

Isle of Man Financial Services Authority: New Funding Model

Report of the Third Party Advisers to the Isle of Man Financial Services Authority,

Ian Tower and Nadege Genetay

17 October 2022

The Isle of Man Financial Services Authority (“IOMFSA” or “the Authority”) has been developing a new approach to its funding, aiming to move from a mixed model (broadly 50% industry-funded and 50% government-funded) to a predominantly industry-funded model (“PIFM”). To support its work, the IOMFSA engaged independent third party advisers with a broad remit to assist the review.

After a procurement process, Ian Tower and Nadege Genetay were appointed in April 2021 for an eighteen month period (see Annex I for brief biographies).

This report sets out the advisers’ approach to working with the IOMFSA and the main lines of their advice. It is issued for the record and not for comment.

Executive Summary

The advisers worked with the IOMFSA team responsible for the new funding model. They participated in discussions with officials of the Isle of Man Government and the Authority’s Industry Working Group and attended discussions at Board meetings. The advisers provided input in the form of policy papers, oral advice and recommendations and comments on draft papers for the Board and for publication. The bulk of their involvement took place in 2021 and focused on agreed policy issues. They made comments at a high level on the resulting detailed fee proposals but were not directly engaged in developing them.

The main issues covered by the advice were: (i) the value of developing principles to guide the preparation of the detailed new fee proposals; (ii) an initial jurisdictional comparison, highlighting areas of difference from the approach of competitor regulators; (iii) design issues and recommendations on the extended use of transaction fees; (iv) options for dealing with surpluses and deficits (in the Authority’s budget) under the new model; (v) options and recommendations for enhancing accountability and transparency of the Authority; (vi) recommendations on the treatment of civil penalties income; and (vii) the treatment of costs associated with innovation in the regulatory regime. In all cases, the advice examined practices in other jurisdictions.

Scope of the work

Background on the proposed adoption of a PIFM is set out in a Discussion Paper issued by the IOMFSA in 2020¹. Detailed proposals were published by the IOMFSA in a Consultation

¹ DP20-01/T14, Funding Financial Regulation and Designated Business Oversight, 30 October 2020. The Authority published a Feedback Statement, FS21-01, on 14 May 2021.

Paper issued in May 2022². The scope of the advisers' expected contribution, as set out in the contractual arrangements, included:

- Comparing funding models and fee structures with other jurisdictions and making recommendations on the Authority's approach.
- Developing a deep understanding of the work of the Authority and its key cost drivers and determining which costs are to be included in the PIFM, i.e., which costs should be borne by industry versus broader society (tax payers).
- Reviewing the fee calculation methodology to be used for each industry sector, reflecting a desire for increased uniformity and the avoidance of complexity, whilst maintaining relevance and credibility for each sector.
- Identifying specific areas of Authority work where charging fees on a transactional basis may be preferable to covering such costs through annual or periodical fees.
- Considering how the PIFM should handle exceptional events, i.e., short-term peaks and troughs in income and/or expenditure.

The main lines of the advice provided by the advisers were reported to the IOMFSA's Board and referenced by the Authority in the May 2022 Consultation Paper.

Approach

The advisers worked closely with IOMFSA staff responsible for developing and consulting on the new funding model and met regularly with the Authority's internal working group (mainly online but the advisers also met with staff for a full day meeting in October 2021 at the offices of the IOMFSA).

The advisers also participated in discussions with officials of the Isle of Man Government (Treasury and Department for Enterprise) and with the Authority's Industry Working Group, its forum for discussion of the proposals. In addition, they attended funding model discussions at the Authority's Board meetings.

The advisers provided input in the form of:

- policy papers setting out analysis and recommendations on particular topics;
- advice and recommendations in discussions on those and other issues; and
- comments and drafting suggestions on draft papers, for the Board and for publication.

The bulk of the advisers' involvement took place in 2021. They used the day spent with the IOMFSA's internal working group in Douglas to brainstorm key issues on which the Authority needed to take a view to complete the design of the model, including the approach to modelling of sectoral fees. They discussed the production of an action plan taking the Authority to publication of a consultation paper.

² New Authority Funding Model from 1 April 2023, CP22-04, 12 May 2022. See also the Consultation Response: New Authority Funding Model from 1 April 2023, CR22-04, issued 23 September 2022.

Following this workshop, the advisers produced their policy papers, initially for discussion with staff and then for publication, in summary form and including the Authority's preferred approach, in the May 2022 Consultation Paper.

The advisers made comments at a high level on the resulting detailed fee proposals but were not directly engaged in developing them.

The advice

The main areas of advisers' input are summarised in this section of the report.

Principles

The May 2022 Consultation Paper set out nine principles aimed at underpinning the work. The advisers recommended the development of the principles and provided initial drafts based on the high-level objectives for the project, taking into account responses to the 2020 Discussion Paper. They worked with IOMFSA staff, senior management and the Board to finalise these principles and use them as a guide to decisions on the detailed design issues and as the basis for engagement of the industry in the next stages of the work. The work on these nine principles provided a focus for discussion of the scope of future industry funding and the extent of cross-subsidisation (i.e., one or more sectors contributing to the costs of regulating others), including in connection with the development of new sectors or entities.

Jurisdictional comparison

The Authority has wanted to ensure that its new funding model takes account of the competitive position of the Isle of Man's financial sector, particularly in regard to Jersey, Gibraltar and Guernsey (and, for some sectors, Ireland). The advisers were asked to undertake a preliminary comparison of the existing IOMFSA funding model structure with those in Jersey, Gibraltar and Guernsey.

The work identified areas where the IOMFSA is an outlier, including in charging mainly application and annual fees rather than transaction (usage-based) fees and not retaining much civil penalty income resulting from enforcement action. Because of limited disclosure by the comparator regulators, it was not possible to establish the relationship between fee income and costs of regulation (and so the extent of cross-subsidisation) at a sector level at those regulators³.

The advisers noted the challenges in comparing fees for specific types of firms arising from the differences in how jurisdictions categorise activities and structure fees (and how far, for example, they rely on transaction-based fees). No consistent pattern was found across the sectors and jurisdictions, and it was agreed with the Board and IOMFSA staff that only in the context of the detailed work required to establish the fees to be charged under the new model could useful comparisons be made across jurisdictions (for some sectors, these would

³ See New Authority Funding Model from 1 April 2023, CP22-04, 12 May 2022, Appendix B. See also the Response Paper CR22-04, issued 23 September 2022.

need to be treated with caution). This work was undertaken by the Authority's staff and informed the proposals set out in the May 2022 Consultation Paper.

Policy issues

The advisers provided input on a number of policy issues identified in discussion with staff.

(i) Transaction fees

The advisers noted that a number of jurisdictions levy transaction fees in addition to annual and application fees. These transactions involved can be varied and include, for example, significant changes of control, business transfers, model approvals, approvals of individuals in key positions, variations of permission and certain notifications.

The main advantage of transaction fees, in the advisers' view, is that companies that generate the additional work (and benefit from the transaction) bear the costs, without other fee-payers having to shoulder them. They also provide additional funds and cash flows to meet unplanned and resource-intensive demands on the regulator. The disadvantages are that transaction fees are an uncertain source of income, while processing them generates additional administrative cost. In addition, fee-payers may feel that their application and annual fees should already cover at least some such transactions.

The advisers recommended that the Authority consider a wide range of transactions fees. The Authority felt that they should introduce them only for the most significant transactions, such as changes of control, portfolio transfers and court transfer schemes. They put particular weight on the administrative costs and wanted to limit sources of uncertainty over future income levels.

(ii) Treatment of surpluses and deficits

The project work identified a need to consider, in the light of the reduction of the government subvention, how surpluses and deficits (differences between budgeted and actual annual financial results) should be treated in future. At present, the Authority, as a Statutory Board, negotiates its planned expenditure with the government, which makes a subvention to cover planned expenditure not covered by fee income. The advisers noted that management of surpluses and deficits under the new model may be complicated by:

- greater unpredictability of overall income, if the Authority were to levy more transaction fees and if it were to retain more income from civil penalties (see below);
- the large reduction of government funding, potentially removing a source of financial support to meet deficits, which may be large; and
- the need for clarity about the treatment of surpluses, which fee-payers will expect to accrue to them rather than to a government which is providing much reduced financial support.

The advisers developed various options for managing these challenges, taking into account international standards which require that financial arrangements do not undermine independence from government. They also had regard to practices of comparator regulatory bodies who do not have routine government funding, where there may be provision for government to make a grant or for the regulatory body to borrow. The main options for change (within the current arrangements whereby the Authority remains a Statutory Board) were identified by the advisers as:

- A “virtual separate agency” approach: the Authority would function as if it were a separate agency, with responsibility for managing surpluses and deficits. It would have a notional balance sheet and would build a “reserve” to absorb surpluses and meet deficits, committing to a target level of reserves. The government would recognise the “reserves” as available to the Authority, enhancing its independence.
- Ex post fee collection to match income to actual expenditure: the Authority’s fees would be based on actual expenditure for the year and be payable early in the following year. Ex post fees would create a cash flow benefit for licensees, but the cash flow deficit of the Authority would need to be covered, presumably by a government loan, potentially compromising financial independence.

As these issues required further discussion with government, the advisers made no recommendation. As noted in the May 2022 Consultation Paper, these discussions continue.

(iii) Accountability and Transparency

The advisers considered the scope for increases in transparency and accountability of the Authority, recognising the significant increases in fees paid by the industry as well as initiatives already being taken by the Authority on increased transparency.

Various options were developed, taking into account the practices of comparator regulators. Some of these publish more than the IOMFSA, such as a plan and budget for the year, information on fees by sector and detail on service standards (target times for responding to queries etc. and performance). The options for the IOMFSA were identified as:

- Publication of an annual budget and plan setting out the key plans for the year and linking them (qualitatively if not with exact numbers) to costs and fees.
- Publication of fee income by sector, maybe in the fees consultation paper and annual report. Information on costs of activities (supervision etc) could also be published.
- Establishment and publication of performance measures and/or service standards, beginning with publishing information on a select set of indicators focused on the most important points of access for firms to the Authority such as speed of response to key requests by firms for information, responses to correspondence etc.

- An occasional published assessment, focusing on use of resources such as a periodic external review of efficiency, the first to take place perhaps when the new funding model is delivered or a published internal view, for example by a Board member.

The advisers recommended that the Authority consider in particular: (i) the proposed publication of an annual budget, including projected fee income from each sector; (ii) a commitment to undertake an external review after full implementation of the new funding model, including the impact on comparisons of fee levels and overall costs of regulation with other jurisdictions; and (iii) publication of performance on key indicators, including those relating to the amount time taken to make key decisions (authorisations etc) where standards exist already, and over time to extend the scope of the standards to include other, including supervision-related, indicators.

The Authority is reviewing the options in the context of existing work on accountability to the government and transparency to stakeholders, including publication of a wider range of service standards and accompanying metrics and key performance indicators.

(iv) Treatment of civil penalties income

The advisers were asked to consider options on how civil penalties income (which comprises both administrative civil penalties - fixed amounts for late reporting etc - and discretionary civil penalties, reflecting enforcement actions) be treated under the new funding model. The advisers noted that even where regulators are industry-funded and financially independent, they generally do not retain all such income, mainly because doing so would create an incentive for the regulator to maximise enforcement action and increase revenue.

The advisers developed various options, taking into account international standards and practices. While practices differ across jurisdictions, where regulators retain penalties income, there are normally constraints on how it can be used. Options considered were:

- for the Authority to retain all penalties as income, free of limitations on how it uses the income, as it does for administrative penalties at present;
- for the government to receive all the income from penalties; and
- for the Authority to receive all civil penalty income subject to conditions its use: these could include requirements that the Authority: (a) use the income to build reserves, at least in the transition to the new funding model; or (b) rebate the income to licensees in full (maybe excluding penalty payers); or (c) rebate to licensees only income equal to enforcement costs with the balance being submitted to government.

The advisers recommended that the third option be chosen. The Authority's preferred approach is that it should be able to retain civil penalties income subject to appropriate constraints to avoid financial incentives to take enforcement action. It should be able to apply the income to reduce enforcement costs, remitting the balance to government.

(v) Treatment of costs associated with innovation in the regulatory regime

The advisers were asked to consider how regulatory costs of innovative new business should be treated under the new funding model. They noted the practical issues associated with funding such costs in the early years, when there are no entities from whom costs of policy and operational preparations may be recovered. Once a new regime is operational, there may also be too few new entrants initially to bear its costs. Even if there is significant interest in the new sector/activity, the authorities may want to keep entry costs low, recognising that they will be competing with other jurisdictions to attract the new entrants.

The advisers developed options to fund the costs of new regulatory activities, some of which could be used in combination. (It was not possible to draw on practices at comparator regulatory bodies in this case as disclosure of such practices is limited). These were: (i) government funding such as a subsidy or grant; (ii) government loan; (iii) cross-subsidisation from other sectors; and (iv) spreading the set-up costs over a number of years.

The advisers recommended that the Authority start with option (iv) as most consistent with the principles. It respects a key objective to limit funding from government. It also gives the Authority flexibility to spread the costs according to the anticipated volume of new entrants over time. A mechanism would need to be found to finance the upfront costs, taking into account the approach agreed on the treatment of surpluses and deficits (see above).

The advisers also noted that some innovation may take the form of business models (or products) for activities that fall within the scope of existing regulated activities. There could be significant costs arising from decisions about the authorisation and supervision of such business. The advisers identified options to meet such costs as follows.

- They could be treated as a normal part of the Authority's overall budget and allocated in the normal way among fee-payers.
- The costs could be calculated and allocated to the sector where the significant innovation is occurring (e.g., the payments sector), with no cross-subsidisation.
- Application fees or modification fees could be levied in amounts that reflect the complexity associated with the relevant business model.

The advisers recommended a combination of the three options, as there is unlikely to be a single approach that would work for all types of innovation.

The Authority included its thinking in the May 2022 Consultation Paper. In the case of a new type of activity, it will discuss with the government how the regulation would be funded, considering for example whether there was a case for the government to provide short-term funding to support the introduction of the new regulatory framework. In line with the principles, the Authority noted that innovation within established sectors would be funded by the sectors in question, by annual fee income or a separate levy for the work in question. The Authority may also consider funding some of the costs with income from other areas (cross-subsidisation) and may also discuss the possibility of short-term funding with the government.

Other inputs

As noted, the advisers provided comments on draft documents (including covering papers sent to the Board of the Authority):

- Feedback Statement: Funding Financial Regulation and Designated Business Oversight, FS21-01, issued 14 May 2021
- Consultation Paper: New Authority Funding Model from 1 April 2023, CP22-04, issued 12 May 2022
- Consultation Response: New Authority Funding Model from 1 April 2023, CR22-04, issued 23 September 2022.

They also offered comments on presentations for government and industry discussions.

Conclusions

The advisers' main involvement was at the discovery and early design stage before the detailed proposals for new fees could be developed. The advisers contributed fully to the development of principles to guide the Authority's work, to the identification of key policy issues and to the development of options for the Authority's consideration, with recommendations as appropriate. The Authority has been transparent in its approach to engaging the advisers and exposing their advice.

The advisers were, however, not involved in the detailed work on the fee calculation methodology.

The advisers thank the Board of the Authority for the opportunity to work with the Board and staff on this important project. They acknowledge the close cooperation of the management and staff of the Authority, especially members of the Authority's Fees Working Group.

London, 10 October 2022

Annex: background on the advisers

Ian Tower has had a long career in central banking and the regulation of banking and insurance. After many years at the Bank of England, he moved to the UK Financial Services Authority (FSA) in 1998 taking on policy and later supervisory responsibilities. He spent three years from 2007 at the International Monetary Fund (IMF) in Washington (in the Monetary and Capital Markets Department), where he specialized in insurance regulation. He returned to London in 2010 and led the supervision of many of the foreign-owned banks in London at the FSA. From 2013, Ian has been working as an independent expert on financial regulation. He works on projects for the IMF, the World Bank, the Toronto Centre and others, focusing on banking and insurance regulation and supervision as well as the organization and financing of supervisory agencies.

Nadege Genetay worked for many years at the UK financial services regulator, starting in 1998 at the Financial Services Authority until 2014, at the newly formed Financial Conduct Authority (FCA). During that time she worked in prudential and conduct policy, supervision, and was represented the regulator at various international committees. At the end of her career at the FCA, Nadege was a member of its senior leadership team and responsible for the relationship with the Financial Ombudsman Service and Financial Services Compensation Scheme, including leading the review of the latter's funding model. Since 2015, Nadege has worked as a consultant advising firms and regulatory bodies on regulatory matters.