Financial Conduct Authority

Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Restrictions on the retail distribution of regulatory capital instruments (PS 15/14)

Lead regulator: FCA

Date of assessment: July 2016

Commencement date:
Rules for mutual society shares came into force on 1 July 2015
Rules for contingent convertible (CoCo) securities; and,
CoCo funds came into force on 1 October 2015

Origin: Domestic

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of UK

Brief outline of proposed new or amended regulatory activity

The FCA regard contingency convertible securities (CoCos) and common equity tier 1 (CET1) share instruments issued by mutual societies, which are complex and risky products, as posing particular risks of inappropriate distribution to ordinary retail customers.

On CoCos, the FCA have introduced rules that prevent firms from distributing CoCos in the retail market without first checking that the prospective client meets certain criteria. In effect, firms should not sell or promote (or approve promotions) to ordinary retail clients (i.e. retail clients who are not sophisticated or high net worth). Other intermediation activities that give effect to transactions in CoCos are not in scope. We have also introduced rules that restrict the retail distribution of certain pooled investments that invest wholly or predominantly in CoCos.

On mutual society shares, the FCA have imposed certain requirements on the distribution of mutual society shares to ordinary retail investors. Firms may only distribute the securities to investors who receive specific risk warnings and who commit to not invest more than they can afford to lose, which we have defined as 10% of their net investable assets, in this type of security. The rules apply only to the primary issuance and not to secondary market dealings. With this approach, the FCA have implemented a risk-based approach that allows firms to distribute investments to high net worth and sophisticated investors for whom the products are more likely to be appropriate but that protects other retail investors from the risk of entering into inappropriate transactions.

The new rules replaced an earlier supervisory approach under which the FCA worked with issuers before new issues are launched. Now, instead of agreeing minimum denominations that exclude most retail investors from the market, we have restrictions on the type of retail investor to whom firms may distribute these instruments.

Which type of business will be affected? How many are estimated to be affected?

In the cost benefit analysis on which we consulted, the proposed changes were anticipated to affect between 48 and 90 distributors, including five to ten banks, three to five building societies, and 40 to 75 specialist wealth managers.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2014	2015	10	-£80.3m	£9.3m	£46.5m

Please set out the impact to business clearly with a breakdown of costs and benefits

Direct costs to business

Training costs – There are likely to be training costs for firms that wish to promote CoCos or mutual society shares to retail investors. To estimate these costs, we referred to work undertaken to support a previous consultation exercise on the introduction of the appropriateness test, which imposed similar requirements. The mean estimate for training in a large firm was £78,000 and, for a medium firm, £10,438.35 increasing these figures in line with inflation would give a training cost of around £100,000 for a large firm and around £15,000 for a medium firm. Since the training will need to relate to more than just the appropriateness test, we doubled these costs to estimate the impact on the market. We assumed that issuers would be classed as large firms and third party distributors as medium firms. We estimated a one-off industry-wide cost of between £2.8m and £5.25m. After that, expected ongoing training costs to fall within existing business as usual training budgets to demonstrate ongoing competence.

Client classification – The one-off cost to firms of introducing systems to categorise clients was expected to be £12,500 per firm. With our earlier assumption of between 48 and 90 firms, this led to a total industry-wide cost of between £600,000 and £1.125m. We estimated the ongoing cost to firms of categorising each customer to be between £24 and £31 per customer. We also estimated that firms need to conduct between 11,000 and 55,000 client categorisation exercises per year,[1] and therefore lead to industry-wide costs of between £250,000 and £1.75m per year. The process for retail investors who commit not to invest more than 10% of their net investable assets in mutual society shares relies on self-certification and is, therefore, more mechanistic. So long as clients confirm that they have read the prescribed risk warnings and confirm that they will invest no more than 10% of their net investable assets, they may proceed with the investment. We expected only minimal costs for these clients.

Compliance confirmation – We estimated that it will take four days (of seven hours per day) of the compliance manager's time to develop the compliance confirmation process. Assuming a cost per hour of £41.60 per hour (for a compliance manager in a large firm) or £69 per hour (for a senior compliance manager), this led to an initial cost of between £1,000 and £2,000 per firm. Based on the earlier estimate of the number of firms in the market, this led to an estimated one-off cost of between £50,000 and £200,000 for the industry as a whole.

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[1] See FCA Consultation Paper: Restriction on the retail distribution of regulatory capital instruments (CP14/23) for the derivations of these estimates.

Based on the assumption used in the previous section, of between 11,000 and 55,000 client categorisation exercises per year and assuming a cost per hour of £18 for compliance staff, and two hours per confirmation exercise, we estimated a total industry-wide cost of between £400,000 and £2m for undertaking the confirmation exercise each year.

Appropriateness test – The industry survey reported the mean estimated cost of setting up systems to be £34,553. Increasing this in line with inflation would suggest the mean cost were approximately £45,000. This would result in a total industry-wide one-off cost of between £2m and £4m. Adjusted for around 10% of non-retail firms that are exempt from the CoCo restrictions, the one-off industry cost was expected to be around £1.8m and £3.6m. The survey also suggests that the average cost per client of gathering information to conduct the test would be £31, or £40 accounting for inflation (since the survey was conducted in 2005). As before, we estimated a total of between 11,000 and 55,000 high net worth and sophisticated clients per annum. We further estimated that the number of ordinary retail investors to whom firms may wish to sell mutual society shares to be between 33,000 and 165,000 per year. Therefore, we expected that the total number of clients for whom firms must conduct the appropriateness test to be between 44,000 and 220,000 per year, resulting in an ongoing cost of £1.8m to £8.8m per year.

Record keeping – Firms were already subject to record-keeping requirements in SYSC and COBS 4.11 in relation to marketing. The new implementation specifically requires them to maintain detailed records of the basis on which an investment has been promoted or sold and the confirmation of compliance with the new rules. As firms were already obliged to keep records and will have processes in place for them, we estimated that there will only be minimal one-off costs for changing the record keeping.

According to the LECG industry survey from 2005, the average annual cost per client of meeting new record keeping requirements was £1.60 (excluding firms that reported zero additional costs and the high outliers). Increasing these costs in line with inflation, would increase the average cost to £2 per client. As before, we estimated that firms are required to keep record for between 44,000 and 220,000 customers per year, and would therefore incur an ongoing cost of between £100,000 and £500,000 per year.

Lost profits – At the time of implementation, we estimated that retail investors accounted for between 2% and 20% of the market for CoCos (i.e. between £140m and £1.4bn), and that retail investment in mutual society shares would account for between 50% and 75% of the market (i.e. between £125m and £187.5m). Under the new rules, retail investment is still possible but firms must determine whether the investment is likely to be one which the retail client and understand and on which they can afford to take any losses. For example, retail investors for whom investment in CoCos may be suitable are likely to meet the criteria to be categorised as sophisticated or high net worth and firms will still be able to sell them these investments. And, any retail investor will be able to buy mutual society shares if they wish, subject to the safeguards provided by the prescribed risk warnings, an undertaking to invest no more than 10% of the individual's net assets, and the appropriateness test.

Firms do not need to cancel and refund sales to existing customers who did not meet the new criteria in the rules. Direct lost profits are therefore confined to sales that firms would have made to investors that are not qualified sales under the new rules.

While the net impact on firms is expected to be small due to the shifting of sales to qualified retail investors, we recognise that the direct loss of sales to ordinary retail investors in CoCos and the direct loss of sales to ordinary retail investors in mutual society shares may be considered direct impact to business by the RPC, while the indirect gain in sales to qualified retail investors may be considered an indirect impact to business, and therefore not in the scope of the business impact target. We have therefore quantified the direct loss of profit to business that we expect to result from the restrictions:

CoCo: Direct lost revenue between £10m and £100m annually. Assuming that dealing commission constituted 1% of the typical value of sale, this represents a direct loss of dealing commission of between £0.1m and £1m annually.

Mutual society shares: We consider issuance sizes of £100m and that retail investors account for between 50% and 75% of investment. Assuming that 50% of these investors are ordinary retail investors, we can assume that between £25m and £37.5m is held by ordinary investors. We consider that if there were no regulatory intervention, the proportion invested per customer was between 25% and 50% of the customer's net assets. The new rules are therefore expected to reduce the proportion invested per customer to 10%, leading to a reduction in sales of between 60% to 80%, i.e. a reduction in sales of between £15m and £30m. Since the direct profits from sales are derived from dealing commissions, which is fixed per transaction and not affected by the reduced value of sales, we do not expect a significant direct loss in dealing commission from the reduced sales values of mutual society shares.

Summary of direct costs
The table below summarises the ranges of the direct costs to business set out above. Without any further information, we have taken the mid-points of these ranges, and use the mid-points to arrive at a point estimate of the total direct costs to business. We use the total one-off costs of £8m and the total ongoing costs of £8.4m per annum to the industry to calculate the BIT score.

Incremental Costs	One-off costs		Ongoing costs per year	
	Range	**Mid-point**	**Range**	**Mid-point**
Training	£2.8m to £5.25m	£4.0	Minimal	Minimal
Client Classification	£0.6m to £1.125m	£0.9m	£0.25m to £1.75m	£1.0m
Compliance Confirmation	£0.05m to £0.2m	£0.1m	£0.4m to	£0.4. to £2m
Appropriateness Test	£2m to £4m	£3.0m	£1.8m to £8.8m	£5.3m
Record Keeping	Minimal	Minimal	£0.1m to £0.5m	£0.3m
Lost Revenues	Minimal	Minimal	£0.1m to £1m	£0.6m
Total	**£5.45m to £10.58m**	**£8.0m**	**£2.65m £14.05m**	**£8.4m**

<u>Direct benefits to business</u>

Benefits for the FCA – In the longer term, we expected the need for FCA resource to reduce as our new approach becomes embedded and the market becomes more established, with firms adapting to the new regime and the risks to retail customers receding. We however do not quantify the benefit for the FCA, and therefore to business, in this assessment.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.