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Advisers will need deeper pockets

FSA publishes proposed changes to Personal Investment Firms' prudential requirements

On 27 November 2008 the FSA issued Consultation Paper 08/20, setting out its proposed changes to the prudential rules for Personal Investment Firms (PIFs).

For a number of years there has been discussion concerning the perceived under-capitalisation of the PIF industry, especially IFA firms. The increasing levels of professional indemnity excesses caused by bad claims experience due to the Pension Review and endowment mortgage issue put capital under pressure from new claims. This has led the FSA to the conclusion that IFA firms need to be better capitalised if they are to survive in the present highly regulated, consumer rights-driven environment. These new rules will impact heavily on many PIFs, and some may struggle to meet the new capital requirements that the FSA is now demanding.

The FSA, by raising the capital requirement, also wishes to reduce the pressure on the Financial Services Compensation Scheme (FSCS) caused by the regular failure of small firms of advisers.

The Consultation Paper (CP) proposes new requirements for PIFs which do not hold client assets and do not manage investments or deal in them as agent or principal. These firms fall outside the scope of MiFID because their investment business falls within the scope of the MiFID Article 3 exemption, which the Treasury has invoked in the UK.

There are over 5,000 such firms authorised by the FSA, and the majority of them are small. The CP is therefore important reading for all PIFs, especially firms of IFAs.

Since the issue of the Discussion Paper (DP) related to this CP, a number of PIFs have chosen to opt in to the MiFID so that they can use their passporting rights to service their clients in other Member States. These firms are referred to as Exempt CAD firms (ECF). FSA has maintained

the requirements for ECFs. The CP does not propose changes to the rules for ECFs other than in respect of terminology to be consistent with the rules for PIFs.

This CP follows a previous DP on the same subject, and is aligned with Feedback Statement 08/02 on the Retail Distribution Review (RDR). This latest CP is the result of the FSA's review of the RDR proposals and the subsequent development of its proposals with regard to the wider context of what is happening in the retail distribution sector.

The proposals need to be read in the context of a perception by the FSA of problems in the IFA sector. There is a belief that consumer confidence demands that the adviser is still around if and when problems emerge – typically at disinvestment – not just the provider.

There are three main sections in the CP:

1. Capital resources and requirements
2. Changes to PII requirements
3. Leaving Resources Behind

Capital resources and requirements

The FSA aims to simplify the calculation of capital resources and

make it consistent for all firms. It proposes to extend the expenditure-based requirement (EBR) for capital to all firms, based on three months of annual fixed expenditure. It also wants to raise the minimum capital resources floor to £20,000 for all firms, but is proposing to remove the minimum "own funds" requirement of £10,000 that has previously applied to some firms.

These are the main proposals:

The rules will no longer differentiate between low resource, network and other types of firms. All PIFs will be subject to the same prudential treatment.

Currently the rules differentiate between low resource firms (those with 25 advisers or fewer) and other PIFs. Low resource firms are currently subject to the "own funds" test requiring a fixed level of capital of £10,000, whereas other PIFs must meet additional capital resources rules, such as the adjusted net current assets test and the EBR. The level of EBR varies across different types of PIFs, depending on the scale of their business activities, but again there is an underlying minimum of £10,000 currently. The capital resources that low resource firms need to meet the requirement are subject to less stringent features than those set for other PIFs.



There is a proposal to extend EBR to all firms, and to streamline the calculation to apply the same method for all firms. All firms will be subject to an EBR of three months, ie one quarter of relevant annual expenditure. Relevant annual expenditure refers to the fixed expenditure that a firm is committed to pay out regardless of the level of its income.

The minimum capital requirement that all firms should hold regardless of their EBR calculation is proposed to be increased, for all firms regardless of their size, to £20,000. The minimum has remained unchanged since it was first introduced 14 years ago, but the new level is some 30% above the level required simply to restore the value of capital required under the original rules.

The adjusted net current assets test is to be removed under the FSA proposals.

The proposals will result in a single definition of capital resources that applies consistently for all firms, replacing complex rules with straightforward principles for calculating capital resources. In the regulator's view, the proposed changes are in-line with its principles-based approach to regulation, but there are also some detailed changes to the calculations proposed. These include introducing a lower limit on the inclusion of subordinated loans, clarifying the treatment of intra-group debtors, and proposals for the use of personal assets by unincorporated firms.

The FSA is proposing to adopt a staged transition, with full implementation to be achieved by 31 December 2012.

Changes to PII requirements

The FSA has set out more specific requirements as to the level of additional capital resources needed where firms have exclusions in their PII policy.

Firms will be required to hold a minimum level of additional capital resources where a business line is excluded. Policy exclusions that are not relevant to the business conducted by a particular PIF would not be caught by this requirement. In the CP, the FSA gives details of a sliding scale of minimum additional capital resources requirements related to relevant income. It has published a table which shows a "floor" for PIF additional capital requirements, dependent on relevant income and inevitably it bites hardest for smaller firms. A small firm with PII exclusions that relate to a business line that is transacted will have to hold a minimum of £5,000 of additional capital, rising where the firm's turnover exceeds £100,000.

Leaving Resources Behind

The FSA has been exploring means by which firms could be required to leave adequate resources behind to cover claims received after they have ceased authorisation. For the present, it has deferred consideration of the Leaving Resources Behind (LRB) work stream pending the outcome of the Banking and Compensation Reform review, but is seeking comments on its discussion of the main issues it sees as relevant.

The FSA has considered options such as run-off PII, a segregated trust for run-off PII and bond and regulator run-off schemes. It found potential problems with all of these approaches.

It has also looked at the further option of developing a requirement for a PIF, as a condition of authorisation, to have adequate resources to pay for consumers' claims arising after it ceases to be authorised. This option has three strands:

1. LRB arrangements could be put in place when a firm leaves authorisation in an orderly fashion.
2. A trust could be set-up at authorisation, with adequate funds to be used when the firm leaves authorisation in an orderly fashion or otherwise.
3. A combination of both regimes, so that the requirement to set up an LRB trust may be triggered at a certain point during authorisation, so funds would be available whether the firm leaves authorisation in an orderly fashion or otherwise.

The question of for how long resources should be left in place after a firm has left the market is also considered, and the FSA noted that most existing similar arrangements in other sectors have found a limit of six years to work satisfactorily. We would caution firms not to take much comfort (if that is the word) from that period. The six year period equates with the normal expiry of any right of action in respect of failures while a firm was in business. However, the limit does not apply in respect of financial advice, and in its recent RDR Feedback Statement the FSA said that it found no case for a time limit. We expect that the penny will in due course drop that a corollary of this is that resources would need to be left behind by PIF firms for a much longer period equating to the expected term before investments made in the period immediately prior to a firm's departure can be expected to mature. On this basis, a term of 20 or 30 years looks more realistic than six, albeit significantly more challenging.

The FSA is aware that there are many issues to be discussed in relation to the

above, such as how to calculate the amount that could be left behind and / or subject to the trust; whether LRB might be used to meet customer claims indefinitely or for a number of years following authorisation; whether after the LRB period has expired, any unused funds could be returned to the firm, and so on.

The FSA states that consideration of how LRB may work in practice, if PIFs are charged with putting the arrangements in place, raises complex practical, legal and economic issues which need further exploration. It would also need to know how such a regime would interact with the FSCS and the Financial Ombudsman Service.

Regarding the outlook for LRB, FSA says that it has found no existing mechanism that appears likely to be practical and cost effective for PIFs.

Funding the FSCS

This CP also contains a summary of the various options for funding the FSCS, both "ex-post", or post-funding as at present, and pre-funding (using contingency funds).

The FSA is mindful that, in connection with recent work being carried out by the Tripartite Authorities relating to the banking sector, there is a Bill pending including amendments to the FSMA 2000 which would allow HM Treasury to make regulations which would enable the FSCS to fund itself using contingency funds (ie pre-funding) as well as under the current funding model (ie post-funding). The objective of that work is to strengthen the UK framework for financial stability and depositor protection, and to provide effective compensation arrangements in which consumers have confidence. The consequence, of course, would be higher FSCS costs in the medium term in order to establish the desired funds.

The FSA has decided that it will monitor the developments in respect of FSCS funding arrangements before engaging in further consideration of the LRB options.

Consultation period for CP 08/20

The consultation period on this paper will last until 31 March 2009, and the FSA expects to issue a Policy Statement when the rules are made - this is likely to be in the fourth quarter of this year. It is looking for feedback on ten specific questions during the consultation period. Whilst the proposals bear mostly upon PIFs, there is a potential impact on all regulated firms. We therefore anticipate that all firms might want to make their feelings known on the principles involved even if not all consider it appropriate to respond to the detailed questions.

However, as mentioned above, the FSA has deferred consideration of the LRB work stream pending the outcome of the Banking and Compensation Reform review, and so is not consulting formally on Leaving Resources Behind at this stage. However, it would welcome comments on the work which has been done to date.

Comment

Unsurprisingly, there has been much industry comment on the above, particularly from AIFA, as the proposals will have major cost implications for PIFs.

The FSA itself has admitted that its review of the prudential rules for PIFs will mean that the combined capital resources proposals will require firms to raise an additional £600 to £850 million of capital by 2013, a significant "hike". Firms will be able to include deposits of cash on current or deposit accounts as long as they can be withdrawn within 90 days. Sole traders and partners can continue to use personal assets as capital to make up any shortfall.

AIFA's Chris Cummings has commented that the potential impact on a firm of 20 advisers with around £1.6 million costs could see its prudential requirements increase radically from around £10,000 to possibly around £300,000 – in other words, some medium-sized firms will be hit with capital adequacy requirements of 30 times their current levels as part of this review.

Commentators have even gone so far as to call this a potential "capital adequacy poll tax on advisers". We have to agree that the situation for those outside networks seems grim, and that the independence of small and medium sized firms outside networks is in peril. Whilst perhaps unintentional,



we don't think that the FSA would regard such an outcome as wholly unwelcome as it has struggled for over twenty years now with the challenge of achieving adequate supervision of small firms economically. Only in the last year has it started to take steps to bring the activities of small firms above its "radar horizon", and the record of disciplinary action over that period suggests that it is far from happy with the picture that is emerging.

Many IFAs will find themselves in difficulties from the combined attack of RDR and the capital requirements regulations. The principals of smaller firms will be asking themselves "Can I continue as I am or do I have to sell up or merge?" We anticipate that for many smaller high street firms, the answer will be that sale or merger are the only viable solutions and a shrinking of the number of IFA firms would seem an inevitability. Of course, the ongoing financial crisis will not help their chances of survival.

It is indicative of the future that firms are setting themselves up as "marriage brokers" to help facilitate the process of IFA mergers. One such organisation expects a shrinkage of the number of IFA firms of about 30% over the next few years. Comparison with the experience of providers since 1988 suggests to us that the rate of shrinkage may be significantly higher than that.

How can OAC help?

If you would like to discuss anything in this article, or for more information, please contact:

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