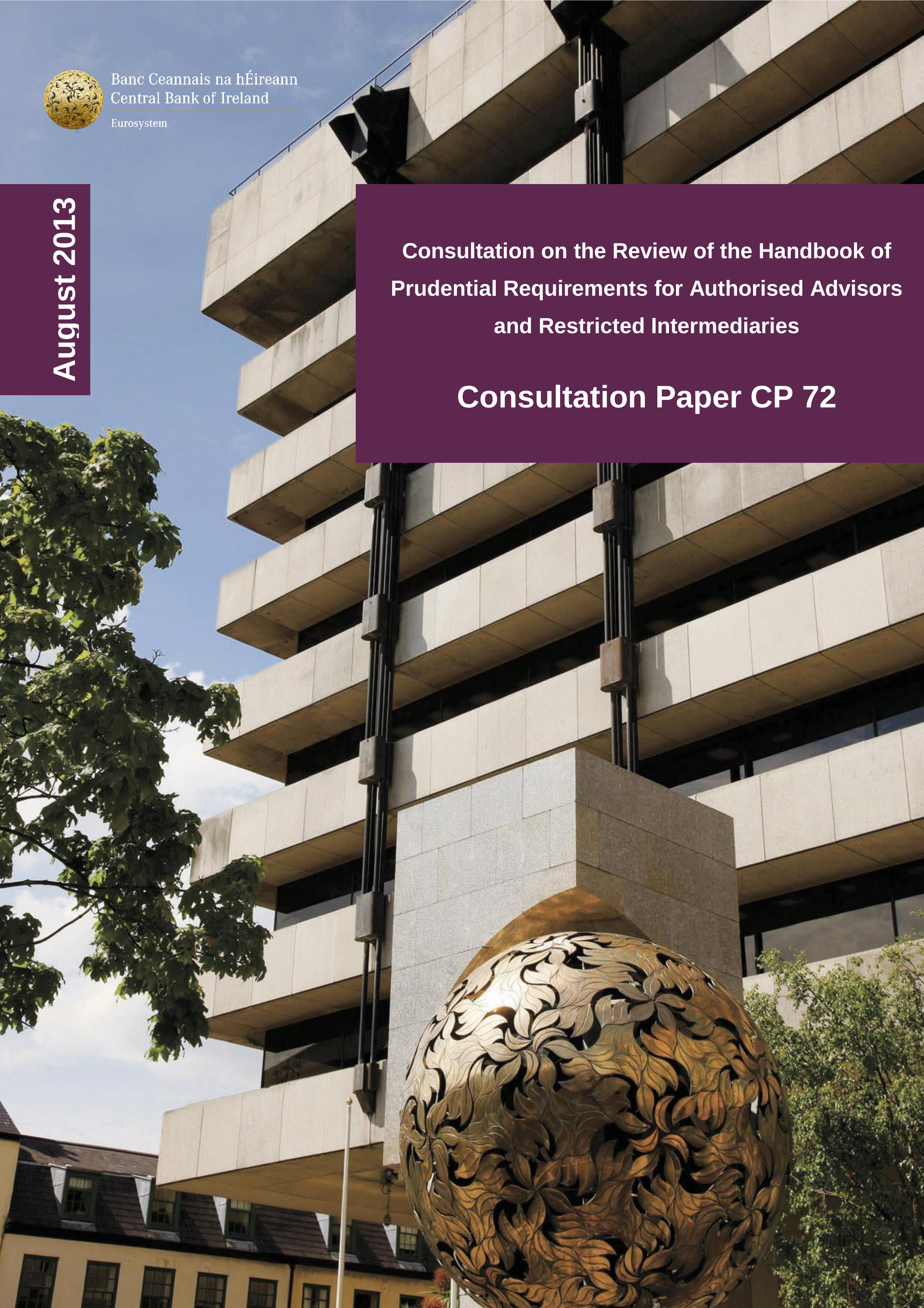
Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

August 2013

Consultation on the Review of the Handbook of Prudential Requirements for Authorised Advisors and Restricted Intermediaries

Consultation Paper CP 72



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1. Purpose of the consultation

In February 2013, the Central Bank of Ireland published its first Report on the Retail Intermediary Sector in Ireland (the Report). The firms in this sector include investment intermediaries authorised under the Investment Intermediaries Act, 1995 (IIA), insurance intermediaries registered under the European Communities (Insurance Mediation) Regulations 2005 (IMR) and mortgage intermediaries (MIs) authorised under the Consumer Credit Act, 1995 (CCA). The Report described our supervisory strategy for the sector and set out a number of proposed work streams for 2013, including a commitment to commence a public consultation on the *Handbook of Prudential Requirements for Authorised Advisors and Restricted Intermediaries* ('the Handbook').

The Handbook is imposed as a condition of authorisation under Section 14 of the IIA. As such, the Handbook is not applicable to firms authorised under the IMR or the CCA.

This consultation paper sets out our key proposed changes to existing prudential rules and also some clarifications in relation to industry practice. We also propose to implement the recommendation of the 2008 Working Group on the Review of the Intermediary Market[1] relating to the categorisation of Authorised Advisors (AAs) and Restricted Intermediaries including Multi-Agency intermediaries (MAIs).

The current Handbook has been in force since 2001 and was revised in 2006. Since 2006, there have been significant changes to the regulatory environment in which the sector operates. For example, the Minimum Competency Requirements and the Consumer Protection Code were first published that year (subsequently revised in 2011 and 2012 respectively) and an on-line Annual Return and new Fitness and Probity Standards were introduced in 2011.

Furthermore in 2011, the Central Bank introduced its formal risk assessment framework, the Probability Risk and Impact SysteM (PRISM). As the name implies, this system is designed to facilitate a more structured and systematic approach to assessing all regulated firms, based on the impact they have on the economy or on consumers, if things go wrong, and the

[1] This review was undertaken by a joint Financial Regulator/industry Working Group, consisting of the Financial Regulator and members of the industry representative bodies.

probability that problems will arise. The PRISM framework complements our on-going conduct of business supervision, which is essential to promoting a resilient and effective retail intermediary market and to '*getting it right for consumers'*.

It is clear that we cannot maintain the same level of scrutiny or seek the same level of low risk of failure for all firms regulated by the Central Bank. As a result, we have deployed our resources to seek to prevent problems occurring where they will cause the most significant detriment. As at end-July 2013, approximately 1,834 firms held an IIA authorisation on the Central Bank's statutory registers and all were designated as low impact firms. The 'low' impact rating reflects the fact that these firms are not authorised to hold client money and the failure of any one firm would not cause economic or systemic problems, nor would it require taxpayer support. However, it is also recognised that these firms can cause consumer detriment, for example, through mis-selling or overcharging. With this in mind, and taking account of the resources deployed to supervising this large sector, a key strategic measure is to strengthen the prudential supervisory framework and to take credible enforcement action where breaches of key risk indicators (professional indemnity insurance (PII) and regulatory capital requirements) are identified.

2. Key Proposals for Consideration

It should be noted that while other minor amendments may be included in the revised Handbook, the Central Bank welcomes your views on the following key proposals:

Reclassification of AAs and Restricted Intermediaries including MAIs – It is proposed that they be reclassified as 'Investment Product Intermediaries' (IPIs);

Minimum regulatory capital requirement – The Central Bank proposes removing the minimum requirement of €10,000 for AAs. Instead, all IPIs must maintain a positive capital balance. Further, the €50,000 minimum capital requirement on intermediaries acting as 'product producers' (PP) will remain;

Solvency – IPIs must, at all times, meet their obligations in full as they fall due and balance sheet assets must at all times exceed liabilities i.e. IPIs must maintain a positive net asset position;

Goodwill and Other Intangibles – will not be eligible for inclusion in the calculation of balance sheet assets for regulatory reporting purposes;

Perpetual Subordinated Loans – Perpetual subordinated loans may be deducted from balance sheet liabilities for regulatory reporting purposes (five-year subordinated loans must be included in balance sheet liabilities);

Professional Indemnity Insurance (PII) – The Central Bank proposes to introduce a requirement for all IPIs to hold PII at the same level as currently applies to insurance intermediaries registered under the IMR[2];

Annual Return – The requirement to submit an annual return, no later than six months after a firm's financial year-end reporting date will be included in the revised Handbook.

While the Consultation Paper proposes to impose the requirements set out in the revised Handbook on IIA firms as a condition on authorisation under Section 14 of the IIA, where the Central Bank is minded to do so, it may choose to impose those requirements, and any such other requirements as it considers appropriate, by way of an alternative power available under the Central Bank (Supervision and Enforcement) Act, 2013.

3. Stakeholder Engagement

This Consultation Paper should primarily be of interest to IPIs and their industry representative bodies as it seeks views on proposed key changes to their prudential requirements, certain industry practices and the re-categorisation of firms. It should also be of interest to insurers and other product producers and to consumer interest groups.

[2] An annual limit of €1.25m per claim and €1.85m in aggregate.

4. Making Your Submission

The closing date for submissions is **29 November 2013** and the Central Bank welcomes comments from all interested parties. Any submissions received after this date will not be considered. When addressing any issue raised in this Consultation Paper, please use the relevant section heading to identify the section you are referring to and clearly set out the basis for your views. If you are raising an issue that has not been referred to in this paper, please indicate this in your submission and the basis for its inclusion.

We intend to make submissions available on our website after 29 November 2013. For this reason, we ask that you do not include commercially sensitive material in your submission, unless you consider it essential. If you do include such material, please highlight it clearly so that we may take reasonable steps to avoid publishing that material. This may involve publishing submissions with the sensitive material deleted and indicating the deletions.

Despite the approach outlined above, we make no guarantee not to publish any information that you deem confidential. It is therefore important that you be aware that, unless you identify any commercially sensitive information, you are making a submission on the basis that you consent to us publishing it in full. The Central Bank will not publish any information which it deems potentially libellous or defamatory. The Central Bank will accept no liability whatsoever in respect of any information provided which is subsequently released, or in respect of any consequential damage suffered as a result. A feedback document and the revised Handbook will be published in 2014.

Your submission should be marked 'Response to Consultation on the Review of the Handbook of Prudential Requirements for Authorised Advisors and Restricted Intermediaries'. Please make your submissions in writing, and if possible electronically, as a Word document by email to handbookipi@centralbank.ie or in writing to:

Consumer Protection - Retail Intermediaries and Payment Institutions Division
Central Bank of Ireland
PO Box 559
Dame Street
Dublin 2

CONSULTATION ON KEY PROPOSALS

5. Reclassification

Currently all investment intermediaries authorised under the IIA are categorised as either Authorised Advisers (AAs) or Multi-Agency Intermediaries (MAIs). AAs are required to provide broad-based investment advice whereby they must provide the consumer with the most suitable investment advice on retail investment instruments without the necessity of holding a letter of appointment from a product producer. MAIs are required to provide the most suitable investment advice from the range of product producers from which they have appointments.

The terms MAI and AA were created specifically for insurance intermediaries following discussions with industry representative bodies in 2001. During 2008, a Working Group comprised of the then Financial Regulator and members of the industry representative bodies was set up to consider, inter alia, intermediary categorisation. The Working Group recommended that the terms MAI and AA should be discontinued.

Consumer research at the time indicated that the term most commonly used and understood by consumers is 'broker' and that consumers are not familiar with the different categorisations in use, such as MAI and AA. The recommendations of the Working Group regarding the criteria for the use of the term 'broker' have been implemented through the Consumer Protection Code 2012 and, therefore, the terms MAI and AA are now essentially redundant. In addition, these terms have no basis in legislation. We propose, therefore, that intermediaries authorised under the IIA will be categorised as 'investment product intermediaries', as set out in Section 25 of the IIA.

Q 1: Do you agree with the proposed reclassification of AAs and Restricted Intermediaries including MAIs to IPIs?

6. Scope

Where a firm is already prudentially supervised by the Central Bank under another primary authorisation, that firm will be excluded from the scope of the Handbook. As the primary authorisation held by these firms (see Section 13 on Definitions) allows for more intensive scrutiny than those applied to IPIs, the Central Bank does not consider it necessary to also apply the rules contained in the Handbook to them.

Q 2: Do you agree that firms which are already supervised by the Central Bank under another primary authorisation should be outside the scope of the Handbook?

7. Minimum Regulatory Capital

Under the current Handbook there is a minimum capital requirement of €10,000 on AAs, and €50,000 on intermediaries acting as 'product producers' (PP) i.e., intermediaries who appoint other intermediaries. However, there is no minimum capital requirement on intermediaries that act solely as MAIs.

The Central Bank considered many options including extending the minimum capital requirement of €10,000 to all IPIs. However, considering the low impact rating of IPIs and particularly the fact that they do not hold client monies, the Central Bank is proposing the removal of the minimum requirement of €10,000 and its replacement by a requirement that IPIs must maintain a positive net assets position at all times (see section on Solvency). We are not proposing any change in the requirement on PPs – they will continue to have a minimum capital requirement of €50,000.

Q 3: (a) Do you agree with the proposal that balance sheet assets of IPIs must maintain a positive net assets position at all times and;
(b) Do you agree with the retention of the existing capital requirement on PPs?

8. Solvency

The provision that an IPI must be solvent at all times is included in the current Handbook. While the Central Bank proposes to continue with this requirement in the revised Handbook, we propose to provide further clarity in relation to defining the requirement.

The Central Bank holds the view that the solvency of regulated financial service providers, including IPIs, plays a fundamentally important role in ensuring the protection of consumers as well as contributing to the prudent regulation of all regulated firms. It is possible for IPIs to have a positive net assets position but not be in a position to meet their debts and obligations as they fall due, due to the fact that an IPI's assets may not be sufficiently liquid to allow them to be converted into cash on time to meet obligations as they fall due.

The Central Bank is proposing that IPIs must at all times be in a position to meet their financial obligations in full as they fall due. Furthermore, balance sheet assets of IPIs must at all times exceed liabilities i.e. IPIs must maintain a positive net assets position for regulatory purposes. The Central Bank considers a solvency breach to be a significant prudential and consumer risk. This is in line with the approach to regulation outlined under the Central Bank's risk-based regulatory framework (PRISM) in respect of low impact firms. It is a basic prudential standard for all financial institutions, and its importance in the context of IPIs is further highlighted by the fact that a breach of this requirement is a ground for revocation under Section 16 of the IIA.

The Central Bank will continue to seek a Certificate of Solvency from IPIs that are structured as a sole trader or partnership. Documentation showing the extent of the enquiries made by the sole trader or partnership to prove that they are solvent and able to meet all liabilities as they fall due will need to be retained for inspection by the Central Bank. If circumstances at a future date would cause this position to change, IPIs must notify the Central Bank immediately.

Q 4: Do you agree with the Central Bank's proposal to require that IPIs must at all times, meet their financial obligations in full as they fall due and that IPIs maintain a positive net assets position?

9. Goodwill and Other Intangible Assets

In the current Handbook, goodwill was permitted to be used towards meeting the solvency requirement in certain limited circumstances for regulatory reporting purposes. Having considered the matter, and the illiquid nature of goodwill, the Central Bank is proposing that goodwill and other intangible assets should be excluded from the calculation of a firm's balance sheet assets for regulatory reporting purposes. Excluding goodwill and other intangible assets for regulatory reporting purposes is common regulatory practice for financial service providers and regarded as prudent practice for the treatment of intangible assets.

In recognition of the current difficult economic climate in which the sector is operating, it is proposed that a transitional period of five years be allowed for IPIs to write down any goodwill currently included in the calculation of a positive net assets position for regulatory reporting purposes.

Q 5: Do you agree with the Central Bank's proposal for the treatment of goodwill and other intangible assets?

10. Subordinated Loans

The Central Bank is proposing that the revised Handbook provides that perpetual subordinated loans may be deducted from balance sheet liabilities for regulatory reporting purposes, subject to an auditor's opinion that the IPI complied with the Central Bank's standard format for a perpetual subordinated loan agreement.

For regulatory reporting purposes, five-year subordinated loans must be included in balance sheet liabilities, subject to an auditor's opinion that the IPI complied with the Central Bank's standard format for five-year subordinated loans. For the small number of IPIs that currently include five-year subordinated loans to meet their regulatory capital requirement (arrangements approved by the Central Bank), the Central Bank is recommending that these loans be converted to perpetual subordinated loans. Alternatively, the five-year subordinated loans may be amortised over five years for regulatory capital purposes.

Q 6: Do you support the Central Bank's proposals for

(a) The treatment of perpetual subordinated loans?

(b) The treatment of five-year subordinated loans?

11. Professional Indemnity Insurance (PII)

The Central Bank is proposing that PII requirements be imposed on all IPIs, as provided for under Section 27 of the IIA, equivalent to the levels imposed on insurance intermediaries under Section 17 the IMR (€1.25m per claim and €1.85m in the aggregate). The Central Bank believes that this requirement will help safeguard the IPI's financial position by ensuring that it can continue to provide a service to its clients, notwithstanding any claims of professional negligence that may be made against it e.g. failure by the IPI to execute client instructions or the provision of negligent or incorrect advice.

IPIs would have the option of extending the cover on their current PII contract (if applicable), or purchasing a new policy to ensure that all their IIA regulated activities are covered. The Central Bank considers that PII, together with the solvency requirement, provide sufficient safeguards to protect the consumer and are proportionate to the activities undertaken by these firms.

Q 7: What is your view on the imposition of PII on IPIs?

12. The Online Annual Return

Section 14 of the IIA provides that the Central Bank can impose conditions or requirements on authorised IPIs (including IPIs deemed to be authorised under Section 26 of the IIA). The Handbook is imposed as a condition on the authorisation of IPIs under Section 14 of the IIA. The current Handbook provides that AAs or Restricted Intermediaries including MAIs are required to respond to correspondence and to any requests for information in a timely manner and within any period of time that may be specified by the Central Bank.

It is proposed that the requirement to submit an online Annual Return (AR) be imposed as a condition on the authorisation of IPIs and set out in the revised Handbook, in lieu of the requirement to submit annual audited accounts. The AR must be submitted within six months of a firm's financial year-end and the financial information must be based on audited annual accounts. However, IPIs will continue to be required to prepare annual audited accounts under Section 33 (1) of the IIA and the Central Bank retains the right to require firms to submit these accounts. Failure by firms to submit their AR will result in the Central Bank taking appropriate regulatory action, up to revocation of their authorisation, as provided for under Section 16 of the IIA.

Q 8: What is your view on the requirement to submit an online Annual Return being imposed as a condition on the authorisation of IPIs and set out in the revised Handbook, in lieu of the requirement to routinely submit annual audited accounts, allowing that the Central Bank retains the right to require submission of the full audited accounts?

13. Definitions

Central Bank means the Central Bank of Ireland.

Investment Intermediary shall be taken to include firms currently categorised as Restricted Intermediaries including Multi-Agency intermediaries and Authorised Advisors. The Central Bank proposes to reclassify these to Investment Product Intermediaries.

Primary Authorisation means an authorisation, licence, or registration issued by the Central Bank to a firm in relation to a sector, other than the retail intermediary sector, and the primary authorisation relates to the core business of the firm.

If a firm holds a number of authorisations in the retail intermediary sector e.g. a firm has a Mortgage Intermediary authorisation under the CCA and/or an Insurance Intermediary registration under the IMR in addition to an authorisation as an AA or Restricted Intermediary including MAI under the IIA, the Handbook will apply to the business carried on by that firm under its IIA authorisation.

Professional Indemnity Insurance is liability insurance that covers businesses in the event that a third party claims to have suffered a loss as a result of professional negligence.

Investment Product Intermediary has the meaning given to it in Part IV of the Investment Intermediaries Act, 1995.

Other Intangible Assets – examples are customer lists, marketing rights and computer software.

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