FCA FEES FEE-BLOCK A ALLOCATION REVIEW

MARCH 2014

CONTENTS

1. BACKGROUND

The FCA is undertaking a review of the way it recovers the Annual Funding Requirement (AFR) from authorised firms in the current ‘A’ fee-block.

The ‘A’ fee-block covers a wide range of firms of all sizes including: banks, building societies, credit unions, insurers, friendly societies, the Society of Lloyd’s/managing agents, securities firms, investment managers, corporate advisors, operators/trustees of collective investment schemes, and retail investment, mortgage and general insurance intermediaries; in aggregate, referred to as ‘firms’.

Currently the ‘A’ fee-block is split into 16 sub-sets most of which are based on groupings of regulated business which firms are permitted to undertake. The FCA allocates a proportion of its AFR to each sub-set fee-block and this is recovered from the firms in the fee-block in proportion to the amount of business they undertake within the fee-block. The amount of business is measured by a metric (tariff base) which differs for each fee-block although income from the specific regulated activity is used as a tariff base in several fee-blocks. The tariff bases relate to UK business.

The review is considering whether the 16 sub-sets of the ‘A’ fee-block should be consolidated and the total ‘A’ fee-block Annual Funding Requirement allocated across all types of firms in proportion to a common metric – UK regulated income.

2. REQUIREMENTS PER STATEMENT OF REQUIREMENT

This report has been prepared to address the following requirements as set out in the Statement of Requirements TEN-13-208.

2.1 Definition of income

A report that sets out the information that enables us to undertake an impact analysis to illustrate to firms what their 2013/14 fees would have been under a consolidated ‘A’ fee-block metric. The information is to include identification of income (adjusted where appropriate) so that it represents a ‘best fit’ across the various types of firms that complete the same regulatory return and across the various different regulatory returns that firms complete.

Also, to include the rationale behind the data fields used and to provide an indication of the degree that the data fields used represent UK regulated income.

A report that sets out the extent that firms could identify at their legal entity level their UK income for all regulated activities, conducted in line with how we direct firms to calculate income where we use it currently for certain sub-set fee-blocks and what different directions would be needed. To include an assessment of what prescription we would need to apply to such directions to ensure that legitimate actions by firms to reduce the levels of income reported for fees purposes are consistently applied across all firms.

2.2 Comparing income against other metrics

A report that sets out an assessment of the relative merits between income as the metric for the Revenue Option compared to other potential metrics.

3. EXECUTIVE SUMMARY

The Statement of Requirement is split into three requests.

The first is to provide suitable data and rationale to enable the FCA to undertake an impact analysis so firms could compare their current fee allocation to an estimate of the fee allocation under a 'Revenue' model. The data we provided to the FCA on the 16th January is included in this report in appendices One and Two and further rationale provided in section 9 'Definition of income by category of firm'. The discussion in section 9 provides insight into how income can indicate the regulatory activity of the firms per category. Some fit well, such as management fees representing the activity of managing assets under management by fund managers, others do not, such as trading gains as an indicator of an investment bank dealing as a principal.

The analysis in section 9 suggests UK regulated income does broadly reflect regulatory activity but far from perfectly.

The second aspect of the SoR is to provide the FCA with an assessment of whether firms could identify their UK income from regulatory activities at a legal entity level. The bulk of our discussion in this report deals with this aspect of the SoR: it is not an easy question to answer.

Broadly, UK regulated income does reflect the level of regulated activity undertaken by firms and does reflect the benefit received by the firm operating within the FCA regulated market. However, there are inconsistencies with regards to the definition and recognition of income (specifically for life insurance which the IASB is currently reviewing), there are multiple interpretations of what constitutes regulated income and significant systems limitations which result in difficulties in universally defining and reporting UK regulated income. Whilst it is important to be cognisant of these inherent weaknesses, these weaknesses do not necessarily mean UK regulated income is not a suitable tool for the purpose of allocating the FCA annual fee. There is a risk that firms could feel compelled to over-analyse and define too precisely with no proportionate benefit rather than assessing the Revenue model as an imprecise but fair, simple and transparent tool which is fit for purpose.

Although we conclude that UK regulatory income is an adequate metric to use, we have identified three sub-sectors which require significant adjustment to regulated income in order for income to fairly reflect regulatory activity in that sub-sector. They are:

- Deposit acceptors (accepting deposits creates an interest expense, not income)
- Life insurers (gross written premiums includes an element that is not revenue)
- Society of Lloyds (income of the Society is closer to an expense recharge than to a regulated activity).

The second aspect of the SoR also requires us to report existing fields captured in firms' returns which identified UK regulated income and our suggestion for what additional Income Data Directions ('IDD's) would be needed. In general, our recommended additional IDDs reflect the need to capture income as regulated or unregulated rather than the current reporting which identifies the nature of the income, such as 'interest income' and not its components of regulated interest income or unregulated interest income. The Appendices show the data fields identified which capture UK regulated income used as inputs into the impact analysis. Although we are certain that these fields contain UK regulated income, we have no evidence to confirm what portion of these cells represent regulated income. Consequently, we cannot form a view as to whether these fields are suitable inputs for the impact analysis.

Finally, we have provided limited commentary on other possible indices in section 10, as also required by the SoR. We have provided a small number of possible alternatives but more as a way of understanding the comparability of UK regulated income rather than championing a better alternative. We have compiled our assessment using the FCA's seven fee governing principles. With this assessment in mind, UK regulated income continues to stand out as a possible index but as will become evident from the discussion within this report, it is not necessarily better or worse than the current methodology but has different strengths and weaknesses.

4. PICTORIAL SUMMARY OF THIS REPORT

- **Definition of income**
  - UK GAAP/IFRS Income and Recognition
  - CP13/14 proposed amended definition of income including 'fair value' estimate
- **Definition of UK regulatory income**
  - Direct, not indirect
  - Income from activity performing regulatory permissions
  - Specific developments in accounting for Life Insurance income
- **Is UK regulatory income currently captured by the FCA?**
  - Income is reported to the FCA by stream
  - Firms are not currently required to identify income that is from regulatory activities
- **Can firms isolate regulatory income in the future?**
  - Yes, in the majority of cases
  - Regulatory income from trading gains might be difficult to isolate but an estimate could be made
- **Does regulatory income represent regulatory activity?**
  - Three exceptions:
    1. Deposit acceptors
    2. Life insurers
    3. Society of Lloyds
  - For firms dealing as principals, income is a very weak measure
  - Consideration of whether netting is appropriate
- **Conclusion**
  - UK regulatory income, modified where appropriate, is an imprecise tool, open to some manipulation, but broadly adequate for purpose

5. DEFINITION OF UK REGULATED INCOME

5.1 Definition of income

In order to form a consistent foundation for all firms to identify UK regulated income, the definition of income in its broader sense needs to be identified. The simplest solution is to use the existing definition of income as defined by accounting standards used by UK entities, namely under IFRS and UK GAAP.

The definitions of income under International Financial Reporting Standards (IFRS) and United Kingdom Generally Accepted Accounting Practice (UK GAAP) are relatively consistent and are as follows:

- IFRS: Income is the revenue recognised from the sale of goods, rendering of services and the use by others of entity assets yielding interest, royalty and dividends[1].
- UK GAAP: Income is the revenue recognised from the supply of goods or services by a seller to its customers[2].

Additionally, there is consistency of revenue recognition under both IFRS and UK GAAP.

The use of the accounting definition of income for the basis of allocating FCA fees is a simple solution but not without weaknesses; the most significant being where firms perform multiple regulatory activities within one entity without recognising income for all those activities. The FCA addresses this in the Consultation Paper published in October 2013 (CP13/14). The FCA has proposed a revised definition of 'annual income' to include 'fair value' for 'the amount the firm would otherwise have received for any regulated activity... but for which it has made a business decision to waive or discount its charges.'

This deviation away from adopting the pure accounting definition of income represents a practical solution which the FCA would put in place regardless of which model was used to allocate the FCA fee. The alternative option is to continue to adopt the accounting definition of income and ignore the weakness noted above, allowing some firms to 'under-declare' income. It could be argued that without the addition of the 'fair value' income firms might be enticed to restructure to reduce their income. Considering the issue broadly, the FCA fee is expected to be a small expense for most firms, thus the cost of restructuring to reduce income reported to the FCA will be disproportionate to any reduction in a firm's FCA fee allocation.

There is a risk that firms will want to investigate bespoke issues or list multiple exceptions without these investigations leading to a proportionate improvement in the accuracy of UK regulated income as an indicator of regulatory activity. Although we acknowledge it is not a perfect fit, we believe it is appropriate to conclude that income for the purpose of FCA Fee allocation should be calculated in the same manner as income calculated for financial reporting purposes. Whether or not the FCA chooses to adopt additional 'fair value' income is for the FCA to conclude upon.

5.2 Definition of UK regulated income

For the purpose of identifying an appropriate FCA Fee allocation metric, our definition of UK regulated income is:

UK income recognised within a firm's financial statements that is directly attributable to the regulatory permission(s) held by the firm.

In CP13/14, the FCA provides the following proposal to define 'UK business':

'As a general rule, any business conducted by a firm or branch based in the UK is likely to be 'UK business' – for example, where it gives advice to a UK client on an overseas investment, or where it gives advice to an overseas client on a UK investment.'

Although this assists in understanding what UK business is, it is more difficult to define what direct income from UK regulated activities is. As noted by the following examples, there is ambiguity and judgement in determining which revenue streams should be captured within this definition:

- An insurance intermediary receives premium funds from a customer to pass on to an insurer. The process of forwarding these funds on to the insurer can be completed within one day. However, it is within the normal terms of trade that an intermediary may retain the premium funds for a longer period before making payment to the insurer, earning interest on the funds held and booking the interest as income. We would consider the interest earned as NOT direct income from UK regulated activity as the regulated activity of an intermediary is dealing and arranging as an agent, ie commission income for services rendered, not interest income.

Note:
1. IAS 18, p1
2. FRS 5, application note G

5. DEFINITION OF UK REGULATED INCOME

- Where a firm is required to hold minimum capital to satisfy prudential requirements and it generates income from investing this (investment gains and interest income), these gains could be included within UK regulatory income. Whilst the income is not derived from an activity associated with the firm's regulatory permission(s), the income has been generated as a direct consequence of requirements associated with being authorised by the regulator ie the requirement to hold a minimum level of regulatory capital. We would consider this income as NOT direct income from a regulated activity because it is not income resulting from an 'activity' but from a prudential requirement.
- A mortgage lender, which reports in GBP, can enter into a mortgage contract in JPY, resulting in residual currency risk which it seeks to manage via a forward currency contract. As a result, uncertainty arises as to whether any gains arising from the use of the financial derivative should be considered UK regulatory income, given that the driver behind entering into this position is the activity undertaken by the firm in line with its regulatory permission, namely entering into a regulated mortgage contract. In this instance, we can see merit in recognising it as either regulated or unregulated income.

The above examples are not flagged to conclude whether or not these meet the criteria of UK regulated income but rather are to prove that judgement is needed. Trying to rigidly define UK regulated income for every business and every transaction in every situation is not achievable but requiring firms to maintain adequate documentation explaining how they have identified income which is directly attributable to the regulatory permission(s) held by that firm represents a reasonable and balanced approach. Therefore we do not believe this need for judgement is an insurmountable flaw.

In the future, the FCA may just require one data field to capture UK regulated income as a single line item within the integrated regulatory reporting framework. For the purposes of this analysis, we have applied the definition of UK regulated income to each sub-category currently included within the 'A' fee block, which broadly categorises firms by the nature of their primary regulated activity. In our analysis under section 9, in addition to defining UK regulated income per sub-sector we have also highlighted the regulatory permissions normally associated with that sub-sector. This then provides a clear flow between the type of business, the regulated activity, the regulatory permissions and the applicable income streams. If the revenue model were to be adopted and only one FCA reporting line is required by all 'A' fee block firms, the requirement for the current sub-sectors would fall away but the permissions and income streams would remain relevant to the preparer.

5.3 Future changes to the definition of income for life insurers

Of the sub-categories of firms that currently pay FCA Fees in fee-block A, life insurers have the most significant issues associated with both the appropriateness of using UK regulated income as a fee allocation metric and identifying relevant data fields from the regulatory returns to derive an appropriate indicator of regulated activity.

Whilst life insurers do have a top line revenue figure in common with general insurers, namely gross written premiums (GWP), it differs from general insurers in that it reflects not only income for the insurance risk taken but also money from customers that reflects the customers' underlying investments. As a comparison, this latter amount is akin to deposit amounts held by banks for their customers. As much as it would be inappropriate to treat customers' bank deposits as income for the bank, it would be inappropriate to treat that same element of GWP as income for the life insurer.

As a result, the GWP figure is not considered to be representative of the actual level of regulated business activity undertaken by a life insurer in a given period.

The International Accounting Standards Board (IASB) is currently in the process of revising accounting standards relating to insurance contracts, which is expected to have a significant impact on the way in which life insurers report income. Under the proposed framework, life insurers will move away from recording the GWP received each year as income and instead will, for any new policy written, recognise the income which reflects the insurance risk only. For each subsequent year, adjustments will be booked to the firm's income which reflects changes to the underlying assumptions on the level of insurance risk remaining. We believe these changes to the definition of income for life insurers will better reflect a firm's regulated activities. Therefore, should the proposed changes to IFRS be implemented, this change in accounting for life insurance income would be seen as supporting the use of the Revenue model. In the meantime, an arbitrary adjustment (discount) to GWP is suggested as a proxy for splitting GWP into deposit and revenue components; we have suggested 50% but acknowledge that this is an arbitrary discount.

5. DEFINITION OF UK REGULATED INCOME

The new IFRS is currently expected to be issued in early 2015, with an effective date following approximately three years subsequent to this, in 2018-2019. Until such time that the proposed changes to IFRS are adopted, a choice will exist between continuing with the status quo of how fees are charged to life insurers or using a reasonable proxy for income that can be derived from the regulatory returns to allow the revenue model to be used in line with other sub-sectors. It should be noted that many life insurers are UK GAAP reporters and that it is not clear that UK GAAP will follow the IFRS in this respect and, if it does, over what timetable?

The issues relating to life insurers are discussed in more detail within the sub-sector analysis in section 9.

6. SUITABILITY OF CURRENT FCA DATA FIELDS

We have been asked to consider the degree to which the data fields used within our analysis represent UK regulated income. To that extent, consideration is also required to be given to the extent to which suitable data is already captured by the FCA as part of the integrated regulatory reporting process.

Whilst the current regulatory returns capture the necessary fields to calculate income, there is currently no reporting of income specifically in respect of regulated activities. Income is currently reported based upon the character of its source rather than the activity it represents. It is erroneous to assume that certain income line items represent regulatory income as highlighted by the examples below:

- A bank may enter into an interest rate swap as a means to hedge net interest rate exposure arising from loans written and deposits taken. Gains on the swap position may be recorded by the firm as interest income, which would subsequently be captured by the FCA within the firm's FSA002 return and included as part of the firm's UK regulated income, even though this may not necessarily be considered by the firm as derived directly from its regulatory permissions (ie not UK regulated income). Furthermore, in practice, gains of this nature could be classified within either interest income or trading income in the relevant firm's FSA002; the classification is dependent on the firm's own judgement. This serves to provide two examples of instances of where the use of data fields is not consistent between firms with similar activities.
- A mortgage provider generates interest income in its ordinary course of business through entering into regulated mortgage contracts, which is a regulated activity. However, all interest income reported by the firm will be captured as part of the regulatory reporting process without splitting out interest arising from activities which are not part of the firm's regulatory permissions, such as interest income on the firm's own current account. Currently the FCA collates data on 'interest income' and not 'interest income from regulated activities'.

To ensure clarity, it should be noted that the SoR requested a report which 'sets out the extent that firms could identify at their legal entity level their UK income for all regulated activities...'. We have taken this to mean the identification of specific income items which reflect specific regulated activities. As an alternative to this, it could be argued that if a firm is regulated, then ALL its activities are regulated (ie a firm cannot be 75% regulated, it either is or it isn't), in which case, all income would be used to measure the UK regulated income. If this were the model chosen, then the FCA would need to collect data for Total Income which it currently does for some fee-block A firms already and which the remainder could provide if requested and which is already available within a firm's financial statements.

In section 9, we have highlighted where we believe additional IDDs are required to allow firms to report UK regulated income to the FCA. Our overarching recommendation is to split income into 'income from UK regulated activities' and 'income from unregulated activities'.

7. EXTENT THAT FIRMS COULD IDENTIFY AT THEIR LEGAL ENTITY LEVEL THEIR UK INCOME FOR ALL REGULATED ACTIVITIES

A level of assumed quality in accounting systems and records exists for regulated firms in order to be compliant with the requirements of SYSC 3.2.20 (1)[3]. As such, it is considered highly probable that most firms (We acknowledge that some intermediaries may find this extremely difficult.) would be able to separately identify and isolate UK regulated income from other income, even if it is not currently reported as split to the FCA.

However, it is also noted that instances exist whereby isolating income arising from regulated activities is likely to be impractical. For example, a bank that generates income in the form of trading income (ie gains on investments), which represents income from investing its own retained earnings and income from investing customers' deposit where the latter is a regulated activity (dealing in investments as principal) and the former is not. As such, not all trading gains may be considered to fall within the scope of UK regulated income. Generally speaking, it is unlikely that a bank will currently have systems that segregate these gains, nor are they likely to be implemented in the future, meaning that it may only be possible to apportion the gains on the basis of the proportionate split of business that the firm otherwise undertakes, as permitted by the proposed FEES 4 Annex 13G.

Linking back to the previous commentary on capturing relevant data, in this case the FCA would currently only capture the total trading income reported by the firm within the FSA002 return, regardless of whether this is representative of regulated or unregulated activity.

Our conclusion is that although firms are not currently reporting their UK regulated income to the FCA, in most circumstances, firms would have this data available. Where exceptions exist, we believe it would be possible for most firms to provide an estimate however we also acknowledge that general insurers and Lloyds firms may only be able to identify UK regulated income rather than specifically FCA regulated income.

Note:
3. A firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system.

8. UK REGULATED INCOME AS AN INDICATOR OF REGULATORY ACTIVITY

A key consideration in determining the appropriateness of the use of the revenue model is whether or not UK regulated income can be considered a satisfactory 'indicator' of the level of regulated activity undertaken by a firm.

Using the term 'indicator' of regulated activity is to acknowledge that any metric used, including UK regulated income, will not always be a completely accurate reflection of regulatory activity. For mature businesses, we would not expect to see significant inconsistencies as to its suitability, although there will be some sub-sector specific issues and individual case specific issues resulting in UK regulated income being unsuitable. For instance, we can foresee the use of income as a measure of regulatory activity as unsuitable for a general insurer in 'run off'.

8.1 Exceptions where modification is needed

During the course of our analysis, three sub-sectors were identified where UK regulated income was not considered a sufficiently strong indicator of regulatory activity:

- Life insurers - as already described in section 5.3, we believe gross written premiums are not appropriate and should be discounted. There is a lack of public data which would allow us to recommend a justifiable discount to gross written premiums so we suggest the FCA discount GWP by 50% as an arbitrary discount.
- Deposit acceptors – in the case of deposit acceptors, the relevant regulatory activity, namely the accepting of deposits, results in an expense, rather than income. In this instance, it would seem appropriate to either take the decision to use interest expense as the indicator of regulatory activity or assume interest income remains a suitable indicator of regulatory activity.
- The Society of Lloyd's – the regulatory structure around the Society of Lloyd's is unique. It is intrinsically unlikely that an appropriate indicator for the Society of Lloyd's will be the same or even similar to that applied to the generality of regulated firms. A different proxy indicator will be needed in this case.

Further analyses of these exceptions are presented in section 9. In section 10, we consider the pros and cons of indicators other than income.

8.2 The use of net income

In the proposed Fees 4 Annex 13G, the FCA provides a definition of annual income and, within that definition, the FCA outlines circumstances where netting can take place. As an example, the FCA has concluded that rebates to investors and introducers can be deducted from income. The FCA also concludes that payments onto other regulated firms can also be deducted.

Although the FCA has defined what deductions to income could be made, there is room for challenge to argue that not all rebates should be deducted. If the foundation of defining UK regulated income is that it reflects the regulated activity, it doesn't necessarily follow that every rebate is a reduction in the responsibility of performing the regulated activity. Additionally, it is important not to assume that a transfer of risk also means a reduction in regulated income (as the risk transfer doesn't mean the regulatory activity has also transferred).

In our view, the starting point should be to assume gross income represents the regulated activity and if a firm chooses to make a deduction to that figure, that firm must also prove that there has been a reduction in the underlying regulatory activity performed rather than the deduction representing a risk mitigation only.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

To assess whether it is possible to identify UK regulated income, we have started with the existing sub-sectors of fee-block A to ascertain the following:

- The regulated activity
- The income associated with the regulated activity
- The suitability of that income stream as an 'indicator' of regulatory activity
- Whether there are any factors which would undermine the credibility of the income stream
- Proposed options for improvement going forward
- Any prescription that would need to be applied to ensure that legitimate actions by firms to reduce the levels of income reported for fees purposes are consistently applied across all firms.

Our analysis has been undertaken on the basis of the sub-sectors' primary regulated activities. However, it is acknowledged that cross over will exist for firms that straddle sub-sectors and for which UK regulated income may comprise different streams. For example, this is particularly common for firms operating in the banking sector, whose regulatory permissions will cover activities ranging from deposit accepting, to entering into mortgage contracts, fund management and dealing as principal. Therefore, in this instance, a bank would need to identify the multiple regulated activities and appropriate UK regulated income under multiple sub-sectors and not just refer to 'interest' as the UK regulated income under the 'Accepting Deposits' sub-sector heading.

One of the matters we have been asked to consider is the consistency of data fields used across different returns completed by firms. Our analysis of the different sub-sectors indicates that the fields are largely consistent between firms. However, issues may arise due to inconsistencies in the way in which certain items are classified by firms themselves, such as the example involving interest rates swaps as mentioned earlier. Similarly, a firm acting as an Authorised Corporate Director and a Fund Manager may not recognise and report the fee from these two services separately even though both services require different regulatory permissions. This type of issue is not overly concerning as the lack of separation doesn't lead to a misreporting of UK regulated income.

Overall, we consider that the data collected across all of the different returns used by firms broadly provides a 'best fit' in generating figures for UK regulated income. There is judgement required and we accept that opinion may vary in identifying the specific data field currently available which best represents UK regulated income.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.1 DEPOSIT ACCEPTORS

Applicable regulated activities

- Accepting deposits
- Operating a dormant account fund.

Identification of income

Deposit accepting is not itself an income-generating activity. Instead, income is generated through the use of the deposits received, either through lending at a higher rate of interest or through the use of the deposits to fund trading. If UK regulated income is zero (or close to) for the activity of deposit accepting, then an alternative measure is needed.

Interest income is made up of interest on loans, overdrawn accounts and card accounts. Interest expense is the expense incurred on deposits held by the firm. Usually, banks would disclose interest receivable, interest payable and a net interest income figure in the primary statements.

An alternative to interest income would be to use interest expense as the underlying metric. This would appear to be the metric aligned most directly to the regulated activity.

Net interest income is not a sufficient metric to measure the full scope of activity, as this will only be indicative of the margin generated.

A further alternative would be to use an absolute measure of interest to take into account all activity undertaken by deposit acceptors, albeit indirectly. This would be calculated by adding relevant (ie pertaining to UK regulated activity) interest income and expenses together, rather than calculating a net figure, thus providing an indicator of regulated activity for deposit acceptors. This too, deviates from the definition of UK regulated income provided in 4.2 and would be difficult to justify.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
FSA002	Interest income	2B
	Interest paid	26B

Whilst the data fields used are considered to be representative of UK regulated income as relevant to deposit accepting, UK regulated income is also derived from other activities by firms within this fee block. As previously discussed, many firms in the banking sector hold regulatory permissions outside of accepting deposits. In cases where firms also deal as principal, identification of UK regulated income will not end with the interest income and/or expense generated as part of accepting deposits; instead, the income generated by the firm through the trading book will also comprise part of the firm's UK regulated income. However, as previously mentioned in this report, segregating the trading book income which arises from regulated and unregulated activities may prove to be a challenge for firms' accounting systems.

Further to this, additional IDDs will be required to properly exclude interest income and expenses that do not arise from regulated activities. Examples of this may include interest payable on debt instruments issued by the firm or interest income charged on intercompany loans.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.2 HOME FINANCE PROVIDERS AND ADMINISTRATORS

Applicable regulated activities

- Entering into a home finance transaction
- Administering a home finance transaction
- Agreeing to carry on a regulated activity (which is included within either of the above).

Identification of income

Home finance providers and administrators include all firms that provide mortgages, from banks to specialist mortgage lenders. UK regulated income is derived from interest received on home financing activities, with the relevant regulated activity being entering into a regulated mortgage contract as lender.

Within the financial statements of a home finance provider, interest income will form the top line of revenue within the income statement. For the purpose of defining UK regulated income, deductions are made from this interest income recognised in the financial statements in respect of interest income arising from non regulated activities. This may arise from, for example, interest income on the firm's cash deposits, other debt instruments held for investment purposes or potentially on derivative contracts entered into for the purpose of minimising net interest rate exposure.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
Mortgage Lending & Administration Return	Interest receivable	B1.2

The rationale for using the above data field is that this is most representative of the income generated by home finance providers.

The data field used is concluded to be representative of UK regulated income and also provides an appropriate indicator of UK regulated activity. However, an additional IDD to separate out interest income arising on non-regulated activities is required to appropriately isolate UK regulated income.

As described earlier, we note that inconsistencies exist between firms as to the classification of gains arising from interest rate swaps. Some firms classify this as interest income on their regulatory returns whilst others classify this as trading income. Consequently, there is a risk that firms will interpret the classification differently resulting in reporting different UK regulated income.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.3 INSURERS – GENERAL

Applicable regulated activities

- Effecting contracts of insurance
- Carrying out contracts of insurance.

Identification of income

For general insurers, the top line of income recognised within a firm's income statement comprises of gross written premium (GWP). This figure reflects all income on policies written, broadly meaning incepting, during the period in question. A material element of this GWP is deferred in the form of an unearned premium, which is the element built into the premium to cover the insurance risk anticipated to arise subsequent to the year end.

Consequently, for the purposes of defining UK regulated income, the appropriate measure for general insurers is concluded to be gross earned premiums during the period, which can be derived directly from the financial statements, but also being GWP plus unearned premiums brought forward less unearned premiums carried forwards.

Consideration has been given as to whether the derivation of UK regulated income should also take into account the impact of any reinsurance contracts held by the firm. As reinsurance is considered to be a representative of a risk management cost borne by an insurer rather than a reallocation of UK regulated activity, it is concluded that deductions should not be made from gross earned premiums to account for reinsurance costs.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
IPRU (INS) form 20	Earned premiums	11-1

The rationale for using the above data field is that this ties into the definition of income for general insurers, being a direct extraction of gross earned premiums. This differs from the data field used for the purposes of the impact analysis, which was earned premiums (net of reinsurance).

As previously described, this data field is concluded to be representative of UK regulated income, which is considered to be a reasonable indicator of regulated business activity and regulatory risk, although GWP would likely be a stronger indicator in this respect. Whilst this is the case for mature, general insurance businesses, the use of income as an indicator will become less relevant when an insurer goes into decline or run-off, when management of the balance sheet will become the predominant business activity. Additionally, the concept of earned premium is expected to disappear under Solvency II. This will need further consideration once Solvency II is implemented to define a more suitable metric.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.4 INSURERS – LIFE

Applicable regulated activities

- Effecting contracts of insurance
- Carrying out contracts of insurance.

Identification of income

The two key issues in determining the definition of UK regulated income for life insurers are as follows:

- The inherent complexity in providing a definition and extracting relevant data from regulatory returns currently collected by the FCA.
- Income as accounted is not considered to be an appropriate measure of business activity and is inconsistent with substantially all other types of firms currently included within the sub-categories of the ‘A’ fee-block.

The main activities associated with regulatory permissions for life insurers are selling new polices, management of the balance sheet and, on a more limited level, communicating with existing policy holders. Of these, the most significant activity undertaken by life insurers is the management of the funds held to match the long term business provision on the balance sheet. The selling of new policies is a driver of the business, but this is more relevant for the purpose of providing additional funding to investment activities rather than to make an underwriting profit (ie a profit on the mortality/morbidity risk taken on).

Income recognised in a life insurer’s financial statements comes in the form of gross written premiums (GWP), which reflects all income due in a given period on all active polices. That income includes both revenue and deposit elements, in widely varying proportions across the sector depending on the business focus of each regulated firm. Within the financial statements, there is no concept of unearned premium within the premium lines for life insurers. Instead, a provision to reflect unexpired risk is made within the technical reserves as part of the larger long term business provision.

Consequently, GWP is not considered to be a reasonable reflection of regulated activity. Instead, a proxy is required to provide a more appropriate indicator of UK regulated activity. This should have the effect of adjusting GWP to remove any amounts that do not bear insurance risk activity; that is to say, the ‘deposit’ element, or receipts that purely bear investment risk.

This data is produced for actuarial purposes, but is not currently collected by the FCA as part of the integrated regulatory reporting process (either through the audited financial statements or through the regulatory returns themselves).

There is a further issue in relation to life insurers (and general insurers) in the case of a business in run off. Where a life insurer is not entering into any new business, thus having nil premium income, but is still required to manage the balance sheet in order to pay out claims, there may be a dislocation between the basis on which fees are charged under the revenue model and the level of regulated activity undertaken.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
IPRU (INS) form 40	Earned premiums	11-1

For a life insurer, the figures reported for GWP and for earned premiums would be expected to be the same. The rationale for using this data field is that this is the nearest identified proxy for UK regulated income for life insurance businesses, although we note that this still does not provide an appropriate indicator of regulated activity. As such, we propose discounting this figure by 50%, which represents an arbitrary reduction in light of there being no available evidence to support a more suitable adjustment.

Depending on the results of the impact analysis to be undertaken by the FCA, it may yet be ascertained that this figure requires adjustment in order to be better reflective of the overall impact of life insurers on the UK financial services industry as a whole. The 50% figure will not be appropriate for most, if not all, firms, but provides a basis for the impact analysis.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.5 MANAGING AGENTS AT LLOYD'S AND A.6 THE SOCIETY OF LLOYD'S

These two sub-categories have been combined as the anomalous nature of the structure which they operate within affects both and similar approaches to appropriate proxies for regulated income are required.

Applicable regulated activities

- Managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's.

Identification of income

For Managing Agents at Lloyd's, income is recognised in the financial statements in respect of agency fees and profit commissions (the latter being performance-related and therefore essentially less suitable as a basis for the present purpose). While there are broadly standard bases for the charging of fees across managing agents of syndicates with unaligned capacity, this is not the case where the capacity is wholly aligned. Rather than using the actual fees charged therefore, it may be more appropriate to use as an indicator the capacity managed multiplied by a representative fee percentage in the range 0.65% - 0.75%.

For the Society of Lloyds, the nature of the regulated activities undertaken means that it is considered to be more appropriate to use an alternative indicator for fee allocation purposes. In this case, the aggregate of annual subscriptions and central guarantee fund contributions charged to members of Lloyds is concluded to be an appropriate measure, as this provides the most relevant indicator of the level of activity undertaken in a given period in connection with the core functions of the Society.

Data fields used, rationale and extent to which data fields represent UK regulated income

Managing agents at Lloyd's are not required to file regulatory returns with the FCA; however, the relevant data is collected by the Society of Lloyd's and in particular the capacity managed by each managing agent is controlled through the capital management functions of the Society.

For the Society of Lloyd's, the annual subscriptions and central guarantee fund contributions charged to members is considered to be the most appropriate indicator of regulated activity as discussed above.

To allow a calculation of UK regulated income in line with the above, the FCA should request Lloyd's to provide the relevant data. Currently, the necessary data is not collected by the FCA.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.7 FUND MANAGERS

Applicable regulated activities

- Managing investments
- Managing an AIF
- Managing a UCITS
- Safeguarding and administering of investments (without arranging)
- Arranging, safeguarding and administration of assets
- Venture capital business.

Identification of income

For fund managers, income recognised in the financial statements represents fees received for investment management and advisory services provided to external clients. Fees are typically generated in the form of management and performance fees, which have separate criteria for recognition under both UK GAAP and IFRS.

For the purposes of defining UK regulated income, deductions are made from turnover as recognised in the financial statements in respect of:

- Rebates paid to investors or introducers (for firms that recognise turnover gross of any rebates payable). These rebates are concluded to constitute an appropriate deduction to UK regulated income since they represent fees that the firm is not contractually entitled to receive, as per the relevant agreement in place.
- Any other fees remitted to other UK regulated entities within the group under separate advisory agreements. These are omitted on the grounds that they will be captured within the regulatory returns of said group firms.

The above amendments are aligned with the FCA's proposed revised definition of annual income.

Standard practice as to whether investment management and advisory fees are recognised gross or net of rebates differs from firm to firm depending on the nature of the agreements in place. Under certain rebate arrangements, rebates may be charged by an investor directly to their shareholding in the underlying fund. In these cases, no adjustment to the regulated firm's income is required. However, in other cases, the UK regulated firm may be party to an agreement whereby a certain proportion of fee income is paid away to a third party investor, which would necessitate the adjustment in deriving UK regulated income as described.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
FSA002	Performance fees	9B
	Investment management fees	10B
	Investment advisory fees	11B
	UCITS management fees	13B
FSA030	Performance fees	6A
	Investment management fees	7A
	Investment advisory fees	8A
	UCITS management fees	10A

The rationale for using the above data fields is that these are the fields that will correspond, on a best fit basis, to the income generated from regulated activities by fund managers.

The data fields used are concluded to be representative of UK regulated income and also provide an appropriate indicator of UK regulated activity. However, as noted above, to fully capture UK regulated income for fund managers, additional IDDs could be considered for applicable pay away arrangements, be they in respect of rebates or amounts payable to other UK regulated entities within the group.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.9 OPERATORS, TRUSTEES AND DEPOSITARIES OF COLLECTIVE INVESTMENT SCHEMES ETC

Applicable regulated activities

- Managing an AIF
- Managing a UCITS
- Acting as a trustee or depositary of an AIF
- Acting as a trustee or depositary of a UCITS
- Establishing, operating or winding up a regulated collective investment scheme
- Establishing, operating or winding up an unregulated collective investment scheme
- Acting as trustee of an authorised unit trust scheme
- Acting as the depositary of an authorised contractual scheme
- Acting as the depositary or sole director of an open-ended investment company
- Establishing, operating or winding in a personal pension scheme or a stakeholder pension scheme.

Identification of income

For firms included in the A.9 fee block, income is recognised in the financial statements in respect of management and administration fees charged to clients for acting as an operator, trustee and depository in line with the above permissions.

In arriving at a measure of UK regulated income, deductions should be made, where appropriate, in respect of fee income arising from activities falling outside the scope of the firm's regulatory permissions.

Additionally, and in line with the guidance provided for other fee blocks by the FCA within FEES 4 Annex 1A, deductions could be made in respect of amounts rebated to clients or passed on to other authorised firms. This may occur in instances where there is a commission chain or where fee rebates are payable to an investor, for example. We refer back to our analysis of fund managers though where we provide further views on what deductions should be made.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
FSA002	Performance fees	9B
	Investment management fees	10B
	Investment advisory fees	11B
	UCITS management fees	13B
	Other fee and commission income	14B
FSA030	Performance fees	6A
	Investment management fees	7A
	Investment advisory fees	8A
	UCITS management fees	10A
	Other revenue	12A

The above data fields have been chosen to provide complete coverage of management and administration fee income that makes up UK regulated income for this sub-sector as described above.

Given the breadth of the scope of data fields 14B from the FSA002 and 12A from the FSA030, an additional IDD is required in respect of fees arising from non-regulated activities, which may have otherwise been captured within this data field.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.10 FIRMS DEALING AS PRINCIPAL

Applicable regulated activities

- Dealing in investments as principal
- Bidding in emissions auctions.

Identification of income

The top line income reported in the financial statements by firms dealing as principal comprises of net trading income, before brokerage or exchange fees and commissions payable. These net trading profits principally arise from proprietary trading or market making in securities and represent the value of net returns of securities and investments traded in a given period.

For the purpose of defining UK regulated income, the following deductions are made from top line turnover reported in the financial statements in respect of:

- Dividend income received from non trading assets, such as subsidiary companies
- Interest income from non trading assets, such as cash deposits and intercompany loans with group companies.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
FSA002	Interest income	2B
	Net trading income/(losses)	15B
	Realised gains (losses) on financial assets & liabilities (other than HFT and FVTPL)	21B
	Dividend income	22B
FSA030	Total dealing profit (or loss)	4A
	Interest and dividends receivable	11A
	Foreign exchange gains	13A

The above data fields correspond to the regulated activities undertaken by firms dealing as principal.

On the FSA002, field 15B comprises realised and unrealised gains/losses generated on traded securities and foreign exchange. These gains and losses constitute part of the net trading income generated by the firm, which forms part of UK regulated income as described above. Field 21B serves to include available for sale and held to maturity assets which form part of the trading book, whilst 2B and 22B, interest and dividend income, are further components of trading book income. However, as noted above, new IDDs are required to appropriately deduct any interest and dividend income that does not arise from trading assets. These data fields are replicated in the FSA030 for firms that report using this data item.

Whilst the above data fields are indicative of income reported in the financial statements of firms dealing as principal, the 'net trading income' line is not consistent with the definition of income noted in 4.2. For this definition of income to apply to firms within this sub-sector, a measure of gross trading gains would instead be used. However, given that the nature of the regulated activity itself results in trading gains and trading losses, the use of a gross trading income measure is not considered to be credible.

Further to this, there are concerns as to whether net trading income provides a suitable indicator of UK regulated activity. For cases where a firm dealing as principal trades intensively, but performs poorly, the net trading income figure is not likely to be representative of the level of activity undertaken.

However, this figure does stand up to scrutiny as a measure of the benefit of being regulated by virtue of being directly attributable to the regulatory permissions held. In our view, the trading gains figure can be an indicator of regulatory activity but it is a very poor one without a more suitable alternative available.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.12 ADVISORY ARRANGERS, DEALERS OR BROKERS (HOLDING OR CONTROLLING CLIENT MONEY OR ASSETS, OR BOTH); AND

A.13 ADVISORY ARRANGERS, DEALERS OR BROKERS (NOT HOLDING OR CONTROLLING CLIENT MONEY OR ASSETS, OR BOTH)

These two sub-categories have been combined for the purpose of our analysis on the basis that the only differentiating factor between the two is the holding or controlling of client money and/or assets and, going forward, the FCA intends on merging them. Given that this is not considered to have a significant, if any, impact on the definition of UK regulatory income, the two sub-sectors have been assessed together.

Applicable regulated activities

- Dealing in investments as agent
- Arranging (brining about) deals in investments
- Making arrangements with a view to transactions in investments
- Dealing as principal in investments, where the activity is carried on as a matched principal broker, oil market participant, energy market participant or local
- Advising on investments (except pension transfers and pension opt-outs)
- Advising on syndicate participation at Lloyd's.

Identification of income

Income is recognised in the financial statements of advisory arrangers, dealers or brokers in respect of commissions and fees from brokerage and advisory services provided, which links to the relevant regulatory permissions as noted.

Firms within these sub-categories are currently assessed on the basis of income for the purposes of calculating fees payable to the FCA. For this purpose, 'annual income' is defined as follows by the FCA:

The gross inflow of economic benefits (ie cash, receivables and other assets) recognised in the firm's accounts during the reporting year in respect of, or in relation to, the provision in the UK of the regulated activities specified in FEES 4, Annex 1A, R Part 12.

The figure should be reported without netting off operating costs or business expenses, but including:

All brokerages, commissions, premiums, fees, and other related income (for example, administration charges, overriders, profit shares, income from appointed representatives, etc.) due to the firm in respect of, or in relation to, the provision in the UK of the regulated activities specified in FEES 4 ,Annex 1AR, Part 12 and which the firm has not rebated to clients or passed on to other authorised firms (for example, where there is a commission chain).

Any ongoing commission from previous business received by the firm during the reporting year, such as trail commission or renewal business.

The 'fair value' of any goods or services the firm provided to clients. This is an estimate, such as a 'commission equivalent,' of the amount the firm would otherwise have received for any regulated activity under (a) above, but for which it has made a business decision to waive or discount its charges.

As noted in appendix 2 of the Statement of Requirements for this report, the FCA has already concluded that firms within this sub-sector are able to meet these IDDs.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
FSA002	Gross commission and brokerage	8B
	Other fee and commission income	14B
FSA030	Gross commission and brokerage	5E
	Total revenue	7E
	Other revenue (income from non-regulated activities)	6E

With regards to the fields used in the RMAR, the appropriate calculation is total revenue minus other revenue (income from non-regulated activities).

Brokerage fee income is concluded to be a suitable indicator of regulatory activity for brokers; the fees are reflective of the level of activity undertaken, with commissions typically based on the size of deals undertaken or advised upon. Inclusion of trading income is not considered to be appropriate, as the regulatory permissions of firms in this sub-sector do not extend to dealing as principal, but are instead limited to dealing as agent. As such, a firm in this fee block would not be entitled to the benefit of trades executed.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.14 CORPORATE FINANCE ADVISORS

Applicable regulated activities

- Carrying on corporate finance business.

Identification of income

Income comprises retainer and success fees generated from corporate finance activity. For accounting purposes, retainer fees are recognised as income over the life of the relevant contract, whilst success fees are recognised when the necessary conditions are met to result in the firm becoming contractually entitled to receive the fees.

It is considered that the accounting definition of income as applied to corporate finance advisors is appropriate for the purposes of identifying UK regulated income.

As is the case for other sub-sectors, income is already used as a tariff base by the FCA for fee calculation purposes for corporate finance advisors. As such, the definition of income applicable for those sub-sectors as described above is also applicable for corporate finance advisors.

A further IDD may be needed to consider the impact of fees arising from non-regulated activities that have otherwise been captured within the UK regulated income metric. However, such fees are not included within the definition of 'annual income' already used by the FCA, which firms in this sub-sector have already demonstrated they are able to effectively report. Notwithstanding this, additional data fields will be required in the FSA002 and FSA030 returns to consider this point if these are to be the primary means of capturing data for fee allocation purposes, as relevant fields are not currently included.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
FSA002	Corporate Finance	12B
	Other fee and commission income	14B
FSA030	Corporate finance	9A
	Total revenue	7E
	Other revenue (income from non-regulated activities)	6E

With regards to the fields used in the RMAR, the appropriate calculation is total revenue minus other revenue (income from non-regulated activities).

It is considered that income is a suitable indicator of regulated activity, given that income is directly generated from the engagement with clients to provide corporate finance advice.

As noted above, additional data fields may be required in the FSA002 and FSA030 to fully capture any fees arising from non regulated activities, which should be deducting in arriving at UK regulated income.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.18 HOME FINANCE PROVIDERS, ADVISERS AND ARRANGERS

Applicable regulated activities

- Entering into a home finance transaction
- Arranging (bringing about) a home finance transaction
- Making arrangements with a view to a home finance transaction
- Advising on a home finance transaction.

Identification of income

Income comprises retainer and success fees generated for home finance providers, advisors and arrangers, income comprises of commissions and fees from mortgage and finance broking and administration of mortgage applications. The turnover reported in the financial statements of these firms comprises of fee income in respect of these activities.

As was the case with sub-sectors described previously, income is already used as a tariff base by the FCA for fee calculation purposes for home finance providers, advisers and arrangers. As such, the definition of income applicable for those sub-sectors as described above is also applicable for this sub-sector.

A further IDD may be needed to consider the impact of fees arising from non-regulated activities which have otherwise been captured within the UK regulated income metric. However, such fees are not included within the definition of “annual income” already used by the FCA, which firms in this sub-sector have already demonstrated they are able to effectively report. Notwithstanding this, additional data fields will be required in the FSA002 and FSA030 returns to consider this point if these are to be the primary means of capturing data for fee allocation purposes, as relevant fields are not currently included.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
Mortgage Lending & Administration Return	Fees and commissions receivable	B1.5
FSA030	Gross commission and brokerage	5A
	Other revenue	12A

As noted above, additional data fields may be required in the FSA002 and FSA030 to fully capture any fees arising from non regulated activities, which should be deducted in arriving at UK regulated income.

9. DEFINITION OF INCOME BY CATEGORY OF FIRM

A.19 GENERAL INSURANCE MEDIATION

Applicable regulated activities

One or more of the following in relation to a non-investment insurance contract:

- Dealing in investments as agent
- Making arrangements with a view to transactions in investments
- Assisting in the administration and performance of a contract of insurance
- Advising on investments.

Identification of income

In respect of general insurance mediation firms, the income reported in the financial statements comprises of commissions and fees, including both fixed and variable elements.

This turnover is noted often, but not always, to be stated net of commissions paid to sub-agents. These commissions can either be paid out of the total commission figure, in which case it is a cost for the main broker, or be a separate commission element in the policy documentation, in which case it does not form part of the main broker's commission at all.

As was the case with sub-sectors described previously, income is already used as a tariff base by the FCA for fee calculation purposes for general insurance mediation firms. As such, the definition of income applicable for those sub-sectors as described above is also applicable for this sub-sector.

Data fields used, rationale and extent to which data fields represent UK regulated income

Data item	Field name	Field reference
FSA002	Gross commission and brokerage	8B
	Other fee and commission income	14B
FSA030	Gross commission and brokerage	5A
RMAR section B	Total revenue	7E
	Other revenue (income from non-regulated activities)	6E

With regards to the fields used in the RMAR, the appropriate calculation is total revenue minus other revenue (income from non-regulated activities).

Turnover is considered to be a reasonable indicator of business activity and, until a broker goes into decline or run-off (when the balance sheet becomes the dominant factor), business activity is a reasonable indicator of regulatory risk. The data fields above are concluded to be representative of UK regulated income, although additional fields may be required to:

- Allow the deduction of commissions paid to sub-agents in instances where income is recorded gross of these amounts
- Consider any other fee and commission income recognised in respect of non regulated activities.

10. COMPARING INCOME AGAINST OTHER METRICS

Background

In assessing the relative merits between income as the common metric for a consolidated ‘A’ fee-block, consideration has also been given to other metrics following an approach whereby fees are recovered via a common measure. The purpose of this section of the report is to compare other metrics against income through assessment of the relative merits of each approach.

Selecting metrics

One relevant factor in selecting an appropriate metric is consideration of applicability to the seven FCA fees governing principles, which are detailed in the below table:

1	Fair	Justify basis for any cross-subsidy
2	Risk aligned	Risk taken into account where effective to do so
3	Transparent	Link between cost allocation, application of risk and level of fees is clear
4	Predictable	Firms can reasonably estimate their fees for the forthcoming year
5	Flexible	Adaptable to changes in financial markets
6	Proportionate	Costs of operating the model should be proportionate
7	Legal	Allowable within the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012

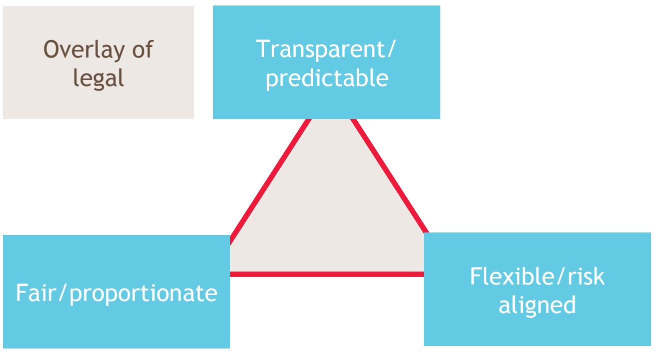
Linking to a firm’s ability to pay is a broad basis on which fees could be allocated across the Financial Services sector as a whole. This could first and foremost be seen to take account of the principles of fairness and proportionality in selecting a metric and most likely suggests the use of profit as a metric. However, there is a fear that in basing the fee apportionment model on profit, fees collected by the FCA may be unfairly skewed towards firms that run their businesses efficiently.

An additional metric that can be used as a measure of ability to pay is income. As described earlier in this report, income can also broadly be considered to be indicative of a firm’s regulated activity. This provides greater correlation with the principles of fairness and risk alignment.

An alternative is to consider metrics which are more proportionate to the level of risk within a firm, such as a measure based on a firm’s regulatory capital requirement. However, there is a concern that this basis will be more indicative of a firm’s prudential risk rather than conduct risk and therefore not aligned to the FCA’s primary objectives, particularly with regard to dual-regulated firms.

The FCA fees governing principles do not take comparability or measurability into account, although this may be considered to be part of ‘predictability’. In our view, comparability and measurability are key factors to consider when determining an appropriate metric for use in the fee allocation model. If derivation of a particular metric is overly complex or not comparable between sub-sectors, it would be likely to lack credibility in the marketplace.

The principles themselves are not necessarily complementary; indeed, we note that a trade-off broadly exists between the principles on three separate planes. Identifying an appropriate metric requires effective trade-off between opposing forces amongst the governing principles as illustrated in the adjacent diagram.



10. COMPARING INCOME AGAINST OTHER METRICS

Overview of metrics

An overview of the assessment of identified metrics (including income) for a model that assesses firms through a common measure of size is presented below.

We have not been asked to conclude on whether there is a better metric than the one offered under the Revenue model. In our investigation there appears to be weaknesses in all the possible options discussed, whether it be a lack of transparency, too much complexity or disproportionate impact. It is up to the FCA, via discussion with the industry, to conclude upon a suitable compromise.

METRIC	PROS	CONS
Income	• Transparent and easy for firms to calculate • Conceptually valid as a 'tax' on the benefit of being regulated • Broadly a good indicator of the level of regulatory activity.	• May be unfair for loss-making firms • Not risk aligned • Income is not always perfectly comparable between sub-sectors • Indicators of regulated activity required for certain sub-sectors rather than income.
Risk weighted income	• Adds an overlay of risk alignment onto the income model in line with FCA fee principles.	• Risk weightings may be largely arbitrary • Fee burden should not necessarily be skewed to more risky activities; the benefit of regulation applies to all regulated firms.
Fixed fee	• Greater predictability for firms and the FCA.	• Lacks fairness as it will discriminate against smaller firms • Creates a barrier to entry and harms competition • Not proportionate.
Capital requirement	• Data is already collected for prudential purposes and is understood by the marketplace • Proportionate in line with the level of regulatory activity undertaken.	• Prudential measure and so not necessarily aligned to FCA's objectives • Not reflective of conduct risk • Not easily comparable between firms.
Value add metric (profit)	• Clear measure of value add • Most closely linked to ability to pay.	• May require significant additional direction and oversight to prevent manipulation • Value add measures suffer from volatility, resulting in a lack of predictability • Unfair apportionment onto firms that run their businesses efficiently.
Number of complaints	• Aligned with conduct failures of a firm.	• Not predictable for firms or the FCA • Likely to be disproportionately onerous towards retail firms.

www.bdo.co.uk

HB05799