Andrew Tyrie MP
House of Commons
London
SW1A 0AA

Dear Andrew,

During the Treasury Select Committee hearing of 4 February, I undertook to provide you with further details of our proposals to change the way we levy fees from investment intermediaries, which had been reported in the press as 'overcharging'. I have looked into the matter and am content that no firms were overcharged. I am also satisfied that by consulting on an annual basis our processes for calculating fees are transparent.

We have spoken to Money Marketing, who calculated the £118m figure you quoted during the hearing. This was calculated by applying the new £16.5m fee charged to investment intermediaries in fee-block A13 fee retrospectively over the last five years.

**Money Marketing Calculation**

<table>
<thead>
<tr>
<th></th>
<th>Actual Fees paid</th>
<th>Application of 2014/15 fees retrospectively</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009/10 - 2012/13</td>
<td>£161.2m</td>
<td>£66m</td>
<td>£95m</td>
</tr>
<tr>
<td>2013/14</td>
<td>£39.2m</td>
<td>£16.5m</td>
<td>£23m</td>
</tr>
<tr>
<td>Total</td>
<td>£200.4m</td>
<td>£82.5m</td>
<td>£118m</td>
</tr>
</tbody>
</table>

We consult on our fees proposals on an annual basis. As we stated in our consultation in October 2013, we are recovering the same amount of money from investment intermediaries in 2014/15 as we did in 2013/14. In previous years, these firms were split into A12 (for firms holding client money) and A13 (for firms not holding client money). Given the risks posed by these firms, we calculated that we needed to recoup £44.5m from firms in A12 and £39.2m from firms in A13.

However, as firms in A12 were significantly larger than those in A13, the fees charged per £100,000 of income were substantially higher for the firms in A13 (£6.89 per £100,000 of income) than for those in A12 (£2.39 per £100,000).
For the first time in 2014/15, we have been able to create a fee-block (A21) specifically to recover costs relating to client money and client asset risk. This has enabled us to pool large and small firms together into a revised investment intermediary fee-block (A13). By pooling large and small firms together, we have reduced the fees charged to a flat rate of £2.84 per £100,000. As a result of the change:

- 44% of firms would have seen no change in fees because they would remain under the minimum fee threshold;
- 43% would have seen a decrease; and
- 13% would have seen an increase.

Whilst creating a new fee-block does lead to winners and losers in the short-term, I do not believe this means that some firms have been historically 'overcharged' any more than others have been undercharged.

I have provided further details on how we calculated the changes in an annex to this letter. If you or your colleagues on the Committee would like to learn more about our approach, I would be happy to meet to discuss further.

John Griffith-Jones

Chairman, Financial Conduct Authority
Appendix 1

FCA Approach

The FCA levies its fees according to the rules set out in the FEES chapter of the FCA Handbook. At a high level, the process is as follows:

- We distribute our budget across fee-blocks to reflect where we allocate our resources and therefore the costs we need to recover. The fee blocks are dictated by the type of business firms are conducting - e.g. deposit-taking, portfolio management, advising on investments. Firms conducting a range of different lines of business will fall into several fee-blocks.

- We then distribute the total cost to be recouped from each fee-block between the constituent firms according to their size, using a metric known as a ‘tariff base.’ The tariff base varies between fee-blocks, depending on the business being conducted - e.g. value of deposits, value of funds under management, income. The fee-rate is calculated by dividing the total cost to be recovered by the total tariff base reported by firms, to give a rate per unit - e.g. per £1,000 of income.

- Small firms whose tariff data falls below a particular threshold - typically £100,000 of income - pay a minimum fee of £1,000, however many fee-blocks they fall into.

FSA approach

When the FSA was set up in 2000, it established two different fee blocks for investment intermediaries, to reflect the fact that firms holding client money or assets pose a higher risk to consumers and market integrity:

- A12 for advisors, arrangers, dealers or brokers who have permission to hold client money or assets; and

- A13 for advisors, arrangers, dealers or brokers who are not permitted to hold client money or assets.

The tariff base for both fee-blocks was, until 2011/12, based on the number of Approved Persons within each firm.

FCA changes 2013/14

Ahead of the creation of the FCA, the FSA consulted on a proposal to base the fees for investment intermediaries on income rather than numbers of Approved Persons. This was introduced from April 2013. This change was made because income was considered a better proxy for our resource allocation than number of approved persons.
In line with the high level approach outlined above, in 2013/14 we calculated that we needed to recover £44.5m from the A12 fee block and £39.2m from the A13 fee block. This reflects the higher regulatory risk posed by firms in A12 than those in A13. The average fee paid by a firm in A12 is around £24,000 and about £6,000 in A13. However, because the total income of firms in A12 is so much higher than in A13, the headline rate in A12 is only £2.39 per £1,000 compared with £6.89 per £1,000 in A13. Table 1 illustrates this.

Table 1: Fee calculations for fee-blocks A12 and A13 – as charged in 2013/14

<table>
<thead>
<tr>
<th></th>
<th>No of firms</th>
<th>FCA Costs to be recovered</th>
<th>Actual costs to be recovered from existing firms(^1)</th>
<th>Total income above £100,000 thresholds(^2)</th>
<th>Fee rate (£/per £100k of income)</th>
<th>Average FCA cost per firm</th>
<th>Average income per firm</th>
<th>Average fee per firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>A12</td>
<td>1,899</td>
<td>£44.5m</td>
<td>£44.5m</td>
<td>£18.6bn</td>
<td>£2.39(^3)</td>
<td>£23,433</td>
<td>£10.1m</td>
<td>£24,038</td>
</tr>
<tr>
<td>A13</td>
<td>6,768</td>
<td>£39.2m</td>
<td>£38.9m</td>
<td>£5.6bn</td>
<td>£6.89(^4)</td>
<td>£5,792</td>
<td>£0.9m</td>
<td>£6,210</td>
</tr>
</tbody>
</table>

The lower fee-rate in A12, which we referred to in our consultation paper as an ‘anomaly,’ created a theoretical opportunity for firms to arbitrage between fee blocks. This would not be a realistic possibility for small firms because meeting the enhanced capital requirements associated with holding client money would have outweighed any benefit they gained through a reduction in fees.

However, larger firms with substantial capital assets (for example, participants in the oil and energy markets) could readily meet the capital requirements so could theoretically have lowered their fees by taking on additional client money permissions they did not want or need. This would have moved them from the A13 to A12 fee block to take advantage of the lower fee rate per £1,000 of income. We have seen no evidence of firms attempting to do this, but acted to close an arbitrage opportunity.

\(^1\) Actual costs to be recovered are marginally lower than FCA costs due to income from new market entrants

\(^2\) Firms only pay towards these fee-blocks on income above £100,000. Firms with annual income below £100,000 do not contribute to these fee blocks (their minimum fee of £1,000 forms part of the AA00 fee-block).

\(^3\) £44,456,030 / £18,632,905,576 = £2.39 per £100,000

\(^4\) £38,898,813 / £5,645,691,351 = £6.89 per £100,000
Proposed FCA changes 2014/15

Following the failure of Lehman Brothers Europe International, the FSA set up a specialist unit to supervise firms that hold client money and custody assets. In 2010, it consulted on creating a dedicated fee-block to recover the costs of the unit from the firms concerned but at that time the FSA did not have robust data to base the fees on. We now have a robust data set on firms’ client money and custody assets balances and so, in last October’s consultation paper, we proposed the creation a new fee block – A21 – focussed solely on client money. This targets cost recovery of the resources we devote to mitigating the risks posed by firms in a more transparent way.

As the creation of fee-block A21 removes the distinction between A12 and A13, we proposed a merger of A12 and A13 fee blocks. All firms currently in A12 and A13 would be moved to the new A13 fee-block, and the firms currently in A12 would also be in A21. Bringing the larger firms from A12 into the merged A13 fee-block brings the blended rate down to £2.84 per £1,000 of income.