Oxera

Review of the Financial Services Compensation Scheme model

Prepared for British Insurance Brokers' Association

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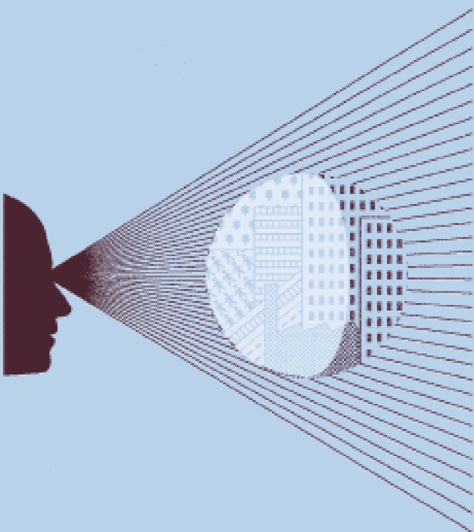

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1 Introduction

The British Insurance Brokers' Association (BIBA) has commissioned Oxera to conduct an independent economic analysis of the funding of the Financial Services Compensation Scheme (FSCS) by the general insurance intermediation sub-class. BIBA asked Oxera to consider the potential for a new sub-class of 'pure' insurance brokers to deliver funding according to the principles set out by the Financial Services Authority (FSA) in its March 2006 discussion paper.[1] These principles, which are explained in section 2, include:

– durability and resilience;
– fairness;
– affinity;
– mutual financial interest;
– affordability;
– low volatility;
– economy and practicality.

This economic analysis has been conducted to assist BIBA in responding to the FSA consultation on its FSCS funding review.[2]

The FSA published its consultation paper on the FSCS funding review in July 2012, with responses to be provided by the end of October 2012. The FSA is considering the structure and composition of the funding classes, cross-subsidies, levy thresholds and the calculation of tariffs. It is also looking to introduce any changes to the funding scheme following the expected implementation of the EU Deposit Guarantee Schemes Directive.

BIBA has been clear about its position that the current FSCS funding model unfairly penalises insurance brokers owing to 'the mistakes of the credit sector, insurers and the regulator'.[3] To address this issue, BIBA has called for the professional 'pure' insurance brokers to be separated from other firms in the insurance intermediary sub-class.

In this context, BIBA has commissioned Oxera to analyse its proposals from a scheme and market functioning perspective. Oxera's analysis has sought to address the following questions.

– What is the justification for introducing a separate sub-class from an economic point of view, taking into account the benefits to the working of the scheme and the financial services sector more generally?

– How can 'pure insurance brokers' be defined, conceptually and practically, and distinguished from other brokers?

– How might the proposed new funding model perform against the FSA criteria? Would the new sub-classes be affordable and sustainable?

Section 2 examines the performance of the current FSCS funding framework from the point of view of insurance brokers, with a focus on their experience during the current period of high levels of claims relating to payment protection insurance (PPI).

[1] FSA (2006), 'FSCS funding review', Discussion Paper 06/1, March.
[2] FSA (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July.
[3] Eric Galbraith, BIBA CEO, quoted in BIBA (2011), 'BIBA campaign results in FSCS funding review', press release, October 3rd.

Section 3 draws on this experience to consider whether there is an economic case for a separate FSCS sub-class for pure insurance brokers.

Section 4 then looks at how pure insurance brokers can be defined in terms of defining an FSCS sub-class, with a view to translating the conceptual framework developed in section 3 into a practical definition.

Section 5 addresses the important issue of sustainability.

2 Recent developments in FSCS funding

FSCS levies for general insurance intermediaries have increased markedly since 2009/10, owing to the rising volume of PPI claims. The current FSCS framework is based on the principle of broad groups of regulated firms that share some affinity with one another sharing the cost of the FSCS claims created by their group. However, in practice, the vast majority of these PPI-related claims have been created by specific types of insurance intermediary. This section of the report provides the context to these developments, looking at:

- the current FSCS funding framework;
- the recent increase in PPI-related claims on the FSCS;
- the nature of the firms that have been causing most of the PPI-related claims.

It also provides the background to support the economic case for the separation of 'pure insurance brokers', which is discussed in section 3.

2.1 The current FSCS funding framework

Since 2001, the FSCS has provided a last resort for customers with a (valid) compensation claim when a firm is unlikely to be able to pay those claims against it, typically owing to insolvency. Set up under the Financial Services and Markets Act 2000 (FSMA), it is an industry-funded scheme, wherein levies are collected annually from UK firms to pay any claims, and is monitored by the FSA. The current funding model is explained by the FSA in its consultation paper published in March 2007.[4] In July 2012, the FSA opened a consultation to review the current funding model, proposing several changes. At the time of writing in October 2012, the proposals are still under consideration.[5]

The current FSCS framework splits financial services firms into five broad classes, which are then split further to form nine sub-classes, including a general insurance intermediation group (see Figure 2.1).[6] Levies are collected from each sub-class, forming the 'pool' of money from which compensation is paid when necessary. A threshold is set for each sub-class, determining the maximum contribution that can be made by that sub-class in any one year. A three-tiered funding model operates during the compensation process, as follows:[7]

- Level 1: in the case of a default, the sub-class in which the default occurs bears the cost of all defaults up to the point of its sub-class threshold;

- Level 2: the other sub-class in the same broad class as the triggering sub-class then pays for any further compensation costs up to its own threshold;

- Level 3: the general retail pool will provide any excess funding for compensation payments if the broad class threshold has been reached but liabilities to eligible claimants remain.

[4] FSA (2007), 'Financial Services Compensation Scheme – Funding Review: Including feedback on DP06/1', Consultation Paper 07/5, March.

[5] FSA (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July.

[6] The other sub-classes include Deposit, General Insurance Provision, Life and Pensions Provision, Life and Pensions Intermediation, Investment Fund Management, Investment Intermediation, Home Finance Provision and Home Finance Intermediation.

[7] FSA (2007), 'Financial Services Compensation Scheme – Funding Review: Including feedback on DP06/1', Consultation Paper 07/5, March, p. 22. The Level 4 mentioned in the Consultation Paper was subsequently dropped and hence no longer operates. See FSA (2007), 'Financial Services Authority FSCS Funding Review: Feedback on CP07/5 and made text', Policy Statement 07/19, November, p. 32.

Levels 2 and 3 provide the explicit cross-subsidy, with other classes contributing to compensation payments if a class reaches its threshold. For example, if the default of a general insurance intermediary firm generates claims exceeding £195m, the general insurance providers would contribute up to an additional £775m (see Figure 2.1). If the claims exceed the sum of £195m and £775m (ie, £970m), level 3 of the funding model would be triggered and the customers would be paid out of the 'general retail pool'.

The sub-classes within any broad class are designed to have a higher level of mutual financial interest compared with the financial interest between broad classes. For example, general insurance intermediaries and general insurance providers are sub-classes within the broad class of general insurance. If the insurance intermediaries sell more insurance policies, it is likely that the insurance providers would benefit. The same would not be true of, say, the fund management sub-class in the broad category of investment.

Figure 2.1 The FSCS funding model

General retail pool—aggregate maximum capacity £4,030m

Life and pensions £790m	Investment £370m	General insurance £970m	Deposits £1,840m	Home finance £130m
Provision £690m	Fund management £270m	Provision £775m	Deposits £1,840m	Provision £70m
Intermediation £100m	Intermediation £100m	Intermediation £195m		Intermediation £60m

Note: The home finance class does not contribute to the general retail pool.
Source: FSA (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July.

2.1.1 Design principles for the FSCS funding framework

As a form of insurance scheme, the levies required to fund the FSCS would ideally reflect the riskiness of participating firms, in terms of their risk of creating claims on the fund. This would be consistent with the principle of 'risk-based pricing' in insurance.[8] Oxera noted in its 2006 paper for the FSA on the FSCS that:

> From an economics perspective, it is desirable to design a funding structure that improves the incentives of participating firms, although other (regulatory) tools are available to achieve this. Incentives are improved if firms pay in accordance with the risks they impose on the system. A risk-based levy structure may also be considered consistent with the competition criterion.[9]

Risk-weighted levies for individual companies may not be practical, however, because it is difficult to make judgements about the (future) likelihood of mis-selling claims being created

[8] The economics explaining the importance of risk-based pricing in insurance was established in a seminal paper by Rothschild and Stiglitz, in which they consider the implications of asymmetric information on behalf of the insurer, regarding the risk type of individuals. Rothschild, M. and Stiglitz, J. (1976), 'Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information', *Quarterly Journal of Economics*, **90**:4, pp. 630–49.

[9] See Oxera (2006), 'Funding of the Financial Services Compensation Scheme', March, p. v.

by a specific firm, combined with the likelihood of default; and these judgements can, therefore, be questioned at the time the risk-based levy is applied.

Despite the practical limitations on risk-based levies, well-defined FSCS sub-classes improve the affinity between firms in each sub-class, and, in turn, improve perceptions of fairness for an industry-funded scheme. The design of the FSCS funding framework therefore needs to balance the practical benefits of applying proportionate levies across broad sub-classes with the fairness inherent in levies that reflect the risk of more specific types of firm.

When designing the funding model, the FSA focused on the following design principles that reflected these considerations, as explained in its March 2006 discussion paper:[10]

– **durability and resilience**: each sub-class must be sustainable, with pockets deep enough to accommodate claims, including during times when there are many claims or one large institution goes bankrupt;

– **fairness**: assigning compensation to the firm that most deserves to pay—ie, to firms that are 'in some way proximate to the failed firm';[11]

– **affinity**: firms that 'look and feel' similar and have similar risk profiles should be grouped together;

– **mutual financial interest**: firms that are in 'mutually beneficial business relationships' may be exposed to each other's FSCS liabilities. Hence, companies that operate similar activities and deal with a similar industry and product space are grouped together;[12]

– **affordability**: this relates to the sustainability principle, whereby the liabilities imposed on firms should be affordable for them and not lead to the exit of firms;

– **low volatility**: the levy payable by each firm should not jump sharply from one year to another, which should allow the levy to be more predictable;

– **economy and practicality**: the funding model should be simple, efficient and economic to implement, for both the regulator and the firms.

The analysis in this report considers the FSCS funding model according to these design principles.

2.2 General insurance intermediation levies and payment protection insurance

The general insurance intermediation class, which started in 2005, is the largest sub-class within the FSCS model (in terms of participants), comprising 13,528 firms. It also contains a wide variety of firms, including insurance brokers, doctors, dentists, caravan park operators, motor dealers and credit brokers. The total levy received in 2010/11 for this sub-class was £57.23m, compared with £7.98m in 2009/10 and £0.63m in 2008/09.[13] The rapid increase in levies has been driven by the increase in claims from this sub-class over the past few years,

[10] FSA (2006), 'FSCS funding review', Discussion Paper 06/1, March.

[11] Ibid., p. 17.

[12] FSA (2007), 'Financial Services Compensation Scheme – Funding Review: Including feedback on DP06/1', Consultation Paper 07/5, March, p. 24, para 3.52.

[13] FSCS Annual Reports 2010/11, 2009/10 and 2008/09. The 2008/09 figures are net of any credit notes that were issued.

particularly in relation to PPI.[14] Table 2.1 below shows the trend in claims for the general insurance intermediation group.

Table 2.1 Trend in general insurance intermediary group

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Total number of claims	n/a	110	740	2,513	8,102	81,497[1]
of which PPI	–	–	535	2,411	8,001	81,005
Percentage of claims that are PPI	n/a	n/a	72%	96%	99%	99%
Total levies (£m)	1.08	1.93	1.41	7.39	59.6	69.5
Total compensation (£m)	0.1	0.07	0.13	12.3	35.8	45.0[2]
Average compensation on PPI (£)	n/a[3]	n/a[3]	n/a[4]	8,540	5,261	n/a[4]
Average compensation on other claims (£)	n/a[3]	n/a[3]	n/a[4]	1,152	1,893	n/a[4]

Note: [1] More than three-quarters of the total claims received in 2011/12 related to one firm: Welcome Financial Services. [2] Of the £45m paid out, £41.4m was in relation to Welcome Financial Services. [3] There were no PPI claims in these years. [4] Data was not available for this period.
Source: FSCS Annual Reports 2007/08 to 2010/11; and 'FSCS Levies Raised', available at: http://www.fscs.org.uk/uploaded_files/Industry/fscs-levies-raised-2012-07.pdf.

Table 2.1 shows that there has been an escalation in the proportion of PPI claims within the general insurance intermediary group. The total number of claims increased by 220% between 2009/10 and 2010/11, with PPI claims forming over 95% of the claims. A large portion of the PPI claims in 2009/10 came from one company, Picture Financial Services plc, which specialised in mortgages, while, similarly, Welcome Financial Services Limited, a credit broker, was responsible for a large portion of the claims in 2011/12. The levies and compensation payments have increased in line with the compensation paid out, implying that all firms within the general insurance intermediation class (including those that do not sell PPI) have been subject to a higher levy.

PPI has dominated complaints and subsequent claims in the financial services sector in recent years, and the problem continues to be a cause of concern, as recognised in the Annual Review 2011/12 of the Financial Services Ombudsman (FOS):

> Our work has been dominated during the year by complaints about the mis-selling of payment protection insurance (PPI). These complaints...accounted for 60% of our total annual workload...We received over 150,000 of these cases during the year – the highest number we have ever received in a year about a single financial product. At the time of writing, we are still receiving PPI complaints – at the rate of over 1,000 new cases every day.[15]

The FOS described the PPI complaints as highly volatile, and noted that it will take measures to expand its capacity to deal with PPI claims. Having spoken to stakeholders and the FSA, the FOS expects the number of cases to increase, at least in the medium term.[16]

In light of these forecasts of PPI claims, the FOS also proposed a supplementary case fee for PPI cases,[17] acknowledging that it would not be fair to require businesses not involved in mass claims regarding the selling of PPI to meet the higher costs of the FOS's capacity:

[14] This type of insurance covers the buyer if they are unable to pay back their loan or pay their debt repayments because of problems such as redundancy or illness. In the event of a claim, the insurance underwriter is liable to pay out.

[15] Financial Ombudsman Service Annual Review 2011/12, p. 6.

[16] Financial Ombudsman Service (2012), 'Our plans and budget for 2012/2013: a consultation paper', January, p. 18.

[17] There are two fees collected by the FOS: a general levy, which is collected by the FSA at the time of the FSCS levy collection; and a case fee, which is collected only when a case is escalated to the FOS. This individual case fee is collected by the business against which the complaint has been levied by the customer (as per the FOS's document). An important point

> we do not believe that it would be fair for these higher costs [as a result of increasing capacity to deal with PPI cases] to be met by those businesses not involved in mass claims about the selling of PPI. This is why we are proposing a supplementary case fee of £350 – in addition to the standard case fee of £500 – for cases involving the mis-sale of PPI.[18]

The FOS publishes data on general insurance complaints received. Table 2.2 shows that, of the total PPI claims made over 2007/08 to 2011/12, the general insurance intermediation group represents, on average, 77% of claims. Evidence indicates that PPI is a continuing concern in the regulatory world and that measures are being taken to recognise its impact.

Table 2.2 FOS complaints data

Year ending March 31st	General insurance	PPI	Total	PPI/total
2011/12	27,563	157,716	185,279	85%
2010/11	20,978	104,597	125,575	83%
2009/10	19,838	49,196	69,034	71%
2008/09	19,102	31,066	50,168	62%
2007/08	16,634	10,652	27,286	39%
Average	**20,823**	**70,645**	**91,468**	**77%**

Source: Financial Ombudsman Service website, http://www.financial-ombudsman.org.uk/publications/ar12/about.html#a5a, accessed on October 5th 2012.

Approximately 80% of the companies triggering PPI-related FSCS claims have been brokers who sell insurance in addition to another (non-insurance) product, such as credit brokers, motor dealers and mortgage brokers.[19] Table 2.3 lists the major defaults and claims paid out, and shows that PPI claims have arisen mainly from large credit brokers. Before 2008/09, PPI claims were not common and, hence, levies were on average £1.5m (see Table 2.1).

Table 2.3 PPI compensation paid in 2011/12

Name of company	Year of default	Total compensation to date (£m)
Welcome Financial Services Limited	2011/12	42.5
Picture Financial Services	2009/10	28.2
Keater Limited	2010/11	7.7
Wilmslow Financial Services	2011/12	3.8

Note: Total compensation for 2009/10 and 2010/11 is calculated by multiplying the total number of claims by the average compensation paid for each firm.
Source: FSCS Annual Accounts 2009/10, 2010/11 and 2011/12.

The above data shows how the sharp increase in FSCS levies for general insurance intermediation has occurred as certain firms mis-sold PPI and then defaulted, so that the FSCS has had to cover the cost of the PPI compensation claims. The primary cause of the rise in levies is therefore the mis-selling of PPI.

here is that, according to the FOS, a business cannot recover the costs from the customer who levied the complaint in the first place. If it does, the customer can contact the FOS to complain about this.

[18] Financial Ombudsman Service (2012), 'Our plans and budget for 2012/2013: a consultation paper', January, p. 18. The FOS charges a size-dependent levy on all companies that are covered by the service.

[19] The proportion has been calculated based on data received from BIBA. A total of 73 firms that were considered to have defaulted as a result of PPI have been divided into groups on the basis of their activities. Any firms conducting lines of business in addition to insurance broking have been classified as brokers that sell insurance in addition to another product, while the others have been classified as brokers that sell insurance as their primary product. The total number of firms falling into the former category was 58, while 15 fell into the latter. As a result, 80% is calculated as 58 divided by the total sample of 73 firms.

2.3 Causes of the mis-selling of PPI

PPI is considered a secondary product because it is purchased only once the primary product (in this case, a credit facility) has been obtained. Secondary products are fairly common. Examples include travel insurance (possibly purchased from a travel agency after booking a flight); certain accessories (a tie to match a suit or shirt purchased in the same clothes shop); or a mobile phone charger (to match a new mobile phone).

The FSA has recognised that product bundling may lead to ineffective competition, and thus give market power to product providers, 'which they may exercise at consumers' expense'.[20] In particular, according to the FSA, if a consumer is sold a secondary or bundled product, this may lead to problems because 'given consumer interest and behavioural traits, consumers may focus less on certain product features or add-on products and request less information about them than they would about standalone products.'[21] Regarding intermediaries in particular, the FSA identified perverse incentives for them to withhold relevant information to the detriment of customers in order to increase sales and hence commissions earned.[22]

The sale of PPI as a secondary product alongside a credit product has been linked to the occurrence of mis-selling, as it created opportunities for firms to obstruct consumers from making informed decisions. When identifying the common reasons for reaching the conclusion that a firm had mis-sold PPI, the FSA stated in an open letter that, in many cases, 'the firm failed to explain [the PPI product] to the customer in a way that was clear, fair and not misleading, in good time before the sale was concluded'.[23] The causes of mis-selling of PPI are discussed further in section 3.

2.3.1 Implications for the FSCS funding framework

The clear link between PPI mis-selling and the sales process suggests that this current driver of FSCS claims may indicate a need for alterations to the FSCS funding framework. The FSCS, as an industry-funded scheme, is based on the principle of firms with 'affinity' to one another sharing the cost of claims. If the nature of PPI mis-selling indicates a structural difference between those firms that typically mis-sold PPI and those firms that did not, there could be a case for redefining sub-classes, so that the extent of affinity between firms in the same sub-class is improved.

This case for change would be based primarily on the strength of evidence that the causes of PPI mis-selling indicate persistent structural differences between firms that are likely to affect the likelihood of future cases of mis-selling. This economic case for the separation of general insurance intermediaries based on the evidence regarding PPI mis-selling is therefore the focus of section 3.

[20] The FSA began investigating the market for PPI in 2005. See FSA (2005), 'The Sale of Payment Protection Insurance—Results of Thematic Work', November; and, for a more recent update, FSA (2009), 'Update on FSA Work on PPI', press release, January 20th. The Competition Commission's 'Payment Protection Insurance Market' investigation was published in January 2009. The quote is from FSA (2011), 'Product Intervention', Discussion Paper 11/1, January, p. 26, para 3.16.

[21] Ibid., para 3.16.

[22] Ibid., p. 27, para 3.25.

[23] FSA (2010), 'Common point of sale failings for PPI sales', open letter, available at: http://www.fsa.gov.uk/pubs/other/trade_associations_ppi.pdf.

3 Economic case for a separate FSCS sub-class

The rapid increase in FSCS levies due to PPI-related claims arising from a specific subset of firms suggests that there may be a case for examining the classification of firms so that the FSCS sub-classes share greater affinity. In particular, this section considers the economic case for separating the general insurance intermediaries for which selling insurance is a secondary (or, in some cases, tertiary) activity (such as credit brokers, motor dealers and banks) from those intermediaries that are focused primarily on the sale of insurance (referred to as 'pure insurance brokers').

This distinction arises because the mis-selling of PPI was done primarily by firms that were selling an insurance product on the back of another financial product, usually loans, mortgages, or some other form of credit. The interaction between these firms and their customers was primarily about the credit product, with the PPI sold as a secondary product. In contrast, pure insurance brokers, which typically did not sell PPI, interact with their customers primarily on the basis of selling insurance products. For the purposes of this analysis:

– 'pure insurance brokers' are defined as those firms whose primary aim is to sell an insurance product on behalf of the insurance provider in exchange for a commission;

– 'non-pure insurance intermediaries' are defined as those firms whose primary aim is to sell other financial or non-financial products—such as cars, dental services, personal loans or mortgages—and act as insurance intermediaries when selling insurance products (such as PPI) on the back of their primary sale.

To make the case for a separate sub-class of pure insurance brokers, it would need to be clear that there are structural differences between them which justify a separate sub-class in terms of the principles for the funding of the FSCS, which is considered in section 3.1. The remainder of section 3 then examines the evidence for a separate FSCS sub-class for pure insurance brokers.

3.1 The basis for a separate FSCS sub-class

The seven principles for the funding of the FSCS (set out in section 2.1) determine the strength of evidence that would be required to justify a separate FSCS sub-class. The principles essentially involve a trade-off between improving the extent of affinity between firms within a sub-class and maintaining practical administration of the system and ensuring that sub-class funding is sustainable. These elements are considered below.

Affinity, fairness and mutual financial interest

While the FSCS does not attempt to achieve risk-based levies, the principles recognise that an industry-funded scheme should have sub-classes of firms that share affinity with one another, and that funding of the FSCS should be fair and proportionate.[24] Mutual financial interest is an important element of this affinity, alongside structural similarities.

The FSA recognises that the levy does have an impact on firms' incentives, and therefore that ensuring affinity between firms in sub-classes is important. In its recent consultation paper, when explaining its reasoning for a proposed end to cross-subsidy between insurance providers and intermediaries (see section 5.2 for discussion), the FSA states:

[24] See FSA (2006), 'FSCS funding review', Discussion Paper 06/1, March, p. 33.

> We are conscious that, to a degree, this approach undermines the natural affinity between these providers and their intermediaries. But cross-subsidy is only likely to be one-way and could have distortive effects – such as over-provision of the subsidised activities or reduced risk management incentives.[25]

This makes it clear that cross-subsidy between different types of firm should be avoided except in extreme circumstances, as it can result in (unwanted) changes in behaviour. Having two different types of firm within the same sub-class creates considerable more cross-subsidy than in this example of providers subsidising intermediaries once the levy threshold has been breached, as the latter example is likely to occur only in exceptional circumstances (and has not occurred so far for insurance intermediaries).

Consumers ultimately pay the levy, and, as explained above, consumers should ideally pay according to the riskiness of the types of service that they use. Their decisions should thus reflect the cost to the scheme of the services they use. This suggests that the concept of affinity should be considered in terms of the demand side (eg, the customer experience) as well as the supply side (eg, the focus and capabilities of the firm).

Section 3.2 below therefore considers whether pure insurance brokers are sufficiently different from non-pure insurance intermediaries to suggest that a separation would be justified in terms of affinity, fairness and mutual interest.

Economy and practicality of administration

The FSCS requires a definition of sub-classes that assists in the practical and efficient operation of the scheme. Objective definitions are required that can be understood by firms and be consistently measured by the regulator.

The practical definition of pure insurance brokers is considered in section 4.

Sustainability, low volatility and affordability

The sub-classes of the FSCS should be set up so that 'the scheme's pocket should be deep enough to cope with a variety of compensation scenarios'.[26] Cross-subsidies in which other sub-classes fund claims once levy thresholds have been breached vastly improve the sustainability of the FSCS; however, in the interests of maintaining affinity and fairness, these cross-subsidies should be relied on only for rare, significant events.

As discussed in section 5, the 2012 FSA consultation paper includes extensive analysis of the affordability of levies (in terms of the percentage of income and profits of firms), but not of the likelihood of levy thresholds being breached. Although sustainability is referred to in a number of places as being a key criterion, no analysis of sustainability is provided.

Within the context of limited FSA analysis, section 5 of this report considers the likely sustainability of the resultant general insurance intermediation sub-classes if pure insurance brokers were separated.

3.2 Are pure insurance brokers different?

To make the case for a separate sub-class for pure insurance brokers, it must be shown that there are sufficiently material and relevant structural differences between pure insurance brokers and other insurance intermediaries to justify separation on the basis of affinity.

The evidence for such a structural difference can be drawn from the ongoing experience of PPI mis-selling claims. The causes of PPI mis-selling point to structural differences in terms

[25] FSA (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July, para 4.11.
[26] See FSA (2006), 'FSCS funding review', Discussion Paper 06/1, March, p. 4.

of the both the demand side (eg, the customer experience) and the supply side (eg, the focus and capabilities of the firm).

Demand side: the customer experience

In the FSA and Competition Commission investigations, the mis-selling of PPI was linked to the fact that it was typically sold as a secondary product at the point of sale of the primary product, which resulted in limitations in consumers' ability to effectively judge whether the product was suitable and the price was reasonable.

There are many examples of secondary products. Pure insurance brokers also sell some add-on insurance products. At first sight, therefore there may not appear to be a difference between non-pure and pure insurance brokers, but a closer examination of the reasons for the serious consumer protection issues with PPI reveals important differences from the consumer's perspective, including:

– the focus of the consumer on insurance products;
– the 'loss aversion' factor; and
– the comparability of prices.

When a customer makes a purchase with a pure insurance broker, their mind is framed in terms of assessing the need for insurance. They need to think about the risks they are exposed to, the amount of coverage they need, what excess they can afford, and so on. This means that they are well placed to think about the need for *additional* insurance products that they may be offered. The add-on may simply be a policy enhancement, such as legal expenses cover in conjunction with motor insurance. In other cases, add-on insurance products may also be sold as separate products in their own right, such as lost key insurance and home insurance.[27]

In contrast, a customer of a credit broker is most likely to be focused on obtaining a loan; likewise, a customer of a caravan dealer is most likely to be focused on obtaining a caravan. After the customer has made a decision about the loan they want to take, the credit broker may offer an insurance policy (such as PPI or identity theft insurance). With the credit broker, therefore, the customer has to change their focus from loans to insurance products. This difference is relevant to the FSCS because, in the case of PPI, the lack of focus on the secondary product has been shown to be a key determinant of the risk of mis-selling, which in turn is a key determinant of FSCS claims.

Behavioural economics[28] and experiments have shown that, once committed to the purchase of the primary product, people may not fully process add-on information about the price and suitability of a secondary product, if that product is perceived to provide 'protection' for the first product that has been agreed to. This behavioural trait is referred to as 'loss aversion'. For example, PPI protects the ability to service the loan that the consumer will have just agreed with the credit broker (and the case for this perceived protection would be made even stronger if there were a suggestion that PPI was required for the loan to be offered in the first place). Another example would be extended warranty agreements, which have also been subject to a Competition Commission investigation.[29]

Products sold by pure insurance brokers, on the other hand, can be expected to create less risk of loss aversion, as they would not typically be perceived by the customer to provide protection for the primary product. Consequently this would suggest that the reasons for the

[27] There are limits to the amount of information that consumers are likely to usefully interpret in a sales situation, which suggests that a wide array of add-on products may lead to a reduction in the quality of consumer decision-making.
[28] Behavioural economics is the study of the effects of social, cognitive and emotional factors on the economic decisions of individuals and organisations.
[29] Competition Commission (2003), 'Extended Warranties on Domestic Electrical Goods: A Report on the Supply of Extended Warranties on Domestic Electrical Goods Within the UK'.

poor decision-making on the purchase of PPI as a secondary product would not apply (at least not to the same extent) for pure insurance brokers.

Also relevant are the Competition Commission findings on the focus of consumers on the price of credit rather than on the price of PPI (or the total price):

> We noted that most consumers focus their search on credit, rather than on the combination of credit and PPI, and that searchers for credit appear to focus on APR. Further, we noted that the price of taking out PPI is often more than the cost of interest and can vary significantly. Searching for PPI can therefore have a significant impact on the value for money consumers achieve on their protected credit products. However, as the cost of PPI is typically shown relative to the total payment on credit, as opposed to the interest cost, consumers may not be fully aware of the relative importance of PPI. We were concerned, therefore, that consumers are not receiving the information they need in a suitable format for them to make a reasoned choice as to the best-value product. In particular we thought that information which allowed an easy comparison between the cost of the PPI on credit and the cost of interest on the credit would help consumers search for the best-value credit product, PPI product, or combination.[30]

In contrast, a customer of a pure insurance broker is focused on insurance as a product and is in a better position to compare prices of the package of insurance being sold, including add-on products. The price of additional products sold by pure insurance brokers, such as legal expenses cover, can be added to the premiums for the primary product, allowing for easy comparison of price levels. This is in contrast to the findings of the Competition Commission investigation into PPI, as summarised in the quote above, where comparison of the cost with the cost of the credit was difficult for most consumers, as the comparison was made with a figure that included the repayment of the capital of the loan, as well as the interest payments.

More generally, the preferences of consumers are reference-dependent (dependent on the circumstances of the sale) and can be exploited during the choice-making process. For example:

– consumers may be more prepared to pay for an add-on secondary product at the point of sale of a primary product (eg, insurance sold alongside a loan product), as they already regard themselves as owning the primary product, and are then prepared to pay to avoid 'losing' it;

– consumers may not actually take account of, or be able to calculate, the full combined cost of the two products at the checkout stage. For example, the price of a loan is expressed in terms of an interest rate whereas the price of PPI is expressed in terms of a premium for a certain amount of coverage. It is then far from straightforward to work out the total price;

– for similar reasons, consumers may be more prepared to incur add-on fees (eg, 'drip pricing' of credit card surcharges on non-financial services products such as holidays, and add-on fees in mortgages) later in the choice-making process, compared with a situation in which the add-on fees are either clearly set out up front or are included in the product price to begin with.[31]

In summary, secondary purchases of insurance from other insurance intermediaries that focus on selling a different primary product (such as credit) can lead to reduced quality of consumer decision-making relative to pure insurance brokers for three main reasons:

[30] Competition Commission (2009), 'Market investigation into payment protection insurance', January, para 5.38.

[31] With drip pricing, consumers face a headline price up front, and as they engage in the buying process, additional charges are 'dripped through' by the seller.

– the customer is likely to be focused on the primary product, which means that for other insurance intermediaries the customer is not likely to be focused on insurance, and hence at risk of not processing in full add-on information regarding the secondary product;

– the customer may suffer from loss aversion in the case of buying insurance as a secondary product related to a different (non-insurance) primary product, as they feel they have achieved a deal on the primary product and do not wish to lose that because of the secondary product; and

– the comparison of price levels by the customer can be hindered in the case of buying insurance from non-pure insurance brokers, as shown by evidence on PPI.

The PPI mis-selling experience supports the expectation that pure insurance brokers should produce less mis-selling of insurance policies such as PPI, as the structural differences between pure insurance brokers and other insurance intermediaries have been apparent in this matter, which typically has not involved pure insurance brokers. These structural differences suggest that pure insurance brokers are likely to produce a different (lower) level of FSCS claims in the future than other insurance intermediaries.

Supply side: firm behaviour

It may also be the case that structural differences between brokers reflecting different customer experiences are bolstered by differences in firm behaviour. Possible supply-side structural differences may include the following:

– pure insurance brokers may have different incentives as they are focused primarily on insurance products, unlike secondary brokers, which sell insurance as an add-on product—this could potentially affect the risk of mis-selling; for example, a motor dealer or a credit broker may focus on their reputation for selling cars or credit, and be less concerned about the quality of their insurance products, as this is not their core business;

– pure insurance brokers may maintain longer-term relationships with their clients, with regard to the provision of insurance contracts, than other insurance intermediaries, also potentially reducing the risk of mis-selling owing to the desire of the broker to maintain the relationship for future sales; this could arise due to many insurance products being repeat purchases that are due for renewal every year, whereas credit and motor transactions, for example, are less likely to be repeated over short time horizons.

Not all pure insurance brokers maintain long-term client relationships, and not all will be more knowledgeable about their products than other insurance intermediaries. However, both the demand- and supply-side arguments reinforce the point that different consumer experiences and different company focus suggest a lack of affinity.

3.3 The potential benefits of a pure insurance broker sub-class

The current classes of the FSCS are defined according to regulated activities: general insurance, investment activities, etc. The sub-classes further separate providers of services from retail activities (those selling to the end-consumer). To separate pure insurance brokers from other insurance intermediaries would be to take this logic one step further, and separate firms according to their primary activities (with respect to how these primary activities can affect the likelihood of creating FSCS claims with regard to regulated activities).

This type of distinction is not new. FSA regulation recognises the importance of similar differences in affinity between firms in other groups of intermediaries. For example, the distinction between IFAs (independent financial advisers) and tied agents reflects structural

difference in how they interact with consumers. The reason why distinctions are made is so that regulation can be tailored to the structural features of each group.

The question then arises, however, as to why an industry-funded compensation scheme such as the FSCS should take these differences into account. It has been recognised that the FSCS levies may not create clear incentives for firms to change their behaviour, as the levies will always be applied to firms that have not caused a claim on the fund, given that the firms that have caused claims have, by necessity, defaulted. However, the FSA recognises[32] that the levies can affect behaviour to some extent. A possible avenue for this could be through altering incentives around different distribution channels and business models, which in turn can affect the supply of products. Furthermore, as the cost of the levies is ultimately borne by the end-consumer, the allocation of resources by the consumer is affected by the levy. The separation should also help to make differences in risk between different channels more apparent to providers, if they are consequently supplying the same product to two different sub-classes (eg, motor insurance to both pure insurance brokers and motor dealers).

Levies separated according to structural differences between firms that reflect the risk of mis-selling should, therefore, encourage more economically efficient allocation of resources in favour of the firms less likely to cause mis-selling. This should therefore ultimately provide benefits to the wider economy through lower levels of mis-selling.

Lastly, it should be noted that the potential costs of separating out a pure insurance broker sub-class come from issues surrounding practical implementation and sustainability, as discussed in sections 4 and 5 below. There is no significant cost arising from the concept of affinity—if the two groups were separated and were then found to have a similar claims profile, both sub-classes would continue to pay according to their claims.

The remainder of this report therefore focuses on the outcome of splitting the groups, and hence benefiting from closer affinity, depending on the other two conditions that need to be met:

– practical application: how should ‘pure insurance brokers’ be identified? (section 4)
– sustainability: how can the sustainability of the resultant sub-classes be ensured? (section 5)

[32] As indicated in FSA (2012), ‘FSCS Funding Model Review’, Consultation Paper 12/16, July, para 4.11, and quoted in section 3.1 of this report.

4 How should ‘pure insurance brokers’ be identified?

Section 3 set out the economic case for why pure insurance brokers are different from other insurance intermediaries, and why they should be treated separately in the FSCS funding mechanism. The question then arises as to how pure insurance brokers might be identified for the purposes of the FSCS, consistent with the economic case for separation.

The FSA considers the identification of firms according to their primary activities to be problematic. In particular, in relation to pure insurance brokers, it states in the 2012 consultation paper that:

> Even if we were able to draw up a list of likely primary firm categories, allocation to a class would nevertheless require uncertain and potentially inconsistent subjective assessments either by firms or by us. (paragraph 3.33)

However, in this section, an approach for identifying pure insurance brokers is considered which aims to provide an objective, consistent and robust measure from the consumer’s perspective, not a subjective approach based on the opinion of firms.[33] The allocation of firms to a separate pure insurance broker sub-class need not be uncertain and subjective, and can therefore be consistent with the principles of FSCS funding, as explained in this section.

4.1 Conceptual framework

At the start of this study, BIBA provided Oxera with a working definition of pure insurance brokers, as developed by the law firm, Beachcroft, in order to distinguish between primary and secondary activities. Oxera considered this from an economics standpoint, and aims to develop further an objective approach to defining insurance brokers from the consumer’s perspective.

The Beachcroft definition of a ‘pure insurance broker’ was as follows:

1) the firm has only insurance mediation activity permissions from the FCA;

2) these activities must include one or more of arranging, advising and dealing as agent permissions; and

3) insurance mediation activities must not be ancillary or supplementary to any other business, trade or profession.

To develop this further, the discussion in section 3 on the economic case for the separation of pure insurance brokers was translated into a conceptual framework for identifying pure insurance brokers, to ensure that the practical definition is in line with the structural characteristics that are linked to lower likelihoods of creating FSCS claims.

The principal conclusion of the economic analysis in section 3 is that when consumers are focused on buying insurance products, from a firm that is similarly focused on selling insurance, there is a lower risk of mis-selling situations (as mis-selling is linked to the insurance being sold as a secondary product). The appropriate conceptual framework should therefore identify firms that meet these criteria. The conceptual framework suggests that the ‘pure’ insurance broker:

[33] The FSA already asks regulated firms whether insurance intermediation is their ‘primary activity’, but this results in a subjective assessment by the firms themselves and would therefore not be appropriate.

– is focused primarily on selling insurance products; and

– has customers who are focused on buying general insurance products, not on buying another product for which insurance can be sold as a secondary product.

The Beachcroft definition used FSA permissions as the initial indicator of primary versus secondary focus of firms, and this is adopted here. Clearly, this is an easily identifiable aspect of firms.

The focus of the conceptual approach is on the consumer's perspective, and the focus of the consumer, in terms of products, would ideally be identified based on the total spend of the consumer (for example, the proportion of total consumer spend with a firm that was on general insurance products). Unfortunately, the total spend by consumers is not recorded for general insurance intermediation;[34] rather, information on the firm's income is recorded.

Typically, a firm's income is a useful indicator of the amount of money that consumers spend on their purchases from that firm, but this is not the case with many types of financial intermediation, as 'eligible income' is recorded in terms of the commissions that the broker receives, rather than the amount of money spent by the consumer. The information on income therefore needs to be supported by further information that can help to identify the range of products that consumers are buying.

Information on product sales can help in this regard. If one were to require that the majority of the product sales were general insurance products, this would help to ensure that a significant number of customers buy insurance and nothing else. This approach should exclude most credit brokers. where the customer's primary interest is a non-insurance product—ie, credit. This is discussed further in section 4.2 below.

This conceptual approach would therefore suggest that pure insurance brokers could be identified according to the following rules:

– the firm has only insurance mediation activity permissions from the FSA—ie, any multiple licence companies would be excluded from this sub-class;

– the majority of total income comes from regulated income (the precise threshold discussed in section 4.2 below)—ie, most of the income of the firm is derived from selling general insurance; and

– the majority of the total number of product sales are insurance products (the precise threshold discussed in section 4.2 below)—ie, most of the sales made by the firm are general insurance products.

This approach to identifying 'pure' insurance brokers would be designed to be objective (rather than using subjective self-identification methods) and consistent with the conceptual framework.

4.2 Practical implication

The objective nature of the approach to identifying pure insurance brokers can be tested through the consideration of how the three requirements identified in the conceptual framework may be implemented in practice.

[34] In the case of credit brokers, the total spend by consumers may not be known, as the broker records only the commission they receive for arranging the loan, not the interest payments that the consumer makes on the loan.

4.2.1 Requirement for only insurance mediation activity permissions

This requirement would exclude from the 'pure insurance broker' sub-class financial services firms that engage in a range of activities, notably:

- banks that sell general insurance; and
- independent financial advisers that sell general insurance.

However, at present this requirement would not exclude many other insurance intermediaries, for instance as credit broking does not currently require a separate activity permission and a motor dealer is likely to have only an insurance intermediation permission from the FSA.

This requirement would produce relatively stable results, as firms do not typically change their activity permissions with any frequency. At the same time, the requirement does not stop a company with multiple licences from setting up a separate legal entity to conduct the general insurance broking business.

Overall, this requirement would be stable and objective, but would need to be combined with other requirements in order to identify pure insurance brokers in line with the conceptual framework.

4.2.2 Requirement for total income to comprise mainly regulated income

The purpose of this requirement is to test whether both the firm and its customers are focused primarily on general insurance products. Ideally, one would have data on turnover (ie, total spend by consumers), although this may not be readily available—for example, with credit brokers that do not report the interest payments/capital repayments made by customers. The FSA collects income data, rather than turnover data, and therefore the use of income data is considered.

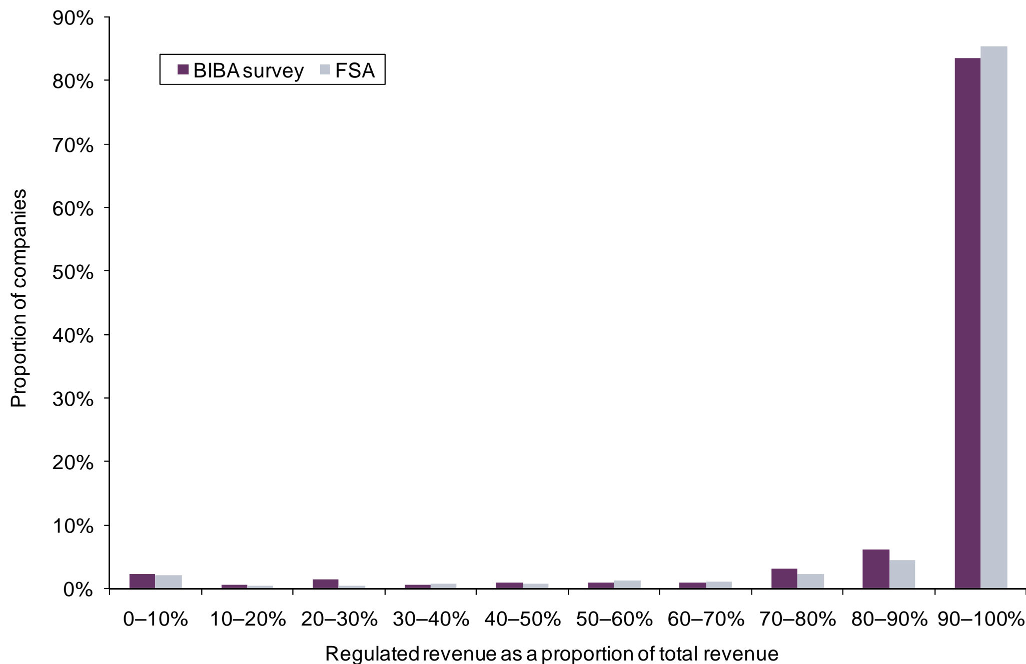
This requirement would therefore need to adopt a percentage of total income as a cut-off point that would have relatively few firms operating at a proportion of total income being close to the cut-off point, to avoid firms moving in and out of the definition due to relatively minor changes in their sales.

Consequently, it was necessary to examine relevant data on the proportion of total income that is regulated income for relevant insurance intermediaries. Data supplied by both BIBA members and the FSA was considered, and similar results were found from both sets of data, as summarised in Figure 4.1 below. Details of the data sources include the following:

- BIBA conducted a survey of 358 of its members, all of whom would consider themselves to be 'pure insurance brokers' based on a subjective self-interpretation. The firms reported on the proportion of their total income that was regulated income;

- the FSA asked in its regulatory returns questionnaire whether 'regulated activities are core' to the business. It provided data on the proportion of total income that is regulated income for firms that have only a general insurance intermediation activities licence and answered 'yes' to the 'regulated activities are core' question (which could be another proxy for pure insurance brokers). This subjective determination of firm type is useful here for understanding the likely nature of pure insurance brokers.

Figure 4.1 Estimated distribution of regulated income as a proportion of total income for pure insurance brokers



Source: BIBA survey, FSA, and Oxera calculations.

Figure 4.1 shows that, for the BIBA members and the FSA-defined sub-set, regulated income makes up the vast majority of total income for most of the firms, as one would expect—92.7% of the BIBA members who responded and 92.1% of the firms in the FSA dataset report that over 70% of their total income is regulated income.

As only around 1% of companies report regulated income of around 60–70% of total income, there would be few firms that would have regulated income just below a cut-off point of 70% of total income.

While this indicates that the vast majority of pure insurance brokers would meet a requirement that 70% of total income be regulated income, it is also the case that some other insurance intermediaries would meet this requirement. For example, some credit brokers were making the majority of their income from PPI, a general insurance product, despite their primary product being credit. This was because their commissions on PPI were much larger than their commissions on the loans themselves. The proportion of income that is regulated income is used as a proxy for the more ideal turnover measure (the proportion of total consumer spend that is on insurance products), but it is not a perfect proxy, and has particular flaws with regard to insurance intermediaries (as income is driven by commissions, which can vary considerably compared with consumer spend).

For this reason, an additional requirement would be necessary to ensure that the methodology identified pure insurance brokers only.

4.2.3 Requirement for most product sales to be insurance products

This requirement aims to ensure that the firm’s customers are focused on buying insurance products, rather than some other product. The product sales requirement complements the regulated income requirement. This is because if a firm makes most of its income from insurance products and most of its product sales are insurance products, it is most likely to be a pure insurance broker. A credit broker that makes most of its commission (and therefore income) from PPI would still be unlikely to sell more insurance products than credit products, as one might expect all customers of a credit broker to purchase a credit facility, but some will not purchase PPI.

There would be some practical matters for consideration, however. The FSA does not currently collect data on the number of products sold, although it does enquire about primary activities at the point of authorisation. Arguably, the FSA could benefit from collecting information about the product sales activities of firms, in terms of gaining a better understanding of the focus of the firm.

As data on the number of product sales does not exist at present, it would be difficult to define a cut-off point at this stage that provides a clear distinction between types of firm. The cut-off point should be at least 50%, as this figure ensures that the majority of product sales are general insurance products and therefore limits the extent to which there are likely to be customers not buying an insurance product (for example, with a credit broker).

Data on penetration rates on PPI sales shows that the total number of PPI policies sold as a percentage of total loans sold ranged between 14% and 36% in 2009, with the lowest being for first-charge mortgages and the highest for second-charge mortgages. Credit card PPI penetration rates were stable at around 20% in 2006, while rates for mortgage and personal loan PPI have steadily declined since 2004.[35] That said, these estimates are averages and some credit brokers may have been selling higher proportions of PPI products.

4.3 Assessment

The outline provided above for how pure insurance brokers could be defined for the purposes of the FSCS levies should produce a relatively objective assessment that is not reliant on subjective self-assessment. The suggested approach would require some additional data to be collected by the FSA. This would clearly have some costs associated with it, but they are likely to be small (the firms are likely to have this information to hand) and there could be other advantages for the FSA from collecting this information, particularly in terms of the FSA's understanding of the (changing) market dynamics in this part of its regulatory responsibility.

Any definition would need to consider how firms may respond, particularly if one sub-class produces consistently lower levies than another (which would be the expectation, given that the pure insurance brokers are expected to be less likely to create FSCS claims). This would give the other insurance intermediaries an incentive to portray themselves as pure insurance brokers. It is likely that it will be possible for such a firm to separate off its insurance intermediation activities into a separate legal entity, which would then, for the purposes of the FSCS, be defined as a pure insurance broker according to the above system. Nevertheless, there remains a question mark over whether there would be sufficient incentives for firms to adopt this policy.

Overall, this suggested approach should provide an objective basis for identifying 'pure' insurance brokers in line with the conceptual framework, with practical requirements that should be feasible.

[35] Competition Commission (2009), 'Developments in PPI markets since the 2009 report', Appendix A, Table 4.

5 How can the sustainability of the resultant sub-class be ensured?

The sustainability criterion requires that each sub-class has sufficiently deep pockets to accommodate claims within the section, including during times when there are many claims when or a large institution goes bankrupt.

The FSA did not include analysis of sustainability in its recent consultation paper, but instead focused the analysis on affordability (the proportion of a firm's income or profits that is used to pay the levy, and the extent to which firms may be able to pass on levies to consumers, or if there is a risk that the firm may exit the market). The FSA acknowledges the importance of sustainability, but does not define or analyse it:

> We have clear objective criteria for inclusion in classes, thresholds set by clearly defined parameters aimed at ensuring funding requirements are affordable and sustainable...[36]

The FSA often refers to sustainability as being a problem for changes in the FSCS sub-classes, although it does not undertake analysis of sustainability to support this conclusion. While the splitting of a sub-class will increase the likelihood of levy thresholds being breached, this does not necessarily mean that the sub-class has become unsustainable.

The FSA proposes a further change to the FSCS funding system that would actually worsen sustainability—removing the cross-subsidy between providers and intermediaries if levy thresholds are breached. This proposed change is considered in section 5.3.

In order to assess whether a sub-class is sustainable, one must first define the concept of sustainability and then consider whether this criteria is met. Based on evidence available (given the lack of FSA analysis of sustainability), this section considers whether the separation of pure insurance brokers would result in sustainable sub-classes. Past evidence suggests that the two separate sub-classes could each meet a relatively stringent definition of sustainability.

5.1 Definition of sustainability

In the 2006 FSCS funding review,[37] the FSA defines the general concept of sustainability as follows, although this refers to the FSCS scheme as a whole rather than the sustainability of individual sub-classes:[38]

> *Durability and resilience*. Any new funding arrangements should be sustainable over time and robust when considered against a variety of future scenarios. In particular, consumers should be able to assume that the scheme has a pocket deep enough to meet valid claims, even when a large number of claims coincide in time, or in the face of default of a significant institution, among other scenarios.

The FSCS scheme can be compared to an insurance portfolio where the insurer expects the portfolio to typically be able to cover claims from premiums, except in unusual and infrequent circumstances when claims exceed premiums and an excess of loss arrangement is

[36] FSA (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July.

[37] FSA (2006), 'FSCS Funding Review', Consultation Paper 06/1, March, p. 11.

[38] The FSA also does not clearly define what is meant by the sustainability of sub-class levies in this context in its 2007 consultation paper, FSA (2007), 'FSCS Funding Review', CP07/5, March, which provides further explanation of the principles that are used to determine the FSCS funding structure.

required. This might take the form of an insurer requiring a reinsurance arrangement, or, in the case of the FSCS, other sub-classes being required to fund the claims of the sub-class that has breached its own levy threshold.

Consequently, one would expect such an insurance scheme to define a risk threshold for the likelihood of alternative funding being required (in this case, the likelihood of the levy threshold being breached). For example, a scheme may decide that it will accept a 5% risk that the levy threshold will be breached, meaning that this could be expected to occur only once in 20 years. One might then consider the volatility of the amount of claims, which in turn depends on the likelihood of major mis-selling events (such as PPI) combined with the probability of the default of firms.

Typically, it can be expected that a large sub-class of firms containing two distinct types of firm would be less likely to breach a levy threshold (based on a proportion of the total income of those firms) than if the two types of firm were separated into two sub-classes. This does not necessarily suggest, however, that splitting a sub-class (such as general insurance intermediation) will breach the principles of FSCS funding if the separate sub-classes still have a sufficiently low probability of exceeding the levy threshold, relative to the desired risk threshold.

The FSA has not defined such a risk threshold, but, for the purposes of this analysis, one might consider an event that is likely to occur with a regularity similar to that of serious financial crises. In the past, the FSA has referred to a 'one-in-25-year event' for stress-testing purposes, based on this logic.[39] In this context, that may be an event that could be likely to occur during a combined economic downturn and a major mis-selling event, but not at other times.

Section 5.2 therefore considers the potential sustainability of separate pure and other insurance broker sub-classes based on this logic and risk threshold.

If the levy threshold is breached in such a scenario then, in the current system, other sub-classes, such as providers, would be expected to contribute. The FSA has proposed that this system should be changed so that activities that will primarily be the focus of the new Prudential Regulation Authority (PRA) (such as deposit-taking and insurance provision) do not cross-subsidise the other activities which will be the focus of the new FCA (eg, insurance intermediation). This is the focus of the discussion in section 5.2.

5.2 Assessment of sustainability of sub-class

While the FSA did not include analysis of sustainability in the recent consultation paper, it has provided some data that can help to provide guidance on the potential sustainability of separate pure and other insurance broker sub-classes. In particular, the FSA informed BIBA that 71% of the levy is collected from firms with only a single approval for general insurance intermediation, and which describe their primary activity as being general insurance intermediation alone. While this definition is likely to differ from the definition of pure insurance brokers described in this report, as the above FSA definition is subjective rather than objective, the data underlying Figure 4.1 (referring to the amount of regulated income) suggests that it is reasonably consistent.

Adopting this estimate therefore suggests that, of the current levy:

– 71% is paid for by pure insurance brokers;
– 29% is paid for by other insurance intermediaries.

[39] See FSA (2006), 'Strengthening Capital Standards 2', Consultation Paper 06/3, February.

Sustainability is determined by the likelihood of the FSCS threshold for a particular sub-class to be broken. The levy threshold for a sub-class is determined as a proportion of the total eligible income. The latest FSA analysis suggests that the levy threshold for all general insurance intermediaries should be £300m (based on estimated total eligible income). The estimates of the proportion of levy paid by the separate types of insurance broker therefore suggest that:

– the levy threshold for 'pure' insurance brokers should be £213m; and
– the levy threshold for 'non-pure' insurance intermediaries should be £87m.

In 'normal' times, before the PPI mis-selling period, claims for general insurance intermediation remained at around £1m–£2m per annum, which would be far lower than either levy threshold.

The risk of a levy threshold being breached arises during periods of significant claims relating to mis-selling, combined with economic downturn. While it is not possible to predict future claims of the FSCS, the potential sustainability of these two sub-classes can be considered with reference to the ongoing and relatively severe PPI mis-selling issue combined with the severe economic downturn. The combination of these two events can be considered to have a severity that is consistent with (or perhaps more severe than) the concept of a one-in-25-year event. If the levy thresholds for the two separate sub-classes had covered recent PPI claims in the downturn, they could be seen to meet the sustainability criterion based on the above assumptions.

These thresholds would not have been breached during the recent PPI claims, as the maximum levy for the entire general insurance intermediation sub-class peaked at £69.5m in 2011/12 (before declining again in 2012/13), which is below either of the assumed levy thresholds detailed above.

The levy thresholds for the separate sub-classes would therefore be sufficiently high to have covered an unusually high level of claims (created by PPI mis-selling), which would suggest that the sub-classes would be 'sustainable'.

More extreme events than the combined PPI mis-selling and severe economic downturn could be envisaged in the future. For that reason, the FSCS funding system includes cross-subsidisation from other sub-classes if such an event were to occur. However, the FSA has proposed limitations to this system, which is the focus of section 5.3.

There may also be other potential adjustments to the FSCS funding system that would reduce the likelihood of a given threshold being breached. One example might be the smoothing of levies over a few years, similar to that suggested by the FSA.[40] The FSA has suggested a system in which:

> Each year, the maximum amount of anticipated compensation costs to be included in the annual levy will be, subject to the applicable annual class thresholds, the greater of:
>
> - one-third of the three-year aggregate; or
> - costs anticipated in the 12 months from the date of the levy. (paragraph 6.11)

This would allow for high future costs to be smoothed over time, which would reduce the uplift to levies of a major event, as long as that event were foreseen more than one year ahead.

[40] See section 6 of FSA (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July.

An effective system of smoothing levies over time could significantly further increase the sustainability of separate insurance intermediary sub-classes, as levies tend to be quite volatile on a year-by-year basis owing to the nature of firm insolvencies.

5.3 The role of cross-subsidisation

The current FSCS funding system involves a system of vertical cross-subsidisation in the case that the threshold is breached. For insurance, this means that, if the threshold for intermediaries were breached, the levy for providers would be increased to cover the cost (up to the threshold for providers).[41] The reason for this cross-subsidy is that it increases the sustainability of the system as, in the case of insurance intermediaries, the providers have considerable resources. As noted in an Oxera report for the FSA:[42]

> The main argument for introducing vertical pooling is in terms of ability to pay and sustainability, and applies in particular to concerns that financial advisers may not be self-sustaining and able to meet the costs of compensation that arise. In addition, although sharing of compensation costs by providers may weaken incentives on the distribution side, in a second-best world where the polluter cannot pay, vertical pooling may have a positive effect on monitoring incentives along the vertical chain of relationships.
>
> Pooling of firms that are commercially connected along the vertical industry chain may be considered 'fairer' or more proportionate than other forms of pooling, in particular if firms along the chain share a common interest in maintaining consumer confidence in the products manufactured and distributed by the chain.

The FSA is now proposing that the current system of vertical cross-subsidy be changed so that activities of deposit-taking and insurance provision do not cross-subsidise the other 'retail pool' activities (such as insurance intermediation). The FSA explains the reason for this change to the system with respect to insurance as follows:

> We are conscious that, to a degree, this approach undermines the natural affinity between these providers and their intermediaries. But cross-subsidy is only likely to be one-way and could have distortive effects – such as over-provision of the subsidised activities or reduced risk management incentives.[43]

The new FSA argument for dropping vertical subsidisation is flawed and inconsistent with the FSA's general policy in relation to providers and intermediaries, for a number of reasons:

– to the extent that the cross-subsidy makes providers more responsible for the claims made against intermediaries, this is likely to result in beneficial improvements in risk management procedures; providers and intermediaries share mutual financial interest and this should be reflected in the cross-subsidy system;

– the cross-subsidy that the FSA refers to has not occurred in practice, despite the PPI mis-selling claims, and is unlikely to be factored into firms' decisions anyway;

– moreover, the new FSA position goes against the wider policy objectives of the FSA and the new FCA. For example, the latest FCA policy document explains that:[44]

> The FSA's experience with many product mis-selling issues has been that products designed for a specific market were sold widely outside it. By putting more responsibility

[41] It should be kept in mind that this event has not happened for insurance intermediaries, despite the PPI mis-selling issue.

[42] Oxera (2006), 'Funding of the Financial Services Compensation Scheme', March, page v. This analysis focused on vertical pooling (ie, having providers and brokers in the same sub-class) rather than vertical cross-subsidy, but the findings are still relevant.

[43] FSA (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July, para 4.11.

[44] See FSA (2012), 'Journey to the FCA', October, p. 13.

on providers to ensure that products only reach the customers they were designed for – and that they function as expected – there should be far fewer incidents of major consumer harm.

– cross-subsidies between related providers and intermediaries is preferable to cross-subsidy between unrelated firms, such as between insurance intermediaries and investment fund managers, yet the changes that the FSA proposes would end the former and place greater reliance on the latter.

There will always need to be some form of cross-subsidy in the event that levy thresholds are breached. The question is then as to which form of cross-subsidy is preferable. The discussion here would suggest that vertical cross-subsidy should be maintained in its current form, for the following reasons:

– the evolving principles of FS regulation support cross-subsidisation; this follows the 'mutual financial interest' criteria as insurance providers mutually benefit from business created by brokers;

– The FSA has recognised that mis-selling occurs partly as a result of poor design of the product done by the insurance providers,[45] and hence providers should share part of the liability, not just to the extent that those firms also provide intermediary services (as most providers do);

– general insurance providers have a threshold limit of £775m and have, on average, been liable for £60m compensation; this indicates that additional liability to the insurers from intermediaries is unlikely to affect the providers' sustainability, perhaps addressing concerns about the impact on prudential regulation.

In summary, the evidence suggests that the separation of the insurance intermediation sub-class between pure and other insurance intermediaries would produce sustainable sub-classes, given the continuation of the current system of cross-subsidy.

[45] See FSA (2011), 'Product Intervention', Discussion Paper DP11/1, January, for example para 4.3.

6 Conclusions

BIBA commissioned Oxera to assess whether there is an economic case for a separate FSCS sub-class for pure insurance brokers, whether such a sub-class could be clearly defined, and whether it would be sustainable, in line with the principles of the FSCS.

There is a solid economic case for a separate sub-class for pure insurance brokers due to structural differences between pure insurance brokers and other insurance intermediaries that arise from the consumer experience. Analysis indicates that consumers are better able to judge insurance products sold by a pure insurance broker than those sold by other insurance intermediaries, and this suggests that products are less likely to be mis-sold by the former. This evidence therefore suggests that pure insurance brokers are less likely to cause FSCS claims in the future and have a lack of affinity with other insurance intermediaries.

This report also sets out a possible approach to defining pure insurance brokers for the purposes of an FSCS sub-class, in order to assess whether such a sub-class can be defined in an objective manner that is not reliant on subjective self-assessment. The suggested approach would require some additional data to be collected by the FSA, but the data required is very limited and there could be other advantages to the FSA from collecting this information, particularly in terms of understanding the (changing) market dynamics in this part of its regulatory responsibility.

The FSA has emphasised the importance of the sustainability of FSCS sub-classes, in terms of the likelihood of other sub-classes being required to subsidise the cost of levies, although it did not undertake analysis of sustainability in its 2012 consultation paper. Based on the evidence available to Oxera, the separation of the general insurance intermediary sub-class would produce two sub-classes that could each meet a relatively stringent definition of sustainability.

Lastly, this report finds that, from an economics perspective, there is no justification for the FSA's proposal for the ending of the current system of vertical cross-subsidy between insurance providers and intermediaries. The justification provided by the FSA is flawed. Moreover, the FSA's proposal for ending the vertical cross-subsidy is also inconsistent with the FSA's general policy, and would not support the new FCA goal of 'putting more responsibility on providers to ensure that products only reach the customers they were designed for – and that they function as expected'.[46]

There will always need to be some form of cross-subsidy (in the unlikely event of levy thresholds being breached), and, from an economics perspective and assessed against the FSA's own criteria, the current system of cross-subsidies between related providers and intermediaries is preferable to cross-subsidy between unrelated firms, such as between insurance intermediaries and investment fund managers.

[46] FSA (2012), 'Journey to the FCA', October, p. 13.

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