director's office in an area. These indirect costs also represent the people costs, to which it adds the overhead costs. The FCA allocates indirect costs to fee-blocks in proportion to the direct costs allocated.

1) **Revenue approach** - this is where the fees are levied based on revenues only. There would be a minimum fee of £100 (compared to the current minimum of £1,000). Firms would not be segmented and all the 'A' Block firms would be consolidated into one block. This is the simplest method but comes with several major weaknesses; in our initial meetings with FCA we have stated that we would not support this option.

Advantages	Disadvantages
• Simple • Easy to implement	• Data quality an issue • Overlooks the complexity of the firm's activities • Overlooks risks of the business to the regulator's statutory objectives • Distribution of firms not taken into account • Does not align with the key FCA's principles or ours • Does not align with how FCA allocates the direct and indirect costs of regulating firms • Unfair

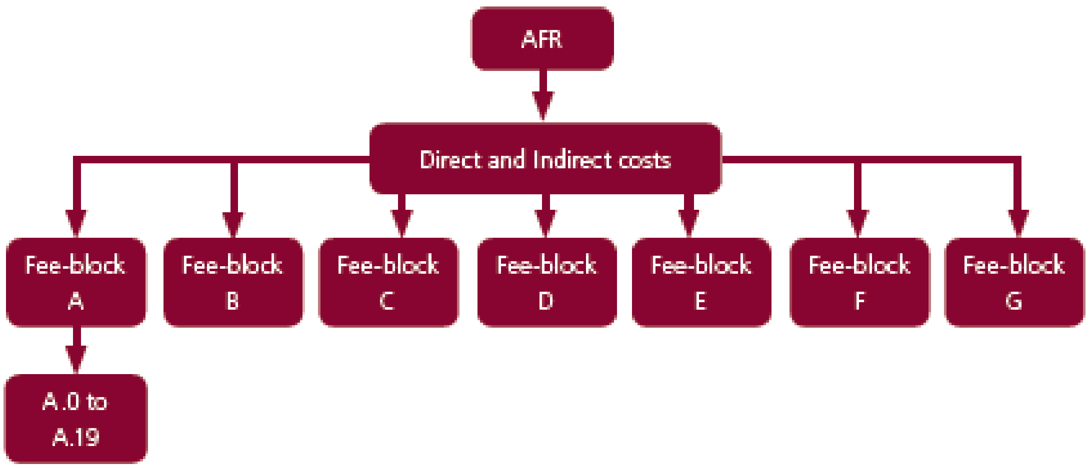
2) **Status quo – segmentation with refinements –** The current system relies on segmenting firms by their regulatory activity (see Table 4).

Table 4 – Fee Blocks

Fee-block
AP.0 FCA prudential
A.1 Deposit acceptors
A.2 Home finance providers and administrators
A.3 Insurers - general
A.4 Insurers - life
A.5 Managing Agents at Lloyd's
A.6 The Society of Lloyd's
A.7 Fund managers
A.9 Operators, Trustees and Depositaries of collective investment schemes etc
A.10 Firms dealing as principal
A.12 Advisory arrangers, dealers or brokers (holding or controlling client money or assets, or both)
A.13 Advisory arrangers, dealers or brokers (not holding or controlling client money or assets, or both)
A.14 Corporate finance advisors
A.18 Home finance providers, advisers and arrangers
A.19 General insurance mediation
B. Recognised Investment Exchanges and operators of Multilateral Trading Facilities (only)
E. Issuers and Sponsors of securities
G. Firms registered under the Money Laundering Regulations 2007. Firms subject to: • Regulated Covered Bonds Regulations 2008; • Payment Services Regulations 2009; and • Electronic Money Regulations 2011.

The Annual Funding Requirement is allocated across fee blocks as follows –

Figure 2



The AFR is apportioned by fee block and the metrics used to determine minimum thresholds vary according to the fee block. By way of example if the threshold is income based then if the minimum income is £100,000; a firm would pay the minimum fee of £1,000 for its income up to £100,000 and thereafter each £1,000 of income would be multiplied by a tariff for that fee block (see Appendix 1 for further detail).

Example

If a firm in A12 has income of £818,862, the fee is calculated on the basis of 718,862. The tariff for this fee block is £2.59. The total fee for this firm is £1,000 (for the first £100,000 of income) plus 719 x 2.39, making the fee £2,781.41 (£1,718.41 plus the £1,000 minimum fee).

The refinements the FCA is proposing to the current approach are as follows:

1) Minimum fee of £1,000 to be retained although this should rise with inflation or rise in line with the AFR.

2) Asset managers to have their fees levied on income rather than assets under management. This is useful refinement to support. The FCA can then take the next step to assess the risks taken to generate that income. For example an asset manager that provides tracker funds that hold physical securities will have less risk when it generates income than a firm that uses a more active approach that includes the use of derivatives and leverage.

3) Insurers (life) treat regular premium income the same as single premium income.

Advantages	Disadvantages
• Current system • Level of detail the FCA can accommodate	• Data quality an issue • Overlooks the complexity of the firm's activities • Overlooks risks of the business to the regulator's statutory objectives • Distribution of firms not taken into account • Does not align with the key FCA's principles • Not aligned with our principles • Does not align with how FCA supervises firms

3) Categorisation

The third option suggested is one that uses the C1-C4 categorisation of firms as a means to raise fees. This categorisation is based on how the FCA actually regulates firms so has some merit to it. However, the FCA would like to use revenue rather than AUM as a metric and this would be enhanced by using complaints and enforcement data as one measure of risk. The FCA has no further thoughts on which other risk metrics to use. However, the FCA remains open to suggestions.

CFA UK suggested approach

CFA UK's suggested approach to fees would be achieved by taking the following steps:

1) The regulator calculates the AFR it requires for the following year
2) Allocate the AFR across the C1-C4 categories
3) Risk weight each firm using the approach below for each of the regulated activities
4) Apply the risk weight to the AFR required to obtain the fee for each activity and so the total fee for that firm.

This approach should not add to the FCA's efforts because the C categories are how the FCA supervises firms. In addition, the FCA is keen to hire a consultant to look at the data issues. The FCA already uses fee blocks to identify regulated activity so this data is already available. All the CFA UK approach is advocating is combine the two segmentation approaches, adding risk weights and some judgment. Risk and judgment are two attributes the FCA are keen to convey in its messaging as it differentiates itself from its predecessor. Hence we have a hybrid approach that takes the form of a matrix as follows.

Illustration

Category ** (AFR allocation)	Regulated activity*				
	Banking and Credit	Mortgages and home finance	General insurance	Life and Pensions	Investments
C1 (45%)	35%	25%	15%	15%	10%
C2 (30%)					100%
C3 (15%)			33.3%	33.3%	33.3%
C4 (10%)		25%	25%	25%	25%
No category (2%)					

* For illustration purposes activities are grouped and reflect the categories used by the Financial Ombudsman. However, we could use the current fee block categories to segment regulated activity.

The fee for the following year should be based on the current fee for the regulated activity adjusted by a factor representing the risk posed by each firm. These factors would cover the risk premium associated with the firm's activity, a conduct premium that reflects previous enforcement actions and complaints upheld; there should be an adjustment which would be based on a surplus accruing to each category. The equation below presents what should take place. Please note that the factor weights we have used are for illustration purposes only.

$$FEE = B\,(1 + \sum_{t=1}^{5} \beta_i E_{t-i} + \sum_{t=1}^{3} \theta_i C_{t-i}\,) - S$$

Where

B = Base fee is the fee the firm paid the previous year.

R = risk factor determined by the FCA/PRA, for illustration purposes a large complex institution has a risk factor of 0.5, and a plain vanilla firm has no risk weighting.

E and C = conduct premia

E = enforcement actions (UK only?) faced by the firm in the preceding 5 years. The factor weight (β) accorded to each year's action and would decrease as one went back in time. For example

AFR Year	**Enforcement Action**	**Factor**
2012/13	Yes	0.80
2011/12	Yes	0.60
2010/2011	Yes	0.30
2009/2010	Yes	0.15
2008/09	Yes	0.05

C= complaints upheld as a percentage of complaints for each regulated activity made weighted by a factor; and any court cases where the firm was found liable (this covers instances where the recompense exceeds the Ombudsman ceiling of £150,000). To count a 30% threshold is used for illustrative purposes.

Complaints upheld factor weights

AFR Year	Complaints Upheld >30%	Factor (θ)
2012/13	Yes	0.40
2011/12	Yes	0.20
2010/2011	Yes	0.10

To understand the threshold please see the table below from the Financial Ombudsman that shows the percentage of complaints upheld against the top three firms when it comes to investments. For example HSBC in this case would not only get uplift for complaints in the category of PPI and Investments as these are above the 30% threshold.

Ombudsman complaints upheld data Jan-July 2013 (top 3 by based on investments)

			Regulated activity – complaints upheld					
Firm	Category	All Cases	Firming and credit	Mortgages and finance	General insurance (ex PPI)	PPI	Investments	Life, Pensions, decumulation
Barclays Firm Plc	C1	64%	38%	41%	46%	74%	56%	33%
HSBC Firm plc	C1	37%	25%	27%	5%	45%	53%	28%
Interactive Investor Trading Limited	C2	48%	see below	see below	see below	see below	48%	see below

Where no data is shown, either there were *no cases* or there were *fewer than 30 cases* and the percentage would not be statistically meaningful.

S= 'Rebalancing item to firms that have relatively better conduct compared to firms that have a relatively poorer conduct record. Better behaved firms would still pay to be regulated but much less than firms with poor conduct in the same fee block. In line with the Chancellor's desire to ensure that firms pay to be appropriately regulated.

Example of the application of approach - C1 firms.

Presume two firms in this category each account for 50% of the revenue and also equally share the AFR allocation. Both undertake the same activities. For 2013/14 the AFR for this category is to rise by 10%.

Firm	Income	AFR allocation 2012/13	AFR for 2013/14 is 10% higher
Firm A	£10Bln	£10Mln	£11Mln
Firm B	£10Bln	£10Mln	£11Mln
Total	£20Bln	£20Mln	£22Mln

However, the rise in fees does not take into account the characteristics of Firm A and Firm B. For illustration purposes Firm A has poor conduct, been involved with Libor manipulation, miss-selling of PPI, and other products to retail clients. Faced enforcement actions over the last three years and has a high percentage of complaints upheld in the previous years. While B has been a model of appropriate conduct faced no enforcement actions in the last 5 years or had complaints upheld that exceed the threshold. Even though Firm A has paid penalties and compensation, its track record demonstrates that it has been willing to take regulatory risks to generate revenues. However, Firm B pays the same fee as Firm A. So how to allocate the fee for 2013/14?

Risk weight each Firm in the category that takes into account the complexity of the business and prior conduct using the above parameters.

Firm A risk measure = 0.5+1.7+0.7 = 2.9

1) C1 category firm risk = 0.5

2) Conduct premium

   a) Enforcement (3 years in this case) risk weight is 0.8+0.6+0.3 = 1.7

   b) Complaints premium exceeds 30% threshold for all times of business

      0.4+0.2+0.1 = 0.7

Firm B risk measure = 0.5

1) C1 category firm risk = 0.5

2) Conduct premium

   a) Enforcement (none in last 5 years) risk weight = 0

   b) Complaints premium = 0; does not exceed 30% threshold for all types of business

Using risk weights should see a different outcome in terms of how the AFR is allocated to each firm. The total risk measure for the C1 category is 3.4 of which 85% is represented by Firm A. We then apply this to the calculation of the fee for 2013/14.

	Risk	**Risk weight**	**Risk weighted AFR allocation for 2013/14 (£Mln)**	**Income based AFR for 2013/14 (£Mln)**	**Difference (£Mln)**
Firm A	2.9	85%	£18.76	£11.00	£7.76
Firm B	0.5	15%	£3.24	£11.00	-£7.76
Total	3.4	100%	£22.00	£22.00	

Benefits of CFA UK approach

The above approach provides the benefits to consumers, firms and the regulator in the following ways:

Consumers

- The approach makes good sense for the investor whom the regulator is seeking to protect
- Consumers have an accessible and easily understood metric to enable them to distinguish between firm based on their conduct track record.
- Consumers can see that the regulator will take into account and is aware of a firm's conduct history

Firms

- The fee incorporates the relative risk and quality of conduct of each firm
- Moral hazard with regard to fees is reduced
- The track record of appropriate conduct is rewarded and would make for good PR to use by firms, not to mention the regulator.
- Each firm pays a fee to the regulator in order to be appropriately regulated

FCA

- The FCA can obtain the resources it needs to cover its costs
- The approach aligns with how the FCA categorises firms and also the types of regulated activity firms conduct. The FCA already has firm level data and the fee block data provides the information about regulated activity.
- The regulator can also demonstrate to other regulators around the world that it is taking the lead on the key issue of how to raise fees from the firms being regulated.

This approach is not as simple as a pure income measure but is aligned with what the FCA is doing already. All the FCA needs to do is expend a touch more effort in this area and the benefits are likely to outweigh any additional costs with developing this approach. The regulator has the data. As a risk and judgment based regulator it can demonstrate that it is keen to ensure high levels of conduct to both consumers and firms. This is an excellent opportunity for the regulator to show how it can develop a consistent approach regarding culture and what better way than to start with fees.

We hope that this paper provides useful insights into how a different approach could be structured and implemented in the setting of fees. We look forward to continuing our discussions on this issue with you.

Yours,

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Chair Professional Standards and Market Practices Committee.

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Appendix 1 – Tariff base

Fee-block		Tariff base	Minimum threshold	Solo or Dual-Regulated (DR) (i)
A.0	**FCA Minimum periodic fee**	Not applicable	Not applicable	Solo
AP.0	**FCA Prudential fee-block**	(ii)		Solo
A.1	**Deposit acceptors** (iv)	Modified Eligible Liabilities (MELs) £m	>10	DR
A.2	**Home finance providers and administrators**	Number of new home finance contracts etc.	>50	Solo
A.3	**Insurers – general** (iv)	Gross premium income £m	>0.5	DR
		Gross technical liabilities £m	>1	
A.4	**Insurers – life** (iv)	Adjusted gross premium income £m	>1	DR
		Mathematical reserves £m	>1	
A.5	**Managing agents at Lloyd's**	Active capacity £m	>50	DR
A.6	**The Society of Lloyd's**	AFR allocated to this fee-block is recovered from the Society of Lloyd's.		DR
A.7	**Fund managers** (iv)	Funds under management £m	>10	Solo

Fee-block		Tariff base	Minimum threshold	Solo or Dual-Regulated (DR) (i)
A.9	**Operators, Trustees and Depositaries of collective investment schemes etc.** (iv)	Gross income £m	>1	Solo
A.10	**Firms dealing as principal** (iv)	Number of traders	>2	Solo & DR (iii)
A.12	**Advisory arrangers, dealers or brokers (holding client money/assets)** (iv)	Annual income £000's	>100	Solo
A.13	**Advisory arrangers, dealers or brokers (not holding client money/assets)** (iv)	Annual income £000's	>100	Solo
A.14	**Corporate finance advisers**	Annual income £000's	>100	Solo
A.18	**Home finance providers, advisers and arrangers**	Annual income £000's	>100	Solo
A.19	**General insurance mediation** (iv)	Annual income £000's	>100	Solo

Notes:

(i) Solo = FCA solo-regulated fee-block activities. DR= Fee-block activities that are dual-regulated by the FCA for conduct purposes and the PRA for prudential purposes.
(ii) AP.0 FCA prudential fee-block is only recovered from FCA solo-regulated firms in proportion to the total periodic fees they pay through FCA solo regulated fee-blocks.
(iii) Includes certain investment firms that have been designated by the PRA to be regulated by the PRA for prudential purposes. These designated firms do not pay fees in the AP.0 FCA prudential fee-block. The remaining firms in A.10 are solo regulated by the FCA and therefore pay prudential fees to the FCA in AP.0.
(iv) Inward passporting European Economic Area (EEA) branches in these fee-blocks are allowed a discount on their fees.

See FEES 4 Annex 1A for detailed: definitions of A.1 to A.19 fee-blocks (Part 1); minimum and prudential fee-blocks (Part 2); tariff bases (Part 3 and 4); and valuation dates (Part 5).

Reference to fee-blocks A.8, A.11, A.15, A.16 and A.17 are not included as they are no longer used.

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CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

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