



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

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

E-mail dp07_04@fsa.gov.uk

Dear Mr Vaughan

FSA Discussion Paper 07/04: Review of the Prudential Rules for Personal investment Firms

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on *Discussion Paper 07/4: A Review of the Prudential rules for Personal investment Firms*.

The ICAEW's 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 and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

This response has been prepared having consulted with the ICAEW's Financial Services Faculty and other interested parties. We have made some general comments and responded to the specific questions referred to in the Discussion Paper.

We also draw your attention to our response in respect of *DP 07/1: A Review of Retail Distribution* and *DP 07/2: Platforms: The Role of Wraps and Fund Supermarkets*.

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

Yours sincerely

John Gaskell
Manager, Financial Planning
T +44 (0)20 7920 8693
F +44 (0)20 7638 6009
E John.Gaskell@icaew.com



ICAEW Representation

ICAEW REP 122/07

FSA Discussion Paper 07/4: Review of the Prudential Rules for Personal investment Firms

Memorandum of comment submitted in November by The Institute of Chartered Accountants in England and Wales, in response to Financial Services Faculty consultation paper *Discussion Paper DP 07/4: Review of the Prudential Rules for Personal investment Firms* published in June 2007.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the *Discussion Paper: 07/4: A Review of the Prudential rules for Personal investment Firms* published by Financial Services Authority.

WHO WE ARE

2. The ICAEW 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 ICAEW provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 700,000 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.

GENERAL COMMENTS

4. We are supportive of any initiatives that are capable of generating more effective regulation which is supportive of efficient and orderly markets, and where the interests of retail consumers are protected.
5. Capital requirements should, in our view, be determined by the amount of capital required for the orderly running and wind-down of any business.
6. We do not believe that there is any substantial evidence to support the view that there is a necessary casual relationship leading from the level of capital held by a firm to the propensity of that firm to mis-sell.
7. We think the minimum level of capital requirements needs to increase as we think that this is likely to reduce the number of transient players in the market, and to generate higher levels of long-term commitment from business owners.
8. Any changes in prudential requirements should be proportionate and should take into consideration the diversity of the retail investments market. Regulation should not pose excessive barriers to entry as this would be detrimental to consumers' long-term interests, and regulation should not have a detrimental impact on the competitive position of the UK retail financial services sector.
9. We are supportive of the proposals for making more effective PI provision on a going concern basis. We are also supportive of the rationale for more effective provision to cover the deferred costs arising from the mis-selling in respect of claims relating to gone concerns.

10. The DP needs to be considered within the broader context the review of retail distribution and the impact that any changes will have on the larger, medium and smaller sized firms in the longer-term. In this regard, we refer you to our response on DP 07/1, and our views on the implications that reconfiguring the UK retail investments market is likely to have on both consumers and firms.

RESPONSES TO SPECIFIC QUESTIONS

Chapter 2 – Background to the PIF sector and current regulatory requirements

Q1: Do you agree that this is the correct scope for our review or should we include MiFID PIFs?

11. We agree that from a capital perspective MiFID PIF's are adequately dealt with under the CRD.

Chapter 3 – Market failure analysis

Q2: What is your view of our analysis of the market failures in the PIFs sector for advice?

12. In principle, we agree with the FSA's high-level description of market failures in terms of the problems associated with asymmetric information, agency issues and conflicts of interest. However, we believe that inappropriate advice and mis-selling relates to poor ethical behaviours rather than the consequences of inadequate qualifications and skills.
13. We agree consumer complaints are one of several indicators of market failure, although not wholly reliable, and note that compensation costs have risen considerably since 2001/02. Given that mortgage endowment related complaints have peaked, it seems unlikely there will be a fall in claims in compensation in the short-term more generally.
14. UK consumers have become increasingly litigious, and claims are likely to put continued strain on the FSCS which is over-reliant on the remaining industry participants. We believe that ways need to be found to make it more difficult for firms to walk away from their responsibilities without making adequate provision for potential claims.

Chapter 4 – Can prudential rules reduce the frequency of mis-selling?

Q3: Do you agree with our analysis of the role of capital resources requirements and PII in reducing mis-selling?

15. We believe the principle cause of mis-selling is poor ethical standards. We cannot find any substantial evidence to support the argument that simply raising capital requirements will necessarily reduce the potentiality for mis-selling. Nonetheless, the existing entry and ongoing requirements from a capital perspective are not sufficiently onerous, particularly for unincorporated firms, and firms with 25 or fewer advisors. The existing capital requirements do not necessarily result in appropriate levels of commitment from business owners.

We are, however, also mindful that any increase in prudential requirements should not create barriers to entry, or stifle innovation.

16. The existence of High-Level Principles and the Conduct of Business Rules cannot in themselves ensure that firms consistently demonstrate high ethical standards. Similarly, whilst the current minimum standards for training and competence demonstrate that advisors have the required technical knowledge, they do not guarantee that advisors will necessarily always act in ways that are consistent with the long-term interests of consumers.
17. In our opinion, threshold conditions, effective supervision, and robust enforcement by the FSA are crucial. In general terms, we do not feel that there should be a distinction between MiFID and non-MiFID firms, but we are mindful that rules need to accommodate the differentiated needs and resources of smaller, medium and large firms.

Q4: What is your view on the use of risk-based requirements?

18. A risk-based approach would be consistent with the FSA's approach. The critical element in adopting this approach relates to determining the most appropriate, effective and robust key-risk indicators which can be easily validated on an ongoing basis. Risk-based threshold conditions are also crucial in ensuring that any firm applying for FSA authorisation is appropriately and thoroughly assessed prior to entry into the market. Similarly, firms seeking a change in their permitted activities should be robustly re-assessed.
19. For the smaller firms, where supervision is currently more remote, the FSA would need to consider how much reliance could be placed upon the information reported. For example, there may be some inaccuracies in information regarding the form of remuneration used by the firm, or the qualification of its advisors. There must, therefore, be a robust framework of independent validation.
20. Any cost-benefit analysis must take a long-term view, particularly given that the FSA has already recognised that mis-selling in the long-term savings and investments market can take many years to crystallise.

Q5: Which parameters do you consider are the best predictors of the frequency of mis-selling?

21. New firms:-
 - i. Available capital
 - ii. Business model, eg whole of market, multi-tie
 - iii. The previous regulatory history of the new business owners
 - iv. Level of '4 eyes' review
 - v. Adequacy of compliance resource
 - vi. Planned business growth
22. Existing firms:-
 - i. Persistency
 - ii. Staff turnover
 - iii. Complaints history
 - iv. Business / product provider mix

- v. Commission as a percentage of income
- vi. Annual accounts – profitability and growth record
- vii. Levels of product churn
- viii. Levels of ‘4 eyes’ review – adequacy of compliance resource

Q6: What is your view on the use of capital resources requirements as a means of mitigating the risks to consumers arising from the remuneration method, professional standards and primary advice?

- 23. We believe that capital resource requirements have some role to play in helping to mitigate the risks to consumers as increased minimum requirements could help to reduce the number of transient players entering and leaving the marketplace.
- 24. We are highly supportive of encouraging higher standards of professionalism, including a transition to establish higher levels of minimum competence. In this sense, we are supportive of prudential requirements that would incentivise such activity, provided that any regulatory changes do not have a detrimental impact on consumer choice, or the international competitiveness of the UK retail financial services sector.
- 25. Whilst we understand the argument that higher professional qualifications might result in reducing the risk of advisors mis-selling, we are not sufficiently persuaded that higher ethical standards are a given simply because an advisor has demonstrated higher technical competence.
- 26. We firmly believe that firms looking to relinquish their FSA authorisation should be required to undergo a pre-exit visit so that the FSA can more fully understand the departure risks. Exiting firms could be required to demonstrate that appropriate provisions had been made for winding-down over a proportionate period, eg a legally binding bond with an approved bank or insurance company.
- 27. We have expressed our views on Primary Advice in our response to DP 07/1, and in the context of this question we refer you that response. On a pure risk-based approach, in general terms we are supportive of the view that advisors operating in the market should have prudential requirements that are consistent with the market risks involved.

Q7: Is reform of underwriting processes by insurers, so that PII premiums are priced to reflect more closely PIFs’ mis-selling risks, feasible?

- 28. The market will determine perceived risks, which will be reflected in the terms and prices offered.

Q8: Is the current practice of writing insurance policies on a claims-made basis a significant barrier to reform of underwriting processes?

- 29. We do not wish to comment.

Chapter 5 – Reducing the impact of mis-selling on a going concern basis

Q9: Do you agree with our analysis of the possible drivers of the amount of capital that PIFs choose to hold?

30. We do not agree that there is substantial evidence to support the argument that there is a necessary causal relationship leading from the capital requirements held to the propensity to mis-sell. However, we can see that firms likely to mis-sell would have higher PII excesses and need more capital to meet the greater level of foreseeable liabilities.
31. We believe that firms who do not display high ethical standards are unlikely to be persuaded by the three key-benefits described to mitigate the impact of mis-selling on their own accord. We also believe providers of PI insurance should be strongly encouraged to review their practice, whereby the terms of the PI policy requires a PIF to defend a complaint. This current practice appears to be inconsistent with the FSA's Treating Customer Fairly Principles, and firms should be reminded of the negative impact this practice has in terms of consumer detriment, and the negative impact this would have on the reputation of the financial services sector.
32. Firms that are less likely to mis-sell on a risk based assessment, and that can demonstrate that they have a well-run business, with strong systems and controls and high ethical standards, should benefit from some form of regulatory dividend. Conversely, those firms which pose the greatest risk of mis-selling are likely to need higher capital cushion, and need to recognise that they will only benefit from a much lower level of regulatory dividend where they can consistently demonstrate that they have a well-run business, with strong systems and controls, and adequate compliance resources.
33. In the context of this question, we also refer you to our comments in DP 07/1 in respect of the 15 year long-stop on liability.

Q10: What is your view on the use of capital resources requirements as a means of mitigating the impact of mis-selling on a going concern basis?

34. In principle, we do not accept that there is substantial evidence to support the argument that there is a simple casual relationship between the relative levels of capital held by a firm and its propensity to mis-sell. However, as referred to above, higher minimum levels may help to reduce the number of transient players in the market, although any such changes need to be balanced against creating barriers to entry.
35. The primary determinant of capital resources should be what levels of capital is required to sustain the business as a going concern in the longer-term. However, we do accept that capital requirements is one factor that needs to be considered within the context of due provisions for the wind-down of the business.
36. Whilst we believe that PII is an effective means for mitigating the impact of mis-selling, the potential effectiveness is very dependent on what excess levels apply. The transfer of risk comes at a price, and if PI Insurers move to a more risk-based approach we are likely to see a significant increase in costs to firms that are assessed as having a higher risk of mis-selling.

Q11: What is your view on our analysis of the problems of the PII market?

37. We agree that there are a number of issues that relate to the PII market, as can be evidenced by the way the market has changed over the last five years or so, and that close consultation with the market participants is essential.

Chapter 6 – Reducing the impact of mis-selling on a gone concern basis

Q12: Do you agree that these measures (run-off PII, segregated trust and a bonding requirement) could mitigate levy payer detriment and secure the other benefits identified? Have we identified the main issues around their feasibility?

38. We broadly agree that some form of regulatory minimum requirement is necessary to reduce the impact of mis-selling on a gone concern basis.
39. We note the 'average total payment by FSCS per firm' figures are considerably well in excess of the minimum capital resource requirement. We believe, however, that these figures may be inflated by the significant volume of mortgage endowment complaints over the last few years.
40. The options each have merit, and our views on these options are as follows:-

i. Run-off PII

We can see the advantages in run-off cover, although the current PI insurance market may pose affordability issues.

We agree that five years should be the absolute minimum. An alternative option might be for policies to provide level-cover for the first five years, and thereafter a decreasing level of cover over a period of up to a further five years.

ii. Segregated Trust

We believe that this is also a viable option, albeit that it may be viewed as creating additional barriers to entry for new firms. In terms of premium setting, we believe that PI Insurers could provide the FSA with an average premium cost for different sectors of the market, with the 'segregated trust' being topped up on a triennial basis. We note the FSA's comment about the administrative costs, but we believe that this would be more than balanced out by a commensurate reduction in the FSCS levy.

iii. Bonding requirement

This may be the most viable option, provided that the bond provider had a regulatory duty to report any failure to pay the regular premium to the FSA. It is also likely to involve less administrative burden, and raise less concerns over barriers to entry.

Q13: Do you consider that, for long term products, the relevant product provider should take some responsibility for mis-selling claims?

- 41. We do not believe this option would be a proper reflection of the respective responsibilities of providers and advisors to customers.
- 42. There is a danger that some distributor firms would view this approach as a dilution of their prime responsibility for demonstrating high standards in their dealings with retail consumers.

Chapter 7 – Enabling firms to wind down in an orderly manner and the quality of capital and capital resources

Q14: Should the FSA require all PIFs to hold capital resources to cover their orderly wind down costs? Should this be an EBR? Do you agree with our view that, as there are different risks, the requirement should be additional to any capital resources requirements in respect of a firm's mis-selling risks? What should be the number of weeks' expenditure applied and should this differentiate in any way between firms, for example on a size basis?

- 43. In general, we do not believe that capital resource requirements should be determined by whether a firm is a MiFID firm or non-MiFID firm, but by the risk and cost profile of the business.
- 44. We would be supportive of the FSA requiring all PIFs to hold capital resources to cover their orderly wind-down costs, and that smaller PIFs should be treated the same as larger PIFs by moving to an EBR. The setting of an appropriate EBR should reflect the size and nature of a firm, and the likely timeframe required to wind-down such a firm in an orderly manner. We would envisage this being achieved by segmenting the market into three or four categories, with a minimum EBR for each category.

Q15: Should we introduce rules to increase the quality of capital used by PIFs to meet their capital resources requirements – for example, by restricting the amount of subordinated loans that are eligible? Are there any other options that would be appropriate to deal with this issue, such as changing the terms of subordinated loans?

- 45. We believe that introducing rules that increasing the quality of capital used by PIFs should be of long-term benefit to the industry.

Q16 Do you agree that, if we set capital resources requirements for wind-downs for all firms (including PIFs), we should also include adjustments to reflect the relative realisability of their assets and liabilities? To what extent do you consider that the approach reflected in existing rules on adjustments could be simplified?

- 46. We think some recognition of the quality of assets and liabilities is important.
 - i. PIF capital requirements, given that they are Exempt CAD firms, should reflect the risks posed by such firms. To avoid adversely impacting the competitive position of the UK and, given the ability that now exists to

passport investment advice, FSA should have regard to the requirements being imposed by other EU regulators in respect of such firms.

- ii. There is a difficult balance to be drawn in more meaningfully reflecting asset quality and risk, whilst avoiding excessive complexity for many small firms.
- iii. One potential option might be a combination of prescribed minimum requirements (perhaps using GENPRU/BIPRU as the basis of calculation), supplemented by a 'Pillar 2 type' approach requiring firms to assess the risks they run and levels of capital (and other risk mitigants) required. As larger PIFs are very close in the regulatory spectrum to limited licence firms (a decision to hold client money, for example being enough to 'tip them across'. We believe there is merit in trying for greater consistency between the approach for PIFs and for BIPRU firms, and for less of a fundamental 'step change' at the point of transition.

Email: john.gaskell@icaew.com

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