Consultation Paper

193

Financial Services Authority

Professional Indemnity Insurance for personal investment firms: proposed policy and rules

July 2003

Contents

1	Executive summary	3
2	Introduction	6
3	Policy rationale	11
4	Industry sponsored solutions	19
5	Summary of proposed rule changes	21
6	Cost benefit analysis	31
7	Compatibility statement	57

Annex 1: List of questions

Annex 2: Loss flowchart

Annex 3: Worked examples

Annex 4: Proposed handbook text

© The Financial Services Authority 2003

Copies of this Consultation Paper are available for download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 29 October 2003.

You can send your response by electronic submission using the form on our website at http://www.fsa.gov.uk/pubs/cp/193/, by e-mail cp193@fsa.gov.uk or in writing to:

Saddia Zia or
Michelle Hallett
Themes Department, Investment Firms Divsion
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 5746
Telephone: 020 7066 9398
Fax: 020 7066 9765
E-mail: cp193@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

1.1 In February 2003 we issued Consultation Paper 169: Professional Indemnity Insurance for personal investment firms (CP169) because of the difficulty these firms were having in obtaining Professional Indemnity Insurance (PII) cover. In that paper we:

- consulted on changes to our rules on PII for personal investment firms based on the general modification made available in November 2002; and
- discussed other more radical future policy options.

1.2 In June 2003 we issued a Policy Statement on the consultative part of CP169 and set out our amended rules. However, we also acknowledged that our amended rules were unlikely to resolve all the issues in the PII market.

1.3 We have continued to work on the ideas set out in the discursive part (Chapter 6) of CP169 to find suitable measures to help resolve the issues in the PII market. We also received a great deal of feedback from the workshops we held across the UK during the consultation period for CP169 and have fed this into our work.

1.4 This Consultation Paper (CP) does two things. First it summarises responses to the discursive part of CP169 and sets out the key issues we have considered in determining our proposed future policy. Second it sets out our proposed future PII requirements and the policy that underlies them. It also sets out our cost benefit analysis in support of the proposed rule changes.

1.5 Overall, our approach has been to focus on what we consider to be the essential elements needed in PII policies to provide the appropriate level of protection for personal investment firms. Our proposed rule changes, whilst ensuring that our requirements comply with EU directives, aim to give personal investment firms greater flexibility by:

- setting resource requirements which will allow firms to combine PII and financial resources so that they have adequate resources to meet likely

claims against them. These will operate in relation to levels of excess and policy exclusions; and

- removing some of the detailed conditions in PII policies so that personal investment firms and their PII brokers can negotiate policy terms with underwriters which are appropriate to their needs.

1.6 We also believe that our proposals will provide enough flexibility to encourage insurers, including Lloyd's syndicates, to compete for business by offering differing policy terms.

1.7 Our other proposals include:

- requiring very large firms to hold more aggregate cover than the Insurance Mediation Directive (IMD) stipulates, to ensure that these firms are adequately protected;
- allowing firms, whether connected or not, to benefit from a policy which covers more than one firm; and
- exempting members of the same group as a bank, building society or insurer from our PII rules, if an enforceable written agreement to provide equivalent PII cover is in place.

1.8 Our proposed rule changes represent the minimum standards that firms' senior management will need to meet. In line with the emphasis placed on senior management responsibility in the FSA Handbook and the Financial Services and Markets Act 2000 (FSMA), we will expect firms' senior management to go further to ensure that their firms have adequate resources, where they deem that necessary.

Pre-consultation

1.9 While developing our new policy, we consulted with trade bodies, the Consumer, Practitioner and Small Business Practitioner Panels, PII brokers and underwriters. We are grateful to those organisations that took part in this exercise.

Who should read this paper?

1.10 This paper will be of particular interest to personal investment firms, the PII market and trade bodies.

CONSUMERS

This paper will be of interest to consumers. PII gives protection to firms against claims arising from various sources. However, most claims arise from retail customers. We are proposing radical changes to our PII requirements, in particular by linking personal investment firms' financial resources to the level of PII cover they hold. We have had close regard to our consumer protection objective and believe that consumers will not be adversely affected by these proposed changes. However, we would like to hear from consumers if they have any concerns or believe that our proposals will adversely affect their interests.

2 Introduction

2.1 In February 2003 we issued Consultation Paper 169: Professional Indemnity Insurance for personal investment firms (CP169) because of the difficulty personal investment firms were having in obtaining compliant PII cover. CP169 had two purposes.

- First, it consulted on changes to our PII rules for personal investment firms based on the general modification made available in November 2002. These rules were subsequently amended and set out in our Policy Statement published in June 2003.
- Second, because we acknowledged that these changes were unlikely to resolve all the issues in the PII market, it set out a discussion on several other policy options for the future.

2.2 The discursive part of CP169 included ideas such as whether we should introduce a system that links a firm's financial resources requirement to its PII cover, remove or amend our standard policy requirements and/or extend the range of investment firms required to maintain PII. It also explained the PII requirements in EU directives.

Purpose of this paper

2.3 This Consultation Paper (CP) provides feedback on the discursive part (Chapter 6) of CP169 and sets out our proposed policy and new rules on PII for personal investment firms in Chapter 13 of the Interim Prudential sourcebook: Investment businesses (IPRU(INV)).

Structure of this paper

- **Chapter 3:** sets out the key issues we considered in determining our proposed rule changes and a summary of the responses to the relevant questions in Chapter 6 of CP169.

- **Chapter 4:** sets out a summary of the responses to the questions on industry sponsored solutions in Chapter 6 of CP169.
- **Chapter 5:** explains the proposed rule changes.
- **Chapter 6:** sets out our cost benefit analysis.
- **Chapter 7:** sets out the Financial Services and Markets Act compatibility statement.
- **Annex 1:** contains a list of the questions asked in this CP.
- **Annex 2:** contains a flow chart that demonstrates how justified claims covered by PII are met.
- **Annex 3:** contains some examples of how our proposed rule changes will work.
- **Annex 4:** sets out the proposed handbook text.

Further background

2.4 The Integrated Prudential Sourcebook (PRU) will replace IPRU(INV) in due course. If the draft rules proposed in this CP are implemented, they will also be incorporated into PRU (Chapter 6: operational risk) without further consultation. The firm categories in PRU will be different to those in IPRU(INV) and so the precise method of applying these requirements to personal investment firms is yet to be finalised.

Purpose of PII

2.5 We currently require most personal investment firms to maintain PII cover. The specifications of the terms we require in PII policies are set out in detail in an appendix[1] to our rules. If a firm does not have compliant PII cover it risks breaching our rules and the threshold condition[2] which requires a firm to have adequate resources.

2.6 A firm that does not have adequate resources may not be able to meet justified claims that are made against it and ultimately could face insolvency. This could in turn lead to claims on the Financial Services Compensation Scheme (FSCS) which must be funded by the rest of the participant firms within the relevant contribution group.

2.7 Historically, we have chosen to use PII because of the relatively low base capital requirements for personal investment firms. Claims against personal investment firms often come from their customers, so PII indirectly supports

1 Appendix 13 (2) E of IPRU(INV)

2 Threshold Condition Four

our consumer protection and market confidence objectives, by providing a source other than the firm's capital from which justified claims can be met.

2.8 When a loss occurs, a firm has to pay an amount equal to the excess on its PII policy out of its own resources. Then the PII policy provider pays a claim in accordance with the terms of the PII policy. Any residual amount is borne by the firm's capital resources. When a firm's resources are exhausted, the firm is insolvent. Any justified consumer claims then fall on the FSCS, which has limits as well. Any residual amount falls on consumers. The challenge we have tried to address in formulating our policy is how the burden should be spread across these groups. Annex 2 contains a flowchart that demonstrates this process.

The characteristics of a better PII market

2.9 In our Policy Statement published in June 2003 we set out our vision of the characteristics of a better PII market for personal investment firms. It is worth considering these characteristics again.

- **The regulatory requirements set minimum standards in key areas but allow flexibility in policy wording.** We believe that this paper sets out proposed regulatory requirements that provide flexibility so that insurers, including Lloyd's syndicates, can compete for business by offering differing policy terms, and personal investment firms can negotiate policy terms which are relevant to their business needs.

- **Personal investment firms run their businesses in a way that minimises the number of claims on their PII policy.** This is mainly firms' and their senior management's responsibility. However, as we said in our Policy Statement, we are willing to work with trade bodies and the industry to improve the professional standards within firms and the competence of the individuals within those firms.

  In April 2003 John Tiner, Managing Director of the FSA, wrote to trade bodies and consumer associations attaching a note restating the key principles of the 'mis-selling' of investment products. Following this we met with representatives of the financial services industry, consumer associations and the Financial Ombudsman Service (FOS) to discuss our note and the steps the industry could be taking to reduce the risk of future mis-selling. In light of these discussions, our note has been amended to clarify what we mean by mis-selling and re-published. This is on our website, www.fsa.gov.uk/pubs/other.

- **There is enough capacity in the market to provide PII cover for all firms that are required to have it.** The capacity in the market is not something we can directly control. However, we believe that the proposed PII requirements set out in this paper provide flexibility which will help PII

providers to supply cover when capacity is tight. Also, we are improving communication with the industry by talking to brokers, providers, trade bodies and firms regularly, to gain a better understanding of their concerns and to exchange information.

- **The insurance market has a better understanding of the risks of insuring independent financial advisers (IFAs).** As mentioned above, we are improving our communication with participants in the PII market, IFAs and trade bodies. We are discussing their concerns regularly to improve PII providers' understanding of the risks of insuring IFAs.

  We have invited representatives of the PII market to the first FSA forum on PII on 29 July 2003. This coincides with the publication of this CP. We will invite attendees to participate in a working group to help resolve some of the issues about underwriting and broking practices that were highlighted in a report recently published by the Office of Fair Trading[3]. We plan to hold these meetings four times a year for now.

Other related consultations

2.10 **CP187: Insurance selling and administration and other miscellaneous amendments** was published in June 2003. CP187 sets out draft rules for regulating the sales process and administration of general insurance contracts and pure protection contracts. It will benefit personal investment firms by clarifying the service they can expect from PII brokers and insurers by imposing statutory requirements which require them to:

- notify commercial customers whether they intend to renew an insurance contract or not, well in advance of the renewal date;
- give suitable advice to commercial customers; and
- provide a statement setting out the customer's demands and needs and the reasons for their recommendation.

2.11 If implemented, these proposals will help to clarify the standard of service that firms can expect to receive from their PII brokers and insurers.

2.12 **CP174: Prudential and other requirements for mortgage firms and insurance intermediaries** was published in March 2003. The results of this consultation will be published in the third quarter of 2003 alongside near final rules adapting the FSA Handbook to cover mortgage firms and insurance intermediaries. The proposed rules include specific requirements about the type and scope of PII cover these firms will be required to have. However, it is proposed the rules about PII will not apply to personal investment firms which are already covered by similar provisions in Chapter 13 of IPRU(INV).

3 The report was entitled 'The UK liability insurance market – OFT 659' and published in June 2003.

General modification

2.13 We are making available, from 29 July 2003, a further general modification by consent to the PII rules in Chapter 13 of IPRU(INV). The effect of this is to give firms the choice to follow the draft rules instead of those currently in IPRU(INV). Firms can notify us of their intention to take advantage of the general modification through the self-certification process. We are writing to those firms that are waiting to receive individual guidance in relation to non-compliant PII policies to bring the general modification to their attention and invite them to consent to it.

Next steps

2.14 We are planning to hold workshops for personal investment firms and other interested parties as part of the consultation process on this CP. These workshops will look at how our proposed regulatory requirements provide more flexibility and what this means for personal investment firms, brokers, underwriters and other interested parties. More information and dates will follow shortly.

2.15 We are seeking comments on this CP from personal investment firms, PII market participants, trade bodies, consumer groups and other interested parties.

2.16 Please send responses to this CP to us by 29 October 2003. We will issue a feedback statement after that. We would like to issue a feedback statement as early as possible next year to ensure that our rules can be implemented in time to allow firms to comply with the IMD, which will be implemented on 15 January 2005.

3 Policy rationale

3.1 This chapter summarises the comments we received on the questions in the discursive part (Chapter 6) of CP169, gives our responses and describes how we have taken them into account in formulating our proposed policy.

3.2 We received 75 formal responses from various sources, with the majority being from personal investment firms. We also received responses from trade bodies, PII brokers, underwriters, life offices, the Small Business Practitioner Panel and the Financial Services Consumer Panel. Please refer to the Policy Statement, issued in June 2003, for a list of non-confidential respondents to CP169. This is available on our website, www.fsa.gov.uk/pubs/policy/ps169/index.html.

3.3 Also, as part of our consultation process for CP169, we held eight consultative workshops across the country, which 461 people attended. The attendees provided very useful feedback including by answering a series of questions using electronic voting technology[4]. This feedback has been incorporated in our work and was taken into consideration when developing our policy. If you would like to look at the feedback from the workshops in more detail please go to our website, www.fsa.gov.uk/industry/pii-apr03.html.

EU directive requirements

3.4 The Insurance Mediation Directive (IMD) covers general insurance and aspects of life insurance, and has been adopted by the European Union. This means that we need to ensure that firms in the UK comply with the requirements in the IMD. We have previously published CP174 which contains proposals for implementing resource requirements, including PII, for general insurance and mortgage brokers.

4 Not all attendees answered all the questions. The largest number of 'votes' received to a question was 397.

3.5 The IMD includes a requirement for insurance and reinsurance intermediaries, which includes the overwhelming majority of personal investment firms, to hold PII. So we need to change our current rules so that personal investment firms comply with this requirement. The need to implement the IMD limits the policy options open to us.

3.6 Article 4.3 of the IMD[5] sets a minimum limit of indemnity for both an individual claim and claims in aggregate, at €1,000,000 and €1,500,000 respectively. These limits apply regardless of the size of the firm although there is an exemption for firms with *"some other comparable guarantee"*. You will see in Chapter 5 that we have had to consider whether the limits in the IMD are adequate and also propose what constitutes a *"comparable guarantee"*.

3.7 Europe is also looking to revise the existing Investment Services Directive (ISD). The scope of the ISD covers 'investment firms' which again includes the overwhelming majority of personal investment firms. These proposed revisions will require 'investment firms' to hold PII cover and they set the same minimum limit of indemnity for both an individual claim and claims in aggregate, as the IMD.

3.8 Negotiations are taking place to deal with the market impact on firms caught by the PII proposals in the revisions to the ISD. These include the ability to substitute capital for the level of PII cover held, either in part or full. However, as the timing of the ISD revisions is unclear we cannot anticipate any changes to our rules now.

Basing our PII rules on EU requirements only

3.9 We could change our PII rules to enable firms to comply with the minimum requirements of the IMD and leave them to negotiate additional terms and conditions as appropriate for their needs. This would give firms considerable flexibility since the IMD only sets minimum limits of cover and does not stipulate a limit on the level of allowable policy excess or any policy conditions to be met when buying PII cover.

3.10 However, this approach is likely to result in a deterioration in the quality of PII cover bought by firms. This is because the IMD does not specify any policy conditions and there is a risk that firms will buy policies that are worthless. As the IMD does not specify a limit on the level of allowable policy excess, there is a risk that firms would end up buying policies with very high excesses simply to meet the requirements of the directive.

5 This is a minimum harmonisation directive, which means that it specifies the minimum standards with which firms must comply.

3.11 Therefore we believe this approach is unsuitable as it would result in a deterioration in the quality of PII cover bought by personal investment firms. This would lead to more firms becoming insolvent and consequently more claims for compensation being made on the FSCS, leading to increased levies on the remaining firms. The risk of consumer detriment would increase due to the limits placed on compensation provided by the FSCS. The maximum pay-out the FSCS can make for an investment claim is £48,000. So any significant increase in the number of firm failures could mean an increase in the number of claims exceeding £48,000, which would have a detrimental effect on consumer welfare. A significant increase in the number of firms becoming insolvent would also have an adverse impact on market confidence.

Exempting firms based on turnover

3.12 In Chapter 6 of CP169, question 9 asked whether, to the extent that it is possible given EU directives, we should exempt firms with a turnover of £10 million or more and adequate capital resources from our PII requirements. Question 9 also asked whether a figure other than £10 million should be used for a turnover based exemption.

Feedback

3.13 There was widespread support for the proposal to exempt firms based on turnover and adequate capital resources. However, several respondents commented that turnover and capital should not be considered in isolation. Respondents suggested that we should also consider the risk profile of firms, their risk management systems and controls, and claims experience before an exemption is granted.

Our response: There are no provisions to exempt firms from the requirement to hold PII in the IMD, except where a firm holds a comparable guarantee[6]. So, we cannot exempt firms based on turnover or capital resources.

Since the proposed revisions to the ISD are yet to be finalised, we will review our requirements should this directive change to include provisions to exempt firms meeting specified criteria.

Prescriptive provisions compared to broad principles

3.14 In Chapter 6 of CP169, question 10 asked whether we should keep the modified evidential provision proposed in the consultative part of CP169 or whether we should replace it with a set of broad principles. We went on to ask for views on what the broad principles should contain.

6 Further details of our interpretation of this term are given in Chapter 5.

3.15 Evidential provision 13.1.5 in our current PII rules details how firms may effect and maintain PII cover that is compliant, including the requirements that should be incorporated within that cover. Appendix 13 (2) E details the provisions to which the PII cover should at least be equivalent and sets out standard wording for PII contracts.

Feedback

3.16 The majority of respondents were in favour of removing the standard policy conditions. They argued that broad principles were less likely to become outdated or be legally challenged. At our consultative workshops 69% (260) of respondents believed that supply would increase if the current detailed rules were replaced by broad principles.

3.17 However, several respondents, including the Financial Services Consumer Panel, expressed concern about replacing prescriptive provisions with broad principles. These respondents believed that there was a potential adverse effect on consumers because they might be confused about whether individual firms' PII cover provided adequate protection.

3.18 Also, a few respondents believed that if we allowed the market to decide the wording of PII contracts, the quality of PII cover would deteriorate. The majority (57% (217)) of workshop respondents also held this view.

Our response: There are some advantages in having PII rules that specify the wording of PII policies. These are:

- a higher degree of clarity for firms and PII underwriters about what constitutes compliant cover; and
- greater consistency in the scope and quality of cover being bought. This may ensure that firms and consumers are better protected.

However, this approach is very similar to our current one. Our experience indicates that it is no longer appropriate to specify the detailed wording of policy contracts as this can create difficulties for firms trying to get compliant PII cover. For example, many PII providers are not willing to offer PII cover that meets our requirements in the current difficult market conditions. So, we do not believe that basing our amended PII rules on this approach would go far enough to alleviate the difficulties that firms are currently facing in getting compliant PII cover.

Broad principles covering essential elements for PII to be effective

3.19 We acknowledge that if our prescriptive provisions are replaced with principles that are too broad, this might reduce the quality of PII cover available to personal investment firms and reduce the protections associated with it. So, we propose to introduce PII requirements that focus on the essential elements of PII policies. We hope that specifying these essential

elements will make policies effective, and will also give firms the opportunities to negotiate other contractual terms that are appropriate to their needs and provide adequate protection to them and their customers.

3.20 This approach has the following advantages.

- It will ensure that core minimum standards are in place so that quality of cover is not compromised.
- Beyond the core minimum standards, it will provide flexibility for firms to negotiate with PII brokers to decide on policy wording. This should result in PII underwriters being able to write PII policies that reflect prevailing market conditions.
- It will enable firms to negotiate contract terms that are tailored to their business needs.

Further details of our proposed policy can be found in Chapter 5.

3.21 However, this approach means that we will no longer specify standard policy wording. So there will be greater responsibility on firms and PII brokers to ensure that PII policies bought adequately protect the firm and meet its business needs.

Relationship between PII and financial resources

3.22 In Chapter 6 of CP169, question 8 asked whether, taking into account EU directive requirements, we should introduce a system that links capital levels to allowable excesses.

Feedback

3.23 The majority of respondents, including those at the workshops, supported this proposal because it would provide greater flexibility. Some respondents were concerned that only a few firms would have the necessary capital to benefit from this option. However, other respondents commented that, since larger firms would be able to use this option, it would free up capacity within the PII market for smaller firms.

Our response: We have been gathering further data in this area, including financial information and claim histories from personal investment firms. We have analysed this information to determine what levels of financial resources personal investment firms need to hold to tolerate particular policy excesses and levels of indemnity cover.

We have concluded that linking the additional financial resources held by firms with levels of allowable excesses would offer greater flexibility and our data analysis shows that this is a viable option.

We propose giving firms the option to use financial resources to complement their PII cover where they have shortcomings in the PII cover they can obtain in two areas.

- **Level of policy excess**

  Where the policy excess exceeds a specified minimum limit, firms will need to hold additional financial resources so that they can meet any claims that fall within the policy excess. The minimum level of policy excess will be determined by analysing financial data on the number and value of claims settled by firms from their own financial resources.

- **Policy exclusions**

  Firms will be allowed to have policy exclusions provided that they hold an appropriate level of financial resources to protect themselves against potential liabilities arising from the business or activity excluded.

  We believe that this approach will have many advantages for personal investment firms and the PII market.

- It should encourage underwriters to write more business for personal investment firms as, for poorly managed or high risk firms, they will be able to decide how much risk they would like to take and how much to leave with the firm.
- In good market conditions it gives senior management within well run personal investment firms more choice in deciding how much risk they would like their firm to take and how much to transfer to insurers. This is consistent with the emphasis placed on senior management in the FSA Handbook and FSMA. In difficult market conditions it allows these firms to maintain adequate resources by holding additional capital to compensate for shortcomings in PII policies.
- It recognises the role that financial resources can play in supporting a firm. This allows for some flexibility in the combination of financial resources and PII a firm is required to hold to be adequately protected.

This approach provides the most flexibility to firms without exposing them to claims that they are unable to meet and without reducing consumer protection. So we have incorporated this into our new policy which is detailed in Chapter 5.

Extending the requirement to hold PII to other firms

3.24 In Chapter 6 of CP169, question 12 asked for views on whether we should just apply a PII requirement to those firms that are required to hold PII as a result of EU directives, or whether we should extend the scope of application of our policy to include a wider range of investment firms.

Feedback

3.25 Many respondents supported extending the scope of application of our PII requirements to other investment firms because they believed that it would create a level playing field and enhance consumer protection. However, many of the respondents also felt that we need to address the immediate difficulties in the PII market first, so that personal investment firms can obtain compliant PII cover.

3.26 Also, some respondents were concerned that extending the scope of our requirement to investment firms not currently required to hold PII would further restrict capacity within the PII market.

Our response: We acknowledge that requiring all firms that provide investment advice to private customers to hold PII appears to create a level playing field. However, this is not necessarily the case, as many other firms that provide investment advice to private customers, not currently covered by our PII requirements, need to comply with other, more stringent, requirements. For example, stockbrokers are required to hold larger amounts of capital than, say, IFAs, in line with the Capital Adequacy Directive (CAD). Therefore, they may be better placed to meet claims made against them. Many firms also choose to hold PII cover even though the FSA does not require them to do so.

Our priority is to address the difficulties firms who are currently required to hold PII are facing. So we are not proposing to extend the scope of application of our PII requirements at the present time.

'Two tier' market

3.27 In Chapter 6 of CP169 we discussed giving firms the choice between obtaining:

- the minimum PII cover in line with EU directives (lower tier); or
- enhanced PII cover in line with our policy conditions (upper tier).

3.28 Question 11 asked whether we should allow a 'two tier' market to develop and what the required disclosure to consumers should be.

Feedback

3.29 The majority of the respondents were in favour of a two tier market. They believed that capacity would increase because most firms would opt for the lower tier requirements. However, other respondents believed that a two tier market would not significantly improve current market conditions.

3.30 In the second part of this question we asked respondents whether consumers should be told about whether a firm has the lower or upper tier PII cover. The majority of respondents did not support disclosing this type of information to consumers. They believed that this would only cause confusion and the

consumer would find it difficult to understand how the different types of cover would affect them. Also, a few respondents believed that firms holding the lower tier PII cover may be put at a competitive disadvantage because consumers would perceive the lower tier cover as inferior.

Our response: Although this approach could give personal investment firms more choice in the type of PII cover they could hold, we agree that there is potential for a competitive disadvantage to those firms opting for the lower tier cover. In addition, we believe that the lower tier would result in a deterioration in the quality of cover purchased for the reasons given in paragraph 3.10. Also, we acknowledge the difficulties surrounding disclosure to consumers. So we are not taking this option forward.

However, in practice, the market is already 'multi–tiered' as many firms buy 'better' policies than our rules specify. Our proposed rule changes will give firms the flexibility to determine many aspects of their PII policy. Above our minimum requirements, firms will have the flexibility to choose the precise combination of PII and financial resources that suits them best. So, there will be even more scope for a multi-tiered approach without a requirement for disclosure to consumers.

Conclusion

3.31 We have concluded that our new policy on PII will:

- enable firms to comply with the IMD;
- set out the essential elements of PII policies but avoid specifying standard policy wording; and
- give firms the flexibility to combine PII policies with their financial resources so that they maintain adequate resources overall.

3.32 Further details of our proposed rule changes are given in Chapter 5.

Q1: Do you have any comments on the thinking (as set out in Chapter 3 of this CP) that underlies our revised policy?

4 Industry sponsored solutions

4.1 In Chapter 6 of CP169, question 13 asked for comments on whether there is anything that we can or should do to help support the creation of an industry mutual.

4.2 Many respondents, including those who attended the workshops, supported the creation of an industry mutual, in principle. Of those in favour, many believed that we should be closely involved in creating an industry mutual and in its ongoing monitoring. However, the majority of workshop respondents (79% (301)) indicated that if an industry mutual was set up it should be on the condition that firms are assessed on a risk basis with the mutual having a right to refuse cover.

Our response: As a regulator, we do not believe it is our role to provide insurance, whether commercial or otherwise. Therefore, setting up an industry mutual is not a role that we can undertake. However, we are in regular dialogue with PII brokers, underwriters, personal investment firms and trade bodies regarding several possible solutions to improve capacity in the PII market. A number of these solutions have been discussed in the trade press.

Also, we received an application for authorisation from Magian Mutual Insurance Company Limited who sought to provide PII for IFAs. Our authorisation team worked closely with the management of the firm and our approach meant that we were able to authorise the firm in five weeks from receipt of its application.

4.3 In Chapter 6 of CP169, question 14 asked for views on whether there were any other industry sponsored solutions that we should consider.

4.4 Respondents put forward various ideas. These included:

- creating a sinking fund (some respondents suggested that the FSA should set this up); and
- creating a captive scheme.

4.5 A sinking fund is commonly established through a group of individuals investing money to pay off a liability at a known future date or to pay liabilities as they fall due. Such funds can be set up in several different ways, but essentially involve contributions being paid by participants to create a fund which could be called on by members to pay claims.

4.6 A captive scheme is usually one owned by a single firm to meet its own insurance requirements. This works by the parent company funding the captive rather than paying an insurance premium. Large companies who would otherwise be paying large premiums for liability or other insurance sometimes use this type of arrangement. Those firms that set up a captive may also need access to the reinsurance market to cover large claims where they are unable to take all the risk themselves. However, our rules do not permit a captive to be set up in this country. Captives that are set up in other countries will be subject to the solvency margin rules that apply in that country.

4.7 Other ideas included changing the scope of the FSCS and the role of the FOS. We responded to the suggestions regarding the FSCS and the FOS in Chapter 3 of our Policy Statement, published in June 2003.

Our response: As a regulator we do not believe it is our role to provide commercial insurance. Therefore, setting up a sinking fund is not a role that we can undertake. It would have to be set up by members of the industry. However, we believe that there are key issues that arise from the creation of a sinking fund. These include:

- **the calculation of contributions.** This should involve an estimate of the size and quantity of claims for the year ahead. If there were more claims than estimated the fund might suffer shortfalls and difficulties in paying compensation as it falls due. This could lead to the liquidation of the fund or compulsory calls on the funds' members; and
- **entry to the fund.** If the fund was open to all personal investment firms there is a danger that firms with good risk management systems and controls and minimal claims experience would end up subsidising the claims of weaker firms.

We believe that captives would probably be unsuitable for small firms because of the nature of such companies as described in paragraph 4.6.

However, as part of our ongoing commitment to work closely with the industry, we are willing to consider proposals in relation to sinking funds and captives as well as other industry-sponsored initiatives. Also, we continue to have discussions with personal investment firms and other organisations looking at other innovative solutions to the supply problems in the PII market. Many of the organisations interested in providing industry sponsored solutions have made their plans known through the trade press.

5 Summary of proposed rule changes

5.1 In our Policy Statement, published in June 2003, we acknowledged that the purpose of PII is primarily to provide protection for firms against claims arising from various sources. We also choose to use PII as a key regulatory tool. Since claims against personal investment firms often come from their customers, PII supports our consumer protection objective by providing a source from which such claims can be met.

5.2 Our proposed rule changes will require firms to maintain adequate resources through a combination of PII and financial resources. However, we do not operate a zero failure regime. So, we have not set out to ensure that firms will never fail. Our proposed rules are the minimum standards that firms' senior management will need to meet when controlling their business. Individual firms may choose to go further.

5.3 Our proposed rule changes also support our market confidence objective, as they should encourage more PII providers into the market of PII for personal investment firms. This will help to resolve the difficulties personal investment firms are having in obtaining cover and the current lack of capacity. In making our policy we have also taken into account the cyclical nature of the indemnity market.

5.4 This chapter sets out the combination of measures we propose to implement. The proposed rule changes relate to our PII rules in Chapter 13 of IPRU(INV). Annex 3 contains some examples of how our proposed rules changes will work.

5.5 We propose to delete current rules 13.1.3 R to 13.1.5 E and Appendix 13 (2) E and replace them with the draft rules in Annex 4.

5.6 Our proposed changes contain rules, evidential provisions and guidance. So it is worth noting the different implications of each of these.

- **Rules** create a binding obligation on firms. If a firm breaches a rule it may be subject to enforcement action.

- **Guidance** is not binding on firms and is used to either explain the implications of other provisions, to indicate possible means of compliance or to recommend a particular course of action.
- **Evidential provisions** are rules that are not binding in their own right. They always relate to some other binding rule. If a firm does not comply with an evidential provision, that creates a presumption that the firm has breached the rule to which it relates.

Scope of PII policies

5.7 Our proposed rule changes require that PII policies are wide enough so that:

- the firm's PII policy covers claims arising from all of its business activities. This means that claims arising from both a firm's regulated and unregulated business[7] will be covered; and
- the firm's PII policy covers any claim for loss or damage for which the firm is liable, including those claims which have arisen from an act or omission by the firm or anyone acting on its behalf (see 13.1.4 (2) R).

5.8 We believe that these two requirements will help to ensure that a firm's financial resources are not eroded by:

- claims arising from unregulated, as well as regulated, business activities; or
- an act or omission by a person acting on behalf of the firm, as well as an employee of the firm.

5.9 Also, 13.1.4 (7) G includes further guidance on the type of breaches a firms' PII policy should protect against; for example, breaches of the firm's duty of skill and care and its duty to look after documents and assets. We believe this will mean that a PII policy will include what should reasonably be covered by such a contract.

5.10 We do not consider it necessary to define PII in our proposed rules. Various regulatory requirements to hold PII have been in force for over ten years in one form or another without such a definition. In our view, this has not caused any particular difficulties.

> Q2: Do you have any comments on the scope of what a PII policy should cover; for example, our proposal to include a firm's unregulated as well as regulated business activities within the scope of its PII policy?

7 Examples of unregulated business activities are receiving estate agency and building society commission.

Level of cover

5.11 Historically, our PII rules have set minimum limits for the level of PII cover to ensure that, in most instances, firms are able to meet the claims made against them. This is an essential element for PII to be effective and so our rules will be amended to specify minimum limits (see 13.1.4 (2) R and 13.1.4 (5) E).

5.12 Our proposed rules relating to the minimum limits of cover will include provisions that:

- set out requirements for personal investment firms that do not fall within the scope of the IMD;
- set out requirements that will enable firms that fall within the scope of the IMD[8] to be compliant with it, when it is implemented; and
- impose further requirements on both types of firms where relevant income exceeds a specified amount.

Non-IMD firms

5.13 While we believe that the majority of personal investment firms will fall within the scope of the IMD, there may be some that do not. So, 13.1.4 (2) R (c) requires those firms that do not fall within the scope of the directive to hold aggregate cover of at least:

- £500,000 where their relevant income is less than £3,000,000; or
- £1,000,000 where their relevant income is between £3,000,000 and £6,000,000.

5.14 This provision also requires firms that fall outside the scope of the IMD to hold cover for a single claim of at least:

- £500,000 where their relevant income is less than £3,000,000; or
- £650,000 where their relevant income is between £3,000,000 and £6,000,000.

> Q3: Do you agree with the levels of cover proposed for firms that fall outside the scope of the IMD? We would particularly like to hear the views of those firms that believe they fall outside the scope of the IMD and to understand how they have arrived at this conclusion.

8 CP174 describes an insurance intermediary as one involved in: introducing, proposing or carrying out work before the conclusion of insurance contracts; concluding such contracts; or assisting in the administration and performance of such contracts, particularly in the event of a claim.

IMD insurance intermediaries

5.15 13.1.4 (2) R (b) will require insurance intermediaries that fall within the scope of the IMD to hold aggregate cover of at least €1,500,000 and cover for a single claim of at least €1,000,000. These firms will need to ensure that they are compliant with the IMD when it is implemented on 15 January 2005. They will be able to do this either by complying with this requirement before the IMD is implemented or by meeting the requirements of 13.1.4 (2) R (c) in the interim and buying a top up policy before 15 January 2005.

5.16 We acknowledge that most firms will buy PII policies denominated in sterling. So, 13.1.4 (3) R requires firms to take reasonable steps to ensure that the level of indemnity cover in place is at least equivalent to the minimum requirements of 13.1.4 (2) R (b) at the inception or renewal of the PII policy, and throughout its term. Firms should take into account potential fluctuations in exchange rates during the time between the date of inception, or renewal, of the policy and the date the policy expires. For example, firms may wish to obtain cover in excess of the limit to allow for some contingency against exchange rate movements during this period.

> Q4: Would it be helpful if we included some guidance in the FSA Handbook on what we consider to be reasonable steps to ensure that policies provide at least equivalent levels of cover as those specified by our PII rules, regardless of the currency of denomination?

5.17 Our research has indicated that very few individual claims exceed €1,000,000 and so we see no reason to set a higher single claim limit.

5.18 However, as well as the minimum requirements for aggregate cover set out above, all firms with relevant income exceeding £6,000,000 will be required to hold additional aggregate cover based on their relevant income. A table in 13.1.4 (5) E (a) (i) sets out the amount of cover firms will be required to hold. The limits of indemnity specified in the table are based on an analysis of claims data.

5.19 We recognise that this requirement will exceed that in the IMD for the relatively small number of firms where relevant income is over £6,000,000. However, we believe this limited super-equivalence is justified and necessary in order to ensure that firms and consumers are adequately protected. The reasons why we consider limited super-equivalence to be necessary can be found in paragraphs 6.43 and 6.50.

> Q5: Do you think that the proposed limits for the level of aggregate PII cover strike the right balance between ensuring that firms have an adequate level of cover and not placing undue costs on firms?

5.20 We will require firms to notify us if their level of aggregate cover has been used up during the term of their PII policy. This requirement will be inserted into table 13.1 (a), which forms part of 13.1.9 R. This will help us to monitor whether firms have suitable PII cover in place at all times.

5.21 We propose to remove the distinction between networks and other firms. This distinction is based on the assumption that networks have a higher turnover than other firms. However, this is not necessarily the case as our rules define a network as an independent intermediary which has five or more appointed representatives[9]. So, our proposed rule changes will distinguish between firms on the basis of relevant income because this is a more accurate indicator of a firm's size. We believe this will reduce the minimum limit of aggregate cover currently imposed on small networks. Table 1 in Chapter 6 provides further details on this.

Levels of excess

5.22 PII underwriters use policy excesses as a risk management tool. This allows them to decide which risks to accept and which risks to leave with the insured. The larger the policy excess, the more the risk is retained by the insured. We believe that firms should hold financial resources to adequately protect themselves against the level of risk retained. We are aware that many firms are already doing this. Therefore, we are making this explicit in our rules.

5.23 Our proposed rule changes allow firms to take out a PII policy with an excess up to £5000 without requiring them to hold additional financial resources. Our data analysis shows that most firms have two or fewer claims for every million pounds of turnover. Our analysis also shows that most firms can afford to settle two claims of £5000 from their own income or capital reserves.

5.24 Where firms cannot or choose not to obtain a policy excess of £5000 or less, 13.1.4 (10) E (a) (i) and 13.1.4 (12) E will give them the flexibility to carry a higher policy excess, provided that it is backed up by additional own funds in a readily realisable form. We will include guidance at 13.1.4 (4) G that defines assets as being 'readily realisable' where they can be realised at any given time, within 90 days. Examples of assets that fall within this definition are cash, investments and securities.

> Q6: Do you agree that additional own funds should be held in a readily realisable form as defined in 13.1.4 (4) G? If not, how should our definition be amended?

9 This is only part of the definition of a network. The definition goes on to give the alternative of an independent intermediary whose appointed representatives (being fewer than five) have, between them, 26 or more financial advisers.

5.25 The amount of additional financial resources required has been determined by analysing financial claims data to work out the average frequency of claims for every million pounds of relevant income. A few firms may have more claims than our additional financial resource requirements cater for. We could have set the financial resource requirements much higher to give us more confidence that such firms would not fail. However, we do not operate a zero failure regime and we do not believe that these financial resource levels would be proportionate. Also, in line with FSA Principles for Businesses 3 and 4, it is the responsibility of a firm's senior management to maintain adequate financial resources. Therefore, the onus will be on a firm's senior management to put additional financial resources aside over and above our requirements, where they deem that necessary.

5.26 We considered whether to provide firms with a formula to enable them to work out the amount of additional financial resources to hold for particular excess levels. Instead, to make it easier for firms, we have opted to provide a table in 13.1.4 (12) E for them to look up the relevant amount.

Q7: Do you think the table in 13.1.4 (12) E is easy to use? If not, what improvements would you suggest?

Q8: Do you think that the own funds required in the table in 13.1.4 (12) E are proportionate to the risk of claims that may arise, whilst providing adequate protection? If not, do you think that the additional own funds requirements should be higher or lower, particularly for firms that hold an excess of more than £200,000 (For example, no less than the level of excess carried)?

Q9: Even with a requirement to hold additional own funds that increases with the size of excess, do you think that we should impose limits on the maximum size of excess permissible? If so, what do you think this should be based on?

Group policies

5.27 13.1.4 (15) R allows firms, whether connected or not, to benefit from a policy which covers more than one firm. We are introducing this new provision to enable firms to take advantage of the possible cost benefits, such as reduced administrative costs, that such an arrangement may provide. Our proposed rule changes aim to ensure that firms that take up this option have the same level of protection as those firms with individual policies. However, we recognise that individual firms included in such policies will have different claims experience. To ensure that none of the firms participating in such an arrangement are disadvantaged, we will put some safeguards in place:

- each firm named on the policy will be required to have access to the same levels of single and aggregate cover as required by our proposed rules for individual firms;
- all firms named on the policy will be required to notify us if any of the firms on the policy cease to have access to the minimum level of aggregate cover required by our rules for individual firms. For example, firm A and firm B buy a joint policy that has an aggregate limit of €2 million. If firm A uses up €1 million, then both firms will need to notify us as the level of cover available will have fallen below the minimum limit of cover of €1.5 million; and
- the relevant income of all firms named on the policy will need to be combined for the purposes of calculating relevant income.

Q10: Do you support our proposal to permit firms to have group policies? If so, do you also support our proposal to permit both connected and unconnected firms to take out "group" or combined policies? In addition, do you agree with the conditions we have attached to those firms that participate in group or combined policies?

Exclusions

5.28 Ideally a firm's PII policy will not have any exclusions, ensuring that the firm is adequately protected for all relevant events, advice given and products sold. However, our experience has demonstrated that one of the main reasons for non-compliance with our PII rules is policy exclusions.

5.29 So our proposed rule changes will take into account circumstances where firms obtain PII cover with policy exclusions. 13.1.4 (10) E (a) (ii) will require those firms to hold additional financial resources, which will be calculated against the firm's potential liabilities from classes of business which are excluded from their PII policy.

5.30 We do not propose to list all types of possible exclusions as this would be too complex and it would be difficult to ensure that all potential exclusions were catered for. Therefore where a business line or activity is excluded from a firm's PII policy, the onus will be on the firm's senior management to decide the appropriate amount of own funds to hold.

5.31 13.1.4 (13) G provides guidance on the factors to be taken into account when assessing the amount of financial resources to be held. Firms will also be required, in accordance with 13.1.4 (14) G, to regularly review the provisions held. In addition, 13.1.4 (8) R specifies that firm's PII policies must not

contain conditions or exclusions that unreasonably limit cover, to ensure that a firm's PII policy provides adequate protection. 13.1.4 (9) G gives some examples of exclusions that we consider reasonable.

5.32 13.1.4 (10) E (a) (iii) will not allow firms to exclude liabilities which are identified or which crystallise as a result of regulatory action against the firm. This will ensure that a firm is adequately protected against such liabilities.

5.33 Firms will be required to notify us where, during the term of the policy, the firm starts a business line for which it has not obtained cover. This is because if a firm starts such a business line it will not have PII cover unless it renegotiates its policy.

Q11: Do you agree that we should provide guidance to firms on how they should assess the amount of own funds to be held to cover potential liabilities for any excluded business or activity?

Exemptions

5.34 Our approach to exempting firms from our PII requirements is constrained by the IMD. The only exemption from the requirement to hold PII in the IMD is where a firm has a 'comparable guarantee' from another entity specifying that it will provide PII cover for the firm that will be at least equivalent to the minimum requirements of the directive. We have defined a 'comparable guarantee' as an enforceable, written agreement which provides equivalent PII cover to that specified in our PII rules.

5.35 13.1.5 R allows for the use of comparable guarantees, but only to members of the same group as a bank, building society or insurer. This is to ensure that such guarantees are only provided by entities of substance, where the liability will be taken into account in their regulatory capital requirements.

5.36 The provision within our existing rules that exempts firms with a stock market capitalisation of more than £50 million from the requirement to hold PII cover will not be carried over to the proposed rules. This is because there is no provision for this exemption in the forthcoming IMD. Nonetheless, firms with additional financial resources will be able to take advantage of the flexible aspects of our amended rules that will allow them to use financial resources to meet some of our requirements.

Q12: Do you think that the proposal to exempt members of the same group as a bank, building society or insurer, if a comparable guarantee is in place, is sufficient? Or, should it be extended to include:

- other authorised entities as well as banks, building societies and insurers that are able to provide a comparable guarantee? If so, which other entities do you think should be included within this exemption?; and/or
- subsidiaries of banks, building societies or insurers where the parent or ultimate holding company is an authorised person and able to provide a comparable guarantee?

Notification requirements

5.37 As well as the notification requirements already mentioned above, we will amend table 13.1(a) in 13.1.9 R to require firms to notify us if:

- PII cover cannot be obtained within 28 days of the renewal date;
- PII cover is cancelled;
- in line with 13.1.4 (15) R, the firm is named on a PII policy which provides cover to more than one firm; or
- the firm is using the exemption in 13.1.5 R.

5.38 These notification requirements will allow us to monitor whether firms have adequate PII cover in place at all times.

Q13: Do you think that the new notification requirements we are proposing are reasonable?

Responsibilities of firms' senior management

5.39 Our amended rules focus on what we consider to be the essential elements for PII to be effective. In recognising that we do not operate a zero failure regime, we will be putting greater responsibility on senior management to ensure that they have appropriate cover in place to protect their firms. So, 13.1.3 (1) G reminds firms' senior management of their responsibilities under FSA Principles for Businesses 3, 4 and 9.

Additional requirements

5.40 Our proposed rule changes will not include standard policy wording. So we will delete the current Appendix 13 (2) E of Chapter 13 of IPRU(INV). This will give firms greater flexibility to negotiate contractual terms as appropriate with their PII underwriters.

5.41 Other provisions from our current rules that will be retained are requirements for firms to:

- have cover for legal defence costs. This will be set out in 13.1.4 (5) E (a) (ii);
- have full retroactive cover for claims arising from work carried out by the firm in the past. We believe that this is essential to adequately protect firms and consumers. This requirement is set out in 13.1.4 (5) E (a) (iii); and
- make provisions for FOS awards made against them in their PII policies. We believe that the FOS plays an important role in protecting consumers, which may be undermined if firms' PII cover does not incorporate such a clause. This requirement is set out in 13.1.4 (5) E (a) (iv).

Q14: Do you think that our rules should retain a specific requirement for firms to have cover for legal defence costs and/or Ombudsman awards, bearing in mind that this is implicitly covered in 13.1.4 (2) R (a), which requires a firm's PII policy to make provision for cover in respect of any claim for loss or damages?

5.42 The current provision in 13.1.6 (1) G that allows firms to insure with any insurer authorised to transact professional indemnity insurance in the UK will be widened to include all countries in the European Economic Area. Where a firm buys a PII policy from an insurer that operates outside the UK, it should ensure that:

- the policy obtained meets any additional regulatory requirements in that country; and
- it is acting lawfully in buying the policy.

Other questions

Q15: Do you think that our proposed rule changes will make it easier for firms to obtain compliant PII cover?

Q16: Do you have any other comments on our proposed rule amendments?

6 Cost Benefit Analysis

Introduction

6.1 The Financial Services and Markets Act 2000 (FSMA) requires us to publish a cost benefit analysis (CBA) of our proposed rules and related guidance, defined as "an estimate of the costs together with an analysis of the benefits that will arise if the proposed rules are made". A CBA is not required if the costs arising from implementing our rules will be of no more than minimal significance.

6.2 The purpose of this CBA is to assess, in quantitative terms where possible and in qualitative terms where not, the economic costs and benefits of the proposed changes to the PII rules as set out in this CP.

6.3 Our CBA considers possible impacts of regulation. These are:

- the direct costs to the regulator;
- the compliance costs of our proposals; and
- the costs or benefits to stakeholders (e.g. firms and consumers) depending on the effect our proposals have on the:

  - quantity of transactions;

  - quality of transactions;

  - variety of transactions; and

  - the efficiency of competition.

  We refer to these as 'market impacts'.

6.4 As we explained in Chapter 3, implementation of the IMD has driven some of the proposals in this CP. Our proposals incorporate and at times go beyond the IMD's requirements, where we believe there are valid reasons for doing so. Our existing rules on PII go beyond the requirements of the directive for reasons of consumer protection and market confidence.

Data used

6.5 In producing this CBA we have used various data from both internal and external sources.

- Survey data of the claims history, PII premiums, own funds and turnover for personal investment firms from AIFA members and workshop attendees.
- Claims data gathered from PII underwriters and large networks.
- Claims, premiums paid, own funds and relevant income data for personal investment firms from sampling the compulsory financial returns we receive.
- Data on renewals and issues arising when firms try to renew PI cover, from supervisors who deal with cases relating to firms with non-compliant or no PII cover.
- Responses to the question and answer sessions at the PII workshops run in March and April 2003.

6.6 We wanted our data analysis to be simple yet robust, statistically relevant and able to be applied widely across firms. With these targets in mind we analysed the data we had collected, with the help of an external consultant.

6.7 The first part of our analysis was to work out the average frequency and size of claims per million pounds of relevant income. This showed a clear relationship between relevant income and claims frequency. With this relationship confirmed it was possible to go further and reach conclusions in two important areas:

- the size of aggregate cover limits required (above the EU minimum) for firms with different relevant incomes; and
- the amount of financial resources required to be able to fund different policy excess levels dependent on a firm's relevant income.

6.8 These two pieces of data analysis were done separately, though they used the same basic claims data. We took this approach because we concluded that the aggregate cover and the excess were separate risks to the firm.

6.9 We fitted the data to a distribution using various statistical techniques so that we could run a large number of simulations to determine the costs to a firm of different aggregate limits and different policy excess levels. We chose a large number of scenarios and for each scenario we ran thousands of simulations. This enabled us to sort the data into bands each with a different implication for the average level of financial failure. We do not operate a zero failure regime, therefore we have not opted for amounts designed to ensure that firms

never fail. Had we done so, the aggregate limits and the amounts of financial resources required to cover policy excesses would have been much higher than those set out in the proposed rules.

6.10 The results of this analysis have enabled us to build the new framework for PII rules allowing a trade off between capital (or financial resources) and policy excesses, and more appropriate aggregate cover limits. We believe the data we have used represents at least 10% of personal investment firms.

6.11 In doing the calculations for the costs and benefits in this CBA we have made the following assumptions.

- There are 4000 personal investment firms. Whilst the actual figure might be slightly higher than this, we consider this to be a fair assumption.
- The exchange rate between the euro and sterling is €1.58 = £1, therefore €1,000,000 = £633,000[10] and €1,500,000 = £949,000.

6.12 For ease of reference and consistency we refer to the rules on PII for personal investment firms in Chapter 13 of IPRU (INV) as the 'current rules'. The changes to the PII rules outlined in this CP are referred to as the 'proposed rules'.

Our approach

6.13 This CBA compares the situation that will arise once our proposed requirements are in place with the situation had they not been introduced, i.e. the counterfactual. For each significant change we estimate the incremental costs of complying with our proposals taking as the baseline what firms currently do. We also use this baseline to analyse the indirect costs and benefits of our proposals.

The areas of significant change are:

- Aggregate (and any one claim) limits of cover;
- Allowable policy excess and corresponding financial resources;
- Removal of detailed conditions for policy contracts to be replaced by specific rules and guidance including the treatment of policy exclusions;
- Firms who are exempted from our PII rules; and
- Firms who obtain policies that are non-compliant because of exclusions.

6.14 The counterfactual mentioned in the previous paragraph is the current rules. These rules explain which firms must have PII, how much PII different firms must have and then detail the sorts of areas the PII contract must include

10 This is based on the 12-month sterling value of the Euro of 63.26 pence valid from 31 December 2002 that we use for insurance regulatory purposes. Please see www.fsa.gov.uk/pubs/press/2003/013.html for more details.

cover for and the narrowly defined areas that it is acceptable to exclude. This is all underpinned by the use of a compliance clause that stipulates the FSA's specific terms and conditions override any less favourable to the insured (this is only activated if there is a dispute).

Market impacts

6.15 In this section when we refer to the level of prescription of the current rules we are referring only to the detailed rules about minimum policy terms and conditions contained in Appendix 13 (2) E of IPRU (INV) and not to the PII rules as a whole. It would be wrong to suggest that the proposed rules are not detailed; they are merely less prescriptive.

Quantity

6.16 PII delivers several benefits, including:

- it protects firms from claims against them;
- FSCS levies will be lower for personal investment firms than they would otherwise have to be (FSCS levies being a cost that is borne by the industry sector and, ultimately, consumers);
- it protects consumers from the risk that the firm they are claiming against becomes insolvent (claims against insolvent firms are generally met by the FSCS; however, claims over £30,000 are not met in full);
- it acts as a discipline on firms and encourages them to comply with our rules. (Because a non-compliant firm will make claims and face higher premiums in future); and
- it allows firms with low financial resources (typically small firms) to demonstrate that they have adequate resources to remain in business. This allows smaller firms to compete with larger firms, for example personal investment firms competing with direct sales forces of product providers, and small personal investment firms competing with large personal investment firms.

6.17 The rule changes proposed here are expected to increase the extent to which the above benefits are delivered. Under the current rules, the quantity of PII available is insufficient to meet demand. The OFT[11] stated that: "A survey by the Association of Independent Financial Advisers (AIFA) of 143 members in December 2002 showed that 22 per cent had no cover at all, 37 per cent had non-compliant cover and a number had no application for insurance pending." To the extent that PII is in short supply, and that non-compliant firms continue to trade, the benefits of PII set out above are compromised.

11 'The UK liability insurance Market – OFT 659' by OFT, June 2003

6.18 The proposed rule changes are, in part, intended to increase the supply and use of PII[12]. This will help us to secure the benefits that can flow from the use of PII as a regulatory tool, as described in paragraph 6.16. The proposed rules are expected to increase the number of personal investment firms with PII because:

- the reduction in prescription will mean personal investment firms will be more able to obtain cover suitable for their particular needs and providers will be more able to provide products that best use their specialist underwriting skills;
- by allowing firms to substitute capital for different levels of excess and for policy exclusions, it will be more likely that firms will be able to get compliant cover at an affordable price. It is worth noting that the stage of the insurance market cycle (as suggested by the quote from the OFT report in paragraph 6.22) is likely to have a more important effect on the price of PII cover than our rules;
- removing the uncertainty over the standard contract terms (in particular the removal of the compliance clause and the accompanying standard policy terms and conditions) and allowing insurers to provide policies with a format and wording that they are comfortable with should encourage more insurers to underwrite PII for personal investment firms and existing providers may be willing to supply more PII; and
- we have already seen evidence of underwriters entering (or re-entering) this market following our modification to the current rules, as outlined in our policy statement. In particular, Magian have set up a mutual insurance company specifically for personal investment firms. This mutual has already written PII policies for a number of personal investment firms and has long term plans to do this for a significant number of firms in the future. Other insurers such as Interpolis Insurance Ireland Limited[13] also propose to write significant amounts of PII for personal investment firms.

6.19 We therefore expect that the proposals will increase the amount of PII consumed and increase the extent to which PII delivers the benefits set out above. This should allow more personal investment firms (particularly the smaller ones) to operate with compliant cover and – to the extent that PII requirements act as a barrier to entering the market for financial advice – reduce the significance of this barrier. This can be important as new entrants can also be innovators.

12 PII is here considered as PII *and* its equivalent (i.e. capital that is, under the proposed rules, used as a substitute for excesses and exclusions).

13 Interpolis is writing a facility solely for clients of Simply Biz Support Limited.

6.20 PII of the same or better quality than is currently on the market is expected to be available at a lower price. We expect the decrease in price per unit of cover purchased will, overall, comprehensively outweigh any increase in the cost of cover that might arise from an increase in the level of cover that some firms will need to buy. Thus, the compliance cost estimates set out in paragraphs 6.42 – 6.74 will be overestimates as they are based on current market conditions which are affected by the current set of rules on PII.

6.21 We also expect that the proposed rules will mean personal investment firms will need to spend less time finding compliant cover (we estimate that firms are spending approximately two days of the senior manager's / principal's time dealing with PII though this might be more in some cases).

6.22 The Office of Fair Trading's (in a report written by Dr Parsons at Cass Business School) recent research into liability markets (including PII) made the following comments on the underwriting cycle:

> "From a purely actuarial viewpoint the underwriting and rating process is one of observation and statistical modeling, with the establishing of distinct classes of risk as its object. However, market forces and market behavior [sic] also play a powerful role in fixing insurance premiums and levels of cover. In a so-called 'soft' market, when insurance cover is generally cheap and readily available, underwriters may be prepared to accept business at rates of premium that they know to be inadequate in order to retain their market share. Conversely, in a 'hard' market, when insurance is expensive and more scarce, insurers may be able to achieve rates of premium that are higher than the levels that are necessary to cover costs and make a normal profit. The phenomenon, whereby insurance markets tend to swing between 'hard' and 'soft' markets, with periods of (relative) profitability and (relative) unprofitability alternating over a cycle of 6-9 years is commonly known as the underwriting cycle[14]."

Quality

Quality from the perspective of the FSA and consumers

6.23 There is a risk that a reduction in prescription could lead to a reduction in the quality (where quality is judged from our perspective in the context of our regulatory objectives) of PII products available. This could compromise, in particular, our consumer protection objective. To counter this possibility, there will be rules and guidance in respect of certain contract terms, which we deem as indispensable for PII to function as a useful regulatory tool for personal investment firms. These rules and guidance will be broad, yet will provide a clear steer to firms and their brokers as to what is required.

14 'An analysis of current problems in the UK liability insurance market' by Dr Christopher Parsons gives a good account of how prices are affected by the insurance cycle. This is a supplemental report to OFT659.

6.24 Nevertheless, the risk remains that the proposed rules will mean PII is a less effective regulatory tool. This could mean claims that would have been met under the current rules are no longer met and these costs will instead be borne by the FSCS (and thus personal investment firms and consumers in general) and, where claims exceed £48,000, by the consumers who are directly involved. While this risk should not be under-played, it needs to be put into the context of current market conditions where significant numbers of firms are trading without compliant cover or without any cover at all.

6.25 To the extent that the new rules reduce the number of firms leaving the market, consumers may also benefit. If consumers wish to make a repeat purchase but are only comfortable doing so from an adviser with which they have had dealings before (with whom they associate quality), a reduction in the number of firms leaving the market may increase the amount of repeat purchases. This can be a benefit as experience can assist consumers in making better informed purchases in subsequent transactions.

Quality from the perspective of firms

6.26 Our current rules prescribe the detail of PII contracts, which in theory could guarantee an appropriate minimum level of quality. However, there are reasons why, in practice, this might not be the case:

- Most PII providers are not willing to offer cover on our current terms;
- The level of prescription in our current rules may prevent or discourage PI providers from providing innovative product features;
- The level of prescription is insensitive to the differing needs and requirements of personal investment firms – for some, other PII products might be more appropriate for their need;
- The level of prescription limits the role of PII brokers mainly to searching for cover that meets the criteria at the best price (rather than also looking for cover that is most suitable for their customer);
- The format of our current rules means that PII providers will always trail any insurance market developments in terms of policy wording and scope of cover; and
- The level of prescription does mean that the regulator is the arbiter of quality and it may be that the information required to make such judgements is extensive and complex. Such judgements are often best made by market participants as a result of the interactions of supply and demand.

6.27 The proposed rules are much less prescriptive in this respect. This will allow sellers, buyers (and their agents: PII brokers) to seek the best available deal

from their own (or their principal's) perspective and this interaction should allow for better quality PII products and better quality advice on PII. It is also possible that the less prescriptive rules may not only encourage incumbent PII providers to provide more, and more innovative, PII products but also encourage new PII providers to enter the market and provide quality alternative products.

Variety

6.28 Many of the considerations relevant to variety have been covered under quantity and quality and are not repeated here. To summarise, the proposed rules will allow personal investment firms to obtain a broader range of products and this will allow PII providers to supply a broader range of products. This will lead to a wider variety of PII products.

Efficiency of competition

Competition between PII providers

6.29 It is, as a rule, more likely that competition will be impaired, or that an existing state of impaired competition can be exploited, the more fixed[15] demand is and the more standardised the product in question is. Our current rules do make PII mandatory for personal investment firms and detail what the PII product must look like. Although this, as indicated in paragraph 6.31, has not given rise to any known competition problems, our proposed rules which allow for firms to accept contracts provided they meet high-level requirements and trade capital for excesses should significantly reduce the risk that competition imperfections may arise or that these imperfections can be exploited if they do arise.

6.30 We believe the flexibility in our proposed rules should encourage competition in the market. By allowing providers to provide products that more effectively use their underwriting skills and experience, there will be greater scope for providers to compete efficiently.

6.31 The Office of Fair Trading's (in a report written by Dr Parsons at Cass Business School) recent research[16] into liability markets (including PII) found:

> "Research by the author has revealed no positive evidence of collusion between liability insurers or breach of competition law by them.
>
> In any event, the nature of liability insurance products and their pricing is such that collusive price-fixing agreements between liability insurers would by quite difficult for the conspirators to police.

15 When we say fixed in this context it is because PII for personal investment firms is compulsory and therefore there will be a given minimum level of demand equal to the number of personal investment firms in business.

16 'An analysis of current problems in the UK liability insurance market' by Dr Christopher Parsons gives a good account of how prices are affected by the insurance cycle. This is a supplemental report to OFT659.

> The most plausible explanation for the current problems of the UK liability insurance is that the situation has been brought about by the unusual conjunction of a number of factors that have exerted upward pressure on liability insurance premiums and restricted its supply."

6.32 The OFT also looked into PII for IFAs in their own report and noted the following:

> "…we recognise that certain types of business have suffered particular adverse effects as a result of premium increases. These include Independent Financial Advisors (IFAs) (who are required by Financial Services Authority (FSA) rules to have PI cover)…"

> "With the possible exception of asbestos related risk, the part of the liability insurance sector where there appear to be major problems of non-availability, is in respect of PI cover for IFAs. IFAs are required to have PI cover under existing financial services regulation. A survey by the Association of Independent Financial Advisers (AIFA) of 143 members in December 2002 showed that 22 per cent had no cover at all, 37 per cent had non-compliant cover and a number had no application for insurance pending."

> "IFAs are generally regarded as a high risk category by insurers. The key reason given by insurers for the non-availability of cover or significant rises in premiums (and/or excesses) for IFAs, focuses on concerns about a noticeable increase in the number and frequency of complaints and, in particular, possible future business reviews by the FSA, along the lines of the review into the mis-selling of pensions, which could translate into huge costs for insurers."[17]

Competition between personal investment firms (and between personal investment firms and other distribution channels)

6.33 While we expect the proposed rules will allow more personal investment firms to continue to operate (and potentially reduce barriers to entry) we did not anticipate that the current rules would lead to significant numbers of exits / increased entry barriers to the extent that effective competition would be compromised in this market. Nevertheless, to the extent that risk exists, the proposed rules should act to reduce it.

6.34 Also, of greater significance, for the efficiency of competition in the market for advice we are proposing to remove the differing treatment of certain types of firm (e.g. networks) which exists within our current rules, as it is not justified on the basis of a risk-based approach to regulation. This should help to ensure that regulation does not distort business decisions and that firms

17 The UK liability insurance Market – OFT 659' by OFT, June 2003.

compete on the basis of the service that they offer to consumers rather than the extent to which they can manipulate our rules to their advantage.

6.35 The efficiency of competition should improve as more insurers enter the market. The insurers mentioned in paragraph 6.18, such as Magian and Interpolis, have been encouraged to write PII for personal investment firms as a result of our changes to the current rules. We believe our proposed rules should encourage more insurers into this market, which should benefit competition.

Direct costs to the FSA

6.36 The direct costs of regulation are those incurred by us to introduce and implement our proposals. We will continue to ask firms to self-certify that their PII policy meets our minimum requirements. We may initially incur additional costs in supervising firms' compliance with our proposed rules and some costs can be expected to arise from our dealing with queries about these rules.

6.37 Overall the costs arising from supervision as a result of our proposals are not expected to impose additional costs of more than minimal significance.

6.38 The one-off direct cost to us of making the rule changes proposed in this CP are estimated to be approximately £280,000[18].

6.39 The direct costs of our current rules have increased recently. Since the insurance market began to harden in 2002 we have found that an increasing number of firms have needed to contact us for help regarding their PII cover. This has ranged from firms who have policies that do not comply with our rules and request individual guidance to firms who have been unable to obtain any PII cover or do not want to pay for it. The cost of dealing with waiver requests, queries, individual guidance and regulatory decisions have been considerable. We expect these costs to be considerable going forward unless there is a significant softening in the market. These costs would then be passed on to firms because our costs would be allocated to the relevant fee blocks.

6.40 There are costs to the FSA in making small changes and clarifications to our current rules. We noted that we expected these to be of no more than minimal significance in CP169 (in relation to the general modification and subsequent rule change in Policy Statement published in June 2003). However, this is unlikely to be the case if small changes have to be made on a more regular basis.

18 584 staff days @ £364 per day plus £65,000 on consultants.

6.41 A reduction in the number of firms having difficulty with their PII, as a result of an improved supply of PII cover, would greatly reduce our supervision and monitoring costs. Approximately £2.5 million[19] will have been spent this year in FSA staff costs in dealing with cases for firms who are having trouble with PII. Dealing with individual cases for a large number of personal investment firms has been particularly time consuming as, to a lesser extent, have the relatively less radical changes to our PII rules set out in our recent policy statement. This is clearly not a process that we, firms or the insurance market would wish to repeat on a regular basis. Our proposed rules aim to reduce and ultimately remove these costs.

Compliance costs

6.42 Our requirements must, as a minimum, reflect Article 4.3 of the IMD. The two areas of change in our rules that the IMD affects are the proposals on aggregate levels of cover and which firms qualify for an exemption from PII. It is important that our policy applies the minimum standards in Article 4.3 at all times.

6.43 Our current rules go beyond the IMD's minimum requirements by imposing higher levels of aggregate cover for certain firms with a high turnover and by setting rules about the level of excess (which the IMD does not). Our proposal on aggregate limits aims to ensure that the amount of PII purchased is sufficient for all firms, whilst acknowledging that we do not operate a zero failure regime. Our proposals on excesses deal with PII policies with a high excess which reduces the intended value of the PII cover. We believe that rules about the policy excess are appropriate, however, our proposed rules ensure that any additional costs are proportionate to the risk arising from the excess.

Aggregate limits

Table 1: Effect of proposed changes to aggregate limits

Type of Firm	Relevant Income	Current Aggregate Limit	New Aggregate Limit
Very Small	Less than £166,000	£500,000	£949,000
Small	£166,000 to £333,000	£500,000 to £1,000,000	£949,000
Medium	£333,000 to £1,000,000	£1,000,000 to £3,000,000	£949,000
Large	£1,000,000 to £6,000,000	£3,000,000	£949,000
Large / National	£6,000,000 - £17,500,000	£3,000,000	£949,000 - £2,800,000

19 Based on 3 associate days per case, £52 per hour. per associate and 2300 cases. This includes current cases and a projection forward based on similar levels of cases.

Type of Firm	Relevant Income	Current Aggregate Limit	New Aggregate Limit
Very Large	Above £17,500,000	£3,0000,000	£3,200,000 plus
Networks	As above	£500,000 to £5,000,000	As above

6.44 Our proposed rules will give rise to costs. This will most obviously be apparent for the two smallest categories of firms (all firms with a relevant income of less than £330,000) and very large firms who might need to increase the level of aggregate cover they hold. The increases for the smallest firms under our proposed rules are as a result of the IMD. This directive sets a minimum aggregate cover limit of €1,500,000 for all firms irrespective of size. Had this not been the case, we would have proposed that most of these firms have the same level of cover (or less) as under the current rules. We are aware of some very large firms who already hold higher levels of cover than our current rules require. The increase in cost will arise from the increase in PII premiums that firms will have to pay. Logically firms will have to pay more for higher levels of cover. However, we would expect this to be a less than linear relationship. For example, a 50 per cent increase in aggregate cover might not mean a 50 per cent increase in premium.

6.45 In fact our figures suggest that the average premium paid in 2002 by a firm with aggregate cover of £500,000 (the current minimum in our rules) was £2691 per financial adviser and for a firm with aggregate cover of £1,000,000 was £3252 per financial adviser. This increase of 21% (£561) was coupled with an increase in the average excess of 19% (£3442 to £4095). It is worth noting that premiums reflect a variety of factors, not just the aggregate cover level. Other important factors for underwriters in arriving at these rates will include the risk rating given to the individual firm, the risk rating given to the firms in the perceived peer group, the excess the firm is paying and the stage in the overall insurance cycle[20].

6.46 Discussions with PII underwriters have indicated that the market will be able to provide these additional aggregate limits, but that premiums will increase.

20 ‘An analysis of current problems in the UK liability insurance market’ by Dr Christopher Parsons gives a good account of how prices are effected by the insurance cycle, as does his quotation in paragraph 6.22. This is a supplemental report to OFT659.

Table 2: Proportion of firms in bands of relevant income[21]

Relevant income	Estimated population	Percentage of total population	Assumed Turnover[22]
Up to £166,000	1808	45.2%	£100,000
£166,000-250,000	500	12.5%	£166,000
£250,000-330,000	296	7.4%	£250,000
£330,000-500,000	500	12.5%	£500,000
£500,000-667,000	228	5.7%	£667,000
£667,000-1,000,000	192	4.8%	£1,000,000
£1,000,000-6,000,000	440	11.0%	£6,000,000
£6,000,000-17,500,000	24	0.6%	£17,500,000
£17,500,000+	12	0.3%	£20,000,000

6.47 Using sampling (see table 2) we have attempted to estimate how many firms will have a higher aggregate cover requirement under our proposed rules. We believe that 45% of firms have a relevant income of less than £166,000 and would need to double their current level of aggregate cover. This equates to approximately 1800 of the 4000 personal investment firms. We have also found that 12.5% of firms (approximately 500) have relevant income between £166,000 and £250,000 and 7.4% of firms (approximately 300) have relevant income between £250,000 and £330,000[23].

6.48 Therefore we assume that:

- up to 1800 firms will need to increase their aggregate cover by £500,000, costing an average premium increase per Financial Adviser ('FA') of £561; given a median number of 2 FAs per firm this should lead to additional costs of £2,020,000 (£561 * 1800 * 2 FAs);
- approximately 500 firms will need to increase their aggregate cover by between £250,001 and £499,999, based on an average premium increase per FA of £561 (this assumes all firms will need the maximum increase); given a median number of 2 FAs per firm this should lead to additional costs of £561,000 (£561 * 500 * 2 FAs);

21 These figures come from a sample of 336 non-networks and has a margin of error of +/- 5%

22 Turnover assumptions allow us to estimate an upper limit on costs.

23 Sampling is necessary as paper reporting by personal investment firms means that this information is not readily obtainable.

- approximately 300 firms will need to increase their aggregate cover by between £10,000 and £250,000, based on an average premium increase per FA of £281 (assuming all firms will need to increase their cover by £250,000); given a median number of 4 FAs per firm this should lead to additional costs of £337,000 (£281 * 300 * 4 FAs); and
- this creates a total cost of £2,918,000 per annum. This cost is unavoidable because it arises directly from the IMD[24]. This is an upper end estimate of the cost as we have assumed the maximum increase for all firms in the band. Data from our 2003 survey of IFAs shows this to be a conservative estimate. It shows that for those with turnover below £330,000; 20% already have aggregate cover of £1,000,000 or more, 22.7% have aggregate cover between £500,000 and £1,000,000 and 57.3% have aggregate cover of £500,000[25]. The removal of mandatory minimum PII contract policy terms and conditions should help further reduce the size of the cost increase.

6.49 If it were not for the IMD, the results of our analysis would not have persuaded us to implement the proposed aggregate limits for firms with relevant income of less than £6,000,000. Instead we would have been content with a minimum aggregate limit of £500,000 for all firms with a relevant income under £3,000,000. For this reason we have proposed that firms who are not covered by the IMD hold minimum aggregate cover of £500,000 (the same limit as the current rules) subject to the relevant income limits described in this paragraph, and that firms with relevant income greater than £3,000,000 but less than £6,000,000 hold aggregate cover of £1,000,000. This could mitigate the cost described in paragraph 6.47. However, we believe that few personal investment firms fall outside the scope of the IMD.

6.50 Our proposed rules linking aggregate cover to relevant income for firms with more than £6,000,000 will lead to an increase in costs for some firms and a decrease for others. These rules are super-equivalent to the IMD. Our analysis has shown this to be justified based on the link between relevant income and total number of claims. Currently firms with a relevant income over £316,334 are required to hold PII with an aggregate limit higher than €1,500,000 or £949,000. These firms, particularly those with higher relevant income (i.e. approximately £1,000,000) should benefit from lower premiums as a result of

24 The figures of £561 and £281 (this is half of £561, we have assumed all firms will need to increase their cover by £250,000 hence half the cost of increasing by £500,000) were derived by using the assumed turnover figures in Table 2 of £166,000 and £250,000 to estimate the extra cover required and using £561 as the cost per FA of an additional £500,000 cover. The ultimate source of this data is from the costs per FA of different levels of aggregate cover (based on the current rules) included in the survey of AIFA members and workshop attendees. The median number of FAs estimate came from this survey plus the results of OP17 'The impact of fees and levies on non-networked Independent Financial Adviser (IFA) firms' – February 2002. These estimates of number of FAs is based on an average relevant income per FA in the ranges used. As such, the estimates of FAs per firm are high-end estimates.

25 From a sample of 110 firms.

lower mandatory levels of aggregate cover. Such firms in applying *Principles 3 and 4* might nevertheless choose to maintain higher levels of aggregate cover for reasons of prudence and risk management.

Table 3: Estimate of number of networks in bands of relevant income[26]

Relevant income	Number of firms	Average Size of firms in this Band	Change in the amount of aggregate cover required[27]
Less than £5,000,000	5	£2,500,000	- £4,000,000
£5,000,000 to £40,000,000	13	£21,500,000	-£1,200,000
£40,000,000 plus	2	£142,500,000	+ £6,500,000

6.51 There are currently networks with a relevant income of less than £5,000,000 who are required to hold PII with an aggregate limit of £5,000,000 (the requirement for most networks). We propose to abolish the distinction between networks and other firms for PII purposes in line with our risk-based approach to regulation. The figures in table 3 shows that all the networks with a relevant income of less than £40,000,000 will require less aggregate cover than they currently do. The five firms in the lowest band will on average require £4,000,000 less aggregate cover (£5,000,000 current rules versus £949,000 new rules) whilst the 13 firms in the middle band would on average require £1,200,000 less cover (£5,000,000 current rules versus £3,800,000 new rules).

6.52 It should also ensure that a small number of very large networks have PII cover which is adequate to mitigate the systemic risk they pose. In table 3 the two largest firms would need aggregate cover on average of nearly £11,500,000 compared to £5,000,000 at present. We are aware that such firms have often obtained levels in excess of our current rules in the past for risk management purposes. However, it is important that this is formalised for all firms with relevant income greater than £40,000,000 to help us meet our statutory objectives.

6.53 Firms (other than networks) with relevant income greater than £17,500,000 will be required to hold an aggregate level that is higher than our current requirements (a maximum aggregate level of £3,000,000). Our estimates suggest that 0.3% of firms (approximately 12) have relevant income greater

26 Based on November 2002 data for Networks.

27 This is based on the amount of aggregate required under the new rules compared with the old rules (£5,000,000 for all in this example) based on the average sizes in the third column.

than £17,500,000. This is because our data gathering and analysis has convinced us that claims are linked to the relevant income of a firm and are not capped at a certain level by size. Therefore for relevant income of up to £6,000,000 (subject to exchange rates) we are content that the IMD minimum of €1,500,000 is sufficient. Beyond this we believe it is prudent for firms to maintain aggregate cover of a set percentage of relevant income. The figures could have been set much higher to give us a higher confidence level that firms would not fail. However, we do not operate a zero failure regime and we do not believe that such aggregate levels would have been proportionate.

6.54 We estimate there are 12 very large firms and two large networks[28] for whom the proposed rules will mean an increase in the minimum level of aggregate cover required. Of these 12 very large firms we believe that seven are subsidiaries of large financial services firms and are eligible to receive a comparable guarantee from their parent that exempts them from our PII rules. However, as we do not have data for the costs of these higher levels of aggregate cover we are unable to provide quantitative estimates of what these cost increases will be.

Individual limits

6.55 Our current rules require firms to have an individual claim limit (also known as an 'any one claim limit') on their policy of three times relevant income subject to a minimum of £100,000. This limit need not exceed £3,000,000. The IMD requires a single claim limit of €1,000,000 (or £633,000). Our analysis shows that the size of claims is independent of the relevant income of firms and that only a small proportion of claims are greater than €1,000,000. In light of this, we believe that a single claim limit of €1,000,000 is appropriate for all firms. This will increase the required single claim limit for all firms with relevant income less than approximately £211,000 (under 58% of firms using table 2) but will reduce this limit for most firms over this size. Our discussions with underwriters have indicated that the aggregate cover limit that is the key determinant of the cost of cover as this is the ultimate risk (or maximum exposure) the underwriter faces. Therefore we expect the cost of these changes to the individual limit (which are necessary to comply with the Directive minimum) to be of no more than minimal significance. Non-IMD firms with relevant income less than £3,000,000 will be able to maintain a single claim limit of £500,000. Firms are, of course, free to choose a higher limit should they feel this is necessary for their protection.

28 We were able to obtain the figure of two networks from our records. However, for the large firms we did not have this level of data and therefore estimated based on the number of FAs these firms have. We have assumed that the average FA has a relevant income of £100,000. Therefore any firms with 175 FAs and over (excluding networks) were considered to have a relevant income of £17,500,000 plus. This should be a conservative estimate as previous research such as OP17 shows that FAs in larger firms such as networks tend to have a lower relevant income, on average, than FAs at smaller firms.

Excess

6.56 The policy excess is used by underwriters as an important tool to mitigate the risks they face from receiving claims. We currently have rules about the maximum excess firms can have on their PII policy and relate these rules to the relevant income of the firm. The logic of this approach is that it attempts to prevent firms having excesses at such a level that they run the risk of insolvency from a few claims, the assumption clearly being that firms with a higher relevant income can fund a higher excess. The IMD does not include any rules about what the excess should be. We explain below why we think this is still necessary. It should also be noted that the counterfactual situation (the current rules) includes rules on maximum excesses.

6.57 We accept that to have a properly functioning PII market it is necessary for underwriters to vary the excesses they place on contracts. We believe that firms benefit from the flexibility of being able to choose between varying levels of excess and financial resources. However, we believe that firms must have adequate resources to fund this excess. This increased flexibility, offered by our proposed rules, should be beneficial to smaller firms. For example, firms with a relevant income of less than £330,000 (approximately 65% of firms) are currently only able to hold an excess up to £10,000 or less. Provided such firms are willing and able to hold additional financial resources (in a readily realisable form) our proposed rules will not prescribe a maximum excess. Such firms should then benefit in terms of greater availability of PII cover at a more competitive price. It is worth noting that under our proposed rules we do not set any maximum or minimum excess limits but instead set out the amounts of additional financial resources a firm is required to retain for a particular level of excess.

6.58 Our analysis has shown that it would not be prudent to assume that all firms with a higher relevant income have sufficient resources to fund large excesses on their PII. We also do not believe that the claims up to this excess level could be met out of future income due to the variability of income and other competing demands on this income. This proposition potentially works when the economy is doing well. However, claims might tend to rise when the economy (and stock market) are in a downturn, which is the same time that sales and revenues fall, as recent ABI[29] statistics indicate. This is just the time when having adequate PI cover, possibly coupled with other financial resources, will become most valuable. For some firms there might be additional costs. This might be in terms of holding additional capital within their business and/or from an increase in the cost of PII cover directly as a result of having a lower excess.

29 Association of British Insurers – 'Long Term Insurance New Business Results Quarter 1 2003' dated May 2003 shows that single premium life products sales by IFAs fell 30.75% (by premium) from Q1 2002 to Q1 2003. Over the same period regular premium personal pensions sales by IFAs fell 24.39%. Total new individual long-term business across all distribution channels fell 15.1% over this period.

6.59 We have analysed claims data to decide what the maximum excess is beyond which firms should hold additional financial resources. Our analysis has clearly shown a positive correlation between the relevant income of a firm and the number of claims it receives. Different data sets have shown the average frequency of claims is somewhere between 1.1 and 1.8 claims per million of relevant income. Our analysis shows that this system of using additional financial resources to back up higher excesses strikes a balance between ensuring a sufficient proportion of firms are able to meet their excesses and not holding additional levels of financial resources that impose disproportionate costs.

Table 4: Effect of changes in excess rules

Relevant Income	Maximum excess allowed under current rules	Extra resources needed under new rules to maintain the old maximum excess[30]	Cost per annum of holding these extra resources[31]
up to £166,000	£5000	£0	£0
£333,000	£10,000	£11,000	£605
£666,000	£20,000	£27,000	£1485
£1,000,000	£30,000	£41,000	£2255
£2,000,000	£60,000	Up to £93,000	£5115
£3,000,000	£90,000	Up to £132,000	£7260
£5,000,000	£150,000	£212,000	£11,660
£10,000,000	£300,000	At least £344,000	£18,920

30 This table looks at the cost of the maximum excess under the current rules; the new rules will allow any excess provided sufficient additional financial resources are held.

31 The cost of capital is based on the average cost of an unsecured business loan (8%). Unincorporated personal investment firms could instead use a personal loan, which may be cheaper, but we use the business loan rate for all personal investment firms to produce an upper limit estimate. Our estimated cost of capital for these firms is the difference between the cost of an unsecured business loan and the return that personal investment firms could make on that capital if it were invested in liquid assets (e.g. a deposit account). Based on this we estimate the net cost of capital to be 5.5%. Because of uncertainty about future returns, there is no single "right" estimate of the cost of capital. The fact that this money must be held as 'own funds' restricts the format in which it can be held. However, we do not believe this should have a significant impact on this estimate. There is rather a range of reasonable estimates, within which our estimate lies.

Table 5: Estimated cost of new rules for firms wishing to maintain the current maximum excess allowable[32].

Relevant income	Estimated population	Percentage of total population	Cost of new excess rules
Up to £166,000	1808	45.2%	£0
£166,000-330,000	796	19.9%	£482,000
£330,001-667,000	728	18.2%	£1,081,000
£667,0001-1,000,000	192	4.8%	£433,000
£1,000,001-6,000,000	440	11.0%	£5,130,000
£6,000,001 +	36	0.9%	£681,000
Total	**4000**	**100**	**£7,807,000**

6.60 Table 5 works on the assumption that firms do not currently hold any of the resources required to meet our proposed rules (this is the cost of maintaining the maximum excess under the current rules) on the excess / financial resources trade off and will need to raise all of this money. It also over estimates the total cost by assuming most firms have a relevant income at the top of the relevant income bands. The figures are partly based on the table in our proposed rules (13.1.4 (12) E). The costs would be likely to reduce if we were to use a far more detailed table providing exact amounts of own funds required for a much wider range of excesses and levels of relevant income.

6.61 Moving to a system where financial resources back up the excess held on the PII policy raises questions about the affordability of such rules for firms. We have analysed this using survey data we have gathered regarding relevant income, excess and additional own funds. We found from the survey data that using our proposed rules 5% of personal investment firms would need additional financial resources to hold the maximum excess they are allowed under the current rules.

32 This table cross refers to table 4 in terms of the cost of raising the additional resources and assumes a relevant income for all firms of the top end of the range (e.g. for £667,000- £1,000,000 relevant income of £1,000,000 is assumed) to produce upper estimates except for the bottom two rows where relevant income of £5,000,000 and £10,000,000 is assumed. We have used the higher annual costs from table 4 to produce the figures in the 'cost of new excess rules' column.

Table 6: Analysis of affordability of excess rules

Relevant income	Max allowable excess under our current rules[33]	Amount of capital required to retain this current excess level under new rules	Average own funds actually held	Median own funds actually held
Up to £167,000	£5000	£0	£94,000	£20,000
£167,000-£330,000	£10,000	£11,000	£119,000	£52,774
£330,001-£667,000	£20,000	£22,000	£127,000	£72,184
£667,001-£1,000,000	£30,000	£41,000	£151,000	£100,000
£1,000,001-£2,000,000	£60,000	Up to £93,000	£376,000	£293,860

6.62 Table 6 shows the amount of capital required for firms to continue retaining the maximum excess permitted under our current rules, should our proposed rules come into force. It compares this with the average and median amount of own funds our surveys have shown these firms to hold. This is in some ways a worst case scenario, as it assumes that firms would only be able to obtain/afford PI cover with their maximum excess (firms will now be able to choose their excess under our proposed rules) and that firms have no other readily realisable resources. It also shows that most smaller firms should be able to afford the excesses illustrated, whilst many would appear to have sufficient resources to hold a higher policy excess than is currently allowable. Overall we believe that 95% of firms already have sufficient resources to meet the additional financial resources requirement under the new rules, whilst retaining the maximum excess allowable under the current rules. It is worth noting that firms will be able to choose the level of excess they hold (subject to market availability), so these additional resource requirements are only optional.

6.63 Whilst we believe that 95% of firms have sufficient financial resources to maintain their current maximum excess under the proposed rules, we recognise that firms might hold these additional resources for other reasons. We have previously done research into the amounts of financial resources other regulated firms hold above their minimum regulatory requirements and their reasons for doing so. This research showed that many firms held amounts of financial resources that were significantly in excess of our

33 Our current rules specify that the maximum excess can be £5000 or 3% of relevant income, whichever is higher.

requirements. An explanation for this has been proposed[34]. This assumes that firms hold these financial resources in order to be able to take advantage of investment opportunities when they arise, rather than attempt to raise money (e.g. through new share issues) to take advantage of such opportunities. This would be due to the perceived detriment to the shareholders of the firm in raising these resources on an adhoc basis. If this is why so many personal investment firms hold additional financial resources, it follows that having to hold more of these amounts as regulatory capital could result in additional costs to firms in either foregoing investment opportunities or raising more financial resources to allow for such investments. This argument might not be that strong for personal investment firms, most of whom are not listed. However, this does not exclude the possibility that surplus own funds are not really set aside for regulatory purposes.

6.64 The results of the electronic voting at the PII workshops provide an interesting snapshot of opinion on the issue of the correct level of excess and the trade off between PII and capital.

- 60% (208) of respondents believed that up to £5,000 was an acceptable level of excess to give adequate protection to both firms and consumers (28% thought £5000 - £10000).
- 73% (282) thought the FSA should introduce a system that links capital to the excess.
- 78% (251) have access to or maintain significant surplus financial resources compared to the minimum requirements.

These results suggest that firms have an appetite for such a trade off whilst recognising that higher excesses need to be backed by adequate financial resources.

Cost of capital / additional financial resources

6.65 We estimate the cost of capital for personal investment firms to be no more than 5.5% of the capital held[35]. This figure is commonly used to estimate the cost of holding additional financial resources. Due to the inverse relationship between the amount of excess retained and the premium charged by the insurer there is an implicit upfront benefit (i.e. lower premium) for firms in accepting a policy with a higher excess. However, over the term of the policy this will probably be counteracted by a higher rate of erosion of a firm's capital when meeting claims. Firms with good systems and controls might benefit from taking a policy with a high excess if these systems and controls result in their financial resources not being eroded by claims.

34 This comes from the corporate finance area of academic economics literature

35 This figure is based on the cost of unsecured loans for incorporated firms less the return that could be made if the capital were invested in liquid assets.

6.66 The figures in table 4 and table 6 suggest that most firms can afford higher policy excesses but that there are still firms who do not appear to have sufficient financial resources to cover the excess they have. A benefit of this proposed rule change is that these firms, without the additional resources proposed, run an increased risk of financial failure and subsequently pose potential costs to other market participants (via unpaid claims being paid by the FSCS) and ultimately consumers when such claims are not met. This reduces the risk of well managed firms subsidising those that are risky and poorly managed via the FSCS, as might happen under the current rules.

Exemptions

6.67 The IMD allows for an exemption from PII if a comparable guarantee is provided. We have interpreted this to mean that a PII policy is not required if the firm receives a guarantee to indemnify the firm by an amount equal to that which the PII policy would have offered. This is slightly more restrictive than our current rules on exemptions in some respects, as it does not allow an exemption based on a market capitalisation of more than £50 million at all times. We expect the compliance costs of this to be limited as there are very few firms who can take advantage of this and most of these firms hold PII voluntarily. This exemption was problematic due to the volatility of equity prices and the assumption that stock market capitalisation indicated that firms had adequate resources. However, our proposed rules do make it clear that the comparable guarantee need not be for any more than the aggregate limit the firm would have normally been required to have under our rules. This is beneficial for the parent firm as it allows them to cap their potential liability and make provision for this.

Exclusions

6.68 There is a clear risk to firms in accepting a policy that excludes certain specified types of past business or activities for which a personal investment firms is potentially liable. We recognise that in some circumstances insurers will wish to do this for risk management purposes. Should firms accept such cover, they will need to hold additional financial resources. It is difficult to write rules that cover every single scenario due to the variability and changes over time to such scenarios. Therefore we have drafted our proposed rules to make it clear that firms must make provision for such exclusions and that they must take reasonable steps to quantify what these provisions must be. This is good business practice and consistent with our policy on senior management responsibilities. We do not believe this imposes any additional costs on firms as this only formalises our current supervisory approach. However, this might have benefits in allowing firms the flexibility to substitute financial resources for PII where they have potential liabilities that the

commercial PII market is unwilling to cover. This should reduce the number of firms with non-compliant policies, and this should reduce our costs and the cost to firms.

Compliance clause and detailed appendix on policy terms and conditions

6.69 The removal of the part of the appendix on the exact minimum terms and conditions a PII policy should adhere to places much more emphasis on the senior management and/or principals of firms to ensure the policy they have is adequate. We expect this will initially increase costs for some firms in terms of the amount of managers' and/or principals' time spent doing this. This is an inevitable result of increased flexibility. This will reduce over time as firms become more familiar with our requirements. We expect brokers will play a key role in assisting firms in finding compliant cover. The IMD and ICOB (Insurance Conduct of Business)[36] should help raise the standards of service provided by insurance brokers to their clients. Firms should also benefit from a reduced amount of time in searching for compliant cover. We estimate that the daily rate for an FA is £234[37]. Thus if each firm were to save two days we estimate a cost saving of approximately £1,872,000 (£234*2*4000 firms)[38].

6.70 We acknowledged in CP169 that the supply-side problems in the PII market for personal investment firms are partly due to perception of past business reviews and uncertainty as to the interpretation of our requirements. We believe that the move away from highly detailed rules regarding the exact terms and conditions of the PII policy contract will remove some of this uncertainty.

Summary of direct and compliance costs

Table 7: Summary of our upper estimates of compliance costs

Relevant income	Potential cost of new excess rules	Cost of new aggregate limits rules	Total
Less than £166,000	£0	£2,020,000	£2,020,000
£166,001 - 250,000	£161,000*	£561,000	£722,000
£250,001 - 330,000	£321,000*	£337,000	£658,000
£330,001 - 500,000	£360,000*	£0	£360,000

36 We are currently consulting on ICOB, please see CP187, published in June 2003.

37 'Cost Benefit Analysis: Depolarisation and the Remuneration of Financial Advisers' A Report for the Financial Services Authority Prepared by NERA 20 December 2002.

38 We think this is a reasonable estimate based on the filling out of application forms, finding brokers, approaching underwriters and possibly arranging individual guidance with the FSA. This has in part been informed by correspondence received by Investment Firms Division from firms.

Relevant income	Potential cost of new excess rules	Cost of new aggregate limits rules	Total
£500,000 – 667,000	£721,000*	£0	£721,000
£667,000 – 1,000,000	£433,000	£0	£433,000
£1,000,000 – 6,000,000	£5,130,000	£0	£5,130,000
£6,000,000 – 17,500,000		£0	
£17,500,000 +	£681,000	increased cost for firms	£681,000
£40,000,000 +		increased cost for Networks	
	£7,807,000	**£2,918,000**	**£10,725,000**

* These figures are derived using the figures from Table 5 and attributing 1/3 of the cost to the lower relevant income band and 2/3 of the cost to the higher band e.g. £161,000 + £321,000 = £482,000.

6.71 The increased costs in column two of table 7 are optional. It assumes firms choose to obtain the maximum excess under the current rules. Should firms choose a lower excess or £5000 or less the costs will be lower or nothing at all (depending on how much their PII increases).

6.72 All compliance costs noted in table 7 are assumed to be annual ongoing estimates. There are also direct costs to us in developing and implementing the proposed rules whilst firms will also have to spend time familiarising themselves with the proposed rules and requirements. However, this will be staggered across the annual renewal process allowing firms to have time to prepare. We will also run a series of workshops which will help firms understand the rules and answer particular queries[39]. We expect our direct costs and direct costs to firms of implementing the new rules to be of a one-off nature and of no more than minimal significance.

6.73 The costs in italics in table 7 are as a result of the minimum limits of indemnity under the IMD. In total, £2,918,000 of the incremental costs are due to minimum requirements of EU Directives. £7,807,000 of the incremental costs are due to our limited super-equivalence. We believe the former estimates are probably on the high side, as firms are unlikely to need to pay the full cost of the increased cover as they will not be perceived as being as high risk as the firms on which these figures were based. Due to a lack of data we are unable to provide estimates of the costs of increased

39 For more details of the workshops please see our website: www.fsa.gov.uk/industry/pii-apr03.html

aggregate limits for firms with relevant income over £17,500,000 and networks with relevant income over £40,000,000. The numbers of firms affected will be approximately 14 but we know that some of these firms already have aggregate limit cover in excess of current requirements. All incremental costs for these very large firms and networks will be due to our limited super-equivalence.

6.74 The figure of £10,725,000 is very much an upper estimate due to the high figures used for cost of capital, the fact some costs are dependent on the decisions of firms and the use of assumptions that use the highest possible cost in most circumstances. It is also worth noting that a large proportion of these costs is at the discretion of firms. For example, the proposed rules allow for virtually any excess, provided that firms hold sufficient financial resources. The discussion of indirect costs and benefits in this CBA also puts forward further reasons why these compliance cost estimates are likely to be upper limit estimates.

Cost savings

6.75 The reduction in minimum aggregate limits and individual claim limits for firms with relevant income between £333,000 and £17,500,000 should produce costs savings for firms in this range. We estimate that this should be up to 34.6% of personal investment firms[40]. We have used this data to provide a rough estimate of how much firms might save as a result of having to hold a lower aggregate limit under the proposed rules. We have generally assumed that firms have the lowest relevant income in their band in order to produce the lowest estimate except for the highest band where doing so would have increased the estimate.

40 These figures come from a sample of 336 non-networks and has a margin of error of +/- 5%

Table 8: Estimated cost savings for firms as a result of lower aggregate limits

Relevant income	Estimated population	Assumed turnover[41]	Reduction in aggregate cover assumed	PI premium saving per firm[42]	Total PI premium saving
£330,000-£500,000	500	£330,000	£0	£0	£0
£500,000-£667,000	228	£500,000	£500,000	£1,970	£449,000
£667,000-£1,000,000	192	£667,000	£1,000,000	£3,940	£756,000
£1,000,000-£6,000,000	440	£1,000,000	£2,000,000	£25,619	£11,272,000
£6,000,000-£17,500,000	24	£12,500,000	£1,000,000	£21,679	£520,000
	1384				**£12,997,000**

6.76 This means that, on balance, while we do not offset savings against increases, compliance cost increases are most likely to fall on firms in the £0 - £500,000 bracket of relevant income (for the proportion of these firms whose relevant income is below £250,000 this increase is mainly as a result of the IMD) and those firms with a relevant income greater than £6,000,000.

Q17: Do you have any comments on our CBA?

41 Turnover assumptions allow us to estimate a lower limit on reduced costs.

42 Based on our survey of personal investment firms, we found that the cost of cover were approximately as follows: £1 Million = £8,035; £1.5 Million = £10,005; £2 Million = £11,975 & £3 Million = £33,654. N.B. the cost for £1.5 Million was established by extrapolating between the costs for £1 Million and £2 Million. The figures were based on PII premiums supplied by 201 firms.

7 Compatibility Statement

Introduction

7.1 This section explains why we believe that our proposed rules are compatible with our general duties under Section 2 of the Financial Services and Markets Act 2000 ('FSMA'). The requirement for this explanation is in Sections 155 and 157 of the Act.

Our statutory objectives

7.2 We believe that the proposals set out in this CP are relevant to our market confidence and consumer protection objectives.

Market confidence

7.3 All of the changes to our PII policy are relevant to this objective and one of our key aims in proposing them is to enhance market confidence. The market that concerns us here is the market for financial advice from personal investment firms. In simple terms, this is the market that provides advice and ongoing service to consumers and small businesses about retail financial products.

7.4 The proposals described in this CP are designed to improve the supply of PII to personal investment firms by providing a more flexible set of requirements, whilst not reducing the level of protection offered to firms by this sort of cover.

7.5 The proposals should help firms to maintain adequate resources through a combination of PII and other financial resources. This will enable them to meet claims on their business as and when they arise. The proposals also aim to reduce the 'moral hazard' risk of well managed firms subsidising poorly managed firms via contributions to the FSCS when these poorly managed firms fail.

7.6 Widespread failures of personal investment firms could affect the confidence of consumers in this sector and make them unwilling to deal with personal investment firms. We balance this risk by noting that we do not operate a zero failure regime and recognise that it is not desirable for us to attempt to keep all firms in business.

7.7 Therefore, our proposals should help to reduce the number of claims on the FSCS, which are funded by the rest of the participant firms within the relevant contribution group. It is in the interest of all well managed firms to avoid increased claims on the compensation scheme.

Consumer protection

7.8 We believe that the key risk to consumers arises when firms are unable to meet legitimate claims made by consumers from their own financial resources. PII provides additional resources with which firms can meet such legitimate claims without becoming insolvent. The proposed changes to our PII policy requirements will help to ensure firms maintain adequate resources overall but also give them the ability to decide what combination of PII and financial resources they hold. Creating a system that allows more firms to meet our threshold condition regarding adequate resources using a flexible combination of PII and other financial resources should benefit the consumers who receive advice and have received advice from these firms.

Public awareness

7.9 The proposals in this CP will have no material impact on this statutory objective.

Financial crime

7.10 The proposals in this CP will have no material impact on this statutory objective.

Explanation of why the change is the most appropriate way of achieving our regulatory objectives

7.11 Our PII rules for personal investment firms help to ensure that these firms have adequate resources, as required by Threshold Condition Four. As mentioned above this primarily impacts on our consumer protection and market confidence objectives. We feel that the best way for us to achieve this in future is to implement the more flexible regime proposed. These changes offer flexibility, as they are less prescriptive regarding the PII contract terms and conditions than our current rules. The absence of prescribed detailed wording will allow firms' senior management to negotiate PII cover that is

tailored to their business needs and also encourage those PII providers who were unhappy with aspects of our prescribed wording to write cover. Further flexibility is offered by allowing firms to decide how much financial resources and PII they hold.

7.12 An alternative to PII would be high capital requirements to ensure that consumers are protected. This tool could act as a barrier to entry or encourage firms that would prefer to remain directly authorised to join a network. Small firms would be particularly affected by such an approach. We are therefore of the opinion that such a policy would be less appropriate, as it would be less proportionate than the proposals advanced here.

7.13 We believe that the proposed changes will encourage more PII providers into the PII market for personal investment firms. This will help solve the difficulties personal investment firms are having obtaining PII cover and increase capacity in the PII market.

7.14 We also propose to amend our rules to ensure that firms that hold a PII policy with an excess greater than our minimum hold sufficient financial resources to fund this excess if they are subject to claims.

7.15 Our proposals continue to protect consumers, meet EU directive requirements and give confidence to other market participants without being too onerous on the firms required to hold PII.

Explanation of how the change fits with the principles of good regulation

7.16 Section 2(3) of the Act requires us to consider the following principles when making new rules and guidance:

The need to use resources in the most efficient and economic way

7.17 Because these proposed changes aim to improve the supply of PII, they should reduce the number of waivers and requests for individual guidance that we receive from personal investment firms who are unable to obtain compliant PII cover. We have continued to make use of evidential provisions in framing our policy as this allows us some flexibility in implementing rules. This should be helped by the fact that firms will be given more responsibility in deciding whether their cover is adequate or not. Therefore this will reduce the burden on our supervisory resources (so far Investment Firms Division has spent approximately £2,500,000[43] in dealing with requests for waivers and individual guidance relating to PII).

43 Based on three associate days per case, £52 p.h. per associate and 2300 cases. This includes current cases and a projection forward based on similar levels of cases.

7.18 Also, by making radical changes now to the current rules, we expect to reduce the cost to the FSA of making adhoc changes to the PII rules on a regular basis.

The responsibilities of those who manage the affairs of authorised persons

7.19 In line with other areas of the FSA Handbook, our proposals in this CP have been framed as high-level principles using detailed rules and guidance. The objective has been to give the responsibility to directors, senior managers and principals of personal investment firms to manage the risks to their firm and to combine a PII policy and other resources in a way that is adequate for their business.

7.20 This is in line with the FSA's Principles for Businesses 3 and 4 which state that a firm is required to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems and to maintain adequate financial resources. The Senior Management Arrangements, Systems and Controls (SYSC) also places responsibility on senior managers to manage and exercise control over the business.

7.21 We operate a non-zero failure regime and our rules are drafted to reflect this. This places a responsibility on senior managers / principals to hold resources above our minimum requirements should their own assessment suggest this is necessary.

The principle that a burden or restriction should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction

7.22 We have carried out a cost benefit analysis of our proposals in line with section 155(2) (a) of the Act and we are satisfied that the costs are proportionate to the benefits.

The desirability of facilitating innovation in connection with regulated activities

7.23 Our proposals set out the type and amount of PII necessary to mitigate the risks a firm faces from claims relating to its business. Provided the policy meets these standard requirements, personal investment firms and their brokers can negotiate price and contract terms with the PII providers. This should allow demand and supply to interact more freely and, specifically, personal investment firms and their brokers to obtain new and more appropriate products. PII providers can meet this demand and supply innovative products where they are of the opinion that demand will be forthcoming.

7.24 This should encourage PII providers into the market, which will help firms obtain compliant cover. Also, one of the proposals sets out that a firm's excess must not exceed £5000, unless the firm holds additional levels of financial resources. This gives firms some latitude when obtaining PII cover, yet still continues to protect the firm, and therefore the consumer.

The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

7.25 We do not believe the changes we are proposing have much of a bearing on this principle as most personal investment firms do not compete on an international basis. However, our proposed rules do take account of the minimum PII requirements of the IMD which personal investment firms will have to comply with from January 2005.

The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions.

7.26 It was clear that the current rules had the potential to cause personal investment firms to leave the market and could also discourage new personal investment firms from setting up. While there was no evidence to suggest this might be bad for effective competition, the proposed rules have been designed to help us to secure our regulatory objectives whilst minimising exits and barriers to entry. The prescriptive nature of the current rules arguably had the potential to influence demand (and therefore supply) conditions in a way that could have led to competition issues in the market for the supply of PII. We have introduced a greater degree of flexibility into the proposed rules to further limit the possibility of adverse competition effects. The rules for networks have been brought into line with those applying to other personal investment firms as there was no risk-based reason for maintaining this different treatment.

The desirability of facilitating competition between those who are subject to any form of regulation by the FSA

7.27 These proposals provide greater flexibility than the current rules and thus have the potential to facilitate competition both between PII providers and between personal investment firms. The proposals allow market forces to play a more significant role in determining the nature of the product and provides for alternatives (in the form of higher capital to be held instead of excesses

and exclusions) that will help to ensure that demand can respond to market conditions. A fuller discussion of the competition effects of the proposals is in the market impacts section of the CBA.

Q18: Do you have any comments on our Compatibility Statement?

List of questions

Q1: Do you have any comments on the thinking (as set out in Chapter 3 of this CP) that underlies our revised policy?

Q2: Do you have any comments on the scope of what a PII policy should cover; for example, our proposal to include a firm's unregulated as well as regulated business activities within the scope of its PII policy?

Q3: Do you agree with the levels of cover proposed for firms that fall outside the scope of the IMD? We would particularly like to hear the views of those firms that believe they fall outside the scope of the IMD and to understand how they have arrived at this conclusion.

Q4: Would it be helpful if we included some guidance in the FSA Handbook on what we consider to be reasonable steps to ensure that policies provide at least equivalent levels of cover as those specified by our PII rules, regardless of the currency of denomination?

Q5: Do you think that the proposed limits for the level of aggregate PII cover strike the right balance between ensuring that firms have an adequate level of cover and not placing undue costs on firms?

Q6: Do you agree that additional own funds should be held in a readily realisable form as defined in 13.1.4 (4) G? If not, how should our definition be amended?

Q7: Do you think the table in 13.1.4 (12) E is easy to use? If not, what improvements would you suggest?

Q8: Do you think that the own funds required in the table in 13.1.4 (12) E are proportionate to the risk of firms claims

that may arise, whilst providing adequate protection? If not, do you think that the additional own funds requirements should be higher or lower, particularly for firms that hold an excess of more than £200,000 (For example, no less than the level of excess carried)?

Q9: Even with a requirement to hold additional own funds that increases with the size of excess, do you think that we should impose limits on the maximum size of excess permissible? If so, what do you think this should be based on?

Q10: Do you support our proposal to permit firms to have group policies? If so, do you also support our proposal to permit both connected and unconnected firms to take out "group" or combined policies? In addition, do you agree with the conditions we have attached to those firms that participate in group or combined policies?

Q11: Do you agree that we should provide guidance to firms on how they should assess the amount of own funds to be held to cover potential liabilities for any excluded business or activity?

Q12: Do you think that the proposal to exempt members of the same group as a bank, building society or insurer, if a comparable guarantee is in place, is sufficient? Or, should it be extended to include:

- other authorised entities as well as banks, building societies and insurers that are able to provide a comparable guarantee? If so, which other entities do you think should be included within this exemption?; and/or
- subsidiaries of banks, building societies or insurers where the parent or ultimate holding company is an authorised person and able to provide a comparable guarantee?

Q13: Do you think that the new notification requirements we are proposing are reasonable?

Q14: Do you think that our rules should retain a specific requirement for firms to have cover for legal defence costs and/or Ombudsman awards, bearing in mind that this is implicitly covered in 13.1.4 (2) R (a), which requires a firm's PII policy to make provision for cover in respect of any claim for loss or damages?

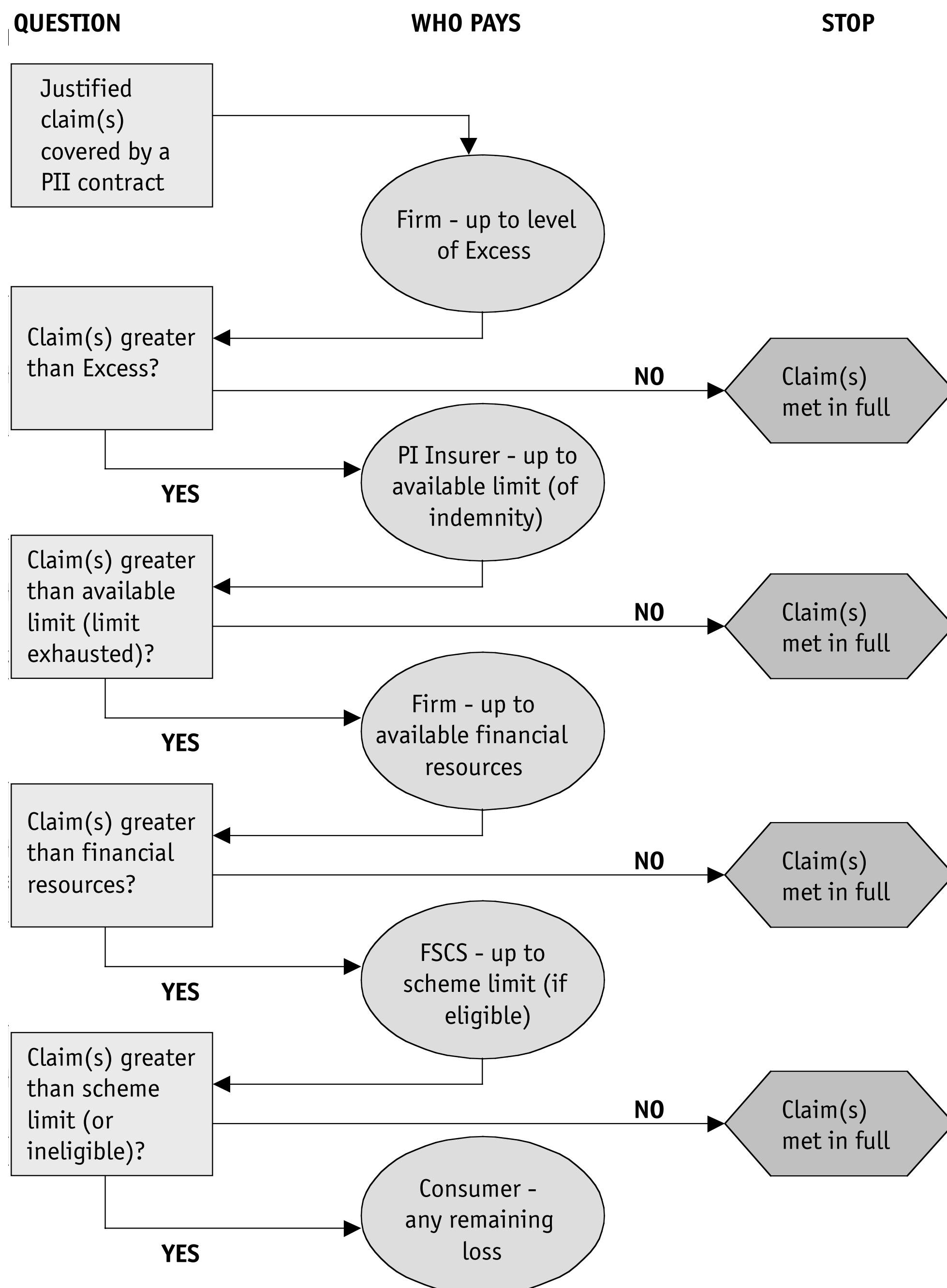
Q15: Do you think that our proposed rule changes will make it easier for firms to obtain compliant PII cover?

Q16: Do you have any other comments on our proposed rule amendments?

Q17: Do you have any comments on our CBA?

Q18: Do you have any comments on our Compatibility Statement?

Loss flowchart



Worked examples

Example 1:

An IMD firm with a relevant income of £135,000 receives a quote for a PII policy which has a general excess of £4000 and an excess for a particular business line (in which the firm has done business) of £12,000. This firm needs to obtain:

1. A PII policy with **limits of indemnity** that are no lower than the equivalent of €1,000,000 for a single claim and €1,500,000 for aggregate claims. This is in line with the minimum IMD requirements detailed in 13.1.4(2)(b).
2. **Additional own funds** of £11,000. This is calculated by referring to the table in 13.1.4(12). In this table £135,000 relevant income fits the row 'more than 100' and 'up to 200'. The highest excess of £12,000 fits the column 'Excess obtained up to 15'. The column and row intersect at '11'. So, the firm needs to hold additional own funds of £11,000 in a readily realisable form (i.e. able to be realised in 90 days).

Example 2:

An IMD firm with a relevant income of £24,000,000 receives a quote for a PII policy which has a general excess of £25,000. This firm needs to obtain:

1. A PII policy with **limits of indemnity** that are no lower than the equivalent of €1,000,000 for a single claim in line with the minimum IMD requirements detailed in 13.1.4(2)(b) and £3,800,000 for aggregate claims as per 13.1.4(5)(a)(i).
2. **Additional own funds** of £259,200. This is calculated by referring to the table in 13.1.4(12). In this table £24,000,000 relevant income fits the row 'more than 10,000' and 'up to 100,000'. The highest relevant excess of £25,000 fits the column 'Excess obtained up to 25'. The column and row

intersect at '108y'. y = relevant income divided by £10m = 2.4. So, the firm needs to hold additional own funds of 108*2.4 = £259,200, in a readily realisable form.

Example 3:

A *non*-IMD firm with a relevant income of £50,000 receives a quote for a PII policy which has a general excess of £3,000. This firm needs to obtain:

1. A PII policy with **limits of indemnity** that are no lower than the equivalent of £500,000 for a single claim and £500,000 for aggregate claims as per 13.1.4(2)(c)(i).
2. The policy complies with 13.1.4(10)(a)(i). **No additional own funds are required.** (This is confirmed by referring to the table in 13.1.4(12)). In this table any 'Excess obtained up to 5' results in £0 additional own funds.

Example 4:

An IMD Network firm with a relevant income of £8,500,000 receives a quote for a PII policy with a general excess of £20,000 and an excess for a line of business (that the firm has not done and will not do during the term of the policy) of £45,000. This firm needs to obtain:

1. A PII policy with **limits of indemnity** that are no lower than the equivalent of €1,000,000 for a single claim in line with the minimum IMD requirements detailed in 13.1.4(2)(b) and £1,475,000 for aggregate claims as per 13.1.4(5)(a)(i).
2. **Additional own funds** of £90,000. This is calculated by referring to the table in 13.1.4(12). In this table £8,500,000 relevant income fits the row 'more than 8,000' and 'up to 9,000'. The highest excess for business the firm has done is £20,000, and this fits the column 'Excess obtained up to 20'. The column and row intersect at '90'. So, the firm needs to hold additional own funds of £90,000 in a readily realisable form (i.e., able to be realised in 90 days).

Example 5:

Two unconnected IMD firms wish to be on the same policy. Firm A has a relevant income of £4,000,000 and Firm B has a relevant income of £3,000,000. The policy quote has a general excess of £50,000. The firms need to obtain:

1. A PII policy with **limits of indemnity** that are no lower than the equivalent of €1,000,000 for a single claim in line with the minimum IMD requirements detailed in 13.1.4(2)(b) and £1,200,000 for aggregate claims as per 13.1.4(5)(a)(i) and 13.1.4(15)(a). The aggregate limit is calculated by

combining the relevant incomes of the two firms concerned (£4,000,000 plus £3,000,000 equals £7,000,000) and then using the row ‘more than 6,000,000’ and ‘up to 7,000,000’ to find the relevant minimum limit of indemnity.

2. **Additional own funds** held by firm A of £102,000. This is calculated by referring to the table in 13.1.4(12). In this table £4,000,000 relevant income fits the row 'more than 3,500' and 'up to 4,000'. The policy excess of £50,000 fits the column 'Excess obtained up to 50'. The column and row intersect at '102'. So, the firm needs to hold additional own funds of £102,000, in a readily realisable form
3. **Additional own funds** held by firm B of £89,000. This is calculated by referring to the table in 13.1.4(12). In this table £3,000,000 relevant income fits the row 'more than 2,500' and 'up to 3,000'. The policy excess of £50,000 fits the column 'Excess obtained up to 50'. The column and row intersect at '89'. So, the firm needs to hold additional own funds of £89,000, in a readily realisable form

Proposed handbook text

In IPRU(INV) 13, delete 13.1.3 to 13.1.5 inclusive and replace with:

REQUIREMENT TO HOLD PROFESSIONAL INDEMNITY INSURANCE

13.1.3(1) G Under *Principles 3* and *4* a *firm* is required to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems and to maintain adequate financial resources. Under *Principle 9* a *firm* is obliged to take reasonable care to ensure the suitability of its *advice on investments* and discretionary decisions for any *customer* who is entitled to rely upon its judgement.

13.1.3(2) G Although financial resources and appropriate systems and controls can generally mitigate operational risk, professional indemnity insurance has a role in mitigating the risks a *firm* faces in its day to day operations, including those arising from not meeting the legally required standard of care when *advising on investments*. The purpose of 13.1.4(1) to 13.1.4(15) is to ensure that a *firm* has in place the type, and level, of professional indemnity insurance necessary to mitigate these risks.

13.1.3(3) **R** **The term "relevant income" in IPRU(INV) 13.1 refers to all income received or receivable which is commission, brokerage, fees or other related income, whether arising from the *firm's permitted activities* or not, for the last accounting year prior to inception or renewal of the professional indemnity insurance policy ("the policy").**

13.1.4(1) **R** **A *firm* must take out and maintain at all times professional indemnity insurance that is at least equal to the requirements of 13.1.4(2) to 13.1.4(15).**

13.1.4(2) **R** **The policy must incorporate terms which are appropriate and must make provision for:**

(a) cover in respect of any claim for loss or damage, for which the *firm* may be liable as a result of an act or omission by:

(i) the *firm*; or

(ii) any *person* acting on behalf of the *firm* including *employees*, *appointed representatives* or its other agents;

(b) appropriate minimum *limits of indemnity* per year, which are, if the *firm* is an *IMD insurance intermediary*, no lower than:

(i) €1,000,000 for a single claim against the *firm*; and

(ii) €1,500,000 in the aggregate;

(c) if the *firm* is not an *IMD insurance intermediary,* then the following *limits of indemnity* apply:

(i) if the *firm* has relevant income of up to £3,000,000, no lower than £500,000 for a single claim against the *firm* and £500,000 in the aggregate; or

(ii) if the *firm* has relevant income of more than £3,000,000, no lower than £650,000 for a single claim against the *firm* and £1,000,000 in the aggregate.

(d) [in the case of a *UK firm* exercising an *EEA right*, cover for breaches of obligations imposed by or under laws, or provisions having the force of law, in each *EEA State* in which the *firm* carries on business.[1]]

13.1.4(3) **R** **If a policy is denominated in any currency other than euros, an *IMD insurance intermediary* must take reasonable steps to ensure that the *limits of indemnity* are at least equivalent to those required in 13.1.4(2)(b).**

13.1.4(4) G For the purposes of the following provisions relating to professional indemnity insurance, the *FSA* expects items included in *own funds* to be regarded as "readily realisable" only if they can be realised, at any given time, within 90 days.

13.1.4(5) E (a) In addition to the requirements in 13.1.4(2), the policy should make provision for the following:

(i) for a *firm* with relevant income of more than £6,000,000, the total aggregate limit required is at the level set out in the table below:

Relevant income is (£)		Minimum *limit of indemnity* (£)
more than	up to	
6,000,000	7,000,000	1,200,000
7,000,000	8,000,000	1,300,000
8,000,000	9,000,000	1,475,000
9,000,000	10,000,000	1,600,000
10,000,000	12,500,000	2,000,000
12,500,000	15,000,000	2,500,000

[1] We plan to bring this rule into place on 15 January 2005

15,000,000	17,500,000	2,800,000
17,500,000	20,000,000	3,200,000
20,000,000	25,000,000	3,800,000
25,000,000	30,000,000	4,250,000
30,000,000	35,000,000	4,500,000
35,000,000	40,000,000	4,750,000
40,000,000	50,000,000	5,500,000
50,000,000	75,000,000	7,000,000
75,000,000	100,000,000	8,500,000
100,000,000	150,000,000	11,500,000
150,000,000	200,000,000	14,000,000
200,000,000	250,000,000	17,000,000
250,000,000	300,000,000	20,000,000
300,000,000	n/a	23,000,000

(ii) appropriate cover in respect of legal defence costs;

(iii) full retroactive cover in respect of the kinds of liabilities described in 13.1.4(2) for claims arising from work carried out by the *firm*, or on its behalf, in the past; and

(iv) cover in respect of *Ombudsman* awards made against the *firm*.

(b) Contravention of (a) may be relied on as tending to establish contravention of the requirement in 13.1.4(2) for the professional indemnity insurance terms to be appropriate.

13.1.4(6) G Appropriate legal defence costs, in 13.1.4(5)(a)(ii), are costs of defence against claims that fall under the terms of the policy and that do not reduce the aggregate limit of cover itself.

13.1.4(7) G The cover provided by the policy should be wide enough to include the liability of the *firm*, its *appointed representatives, employees* and its agents for breaches of the *firm's* duty of skill and care, fiduciary duty, duty to look after documents or assets, fraud, and breaches of obligations imposed by or under *the Act* (or the Financial Services Act 1986 if relevant). If the *firm* operates outside the *UK* then the policy should cover other regulatory requirements imposed under the laws of other countries in which the *firm* operates.

13.1.4(8) **R** **The policy must not be subject to conditions or exclusions which unreasonably limit the cover provided for in 13.1.4(2) (whether by exclusion of cover, by policy excesses or otherwise).**

13.1.4(9) G (a) The *FSA* considers it reasonable for a *firm's* policy to exclude cover for:

(i) specific business lines if that type of business has not been carried out by the *firm* in the past and will not be carried out by the *firm* during the life of the policy; or

(ii) specific claims that have been previously notified to the *firm's insurer* and claimed for under another policy.

(b) The *FSA* does not consider it reasonable for a *firm's* policy to treat legal defence costs cover as part of the *limits of indemnity* if this reduces the cover available for any individual substantive claim.

13.1.4(10) E (a) The policy should not:

(i) make provision for payment by the *firm* of an excess on any claim of more than £5,000. (This does not apply if the *firm* holds *own funds* in a readily realisable form, in accordance with 13.1.4(12)); or

(ii) exclude any type of business or activity that has been carried out by the *firm* in the past or will be carried by the *firm* during the time for which the policy is in force. (This does not apply if the *firm* holds, by way of additional *own funds* in a readily realisable form, an amount representing a reasonable provision against its potential liabilities for that business or activity, in accordance with 13.1.4(13) and (14)); or

(iii) exclude liability which is identified or crystallised as a result of regulatory action against the *firm* (either individually or as a member of a class of *authorised person*).

(b) Compliance with (a) may be relied on as tending to establish compliance with 13.1.4(8).

(c) Contravention of (a) may be relied on as tending to establish contravention of 13.1.4(8).

13.1.4(11) G The reference to the excess in 13.1.4(10)(a)(i) is to the highest excess level required to be paid under the policy unless that excess relates to a type of business that has not been carried out by the *firm* in the past. In those circumstances, the reference is to the next highest excess level required by the policy.

13.1.4(12) E The amount of additional *own funds* in 13.1.4(10)(a)(i) should be calculated by referring to the *firm's* relevant income and excess obtained in the following table:

All amounts are shown in £000s													
Relevant income is		Excess obtained up to											
more than	up to	5	10	15	20	25	30	40	50	75	100	150	200+
0	100	0	4	7	9	12	14	18	21	28	34	45	54
100	200	0	7	11	14	17	20	25	29	38	46	59	70
200	300	0	9	14	18	21	24	30	35	45	54	69	82
300	400	0	11	16	21	24	28	34	39	50	60	77	91
400	500	0	13	18	23	27	30	37	43	55	66	83	98
500	600	0	14	20	25	29	33	40	46	59	70	89	105
600	700	0	16	22	27	31	35	42	49	63	74	94	111
700	800	0	17	23	28	33	37	45	52	66	78	99	117
800	900	0	18	24	30	35	39	47	54	69	82	103	122
900	1,000	0	19	26	31	36	41	49	56	72	85	107	126
1,000	1,500	0	23	31	37	43	48	57	66	83	99	124	146
1,500	2,000	0	26	35	42	48	54	64	73	93	109	138	161
2,000	2,500	0	29	38	46	53	59	71	81	102	121	152	179
2,500	3,000	0	32	42	51	58	65	78	89	112	132	166	195
3,000	3,500	0	35	46	55	63	71	84	96	121	142	179	210
3,500	4,000	0	38	50	59	68	76	90	102	129	152	191	223
4,000	4,500	0	41	53	63	72	80	95	108	137	161	202	236
4,500	5,000	0	43	56	67	76	85	100	114	144	169	212	248
5,000	6,000	0	48	62	73	84	93	110	125	157	185	231	271
6,000	7,000	0	52	67	79	90	101	119	135	169	199	249	291
7,000	8,000	0	56	72	85	97	107	127	144	181	212	265	310
8,000	9,000	0	59	76	90	103	114	134	152	191	224	280	328
9,000	10,000	0	63	80	95	108	120	141	160	201	236	294	344
10,000	100,000	0	63y	80y	95y	108y	120y	141y	160y	201y	236y	294y	344y
100,000	n/a	0	630	800	950	1080	1200	1410	1600	2010	2360	2940	3440
Value y is calculated by: relevant income divided by £10m													

13.1.4(13) G A *firm* should take into account the following when assessing the amount of additional *own funds* to be held as provision as described in 13.1.4(10)(a)(ii):

(a) the type of business line or activity excluded and the types of claim which might arise from it;

(b) the number of contracts written or volume of activity;

(c) the number of complaints received by the *firm* relating to the excluded business or activity;

(d) generally accepted accounting principles applicable to provisions; and

(e) any other relevant information.

13.1.4(14) G The level of the *firm's* provision in 13.1.4(13) should be reviewed regularly. The reviews should take account of changes in the status of the policy exclusion(s) and the conditions associated with this provision.

13.1.4(15) R **If the policy provides cover to more than one *firm* then in relation to 13.1.4(2) and (3):**

(a) the relevant income is that of all the *firms* named in the policy combined;

(b) each *firm* named in the policy must have the benefit of the minimum *limits of indemnity* as required in 13.1.4(2);

(c) any *firm* named in the policy must notify the *FSA* if the aggregate cover in the policy falls below the minimum in 13.1.4(2).

13.1.5 R **A *firm* is not required to effect or maintain professional indemnity insurance if:**

(a) it is a member of the same *group* as a *bank*, *building society* or *insurer (*other than a *friendly society)* ; and

(b) there exists between the *firm* and an entity specified in (a) above an enforceable, written agreement to provide equivalent cover to that required for professional indemnity insurance in 13.1.4(2).

In IPRU(INV)13:

- Insert at the end of **13.1.6(1)** '…, or as appropriate elsewhere in the EEA.'

- In **13.1.6(2)** delete the words after '…professional indemnity insurance cover' in line two.

- Delete the first item in the **table 13.1(a) in 13.1.9** and replace with the text shown below:

1.	In relation to professional indemnity insurance, required in accordance with 13.1.4(1) to 13.1.4(15) and 13.1.5, if: (a) it cannot be obtained within 28 days of the inception or renewal date; (b) it is cancelled; (c) the amount of aggregate cover is exhausted; (d) the *firm* commences business lines for which it had not obtained cover; (e) the *firm* is relying on 13.1.4(15); or (f) the *firm* is relying on 13.1.5.

- Delete Appendix 13(2)E.

ISBN: 0117045845

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: http://www.fsa.gov.uk
Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.