



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

16 March 2009

Our ref: ICAEW Rep 29/09

Your ref:

Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London  
E14 5HS

By email: cp08\_20@fsa.gov.uk

Dear Sirs

**CONSULTATION PAPER 08/20: *REVIEW OF THE PRUDENTIAL RULES FOR PERSONAL INVESTMENT FIRMS.***

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on Consultation Paper 08/20: *Review of the Prudential Rules for Personal Investment Firms*, published by the Financial Services Authority in December 2008.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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## ICAEW Representation

ICAEW REP 29/09

**FSA CONSULTATION PAPER 08/20: *REVIEW OF THE PRUDENTIAL RULES FOR PERSONAL INVESTMENT FIRMS***

**Memorandum of comment submitted in March by The Institute of Chartered Accountants in England and Wales, in response to Financial Services Authority] consultation paper 08/20: *Review of the Prudential Rules for Personal Investment Firms* published in November 2008**

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on Consultation Paper concerning the review of *Prudential Rules for Personal Investment Firms* (CP 08/20), published by the Financial Services Authority (FSA) in December 2008. This response has been prepared having consulted with the ICAEW Financial Services Faculty and other interested parties.

## WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.
4. The ICAEW Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest. It draws together professionals from across the financial services sector. This includes those working for regulated firms, in professional service firms, intermediaries and regulators.

## MAJOR POINTS

4. We are conscious that a significant amount of work has been undertaken in relation to the Review of the Prudential Rules for Personal Investment Firms by both the FSA and various industry wide stakeholders. This work includes FSA Discussion Paper 07/4: *A Review of the Prudential Rules for Personal Investment Firms*, the report by Frontier Economics<sup>1</sup> and the FSA proposals and stakeholder feedback in respect of the Retail Distribution Review (RDR). We draw your attention the ICAEW response to DP 07/4<sup>2</sup> and views on DP 07/1: *A Review of Retail Distribution*<sup>3</sup>, and the views we submitted in respect of the FSA June 2008 Interim Report on the RDR<sup>4</sup>, which need to be considered in this context. Prudential Rules here comprise capital resources and professional indemnity insurance (PII) for firms that broadly advise on investments or arrange deals in investments in relation to packaged products (PIF's).

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<sup>1</sup> Frontier Economics Ltd., 'A market study of professional indemnity insurance for personal investment firms', 29 April 2008.

<sup>2</sup> ICAEW Rep. 122/07.

<sup>3</sup> ICAEW Rep. 111/07.

<sup>4</sup> ICAEW Rep. 73/08.

5. As explained in our response to DP 07/4, we do not believe that there is a clear link between the level of prudential capital held and the propensity for firms to mis-sell. Most respondents to DP 07/4 support this view. We believe that the principle cause of mis-selling is poor ethical standards, which is an issue that is being taken forward within the context of the RDR.
6. We believe that if these proposals are adopted in their current format they would be counter-intuitive to some of the key objectives of the RDR, with its associated aspiration of encouraging firms to migrate away from transactional business models. Many small firms will be investing funds in their business in order to move to fee-based service model that breaks their dependence on indemnity commission at a time when capital is in particularly short supply.
7. The scope of this Consultation Paper relates to the disparate population of organisations in the retail investment sector. This diversity inevitably means that the potential risks posed to retail consumers will vary accordingly to the nature of the particular services provided by each individual firm. As such, the prudential regulation of this sector should reflect the disparity of the respective risks. The ICAEW has concerns that these proposals do not adequately reflect that fact. Further any FSA levy charged to firms should include a regulatory dividend to reflect a firms individual claims record.
8. We do not accept that there is any clear relationship linking the level of prudential capital to the propensity to mis-sell. Furthermore, we do not believe that these proposals adequately reflect the differentiation between economic capital and regulatory capital. The nature and extent of claims relating to unsuitable advice in respect of a particular product means that one claim may well result in the utilisation of all a member firm's spare prudential capital resources. Consequently, we believe that professional indemnity insurance (PII) is the most appropriate mechanism for covering this type of risk and addressing the problems referred to in this Consultation Paper.
9. In order for PII to be effective it is essential that risk can be spread across a sufficiently large pool to create a viable market. The potential problems are complicated by the nature of this particular market, where the consequences of unsuitable advice may not materialise for many years after advice was provided. Additionally, there have also tended to be 'spikes' in claims relating to particular categories of products. The regulatory environment must provide consistency so that insurers are able to predict with a reasonable degree of certainty the likelihood of claims arising and the costs of meeting such claims should they arise. We believe that the FSA should engage directly with insurers to explore the possibility of PII cover being provided on a business written during the course of a year basis rather than claims made during the course of a year basis, which would help to solve a lot of difficulties for all parties. We are conscious of the problem that the absence of a long-stop for claims potentially poses to insurers. The FSA would also be able to provide assurances to the insurers as regards the regulatory environment in context of the RDR and the Treating Customers Fairly Programme (TCF), which should help to address issues relating to gone concerns.
10. In terms of firms leaving the industry and potential costs being occasioned to the Financial Services Compensation Scheme (FSCS), we believe the FSA should give further consideration to an industry wide solution that would facilitate a mandatory period of run-off PII for member firms before they are permitted to exit the market. Such a revised approach would be more advantageous for the FSCS

than is currently be the case. We also suggest that insuring the FSCS against the possibility that claims exceed funds held should be explored.

11. If the package of proposals referred to above was adopted it would significantly improve the current position without restricting entry to the market for the smaller advisory players, many of whom have, or are in the process of, building business models that are consistent with the aims of the RDR. Any changes to prudential requirements should build on these existing market developments.
12. We welcome any proposals that make the mechanics of expenditure based test more understandable and consistent, although for the reasons stated above we are concerned about the extension of this requirement.
13. We believe that consideration should be given to retaining some form of net current asset test as the importance of liquidity has been emphasised by the current credit crisis.
14. The ICAEW are conscious that because of the nature of this sector any proposals involve a considerable degree of complexity. We would therefore welcome the opportunity to discuss the issues that arise from these proposals at greater length, drawing on our Financial Services Faculty and experience of our members, as appropriate, with the objective of finding ways to more effectively address the objectives outlined in this Consultation Paper.

## **RESPONSES TO SPECIFIC QUESTIONS**

### **Question 1**

#### **Do you agree with our proposal, to apply a three month EBR for all PIFs ?**

15. No. Our understanding of the original purpose of the EBR was that it recognised the extra business risks that came with additional permissions and so sought to ensure that those firms had greater financial resources to protect clients. The aim of these proposals are said to complement the RDR by requiring PIFs to bear more of the costs of unsuitable advice. Capital resource requirements have some role to play in helping to mitigate the risks to consumers. Nonetheless, any changes in prudential requirements should be proportionate and need to take into consideration the diversity of the retail investments market and should reflect the different nature of the roles that economic and regulatory capital play.

Regulation should not pose excessive barriers to entry or exit as this would be detrimental to consumers' long-term interests and regulation should not have a detrimental impact on the competitive position of the retail financial services sector. The ICAEW has concerns that the proposals may not be proportionate and could therefore have a detrimental impact on consumer choice. We believe that a three month EBR may be excessive for firms with a limited range of advisory activities and could drive competent small firms, who provide valuable services to their clients, from the industry. If it is felt that an expenditure based requirement is necessary for all PIFs to cover the risk of unsuitable advice then consideration of a lower requirement eg one month should be considered for low risk firms.

In addition, it is unclear whether the FSA are proposing the extension of the three month expenditure requirement as an indirect way of reducing the FSCS Funding

requirement on exit rather than to address the cost of unsuitable advice. If this is the case, we do not believe that this is the most appropriate course of action.

## **Question 2**

### **Do you support our proposals to apply a minimum capital requirement of £20,000 for all firms?**

16. Yes. We accept that the minimum standards for entry and ongoing requirements should be increased as this would tend to encourage longer term commitment from business owners. The ICAEW therefore support the proposal that the minimum level of prudential capital requirement should be increased to £20,000 as this is likely to generate higher levels of long-term commitment from business owners and therefore reduce the potential for transient players in the marketplace.

## **Question 3**

### **Do you agree with our proposal to remove the adjusted net current assets test?**

17. No. The banking crisis has emphasised the importance of liquidity and some form of net current asset / liquidity test would fulfil a useful regulatory function. It is accepted that liquidity is considered to some extent in the calculation of the expenditure based requirement but we feel that a net current asset test is a more focused test of liquidity. Consideration should be given to raising the required level from its existing level of £1.

## **Question 4**

### **Do you have any comments on our approach to capital resources?**

18. We support an approach which leads to simplification and standardisation of the requirements. In particular, we support the attempt to make the expenditure based calculation more logical by clarifying and improving the current rule book wording. For the reasons referred to in our general comments, answers to the other questions and the diverse nature of this sector means that a one calculation fits all nature of the proposed changes should be reconsidered.

We believe it is illogical to impose an EBR approach to address the costs that arise from the mis-selling of gone concerns, but we fully acknowledge that there is no straightforward solution to ensuring that the polluter pays. We believe further consideration is required before any changes are made.

The ICAEW believe that PII cover is the most appropriate mechanism for addressing any costs that arise from the consequences of mis-selling as regards both going and gone concerns. In respect of gone concerns, it may be that such cover could be organised by FOS and paid for by those leaving the industry as part of the closedown process and cancellation of Part IV permissions.

## **Question 5**

### **Do you support the retention of a standard form for subordinated loans?**

19. Yes. Subordinated loans play a useful role in providing regulatory capital. A standard form means that the obligations and requirements are clear and well understood.

#### **Question 6**

**Do you have any comments on the proposed amendments to the capital resources calculation?**

20. In general terms we agree with the clarifications and proposed amendments to the calculation of the expenditure based requirement. However, some of these do not appear to be adequately dealt with in the rule amendments set out in Appendix 1 eg the definition of the contingent liability adjustment and the admissibility of indemnity commission clawback debtors.

#### **Question 7**

**Do you have any comments on the options above, in particular whether the transitional arrangements should come to an end earlier than the end of 2012?**

21. Normally we would regard the period to 2012 to be sufficient to allow PIFs to build extra necessary resources. However, in the current economic climate we consider that additional time should be allowed.

#### **Question 8**

**Do you agree with our proposed minimum additional capital requirements for policy exclusions?**

22. Subject to our comments as above, where firms can genuinely not obtain cover for a particular business line we agree that there should be additional capital requirements. Our concern with the proposed rule changes is that they do not take account of the risks relating to or the claims potential which may attach to a particular business line. There is also a concern that some firms may actively seek policy exclusions as, on a net basis, additional capital is cheaper than insurance.

#### **Question 9**

**Do you agree with the proposed handbook changes in Appendix 1?**

23. We think that additional guidance may be needed to assist smaller firms understanding what is variable and what is fixed expenditure, such as the different outcomes that could occur in relation to a going concern basis as opposed to the closing down of a business. There is a risk that the limited guidance contained in the rules will lead to inconsistencies in the calculation of the expenditure based requirement. Also please refer to the answers to the other questions.

#### **Question 10**

**Do you have any comments on LRB as discussed above?**

24. We believe that the proposals may discourage entrants into the profession and produce an unfair burden on those who wish to leave it. We believe that other

avenues should be reconsidered further as stated above, including run-off PII for a defined period. If the professionalism within the industry improves in line with the expectations of the RDR these other avenues, including a long-stop for claims, may become more acceptable and affordable.

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