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CP19/20 – a most confusing consultation paper

A recent missive from the Financial Conduct Authority that appears to place new requirements on firms with regard to 'adequate financial resources' while simultaneously stating that it does not impose specific obligations, has the industry confused and concerned. Julian Sampson calls for clarification.

You know you need to worry when the FCA talks about making the regulatory system fairer for firms.

The FCA's proposals in CP19/20 are couched in such terms as to make them seem entirely commendable and uncontroversial. But they are in fact deeply concerning. Unless they are significantly amended as a result of the consultation process (now closed), these proposals have the potential to impose a significant burden on firms, both in terms of capital and process, for illusory benefit.

The FCA starts from the premise that, under the existing rules, all firms must maintain adequate financial resources as part of the Threshold Conditions. The consultation paper then indicates what risks these adequate resources might cover, but makes no suggestions as to the level and nature of the financial resources that might be required to do so. All firms, the FCA says, bar consumer credit firms must make greater efforts in planning their capital.

For firms currently subject to the detailed prudential regimes of MiFID II, CRD, BIPRU, GENPRU and even IPRU-INV, this will come as a surprise and might seem superfluous. Don't these sections of the handbook already set out in some detail the precise level of resources needed to be held by each firm, given, for example, whether they hold client money or deal as principal? And don't these sections set out in some detail the amount of capital to be provided against specifc counterparty and postions risks, to name but a few?

Thus, firms are faced with the prospect of widely differing interpretations by similar firms of what capital they need, leading to an un-level playing field where those comparable firms hold varying levels of capital for largely similar risks.

This is potentially aggravated when the FCA decides to engage with specific firms to review their adequacy arrangements. Such an exercise is unlikely ever to result in a firm being invited by the FCA to reduce its levels of appropriate financial resources. Therefore, the greatest differentiator between firms of similar risk profile is likely to be – in the absence of more specific requirements – the purely random occurrence of whether a firm has been asked to explain its processes to the regulator.

In an ideal world, most firms would not be significantly affected by the FCA's proposals, which they say are primarily aimed at the firms they oversee but which are not subject to what they describe as their "detailed" prudential oversight. It's here that the regulator plays its "fairness" card. Pointing to the £846 million paid out by the Financial Services Compensation Scheme in the period 2013-2017, the FCA says that 70 per cent of these payments related to firms which were not subject to their detailed prudential supervision. The FCA then asks the unanswerable question – wouldn't it be fairer on those hard-pressed levy payers if all firms planned better, held more funds on their balance sheet and were generally better able to wind down their affairs in an orderly – and cheaper – manner? It's a simple equation to the FCA: "if firms have resources to match their risk, there should be fewer disorderly firm failures, with lower costs passed onto the industry via the FSCS levy." Simple.

So, what is the FCA suggesting? In Chapter 2, it sets out its current expectations. In short, firms should carry out a proportionate and regular assessment of the risks they face, understand their business model and strategy, put things right when they go wrong and seek to minimise the harm that might arise from failure. The FCA's new proposals cover broadly the same headings, but at a level of unspecified vagueness that will be difficult for most firms to comply with in any consistent way.

When considering systems and controls, the FCA wants to see a sound risk management and controls framework that allows firms and their senior management to identify, understand, manage, monitor and mitigate the risk of potential harm caused to consumers and markets. It then goes on to discuss in some detail its expectations in terms of risk identification and management. The regulator starts from the premise that when considering the adequacy of capital, firms should consider the liquidity of their balance sheets, currency risk and convertibility.

The FCA goes on in Chapter 3 to consider the capital adequate to minimise the risk of harm to consumers or other users, and lists a number of potential conduct issues that could become causes of harm and that should be considered by firms in the calculation of adequate resources. These include, for example, the risks that discretionary portfolio managers may breach their mandate, that financial advisers may provide unsuitable advice, or that firms advising on corporate finance deals may fail to apply appropriate due diligence. For all these, and other potential harms, the FCA's expectation is that firms should consider the likelihood and impact of such things going wrong, and have in place adequate financial resources to ensure that they can put the wrong right.

But how should firms do this? It's all very well saying "consider 'what-if' scenarios" and "estimate the potential impact on their financial resources", but unless there are common standards of provision for these common risks, firms can only make individual efforts, leading to wide disparity among similar firms. And this focus on capital may lead to firms actually taking their eye off the conduct ball itself – a sort of 'don't bother me with the detail of the conduct, we have enough capital to absorb any risk of harm' attitude. The FCA has seen this before. Back in 2013, the regulator said in its initial CP on revised client money rules: "There is a risk that firms who prudently over-segregate do so to protect clients without complying with the detailed rules …" *ie*, they considered they had enough of a buffer in client money, making it less important to calculate the actual required amount. The FCA said then that this was inappropriate. Money doesn't fix everything.

The FCA also wants firms to consider any amounts they might have to pay to compensate for losses consumers have suffered as a result of the firm's misconduct, and that they might have to pay by way of enforcement and fines. Litigation costs should also be included. Most firms would quickly consider these to be zero balances, but it's clear that firms who are in such difficult situations must look at these potential costs in some detail.

When assessing the firm's business model, the FCA's expectation is that firms should "consider forward-looking financial projections and strategic plans, under both business-as-usual and adverse circumstances that are outside their normal and direct control". This includes stress and reverse stress testing. That may be reasonable, but the FCA's further expectation is that this should be over a period of three years. Given the current political environment, it would be a brave person who forecast one year ahead, let alone three years. As Niels Bohr, the Nobel prize-winning physicist, said: "It is very hard to predict, especially about the future." One year is surely enough.

All of this may come as second nature to larger firms who represent a systemic risk to the market. As the FCA says: "some firms may have approaches to assess adequate financial resources which already address the risks arising from their business models and activities… In these cases, it is possible that firms will not need to take any further action in response to our proposed guidance, meaning our proposals would result in no, or negligible, incremental costs."

But to include in these proposals all other firms except the most simple consumer credit firms is disproportionate. It is only these consumer credit firms which the FCA believes can demonstrate that they meet the regulator's adequate resources expectations by showing they can meet their debts as they fall due. There's no recognition that firms, say, without retail permissions and who do not hold client money or assets pose a far lesser potential threat to the FSCS than firms with those permissions. Any yet all are treated alike.

And the FCA's expectation that firms will, as a result of these proposals, hold higher levels of capital, is real. While they say on one hand that "smaller, simpler firms are… not expected to incur the same level of expenditure on managing risk as larger more complex firms", they say on the other that "to achieve our objectives, in some instances and by applying a targeted approach to individual firms, it may be necessary to set a level of financial resources beyond the minimum required by prudential regimes for those firms."

The FCA's cost-benefit analysis estimates the one-off and ongoing costs of its proposals to be £46.5m and £10.1m per annum. Irrespective of how these figures are derived, the regulator is surely correct in identifiying that these costs will be primariliy incurred by what it has called Class 3 firms – these are the 45,062 firms not subject to a regular supervisory review or an ICAAP. Indeed, the FCA's figures show that 84 per cent of the one-off costs and 100 per cent of ongoing costs will be borne by the Class 3 firms – arguably those least able to afford it.

Which might be fine, but the FCA fails to make the case that the FSCS levy would be lower if these proposals were in place. There is no analysis of why these firms actually failed or any support for the view that they failed due to

their poor financial planning. Indeed, one might expect that if a firm is bad, its financial planning will be similarly bad. Bad firms will still fail and the good firms will still pick up the bill. Only now, those good firms will have the added burden of the higher capital thresholds envisaged – but not clearly set out – in this CP. The FCA's case relies on a general assumption that forecasting the future will enable you to fix the future; an assumption which is heroic at best, naive at worst.

The FCA's objectives in seeking to minimise the cost (and, arguably, the incidence) of firm failure, may be worthwhile. But there are alternatives to the approach taken in CP19/20. It would be interesting to see the analysis of those firms that did form a call on the FSCS, and how many of them were already known by the FCA to be in difficulty. Earlier and more direct intervention by them would almost certainly have brought matters to a head sooner and may have reduced the loss to investors. Yet this is not mentioned in the CP.

And then there's the question of firm failure itself. "We accept that some firms will fail as a sign of markets functioning well," says the FCA in the introduction. This remark is qualified three pages later: "Some firms will fail, but this should be as orderly as possible." Yes, in an ideal world. But this is not a world of perfect. And the unintended consequence of these proposals may be that a far higher level of capital is required for risks at too great a distance in the future. This either constitutes a barrier to entry or calls into question how serious the FCA is about its commitment not to be a zero-failure regulator.

Interestingly, these proposals are likely to run counter to new European Union capital proposals due to be implemented in the United Kingdom (irrespective of Brexit) in 2021. These proposals, recently passed by the European Parliament and expected to be consulted upon by the FCA soon, create a category of "small and non-connected" firms who will benefit from a "simplified new regime". Some of the criteria for being so treated include not holding client money or assets, having Assets Under Management under €1.2 billion and a balance sheet under €100m. These firms will be released from the obligation to prepare an ICAAP. So, while the EU may be lightening the regulatory burden in this specific area, the FCA will be increasing it. So much for a Brexit dividend.

And all of this comes at a time that puts maximum strain on firms, when they are already up to their eyes in SMCR, Brexit, etc. To ask for responses over the summer holiday period, and then hold out the prospect of a policy statement (presumably with draft rules) in "late 2019" is wildly ambitious, especially as the firms most impacted will have least resources to absorb any changes, whatever the proposed implementation date.

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