The Impact of FSA Regulation
A Case Study: PII for personal investment firms

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Agenda

• Why PII
• Problems
• Desired Outcomes & Approach
• Rules
• Communications
• Standards
• EU and what is next
Purpose of PII

- Initial purpose – to protect firms
- And so indirectly protects consumers as claims against firms usually come from their customers
Benefits of PII

- Encourages good risk management within firms as less risky firms pay less for PII
- Less burden on any compensation schemes available
- Market Confidence and Consumer Protection objectives
Problems: Supply

- Global shortage of capacity since 9/11
- Market perceives liability sector as higher risk
- Market perceives regulated sectors as highest risk (fear of “retrospective action”)
- Cyclical nature of the market
- Pricing and terms
Demand for PII increasing due to requirements in:

– Insurance Mediation Directive (IMD);

and

– Markets in Financial Instruments Directive (MiFID)
Size of the Problem for personal investment firms (IFAs)

• 2283 ‘cases’ between 01.09.02 – 23.03.04
• 344 referrals at peak (May 2003)
• Approx 35 front line staff

• Now running at approx 25 a month
The problem: some perceptions?

- **Insurers**
  - Cherry picking
  - Insufficient risk assessment
  - Fear of industry reviews

- **Brokers**
  - Have to work harder
  - Difficult relationships with insurers
  - Status disclosure

- **IFAs**
  - Unrealistic expectations of their policy
  - Bad at applying for PII
Have I got PII news for YOU!
Regulator’s clamp on _____ won’t stop the _____
Regulator’s clamp on Lloyd’s won’t stop the cycle
Lloyd’s fears PI _______ _______
Lloyd’s fears PI price war
FSA fears that advisers will go
FSA fears that advisers will go uninsured
‘Let down’ by FSA on PI
Rising _____ of cover lands Lloyd’s broker in __________
Rising cost of cover lands Lloyd’s broker in liquidation
2003: The year that went ___ shaped
2003: The year that went PI-shaped
Characteristics of a better PII market

- Regulatory requirements set minimum standards in key areas but allow flexibility in policy wording
- Firms run their businesses in a way that minimises the number of claims on their PII policy
- There is enough capacity in the market to provide PII cover for all firms that are required to have it
- The insurance market has a better understanding of the risks of insuring firms
A successful outcome - (Paul Smee, AIFA)

- Maximum flexibility
- A shared understanding of the purpose of PII
- Identification of different routes to the same end
- No artificial regulatory barriers
The Challenge!

(Pig of loss)
Key Drivers

- PII is a valuable tool
- We do not operate a zero failure regime
- The responsibilities of firm’s senior management
- Need to implement European directives
Changes to our rules

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<th>Old rules</th>
<th>New rules</th>
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<tr>
<td>• Detailed requirements covering all aspects of PII policy</td>
<td>• Focus on essential elements for PII</td>
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<td>• Standard policy wording for PII contracts</td>
<td>• Give firms greater flexibility by allowing them to combine PII and financial resources</td>
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<td>• Remove detailed policy wording</td>
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<td>• Implement IMD</td>
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Essential Rules

Level of cover

- Cover for legal defence costs
- Cover for Ombudsman awards
- Cover for business lines and activities

Policy excess

PII policy

policy exclusions
The price of flexibility

• Self insured layers
• “Group” purchasing arrangements
• Alternative risk transfer mechanisms
• Alternative funding schemes
• Comparable guarantees
• Captives
• Unusual business profiles
External communications

- PII forum
- Guide for IFAs to buying cover
- Training on new rules
- PII section on FSA website
- Definition of mis-selling
- S404 of FSMA provides important safeguards
Raising Standards

• Extensive programme of communications to inform and educate

• Roadshows, website and overview of the Handbook
  – Targeted information, plain language and best practice

• Aim to help IFAs help themselves, which should reduce the regulatory risks they face
EU - IMD requirements

Article 4.3 requires insurance and reinsurance intermediaries to hold PII cover of:

- €1,000,000 each and every claim &
- €1,500,000 for claims in the aggregate; or
- A ‘comparable guarantee’
EU - MiFID requirements

Article 67 gives firms 3 options:

a) Initial capital of €50,000; or

b) PII cover of €1,000,000 single claim and €1,500,000 in the aggregate; or

c) A combination of initial capital and PII resulting in a level of coverage equivalent to a) or b).
EU - MiFID requirements

Additional requirements for firms who are also caught by IMD:

a) initial capital of €25,000; or

b) PII cover of €500,000 single claim and €750,000 in the aggregate; or

c) A combination of initial capital and PII resulting in a level of coverage equivalent to a) or b).
EU - Overlap between MiFID & IMD

- IMD
- MiFID

Insurance

Investments

Combined products with life insurance
MiFID gives firms flexibility to use financial resources
However firms that sell insurance and investment products will be caught by both directives
Estimate most personal investment firms to be caught by both directives
Impact of EU directives in the UK

• Most UK firms of Independent Financial Advisers are small – going forward IMD effectively doubles PII cover required

• Effects on competition (EU wide)?

• The MiFID will add a further burden, but possible optional exemption?

• Review clause in MiFID………….?
Estimate of number of FSA authorised firms requiring PII

• ~ 4,000 personal investment firms (IFAs)
• ~ 6,000 general insurance and 7,000 secondary intermediaries expected
• ~ 1,000 other firms caught by IMD
• ~ 5,000 mortgage intermediary firms
• ~ 750 authorised professional firms
Conclusion

• Working with Firms
• Working with PI industry
• Working with Europe
• Large potential market
More PI woe as _____ is set to force ______________?
More PI woe as EU is set to force 50% rise in IFA cover?
Will __________ __________ be made to eat ________ ___?


Will mortgage brokers be made to eat humble PI?
Questions