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Making the ‘polluters’ pay in the advice market

CP23/24: Capital deduction for redress: personal investment firms (PIFs)

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The FCA's 'polluters pay' proposals could have significant implications for firms, particularly those who have provided advice on defined benefit pension transfers. Quantifying and holding capital for potential redress liabilities will become a requirement under the proposals set out in CP23/24

The proposals put forward by the FCA in their consultation paper (CP23/24 Capital deduction for redress: personal investment firms) will require firms to quantify their potential redress liabilities and set aside capital to meet these potential obligations. Firms unable to demonstrate the capital adequacy would be subject to asset retention restrictions.

Whilst firms should already understand where they are potentially exposed to future redress claims, putting a value on this exposure could be a challenging and time-consuming task which will require external expert support.

Firms should be watching the outcome of the consultation carefully, considering the steps they can take now and the support they might need in the future.

The consultation closed on 20 March 2024. The FCA intends to publish a Policy Statement in H2 2024 with rules coming into force in H1 2025.

> "We want to ensure that the firms that generate redress costs are better able to meet them without recourse to the FSCS and that should a firm fail there is more capital for FSCS recoveries. In short, we want the polluter to pay."
>
> **The Financial Conduct Authority CP23/24**

How can you prepare?

Understand features of your past book

Understand the scale and nature of your past book where there is potential to be a redress liability. This is the first step in understanding the potential quantum of any redress liabilities and thus capital required.

Understand the factors impacting redress

Understand how redress is calculated for your past book of advice and in particular the key factors that influence redress values, the sensitivity to these and how frequently they can change.

Understand the potential quantum

Get an understanding of the potential quantum of the capital requirements if the proposals come into force. Consider factors such as: monitoring approach, frequency of updates and margins for prudence.

What is the FCA seeking to achieve?

The FCA's view is that too often those firms which have got things wrong do not take responsibility for their mistakes with the financial burden of those mistakes falling instead on the Financial Services Compensation Scheme (FSCS) and its levy payers.

As set out in the CP23/24 consultation paper published by the FCA, data from the FSCS shows that they paid out £757m in compensation between 2016 and 2022 relating to Personal Investment Firms (PIFs). 95% of these compensation costs were generated by just 75 firms out of c5,000 PIFs authorised in the UK. More than 98% of these claims resulting in FSCS payments were due to unsuitable advice.

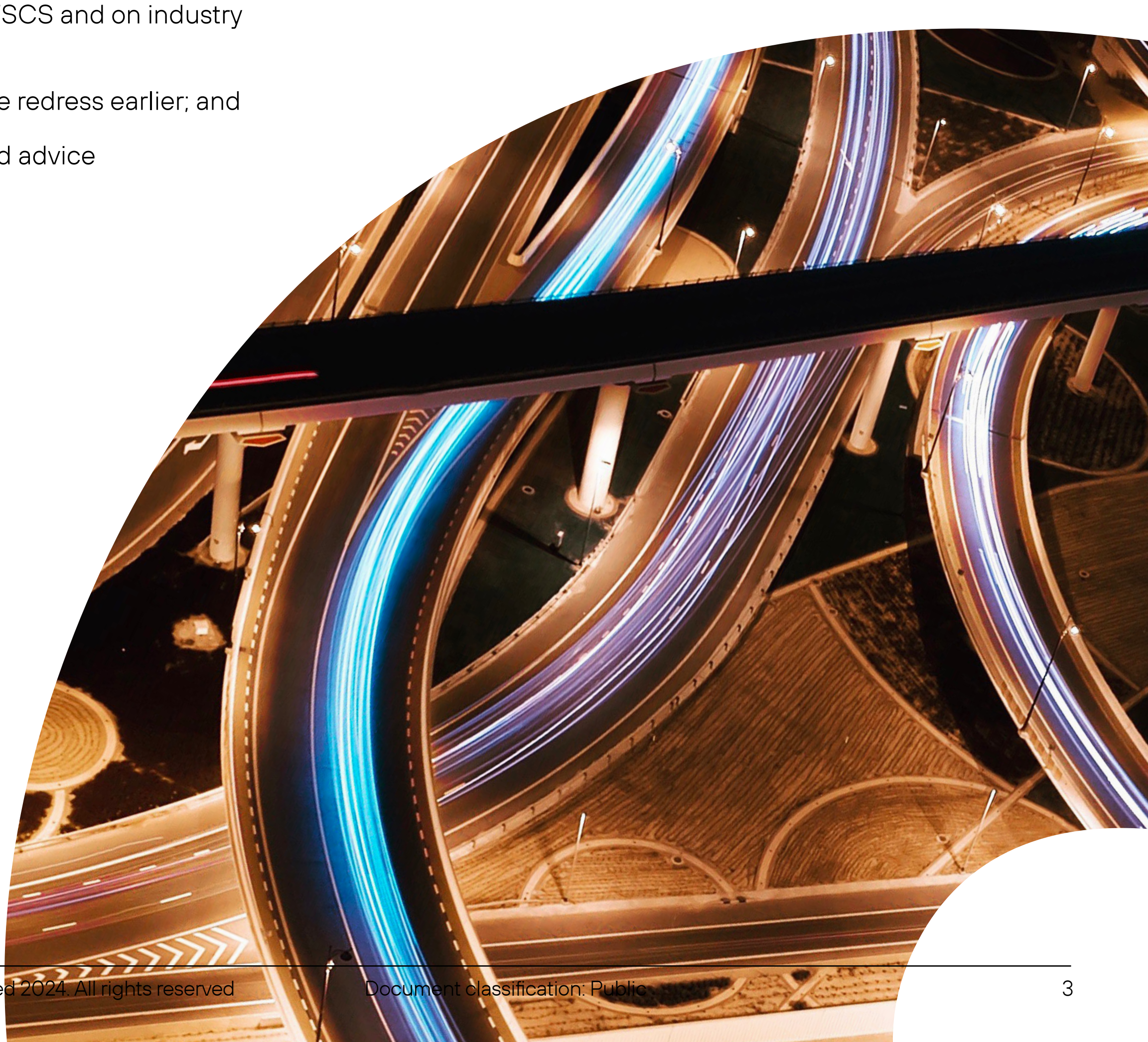
This FSCS redress is met by the FSCS through the levies paid by other financial firms. This results in higher fees being paid by consumers and an inefficient market. The FCA is therefore keen to make the 'polluters pay' and hence the proposal for capital requirements to be imposed on those firms which are potentially exposed to redress claims.

The proposals put forward by the FCA have the following aims with the overarching principle of being proportionate and minimising the burden on firms whilst targeting the firms most likely to cause redress liabilities:

- Make the polluters pay;
- Make firms with redress liabilities more resilient;
- Reduce the burden on the FSCS and on industry (through reduced levies);
- Enable consumers to receive redress earlier; and
- Incentivise firms to give good advice

> "Our aim is to promote culture change by incentivising firms to resolve existing complaints and issues quickly and resolve recurring or systemic problems to help future customers. The proposals will also incentivise PIFs to improve their practices to reduce the need for them to set aside capital for potential redress liabilities. The outcomes we want to see are greater numbers of consumers receiving the full redress they are owed by the firm that caused the harm and a decrease in the redress costs that fall to the FSCS."

The Financial Conduct Authority CP23/24



What are the proposals?

To achieve their stated aims and objectives, the FCA is proposing that PIFs be required to undertake the following steps:

Step 1

Identify potential redress liabilities (in line with existing requirements)

Step 2

Quantify potential redress liabilities, taking into account expected redress, Professional Indemnity Insurance (PII) cover and probability factor – covering both 'unresolved' and 'prospective' redress

Step 3

Set aside capital by deducting potential redress liabilities from capital resources

Step 4

If undercapitalised after setting aside capital, the asset retention requirement applies

Firms will have to report on the outcome of the analysis as part of their regular financial accounting cycle or sooner if they become aware of a reason why the outcome would have materially changed.

The redress obligations are separated into 'unresolved' and 'prospective':

- **Unresolved redress liabilities** refer to instances when a PIF has already received but not resolved a complaint and where this complaint may give rise to a redress liability. The FCA expect it should be straightforward for a PIF to identify its unresolved redress liabilities, as they are already required to have complaints-handling procedures in place to collect this information.
- **Prospective redress liabilities** refer to instances where a PIF has identified:
  - foreseeable harm that could give rise to an obligation to provide redress, or
  - recurring or systemic problems in the course of its complaints handling which could lead to an obligation to provide redress.

The Consumer Duty and existing complaints-handling rules already require PIFs to monitor their business, and proactively rectify harm by providing redress in appropriate circumstances. The FCA expect PIFs to use this existing monitoring to identify prospective redress liabilities. Importantly, the FCA states that it is not placing a new requirement on PIFs to proactively uncover potential redress liabilities in their past business.

Helpfully the FCA has clarified that identifying a prospective redress liability is not an admission of wrongdoing on the PIF's part and will not be treated as such.

How can you quantify potential redress liabilities?

The FCA has proposed a three-step process for PIFs to quantity potential redress liabilities.

1. Estimate the redress amount for each customer (reflecting any professional indemnity insurance in place);
2. Aggregate the redress amounts for each customer; and
3. Apply a probability factor to this total (proposed to be 28%).

Despite the apparent 'simplicity' of the three-step approach, there are significant complexities which PIFs will need to consider. Whilst the FCA consultation paper sets out the building blocks of the calculation there is a still a lot of expertise (and ultimately judgement) going to be required to appropriately quantify potential redress liabilities.

Estimating the redress amount for each customer

The FCA states that PIFs will be required to make a 'reasonable estimate of the amount of funds they will need to provide redress to each customer if the liability crystallised'.

Making a 'reasonable estimate' across a firm's whole past book of products is not a simple task. There are a wide range of factors which impact on redress values, even when you narrow down the considerations to one product. Consider defined benefit transfer advice for example; redress for this will vary by consumer age, marital status, underlying ceding scheme benefits, withdrawal timings and amounts and DC pot investment performance.

Perhaps most importantly, redress levels are explicitly linked to the market conditions at the time of the calculation. They therefore change over time and could change materially depending on the date on which the calculation is undertaken.

Firms are required to have adequate financial resources at all times, however, the consultation paper leaves it to PIFs to determine the frequency with which calculations should be updated based on their circumstances. Firms will need to consider the frequency with which to update their calculations and whether to incorporate margins for prudence into their calculations and adopt a regular monitoring approach. Firms will need to understand the factors that impact the quantum of redress liabilities.

In supervising compliance with these requirements, the FCA states that it would expect PIFs to be able to explain how they have quantified their amounts for potential redress liabilities. It will therefore be important for firms to have a clear audit trail of the approach taken, the quantification and the rationale for the frequency of updates.

The probability factor

The probability factor of 28% is based on the uphold rate seen by the FCA for PIFs' complaint data between 2020 and 2022. Where the firm has knowledge that this factor will underestimate the potential exposure (e.g. based on known cases reviewed by that firm or by product type) then it should apply a higher rate.

This appears to introduce a level of subjectivity into the calculation which may be more supportable if verified by an external third-party advisor. Applying a lower rate is also possible, but this would require agreement with the FCA.

The costs of complying

The cost of undertaking these calculations hasn't been explicitly referenced by the FCA. These could be material for firms, particularly where they have a diverse book of previous advice where it is not possible to make general assumptions across the advice portfolio and/or there will be a need for the calculations to be updated on a regular basis.

The supervisory regime

Whilst further information is going to be needed to fully understand how the FCA will monitor and review these calculations, given the complexity of the calculations there is a risk that PIFs are seen to be 'marking their own homework' as they are estimating their own exposure to unsuitable advice. Having expert third-party advice to get the calculations right is therefore likely to play a key part in the success of the FCA's proposals.

Actions firms should consider taking now?

In order for the proposals to be effectively implemented, and the FCA's aims achieved, we anticipate that PIFs are going to require external expert support. The level of support required will be linked to the breadth and variety of advice products provided and the in-house expertise, but there are three key actions firms can be considering now:

1. **Understand features of your past book:** Understand the scale and nature of past books where there is potential to be a redress liability. This is the first step in understanding the potential quantum of any redress liabilities and thus capital required.

   Some areas may be clear, however where there has already been work taken to review advice procedures and/or deal with certain products, this task may be more nuanced for firms. There are likely to be differences of opinion on the potential obligations, particularly for the prospective redress liabilities. Our experience of supporting clients with this has shown our knowledge of the wider market and insight into the risk exposure of firms is a valued input into this discussion.

2. **Understand the factors impacting redress:** Understand how redress is calculated for their past book of advice and in particular the key factors that influence redress values, the sensitivity to these and how frequently they can change.

3. **Understand the potential quantum:** Get an understanding of the potential magnitude of the redress if the proposals come into force and consider factors such as: monitoring approach, frequency of updates and margins for prudence. Understanding the level of PI cover (and excess) in place across products as well as any exclusions will be important.

Working out the appropriate figures is going to need a mix of data and actuarial judgement. Having completed 1,000's of cases across multiple products has shown us the variety of outcomes which can be reached on redress calculations, where simple misjudgements can lead to £100,000's of overestimated redress.

Added to this is the need to get the right level of probability factor to apply. We have supported our clients to understand and document analysis which has already been completed and also helped them identify the factors which mean that the past may not be a good predictor of the future. This analysis will be key to provide to the FCA if looking to move away from the default 28% factor.

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