

REVIEW OF THE PRUDENTIAL (CAPITAL) RULES FOR PERSONAL INVESTMENT FIRMS

The FSA has published a Discussion Paper (DP 07/4) (DP) setting out its initial thoughts and proposals for discussion on how it might revise the requirements covering the amount of capital that must be held by Personal Investment Firms (PIFs). The DP is closely related to the recent DP on the Retail Distribution Review (RDR).

The issues in this paper will affect retail firms who are outside the scope of the Markets in Financial Instruments Directive (MiFID) and thus the provisions of the related Capital Requirements Directive (CRD). This means firms who do not hold client assets (including money) and do not manage investments or deal in them as agent or principal. Such firms are also often known as Article 3 firms, as this is the relevant MiFID clause. Such firms mainly include, but are not limited to, financial advisers, but not mortgage brokers or general insurance brokers.

The DP has a six month period (expiring on 7th January 2008) during which comments may be made.

1. INTRODUCTION

The prudential standards (or capital requirements) for Personal Investment Firms (unlike for most other types of regulated firm) have not been substantively reviewed since their inception under the previous regulator (Personal Investment Authority – PIA) in 1994. Currently, a firm must hold capital resources as proof of financial commitment by the owner(s) (for smaller PIFs) or to ensure that it has enough financial resources so that it can wind down in an orderly manner (larger PIFs, particularly networks). Firms must also hold Professional Indemnity Insurance (PII) against the costs of successful claims for compensation for poor advice, mis-selling etc by customers. Should a firm not be able to meet its obligations when a claim is made, it falls to the wider industry to “pick up the bill” through the Financial Services Compensation Scheme (FSCS) which may declare a firm to be in default. This scheme is funded by a levy on firms which are still in business. Thus there is an element of penalty on well run, surviving firms, who are expected to pay for those that do not have sufficient resources to meet their obligations or have left the industry.

2. FSA OBJECTIVES

The FSA's prime objective is to reduce the consumer detriment when consumers are sold inappropriate products that leave them financially in a worse position than if they had received suitable advice. However, it is also concerned about several issues which it believes are unsatisfactory with the current regime, including the lack of incentive for firms to reduce the instance of mis-selling products. The separately issued Retail Distribution Review (RDR) deals with ways in which this might be achieved through a restructure of the advice market and this DP considers possible ways in which the financial requirements of firms might be adjusted to encourage firms to reduce the risks of mis-selling. For the first time, the FSA has put forward options designed to minimise the negative impact on well-run, successful firms by the failure of less well-run firms who have left the industry, leaving the going concern firms to pay, through the FSCS, compensation to consumers of those “gone concern” firms.

The FSA has set out its objectives as follows:

- **reducing the frequency** of mis-selling i.e. reducing the amount of consumer detriment – the “best” outcome;
- **reducing the impact** of mis-selling i.e. mitigating consumer detriment after it has occurred, through firms bearing the costs of their own mis-selling – the “second-best” outcome;
- **for firms that have left the market or defaulted**, mitigating the impact of latent liabilities i.e. reducing consumer and levy-payer detriment, by requiring particular firms to meet the costs of their mis-selling through appropriate mechanisms – the “third best” outcome; and
- enabling a firm to **wind down** in an orderly manner.

3. ENCOURAGING FIRMS TO MIS-SELL LESS

3.1 Capital Resources

The current rules distinguish between firms on the basis of size and the number of advisers. The minimum amount that must be held by smaller firms is £10,000, but many firms hold more than this (73% hold more than twice their requirement and 41% hold more than five times that requirement). The intention is to ensure that firms are of substance. Larger firms and networks must hold an additional amount, based on an expenditure based requirement (EBR) which relates the amounts to their costs. The intention is to require larger firms to hold sufficient capital to close the business and meet its obligations (see 6 below). The capital resources requirements are not structured, and are not intended to be structured, to do more than meet a firm's financial obligations.

The DP considers whether, and how, the capital requirements might be changed to reduce the frequency and impact of mis-selling. No specific proposals are put forward in this DP, but several suggested points are made. These are:

- Is the flat rate £10,000 figure for smaller PIFs set at too low a figure? The FSA thinks it might be and that there is no incentive to "protect" this business stake.
- Is the relationship between capital resources and the giving of unsuitable advice too remote to give any incentive to reduce the probability of the latter? The FSA thinks that firms may hold funds in excess of the regulatory minimum to enable them to meet claims as a normal part of business expenses rather than acting to reduce the instance of claims in the first place.

Capital resources requirements that are more specifically targeted at mis-selling could be used to deliver the appropriate incentives. However, the difficulty is how to predict which firms are likely (or not) to mis-sell. There is no agreed way of doing this, and the DP notes that further work is required. Some of the factors suggested in the RDR could be relatively easy to apply, being objective tests, such as the form of remuneration used by the firm and the qualifications of its advisers. However, a risk-based capital resources regime going forward would not influence the quality of past advice, and thus the extent to which FSCS levies cover past mis-selling.

3.2 Professional Indemnity Insurance (PII)

The PII cover that firms must hold includes a level of excess in the PII policy of typically £5,000 for a single claim, although this can be increased if the firm holds a specified amount of additional capital resources. Larger firms must hold higher levels of PII cover.

The DP considers whether and how, PII requirements could be amended to discourage the frequency and impact of mis-selling. Again, no specific proposals are put forward, but several suggested ways forward have been identified.

The FSA notes that if PII cover and requirements were more sensitive to the risk of a firm mis-selling then this would be more likely to encourage firms to reduce mis-selling, because good behaviour would enable them to reduce their operating costs. However, this would depend on PI insurers undertaking risk assessments of individual firms and pricing PII on the basis of how likely mis-selling claims would be. This does not happen to a large degree in practice at present.

The FSA will take forward further work on a number of PII issues during the discussion period. This will include considering, in conjunction with PI insurers:

- ways in which policies could be more effectively drafted and priced;
- insurers' willingness to write policies with lower excesses, including the costs and availability of such policies; and
- insurers' willingness to provide 'catastrophe' cover as a part of policies

4. REDUCING THE IMPACT OF MIS-SELLING ON GOING CONCERN FIRMS

Ensuring that the consumer is compensated quickly and fairly for any mis-selling that has occurred is the second best outcome that the FSA has identified. A firm considered as a "going concern" is one that is not forced out of business by its liabilities, and continues to trade after the consumer has received compensation. The firm can pay this compensation from its own resources or, possibly, from a combination of its own resources and/or money paid out following a PII claim.

The FSA has identified some advantages of firms dealing themselves with such cases:

- consumers are more likely to be compensated in full for large claims – the FSCS cap does not apply;
- there is no impact on the rest of the industry through the FSCS as the “polluter pays”; and
- consumers may be paid more quickly by the firm rather than having to wait to apply to the FSCS.

Payment from available working capital may also be quicker than where the firm makes a PII claim, as some PII policies require a firm to defend a complaint, forcing the consumer to apply to the Financial Ombudsman Service (FOS) for adjudication. The FSA notes that if the defence of complaints is a common requirement of PII policies, it may ask the insurance industry to reconsider this practice.

The DP notes that the current capital resources requirements are not effective at mitigating the impact of mis-selling on a going concern basis. This is largely because they were not designed for this purpose.

No specific proposals are put forward on ways to reduce the impact of mis-selling on a going concern basis, but several points are made. These are:

- requiring a firm to hold capital resources which would enable it to meet consumer claims as they occur would reduce the impact of mis-selling and allow the firm to remain in business – as a going concern;
- a ‘risk-based’ approach would relate the amount of capital resource required to the risk of a consumer complaint leading to a compensation payment, for particular firms.
- PII policies would be more effective at encouraging less mis-selling if they were more effectively priced, better drafted for the benefit of consumers, and had lower excesses.

5. REDUCING THE IMPACT OF MIS-SELLING FROM FIRMS NO LONGER IN BUSINESS

The FSA refers to such firms as “gone concern” firms, and it means when firms have ceased to trade and:

- have wound down in an orderly manner;
- have become insolvent; or
- have been forced to cease trading as a result of FSA enforcement actions.

In all these cases, claims for compensation as a result of mis-selling are likely to be made to the FSCS, and thus the detriment is to the consumer, who may not get the full amount of compensation due under the FSCS cap, and to the firms left in business, through the imposition of the FSCS levy.

No specific proposals are put forward on ways to reduce the impact of mis-selling on a gone concern basis, but several options are outlined. These are:

- Requiring firms to purchase “run-off” PII to cover claims for, say, a five year term after they exit.
- Requiring firms to establish a segregated trust account to purchase run-off PII, again, for a five year term after exiting.
- Setting up a bonding requirement with a PII insurer to cover claims made after the firm ceased to be authorised. The firm would pay a premium and the bond would provide cover similar to run-off PII. However, this would be paid for over the firm’s lifetime rather than at the time that the firm was exiting authorisation. This is a requirement that currently applies to authorised accountants.
- Product providers could take some responsibility for their products sold - recognising that for some long-term products, the product provider is likely to be the only entity around at the time the product matures

6. ORDERLY WIND DOWN AND THE QUALITY OF CAPITAL AND CAPITAL RESOURCES

FSA rules also set out the nature of the capital resources needed to meet the requirements. The DP therefore looks at the quality of capital that a firm should have. Apart from requiring firms to have sufficient resources to cover the day to day costs of running the business (which includes meeting compensation claims and PII costs), the only other “risk” to be met by PIFs are those surrounding the “orderly” closure of a business and to meet its obligations. This is in contrast to other types of firm (banks, those holding client funds etc).

Although no specific proposal is put forward on ways to ensure firms have sufficient resources to enable them to wind down in an orderly fashion, several options are given. These are:

- Requiring firms to hold funds based on their fixed expenditure (overhead) – as larger firms have to do at present. This could be a four week or thirteen week figure.
- Requiring firms to hold any amount for winding down in addition to that required to cover mis-selling risks.

The quality of capital resources means restricting the amount of subordinated loans that smaller firms can include in their own funds computations in much the same way as applies for larger firms. In theory, better quality of capital means a firm would be better placed to meet its obligations, because subordinated loans only absorb losses when a firm is in liquidation – unlike the share capital and reserves of limited companies; partners' capital accounts; and sole traders' capital accounts.

The FSA has also outlined possibilities on the treatment of capital:

- changing the valuations of a firm's assets, which would be complex and perhaps prohibitively expensive for smaller firms; or
- replacing the detailed individual requirements with a flat rate deduction related to the recoverability of a firm's assets on a wind down basis.

7. NEXT STEPS

The period for comment on this DP runs until 7th January 2008. This is very similar to that of the Retail Distribution Review (RDR). Further work, particularly on and with PII participants is planned as outlined above, which will take place during this time. The FSA will also investigate, in more detail, the feasibility, including indicative costs and benefits, of some of the ideas raised by the RDR. The issues outlined in this DP will be developed in parallel with those in the RDR, although the FSA says it may consult on a free-standing basis about some options for reforming firms' capital resources and PII.

http://www.fsa.gov.uk/pubs/discussion/dp07_04.pdf

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