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Product levy would penalise consumers

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Of all the necessary reforms in financial services, the issue of how the Financial Services Compensation Scheme is funded is one of the most urgent. In the past 12 months, IFAs have seen a huge hike in FSCS levy payments. Advisers in the investment intermediation sub-class have been particularly hard-hit, with an interim levy of £93m this year.

The FSCS has blamed the failures of Keydata, Wills & Co and other major firms for the sharp rise in levy costs. Next year's costs will fall, it promises, if only because it does not foresee another Keydata occurring any time soon. That is as maybe. What is certain, however, is the system reeks of unfairness. Moreover, what is also becoming apparent is the way the levy is raised is flawed on many different levels.

For example, one side-effect of the way the system works is that advisers and wealth managers who never touched Keydata products have faced massive hits, while other businesses heavily involved in misselling have got off scot-free.

The classic case is Norwich & Peter-borough Building Society, which sold Keydata life settlement bonds to 3,100 investors across its 46 branches. Yet it has been allowed to define its "eligible income", the key criteria through which it is assessed for the FSCS levy, by reference to its tiny IFA business alone. By contrast, wealth manager Brewin Dolphin has taken a £6m hit, with Charles Stanley stung for £2.6m and Rathbone Brothers paying out £3.6m.

No wonder there are calls for reform. The issue, however, is what kind of reform. People are now dusting off ideas proposed many moons ago as to how to fund the FSCS. Among them is SimplyBiz chairman Ken Davy, who is revisiting a proposal for a product levy first advanced by the old LIA more than 17 years ago and backed by him ever since. Ken believes a product levy would only cost "a fraction of a penny for each £1 of investment".

Aifa, with its talent for tailing behind whoever shouts the loudest, appears to agree. The trade body aims to publish a discussion paper on FSCS reform later this month. Meanwhile, it supports an idea previously mooted by the FSA whereby firms' existing regulatory capital is held on account when a firm exits the market and returned to it after a set period if no claims had arisen during that time.

At the same time, Aifa policy director Andrew Strange told the All Party Parliamentary Group on Insurance and Financial Services the other week that his trade body would "welcome further debate" on a product levy. "At a time when consumer transparency of both cost of product and advice is at the heart of many of our regulatory interventions, we believe that a specific cost built into a product holds some degree of merit and would foster an approach of consumer responsibility," he said.

Maybe Ken thinks his old idea's time has finally come. I sincerely hope not. A product levy would penalise consumers instead of the industry for cases of misselling, although I accept there may be some knock-on effect in terms of overall product costs.

I should add two caveats. When this issue was discussed a few years back, I said the current system was a crude but potentially useful mechanism for ensuring better long-term compliance with FSA rules. It would also force IFAs to take direct financial responsibility for their peers' behaviour while serving as a semi-Darwinian method of ensuring only the most financially stable intermediary firms remain open for business.

What I had not taken into account is that no matter how much IFAs improve in dealing with the public, there will always be a minority able to damage their peers. Neither had I accounted for the FSA's appalling inability to classify individual firms into appropriate categories, as happened with Keydata. I also did not account for the FSA failure to regulate firms appropriately, even those doing terrible damage to their clients.

Ironically, the campaign against the FSCS by Martin Bamford is a classic example of IFAs doing something right by consumers. It calls on the FSA to do its job properly, presenting itself as being on the side of the public. By contrast, there is no doubt that a product levy, whether costing a little or a lot - for someone with a portfolio of, say, £250,000, Ken's "fractions" could amount to hundreds of pounds a year - is unfair to consumers.

It would turn what is currently a vague promise of probity on the part of the financial services industry towards its clients into a basic form of insurance. Instead of promising that if anything goes wrong the industry will make sure no one loses out unduly, clients would be told that fraud, misselling and failure are inevitable and they might as well take out cover against it.

I cannot think of a message to consumers more depressing than that.

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