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

Problems: Demand

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

‘_______ _________’ by FSA on PI

‘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

FSA

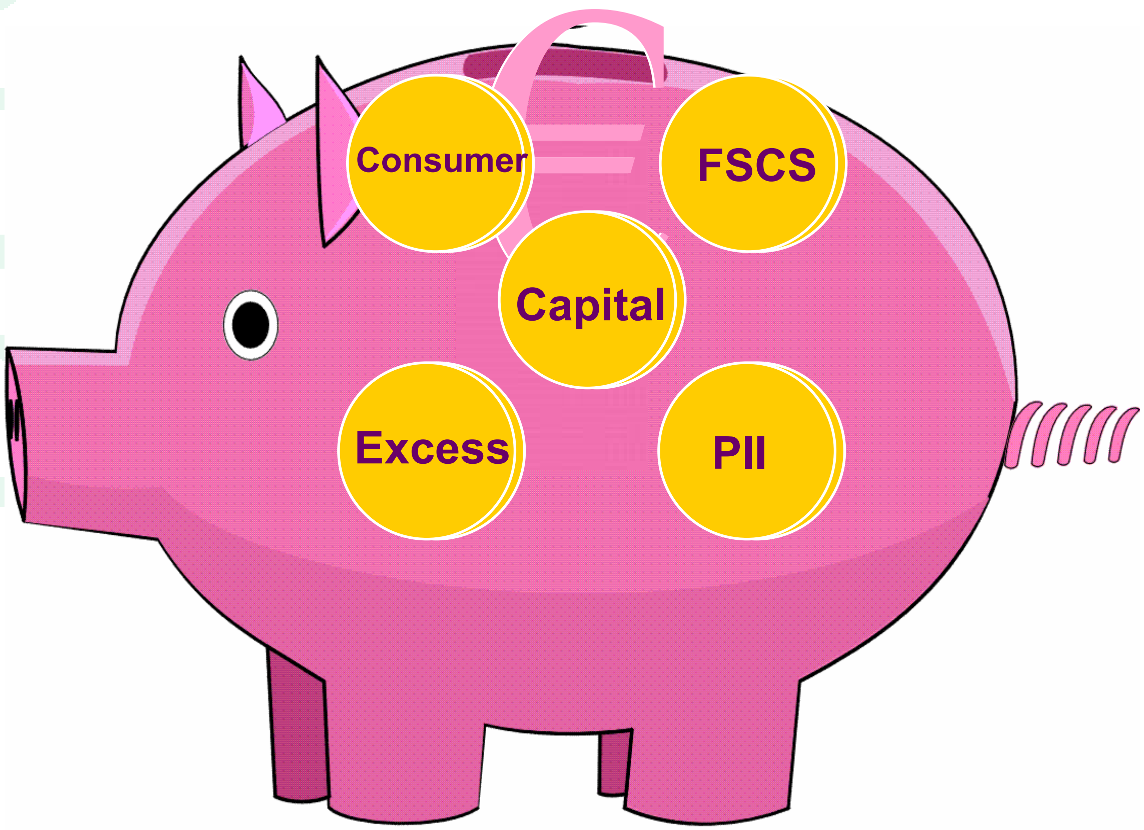
- Regulatory requirements set minimum standards in key areas but allow flexibility in policy wording
- Firms run their businesses in a way that minimises the number of claims on their PII policy
- There is enough capacity in the market to provide PII cover for all firms that are required to have it
- 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

Old rules

- Detailed requirements covering all aspects of PII policy
- Standard policy wording for PII contracts

New rules

- Focus on essential elements for PII
- Give firms greater flexibility by allowing them to combine PII and financial resources
- Remove detailed policy wording
- Implement IMD

Essential Rules

PII policy

Level of cover

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

policy exclusions

Policy excess

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

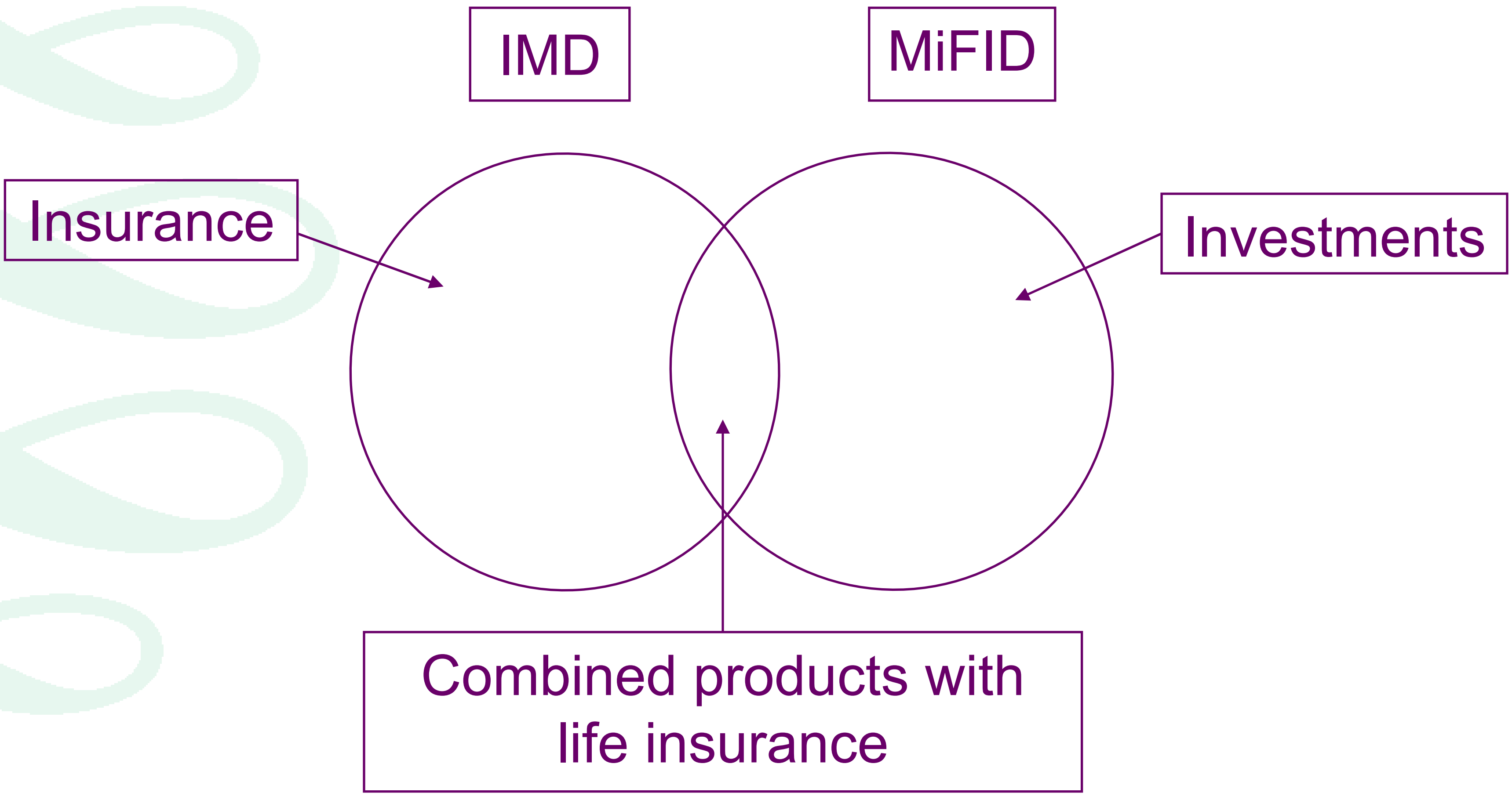
Additional requirements for firms who are also caught by IMD:

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



EU - Summary

- 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

FSA

- 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