Financial services, regulation and ethics

R01: 2024–25 Study text

RevisionMate
Provided as part of an enrolment, RevisionMate offers online services to support your studies and improve your chances of exam success. **Access to RevisionMate is only available until 31 August 2025.** This includes: • **Printable PDF and ebook of the study text**. • **Student discussion forum** – share common queries and learn with your peers. • **Examination guide** – practise your exam technique. To explore the benefits for yourself, you can access RevisionMate via your MyCII page, using your login details: *ciigroup.org/login*

Updates and amendments to this study text
This edition is based on the 2024–25 tax year and examination syllabus which will be examined from 1 September 2024 until 31 August 2025. Any changes to the exam or syllabus, and any updates to the content of this study text, will be posted online so that you have access to the latest information. You will be notified via email when an update has been published. To view updates: **1.** Visit *www.cii.co.uk/qualifications* **2.** Select the appropriate qualification **3.** Select your unit from the list provided Under 'Unit updates', examination changes and the testing position are shown under 'Qualifications update'; study text updates are shown under 'Learning solutions update'. Please ensure your email address is current to receive notifications.

Print edition ISBN: 978 1 83727 049 1
Electronic edition ISBN: 978 1 83727 050 7
This edition published in 2024

Authors and updaters

Tessa Roberts, MSc, BSc (Hons), FPFS, Chartered Financial Planner, is a freelance technical author and online tutor specialising in financial services. With 20 years of training design and delivery, she works with the CII in creating and updating distance learning materials for a range of qualifications. Tessa reviewed and updated chapters 2, 3 and 9.

Alan Whittle, MA (Hons), FPFS, IMC Chartered Financial Planner, is an independent provider of training and compliance support services with 18 years' experience across financial planning, investment management and financial protection. Alan reviewed and updated chapters 1, 4, 5, 6, 7, 8 and 10.

Duncan Minty, ACII, Chartered Insurance Practitioner, is an independent ethics consultant with over 18 years' experience in a variety of senior posts in the insurance sector. Duncan reviewed and updated chapter 11.

Technical checkers

Ian Patterson, BA (Hons), Chartered Insurance Practitioner, DipPFS, Assoc CIPD, reviewed and checked chapters 1, 4, 5, 6, 7 and 10 of the 2020–21 edition.

Lorraine Mousley, APFS, checked chapters 1 to 9 of previous editions.

Acknowledgements

The CII would like to thank RGP Compliance for their help with previous editions of the study text.

The CII thanks the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) for their kind permission to draw on material that is available from the FCA website: *www.fca.org.uk* (FCA Handbook: *www.handbook.fca.org.uk/handbook*) and the PRA Rulebook site: *www.prarulebook.co.uk* and to include extracts where appropriate. Where extracts appear, they do so without amendment. The FCA and PRA hold the copyright for all such material. Use of FCA or PRA material does not indicate any endorsement by the FCA or PRA of this publication, or the material or views contained within it.

While every effort has been made to trace the owners of copyright material, we regret that this may not have been possible in every instance and welcome any information that would enable us to do so.

Unless otherwise stated, the authors have drawn material attributed to other sources from lectures, conferences, or private communications.

Typesetting, page make-up and editorial services CII Learning Solutions.

Printed and collated in Great Britain.

This paper has been manufactured using raw materials harvested from certified sources or controlled wood sources.

FSC www.fsc.org MIX Paper from responsible sources FSC® C041357

Using this study text

Welcome to the **R01: Financial services, regulation and ethics** study text which is designed to support the R01 syllabus, a copy of which is included in the next section.

Please note that in order to create a logical and effective study path, the contents of this study text do not necessarily mirror the order of the syllabus, which forms the basis of the assessment. To assist you in your learning we have followed the syllabus with a table that indicates where each syllabus learning outcome is covered in the study text. These are also listed on the first page of each chapter.

Each chapter also has stated learning objectives to help you further assess your progress in understanding the topics covered.

Contained within the study text are a number of features which we hope will enhance your study:

Activities: reinforce learning through practical exercises.

Be aware: draws attention to important points or areas that may need further clarification or consideration.

Case studies: short scenarios that will test your understanding of what you have read in a real life context.

Consider this: stimulating thought around points made in the text for which there is no absolute right or wrong answer.

Examples: provide practical illustrations of points made in the text.

In-text questions: to test your recall of topics.

Key points: act as a memory jogger at the end of each chapter.

Key terms: introduce the key concepts and specialist terms covered in each chapter.

Refer to:

Refer to: extracts from other CII study texts, which provide valuable information on or background to the topic. The sections referred to are available for you to view and download on RevisionMate.

Reinforce: encourages you to revisit a point previously learned in the course to embed understanding.

Sources/quotations: cast further light on the subject from industry sources.

On the Web: introduce you to other information sources that help to supplement the text.

At the end of every chapter there is also a set of self-test questions that you should use to check your knowledge and understanding of what you have just studied. Compare your answers with those given at the back of the book.

By referring back to the learning outcomes after you have completed your study of each chapter and attempting the end of chapter self-test questions, you will be able to assess your progress and identify any areas that you may need to revisit.

Not all features appear in every study text.

Note
Website references correct at the time of publication.

Examination syllabus

Chartered Insurance Institute

Financial services, regulation and ethics

Purpose

At the end of this unit, candidates will have investigated the:

- purpose and structure of the UK financial services industry;
- how the retail customer is served by the financial services industry;
- regulatory framework, powers and responsibilities to protect the consumer;
- legal concepts and considerations relevant to financial advice;
- Code of Ethics and its impact on the business behaviours of individuals.

Summary of learning outcomes		Number of questions in the examination*
1.	Understand the UK financial services industry in its European and global context.	6 standard format
2.	Understand how the retail consumer is served by the financial services industry.	12 standard format
3.	Understand the legal concepts and considerations relevant to financial advice.	9 standard format
4.	Understand the regulation of financial services.	6 standard format
5.	Understand the financial regulators' responsibilities and approach to regulation.	29 standard format
6.	Apply the principles and rules as set out in the regulatory framework.	4 standard format/5 multiple response
7.	Apply the regulatory advice framework to ensure fair outcomes for the consumer.	5 standard format/8 multiple response
8.	Understand the range of skills required when advising clients.	4 standard format
9.	Understand the financial regulators' use of principles and outcomes based regulation to promote ethical and fair outcomes.	7 standard format
10.	Apply the Code of Ethics and professional standards to business behaviours of individuals.	2 standard format
11.	Critically evaluate the outcomes that distinguish between ethical and compliance driven behaviours.	3 standard format

* The test specification has an in-built element of flexibility. It is designed to be used as a guide for study and is not a statement of actual number of questions that will appear in every exam. However, the number of questions testing each learning outcome will generally be within the range plus or minus 2 of the number indicated.

For reference only

Published June 2024

Important notes

- Method of assessment: 100 questions: 87 standard format and 13 multiple response questions. 2 hours are allowed for this examination.
- This syllabus will be examined from 1 September 2024 to 31 August 2025.
- Candidates will be examined on the basis of English law and practice in the tax year 2024/2025 unless otherwise stated.
- It should be assumed that all individuals are domiciled and resident in the UK unless otherwise stated.
- This PDF document has been designed to be accessible with screen reader technology. If for accessibility reasons you require this document in an alternative format, please contact us on online.exams@cii.co.uk to discuss your needs.
- Candidates should refer to the CII website for the latest information on changes to law and practice and when they will be examined:
  1. Visit *www.cii.co.uk/qualifications*
  2. Select the appropriate qualification
  3. Select your unit from the list provided
  4. Select qualification update on the right hand side of the page

Published June 2024

1. Understand the UK financial services industry in its European and global context.

1.1 Describe the role, structure and context of the UK and international financial services markets.

1.2 Explain the function and operation of financial services within the economy.

1.3 Describe the role of the Government on the UK financial services industry.

2. Understand how the retail consumer is served by the financial services industry.

2.1 Explain the obligations that the financial services industry has towards consumers.

2.2 Explain consumers' main financial needs and how these may be prioritised and met.

3. Understand the legal concepts and considerations relevant to financial advice.

3.1 Explain the concepts of legal persons, powers of attorney, law of contract and agency, and ownership of property.

3.2 Explain relevant laws governing insolvency and bankruptcy.

3.3 Explain relevant laws governing wills, intestacy and trusts.

4. Understand the regulation of financial services.

4.1 Examine the roles of the PRA, FCA, HM Treasury and the Bank of England in regulating the market.

4.2 Examine the role of other regulatory bodies and sources of additional oversight.

4.3 Examine the statutory framework of regulation including the impact of global regulation and key regulatory directives.

5. Understand the financial regulators' responsibilities and approach to regulation.

5.1 Explain the financial regulators' statutory objectives and how they are structured to achieve these objectives.

5.2 Explain the main principles and rules of the PRA and FCA.

5.3 Explain the approach to risk based supervision, discipline and enforcement, and sanctions to deal with criminal activities.

6. Apply the principles and rules as set out in the regulatory framework.

6.1 Apply the FCA's and PRA's regulatory principles and rules.

6.2 Apply current anti-money laundering, proceeds of crime and data protection obligations.

6.3 Apply the rules of relevant dispute resolution and compensation schemes.

7. Apply the regulatory advice framework to ensure fair outcomes for the consumer.

7.1 Apply adviser responsibilities in terms of client relationships, regulated advice standards, and positive customer outcomes.

7.2 Monitor and review client plans and circumstances.

8. Understand the range of skills required when advising clients.

8.1 Examine the range of skills required when advising clients.

9. Understand the financial regulators' use of principles and outcomes based regulation to promote ethical and fair outcomes.

9.1 Examine the Financial Conduct Authority's Principles for Businesses and the obligations these place on firms.

9.2 Examine the impact of corporate culture and leadership.

9.3 Examine the responsibilities of those under the Senior Managers and Certification Regime (SM&CR) and the need for integrity, competence and fair outcomes for clients.

10. Apply the Code of Ethics and professional standards to business behaviours of individuals.

10.1 Apply the professional principles and values of ethical, inclusive and sustainable advice.

10.2 Identify ethical dilemmas and apply the steps involved in managing ethical dilemmas.

11. Critically evaluate the outcomes that distinguish between ethical and compliance driven behaviours.

11.1 Evaluate the indicators of ethical behaviour and of limiting behaviour to compliance within the rules.

11.2 Critically evaluate the outcomes that distinguish between ethical and compliant behaviours.

Reading list

The following list provides details of further reading which may assist you with your studies.

Note: The examination will test the syllabus alone.

The reading list is provided for guidance only and is not in itself the subject of the examination.

The resources listed here will help you keep up-to-date with developments and provide a wider coverage of syllabus topics.

CII study texts
Financial services, regulation and ethics. London: CII. Study text R01.

Books
A practitioner's guide to MiFID II. 3rd ed. Jonathan Herbst. London: Sweet and Maxwell, 2018.

Business ethics and values: individual, corporate and international perspectives. 4th ed. Colin Fisher and Alan Lovell. FT Prentice Hall, 2012.

Competition law and policy in the EU and UK. 6th ed. Barry Rodger, Angus MacCulloch. Routledge-Cavendish, 2021.* *

Ethics and finance: an introduction. John Hendry. Cambridge: Cambridge University Press, 2015.

The business ethics twin-track: combining controls and culture to minimise reputational risk. Steve Giles. Chichester: Wiley, 2015.*

Winning client trust : the retail distribution review and the UK financial services industry's battle for its clients' hearts and minds. Chris Davies. London: Ecademy Press, 2011.*

Ebooks
The following eBooks are available via www.cii.co.uk/elibrary (CII/PFS members only):

Business ethics. Michael Boylan. 2nd ed. Chichester: Wiley, 2014.

Business ethics in the social context: law, profits, and the evolving moral practice of business. Lisa Newton. Cham [Switzerland]: Springer, 2014.

International finance regulation: the quest for financial stability. Georges Ugeux. Wiley, 2014.

Promoting information in the marketplace for financial services: financial market regulation and international standards. Paul Latimer, Philipp Maume. Cham [Switzerland]: Springer, 2014.

The role of law and regulation in sustaining financial markets. Niels Philipsen, Guangdong Xu. Hoboken: Routledge, 2014.

Online resources
The EU single market. The European Commission. Updated as necessary. Available online at ec.europa.eu/internal_market

Code of ethics explained. Duncan Minty. CII Faculty lecture, 2014. Available online at www.cii.co.uk/30790

IIL financial services podcast lectures can be found on the CII website at IIL Financial Services Lectures Additional articles and technical bulletins are available under the Personal Finance section of the CII knowledge website at www.cii.co.uk/knowledge/personal-finance.

Journals and magazines
Financial adviser. London: FT Business. Weekly. Available online at www.ftadviser.com.

Personal finance professional. London: CII. Four issues a year. Available online at www.pfp.thepfs.org (CII/PFS members only).

Reference materials
International dictionary of banking and finance. John Clark. Hoboken, New Jersey: Routledge, 2013.*

Financial Conduct Authority (FCA) Handbook. Available at www.handbook.fca.org.uk/handbook.

Harriman's financial dictionary: over 2,600 essential financial terms. Edited by Simon Briscoe and Jane Fuller. Petersfield: Harriman House, 2013.*

Prudential Regulation Authority (PRA) Rulebook Online. Available at www.prarulebook.co.uk

Examination guide

If you have a current study text enrolment, the current examination guide is included and is accessible via Revisionmate (ciigroup.org/login). Details of how to access Revisionmate are on the first page of your study text. It is recommended that you only study from the most recent version of the examination guide.

For reference only

Exam technique/study skills

There are many modestly priced guides available in bookshops. You should choose one which suits your requirements.

The Membership Advantage

Membership makes insurance and personal finance professionals better by enhancing your credibility, giving you a home within a community of like-minded individuals and the resources to achieve your career aspirations.

R01 syllabus quick-reference guide

Syllabus learning outcome		Study text chapter and section
1.	**Understand the UK financial services industry in its European and global context.**	
1.1	Describe the role, structure and context of the UK and international financial services markets.	*1B*, *1C*
1.2	Explain the function and operation of financial services within the economy.	*1A*
1.3	Describe the role of the Government on the UK financial services industry.	*1D*, *1E*
2.	**Understand how the retail consumer is served by the financial services industry.**	
2.1	Explain the obligations that the financial services industry has towards consumers.	*9A*, *9B*, *9C*, *9D*
2.2	Explain consumers' main financial needs and how these may be prioritised and met.	*2A*, *2B*, *2C*, *2D*, *2E*, *2F*, *2G*
3.	**Understand the legal concepts and considerations relevant to financial advice.**	
3.1	Explain the concepts of legal persons, powers of attorney, law of contract and agency, and ownership of property.	*3A*, *3B*, *3C*, *3D*, *3E*
3.2	Explain relevant laws governing insolvency and bankruptcy.	*3F*
3.3	Explain relevant laws governing wills, intestacy and trusts.	*3G*, *3H*
4.	**Understand the regulation of financial services.**	
4.1	Examine the roles of the PRA, FCA, HM Treasury and the Bank of England in regulating the market.	*4B*
4.2	Examine the role of other regulatory bodies and sources of additional oversight.	*4D*, *4E*
4.3	Examine the statutory framework of regulation including the impact of global regulation and key regulatory directives.	*4A*, *4C*
5.	**Understand the financial regulators' responsibilities and approach to regulation.**	
5.1	Explain the financial regulators' statutory objectives and how they are structured to achieve these objectives.	*5A*, *5B*, *5D*, *5E*
5.2	Explain the main principles and rules of the PRA and FCA.	*6A*, *6B*, *6C*, *6D*, *6E*, *6F*, *6G*, *7A*
5.3	Explain the approach to risk based supervision, discipline and enforcement, and sanctions to deal with criminal activities.	*5C*
6.	**Apply the principles and rules as set out in the regulatory framework.**	
6.1	Apply the FCA's and PRA's regulatory principles and rules.	*7A*, *7B*, *7C*, *7D*
6.2	Apply current anti-money laundering, proceeds of crime and data protection obligations.	*7E*, *7F*
6.3	Apply the rules of relevant dispute resolution and compensation schemes.	*7G*, *7H*, *7I*
7.	**Apply the regulatory advice framework to ensure fair outcomes for the consumer.**	
7.1	Apply adviser responsibilities in terms of client relationships, regulated advice standards, and positive customer outcomes.	*8A*, *8B*
7.2	Monitor and review client plans and circumstances.	*8C*
8.	**Understand the range of skills required when advising clients.**	
8.1	Examine the range of skills required when advising clients.	*9A*, *9B*, *9C*, *9D*

Syllabus learning outcome		Study text chapter and section
9.	**Understand the financial regulators' use of principles and outcomes based regulation to promote ethical and fair outcomes.**	
9.1	Examine the Financial Conduct Authority's Principles for Businesses and the obligations these place on firms.	*10A*
9.2	Examine the impact of corporate culture and leadership.	*10B*
9.3	Examine the responsibilities of those under the Senior Managers and Certification Regime (SM&CR) and the need for integrity, competence and fair outcomes for clients.	*7B*, *10C*
10.	**Apply the Code of Ethics and professional standards to business behaviours of individuals.**	
10.1	Apply the professional principles and values of ethical, inclusive and sustainable advice.	*11A*, *11B*, *11D*
10.2	Identify ethical dilemmas and apply the steps involved in managing ethical dilemmas.	*11B*, *11E*
11.	**Critically evaluate the outcomes that distinguish between ethical and compliance driven behaviours.**	
11.1	Evaluate the indicators of ethical behaviour and of limiting behaviour to compliance within the rules.	*11C*
11.2	Critically evaluate the outcomes that distinguish between ethical and compliant behaviours.	*11C*, *11E*

Exam guidance and accessibility

Before you begin the study text, we would encourage you to read about how to approach the exam.

Study skills

While the text will give you a foundation of facts and viewpoints, your understanding of the issues raised will be richer through adopting a range of study skills. They will also make studying more interesting! We will focus here on the need for active learning in order for you to get the most out of this core text.

Active learning is experiential, mindful and engaging

- **Underline or highlight key words and phrases** as you read – many of the key words have been highlighted in the text for you, so you can easily spot the sections where key terms arise; boxed text indicates extra or important information that you might want to be aware of.
- **Make notes in the text**, attach notes to the pages that you want to go back to – chapter numbers are clearly marked on the margins.
- **Make connections to other CII units** – throughout the text you may find 'refer to' boxes that tell you the chapters in other books that provide background to, or further information on, the area dealt with in that section of the study text.
- **Take notice** of headings and subheadings.
- **Use the clues in the text** to engage in some further reading (refer to the syllabus reading list) to increase your knowledge of a particular area and add to your notes – be proactive!
- **Relate** what you're learning to your own work and organisation.
- **Be critical** – question what you're reading and your understanding of it.

Five steps to better reading

- **Scan**: look at the text quickly – notice the headings (they correlate with the syllabus learning outcomes), pictures, images and key words to get an overall impression.
- **Question**: read any questions related to the section you are reading to get a feel for the subjects tackled.
- **Read**: in a relaxed way – don't worry about taking notes first time round, just get a feel for the topics and the style the book is written in.
- **Remember**: test your memory by jotting down some notes without looking at the text.
- **Review**: read the text again, this time in more depth by taking brief notes and paraphrasing.

On the Web

Visit here for more detail on study skills: *www.open.ac.uk/skillsforstudy*.

Note: website reference correct at the time of publication.

Exam guidance

Answering multiple-choice questions

When preparing for the examination, candidates should ensure that they are aware of what typically constitutes each type of product listed in the syllabus and ascertain whether the products with which they come into contact during the normal course of their work deviate from the norm, since questions in the examination test generic product knowledge.

Some questions are simply questions of fact, whereas others may be more progressive in nature, requiring reasoning to determine the correct option or, perhaps, being answerable by a process of elimination. Whatever the question, read it carefully to identify what it is really asking. Do not assume that you 'know' what it is asking, even if the question is on a topic about which you feel very confident; answer the question exactly as it is asked. Also, look out for the occasional negative question (Which of the following is not …?).

Try to answer all of the questions. While there is no substitute for a good grasp of the subject matter, and you cannot expect to pass the examination purely on guesswork, you do not lose marks for giving a wrong answer!

You can find more information on the specific unit in the exam guide (available on the unit page on the CII website and on RevisionMate).

Important note on tax rates and allowances

Tax tables giving rates of tax, tax bands, reliefs, etc. will be provided, where necessary, when you take the exam. This information will be restricted to figures and amounts only; you will still be expected to know the principles of the tax system, and how to apply these using any figures supplied. You will also need to understand the workings of the main forms of taxation and the types of exemptions, reliefs and allowances available.

On the Web

You can find more on preparing for your exam by visiting: *https://www.cii.co.uk/learning/qualifications/assessment-information/before-the-exam/*.

Note: website reference correct at the time of publication.

Accessibility

The CII has produced a policy and guidance document on accessibility and reasonable/special adjustments. The purpose of this is to ensure that you have fair access to CII qualifications and assessments.

On the Web

The ‘Qualifications accessibility and special circumstances policy and guidance’ document can be found here: *www.cii.co.uk/media/bxsjd2e2/cii-qualifications-accessibility-and-special-circumstances-policy-and-guidance.pdf*.

Note: website reference correct at the time of publication.

Introduction

In this study text we will look at three inter-linked topics of regulation, financial products/services and ethics.

Regulation

The financial services industry is a key part of the UK economy and we need to appreciate how this industry fits within the UK and also how it interacts with world economies. We consider the roles of the various UK regulators and examine how these link together to develop the framework of regulation that now exists.

Regulation is essential as any sector of financial activity needs to have rules to help ensure an orderly and fair market. The regulators – in their various guises – are there to 'police' the industry to help ensure that markets work with integrity and customers are protected and treated fairly. We will look mainly at the work of the Financial Conduct Authority, within both the overall framework of regulation and its main participants, and then go on to consider particular areas of regulation in more detail. These will cover the respective responsibilities of the regulator, regulated firms and those regulated individuals working within them and the overriding duty of care to retail clients.

Products and services

Having examined regulation, we also consider how the financial products and services that customers need in different stages of their lives can be identified, and we then see how these needs can be satisfied by the industry developing solutions to meet them.

Financial advisers have obligations to consumers and consumers' perceptions of financial services. This includes making disclosures and the duties that they must fulfil.

Consumers' main financial needs are managing money, debt and borrowing, protection, retirement, saving and investing, and estate and tax planning. Having identified a client's needs the adviser must then consider the products and services available to satisfy those needs, as well as the role State benefits might play.

The UK legal system has a major effect on the financial services industry. An adviser should therefore be familiar with the main aspects of the system that impact on savings, insurance and pension practice, as well as the major types of businesses.

The advice given to a client may be affected by any of the following: powers of attorney; the laws of contract and agency; types of property and its ownership; insolvency and bankruptcy; the law of succession, personal representatives and the administration of estates; and finally, the law of trusts and their use. An adviser, therefore, needs a basic understanding of each of these matters.

Ethics

We conclude this unit by considering the behaviour of individuals and, by extension, of the firms they work in. We will see how 'doing the right thing' is influenced by the culture within firms and the leadership example set.

Contents

1

The UK financial services industry: an overview

Contents	Syllabus learning outcomes
Introduction	
A How financial services function within the wider economy	*1.2*
B UK financial services structure	*1.1*
C The role and structure of international markets	*1.1*
D How global regulation impacts UK regulation	*1.3*
E The role of Government	*1.3*
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- discuss the function and operation of financial services within the wider economy;
- explain the role and structure of the UK and international markets;
- identify the key participants in the UK and international markets;
- outline the impact of global regulators on UK regulation; and
- discuss the role of the Government in regulation, taxation, economic policy and social welfare.

Introduction

The UK operates within a wider global economy and is much affected by it. In this chapter we will outline some of the bodies that influence the operation of the UK financial services industry, including the pivotal role of the UK Government in the direction of the industry, economic policy and regulation.

Key terms

This chapter features explanations of the following terms and concepts:

Bank of England	Banks and building societies	European Banking Authority (EBA)	European Central Bank (ECB)
European Insurance and Occupational Pensions Authority (EIOPA)	European Securities and Markets Authority (ESMA)	European System of Financial Supervision (ESFS)	European Systemic Risk Board (ESRB)
Financial Action Task Force (FATF)	Financial Services Action Plan (FSAP)	Fiscal policy	Intermediaries
Monetary policy	Quantitative easing		

A How financial services function within the wider economy

Financial services can be said to perform four essential functions:

- provide a vehicle through which savings are protected and channelled into capital management;
- provide a means by which savers' desire for ready access to their capital can match borrowers' requirements for long-term funds, and allow financial institutions to take positions with longer terms and potentially greater return;
- allow individuals and companies to insure against risks they do not wish to take but which others are prepared to assume in return for payment; and
- allow investors to disperse risk across a number of different investment products.

Savings can take many forms, from deposits with banks and building societies to the purchase of gilts or shares.

A1 Short-term savings

Banks and building societies have developed from people's need to keep money safe yet readily accessible. The bank or building society protects its customers' money while benefiting from the relationship by using that money to make a return for itself.

At the most basic level, a bank lends the money it receives in deposits to other individuals who wish to borrow from it. Providing there are always sufficient reserves available for those customers wanting to withdraw their balance, the system works successfully. The bank makes a return by charging interest on the loan, which covers its costs and generates profit for the bank's shareholders, some of which may be returned as interest to account holders. In reality, however, the process is much more complex. Due to the nature of fractional-reserve banking, a bank may lend out a higher amount than it receives in deposits, with much of the liquidity required to repay any depositors coming from inter-bank lending. The failure of the inter-bank lending market was a key contributor to the financial crisis in 2008/09. Banks are required to maintain a substantial amount of capital and much of this is held in the form of Government bonds. As these investments change value, banks have to keep a close eye on the value of their investments to ensure they maintain enough liquid capital to repay their depositors.

Example 1.1

In 2023, Silicon Valley Bank in the USA collapsed in part due to what have been described as poor liquidity controls. The bank held much of its capital in long-term Government bonds which are subject to high-interest-rate risk. As interest rates rose in 2022, the value of these bonds fell and the bank saw its available liquidity squeezed. When companies with deposits at the bank caught wind of its liquidity problems, they tried to withdraw their cash but the bank was unable to make good on its deposits. The US Federal Reserve Bank stepped in to protect depositors.

Asset or liability

Loans: A bank will make money on the interest charged on a loan and it will eventually be paid back. A bank's loan book is considered an income producing **asset**.

Deposits: A bank will have to pay deposits back at some point, so they are considered a **liability**.

Banks can also use some of those short-term investments to make their own longer-term, and potentially higher-return, investments.

While banks are owned by their shareholders, building societies developed as 'mutually owned' organisations to perform a similar function. They differ in that they were originally set up specifically to lend money to their members to buy houses. Building societies are owned by the individuals who have share accounts with them and as a result there are no shareholders to pay dividends to. This leaves more money available for distribution to account holders in the form of interest and allows the company to charge slightly less interest on the money it lends.

Banks and building societies still perform this important function of turning short-term savings into longer-term lending, but the development of these institutions has widened. They now offer a wider range of short- and longer-term deposit investments, and have diversified into other areas of financial services – acting as intermediaries by offering products from other institutions, as well as a range of their own.

Question 1.1

What do banks do with the money they receive in current accounts?

A2 Government savings

The Government has traditionally used the savings of private individuals to fund its own borrowing.

Refer to

More detail on gilts in *Government securities and corporate bonds* on page 2/46

Its main way of achieving this is to act as a financial institution in its own right and issue fixed interest investments via the UK Debt Management Office. These investments pay a fixed level of interest at regular intervals over a fixed (or variable) period of time. While they act as an investment to the individual buying them, returning the original capital at the end of the term and interest at intervals during it, they function as a loan to the Government. Gilts are one of the best-known types of this investment.

Conventional gilts represent the majority of UK Government debt. They promise to pay a fixed coupon (interest) rate every six months. When a conventional gilt matures, its holder is paid back the nominal or face value investment which may not be the same amount as the original investment. The Government borrows money over different time periods such as five, ten and thirty years. There are also gilts where the nominal value and the interest rate are linked to the Retail Prices Index (RPI) to protect against the effect of inflation. This is known as index-linking. Different measures of inflation exist and RPI is no longer the benchmark measure used by the Government. A move to using the Consumer Prices Index including Housing (CPIH) to index-link gilts has been confirmed, but this change is not anticipated to take place until 2030.

In 2021 the UK Government issued its first green gilts. These investments are used to fund green projects across the UK, with the aim of driving progress towards UK net zero goals, and are often offered at different rates of interest to their conventional counterparts.

The other Government financial institution is **National Savings and Investments (NS&I)**, best known as the issuer of Premium Bonds. Savings and deposits into this institution are also used to fund Government borrowing.

Question 1.2
What is the main purpose of a gilt?

A3 Insurance and risk management

The principle of insurance and risk management is simply to protect and safeguard assets from the financial effects of damage or loss. This can be done by insuring against certain situations using some form of policy, or by managing the circumstances so that the risk of damage or loss is reduced.

Both individuals and companies can have protection needs on their:

- physical assets;
- earnings;
- profit potential; and
- financial transactions.

Most people are familiar with the insurance policies of physical assets such as cars and houses. The basic principle is that the relatively small premiums paid on each policy are pooled by the insurer, who then invests the money (when it is not required to pay claims) on a short- or long-term basis. The investment returns then serve to maintain and even grow the value of the financial institution's reserves against inflation.

Insurance is a means of **risk transfer**. In return for the payment of a premium by the policyholder, the insurance company takes over the risk.

In a family unit, one or more individuals will be responsible for providing an income. These earnings are often vital to support the family and any interruption could cause severe financial hardship. **Life assurance** can be used to protect these earnings from the death of a breadwinner, while other types of policy can be used to protect against the inability to work through injury or the development of a serious illness.

Similarly, all but the very largest of businesses will need to give consideration to this protection need, and there are specialist 'key person' policies to insure against the death or long-term illnesses of individuals who are vital to the income stream of a company.

Employee benefits, including death benefits, sickness benefits and pensions, are typically paid for by the employer, but do not necessarily help to protect the earnings potential of the company. They do, however, help protect the earnings potential of the employees and their families, and this in turn helps the company to attract and retain employees.

All these forms of protection are provided by financial institutions and insurance companies, but there are some risks that are simply too big to be covered by a single company. In this case the risk is initially accepted and assessed by an insurance company, but then passed on to a **reinsurance company** for a proportion of the premium. Very large risks may need to be reinsured with several companies. Probably the best-known insurer in the world is **Lloyd's of London**, which offers a specialist insurance and reinsurance market through its underwriting syndicates.

Protection of financial transactions is a more complex area but a similar principle applies except that instead of using an insurance policy for protection, financial instruments called *derivatives* are used to offset potential losses. See Other investments on page 2/52.

Question 1.3
Apart from physical assets, what else can be insured?

A4 Longer-term investment and capital markets

The capital markets developed to meet two key objectives:

- enable investors to invest in assets that provide the potential for real growth (growth over and above the general increase in prices); and
- help companies to raise money without necessarily having to borrow it from a bank.

These requirements gave rise to two different types of financial instrument:

- **Shares** are the means by which private investors and corporations can buy ownership of a percentage of a company. This means they benefit from an increase in the value of the company and receive a proportion of the distributed profits in the form of a **dividend**. It also grants them the right to vote in shareholder meetings on certain key decisions.
- **Fixed-interest stocks** (**bonds**) allow private investors and corporations to lend a company money, subject to certain predefined terms, in exchange for an interest payment. The interest charged will be higher than that which might be available from a bank due to the increased risk for the initial sum and interest not being repaid. (This is similar to the lending to the Government described in *Government savings* on page 1/3.)

While some private individuals access these investments directly, the vast majority access them indirectly through collective schemes for savings, investments and pensions.

B UK financial services structure

There are four key components within the financial sector:

- financial **infrastructure** – the payment, settlement, clearing and trading systems;
- financial **markets** – both on-exchange and over the counter (OTC);
- financial **firms** – including banks (retail or investment), pension funds and insurance firms; and
- the financial sector **authorities** – the Bank of England, the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), and HM Treasury.

B1 Financial infrastructure

The financial sector is heavily dependent on collective pieces of financial infrastructure; in this context, the payment, settlement, clearing and trading systems.

Payment systems are important to the financial sector either because they deal with very high values or because they are widely used by customers. High-value systems are used by wholesale financial markets, and their failure could rapidly transmit shocks from firm to firm, and from one market to another. Widely used systems are integral to the wider economy, and their failure could impact substantially on normal economic activity.

The Bank of England oversees payment systems in the UK; it monitors and facilitates the functioning of the Sterling money markets and payments systems, and has close links with the various separate clearing companies responsible for maintaining the operational efficiency and integrity of the payment systems, e.g. CHAPS Clearing Company, Cheque and Credit Clearing Company, Faster Payments Scheme and BACS Payment Schemes Ltd.

Pay.UK is the operator of the UK's retail payment systems and sets the standards for providers of payment systems.

The **Payments Systems Regulator (PSR)** is the economic regulator for the £95 trillion payment systems industry in the UK. The statutory objectives of the PSR are to:

- ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them;
- promote effective competition in the markets for payment systems and services – between operators, payment service providers and infrastructure providers; and
- promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems.

The PSR's purpose is to make payment systems (that are accessible, reliable, secure and value for money) work well for those that use them.

Clearing houses and **settlement systems** provide the infrastructure for clearing and settlement of the securities and derivatives markets. The FCA is the regulator of recognised investment exchanges. The Bank of England supervises recognised clearing houses as part of its regulation of the UK's financial market infrastructure.

B2 Financial markets

Member firms use **on-exchange markets** to trade investments such as equities and derivatives via the trading floor, whether electronic or (rarely now) physical. The FCA regulates the key exchanges in the UK.

There are no physical exchanges for **over-the-counter (OTC) markets**, but users of the markets have formed committees that examine how their respective markets function.

B3 Financial firms

Refer to
See *The regulation of financial services* on page 4/1 for coverage on the financial sector authorities

It is important at this stage to understand that the UK financial services industry is part of a much wider system of institutions and markets. The bank which holds your account (and possibly provides other financial services) is also connected to the following:

Money market	A wholesale market for commercial borrowers and lenders.
Capital markets	For trading stocks and shares, fixed interest investments and derivatives (these supply capital for businesses and investments for investors).
Commodity markets	For trading physical goods (i.e. steel, oil, foodstuffs etc.).
Foreign exchange (FX) markets	For trading foreign currency.
Insurance companies	For insuring physical assets. These that provide capital to secure insurance policies and provide banking and investment management.
Investment companies	These invest surplus funds for longer term gain.
Life assurance and pension companies	These invest their assets to meet long-term policyholder obligations.
Reinsurance companies	Companies that provide security to diversify risk from insurance companies.
Investment houses	These Issue pooled investments like unit trusts and open-ended investment companies (OEICs).

All these institutions or markets are directly or indirectly part of the UK financial services industry. However, at this stage we will be concentrating on those that interact most directly with the public.

B3A Banks and building societies

Retail banks and building societies have rapidly increased the range of financial services which they offer to the general public in an attempt to capitalise on their significant town/city centre presence and widespread 'brand awareness'.

In considering the range of services, we can usefully make a distinction between core services and those that are peripheral to the main banking role, but which have become increasingly crucial to the profitability of these institutions.

Core services
Let us begin by looking at the core services offered by banks and building societies:

- **Current accounts.** Otherwise known as cheque accounts, these are the most flexible accounts offered by banks and by some building societies. They provide security for customers' money, easy access to it and many other services (such as direct debits, standing orders and the provision of foreign currency), but pay little or no interest on credit balances.

- **Deposit accounts**. These accounts, also known as bank savings accounts or building society share accounts, are less accessible than current accounts, but still offer a very liquid (i.e. accessible) depository for money which might be needed in the near future. Rates of interest vary widely depending on the institution, the amount of money deposited and any special features such as a fixed term or notice period for withdrawals.
- **Mortgages and loans**. Traditionally provided by both banks and building societies to finance the purchase of property (e.g. houses, cars etc.) or other assets.

When a number of building societies abandoned their mutual status (known as **demutualisation**) in favour of becoming public corporations (i.e. banks), it was usual for borrowers, as well as members, to benefit from a windfall in cash and/or shares in the new company.

Indirect services
The main indirect services offered by banks and building societies include the following:

- **Portfolio management**. Some banks and building societies offer a portfolio management service to those investing substantial amounts of money on the **UK stock market**. The bank's specialist investment managers establish and manage a suitable portfolio of financial assets, taking all the relevant decisions to meet the investor's objectives. This is known as a **discretionary service**. Alternatively, a bank will administer the client's own portfolio of shares, unit trust/OEICs or other financial assets, making suggestions to its clients regarding holdings that should be bought or sold (called an **advisory service**). These services allow the bank's clients to choose the level of involvement they want in managing their investments. Fees are charged for these portfolio management services.
- **Stockbroking services** enable customers to buy and sell securities, gilts and/or corporate bonds (called an **execution-only service**).
- **Wills and executorship**. This service is one that is offered primarily by the major high-street banks, promoting themselves on the basis of their accumulated expertise, experience and continuity of service.
- **Collective investment (unit trusts and OEICs)** services offering access to collective investments. Some even have their own unit trust subsidiary. Investors in the unit trusts/ OEICs are attracted mainly through the firm's branch network. This allows for those seeking a wide spread of investments, without wanting day-to-day control of investment decisions. It is also a more appropriate and cost-effective alternative for lower levels of capital investment. For those firms with their own unit trust/OEIC company these funds are typically distributed by the **tied** or **multi-tied** financial services arm of the firm, rather than an independent financial adviser subsidiary.
- **Insurance and pensions**. Most high-street banks and building societies have now established divisions or subsidiaries to transact life insurance and pensions business. Most also offer various general insurance products, with motor, household, travel and payment protection insurance being those that are most frequently sold.

Reinforce

In respect of the life assurance and pensions business, the offering will be one or more of the following (where more than one form of advice is available, the adviser must make it very clear which applies in each case):

Independent A firm that assesses a sufficient range of relevant products that are diverse enough in type and issuer to ensure that the client's investment objectives can be suitably met may be described as 'independent'. In other words, all retail investment products need to be considered.

Restricted A firm that can only recommend certain products or providers or both. This might mean it can recommend the products of several providers but not all. Or, that it will recommend one or a small range of products but not all retail investment products. Restricted advisers must not describe themselves as 'independent'.

Some larger financial services providers, such as banks and building societies, may have both an independent offering, as well as a restricted offering from different subsidiaries. It is generally accepted that these forms of advice appeal to different market segments.

Some banks and building societies have set up their own life insurance company (typically with help from an existing company), which forms the basis of their tied or multi-tied offering. Such organisations are often described as **bancassurers**.

The future of financial advice

It is likely that in future there will be fewer companies falling into the tied financial advice category, as the regulations now make it just as easy to operate a multi-tied organisation with offerings from other providers where there is a weakness or a gap in the product range.

Most banks and building societies will follow a similar model in their provision of financial advice, either:

- an arm (or subsidiary) offering a range of products from a limited number of providers (a multi-tied arrangement), one of which could be the bank's own insurance company (a bancassurer); or
- an arm offering fully independent financial advice on products from providers across the whole market.

If they can do both, this will present them with the best opportunity to write business and to profit from the financial services sector as both an adviser and a provider.

B3B Life assurance companies

Life assurance companies can distribute their products via:

- intermediaries (independent or restricted advisers); or
- their own financial services sales team.

Depending on their view about the future of the industry, some insurers and fund management groups adopt a particular policy, i.e. to make a commitment to the **independent financial adviser (IFA)** sector. Providing the company is prepared to back the stance with action, it can be a good approach to take.

Many IFAs view restricted advisers as being in competition with their market and so may be less willing to support a company that is not committed to their sector. The Retail Distribution Review (RDR) had a profound impact on distribution of financial products through all channels and brought about a considerable number of changes.

B3C Friendly societies

Friendly societies were established in the nineteenth century as mutual self-help groups with no shareholder taking any part of the society's profits; all profits (after expenses) would be repayable to the society's members. In accordance with their 'self-help' status they were assisted by being granted complete exemption from taxation. This has enabled them to offer tax-efficient savings plans, although legislation has restricted their business by imposing a limit on the nature and size of contracts they can offer.

While being active participants in the financial services market, many of the societies are small and only a few actively market tax-exempt endowment-based savings plans. Friendly societies can also offer a limited range of home service-type, small 'industrial' life policies.

In many cases the products are distributed by the sales staff of the friendly society. Others distribute some or all of their products via independent financial advisers.

Since the passing of the **Friendly Societies Act 1992**, societies are able to apply for corporate status and extend the scope of the services they offer to include unit trusts/OEICs and individual savings accounts (ISAs).

B3D Multi-distribution organisations

The marketing of financial services becomes considerably easier when you already have a large established base of loyal customers, particularly when there is no past history to colour clients' views. This is a factor recognised by companies such as Virgin, Sainsbury's, Tesco and M&S. All took advantage of their established name and reputation (together with their considerable financial resources) to begin offering a range of financial products. The product range typically includes life assurance, ISAs, unit trusts/OEICs and, in some cases, pensions.

The catalyst for significant expansion was the introduction of the requirement for Government approval of products that fall within clearly defined rules relating to **Charges, Access and Terms (CAT)**, first on ISAs in 1999 and then on pensions in 2001. Restricted requirements for fact-finding and advice allowed these organisations to make further inroads in the financial services market without using a qualified sales team.

However, in January 2024 Sainsbury's announced that it would be gradually winding down its banking services. In February 2024 Tesco announced the sale of its banking business to Barclays. Both companies sought these changes to renew focus on their core operations.

C The role and structure of international markets

As an international financial centre, the UK is host to a wide range of overseas firms and is home to financial markets that are highly integrated within the global economy. Many UK firms also have significant operations overseas. As a result, there is an important international dimension to the UK financial services industry.

There are a number of international bodies that set global regulatory standards and promote regulatory convergence.

Global	• The Financial Stability Board coordinates national financial authorities and makes recommendations about the global financial system. • The ***Financial Action Task Force (FATF)*** sets international standards on anti-money laundering and countering terrorist financing. • The International Organization of Securities Commissioners (IOSCO) brings together the world's securities regulators to set common standards. • The International Association of Insurance Supervisors (IAIS) supervises and sets common standards for the international insurance sector. • The Basel Committee on Banking Supervision (BCBS) is the primary standard setter for the prudential regulation of banks and provides a forum for banking supervisory matters. • The International Swaps and Derivatives Association (ISDA) represents participants in the privately negotiated derivatives industry, including interest rate, currency, commodity, credit and equity swaps. • The International Securities Market Association (ISMA) is a trade association and self-regulating organisation, supervising markets in international debt.
EU	There are three **European Supervisory Authorities (ESAs)**: • the ***European Banking Authority (EBA)***; • the ***European Securities and Markets Authority (ESMA)***; and • the **European Insurance and Occupational Pensions Authority (EIOPA)**. There is also the **European Central Bank (ECB)**. Its role is to coordinate and control monetary policy and interest rates in the Member States using the euro.

The EU has also established a ***European Systemic Risk Board (ESRB)*** to monitor and assess risks to the stability of the financial system as a whole (macro-prudential supervision), and a **European System of Financial Supervision (ESFS)** for the supervision of individual financial institutions (micro-prudential supervision), consisting of a network of national financial supervisors (e.g. the Financial Conduct Authority (FCA) in the UK prior to January 2021). While the UK is no longer a member of the EU, these institutions are still relevant to understanding the global regulatory landscape.

D How global regulation impacts UK regulation

Prior to the UK's departure from the EU, the UK financial services industry was subject to regulations imposed by both the EU (as a condition of membership) and the UK Government. Many aspects of the UK regulatory system remain largely aligned with the EU's. However, the UK has diverged from EU laws and regulations. The first evidence of divergence was the loss of passporting rights which allowed UK financial services companies to do business in EU Member States without being directly regulated in those States. Some EU regulations, such as the EU Sustainable Finance Disclosure Regulation

(SFDR), do not apply to the UK but will still be relevant to those offering services to EU clients or where investments established in the EU are used in the UK.

Around 70% of the FCA's policymaking effort prior to 2020/21 was driven by European initiatives, including the ***Financial Services Action Plan (FSAP)***. Many of these rules have been written into UK law and continue to apply. A key element of divergence is that regulatory developments are now led primarily by regulators, rather than through the creation of new laws based on EU regulations and directives, which regulators must then interpret and implement.

Divergence creates both opportunities and risks. The approach of UK regulatory agencies is to demonstrate how their regulations align with those of their international counterparts. This is particularly notable in the FCA's demonstration of alignment of its Sustainable Disclosure Requirements (CP22/20) with existing rules in the EU and proposed rules in the USA (SEC Climate-related Disclosures for Investors).

The FCA will continue to engage with regulatory counterparts globally, including the EBA, EIOPA and ESMA.

Onshoring was the process of amending EU legislation and regulatory requirements so that they work in a UK-only context. This includes directly applicable EU legislation such as regulations and decisions that form part of UK law by virtue of the **European Union (Withdrawal) Act 2018**.

The onshoring process means the requirements for firms and other regulated persons will change. To help firms adapt to the new requirements, the Treasury gave UK financial regulators the power to make transitional provisions to financial services legislation for a temporary period. This is known as the Temporary Transitional Power (TTP).

D1 EU regulation of financial services

The FSAP played a part in improving the Europe-wide single market for financial services, prompting a comprehensive legislative programme, which was implemented and applied in the UK. Many regulatory initiatives which applied during the period of EU membership continue to apply in the UK through onshored legislation.

The three original objectives of the FSAP were to:

- create a single EU wholesale market;
- achieve open and secure retail markets; and
- create state-of-the-art prudential rules and structures of supervision.

These objectives aimed to promote Europe’s wider economy by removing barriers and increasing competition among financial services firms, thereby making markets more efficient and reducing the cost to the wider economy of raising capital.

Since 1999, the European Commission adopted or updated requirements concerning, among others:

- the amount of capital that firms should hold;
- the rules they must comply with when carrying on business with their customers;
- the controls they must apply to counter the risk of money laundering and terrorist financing;
- the tests to apply when assessing the suitability of new controllers or large shareholders;
- the requirements they must impose to counter the risk of market abuse; and
- the disclosures that companies must make when seeking new capital.

Much UK financial services regulation was established under this regime, however, these same issues remain important factors for UK regulators.

On the Web

The FCA website features a comprehensive international standards and regulations section: *www.fca.org.uk/about/international-standards-regulations*.

D2 UK regulation of financial services

The UK Government department responsible for the regulation of the financial services market is the Treasury, under the direct authority of the **Chancellor of the Exchequer**. While there is no doubt the Treasury is involved in the implementation, it is the Chancellor who has direct responsibility for the regulation and conduct of business both directly and via the legal instruments they introduce. Government policy is, therefore, open to change – depending on which political party is in power.

Refer to

See *The regulation of financial services* on page 4/1 for more on UK regulation

The key legal instruments governing the regulation and conduct of business of the financial services industry are the **Financial Services and Markets Act 2000 (FSMA)**, the **Financial Services Act 2012** and the **Bank of England and Financial Services Act 2016**.

The current regulatory framework in the UK is:

Prudential Regulation Authority (PRA)	A part of the Bank of England that has responsibility for the authorisation and prudential regulation ('prudential' means issues such as levels of capital, solvency and risk management) of certain larger firms, such as banks and insurers.
Prudential Regulation Committee (PRC)	A committee of the Bank of England, operating alongside the Financial Policy Committee and the Monetary Policy Committee.
Financial Policy Committee (FPC)	A committee set up within the Bank of England to monitor the UK economy.
Financial Conduct Authority (FCA)	This regulator has conduct and market responsibilities. It also authorises smaller firms such as financial intermediaries and mortgage brokers.

It is essential that the PRA and FCA are well equipped to interact in the ever-changing and growing international arena. Both have retained the focus on international engagement from their predecessor, the Financial Services Authority (FSA), and will continue to develop appropriate collaboration and coordination mechanisms for the future.

The current regulatory model means that banks, building societies, insurers and major investment firms have two groups of supervisors, one focusing on prudential matters (PRA) and one focusing on conduct (FCA). This is known as dual regulation. All other firms are supervised solely by the FCA (solo regulation).

The key characteristics of the model include:

- Two independent groups of supervisors for banks, building societies, insurers and major investment firms, covering prudential and conduct matters.
- Supervisors making their own, separate, set of regulatory judgments against different objectives.
- 'Independent but coordinated regulation' designed to allow internal coordination between both conduct and prudential supervisors to maximise the exchange of information relevant to their individual objectives, but with supervisors still acting separately when engaging with firms.
- Retaining the principle of seeking to ensure that regulatory data is only collected once.

On the Web

The FCA, PRA and Bank of England have a Memorandum of Understanding (MoU) which sets out the high level framework they will use to cooperate with one another in relation to the supervision of markets and market infrastructure

www.fca.org.uk/publication/mou/mou-bank-pra.pdf.

E The role of Government

The Government not only regulates but also participates in finance through its fundamental role in maintaining the economic stability of the country, therefore fulfilling its primary electoral mandate to protect the interests of UK citizens.

E1 Taxation within the UK

Taxation, both in its form and amount, has a profound impact on the economy and the financial services industry.

High taxation reduces the ability of consumers to spend and businesses to invest, thus slowing down economic growth in the private sector. Equally, low taxation leaves more money available for private expenditure and commercial investment, thus stimulating economic activity.

The primary aim of taxation is to raise revenue for the Government. Secondly, and to a degree dependent on the policies of the party in power, it can be used to re-distribute wealth from the better-off to the poorer and less fortunate members of society through, among other methods, welfare payments and the National Health Service (NHS).

The Government can also encourage savings and investment through tax concessions when necessary. For example, there are tax concessions on:

- pension schemes (including personal pension and stakeholder pension plans);
- individual savings accounts (ISAs), including junior ISAs (JISAs);
- qualifying life assurance policy proceeds;
- friendly society savings plans;
- capital gains on directly-held gilts and corporate bonds;
- investments into companies listed on the Alternative Investment Market (AIM); and
- certain National Savings and Investments products.

There is no doubt that the tax concessions on these products influence the extent to which they are taken up by the investing public. Removal of tax concessions can influence a change in investment strategy.

The method of paying income tax on different forms of investment can increase or decrease the attractiveness to different classes of investor. For example:

- the availability of gross interest on bank, building society, gilts and some National Savings products, together with the personal savings allowance, make them more attractive;
- tax-free interest on certain National Savings products to appeal to higher-rate taxpayers; and
- the inability of non-taxpayers to recover tax paid by life assurance funds discourages their investment in such products.

Taxation influences investors' willingness to invest and advisers' recommendations to clients in different tax brackets.

Here we need merely note that tax rates not only determine the level of revenue received by the Treasury, they also affect the economic activity of the country, the ability of people to invest, and influences the best or most convenient choice of investments for individuals.

Question 1.4
How can changes in tax rates be used to manipulate the economy?

E2 Economic policy

Economic policy is the set of actions a government proposes to take on expenditure, borrowing and the setting of interest rates to help control the country's economy.

The control of taxation, borrowing and government spending methods are collectively known as ***fiscal policy***; and actions involving interest rates and the money supply are known as ***monetary policy***.

In the UK it is the responsibility of the Chancellor of the Exchequer to define the level of Government expenditure and borrowing, but the responsibility for the control of interest rates now lies with the Bank of England's independent **Monetary Policy Committee (MPC)**.

E2A Government spending

Government spending can have a significant influence on the domestic economy. The main reason for this is that the Government typically spends money on goods and services provided by UK companies within the UK. This stimulates the companies concerned and feeds through to the economy as a whole. In this respect, Government spending can exert a more significant effect on the economy than tax cuts.

Example 1.2

Let's compare £100 worth of expenditure with an equivalent £100 reduction in tax:

- £100 worth of expenditure could be spent on buildings, infrastructure or services. This investment could stimulate the employment and profits of the companies concerned, thereby generating more tax and National Insurance contributions for the Government and an increase in the value of pensions and savings, as the shares in the company could form the underlying investment of the scheme.
- £100 reduction in tax could be saved or could be spent on goods and services from UK companies. However, the products or services on which people often spend their disposable income could just as easily be foreign holidays or imported electrical goods, the majority of which will be boosting the economy of another country.

E2B Government borrowing

The Government can borrow money from individuals and institutions at a low rate by issuing **financial instruments** such as gilts. In the first instance, new UK Government gilts are issued by the Debt Management Office, an executive agency of HM Treasury. Any subsequent trading is done on the London Stock Exchange.

Government borrowing not only affects the areas it targets, but it also has repercussions on the wider economy.

When the Government borrows money, it effectively reduces the amount in circulation and this can have a dampening effect on the economy. Conversely, when the Government repays the loan it injects money back into circulation and this can stimulate economic activity.

The 2007/08 banking crisis first saw the use of **quantitative easing** on a massive scale (totalling £435bn). Broadly, this involves the Bank of England buying back gilts and corporate bonds from the financial sector, thereby injecting more liquidity into the system to stabilise the banking and financial sector.

The Bank of England again committed to quantitative easing during the COVID-19 pandemic to lessen its financial impact. The total amount of quantitative easing (pre and post pandemic) had reached £895bn by October 2021.

E2C Interest rates

The Bank of England primarily uses the **Gilt Repo Market** to influence short-term interest rates. Repo is short for a 'sale and repurchase agreement', where one party sells gilts to another with a legally binding agreement to purchase equivalent gilts for an agreed price at a specified future date. The interest rate implied by the difference between the sale and the repurchase price is the repo rate.

The MPC is responsible for setting an interest rate which will enable the Chancellor's inflation target of 2% of consumer price inflation (CPI) to be met. The Committee meets eight times a year and announces the bank lending rate from which all bank interest rates are derived.

The MPC is made up of nine members – the Governor, the three Deputy Governors for Monetary Policy, Financial Stability and Markets and Banking, the Bank's Chief Economist, and four external members appointed directly by the Chancellor The appointment of external members is designed to ensure that the MPC benefits from wider thinking and expertise in addition to that gained within the Bank of England.

The final decision on the interest rate is taken from the Chancellor and given to an independent committee to ensure that it is used to influence the current rate of inflation (and hence the economy), rather than out of political expediency.

The COVID-19 pandemic saw the Monetary Policy Committee lower the interest rate in the UK to 0.1%, its lowest official rate since the founding of the Bank in 1694, to help with the economic shock of the crisis. The Bank began raising interest rates again in December 2021 to help address rising inflation.

E2D Controlling the economy without using interest rates

While interest rates are the key method of controlling the economy (and are sufficiently important for their control to be placed with an independent committee), taxation, spending and borrowing also have a significant effect on the overall economy. It is important not to underestimate this.

It is less common today, but in recent history several countries had currency control regulations with a fixed rate of exchange. Under these circumstances it is not possible to influence the economy using interest rates as this will put undue pressure on the rate of exchange. In this model the tools used are taxation and Government spending and borrowing, all of which influence the economy by controlling the overall money supply. Increased money supply stimulates the economy and reduced money supply reins it in.

E3 Welfare and benefits provision

In the UK the welfare and benefit system covers a number of different needs, including:

- the NHS;
- sickness and disability benefits;
- unemployment benefit;
- tax credits;
- the State Pension;
- pension credits; and
- NHS-funded nursing care.

It is true to say that State welfare and benefits create an increasingly greater burden on existing resources; however, if the UK did not have a such a system there would be a much greater need for private insurance and pension provision than exists at present.

Most agree that the welfare system should provide a final safety net to those in financial difficulties, but its scope and generosity is frequently misunderstood and overestimated. As a result, fewer individuals contribute to private pension arrangements, purchase income protection and medical insurance arrangements, and provide for long-term care than should be the case. Typically, it is the more affluent who purchase these types of products, but even so, relatively few individuals within this group make truly adequate private arrangements. Ultimately, these individuals may see a steep drop in income in the event that they cease working through poor health or redundancy.

The State's level of provision has undoubtedly decreased over recent years, for example with the reduction of mortgage support for the unemployed and the introduction of benefit caps.

Some welfare-to-work programmes through the Department for Work and Pensions (DWP) and Social Security Scotland make payments which are dependent on individuals being medically unable to work or on their commitment to find paid work.

Pension provision

There is a mounting body of evidence pointing to a future pensions crisis and the possibility that we will all need to work long past the age our parents and grandparents were able to retire. Add to that the ongoing problems of an underfunded and overburdened NHS and it is clear that the State welfare system cannot be (solely) relied upon by most people to sustain a comfortable standard of living.

Even those benefits that were paid for directly are being reduced. The move to the new State Pension regime in April 2016 continued this trend, with the amount of State pension payable being calculated on the amount of National Insurance contributions paid over a person's qualifying years, with a minimum of 10 years and a maximum of 35 years (up from 30 years) required. The State pension age is being gradually increased to reflect people living longer and also as a tool for managing the Government's pension liability.

Be aware

Many people think the State pension has the same qualities as a private pension into which contributions are made to form a pension pot. This is not the case. The State pension is paid out of receipts of National Insurance payments and general taxation.

The State pension is a contributory benefit and has been classified as such since its inception in 1946.

The Government has stimulated private pension uptake by introducing pension freedoms, auto-enrolment and the **National Employment Savings Trust (NEST)**. However, other Government actions, such as the removal of dividend credits from pension schemes and changes to accounting regulations, have contributed to more and more employer-funded final salary pension schemes being closed or having their benefits reduced.

Social care

The number of beds available for long-term care funded by the State is reducing. Although there are private facilities, the costs can be high and can often involve an individual selling their home to cover them. There are insurance and savings plans available to assist in the payment of future care costs, however, these may be viewed as an unwelcome expense, even though they may be beneficial in the long term.

The longer term

While the State welfare system still provides a subsistence-level safety net, it is generally considered that matters are likely to get worse. In the UK we have an ageing population which, coupled with a declining birth rate, will lead to considerably fewer taxpayers in the future to support increasing numbers of individuals who are retired or on benefits.

The introduction of compulsory pension contributions by employers is also designed to ensure that more individuals secure more realistic pension benefits than under the current voluntary system.

There are a number of further actions the Government could take to relieve the situation should it choose to do so, including:

- the extension of laws requiring compulsory contributions to pensions by employers and employees (which it has done to a limited extent via auto-enrolment);
- the introduction of compulsory private medical insurance;
- the introduction of tax breaks for health insurance, medical insurance or long-term care; and
- further increases in the State pension age.

The current arguments against this form of action concentrate on the costs of introducing it. Counter arguments suggest that the overall savings to the welfare system could more than cover these costs in the long term.

Question 1.5

Does the UK welfare system offer sufficient benefits to avoid the need to make private provision?

Key points

The main ideas covered by this chapter can be summarised as follows:

How financial services function within the wider economy

- Banks and building societies arose from customers' need to keep money safe and readily accessible.
- Banks and building societies still perform the important function of turning short-term savings into longer-term lending.
- The Government has traditionally used the savings of private individuals to fund its own borrowing.
- National Savings and Investments provide a fund for Government borrowing.
- The principle of insurance and risk management is simply to protect and safeguard assets from the financial effects of damage or loss.
- The capital markets developed to meet two key objectives:
  - the need for investors to be able to invest in assets that provide the potential for real growth (growth over and above the general increase in prices); and
  - the need for companies to raise money without necessarily having to borrow it from a bank.

UK financial services structure

- There are four key components within the financial sector:
  - financial infrastructure – the payment, settlement, clearing and trading systems;
  - financial markets – both on-exchange and over the counter (OTC);
  - financial firms – including banks (retail or investment), pension funds and insurance firms; and
  - the financial sector authorities – the Bank of England, the FCA, the PRA and HM Treasury.
- The Treasury is responsible for the regulation of the financial services market under the direct authority of the Chancellor of the Exchequer.
- The key legal instruments governing the financial services industry are the Financial Services and Markets Act 2000 and the Financial Services Act 2012.
- Fully independent financial advisers are qualified and authorised to give advice on life assurance pensions and investments from any provider in the market.
- Restricted advisers may be similar to independent financial advisers but they do not offer advice on all retail investment products, or only offer the products from one provider, so may not describe themselves as independent.
- Life insurance companies can distribute their products via intermediaries (independent, multi-tied and tied) or their own financial services sales team.

How global regulation impacts UK regulation

- Brexit has affected the adoption of EU regulation into UK law. Over time a further divergence in regulation is likely.
- One of the key developments for European regulation of the financial services industry was the Financial Services Action Plan (FSAP).
- Approximately 70% of the FCA's pre-Brexit policymaking effort was driven by European initiatives, including the FSAP.

The role of Government

- Taxation can be used to influence economic activity and encourage or discourage the use of financial services products.
- Government spending and borrowing can also be used to influence economic activity.

Key points

- The setting of interest rates is the responsibility of the independent Monetary Policy Committee (MPC), which sets an interest rate it judges will enable the inflation target set by the Chancellor of the Exchequer to be met.
- In the UK, the welfare and benefits system provides for a range of different needs, but these benefits and services are being reduced due to costs incurred by an ageing population and fewer taxpayers.
- The Government is trying to stimulate private pension uptake by further sweeping pension simplification reforms and the introduction of auto-enrolment and National Employment Savings Trusts (NEST).

Question answers

1.1 They may place some of it into long-term investments and some is used to provide loans to customers.

1.2 The issue of gilts allows the Government to borrow money from investors in return for a fixed level of interest; it is worth noting however, that there is some variability in the interest (and capital repayment) of index-linked gilts due to their link with the movement in RPI.

1.3 Earnings, profit potential and financial transactions.

1.4 By changing the tax benefits of certain investments the Government can encourage people to save thus restricting growth in the economy or to unlock capital and spend savings on goods to stimulate the economy.

1.5 Typically, most individuals would find that State welfare is at subsistence level, well below the standards that they currently expect.

2
Serving the retail consumer

Learning objectives

After studying this chapter, you should be able to:

- discuss the main areas where clients require financial advice and their importance within a financial planning context;
- identify the factors which are relevant when analysing clients' needs in these areas;
- discuss the main methods of repaying a mortgage loan;
- describe the main financial protection methods currently available;
- explain why State benefits must be taken into consideration in planning a client's finances;
- identify and discuss the range of State benefits available and the circumstances in which they are payable;
- describe the ways in which clients can create income and capital for their retirement;
- outline the main reasons clients put money aside for the future and the savings and investment vehicles that help them to do this; and
- discuss the main methods of mitigating tax during a client's lifetime and on death.

Introduction

In the following sections we turn our attention to assessing clients' needs and look at the products available to meet those needs, with further advice given as appropriate.

When trying to establish priorities in this area, it is helpful to consider the following hierarchy of needs and to discuss their relative importance with the client:

- Budgeting.
- Managing debt.
- Borrowing, including house purchase.
- Financial protection.
- Retirement planning.
- Saving and investing.
- Estate and tax planning.

Key terms

This chapter features explanations of the following terms and concepts:

Annuities	Bankruptcy	Collective investments	Debt consolidation
Debt management plan (DMP)	Defined benefit	Defined contribution	Derivatives
Equity release	Family income benefit	Full medical underwriting	Help to buy ISA
Income protection	Individual voluntary arrangement (IVA)	Investment trust savings scheme	Long-term care insurance (LTCI)
Permanent health insurance	Permanent interest bearing share (PIBS)	Potentially exempt transfers (PETs)	Term assurance
Whole of life			

A Budgeting, managing debt, and borrowing

A1 Budgeting

Clients who know how they spend their money will have a better control of their finances than those who cannot or will not budget effectively.

Everyone needs to be able to pay their basic monthly outgoings, although not all will achieve this objective. Ideally, there should also be some money left over to cover large one-off expenses such as holidays and household and motor repairs, as well as Christmas and birthday presents. Alternatively, for those who finance such expenditure through short-term borrowings, overdrafts or credit cards, there should be enough money to pay off these debts.

If your client can be persuaded to draw up a reasonably detailed breakdown of their expenditure, they are likely to find it to be something of a revelation. A budgeting exercise will help you to determine whether the client is living beyond their means or whether there is surplus income available for financial planning purposes. Budgets can also be very important for people who are living off their investment income, as any dipping into the investment itself will reduce its ability to produce the required level of income.

Refer to

An example of a fact-find can be found in Appendix 2.1 on RevisionMate (*ciigroup.org/login*)

From the fact-find, the adviser will discover the level of monthly needs from the answers on:

- income details; and
- main outgoings.

The difference between income and expenditure gives you the client's disposable income, but the resulting figure is likely to be very approximate and may lead to exaggerated expectations about how much your client can afford to save regularly. However, even when the client's total net income appears to be fully allocated, savings can sometimes be made. Furthermore, the **budgeting assessment** will allow you to examine whether a proportion of income might be redirected away from a current area of expenditure to an area of higher priority. For example, reducing the amount available for eating out or entertaining would allow for more money to be redirected to life or health insurance premiums.

Income and expenditure analysis is very important and will play a significant part in obtaining your client's agreement to proceed with any recommendations. It should be carried out as an integral part of the advice process.

A number of advisers seek only to determine the 'surplus' income and capital available for future financial planning. While this is appropriate in some cases, it is only by fully understanding your client's income and expenditure position, and then taking care to formulate recommendations which strike a balance between the identified needs and the budget available, that you can ensure the advice is sustainable. Where assumptions are made instead, it is possible that the client may find that they cannot continue with an important financial commitment leading to policies lapsing and a loss of value for both you and the client. For this reason, it is better to fully analyse the situation and recommend a partial solution that your client can afford to sustain, rather than the perfect solution which they cannot.

Question 2.1

What are the two key pieces of information you need to determine a client's budget for spending on financial services?

A2 Managing debt and borrowing

Working out how much money there is coming in and how much is going out is an essential first step to managing debt. Income will include any earnings from employment or self-employment, any State or private benefits, any pensions, any income from savings and investments, any maintenance and any other types of income (e.g. rental).

Expenditure can be considered under three headings:

- **Essential spending**. For example, housing costs, insurance, council tax, utilities, childcare etc.
- **Everyday spending**. For example, food, cleaning, travel, school etc.
- **Occasional or non-essential spending**. For example, clothing, entertainment, birthdays, holidays etc.

If there is not much money left over and your client is finding they are regularly struggling to make ends meet, they will need to reduce their spending. These tips may help:

- Consider making small cut-backs on non-essential items. What could they do without to help them get back on track?
- Check the annual percentage rate (APR) on credit cards and loans. This shows the overall cost of borrowing including interest and charges. See if they can shop around for a better deal.
- They may get a better deal by switching services such as phones, electricity or gas to new suppliers. There are various online switching sites they can use.

Your clients will need to draw up a list of the people and companies to whom they owe money; these should then be prioritised. **Priority debts** include mortgages, utilities and council tax. Debts of lesser importance include credit cards, overdrafts and personal borrowing.

Debt problems

Your client may have the start of a debt problem if you find they are:

- using credit (loans) to pay everyday bills;
- considering taking out a consolidation loan to reduce their monthly payments;
- paying no more than the minimum amounts due on their credit cards;
- using their credit card to take out cash advances or to make their mortgage repayments; or
- borrowing money without knowing how they are going to pay it back.

If your client is struggling, it is best to encourage them to get in touch with those they owe money to as soon as possible. A lender may be able to set up an arrangement where the client can spread their payments until they get their finances sorted out.

You should also check their income and see if there are any further benefits or tax credits they may be entitled to. Whatever the situation a client finds themselves in, always make sure they pay their priority debts.

If there is surplus income each month and there are a number of unsecured debts, then a **debt management plan (DMP)** may be the best way forward. These are usually set up by a third party provider, such as a debt charity or a debt management company, which will negotiate with their client's creditors and establish acceptable repayment plans with each one. The DMP provider will consolidate all debts into one monthly affordable payment. On receipt, the payment is distributed fairly between the creditors. Debt management companies will charge a fee for this service, although free plans are available through debt charities. DMP providers must be properly licensed under the **Consumer Credit Acts 1974/2006** and authorised with the relevant permissions from the Financial Conduct Authority.

Debt consolidation means negotiating a new loan to repay an existing loan or loans, often with a lower interest rate and lower monthly payments.

Advisers should exercise great caution in recommending debt consolidation, particularly when it is secured on the client's property, for the following reasons:

- Companies that offer this service often charge high fees, including those for early repayment.
- Even though the monthly payment might be lower, clients could end up paying much more over the length of the loan.
- A client with a history of running up loans may simply continue to do so, and eventually put themselves in a more serious position.
- If the client cannot afford to service the loan, this may lead to higher costs and penalties that, ultimately, make the client's financial position worse.
- In a worst-case scenario, if the loan is secured on their property they could lose their home if they default on payments.

Be aware

Clients may see adverts or get calls from companies offering to help them manage their debts. They offer a similar service to charitable advice agencies, but they will charge a fee. Before using them, make sure your client has considered all their other options.

If you find that a client's situation is spiralling out of control, try not to let them panic as you can assist and further expert help, including debt counselling, is available. Several organisations offer a free service, either face-to-face, or by phone. For example, **Citizens Advice**, **National Debtline**, **PayPlan** and the **StepChange Debt Charity**. These advice agencies can help clients tackle their debts by setting up a budget, prioritising their debts and working out how to live within their means.

Failing all else, the final options for a client would be an **individual voluntary arrangement or *bankruptcy***. Both of these involve formal legal proceedings and are not to be considered lightly, often being the very last option available to clients.

Question 2.2

Why should particular care be taken when taking out a consolidating loan secured on the family home?

A3 Borrowing

Clients may wish to raise extra funds to finance home improvements, establish a business, or to pay for a holiday or family wedding. This may be done via unsecured loans from banks and other lenders or by borrowing money secured on a client's home.

Risks of property loans

It is very important that clients are aware that loans secured on their property, such as a mortgage, could result in them losing their home if they fail to make the required repayments.

It is important to give consideration to whether individuals in significant debt could benefit from **debt counselling**, possibly through the services of a charity such as Citizens Advice.

Note that some clients may have mortgages on other properties aside from their main residence, such as those who have 'buy to let' property investments.

Clients with mortgages who hold significant amounts of cash or other investments should consider whether to use these to reduce their borrowings.

B Mortgages and loans

B1 Basic terms

The common usage of the term 'mortgage' is to refer to a loan used to buy a property, but this is technically incorrect – the mortgage is actually the **security** offered in exchange for the loan. When using this term, most people are, therefore, actually describing a residential home loan.

When the security is signed over to the lender in exchange for the mortgage, this transfer of ownership is called the **assignment**; in this case a temporary assignment for the term of the loan.

In the case of a loan on a property, the security offered in exchange for the loan is typically the deeds of the property. Very few lenders now take the actual deeds due to the cost and risk of storage; many simply register a charge on the property with the Land Registry.

B2 Method of interest repayment

There are two main ways in which a mortgage can be repaid:

- **Capital and interest repayment**, where monthly repayments to the lender include a sum to cover a contribution towards the repayment of the capital, plus a sum to cover interest. Over the term of the mortgage the loan is gradually repaid and the interest payable reduces in line with the reducing outstanding capital. Lenders try to keep the monthly cost the same overall, but inevitably the interest element will fall over time and that relating to capital will increase. Monthly repayments usually only change if interest rates change and the client does not have a fixed rate deal.
- **Interest-only**, where only the interest accruing on the loan is repaid during the term of the mortgage and the outstanding capital remains the same. The objective with this type of loan is to repay it from another source at the end of the term (e.g. via an endowment policy, an ISA, a tax-free pension commencement lump sum (PCLS) or other savings or investments), or simply by selling the property. ISAs are covered in more detail in *Other investments* on page 2/52.

There are many arguments for and against each of these two methods. Until the 1980s most mortgages were capital and interest, but this reversed dramatically during that decade and interest-only became popular, being supported in tandem by 'low-cost endowments', up until the mid-1990s.

Another reason for the move towards interest-only mortgages was rising house prices. Higher prices meant higher borrowing requirements and people could not easily afford to take out capital and interest repayment mortgages at the correspondingly higher monthly repayments. As a result, buyers were often left with interest-only as the only affordable option if they wished to buy their own house.

An interest-only mortgage with no associated repayment plan can, in the short term, appear attractive as it is much cheaper than a capital and interest repayment loan. However, in the longer term interest-only in isolation is not suitable, as there is no method of repaying the capital borrowed on maturity. The use of capital and interest repayment revived in the aftermath of the financial crisis, due to problems with alleged endowment mis-selling and the need to guarantee repayment of mortgages. The **Mortgage Market Review (MMR)**, which came into effect in April 2014, has significantly reduced the availability of interest-only mortgages as lenders are now required to check that borrowers wishing to take out an interest-only mortgage have a credible repayment strategy.

B3 Mortgage types

Both capital and interest and interest-only loans can be structured in a number of different ways, the most popular of which are:

Cap and collar	The lender guarantees that the interest rate on the loan will not rise above a given level (the cap). However, there is also a minimum rate below which the interest will not fall (the collar). The two can be applied together, so that rates are guaranteed to be between an upper and lower limit for a given period of time, e.g. two years.
Capped	The lender guarantees that the interest rate will not rise above a given level for a certain period of the loan.
Discount	The interest rate charged for an initial period of the loan (frequently for one, two or three years) is reduced by a set percentage below the standard rate charged by the lender.
Euro (or other foreign currency)	The interest and capital of the loan is designated in euros (or another currency), usually to take advantage of lower interest rates. This can result in gains or losses as the currency exchange rate moves relative to sterling, but can be useful for individuals paid in the overseas currency.
Equity-linked, also called shared appreciation mortgages (SAMs)	The lender takes a stake in the equity of the property that has been purchased. The amount loaned, on which interest is charged, is less than the amount advanced for the purchase. On the sale of the property, the proportion of the lender’s equity stake is repaid to them. It is possible for the borrower to slowly accrue the lender’s equity stake over time.
Fixed interest	The interest rate charged remains fixed for a given period. The borrower takes a risk that interest rates generally might fall below the rate charged, but in exchange have a known liability for mortgage interest over the fixed period. These schemes often carry early redemption penalties.
Flexible	Monthly payments can be varied if required and lump-sum capital repayments made at any time. As capital is repaid, this creates a reserve from which the borrower can withdraw cash up to the initial mortgage amount at any time. If a borrower experiences financial difficulties, they can use the reserve to meet future interest payments.
Green	A green mortgage is one that rewards the borrower for buying an energy-efficient home by offering them more favourable terms than come as standard, such as a slightly lower interest rate, or cash back when they take out the mortgage, or both. Such deals may, however, be restricted to new builds.
Offset	This is where a mortgage account and a current account are linked. Interest is charged on the net balance of the two accounts, so if money is kept in the current account the size of the mortgage is effectively reduced. Even the effect of a monthly salary going in can have an effect and reduce the overall interest payments.
Tracker	A variable rate mortgage where there is an automatic link built in, so the interest ‘tracks’ an index, usually the Bank of England base rate. It is designed to move as the index moves, usually after a period of, say, 15 days.

B4 Other home finance products

The products detailed below are more complex and may require additional qualifications for an adviser to advise on them. They are described here generically in overview so that those without the appropriate qualifications and permissions can refer clients if necessary.

B4A Equity release

Equity release describes a range of products only available to older clients, typically over the age of 60. It allows them to release the equity (cash) tied up in their home. The products have no fixed term and allow them to stay in their home for the rest of their life, or until they move into a long-term care facility.

These schemes can be helpful in certain circumstances but are not suitable for everyone. For example, they can be expensive and inflexible if clients' circumstances change in the future and may affect their current or future entitlement to State or local authority benefits.

Equity release schemes are either **lifetime mortgages** or **home reversion plans**.

Lifetime mortgages
With a lifetime mortgage, the client takes out a loan secured on the home. This mortgage may be:

- A roll-up mortgage (interest is added to the loan – for example, each year). The client gets a lump sum or a regular income and is charged a monthly or yearly interest that is added to the loan. The original amount borrowed plus the rolled-up interest is repaid when the home is eventually sold.
- A fixed repayment lifetime mortgage. The client gets a lump sum, but doesn't have to pay any interest. Instead, when the home is sold, they pay the lender a higher amount than they borrowed. That amount is agreed in advance. The lender uses this higher sum to repay the mortgage when your home is sold.
- An interest-only mortgage. The client gets a lump sum, and pays a monthly interest on the loan, which can be fixed or variable. The amount originally borrowed is repaid when the home is eventually sold.
- A home income plan. The money borrowed is used to buy a regular fixed income for life (an annuity). This income is used to pay the interest on the mortgage and the rest is the client's. The amount originally borrowed is repaid when the home is eventually sold.

Historically, some lifetime mortgages included a **shared appreciation** element. This meant the lender had a share in the value of the home.

With lifetime mortgages, clients can choose to borrow a lump sum or instead go for a **drawdown** facility. They may even be able to take out a combination of these to meet their needs. The drawdown facility is suitable if they want to take occasional small amounts rather than one big loan. It is also cheaper as clients only pay interest on the money they actually need.

As with a conventional mortgage, clients borrow money secured against their home. The home still belongs to them. Apart from roll-up schemes and fixed repayment lifetime mortgages, they will have to pay interest on the loan every month. When they die or move into a long-term care facility, the home is sold and the money from the sale is used to pay off the loan. Anything left goes to the client or their beneficiaries.

If there is not enough money left from the sale to pay off the loan, the client or their beneficiaries would have to repay any extra above the value of the home. To guard against this, most lifetime mortgages offer a **no negative equity guarantee**. With this guarantee the lender promises that the client (or their beneficiaries) will never have to pay back more than the value of the home – even if the debt has become larger than this.

Home reversion plans
With a home reversion plan, the client sells all or part of the home in return for a cash lump sum, a regular income, or both. The home, or the part of it sold, then belongs to the home reversion provider, but the client is allowed to carry on living in it under a lease until they die or move into a long-term care facility. Because of this, the client will usually only get between 20% and 60% of the market value of their home. The older they are when they start the scheme, the higher the percentage they will get.

The terms of the lease will vary depending on which reversion provider is chosen. Clients may be asked to pay a nominal rent of say £1 each month, or they may have the choice of paying a higher rent in return for more money from the sale.

B4B Home purchase plans

These help buy a home in a way that does not involve paying interest. So they may be of special interest to Muslims wanting to buy a home in a way that complies with Sharia (Islamic) law.

There are two types of Sharia-compliant home purchase plan available:

- ***Ijara***: the monthly payments made towards buying the property are held by the firm and used to buy the home at the end of the agreement.
- **Diminishing *musharaka***: each payment made towards buying the property buys an extra slice of the firm's share. As the client's share increases, the firm's share gets smaller and so does the rent paid for the use of the firm's share.

B4C Sale and rent back agreements

Some companies may offer to help clients with financial difficulties by buying their home and then renting it back to them for a fixed period. These are sometimes called **flash sales** because they can buy the home quickly – sometimes within a week, but more often three to four. You may also hear them called **mortgage rescue**, **rent back** or **sell-to-let** schemes.

Firms must treat clients fairly when selling a scheme and their advertising must be clear, fair and not misleading. By dealing only with regulated firms, clients can be sure they will have access to complaints procedures if things go wrong.

Selling the home in this way may allow clients to clear their mortgage debts and stay in their home, but they will no longer own it. Points to watch out for include:

- Clients will normally be paid less than the full market value of their home.
- Clients should check how long they can stay in their home as their rental agreement may not be renewed, so they could still have to leave after the initial term comes to an end.
- They could still be evicted if they breach the terms of their tenancy, for example if they fall behind with their new rental payments.
- If the firm buying the home gets into financial difficulties, the property could still be repossessed and the client might have to leave.

Be aware

So think carefully before advising on entering into such a scheme and make sure you and your client understand the consequences.

B5 Buy-to-let mortgages

Buying a property to let is a long-term investment which aims to generate an income from rents and a capital gain when selling the property. There is no guarantee that there will be a profit on the investment or that the rental income will exceed any associated mortgage and other costs.

Although most mortgages are regulated by the FCA, business buy-to-let mortgages are not. This means there is less consumer protection if things go wrong with a business buy-to-let mortgage. In contrast, consumer buy-to-let mortgages are regulated by the FCA.

B5A Consumer buy-to-let

Consumer buy-to-let mortgages cover lending to some consumers and are regulated by the FCA.

A consumer buy-to-let mortgage contract is defined as one 'which is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower'. Examples include borrowers travelling overseas who need to let out their home to cover their mortgage, borrowers who have inherited a mortgaged property who need to let it out and borrowers moving elsewhere who do not wish to sell their existing property. The regulator feels that these borrowers are 'accidental landlords' in need of consumer protection.

B5B Business buy-to-let

In contrast, **business buy-to-let** mortgages are not regulated.

The rationale here is that borrowers are entering into the contract as a professional landlord, and as such are engaging in an enterprise. Examples include where a borrower uses a mortgage to buy a property intending to rent it out, where a borrower has previously bought a property intending to rent it out and neither they nor their relatives live there, and where a borrower already owns another property that they have let out on a rental basis. In the Government's view, these are characteristics of a business rather than a consumer activity and therefore such borrowers do not need to be protected by FCA regulation.

B6 Types of loan

There are two main types of loan:

- **Unstructured.** Mortgages and loans on commercial property would fall into the category of unstructured loans. With these it is possible to increase loan repayments, reducing the capital outstanding and also, therefore, the interest. The loans can be repaid at any time (usually without penalty) to save more interest. Overdrafts and some personal loans also fall into this category. The interest rate applied to the loan varies in line with the risk of default and is usually related to a base rate (bank or mortgage). A rate of 1% above base rate is good; 4% above base rate implies the lender feels there is a higher than average risk of default.
- **Structured.** Structured loans tend to be used for smaller purchases, such as a sofa or a car. This type of loan has a fixed rate of interest payable over the term of the loan and a fixed repayment structure. The structured nature of the product means that payments do not change if base rates alter and this makes budgeting easier. There is a disadvantage to this type of loan in that it falls at the higher risk end of the market and often where there is no collateral to back up the loan. For this reason, the costs can be higher than an unstructured loan.

Example 2.1

Structured car loan for £10,000 over five years with an interest rate of 4%.

This would normally work by adding interest of 4% × 5 based on £10,000 (£12,000). This repayment is then spread evenly over five years: 60 months at £200.

One final point on structured lending is that if the loan is repaid before the end date there is usually a penalty. Lenders make a fixed profit on loans of this type and like to ensure they get the same profit (or as much of it as possible) even if the loan is repaid early. This factor should be taken into account when clients are looking to rearrange their loans.

Question 2.3

Which type of loan would you expect to be more expensive in APR terms: a mortgage to buy a house or a structured loan to buy a car? Why?

C Financial protection

Financial protection is another basic requirement of financial planning. Life and health cover are top priorities for most clients, although not necessarily to the exclusion of all other financial aims. While people are still working, it is usually possible to earn their way out of financial difficulties and they can probably borrow to fund short-term needs. However, the occurrence of a death or ill-health often changes that fundamental assumption and for this reason clients should consider protection against the financial consequences of death (including inheritance tax), critical and long-term illness, accidents and redundancy, and take steps for business protection.

C1 Critical influences on protection needs

Individual protection needs are influenced by many factors, but the most important include:

- age;
- dependants;
- income;
- financial liabilities;
- employment status; and
- existing cover.

Consider this…

How might these factors affect any recommendations made?

What are the key influences on each factor?

All of these factors interact so they should be considered in relation to one another when making any recommendations.

C1A Age

Figure 2.1 illustrates how the protection needs of individuals are affected by their age.

Figure 2.1: Protection needs – age

18 to mid 20s – before adulthood parents provide for their children, but protection needs tend to start as they gain independence.

Mid 20s to early 40s – most face their largest protection needs by having a dependant (eg. partner/children), and as the family grows so do their protection needs – mortgages, death/ill-health or accident/divorce, redundancy etc.

Mid 40s – investments and pension needs increase as children become independent.

Mid 50s – investment for retirement income is now a priority, but protection is still required in case of death/ill-health or accident.

Retirement – the primary concern at this stage is to maximise income without undue risk; protection now focuses on health care/long-term care, and inheritance tax planning may also be needed.

Question 2.4

At around what age is there the greatest need for protection products?

C1B Dependants

The number and age of dependants is one of the most important factors governing protection needs. Clearly, the more individuals that are dependent on a particular source of income and the greater their need, the more important it is to protect it.

Adult dependants

It is not only children who can be dependants – some adults for reasons such as age, incapacity due to ill-health or disability, or simply because they choose to stay at home to raise a family may also be financially dependent.

Consider this…

What do you think the protection needs for the types of dependants listed above might be?

Their needs may be:

- For an elderly or disabled dependant, protection will probably be needed for the rest of their life.
- For a partner raising a family, the period of dependence will vary depending on whether there is a desire or need to work again and their ability to obtain employment.

Where the dependants are children, the need to protect them should cease when they become financially independent, usually in their late teens to mid-20s. Before that time, protection needs for dependent children may vary:

- They may need to be reviewed on the birth, adoption or 'acquisition' of children via marriage, but also on the premature death of children.
- It may be difficult to estimate in advance when a child might become financially independent. Some will leave school and start work as soon as they can, others may not leave university until their mid-20s, but some estimate will need to be made at an early age, preferably with the flexibility to vary this as necessary.

Consider this…

Dependencies may change in mid-life. How do you think they may change?

Dependencies may change in a number of ways, such as:

- a person in a long-term relationship may become a single parent, solely responsible for the children, due to a death or separation;
- a single parent may enter a new relationship and become responsible for two families of children; and
- some couples may have children at a relatively advanced age.

C1C Income

Income is relevant to the amount of protection required and the affordability of it. As the objective of most forms of protection is the replacement of income lost due to death or ill-health, the level of current income will help determine the amount of cover required.

- **Level of death cover**. As a rule of thumb, this can be estimated by taking a multiple of income less any State benefits, pension scheme benefits and cost savings arising from death – a factor of ten is frequently used for this. A more complex, and more appropriate, method of calculating this is an examination of lifetime cashflow.
- **Level of ill-health cover**. This will usually be a percentage of current earnings less benefits from other sources (the State or an employer). Most insurers limit maximum ill-health benefits to between 50% and 75% (or lower for high earners) of earnings to allow for the fact that individual insurance benefits are not subject to income tax and National Insurance – this avoids the 'moral hazard' of an individual getting more income than they would by working.

An allowance needs to be made for future inflation, either by taking index-linked cover or specifying increase options. Recently, this has become more important as the cost of living crisis has made more people aware of the impact of inflation.

Current income also determines the extent to which a client can afford to pay for the protection required:

- There might be substantial protection needs but no spare income to pay for the required protection.
- A judgment might have to be made as to the desirability of paying for protection needs rather than current items of expenditure.
- If there is insufficient spare income to meet all protection needs, those needs would have to be prioritised and choices made accordingly.
- Sometimes a compromise may need to be made to balance the desire to provide long-term protection and the cost.

C1D Financial liabilities

Existing and future financial liabilities need to be taken into account in assessing protection needs. These might consist of the following:

- mortgages;
- bank loans;
- credit cards;
- any other loans and hire purchase;
- normal living expenses; and
- taxes (e.g. income tax, capital gains tax (CGT) and inheritance tax).

These liabilities might be capital sums or regular payments. Regular expenses need to be deducted from income to ascertain how much 'spare' money is available to pay for protection needs.

Inheritance tax

For individuals fortunate enough to have a large estate to pass on there is a dilemma regarding inheritance tax (IHT). This must be paid by the legal personal representatives (LPRs) before the estate can be passed on to heirs. In some cases there will be sufficient cash to pay it, but often the main assets will be physical – such as a property. While a loan can be taken out using the estate's assets as security to pay the IHT, it may ultimately be necessary to sell the asset(s) to repay the loan. This may defeat the object if the property is a family home that the donor wishes to pass on. In these circumstances, a whole of life second death (last survivor) policy written in trust for the heir(s) can be used to pay the IHT and allow the property to be kept intact.

On death, HMRC has first call on the assets. Where income tax remains payable this is deducted from the estate before it is passed on. Where an individual has a large income tax liability that they are planning to pay off from earnings or from the capital proceeds of an ongoing project, they may wish to take out a protection policy to pay it in case they die before it is paid. This could save their family and heirs from a reduction in their inheritance and possibly their standard of living in the future.

C1E Employment status

In addition, an individual's employment status also needs to be taken into account:

- Employees of companies are more likely to have protection benefits such as the provision of ongoing pay in the event of ill-health or a lump-sum benefit in the event of death, plus State benefits.
- Unemployed and retired individuals are unlikely to be entitled to benefits except those provided by the State and policies they have funded by themselves.
- Business owners could have a variety of additional protection issues:
  - As they are their own employer, they may wish to provide life assurance and income protection insurance for themselves.
  - They are responsible for creating the income for the business as well as for their own family and dependants, so they may wish to have private medical insurance cover to ensure quick treatment of any health issues so they can return to work.

– There are a number of business protection issues to cover, such as key person insurance (to allow the business to continue to operate in the event of their death or incapacity), and/or director share purchase protection, or partnership protection (to ensure that their families can receive fair value for the business in the event of their death or incapacity).

C1F Existing cover

Existing cover needs to be taken into account when assessing protection needs. There is little point in covering a need that is already covered and, in any case, this would be a breach of the 'suitable advice' rules.

Existing cover might be provided by:

- existing insurances;
- lump-sum benefits from private pensions;
- an employer (e.g. sick pay or lump-sum death benefit); and
- the State (e.g. Bereavement Support Payment, Universal Credit, Statutory Sick Pay, Employment and Support Allowance (ESA)).

Stigma of benefits

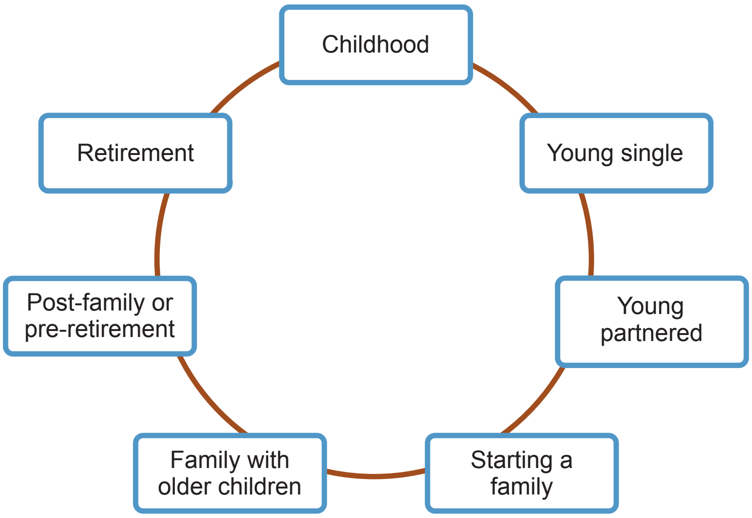
It is worth noting that some people are reluctant to claim State benefits but there is really no reason why they should not as, in most cases, they will have already paid for them via their taxes and National Insurance contributions.

Question 2.5

Why must existing cover be taken into account in assessing protection needs?

C2 Life cycles

One way to illustrate customers' needs and how they change over time is by using the **personal financial life cycle model**. A simplified version of the model divides an individual's financial life cycle into seven stages:



C2A Childhood

Childhood is a period of dependency which usually lasts until children finish their full-time education. A child's financial needs are usually met by parents or legal guardians.

As a minimum, parents will need to provide their child with food, shelter, clothing and education from their own income. As they grow older, children may want personal spending money, money for school trips and social activities. Finally, parents or grandparents may wish to start investing to meet anticipated school fees or higher education costs. The total cost of raising and educating a child is, therefore, considerable.

Children's financial protection needs are also provided by their parents or legal guardians. Occasionally, a child with independent means may require investment advice and protection.

Otherwise, their main needs may be to establish savings from their pocket money or allowance, and to invest any cash gifts to provide a lump sum for when they become young adults. Until they reach adulthood, however, these arrangements will have to be made with their parents or legal guardians.

C2B Young single

As childhood ends, most young people pass through a stage when they partially depend on their parents before full independence. If they are single with no dependants, they have little need for life assurance to protect other people against the financial consequences of their early death. Occasionally, a young single person supports a relative financially, such as a child or an elderly parent. In these circumstances, the young person's death would bring financial hardship to the dependent relative. The young person might, therefore, feel the need to take out life assurance on their own life for the benefit of the dependent relative. The term of the policy will depend on the relative's age.

Consider this…
What are a young single person's primary protection needs?

Typically, the main protection needs of a young single person in work are to build an **emergency fund** and to **protect their earnings** in the event of being unable to work due to illness. They might also consider taking out insurance to provide a capital sum should they be diagnosed with a critical illness.

The purpose of an emergency fund is to provide a lump sum to meet urgent or unexpected expenditure, such as car repairs, or enough money to live on in the event of a few weeks' unemployment. The fund might also be supplemented by **short-term savings** towards, for example, the cost of a holiday, a wedding or a deposit for a home.

Without such a fund, a genuine financial emergency might mean that they could not continue contributing to their longer-term investment plans, or even their protection policies. In such circumstances, they might well lose the money already spent on financial planning.

Only when there is a sufficient emergency fund should longer-term investment plans to fund **pensions** or other personal aspirations be put in place. Arguably, if affordability allows, it is never too early to start contributing to a pension scheme to provide an income in retirement; the earlier the scheme starts the lower the annual cost will be.

One of the barriers to young people investing in a pension is affordability. They feel they have no spare cash to set aside. However, the counter-argument to this would be can they afford not to? If they feel they cannot afford to set aside money for their retirement while they are earning, how will they be able to afford to live when they are not? On understanding this concept, a young person may be encouraged to look at their budget and see if they can reduce spending elsewhere in order to at least make a start on their retirement planning.

C2C Young partnered

The needs of young people can change considerably when they form long-term relationships. A young couple may become **financially interdependent**, with a shared responsibility for domestic costs and the achievement of future goals. Their incomes may still be fairly low on the earnings scale. Their financial planning needs will vary depending on whether one or both partners work.

C2D Starting a family

The arrival of children quickly changes the financial situation of any couple. The availability of money to meet the family's needs will be impacted depending on whether the main carer stays at home, in which case an income will cease, or whether they return to work and need to consider childcare costs.

The need for financial protection takes priority. However, a family's investment needs also increase. For example, many parents will wish to invest for their children's future education or to help them buy their first home.

Consider this…

How can parents' aspirations for their children's futures impact on their own pension and investment goals?

Parents will now need to balance their own pension and investment plans with what they want to provide for their children. Very few families have the resources to achieve all their financial goals but, as alluded to earlier, the sooner they can start putting sums towards them, the better.

C2E Family with older children

Generally, as parents grow older, their capacity to earn increases and, as their children make the transition to young adulthood, the need to protect them from the financial consequences of their parents' early deaths or illnesses reduces. This frees up funds to put towards financial objectives that could not previously have been afforded.

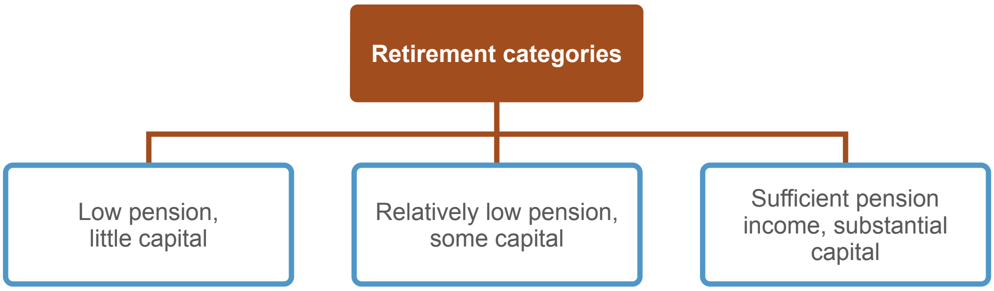
C2F Post-family/pre-retirement

Finally, the children grow up, complete their education and become financially independent. The need to protect them against the financial consequences of parental death or illness disappears, as does the cost of their keep and education.

C2G Retirement

Most people would like to maintain the same standard of living in retirement they had when they worked. Experts tell us that to achieve this, we need an annual retirement income equal to two-thirds of our final year's employment income.

By the time people reach retirement they fall into one of three categories:



C3 Relationship breakdown

Relationship breakdown may well interfere with the above life cycle: a single parent may have to make financial adjustments to cope with fewer resources and may have to protect themselves and their children single-handedly. A separated person may have new liabilities such as maintenance to an ex-partner and/or children, and separation may result in reduced pension provision due to pension attachment orders or pension sharing. A future long-term relationship following a separation could bring further complications and responsibilities.

C4 Life assurance contracts

We will now look briefly at some of the major types of life assurance policy, which are designed primarily to provide financial protection for the assured and/or their dependants.

C4A Term assurance

Term assurance pays a lump sum (or, in the case of family income benefit, a series of lump sums) on the death of the life assured.

Under these contracts, the client decides on the number of years for which they require cover and selects that term for the contract. Depending primarily on age, level of cover required and the term of the contract, the life office then quotes a premium to be paid either monthly or annually. The older the life assured and the longer the policy term, the higher the premium.

If the life assured dies during the term of the contract, the life office pays the sum assured under the policy, but if the life assured survives until the end of the policy term the contract simply comes to an end. If this happens, the policyholder pays no further premiums to the life office. There is no payment from the life office in the form of a maturity or survival value.

A term assurance, therefore, is a policy that offers life assurance only, with no savings element whatsoever. This also means no surrender value if the policy is cancelled early. It usually offers the cheapest way to purchase life assurance where the need for cover is likely to last for only a certain length of time. The various types of term assurance include the following:

- **Level term assurance**. This offers a level sum assured in return for a level premium throughout the term of the contract.
- **Decreasing term assurance**. These policies are designed to meet the needs of individuals with a decreasing liability on death, such as those with loans that are gradually being repaid. Individuals with a capital and interest repayment mortgage use a variation on this type of plan, which has a profile that matches the way in which the outstanding liability reduces, known as mortgage protection insurance. As the amount of the loan is constantly being reduced by the borrower throughout that term, so the sum assured under the policy also reduces. The premium level remains the same throughout the term of the contract. The premium for a decreasing term assurance policy will be lower than that for a level term policy with the same initial sum assured because the amount of cover reduces over time.
- **Family income benefit policies**. These are a special form of decreasing term assurance whereby, on the death of the life assured, the life office will make a series of regular annual or monthly payments, instead of one lump-sum payment.

Example 2.2

Consider a family income benefit policy for £10,000 benefit per annum over 20 years. If the life assured dies after 2 years, then this policy will pay £10,000 per annum for the remainder of the original policy term (that is, 18 years). If the life assured dies after 6 years, then the policy would still pay an annual benefit of £10,000 per annum, but this time only over 14 years.

- **Increasable term assurance**. This provides for the sum assured to be increased regularly over the term of the contract (for example, by 5% per annum), without any evidence that the life assured is still in good health, or alternatively offers the option to the policyholder to make such increases. For this variation on the basic term contract, the life office will charge higher premiums, which also increase as the sum assured increases. Such policies enable clients to ensure that their life assurance maintains its value in real terms against inflation.
- **Convertible term assurance**. This allows the policyholder to change the term policy into either an endowment policy or a whole of life policy with up to the same sum assured at any time before the end of the term of the original policy. This is a valuable feature if the policyholder's need is for additional savings (convert to endowment) or longer-term protection (convert to whole of life).
- **Renewable term assurance**. This allows the client to effect a term assurance policy for, say, three or five years, at the end of which the client has the guaranteed right to effect a similar policy for a similar term without having to give the life office any evidence that they are still in good health. The short initial term means that premiums are very low, while the guaranteed ability to renew means that the client will not then be left without life assurance at the end of the term (assuming they take up the renewable option). Although premiums will be low for the initial term, the premium rates will increase with age each time a new policy is taken out under the option.

Contract variations

Some life offices offer contracts which include two, or even all, of these last three variations. The premium will normally be higher than for a basic term contract, but the client gains added flexibility. The adviser should compare the benefits with those available from a flexible whole of life policy, where that is the primary need.

C4B Endowment policies

Endowment policies pay a lump sum on the death of the life assured but these policies are primarily savings vehicles. Some schemes have the option of providing critical illness cover at the same level as the death benefit at extra cost. Endowment policies are not usually suitable as a means of providing a significant level of life cover where the client's budget is limited. This is because the bulk of the premium is directed towards the savings element of the contract, leaving relatively little to provide the life cover.

Surrender values are likely to be non-existent or very low in the first one to two years.

Conversely, low-cost endowment products, once used in home purchase, have a higher amount of life cover (to match the mortgage loan) and a consequently lower savings element.

C4C Whole of life policies

Whole of life policies are primarily geared towards providing a substantial level of life cover, but some do have an element of investment. The balance between life cover and investment will depend on the policy type and options selected.

Whole of life policies provide cover for the lifetime of the assured. Although single premium policies are available, most policyholders pay a fixed regular premium for one of three main types of whole of life contract.

As mentioned earlier, whole of life assurance written on a joint life second death basis can be used as protection to allow heirs to pay IHT without reducing the overall estate.

Non-profit
The non-profit whole of life policy guarantees to pay a fixed amount of life cover on the death of the life insured, whether this occurs one day after the policy was taken out or 30 years later. This policy (unlike term assurance contracts) may accumulate a surrender value, but this is likely to be relatively low.

With-profit
The with-profit whole of life contract guarantees to pay a minimum level amount of life cover on the death of the life assured, and this amount increases annually by the addition of annual (or 'reversionary') bonuses, although these bonuses are not guaranteed. Once added, the bonuses permanently increase the basic guaranteed sum insured (i.e. they cannot be taken away). Furthermore, a final ('terminal') bonus is usually paid on death, which can increase the level of payout substantially. These policies may also accumulate a surrender value which will be higher than that for a non-profit contract. Any surrender value is still unlikely to be substantial in the early years of the policy and for the first two years at least it is likely to be nil. Premiums for with-profit policies are significantly higher than those for non-profit contracts.

Flexible
With flexible whole of life policies, the policyholder chooses between a minimum and maximum level of life cover. The cover selected at the outset can be changed within these upper and lower limits at any time.

Also commonly known as unit-linked whole of life plans, such policies allocate the policyholder's premiums to buy units in one of the funds offered by the life office. Then, every month, the life office calculates the cost of life cover for the next month and deducts this charge by 'cancelling' just enough of the policyholder's units to pay for it.

In this way, the policy grows in value as the number of units held in the policy accumulates and (hopefully) the value of each unit also increases. Investment growth will depend on how much is being deducted to pay for the life cover and any other optional benefits selected. Typically, the value increases in the early days of the policy when the cost of life cover is lowest and reduces later as the life assurance costs increase with age.

Example 2.3

Russell is 32, and is starting a flexible whole of life contract with a premium of £50 per month. The life office advises him that he can select any level of cover, for this premium, between £20,000 and £300,000.

If he selects a level of £20,000 then the deduction from his units to pay for the cost of cover will be very low. By selecting this 'minimum' cover option, the investment element of the policy is likely to grow faster. However, if Russell selects £300,000 of 'maximum' life cover then the deduction to meet this cost will be high, and so the policy will not increase in value as quickly.

In fact, if high levels of cover are selected, it is quite possible that at some stage there will be insufficient units in the policy to sustain cover. If this looks like happening, the life office will usually allow the policyholder to:

- increase the level of regular premium, to meet the cost of the cover; or
- decrease the level of cover.

For this reason, the policy is usually reviewed after the first ten years, and thereafter every five years.

Flexible policies allow the level of cover to be altered from time to time, and also give a number of other options that help the policyholder to tailor the policy to their specific and changing needs.

The flexible whole of life policy can offer the policyholder an opportunity to obtain high levels of cover at very low cost (similar to a long-term life assurance contract), or to place more emphasis on savings (similar to endowment policies, but with no fixed maturity date), or a balance anywhere between the two.

Each type of whole of life contract has specific merits in different situations. However, the with-profits contract offers the highest levels of guarantees with an increasing level of cover, while the flexible contract offers (as the name suggests) the greatest level of flexibility to match changes in the client's circumstances.

Question 2.6

Janet has a £10,000 loan, which is repayable in one lump sum in ten years' time. She needs a policy with a sum assured of £10,000 at the lowest cost to provide protection should she die before the loan is repaid. What is the most suitable policy for Janet?

C5 Sickness and health insurance

Under this very general heading, we will briefly outline the main types of sickness and health insurance available. These contracts do not pay benefits on the death of the insured other than as an incidental or supplementary part of the contract. They provide either an income or a lump sum in the event of the insured being sick or injured.

Each different kind of contract has its own particular applications, being designed to answer specific needs within certain budgets. The different forms of contract should not necessarily be seen as alternatives or competitors but rather as complementary to each other.

C5A Income protection (IP)

IP policies are designed to replace lost income for an individual who, due to illness or accident, is unable to work.

Benefits do not start to be paid unless or until the insured is unable to work for longer than the deferred period under their contract. Most insurers offer a range of deferred periods to choose from, the most popular being 4, 13, 26 and 52 weeks. The longer the deferred period, the lower the premiums will be because the insurer will not have to pay benefits for illnesses with a shorter duration.

Once the benefits have started to be paid, they will continue until the insured returns to work, dies or reaches the expiry date of the contract. This is usually when the insured expects to retire. The benefits from an individual policy are exempt from income tax.

There are usually restrictions applied to the level of benefit most insurers will offer. The maximum percentage is typically 50–60% of earnings, although some companies will offer up to 75% for lower levels of earnings. This restriction is not enforced by legislation, but is widely adopted.

Restrictions are imposed by insurers because they want to make sure that claimants have an incentive to return to work. Without this incentive (for example, if their benefits were higher than their potential earnings), insurers fear that the after-effects of an illness or accident would continue for an unusually long period of time. This is sometimes described as a 'moral hazard'.

This type of contract used to be called a **permanent health insurance (PHI)** policy. The reason for the term 'permanent' still applies in that once the insurer has issued the contract it cannot cancel it as long as premiums continue to be paid, no matter how many times or for how long claims are made. The main exception to this is where there has been 'non-disclosure', e.g. the insured did not tell them about a pre-existing condition.

The underwriting considerations for income protection policies are quite different from life assurance policies. Life assurance is based on the study of **mortality**, that is – the length of time someone is likely to live.

With income protection policies, underwriting is based on **morbidity** – the rate of incidence of disease or medical problems.

C5B Personal accident and sickness insurance

These accident and sickness policies also pay a regular benefit while the insured is unable to work due to illness or following an accident. However, there are a number of differences between these contracts and income protection insurance:

- In addition to the regular benefit, accident and sickness policies may pay a one-off lump sum if, for example, the insured loses a limb or digit, the sight of one or both eyes, or is permanently disabled.
- A second difference relates to the period of time for which this policy will pay benefits, a maximum of one or two years only, compared to up to retirement age for income protection policies. The deferred period is likely to be very short (one to fourteen days, compared with at least four weeks for income protection contracts).
- A further difference relates to the much-reduced number of health and occupation questions asked on sickness and accident proposal forms, and the likelihood that a greater range of occupations are likely to be accepted (income protection underwriters will refuse more dangerous occupations and exclude a range of pastimes from benefit payment).
- One final difference is that the regular benefit is likely to be a fixed sum, rather than a percentage of the policyholder's earnings.

Insurer's right to cancel

Whereas an income protection contract cannot be cancelled by an insurer, the accident and sickness policy can be cancelled at an annual renewal date if the insurer feels that the number or length of claims has been unacceptably high. If this happens, the insured might find replacement cover difficult to obtain.

The cost of accident and sickness policies is very competitive, and usually much lower than income protection. Also, the application procedure is considerably simpler.

Accident, sickness and unemployment (ASU) cover

Accident, sickness and unemployment (ASU) cover is similar to personal accident and sickness insurance in that it pays out an income if the insured is unable to work through sickness or accident. It may also pay out a small lump sum for accidents leading to the loss of sight or a limb.

In addition, as its name suggest, ASU pays out if the insured is made unemployed through no fault of their own.

Like personal accident and sickness insurance, ASU is an annual policy with a maximum payout period of one to two years. Premiums will be more expensive due to the addition of unemployment cover, but still less than for income protection.

C5C Critical illness cover (CIC)

Critical illness cover (CIC) policies are often combined with life cover and differ from income protection contracts in three ways:

- They pay a lump sum as opposed to a regular income.
- Payment is made on the diagnosis of specified illnesses only, regardless of whether or not that illness prevents the life insured working. Income protection contracts only pay benefits if the insured is unable to work.
- CIC can be provided by standalone policies or incorporated in whole life, term or endowment policies.

Typically, the CIC policy will pay a lump-sum benefit on the diagnosis of one of a specified list of illnesses, or on the permanent total disability of the insured (usually only where this occurs before age 65). Every provider will typically include at least (noting the particular exclusion of HIV):

- heart attack;
- stroke;
- cancer;
- surgery for coronary artery disease;
- major organ transplant; and
- kidney failure/transplant.

Other conditions commonly covered include multiple sclerosis, paralysis and blindness.

Although it is very easy to see why there will nearly always be a need for income protection (replacing the client's lost earnings), the need for critical illness cover is sometimes not immediately obvious.

Consider this…

Why might CIC cover be needed?

The following specific uses or needs can be identified:

- Provision of private health care or treatment, i.e. the capital sum could be used to purchase additional health care, as distinct from a policy to do this, but is limited to the capital available (noting that conditions requiring long-term hospital treatment are often excluded by private medical insurance policies).
- Alterations to the insured's home (widening doorways for wheelchairs, installing a chair lift etc.).
- Purchasing of special medical equipment to make the insured's quality of life more bearable (for example, a kidney dialysis machine, or equipment to commence a home-based business, such as desktop publishing equipment).
- Income replacement (although this is limited by the capital sum available and is not an insured arrangement).
- Repayment of a mortgage or other loans.

Optimum protection

CIC and income protection plans are complementary to each other and both can play an important role in the protection of a client.

Reviewable CIC cover

There is a trend towards reviewable CIC policies as the cost of guaranteed premiums increases, due to possible future medical advances in diagnostic techniques. Reviewable premiums are considerably cheaper than guaranteed ones. The policies are reviewed every five or ten years, based on general advances in medical science at that time and not on individual circumstances or the individual insured's health.

C5D Private medical insurance (PMI)

Every UK resident is entitled to free health care from the NHS, but they may consider buying health insurance so they have a choice in the care they receive.

Like all insurance the cover varies, but basic private medical insurance may pick up the costs of most inpatient treatments (tests and surgery) and day-care surgery, while some extend to outpatient treatments (such as specialists and consultants).

Cover can be purchased on a ***full medical underwriting*** basis, which means the client will be asked a number of questions about their health and, based on the information they provide, the insurer will decide the conditions of the cover. Clients can also apply for cover on a **moratorium** basis, which means they will not be asked any questions about their health, but if they have suffered from any health conditions in the last five years these will initially be automatically excluded from cover.

Policies will typically **not** cover:

- treatments clients know they are already going to need at application stage;
- health problems from the recent past (**pre-existing conditions**) – if asked, clients must disclose these when applying for the insurance, or the policy could be invalidated, which means the insurance company won’t pay out if a claim is made;
- treatments for chronic medical conditions – these are long-term medical conditions, which are likely to continue to need regular or periodic treatment;
- some policies exclude certain types of treatments such as outpatient treatments, routine treatments (such as health checks), dental care or experimental treatments; and
- most policies also exclude routine pregnancy, HIV, fertility treatment, mental or psychiatric conditions, and elective treatments such as cosmetic surgery.

C5E Long-term care insurance (LTCI)

This is what clients need for the foreseeable future, as a result of an illness (of a permanent condition such as arthritis, stroke or dementia) or old age. As clients get older, they might develop health problems that could make it difficult to cope with everyday tasks – it could mean help is required with activities such as washing, dressing or eating (the **‘activities of daily living’ or ADLs**). So clients may well need help to stay in their own home or perhaps have to move into a care home (residential or nursing).

The State may provide some help towards the cost of this care depending on the individual’s circumstances. There are other ways to help clients cover the cost of care, including using savings and investments. This section focuses on one option – long-term care insurance (LTCI).

There are two types of long-term care insurance:

- **Immediate care LTCI – bought when care is needed**. This can be at any age. An immediate care plan is bought with a lump sum. The plan pays out a regular income for the rest of the client’s life, which is used to pay for the care.

  The cost varies depending on the amount of income wanted; whether the income is to increase, for example, with inflation; age; the state of health. Clients may need to be assessed medically to determine how much they must pay for their chosen level of income. These plans are widely available.
- **Pre-funded LTCI – bought in advance, in case care is needed in the future**. This can usually be bought at any age. In return for payment of a regular or single premium, the policy would pay out a regular sum if the client needed care in the future. The policy pays out if the client is no longer able to perform a number of activities of daily living without help, or if they become mentally incapacitated. The money paid out is tax free. There are no pre-funded LTCI plans on the market at present, although some clients may have policies bought in the past.

Regulation of LTCI

Firms advising on LTCI must be regulated and the products are subject to an enhanced regulatory regime. Additional professional qualifications are required to provide advice in this area.

C6 Payment protection insurance (PPI)

Insurance policies which pay benefits if an insured person is made redundant are usually only available in connection with mortgages and loans. They may also offer accident and sickness benefits.

No policy will pay a significant lump sum on redundancy only and very few will allow a policy to be effected merely for general redundancy protection. Such offers would tend to attract applications from those who feel they have an above average likelihood of being made redundant, effectively selecting against the insurance company.

Premiums for these contracts must be paid monthly. Benefits, where payable, will usually match the monthly debt repayment, and will continue until the insured person returns to work, subject to a maximum payment period of either one or two years.

Although many people are initially attracted to the idea of payment protection insurance, the restrictions placed on it and the premiums charged for these contracts mean that they are not widely bought. However, the reduction of State help with mortgages has made them more necessary than ever and there is an increasing public demand for reasonably priced policies.

Question 2.7

What is the purpose for which payment protection is offered by insurance companies?

C7 Mortgage payment protection insurance (MPPI)

These policies contain many features of standard payment protection insurances. However, all products currently issued contain minimum standards laid down by **UK Finance** and the **Association of British Insurers (ABI)**. Under the benchmark for such policies, all policies:

- provide accident, sickness and unemployment cover;
- pay out after a maximum of 60 days off work;
- provide cover **for no less t**han twelve months;[1] and
- pay out to the self-employed who have informed HMRC that they have involuntarily ceased trading and have registered for Employment and Support Allowance (ESA).[2]

Policies can be taken out by joint borrowers and may offer the choice of mixing and matching benefits according to need. Policyholders taking temporary work during the period of a claim will have their benefit only temporarily suspended until such time as they return to unemployment.

Policies may be cancelled or withdrawn by the provider at a minimum of 90 days' notice or amended with at least 30 days' notice.

Such policies protect not only mortgage payments but can also cover the premiums of mortgage-related policies. The cover is, however, relatively expensive.

Reinforce

Take a moment to make sure you understand the differences between these many types of protection products and how they meet differing client needs.

D State benefits

The UK welfare system provides a wide range of benefits payable in various circumstances which we shall look at in this section.

You should note that where an individual has not paid the required number of contributions of the appropriate NI class to qualify for certain benefits, these benefits will not then be payable in full even though the other conditions of eligibility (e.g. absence from work, reaching

[1] There are some basic exclusion clauses, such as medical conditions occurring in the year before policy commencement. Specialist medical advice will be taken before certain conditions are underwritten.
[2] Contract workers can claim benefits provided they have worked for the same employer for at least two years or have renewed an annually renewable contract at least once.

State pension age etc.) may have been fulfilled. However, in cases of real need, financial assistance will usually be provided from an alternative source of benefit.

The provision of State benefits affects the need for private, voluntary financial planning in two major ways:

- receipt of State benefits may reduce the level of necessary private financial provision for illness, retirement or death; but
- the low level of State benefits frequently emphasises the need for private financial provision.

Where you identify a need for financial provision against adverse events such as death or illness, this need should then be agreed with the client and quantified. Where certain State benefits will become payable following these occurrences, the need for private provision by the client can be reduced by the likely amount of the benefit received (why insure the same need twice?). It is essential you are aware of the range of State benefits and the circumstances in which they become payable.

D1 Scope of State benefits

There is a very wide range of State benefits paid by the UK Government, usually through the **Department for Work and Pensions (DWP)**. The full list is somewhat bewildering, and to attempt a complete explanation of even the more common benefits would require a separate book. For this reason, in this study text we will concentrate on providing a practical working knowledge of the main State benefits which affect the need, and the desire, for further financial provision.

On the Web

DWP: *www.gov.uk/government/organisations/department-for-work-pensions*.

For each benefit, we will look at the circumstances in which it is paid, whether it is a contributory or a non-contributory benefit (i.e. whether it is only paid to those who have made or been credited with certain NI contributions), whether the benefit is means-tested (i.e. paid only to those with incomes and/or savings below a certain level) and whether the benefit paid is taxable or not.

Question 2.8

What is meant by the term ‘means-tested’?

Unless otherwise stated, entitlement to the full amount of any particular State benefit may be reduced if the claimant is also receiving other State benefits.

Welfare

The welfare system in the UK, as is the case in most of the western world, is the subject of continuing political debate, and changes of government have frequently led to major overhauls in some of the benefits provided by the system. The ongoing problem faced by the UK and other countries is that the country may not be able to afford the growing cost of welfare provision, particularly in the light of an ageing population. Governments, like people, must live within their means. This should be kept in mind when considering an individual’s longer term needs for additional provision, as projected benefits from the State might not be available when they are most needed.

The limitations of State benefits **must** be understood by you and your clients. While there are numerous available benefits (as will be seen later in this chapter) the level of benefit is unlikely to be enough for the client to maintain their desired lifestyle. Also, not all clients who would expect to be eligible for a certain benefit will actually be so. There may be tight eligibility definitions, means testing, or it may only be available for those with sufficient NI contributions or credits. Therefore, State benefits cannot necessarily be relied upon and private provisions of benefits via insurance and pensions will often be necessary.

D2 Benefit cap

Refer to
See *Universal Credit* on page 2/24

A cap was introduced on the total amount of benefit that most working-age people (i.e. those aged between 16 and State pension age) can receive in England, Wales, Scotland and Northern Ireland. This means households that do not work should not be able to receive more in benefits than the average earnings of working households. The cap is by DWP for Universal Credit claimants and local authorities for Housing Benefit claimants.

The cap applies to the total amount that members of a household receive from the following benefits:

- Bereavement Allowance.
- Child Benefit.
- Child Tax Credit.
- Employment and Support Allowance (ESA).
- Housing Benefit.
- Incapacity Benefit.
- Income Support.
- Jobseeker's Allowance.
- Maternity Allowance.
- Severe Disablement Allowance.
- Universal Credit (except in certain circumstances).
- Widowed Parent's Allowance, or one of its predecessors.

Benefit cap for 2024/25				
	Couple/single parent with children		Single, no children	
	(p.w.)	(p.m.)	(p.w.)	(p.m.)
Outside Greater London	£423.46	£1,835	£283.71	£1,299.42
Inside Greater London	£486.98	£2,110.25	£326.29	£1,413.92

The benefit cap does not apply if anyone in a household qualifies for Working Tax Credit, gets Universal Credit (in certain circumstances), or receives any of the following benefits:

- Adult Disability Payment (ADP).
- Armed Forces Compensation Scheme.
- Armed Forces Independence Payment.
- Attendance Allowance.
- Carer's Allowance.
- Carer Support Payment.
- Child Disability Payment.
- Disability Living Allowance (DLA).
- Employment and Support Allowance (ESA), if you receive the support component.
- Guardian's Allowance.
- Industrial Injuries Benefits.
- Personal Independence Payment (PIP).
- War or War Widow(er)'s Pensions.

D3 Universal Credit

The introduction of Universal Credit began in April 2013 and aims to simplify and streamline the benefit system by bringing together a range of benefits and credits into a single system.

The Government plans to move everyone on the benefits and tax credits listed below onto Universal Credit in due course:

- Child Tax Credit.
- Housing Benefit.
- Income-based Jobseeker's Allowance.
- Income-related Employment Support Allowance (ESA).
- Income Support.
- Working Tax Credit.

All these payments will be wrapped into this new single benefit. Universal Credit is paid either on an individual basis if claimants are single, or jointly to couples.

When calculating how much Universal Credit people get the Government includes a basic rate called the 'standard allowance' which depends on the claimant's age and whether they are making a single or joint claim. Extra amounts, known as 'elements', may be payable for people in different circumstances – for example, if they have children, a disability or health condition which prevents them from working, or they need help with paying their rent.

Universal Credit aims to ensure that claimants will be financially better off in work, which will help them and their families become more independent.

The main aims of Universal Credit are to:

- improve claimants' incentive to work;
- make it easier for claimants to move in and out of work;
- be easier to understand;
- reduce poverty among people on low incomes;
- cut back on fraud and error; and
- be more cost-effective to run.

Universal Credit is usually paid monthly to help people budget effectively and reflect the world of work, where the majority of employees receive wages on a monthly basis. This will help smooth the transition into monthly paid work, encourage claimants to take personal responsibility for their finances and to budget on a monthly basis, which could save households money. For example, monthly direct debits for household bills are often cheaper than more frequent billing options.

D4 Benefits for families and children

Benefit	Application	Taxation	Current rates (2024/25)
Child Benefit	Universal	Non-taxable	£25.60 p.w. (first child) £16.95 p.w. (each other child)
Child Tax Credit	Means-tested	Non-taxable	Various elements, including: • Family element: £545; plus • Child element: £3,455 per child (up to two children only where they are born on or after 6 April 2017). Amounts are reduced based on total family income.
Maternity Allowance	Contributions-based	Non-taxable	£184.03 p.w.
Statutory Maternity, Paternity, Adoption, Shared Parental Pay	Contributions-based	Taxable	£184.03 p.w.

Child Benefit
A universal non-means-tested benefit for parents to claim for their children. A tax charge is payable if the parent or their spouse, civil or cohabiting partner has an income of over £60,000.

Child Tax Credit
Child Tax Credit is paid to families with children regardless of whether the parents work. It is integrated within the tax system, rather than a straightforward handout, and administered by HMRC. New claims can only now be made by those who already receive Working Tax Credit. It has been replaced by Universal Credit for other new claimants.

Maternity Allowance
This pays a standard weekly rate of £184.03 or 90% of average weekly earnings (before tax), whichever is the smaller, to somebody who does not qualify for statutory maternity pay. A smaller amount is payable in certain circumstances.

Statutory Adoption Pay
Provides help for adoptive parents to take time off work after adopting a child. It is paid on the same basis as Statutory Maternity Pay.

Statutory Maternity Pay
For new mothers, this is paid for the first six weeks at 90% of their average weekly earnings (before tax) with no upper limit and, for the remaining 33 weeks, at the lower of either the standard rate or 90% of their average weekly earnings (before tax).

Statutory Paternity Pay
For new fathers, this is paid for one or two consecutive weeks at the standard rate or 90% of their average weekly earnings (before tax) if this is less. As with maternity pay, they must have worked for the same employer without a break for at least 26 weeks by the 15th week before the baby is due.

D5 Financial planning for families with State benefits

The effect of State benefits on the need or desire for life assurance and income protection (IP) cover is primarily that State benefits are payable at a level much lower than most working families would find sufficient to maintain their standard of living if one or both of their earned incomes were to cease.

Some families do not actually rely on child benefit payments to help ‘make ends meet’. Instead they put these payments into some form of regular savings plan (perhaps a Junior ISA) to provide a ‘nest egg’ for their children in the future. Other families use the child benefit payments to pay the premiums under life assurance or IP policies to ensure that their standard of living is maintained on the happening of certain unwelcome events.

D6 Unemployment and low income benefits

Benefit	Application	Taxation	Current rates (2024/25)
Income Support	Means-tested	Non-taxable	£71.70 p.w. – lowest (single) £142.25 p.w. – highest (couples)
Jobseeker’s Allowance	Contribution-based	Taxable	£71.70 p.w. (under 25) £90.50 p.w. (25 and over)
Statutory Redundancy Payments	Eligibility criteria	Non-taxable	Based on the number of years’ service with the employer. There is a maximum payment of £21,000. Weekly pay is capped at £700.
Working Tax Credit	Means-tested	Non-taxable	Dependent on circumstances/ income. Single parent or couple applying together: up to £2,500 p.a.

Income Support
New claims can no longer be made for Income Support. Those on low incomes who need help covering their living costs should apply for Universal Credit instead.

Jobseeker's Allowance
Claimants can apply for New Style Jobseeker's Allowance (JSA) to help them when they are looking for work. Eligibility depends on having previously worked as an employee and having paid or been credited with Class 1 NI contributions. The claimant must take reasonable steps to look for work as agreed with their work coach.

Statutory Redundancy Payments
These are not liable to tax. In practice, however, many employers will make redundancy payments in excess of the minimum amounts prescribed by Parliament. Where the payment is over £30,000, the excess is subject to income tax and employer (but not employee) National Insurance.

Working Tax Credit
Like Child Tax Credit, this is administered by HMRC and has been replaced by Universal Credit for new claimants, unless they already get Child Tax Credit. It is paid to people on low incomes and can, in certain cases, include a 'childcare element' to help with up to 70% of childcare costs.

Those aged 25 to 59 must work at least 30 hours per week.

D7 Support for mortgage interest

Homeowners with either mortgages or loans for essential repairs, improvements or disability adaptations to their homes, who are in receipt of a qualifying benefit (i.e., Income Support, income-based Jobseeker's Allowance, income-related Employment and Support Allowance, Universal Credit or Pension Credit), may be eligible for **support for mortgage interest (SMI)**. It is paid as a loan, which needs to be repaid with interest when the home is either sold or its ownership transferred to someone else (e.g. on death).

Claimants get help paying the interest portion of their mortgage or loan repayments on up to £200,000 of their mortgage or loan (£100,000 for those getting State Pension Credit). The payments are made directly to the lender after a waiting period of 39 weeks after claiming the income-related benefit (there is no waiting period for those getting State Pension Credit). Those claiming Universal Credit must wait until they have received three consecutive Universal Credit payments.

On the Web
For further details, you can visit *www.gov.uk/support-for-mortgage-interest*.

D8 Disability and sickness benefits

Benefit	Application	Taxation	Current rates (2024/25)
Attendance Allowance	Not means-tested	Non-taxable	£108.55 p.w. – higher £72.65 p.w. – lower
Carer's Allowance	Means-tested	Taxable	£81.90 p.w.
Disability Living Allowance ('care' & 'mobility' components) This is being replaced by the **Personal Independence Payment (PIP)**	Eligibility criteria	Non-taxable	Care component: £108.55 p.w. – higher rate £72.65 p.w. – middle rate £28.70 p.w. – lower rate Mobility component: £75.75 p.w. – higher rate £28.70 p.w. – lower rate
Employment and Support Allowance (new claimants)	Contributions-based (not means-tested)	Taxable	Assessment phase: £90.50 p.w. – single >25
	Income-related (means-tested)	Non-taxable	Main phase: Up to £126.45 p.w. (work-related) Up to £138.20 p.w. (support group)
Statutory Sick Pay (SSP)	Contributions-based	Taxable	£116.75 p.w.

Attendance Allowance
A tax-free benefit to help with extra costs for those over State pension age with a disability severe enough that they need someone to help look after them.

Carer's Allowance
A taxable benefit for those who look after someone who is disabled. They do not have to be related to, or live with, the person that they care for.

Disability Living Allowance
A tax-free benefit for disabled people, including children, who have difficulty walking and who need somebody to look after them. This allowance is ending for those born after 8 April 1948 and are 16 or over.

Personal Independence Payment (PIP)

The **Personal Independence Payment (PIP)** is replacing the Disability Living Allowance (DLA) for those aged between 16 and State pension age.

What the change means:

- DLA will end for everyone of working age even if they have an indefinite period award. 'Working age' refers to everyone aged between 16 and 64 on the day that PIP was introduced.
- There are currently no plans to replace the DLA for children below 16 and people born before 8 April 1948 who are already receiving the allowance.
- PIP is based on an assessment of individual need. The assessment focuses on an individual's ability to carry out a range of key activities necessary for everyday life. Information is gathered from the individual, as well as healthcare and other professionals who work with and support them.
- Most people will be asked to a face-to-face consultation with a trained independent assessor as part of the claims process.

There is no automatic transfer from DLA to PIP. The amount paid ranges from £28.70 to £184.30 per week in 2024/25.

Employment and Support Allowance (ESA)
Claimants can apply for ESA if they have a disability or health condition that affects how much they can work.

Motability scheme
The Motability scheme enables disabled people to lease a new car, scooter or powered wheelchair using their Government-funded mobility allowance. Those receiving the higher rate of the mobility component of the DLA, the enhanced rate of the mobility component of the PIP, war pensioners' mobility supplement or armed forces independence payment may be eligible to join the scheme. In Scotland, children in receipt of the higher rate mobility component of the Child Disability Payment and adults in receipt of the enhanced rate mobility part of the Adult Disability Payment are also eligible.

Statutory Sick Pay
A standard rate per week, it is paid by employers for up to 28 weeks if somebody is unable to work because of illness.

Summary
The level of State benefits for those who are sick or have disabilities will obviously affect the need and desire for private insurance provision (for example, IP contracts). Indeed, insurance companies will invariably only provide insurance up to a level of benefits which, when added to benefits the insured will receive from their employer and the State, is at least 25% lower than the insured's earned income.

D9 Retirement benefits

Benefit	Application	Taxation	Current rates (2024/25)
New State Pension – retired on or after 6 April 2016	Contributions-based	Taxable	Up to £221.20 p.w.
Basic State Pension – retired before 6 April 2016	Contributions-based	Taxable	Up to £169.50 p.w.
Additional State Pension – retired before 6 April 2016	Contributions-based	Taxable	According to contributions
State Pension Credit	Means-tested	Non-taxable	Up to £218.15 p.w. (single) Up to £332.95 p.w. (couple)

Refer to
State pensions on page 2/33

New/Basic State Pension
Arguably the best known of all benefits, this is available to those who have reached State pension age and made or received sufficient NI contributions or credits.

Question 2.9

What does the payment of the new State Pension depend upon?

Additional State Pension
Taxable, earnings-related component of the State pension made up of one or more of the State Graduated Pension, State Earnings Related Pension and the State Second Pension. Paid in addition to the Basic State Pension for those retiring prior to 6 April 2016. For those retiring after that date, a deduction is made from the new State Pension for any time spent contracted out of these schemes.

State Pension Credit
This guarantees a minimum income to those of State pension age by topping up the weekly income. There is also a savings credit of up to £17.01 (single) and £19.04 (couple) per week, although this not usually available to those retiring on or after 6 April 2016.

D10 Other State benefits

Bereavement Support Payment
A first payment of £3,500 (£2,500 if the claimant was neither entitled to Child Benefit nor pregnant when their partner died) followed by up to 18 monthly payments of £350 (£100, if circumstances above). The claim must be made within three months of their partner's death to get the full amount. For the purposes of Bereavement Support Payment, the term 'partner' includes married couples, civil partners and parents who were living together but not married or in a civil partnership when one of them died (i.e. cohabiting parents with dependent children).

Cold Weather Payment
Paid to people already in receipt of certain benefits or SMI to help with their additional heating costs during winter months. A payment of £25 is made for each seven-day period of very cold weather between 1 November and 31 March when the average local temperature is recorded as, or forecast to be, freezing (zero Celsius) or below, over seven consecutive days.

Council Tax Reduction
Financial help for those on low incomes to pay their council tax bill.

Funeral Expenses Payment (Funeral Payment)
Help for those on low incomes to pay for a family funeral. It will have to be paid back from the estate of the person who has died, if this is possible.

Healthcare Travel Costs Scheme (HTCS)
Those on a low income and who need NHS treatment at a hospital, another NHS centre or a private clinic and have been referred by an NHS hospital consultant, doctor or dentist, can apply for help with travel costs at the time of their appointment.

NHS Low Income Scheme (LIS)
There are various options for financial assistance for the young, old and those on low incomes to pay for health costs ranging from dental work to wigs.

Healthy Start
Help for pregnant women and low-income families. Those eligible are sent a Healthy Start card that can be used in some UK shops to buy milk, fruit and vegetables, pulses and vitamins. The benefit is added to the card every four weeks.

Housing Benefit
Aimed at those who struggle to pay their rent because they have a low income, irrespective of whether they work or not. A new claim can only be made by those who have reached State pension age or by those in supported, sheltered or temporary housing. For all other claimants, Housing Benefit has been replaced by Universal Credit.

Local Housing Allowance
Similar to Housing Benefit, this is the allowance paid to a private tenant on a low income who is renting property or a room from a private landlord.

Winter Fuel Payment
This is paid to those born before 25 September 1957. The payment amount varies depending on the recipient's situation and aims to help pay increased heating bills. It is different to the Cold Weather Payment.

E Retirement planning

The purpose of pension provision is the avoidance of poverty in old age. Most people who consciously consider the problem would wish to continue the same standard of living after retirement as they enjoyed before; others may actually seek to be better off.

Reinforce

The actual retirement picture is very different:

- Less than 1% of members of occupational pension schemes retire on their maximum allowable pensions.
- A great many individuals retire on pensions between 20% and 30% of pre-retirement annual earnings.
- Many others have little, if any, pension provision beyond that provided by the State.

Inflation can cause considerable problems for pensions, especially to individuals who live long lives. The State Pension acts as a safety net, but there is increasing uncertainty over this as people are living longer than in previous generations, the number of individuals that are working is falling and these will be required to support a larger retired population.

The reasons for financial hardship are not hard to find: the major cause is lack of adequate planning. Too many people contribute too little to pension schemes, start making contributions too late or ignore shortfalls in their pension provision as a result of job changes or periods of unemployment. The need for sound advice in the field of pensions planning cannot be overstated.

E1 Factors affecting a client's pension requirements

The basic factors on which a client's pension requirements depend include:

- age;
- income;
- dependants;
- previous and current pension arrangements; and
- State provision.

E1A Age

Age is an important factor in pension planning for several reasons. The two main considerations are:

- How old are you now?
- At what age do you want to retire?

Age affects the question of urgency and priority:

- If you are 50, self-employed, with little or no private pension provision, you do not have much time in which to accumulate pension benefits.
- The same principle applies if you are a member of an occupational scheme and, for reasons of short service or inadequate employer provision, you will receive less than the minimum pension you need in order to live comfortably.

The difference between your current age and the age at which you want to retire determines the length of the funding period available to provide the benefits.

Question 2.10

David is age 30 and planning to retire at age 65. He wants advice on whether to start saving now or to leave this until he is age 50.

What advice would you give and why?

The shorter the time you have to build up your pension entitlement, the higher the contribution you have to make each year to achieve your objectives. People who want an earlier retirement age must be prepared to make larger contributions. Some will have to accept that they cannot afford early retirement and must plan for a later date.

State pension age

Since October 2020, the State pension age for both men and women has been 66. It will then increase to 67 between 2026 and 2028. This change was included in the **Pensions Act 2014**, along with details of ongoing reviews which will take place every six years. The second review was in 2023. As a result, a decision on a further planned increase to age 68 between 2037 and 2039 has been delayed, with a further review and decision expected by early 2027 at the latest.

Age also affects the relative importance of pension provision in the context of other financial needs:

- For a young person with a dependant family and relatively little spare income, the provision of protection for them may be a much higher priority than pension contributions.
- A couple in their 40s, on good incomes but still struggling with school fees and the parental costs of university education, may also find that their ability to make pension contributions is restricted.
- By the time that a client has reached their 50s, there is no time for those without maximum pension provision to delay. Fortunately, many will be getting close to their peak earning power, many will have acquired some capital and most will have a larger surplus income available for investing.

E1B Income

Pension provision is affected by several factors:

- The income you want to receive in retirement, which in turn is affected by what you think you will need (i.e. your anticipated expenditure).
- The maximum allowable pension contribution that can be made: either by you or on your behalf.

Annual allowance

The annual allowance for tax-relievable contributions into UK registered pensions is usually £60,000. For those with adjusted annual incomes of over £260,000, this allowance is reduced by £1 for every £2 over £260,000, down to a floor of £10,000. Those who have flexibly accessed their pension benefits are subject to the money purchase annual allowance of £10,000.

One method of deciding the amount of pension a client requires is to assume the client were retiring tomorrow:

- This allows all benefits and costs to be expressed in today's values.
- You can help your client to determine the level of income they require in retirement as a percentage of current earnings. Their desired lifestyle, their expected level of monthly expenditure (e.g. food, transport, utilities, council tax etc.) plus any major 'one off' types of expenditure should be taken into account. Remember that some costs such as a mortgage and commuting expenses might be reduced.
- An inflation factor can then be applied to project the figures forward to retirement age.
- You should consider alternative scenarios, such as the client deciding to retire early or their income failing to rise to the level they expect.

E1C Dependants

Dependants and their costs will be a major factor in determining both the client's priorities and the money available for contribution.

Factors such as an income-earning partner giving up work to raise a family need to be taken into account in identifying the amount of ongoing pension provision that can be made. Equally, a financially dependent partner returning to work will create more funds for pension planning.

The cost of raising a family will often take priority over pension provision, although it is wise for most clients to find some sort of balance. Pension funds do need time to grow and a partial contribution will be better than no contribution at all.

Dependants may also affect the form and quantity of benefits required. Clients with dependants need adequate life cover (death-in-service benefits in an occupational pension scheme) to provide for the family if they die before reaching retirement age.

There is also consideration of pension provision for dependants, and even non-dependent partners. In most cases, members of pension arrangements will not generally have a need to provide for their children in retirement, as they will no longer be dependent upon them.

However, some clients may have children late in life or have a permanently disabled child to provide for. A partner may have some pension provision of their own, thus reducing the member's need to make provision for them; or the partner may be entirely dependent on the member so that pension provision has to provide for two.

E1D Previous and current pension arrangements

A client's required pension income may already be met in whole or part by existing pension arrangements. Therefore, it is necessary to deduct existing pension provision from the total income required during retirement to identify any shortfall that must be funded.

There are three potential sources of existing pension provision:

- State pension benefits.
- The client's current membership of pension arrangements.
- Retained benefits within old pension schemes or plans.

You should identify the level of benefit that a client has already built up. These benefits then need to be projected forward to the client's intended retirement age and compared to their desired level of income in retirement. Assuming that the existing benefits are less than the desired income, the 'shortfall' is the level of pension that the client now needs to fund.

E2 Other methods of funding for retirement

Pensions can be a very effective way of providing an income in retirement, particularly due to the tax relief on the contributions and the exemption from tax on income and gains within the fund; but there are other methods of funding for retirement.

ISAs are very popular despite the lack of tax relief on the contribution. The reason for this is that the fund grows free of tax on income and gains (like a pension) but the proceeds are also free of tax, in contrast to most of a pension, which is taxed as earned income. The whole fund can also be taken as a tax-free lump sum at any time. ISAs are particularly attractive to those who do not pay tax at the higher rates and so do not gain any additional tax relief on pension contributions.

Any investment can be used to provide income or capital in retirement, but it is important to give consideration to those which benefit from an advantageous tax treatment. Historically, pensions have provided retirement benefits in two forms: income and a tax-free pension commencement lump sum (PCLS). Due to its tax treatment, a purchased life annuity is a good option for turning a PCLS into a secure income in retirement.

There are significant differences between a **compulsory purchase annuity (CPA)** – commonly known as a **lifetime annuity** and bought from the proceeds of a pension fund – and a **purchased life annuity (PLA)** bought using other capital (or the tax-free PCLS from a pension). Whereas a CPA is taxed as earned income on the whole of the income paid at the 20%, 40% and 45% tax rates, the income from a PLA is separated into an interest and a capital element.

The reason for this separation is that part of every income payment is deemed to be the return of part of the capital paid in and there is no need to tax this. The interest element is taxed as savings income with 20% usually deducted at source and a further 20% or 25% payable by self-assessment for higher and additional rate taxpayers respectively. This interest can be set against the 0% savings rate (available where taxable non-savings income does not exceed the starting rate limit of £5,000) and the personal savings allowance.

Note that PLA annuity rates tend to be better than for the equivalent CPAs. This is simply because the former have to compete for business, whereas the latter have a ready-made market.

If a client is a member of a defined contribution (DC) pension scheme and either wishes to delay purchasing an annuity or does not wish to purchase an annuity at all, the alternative is to go into either 'flexi-access drawdown' or to take an uncrystallised funds pension lump sum (UFPLS). Once they have taken their tax-free PCLS, flexi-access drawdown permits them to take out any amount, either as a regular or ad-hoc income or as a lump sum, subject to that amount being taxed as earned income. An UFPLS, on the other hand, involves taking a lump sum, a quarter of which is usually tax free, and three-quarters is taxed as earned income.

E3 Pension provision products

Nearly everyone in the UK is likely to need an income after they stop earning. This means pensions are vital to all of us and for many years now pensions have been an important consideration. Over the last hundred years or so pensions have developed considerably and there are now established systems of State and private pensions in the UK, and most other industrialised countries. In this section the current UK State pensions a person may get are outlined along with the key types of private pensions available.

E3A State pensions

Those reaching State pension age **on or after 6 April 2016** receive the **new State Pension**. To receive a full new State pension of £221.20 (2024/25) per week, the individual must:

- have paid, or been credited with, 35 qualifying years' National Insurance contributions (NICs); and
- not have been 'contracted out' of the State pension at any time during their working life.

Individuals will receive a proportionately smaller pension where fewer years of NICs have been credited. A minimum of ten qualifying years is required in order to receive any new State pension at all. A deduction will be made for time spent contracted out.

On reaching State pension age an individual's NI record will be reviewed to calculate the new State Pension they are entitled to. This is referred to as their starting (foundation) amount. This will be the higher of the amount they would have received under the previous rules, i.e. the Basic State Pension plus any Additional State Pension(s) accrued, and the amount they would have received under the new State Pension had it been in place at the start of their working life.

Those who reached State pension age **before 6 April 2016** continue to receive the predecessor to the new State Pension – the **Basic State Pension**. The full amount of Basic State Pension for a single person is £169.50 (2024/25). A proportionately smaller amount will be payable where they have insufficient NI credits.

Those reaching State pension age prior to 6 April 2016 and who were employed (rather than self-employed) were able to build up rights to an earnings-related Additional State Pension.

There were a number of these schemes over the years and each had a maximum level of earnings beyond which no additional benefits built up. This means that for very highly paid people who receive the maximum State pension, the proportion of their earnings that the State pensions represent is much smaller than for those on average earnings.

On the Web

If you'd like to know more about the various schemes that make up the Additional State Pension, see: *www.gov.uk/additional-state-pension*.

Private pensions could be beneficial for those who are:

- **self-employed**;
- **highly-paid employees**; and
- **employees** with average earnings, but want a higher pension income than the State will provide.

Providing State pensions is expensive for the Government, and often people who receive only State pensions become entitled to other State benefits because their incomes are so low. To encourage people to make private provision, the Government provides incentives, e.g. tax relief on pension contributions. By doing this it encourages people to accept responsibility for their own retirement income and reduces the burden on the Government.

Historically, the Government allowed schemes to opt out of each of the earnings-related Additional State Pension schemes. In doing this, National Insurance contributions for those who were not included in the earnings-related schemes were reduced, but no earnings-related pension is payable to the individuals for the period during which they were not paying contributions for the earnings-related pensions. When a scheme, or person, opted out of these schemes it was known as **contracting out**.

Contracting out was fully abolished on 6 April 2016 and, as stated earlier, a deduction will be made from an individual's new State Pension for any time spent contracted out.

Question 2.11

How many qualifying years of National Insurance contributions are required for a full new State Pension?

E3B Private pensions

Pension schemes can be provided by employers for their employees and by financial service companies. The latter can provide pensions for employers and for individuals.

There are two main types of pension scheme in the UK:

- **occupational**; and
- **personal**.

Historically, employers provided occupational schemes for their employees, whereas individuals have traditionally bought personal pensions. It is more common now for employers to offer their employees group personal pensions in place of traditional defined benefit occupational schemes (with their higher ongoing liabilities). In the next section we shall look at the types of pensions available.

Occupational pensions
Occupational schemes are set up by an employer and trustees are appointed to oversee the scheme for the members. Occupational pension schemes can provide benefits on a defined benefit basis or on a defined contribution basis. Some schemes now provide both these types.

All types of scheme can receive the tax benefits of registered schemes. The trustees are responsible for making sure that the appropriate benefits are paid. By setting the scheme up under trust it allows the pension scheme's assets to be kept separate from those of the employer. The trustees are the owners of the pension scheme's assets and have a duty to pay the members and their beneficiaries the benefits promised in the scheme rules.

We shall now look at the distinguishing features of each type of occupational scheme in turn.

Defined benefit (DB)
This type of scheme sets out to provide members with a pension that is related to their earnings close to retirement. The scheme's rules define exactly what salary is used. It may be basic earnings or perhaps average of total earnings in the three tax years before retirement.

Usually, earnings are based on basic salary which may be less than the person's total annual earnings. This means that if the person earns bonuses, commission or overtime these may not be included and the person could receive a pension substantially less than their total before retirement.

Even if total earnings are used, these may be averaged over a period of three years, so again may not reflect a person's earnings immediately before retirement.

The scheme rules will set out the accrual rate. This is how quickly the pension will build up. A person who works for one employer throughout their working life could expect to receive a larger proportion of their earnings than someone who worked only a few years before their retirement. In the latter situation the person may have built up other similar pensions from previous employers.

Typical accrual rates for a pension are 1/60th or 1/80th of earnings for each year of pension scheme service.

Example 2.4

A member retiring on a salary of £30,000 after 40 years' scheme membership would be entitled to a pension of 40/60 × £30,000 = £20,000 per annum.

A member who retires on the same salary but after only six years' membership would receive a pension of 6/60 × £30,000 = £3,000 per annum.

DB schemes based on final salary are expensive to provide. A combination of lower-than-expected investment returns and the fact that scheme members are generally living longer mean that the amount the employer needs to contribute to cover the costs of their workers' pensions has increased at an alarming rate. As a result, many schemes have now closed. Some have changed to **career average revalued earnings (CARE) schemes**.

A CARE scheme is still a DB scheme, but promises a proportion of salary averaged over a worker's whole career, rather than their final salary at retirement. This, generally, leads to a lower pension being paid.

Funding of DB schemes
As someone continues to work for an employer and builds up rights in the pension scheme, the employer has to ensure that when the employee retires there is enough money to pay the promised pension.

In these schemes there is generally one fund for the whole scheme. An actuary advises the trustees how much money needs to be paid into the fund to pay the promised benefits.

In these schemes it is not possible to determine the share of the fund belonging to each member. These schemes are sometimes known as **pooled funds**.

The advantage of DB schemes for employees is that they can relatively easily determine what their benefits will be. However, since salary levels are affected by inflation the exact value cannot be accurately forecast. Overall this means that the employer has no actual control over the costs of such schemes. This has led to many DB schemes being closed to new entrants, and in some cases existing members can no longer build up further benefits in them.

Defined contribution (DC) or money purchase (MP)
As employers have tried to control costs, they have tended to switch to schemes where they decide how much their contributions will be. Employees are usually asked to contribute too. The rates of contributions tend to be expressed as percentages of earnings, but sometimes may be expressed as a fixed monetary amount such as £50 per month. These types of scheme are known as ***defined contribution*** or **money purchase** schemes.

Each time employees are paid the employer will deduct the employee contribution from pay, and add in their own contribution. The contributions will be invested until the employee retires. At retirement the fund that has been built up from the invested contributions is then used to provide retirement benefits.

Consider this…
What is the key difference between DB and DC schemes? Why is this?

The key difference between DB and DC schemes is that in the former an employee knows what proportion of their final pay they will receive as a pension. However, in DC schemes there is no such promise. The pension will be dependent on investment returns and the cost of providing pension benefits at retirement. For the employee, this is a less certain method of pension provision.

For the employer, with a DB scheme the contributions are known for the current year, but the potential future liability is unknown and potentially unlimited. With a defined contribution scheme they know the costs and can therefore allow for them in future budgeting exercises.

Funding of DC schemes
In some DC schemes the trustees invest the contributions for the scheme as a pooled fund; when someone retires the trustees determine what share of the pension fund's assets the member is entitled to.

More commonly, each member of the scheme is given an identifiable 'pot'. The contributions paid to the scheme for a member are added to their pot and invested for them. At any time their share of the fund can be identified. This type of scheme is known as an **earmarked money purchase scheme**.

Personal pensions
These are policies set up between the individual and the personal pension scheme provider. The individual has their own pension and the provider has a direct responsibility to them to pay the benefits promised in the contract.

With these types of pension the policyholder decides how much they can afford to save. This will be paid to the provider who will invest it for the policyholder. Most schemes offer a choice of funds so the policyholder can select the one most suited to their risk profile and retirement objectives. The policy is earmarked, in the same way as a member of an occupational scheme can have earmarked benefits, which means that at any point in time it is possible to determine the value of each policyholder's benefits.

Group personal pensions (GPPs)
Personal pension plans have been available since 1 July 1988 and since then employers have been allowed to pay contributions to GPPs for their employees. Many companies are attracted to GPPs. They offer control of costs, and avoid the expense of having to put in place trustees to look after the pension scheme.

Stakeholder pensions
In April 2001 stakeholder pensions became available. These are personal pensions which meet the additional requirements with which all stakeholder products must comply.

Question 2.12

What affect does having previously been contracted out have on the new State Pension?

E3C Providers of pension arrangements

We have already seen that there are DB and DC pension schemes. A different subdivision of occupational pension schemes is into:

- **public schemes**; and
- **private sector schemes**.

We shall now briefly look at how these two types of schemes are funded.

Public sector schemes include the pension schemes of nationalised industries and the statutory schemes for civil servants and other quasi-public servants, such as National Health Service employees, lecturers and teachers, police officers and fire officers.

Most statutory schemes are unfunded and provide benefits on a pay-as-you-go basis; the pension funds of the nationalised industries (and their privatised successors) are funded.

Private sector schemes are provided by non-Government employers ranging from large public companies such as Shell or Vodafone to sole traders and partnerships for their employees.

Funded schemes may be either:

- **self-administered schemes**; or
- **insured schemes**.

Self-administered schemes manage their own investment of contributions to provide future benefits. They either employ their own actuaries and investment specialists or they use the services of professional firms, such as consulting actuaries, stockbrokers and investment managers. Often, the services and judgment of in-house experts will be supplemented by external expertise, such as allowing external fund managers to invest a portion of the fund.

Insured schemes are provided by life assurance and pension providers which may be independent or part of a financial services group. They provide the insurance policies to the trustees of insured occupational schemes.

A range of types of organisation provide investment funds for pensions. These include **unit trusts**, **open-ended investment companies (OEICs)**, banks, insurance companies and **investment managers**.

Auto-enrolment
All employers must enrol eligible jobholders, i.e. those between the age 22 and State pension age and earning in excess of £10,000 a year, in a qualifying workplace pension scheme. Both employer and employee must pay a minimum level of contribution, although the employee can opt out. Non-eligible jobholders and entitled workers are allowed to opt in.

Eligible jobholders are classed as 'type 1' workers, whereas non-eligible and entitled workers may be known as 'type 2' workers. The difference is that an employer must put type 1 workers into a qualifying pension scheme. There is no such requirement for type 2 workers.

The minimum level of contribution (8%) into a qualifying DC scheme is made up of money paid in by the employer, the worker and the Government (in the form of tax relief). Contributions are payable on earnings over the lower level of qualifying earnings (£6,240 in 2024/25).

To help employers meet these requirements the Government introduced the **National Employment Savings Trust (NEST)**. NEST is a pension scheme that complies with auto-enrolment rules that any employer can join.

On the Web

NEST is designed to help even the smallest employers meet the needs of auto-enrolment: *www.nestpensions.org.uk*.

To be qualifying, a workplace pension must meet requirements in relation to minimum contributions (for DC schemes) and minimum benefits (for DB schemes).

Employers have an ongoing duty to maintain qualifying pension provision for workers who:

- are already members of qualifying schemes; or
- become members of such schemes.

Question 2.13

Under what circumstances are each of the following policies payable?

- Family income benefit.
- Personal accident insurance.
- Income protection insurance.
- Personal pension.

F Saving and investing

The need to generate sums for future spending is nearly always present, but the resources to do so can sometimes be limited.

If asked, most clients want their money to grow quickly, but many are not prepared for the value to fall. It is very important that you explain to your client that these two situations are mutually exclusive and that the potential for investment return will be reduced if the risks are to be lessened. You should understand and be able to communicate the nature of this compromise. An appropriate questionnaire to determine the client's knowledge, understanding and experience of investment vehicles in addition to an appropriate **risk profiling questionnaire** will help considerably.

On the Web

The Royal London website provides a useful example of the kind of questionnaire an adviser might use to ascertain a client's risk profile: *www.royallondon.com/pensions/investment-options/risk-profiler*.

F1 Savings and investment objectives

Regular savings

This phrase tends to be used where the objective of the client is to turn small amounts of money put aside on a regular basis into bigger lump sums.

In many cases the reason for saving is expensive, such as a house or a car, a holiday or fees for a child's education.

With items such as the house, the savings phase may take more than one form. This may start with a deposit and end up with some form of savings vehicle to repay an interest-only loan at the end of the term.

Lump-sum investment

Where a sum of money has been accumulated over time, inherited or arisen as the result of a windfall, the phrase 'lump-sum investment' is used.

In this case the objective could be as simple as maintaining the value of that money in real terms, measured against inflation, or there may be an active desire to provide 'real growth' at rates above inflation.

As an alternative, the objective could be to convert that money, either now or at some time in the future, into a regular income for retirement or other purposes.

Timescales

Whatever the objective of the savings or investment, in many cases it will be necessary to identify a specific date or range of dates for the money to be made available:

- **Short-term investment**. Starting at the short end of the timescale, most adults want some form of readily accessible emergency fund. While acknowledging that credit cards do provide a form of instantly accessible cash for dealing with financial emergencies, it is far better in most cases to have an accessible 'pot of money'. The precise level of emergency fund required can vary from person to person. For individuals who are earning, three to six months' expenditure could be used as a guide and for those dependent on capital only, some 10% of total investments is a typical figure to put aside as cash for an emergency fund.

The phrase 'short term' in many financial definitions can stretch to as long as five years, so will often encompass deposits for houses, holidays, cars and weddings.

- **Medium-term investment**. This typically covers the five- to fifteen-year period and there will be some overlap with short-term investment such as where a parent is saving for a wedding over a longer period than an individual would tend to save for their own. Typically, objectives such as school fees would also fall in this category, but it can encompass grander ideas such as the purchase of a motorhome or an 'around the world' cruise.
- **Long-term investment**. This typically means 15 years plus and the longer the term of the savings, the more important it is to maintain and build on their value, but fortunately over this timescale there is a wider range of potential investment choices.

In each case, it is vitally important that the investment chosen is compatible with the timescales and the level of risk acceptable.

Question 2.14

If your client is looking for high investment returns and low risk, why is that a problem and what should you do about it?

Getting to grips with money involves considering the 'priorities' first. Everyone's circumstances are different, but these are the general rules:

- **Pay off any expensive debts** such as credit cards. This is because the interest paid on borrowed money is usually higher than the interest received on a savings account.
- **Protect the family**. Think about taking out insurance to cover unforeseen events, for example a house fire, illness, redundancy or death.
- **Have an 'emergency fund' of money** that is easy to get hold of.

After meeting these priorities, a good position to consider further savings and investments is reached.

F2 Savings products

Saving tends to be for short-term goals or when there is a need to get at money quickly (for example, to pay for a holiday, birthdays, Christmas or an emergency such as replacing a household item). Money will grow slightly by having interest added to it either monthly or yearly.

Customers can save in a wide range of savings accounts with banks, building societies, credit unions and NS&I. Each has different interest rates and access conditions. Savings accounts are 'deposit' based. This means you'll usually get back the money you put in plus interest, unless the bank or building society collapses.

Some customers will have started a savings or investment account for their child using a Junior ISA or child trust fund (CTF).

Be aware

The CTF was superseded by the Junior ISA from November 2011 onwards. Children with an existing CTF cannot have a Junior ISA as well but, since April 2015, are permitted to transfer their CTF to a Junior ISA.

F2A Savings accounts

The main types of deposit-based savings account are detailed in the following table:

	Features	Access	Benefits
Savings	Usually pays higher interest than current accounts.	Instant or easy access.	You usually get back at least what you put in.
Cash ISA	The maximum you can put in is £20,000 per tax year (2024/25). Sometimes pays higher interest than normal deposit accounts and this is not taxed.	Instant or easy, but some can have notice periods.	You usually get back at least what you put in. Interest is tax free.
Notice	You have to give notice to take your money out, e.g. 30, 60 or 90 days.	Involves a penalty (usually in the form of reduced interest) if you withdraw your money without giving enough notice.	You usually get back at least what you put in.
Fixed-rate bond (term accounts)	You usually have to leave your money in for one year or more (the term). A minimum deposit is often required, e.g. £1,000.	Might be difficult or could involve a penalty if you withdraw during the term.	You usually get back at least what you put in.
High-interest regular savings	Your current account is with the same provider as your savings account. You regularly transfer the same amount each month into this account for a fixed period.	Usually interest is only paid yearly, and you can only withdraw yearly.	You usually get back at least what you paid in. You get a higher interest rate.

Savings accounts offer many different features, including:

- **Interest rates** – some accounts have a higher interest rate including a 'bonus' (the teaser rate) for an introductory period which then drops away, while others have a rate that goes up the more money you have in the account (stepped interest rates).
- **Notice periods** for withdrawing your money without penalties – such as 7, 30, 60 or 90 days.
- **Minimum deposits** – some accounts require a certain amount to be paid in regularly.
- **Additional bonuses** – these are usually payable only in certain circumstances, and you should make sure you understand what these are.
- **Restricted access** – by selecting an account where you have to keep the money in the account for a minimum period you may get a higher interest rate.
- **The way interest is added** – some accounts add it monthly and others once a year.
- **How the account is accessed** – this may be via some combination of branch, telephone operated or online accounts (the latter tend to offer better rates of interest due to the provider's lower costs).
- **Tax-free savings** – by using a cash or Junior ISA.

Help to buy ISA

The Help to buy ISA is a type of cash ISA for first-time buyers, which offers a Government bonus when investors use their savings to buy their first home. The last date for opening a Help to buy ISA was 30 November 2019. Existing account holders can continue saving until 30 November 2029, at which point no further contributions can be made.

For every £200 that a first-time buyer saves in a Help to buy ISA, there is a £50 bonus payment up to a maximum of £3,000 on £12,000 of savings. The bonus is available for purchases of homes of up to £450,000 in London and up to £250,000 elsewhere.

The bonus only applies for home purchase. Savers have access to their own money and can withdraw funds from their account if they need them for any other purpose. The maximum initial deposit was £1,200 and the maximum monthly saving thereafter is £200.

Existing Help to buy savers are not usually permitted to contribute to both a cash ISA and a Help to buy ISA in the same tax year.

Tax
Banks, building societies and NS&I pay interest gross (without deduction of tax). There is also a £5,000 0% starting-rate band for savings income. Basic-rate taxpayers can earn up to £1,000 of interest tax free each tax year under the personal savings allowance (PSA) – once this amount is exceeded, tax will be charged at 20%. Those who pay tax at the higher rate have a PSA of £500. They pay tax on any further interest at 40%. Those who pay tax at the additional rate do not benefit from a PSA and pay tax on interest at 45%. ISAs and some NS&I savings products, such as saving certificates (when available), pay tax-free interest.

F2B NS&I

NS&I provides Government-backed savings and investment products. As a result, any money invested is totally secure.

There are lots of different types of products; for example, some are aimed at particular sorts of taxpayer, some are for people looking for income, while others provide growth. Some products are aimed at specific age groups, for example the Junior ISA.

All current NS&I products are '**deposit-based**'. This makes them a good home for savings with which savers don't want to take risks.

It is a good idea to compare NS&I with similar deposit-based products from banks and building societies before deciding where to save.

The different types of NS&I product available include the following:

- **Tax-free investments**
  As well as its ISA, NS&I has a range of investments with no UK income tax or CGT to pay on the returns. Prizes on premium bond holdings (which may be viewed as a deposit) are included here.
- **Guaranteed returns**
  Suitable for savers who want the certainty of guaranteed returns (growth or income), e.g. the British Savings Bonds.
- **Income products**
  A choice of fixed or variable-rate accounts paying interest monthly.
- **Simple savings accounts**
  Straightforward savings accounts for any purpose.
- **Investments for children**
  Whether investing for a child's future or encouraging them to save for themselves, NS&I has a range of investments to choose from.
- **Sustainable investing**
  Money invested in NS&I's Green Savings Bonds helps finance green projects as part of the Government's strategy to reduce the UK's greenhouse gas emissions to net zero by 2050. Issue 7 of the Green Savings Bond has a fixed interest rate for three years.

On the Web
The NS&I Adviser Centre can be found at: *nsandi-adviser.com*.

F2C Use of deposit-based savings

Deposit-based investments are an important part of the planning for short, medium and long-term financial portfolios.

Emergency fund
Deposit-based investments have a specific role in financial planning to ensure that there is money available to deal with emergencies as and when they arise. The benefit of this is that other longer-term investment plans can remain undisturbed if there is a need for money, particularly as this can result in penalties or, at the very least, the disruption of the longer term investment strategy.

Short-term use
Over the short term deposits are the only asset that can reliably maintain the nominal value of the capital and achieve any form of return.

The forces of inflation tend to erode investment returns over the longer term, but over the shorter term the main investment problem is **preservation of capital**. All the other asset classes will have problems in this field.

Effective returns can be improved by matching the investment chosen to the investment term required, such as by using an appropriate termed deposit investment and benefiting from the higher interest rate available.

A further method of improving the situation may be to use tax-free schemes to improve net returns for taxpayers.

It is important to remember, however, that tax-free plans do not always provide the biggest net returns and that it is the net return, not the saving of tax that is important.

Medium-term use
Over the medium term, capital preservation is more difficult as the effects of inflation creep in. Fortunately, fixed-interest investments and equities at the lower end of the risk scale can be used, providing there is a full five years-plus investment period.

Deposit-based investments are vital to the mix in the above strategy.

A suitably-sized **emergency fund** should be placed in deposits to provide a temporary income and money for when things go wrong.

By doing this, the investments in the other asset classes can remain untouched and do what they do best; i.e. provide higher rates of return over the medium to long term.

Where emergency and income needs are met from other funds, it is still often a good idea to keep 10% or more of the overall funds in deposits. The reason for this is to allow the investor to take advantage of **new investment opportunities** as they come up and to provide money for annual investment in tax exempt schemes (such as ISAs) as each year's allowances become available.

Long-term use
Over the long term, it is important that a portfolio is set up on the right basis.

As with shorter investment spans, deposits are important for **liquidity** and **emergency purposes**, but they should also be used for **asset allocation**.

In simple terms, not all asset classes perform well all the time, but by diversifying throughout the asset classes, there is a greater chance of an overall increase.

By having a proportion of money in fixed interest, deposits and other investments, the losses in equities can potentially be balanced by gains in the other asset classes.

Question 2.15
What are the four main uses for deposit-based investments in investment portfolios?

F3 Investment products

Investing is for the longer term – and usually means putting money into schemes or funds linked in some way to the performance of the stock market.

Investors take a risk by investing their money in assets, which could rise or fall in value. They need to be willing to tie up money that they do not need immediately, and take some risk to get a better return. Investors also need to balance the risk of a short-term loss against the chance of a long-term gain.

Unlike savings accounts, there is no guarantee investors will get a return on their investment, or even get back as much as they put in. However, they may get a greater return than they would from savings, giving them better protection against inflation in the long term. Risk and reward generally go hand in hand. The more risk an investor is prepared to take, the higher the potential reward. But, equally, they could lose some, or all of their money.

Different investments provide:

- capital growth – the original amount you invest grows; or
- income – a regular payment, for example dividends from shares; or
- a combination of income and growth.

There are different types of investment products including pensions, life policies with an investment element, stocks-and-shares ISAs, collectives and employee share schemes.

What are investments?
A good way to understand investments is to think about investing in three layers. The first layer, common to all forms of investment, is the underlying investment itself. It will typically fall into one of four asset classes:

- **Shares** (or equity) – a stake in a company.
- **Bonds** – loans to a company or the Government.
- **Property** – either commercial or residential.
- **Cash**.

A possible fifth class – 'alternatives' – encompasses a range of further investment types such as absolute return funds, other hedge funds, derivatives, commodities and other tangibles (e.g. antiques, fine art and wine etc.).

Investors can invest in any one of these asset classes, and there are different risks for each one. These risks can be reduced (but not eliminated) by diversification, which simply means spreading the risk over a range of investments – in other words, not putting all the eggs in one basket.

The second layer is called a pooled investment and provides a relatively easy way of spreading investment risk by investing in a range of assets. This is because money is pooled with that of other investors, and is invested in one or more of the above asset classes by a fund manager. The most common types are open-ended investment companies (OEICs), unit trusts, investment trusts, and life funds.

The third layer is what is sometimes known as a tax wrapper. This means that your investments are held in a wrapper such as an ISA or a pension, and you pay less or no tax. With a pension you may also get tax relief on the contributions.

F3A Investment platforms

Some services allow investments to be held and dealt with more conveniently. These are called **investment platforms**.

Broadly speaking, an investment platform is a proprietary system that provides access to a defined selection of investments. Within the investment platform there may be different products that all use the defined selection of investments, but effectively provide access to different tax wrappers, e.g. ISAs, OEICs, offshore bonds, pensions etc.

The investment platform facilitates the use of the underlying investments and potential advantages include the ability to:

- switch between holdings from different investment companies, quickly and cost effectively;
- aggregate holdings from several different companies onto the same system – useful for reporting purposes and for asset allocation and portfolio construction.

F3B Approaches to investing

Client objectives for investments do not always include purely economic goals. Many people have strong ethical reasons for choosing or excluding certain types of investment.

Conventional investing
Conventional investing focuses on generating financial returns through investing in companies that are expected to perform well. Conventional fund managers will focus on financial metrics including the price-to-earnings ratio, return on equity, dividend yield, gearing ratio, earnings per share and cash flow from operations, among others.

While environmental, social and governance (ESG) factors may be considered in the investment process, the focus will be on financial returns rather than social or environmental impacts.

Sustainable and responsible investing
Sustainable and responsible investing, along with related areas like ESG and ethical investing, enable clients to reflect their views through how they invest.

- Sustainability comprises a wide range of issues, most of which can be classified as either environmental, social or both. The way these are managed or governed is also important.
- Ethical issues typically relate to personal values. When investment managers talk about ethical issues, they tend to mean topics like armaments, tobacco, gambling and adult entertainment, many of which have social implications.

Sustainable funds

- What makes sustainable investment different from other types of investing is that these funds (and other forms of finance) pay significant attention to environmental and/or social issues, which are collectively referred to as sustainable. The sustainability issues a fund manager considers contribute to where a fund will and will not invest, alongside standard financial analysis.
- Sustainable investment strategies are normally accompanied by responsible ownership or stewardship activity, which involves fund managers working with companies to encourage higher standards to help improve financial outcomes.

ESG funds
ESG funds focus primarily on ESG risk and how businesses operate, rather than problem solving or benefiting from societal shifts. Unless fund literature says otherwise, an ESG fund may invest in well-run but controversial and apparently unsustainable companies.

Funds that focus on ESG sometimes supplement additional research with exclusions (e.g. tobacco, armaments and major polluters), as well as carrying out responsible ownership activity.

Sustainable and ESG investment approaches
There are three main strategies or approaches that funds use:

1. **Positive selection** directs managers to invest in assets that meet specific published policy requirements. For example, a fund may 'screen in' or select assets that:
   - provide beneficial or useful products and services (e.g. waste management, water or education);
   - meet certain standards (e.g. international standards or norms);
   - are regarded as having higher standards than their peers (e.g. best in sector); or
   - fit within a named theme (e.g. renewable energy or nature).
2. **Negative exclusions** direct fund managers to avoid particular sectors or behaviours. For example, a fund may exclude tobacco companies, weapon manufacturers, fossil fuel companies or companies with poor diversity, inclusion and equality practices. Where funds draw the line (e.g. percentage of turnover from excluded activities or number of controversies) varies.
3. **Responsible ownership (stewardship) activity** involves asset owners encouraging companies to have higher ESG standards, largely because it makes financial sense to do so. This has become increasingly high profile recently because of improvements in investors' understanding of sustainability and ESG-related risks and opportunities.

For some clients, faith may also be an important issue. Some religions, notably Islam, have precepts against charging or receiving interest, which can affect borrowing as well as investment and savings decisions. If the client is Muslim, it is important to ask whether this will affect their financial planning. Where the client wants to use Islamic financial products, it may be necessary to consider price implications and perhaps enlist help of a specialist.

On the Web

Greenwashing, where companies exaggerate their green credentials, is a potential concern. The FCA's PS23/16 (Sustainability Disclosure Requirements (SDR) and investment labels) came into effect on 31 May 2024 to help consumers navigate the market for sustainable investment products. Measures include an anti-greenwashing rule, naming and marketing rules for investment products and four labels for consumers: *www.fca.org.uk/publication/policy/ps23-16.pdf*.

You can also refer to the CII Green Finance Companion Guide: *www.cii.co.uk/media/10129409/green-finance-companion-guide.pdf*.

The investment advice process

When constructing a sustainable investment portfolio, the following need to be taken into account:

- The strength of the client's beliefs and extent to which they want to build them into their portfolio.
- Incorporating the client's values and views into the investment process and reviewing them regularly as they may change over time.
- Recommending products and funds that are most appropriate for the client from both a financial and personal perspective.
- Whether their beliefs will lead to a restricted choice of funds and less diversification.
- Whether the funds chosen have higher charges than their non-sustainable equivalents.
- Whether the funds chosen are likely to perform differently and with more or less volatility than their non-sustainable equivalents.

In addition, a client's views on sustainable and responsible investing may change over time. Perhaps due to changes in their personal values or financial goals, or by being exposed to new information, or by changes in the investment market. It is therefore essential that a client's views are revisited as part of the review process and adjustments made to their investment portfolio where necessary.

F3C Equity investment

Investors can buy shares as part of a pooled investment or directly through the stock market. Shares are also known as **equities** or **stocks**.

When you buy shares in a company, you are buying a part of that company, and you become a shareholder, which usually means you have the right to vote on certain issues. You can either buy new shares when the company starts up and sells them to raise money (through an Initial Public Offering) or buy existing shares which are traded on the stock market.

The aim, of course, is for the value of your shares to grow over time as the value of the company increases in line with its profitability and growth. In addition, you may also receive a dividend, which is an income paid out of the company's profits. Longer-established companies usually pay dividends, while growing companies tend to pay smaller or no dividends – with these you would typically be hoping for better capital growth to offset the lack of dividend. In any event, dividends are not guaranteed. Companies can choose not to pay them if they have made insufficient profit.

Risk

The level of a stock market index goes up or down as the prices of the shares that are the constituents of that market go up or down. The main factor determining the price of a share is the perception of its current value to its owner – often called investor sentiment. One factor that could affect the price of a share is a change in opinion as to how well the company itself is performing or could perform in the future. This opinion is frequently based on predictions about the economic conditions in which a company is operating.

Shares are generally the most volatile of the four asset classes – their value goes up and down more than the others. However, risk and reward tend to go hand in hand and – in the long run – the hope is that these investments would provide better returns than the other asset classes (but this is not guaranteed).

If investing in shares, investors should expect the value of their investment to go down as well as up, and they should be comfortable with this.

Holding shares is high risk. If investors have put all their money into one company and that company becomes insolvent then they will probably lose most, if not all, of their money.

Long-term investments

In the short term, shares will go up and down in value and this can occasionally be very significant. However, remember that holding a wide range of shares reduces the likelihood of losing all or most of your money. It is important to stress that investors need to be looking at the medium to long term when investing in shares – at least five years but preferably longer.

There is a higher level of risk involved in shares in the short and medium term, but if investors hold their shares for over, say, ten years, then they reduce the risk of ending up with less than they started, providing they have a good spread of shares (for example, through pooled investments).

Use of equity investments
Few advisers will make active use of individual shares within a financial plan. In most cases, it is simply a matter of accommodating shares that a private investor may already have within the overall plan. In many cases, it is the investors themselves who use shares in the following ways:

- **Short-term use**. There is only one short-term use for shares, namely pure speculation. In this role, shares are a very high-risk investment and this should only be traded in by experienced investors or professionals whose other assets are sufficient to offset any losses they may experience.
- **Medium-term use**. Although this is not something on which to rely completely, it is true that many companies aim to increase their dividends on an ongoing basis, provided that they continue to make increasing profits.
- **Real growth/capital preservation**. In simple terms, shares are an investment in companies that produce real goods and services. The prices of these goods and services will increase with inflation, often taking profits with them and providing investors with a return in excess of inflation.
- **Asset allocation**. By combining equity holdings with those of other asset classes, the overall fluctuations of the portfolio and its risk profile can be reduced.

Be aware

It is important to remember that a diversified portfolio of shares will do this more effectively than a single holding.

- **Long-term use**. The use of shares as a long-term investment is broadly in line with the objectives for medium-term:
  - increasing income;
  - capital preservation; and
  - asset allocation.

  Over the longer term, the capital preservation properties of shares improve as the effects of short-term fluctuations in local and global economies are ‘ironed out’. As an asset class, over the longer term, equities have usually outperformed deposit and fixed interest investments.

  For this reason, shares can be used for one of the longest-term savings objectives, namely pension planning.

F3D Government securities and corporate bonds

A **bond** is a loan to a company, the Government or a local authority, and in return investors get a regular income from the interest until the loan is repaid.

There are many other names for this type of investment, for example:

- **loan stock**;
- **fixed interest**;
- **debt securities**;
- **gilts** (loans to the Government); and
- **corporate bonds** (loans to companies).

The main benefit of these investments is that investors normally get a regular, stable income. They are not generally designed to provide long-term capital growth.

Bonds have a **nominal value**. This is the sum that will be returned to investors when the bond matures at the end of its term. Most bonds have a nominal value of £100.

However, because bonds are traded on the bond market, the price you pay or receive for a bond may be more or less than £100.

Risk
Bonds are generally less risky than having a share in a company. One of the main risks is that the company you have lent money to will default, and be unable to pay the interest due or return the money at the end of the term (if the company has folded, for example).

These risks do not generally apply to **gilts** – the UK Government is expected to always repay in full – though there have been instances of other countries having been unable to repay. Bonds issued by the Government pay a lower rate of interest in line with the inverse relationship of risk and reward, i.e. gilts are perceived as lower risk therefore the returns are lower. Companies have different credit ratings and a company with a high credit rating is regarded as safer than a company with a low credit rating. Companies with a low credit rating will have to offer a higher rate of interest on their bonds than companies with a higher credit rating, simply to attract investors and to compensate for the higher risk.

Index-linked fixed interest investment
A number of issues of fixed interest stocks are index-linked, with both the interest and capital value currently linked to the Retail Prices Index (RPI). In the UK, the majority of index-linked fixed interest investments are issued by the Government as gilts, but a few are issued by other financial institutions.

Ultimately, index-linked investments such as these seem to answer the problem of inflationary risk. Certainly, by buying them investors can ensure that they receive returns over and above inflation in both capital and income terms. However, the situation is a little more complex than this. As always, there will be a balance of value between a stock paying, say, 2% above inflation, with inflation at, say, 2.5% and a normal fixed interest stock paying 5%.

Other complications may relate to the fact that the RPI, commonly used as the reference for index-linked investments, and the Consumer Prices Index (CPI), may increase at different rates.

Be aware
The UK's RPI inflation measure will be aligned with the CPI including housing costs (CPIH) from 2030, with no compensation for holders of index-linked gilts. CPIH generally runs around 1% lower than RPI, reducing the attractiveness of these gilts.

F3E Bank and building society loans

Building societies used to issue a form of fixed interest investment called **a permanent interest bearing share (PIBS)**. PIBS are very similar to the other fixed interest investments we have discussed except:

- they are undated;
- interest payments can be missed in exceptional circumstances; and
- missed interest payments do not need to be made up at a later stage.

Therefore, this type of investment is higher risk than other forms of loan stock but does tend to produce higher rates of return.

Where a building society has been demutualised, PIBS become **perpetual subordinated bonds (PSBs)**:

- **Perpetual**: as they have no redemption dates.
- **Subordinated**: as they are a low-ranking debt for repayment in the event of insolvency.
- **Bonds**: as this is a general name for fixed interest investments.

PIBS are no longer issued as they do not meet regulatory requirements; however, existing holdings can still be traded on the stock exchange.

F3F Use of fixed-interest investments

Although fixed interest investments as an asset class rate as 'low risk', it is fairly unusual for individuals to actively seek them out as an investment medium in their own right. They are a specialised form of investment and, although 'amateurs' can get good returns, most investors would be best advised to leave it to investment managers who specialise in that field.

One of the best ways to access fixed interest investments is via investment funds such as unit trusts, OEICs or life assurance and pension funds. In this environment they are managed by professionals. As the funds are not necessarily held to maturity, such funds may be categorised as low or low-to-medium risk, although care must be taken.

Investments can be based on gilts, investment grade stocks (large companies with good credit ratings) and high yield bonds (smaller companies with lower credit ratings but high yields due to the higher risk of default) and there are funds to represent each of these. **Strategic Bond funds** are popular. These are where the investment manager decides on the proportions of the above assets, which essentially enables the bond fund to adapt to changing market and economic conditions.

Some funds are based on the higher risk 'junk bonds' (non-investment grade stocks), where the potential for higher returns is balanced against the proportion of loans that do not get repaid. The risk of capital loss with a junk bond fund can be significant.

	Short-term use	Medium-term use	Long-term use
Savings	For holidays, school fees, weddings etc. with a view to capital preservation over the short term.	For holidays, school fees, weddings etc. with a view to capital preservation over the medium term.	
Income	They can provide a usable income to pay for school fees or other fixed commitments.	They can provide a usable income for help with school fees or other fixed commitments such as providing an income in retirement, either directly or via collective investments such as unit trusts and ISAs. Income from purchased life annuities is made possible for life companies by the use of fixed interest investments as the underlying asset.	As age increases and the risk tolerance of an investor reduces, there is an increasing need for an asset that can provide an income with a very low risk to capital and fixed interest investments can achieve this.
Pensions	For capital preservation where there is a short period of time to retirement, fixed interest investments are more reliable than equities and many professionals switch a proportion of their clients' pensions to fixed interest funds as retirement approaches.	Often used in 'lifestyle funds' which involve a pension investment strategy that uses increasingly larger proportions of fixed interest investments as retirement approaches.	Long-term gilts and other fixed interest investments are the underlying asset for pension annuities.
Asset allocation		An asset class in their own right which can be used in conjunction with deposits and equities to 'diversify' a medium-term portfolio.	Effective long-term investment portfolios need to be diversified over all asset classes, including fixed interest investments.

F3G Property investments

Investing in property can give investors both income (rent), as well as capital growth (when selling it for a profit in the future). However, there are risks.

If, as an example, investors choose to invest directly in a buy-to-let property they will be tying their money up and, unlike shares, bonds and cash, it can be difficult to get at their money quickly as they will need to sell the property. The investment is effectively illiquid.

Alternatively, investors can invest in a pooled investment that invests in a range of properties. These normally invest in commercial properties.

The commercial property market is different to the residential property market in terms of what causes the price to change. Commercial properties are let out to companies and tend to be on long leases, often 25 years. As a result, the value of the property will often be increased as a result of the length of the remaining lease and the perception of the financial strength of the company paying the rent. If there is a long lease and a financially strong company paying the rent then the owner of the property has a reasonably safe long-term rental income.

Risks

Even though property prices can experience boom periods (as happened between 1997 and 2007), it is important to remember that property prices can – and do – go down as well as up (as happened after 2007).

If investing in property directly then there are various other risks including, for example, the risk of interest-rate rises if borrowing to buy, the risk of problems with tenants and of needing costly repairs. Also, there is the risk of not having a tenant to pay the rent. Investing directly is a major undertaking and investors should do their homework first.

Buying and selling

If investing in a property directly then it can take some time to sell and there are costs involved. If investing in property through a pooled investment then investors can usually sell much more quickly. However, pooled investments often reserve the right to delay payment to allow time to sell properties if needed. The delay is typically up to six months, but it may be longer.

F3H Pooled investments

A pooled investment is where investors' money is 'pooled' together into a fund which is then invested in one or more asset classes by a fund manager. They are sometimes called **collective investments**. The main benefits of pooled investments are:

- **Professional expertise**. An investment expert picks investments for the fund and is responsible for monitoring those investments and making decisions such as when to sell them.
- **Spreading your risk**. Even if an investor only has a small amount to invest, they can spread their money across a wide range of investments. This reduces the impact on the investment if, say, one company performs badly. Pooled investments can invest in one or more asset classes.
- **Reduced dealing costs**. Direct investments have significant costs, which will mean it may not be cost effective to create a diversified portfolio. By pooling money, collective investments make savings by effectively **buying in bulk**.
- **Less administration**. The fund manager handles the buying, selling and collecting of dividends and income and deals with foreign stock exchanges and brokers, which can be tricky and time consuming.
- **Choice**. There is a very wide choice of funds so that you can pick one – or several – that suit you individually.

There are several types of pooled investment but the main ones are:

- open-ended investment funds;
- life and pension funds;
- endowments; and
- investment trusts.

Investment strategy

Many pooled investment funds are **actively managed**. The fund manager researches the market and buys and sells assets to try and provide a good return for investors.

Others, such as tracker funds, are **passively managed** – they simply aim to track the market in which they are invested. For example, a FTSE 100 tracker would aim to replicate the movement of the FTSE 100 (the index of the largest 100 UK companies). They might do this by buying the equivalent proportion of all the shares in the index.

For technical reasons the return is rarely identical to the index, in particular because charges need to be deducted.

There is a trade-off in the choice of active or passive fund management. While active management aims to beat the relevant markets, they do not always do so and the investment costs will be higher than a passive strategy. This can compound under-performance. Passive investment is often provided at lower costs, but there can be tracking errors and investment costs inevitably mean the funds under-perform the market once costs are deducted.

There is a concern that some 'actively managed' funds are essentially 'closet trackers' and simply replicate markets but with higher 'active management' costs.

In terms of risk, active and passive funds operating in the same markets are broadly similar; although there is certainly more scope for active fund managers to take positions that can lower the overall risk of the fund.

Open-ended investment funds can be trackers.

Open-ended investment funds

Open-ended investment funds are often called collective or pooled investment schemes and are run by fund management companies. While there are many different types of fund, the most common are typically either structured as unit trusts or as OEICs (open-ended investment companies, which are essentially the same as the European version of investment companies with variable capital (ICVCs)).

There are many funds to choose from and some are valued at several billions of pounds. They are called open-ended funds as the number of units (or shares) in issue increases as more people invest and decreases as people take their money out.

An investor buys units/shares in the hope that the value rises over time as the prices of the underlying investments increase. The price of the units/shares depends on how the underlying investments perform.

Investors might also get income from their units/shares through dividends paid by the shares (or income from the bonds, property or cash) that the fund has invested in.

Investors can either invest a lump sum or save regularly each month.

Life funds

Life offices run open-ended life funds which are linked to their 'investment bond' life products. Investment bonds are designed to produce medium to long-term capital growth, but can also be used to give investors an income via a regular withdrawal facility.

There are other types of investment that have 'bond' in their name (such as guaranteed bonds and corporate bonds), but these are very different.

> **Reinforce**
> Investors can pay a lump sum to a life office and this can be invested into a single premium investment bond for them until they cash it in or die.
>
> Investment bonds are not designed to run for a specific length of time but they should be thought of as medium to long-term investments, and investors will often need to tie up their money for at least five years. There will often be a charge if cashing in the bond during the first few years.
>
> The bond includes a small amount of life assurance and, on death, will pay out slightly more than the value of the fund.
>
> For most investment bonds, you take the risk of losing some money for the chance of making more than you could get from putting money in a savings account. Some investment bonds offer a guarantee that you won't get back less than your original investment, but this will cost you more in charges.

Endowments
Endowments are regular premium policies which combine investments with life cover and were once used to repay interest-only mortgages.

> **Reinforce**
> Endowments are offered by life offices, have a fixed term and usually require investors to pay a fixed premium on a regular basis.
>
> Some of the premium is used to buy life cover (so if the investor dies before the end of the term the policy pays out a death benefit) and the remainder of the premium is invested. The amount of life cover will depend upon the premium paid, age, and the length of the policy.

- **Mortgage endowments** – at one time, endowments were commonly taken out to pay off interest-only mortgages. Policies would provide life cover to repay the mortgage if the investor died during the term and, at the end of the term, assuming sufficient investment returns, would aim to repay the mortgage. Mortgage endowments have lost a great deal of their popularity but investors may have existing policies that are still in force.
- **Savings endowments** – endowments can also be held for other specific savings goals or for general investment, without being linked to a mortgage. One type of savings endowment sometimes offered by life offices is called a **maximum investment plan (MIP)**. These plans are now limited to total premiums of £3,600 per annum.
- **Friendly society savings plans** – friendly societies are mutual associations with no shareholders. Their savings plans have certain tax advantages. Investors can save up to £25 a month or £270 a year (if they pay yearly premiums) into a fund that grows free of tax on income and gains.
- **Friendly society children's savings plans** – investors can invest money on behalf of a child in a children's version of the savings plan. The same tax exemptions and savings limits apply.

Endowments may be invested either as with-profits policies (which have investment returns 'smoothed' by reference to actuarial considerations) or as unit-linked (in which the price/value is directly linked to the underlying basket of investments held).

Investment trusts
An investment trust is a listed company with a set number of shares. It is allowed to borrow money to invest (called gearing). Unlike open-ended investment funds like OEICs and unit trusts, an investment trust is **closed-ended**. This means there is a set number of shares available, and this will remain the same no matter how many potential investors there are. Closed-ended investment funds cannot create and cancel shares depending on the amount being invested, so the demand for their shares will have a direct impact on the price.

Where demand for the shares is high and the listed buying price exceeds the valuation of their underlying assets, the investment trust is said to be trading at a 'premium'. Conversely the company may be trading at a 'discount' when demand for the shares is low and the listed buying price is lower than the valuation of its underlying assets.

Investors can invest a lump sum by buying investment trust shares direct from the investment-trust company or through a financial adviser, stockbroker or private client manager. Alternatively, investors can save on a regular monthly basis through the investment trust company (***investment trust savings scheme***).

F3I Other investments

Derivatives

There are also other types of asset called ***derivatives***, which are unlikely to be invested in directly, but which may be included in the assets of a pooled investment vehicle.

A derivative is typically a right or an obligation to buy or sell another type of asset – such as a share, a fixed interest investment or a commodity – at a specific price from or to someone else at a specific future date. The specific price may turn out to be higher or lower than the market price at that date. The most common types of derivatives are **futures and options**.

Contracts for differences (CFDs)

CFDs are contracts stating that one of two parties will pay the other the difference between the current value of an asset and its value at a later date. Usually (but depending on the position investors take), if the difference is positive, then you make a profit, but if the difference is negative you could lose your money and also have to pay the other party the difference in value.

One common example of a type of CFD is a spread bet – a form of wager on an outcome which may relate to a financial instrument or index or even a non-financial event.

High-risk investment

CFDs are highly complex and carry a high degree of risk. It is possible to lose more than your initial investment, so investors must make sure they fully understand the risks involved and seek financial advice if necessary.

Structured products

These can be any one of a wide range of investments and can offer income, capital growth, or a combination of both. Most structured products tend to be open to new investment for a limited and relatively short period of time. This is due to the requirement to support the underlying investments with derivative contracts, the pricing of which is sensitive to market movements.

Investors' money will then usually need to be tied up for between one and ten years. Some structured products offer full capital protection, but others offer partial (sometimes called soft protection) or no capital protection.

Understanding the risks

Structured products can be complicated and investors could lose some or all of the money put in to these products; it is vital to make sure they understand the risks before investing.

Reinforce

Structured products offer returns based on the performance of underlying investments. Many products are linked to a stock market index such as the FTSE 100. The underlying investments may involve different indices or companies based in various countries. A typical structured product will have two underlying investment components:

- A **note** – (a type of debt security). This component is used to provide capital protection. It may pay interest at a specified rate and interval, and may repay some or all of your original money at maturity; and
- A **derivative** – (a financial instrument linked to the value of something else, such as a stock market index or the price of another asset, such as oil or gold). This component is used to provide the potential growth element that you could get at maturity.

Investors are usually offered a proportion of any increase in the level of the index or asset price which occurs during the term of the investment.

Individual savings accounts (ISAs)
An ISA is not a product on its own, but a tax wrapper, which protects investors' income and capital from being taxed.

Currently, eligible investors can make contributions to:

- a cash ISA;
- a (cash) Help to buy ISA;
- a stocks and shares ISA;
- an innovative finance ISA; and
- a Lifetime ISA.

The current ISA limit for 2024/25 is £20,000. This amount can be invested entirely in a cash ISA, entirely in a stocks and shares ISA, entirely in an innovative finance ISA or split in any proportion between the three. Up to £4,000 of the limit can be invested in a Lifetime ISA.

An investor can open and contribute to multiple ISAs of the same type in the same tax year, except for Lifetime and Junior ISAs.

With the exception of Help to buy and Lifetime ISA savers, individuals who withdraw funds from their ISAs can replace them in the same tax year without them counting towards their annual ISA subscription for that tax year, as long as their product provider offers this flexibility.

The minimum age eligibility is 18 years for the cash ISA, stocks and shares ISA, Innovative finance ISA and Lifetime ISA. Those aged 40 and above are not eligible to open a Lifetime ISA. Investors do not have to pay any income tax on income or CGT on the growth of the ISA investments, so this is good for anyone who pays such taxes.

A **stocks and shares ISA** involves longer-term investments such as individual shares or bonds, or pooled investments (such as unit trusts, OEICs and investment trusts).

The **innovative finance ISA** originally enabled savers using a crowdfunding peer-to-peer (P2P) lending platform to receive their interest tax free. Since 6 April 2024, innovative finance ISAs can also include long-term asset funds and open-ended property funds with extended notice periods. Money invested is not protected by the Financial Services Compensation Scheme (FSCS).

The **Lifetime ISA** became available on 6 April 2017 for adults under the age of 40 as a means of saving for a first home and retirement. There is an annual contribution limit of £4,000 and savers will receive a 25% Government bonus, i.e. a £1,000 bonus for every £4,000 contributed before the saver's 50th birthday.

The savings and the bonus can be used towards a deposit on a first home worth up to £450,000 anywhere in the UK. Savers with a Help to buy ISA can transfer their savings into their Lifetime ISA or continue to save in both, although they will only be able to use the bonus from one to buy a house.

If the saver chooses to save for retirement, then after their 60th birthday they can take out all their savings, including the bonus, tax free. If they withdraw any of the money before they turn 60, with the exception of money to buy their first home or in the event of them being terminally ill, they will have to pay a 25% charge.

UK ISA consultation

In the Spring Budget 2024, the Government announced it was looking to introduce a UK ISA (also known as British ISA). This will have a new ISA allowance of £5,000 in addition to the existing ISA allowance and will provide a new tax-free opportunity to invest in the UK. A consultation took place between 6 March 2024 and 6 June 2024. You should keep up-to-date with any developments in this area.

Child trust funds (CTFs)
Investors could start a savings or investment account for their child using the Government's CTF scheme. This was available for every eligible child born on or after 1 September 2002.

There were three types of CTF – a cash account, a stocks and shares-based account and a stakeholder account. The stocks and shares-based account was invested in stock-market investments, such as shares and bonds, whose value could go down as well as up.

Originally, the stakeholder account was stocks and shares-based during the early years, but from age 13 onwards the fund automatically shifted to lower-risk investments in order to lock in previous growth. This 'lifestyling' requirement has since been removed.

Junior individual savings accounts (Junior ISAs)
New CTFs were withdrawn from 3 January 2011 and Junior ISAs came into being on 1 November 2011. Junior ISAs are now generally available to any child born after 2 January 2011. Their main features are:

- Unlike CTFs, there is no initial Government contribution.
- The investment components are cash or stocks and shares and there is no restriction on how a contribution may be divided between the components.
- Withdrawals are not permitted before age 18, other than in very limited circumstances.
- The normal ISA tax benefits apply, except there is no personal liability on income generated from contributions made by a parent.
- The annual limit for Junior ISAs for 2024/25 is £9,000.
- Existing CTFs can be transferred into JISAs.

G Estate and tax planning

G1 Estate planning

Inheritance tax (IHT) is potentially chargeable on the estate of anyone who is UK domiciled (domicile refers to the country regarded as an individual's permanent home, whether or not they actually live there). It is based on the value of an individual's worldwide assets and also on the UK assets of non-domiciles.

The first £325,000 of every estate is covered by the **nil rate band (NRB)**. A further £175,000 is available to estates where a parent leaves their main residence to a direct descendant. This is known as the **residence nil rate band (RNRB)** and is also available to those who downsized or ceased to own their home after 7 July 2015, and assets of an equivalent value are passed to their direct descendants on death. For estates with a net value of over £2m, the RNRB is withdrawn at a rate of £1 for every £2 over the £2m threshold.

The need to protect an estate on death may not be recognised by the client if they are unaware of the impact of IHT, so you should take steps to identify the potential tax liability as part of the financial planning process.

There are two main ways to reduce the impact of IHT:

- organising an estate to reduce the overall liability – by ensuring wills are in place and written correctly, using lifetime gifts, making use of allowances, writing property in trust etc.; and
- providing for money to cover the liability – using a life policy such as a whole of life policy written on a second death basis or by building up a sum in trust to pay the tax.

A potential liability to IHT will usually arise:

- on death; and
- on certain lifetime gifts.

IHT is calculated on the death of an individual and is based on the assets they owned. No IHT is payable if the estate is left to a UK-domiciled spouse or civil partner, but any other amount left to children/grandchildren or others which exceeds the NRB and RNRB could be subject to IHT at 40%.

Example 2.5

Val died on 1 July 2024 leaving an estate of £600,000 to her two grown-up children.

Her estate included the family home which was valued at £200,000. Val had never been married.

The IHT payable as a result of Val's death is therefore:

Value of estate left to children	£600,000
Less RNRB	£175,000
Less NRB	£325,000
Taxable estate	£100,000
IHT payable at 40%	£40,000

One simple solution is to have life protection arranged which on death will pay the amount anticipated as the IHT liability. The most common type of policy used is a whole of life policy written (on a second death basis for couples who are either married or in a civil partnership) under trust to take the policy proceeds outside the estate, so that it would be available to the beneficiaries after death.

Rules of IHT

It is important to remember that the actual IHT payable will be based on the rates of tax, exemptions etc. applicable at the date of death, not when the arrangements are made.

Question 2.16

Ken died on 17 April 2024. His estate was valued at £975,000 at the time of his death, but he did not own a property. In his will he left £325,000 of his estate to his spouse, £325,000 to his children and the remainder to his favourite UK charity. The assets left to the children are made up of both cash and shares.

Using the current thresholds, calculate how much IHT is payable and by whom.

On the Web

Visit *bit.ly/2sBLtPA* and familiarise yourself with how thresholds have changed over the years.

Another way to reduce IHT is to make outright gifts. These may be as part of their annual IHT exemptions, or gifts from surplus income, which would not be subject to IHT. They could also be ***potentially exempt transfers (PETs)*** as there is no tax payable at the outset and if the donor survives for seven years the gift will become fully exempt. Two points should be kept in mind:

- The gift must be irrevocable (i.e. the donor cannot retain any benefit or change their mind).
- The gift must be part of a long-term planning strategy and not made shortly before death. This is to stop people giving away their estate on their deathbed. If the donor dies within seven years, the gift will eat up the donor's NRB and for larger gifts, the recipient may be subject to a reducing IHT liability on the transfer.

A further common approach used to reduce overall IHT liabilities is to make appropriate use of the NRB on death to pass assets on to the next generation. Assets passed to a UK-domiciled spouse or civil partner are exempt, but assets within the NRB (£325,000) could be passed to children or grandchildren with IHT payable at the rate of 0% (hence the term NRB).

Where a spouse or civil partner does not use up their full NRB on first death, the unused proportion may be used on the death of the other partner. Therefore, if the first partner dies and leaves the whole value of their estate to the partner spouse, when the second partner dies the NRB that applies to their estate is theirs plus a further 100% of their partner's

(£650,000 in total). Where the NRB is partially used up on first death, the unused proportion can be passed on to the second partner.

eg

Example 2.6

Bill died in July 2007, leaving his wife Joan two-thirds of the then NRB of £300,000; he passed assets equivalent to the balance of £100,000 to his children (the assets left to Joan are the 'unused proportion').

When Joan died in June 2024, leaving an estate valued at £600,000 to her sister, her NRB was increased by the proportion of Bill's unused band, i.e. £325,000 + (£325,000 × 2/3) = £541,667. Note that it was the NRB at the time of Joan's death (the second death) that the unused proportion was applied to, and not the NRB at the time of Bill's death (the first death).

The total IHT due as a result of Joan's death was therefore:
£600,000 – £541,667 = £58,333 × 40% = £23,333.20.

This is a considerably lower charge than under the old rules, where Bill's unused allowance would have been lost.

The RNRB is transferable in the same way as the standard NRB, providing the second death occurs on or after 6 April 2017. The RNRB that a surviving partner inherits is based on the percentage (not amount) of the RNRB that was unused on first death. This remaining percentage is then applied to the RNRB in place at the date of the second death. Where the first death occurs prior to 6 April 2017, the estate would not have used any of the RNRB as it was not available. One hundred per cent of the RNRB would therefore be available to bring forward in these circumstances.

Example 2.7 illustrates how this works in practice.

eg

Example 2.7

Heather's husband Terry died on 8 May 2016. At that time, their home was worth £500,000. It was owned on a joint tenancy basis. Because Terry died before 6 April 2017, his estate could not have used any of the RNRB, so 100% is available to bring forward.

When Terry died, his share of the property passed directly to Heather under the survivorship rules. Heather also inherited the rest of Terry's estate. There was no IHT to pay as the spousal exemption applied.

When Heather died on 1 June 2024, she left her estate to their son Simon.

Let us assume the value of the family home at the date of Heather's death was £550,000 and the value of her other assets £600,000.

The following NRBs are available to set against Heather's estate:

100% of Terry's NRB	£325,000
100% of Terry's RNRB	£175,000*
100% of Heather's NRB	£325,000
100% of Heather's RNRB	£175,000
Total estate exempt from IHT	£1,000,000

* The unused proportion of Terry's RNRB is 100%. If we apply this unused proportion to the current RNRB, Heather receives a brought forward RNRB of £175,000 in addition to her own.

As Heather's estate is worth £1,150,000, there is IHT of £1,150,000 – £1,000,000 = £150,000 at 40% = £60,000 to pay.

Without the benefit of Heather and Terry's RNRBs, the IHT bill would have been £200,000: £1,150,000 – (2 × £325,000) × 40% = £200,000.

Financial planning and inheritance tax (IHT)
You should be aware of the uses of life and pension-based policies in relation to IHT planning:

- A number of life policies and combinations of policies with trusts can be used as single premium investments which reduce the value of an individual's 'estate'. Typical investments are single premium whole of life policies, where a 'one off' contribution is made to a policy which provides a certain level of life cover, which is payable to a trust for the nominated beneficiaries of the person making the contribution.
- This helps in IHT planning, as the initial investment to the trust policy reduces the amount of capital owned by the individual, and gives it to the trust. The less capital the individual owns on death, the lower the value of the estate and the lower the liability to IHT on death. By ensuring that the death benefits are payable to nominated beneficiaries, rather than back into the estate on death, those benefits will not form part of the estate when the IHT liability is calculated. **Note that the premium would be a potentially exempt or chargeable lifetime transfer, depending on the trust used**.
- Other types of life policy can be effected in trust, whether funded by single or regular premiums. However, you should be aware that the use of trusts is a very complex subject and usually requires expert legal handling.
- The most common way to ensure that benefits are paid in accordance with the donor's/transferor's wishes is to write the policy under trust. A full explanation of trusts is beyond the scope of this book; in brief, the trustees hold the policy for the eventual benefit of one or more persons named as potential beneficiaries by the donor.
- Individual trustees are normally appointed to ensure that the donor's (settlor's) wishes are carried out. The whole procedure should ensure that the death benefits pass without any liability to IHT. Furthermore, certain trusts can allow the trustees (i.e. including the donor) to change the beneficiaries within laid-down parameters. By appointing themselves as a trustee, the settlor (donor) can change their mind about who will benefit under the trust, if the other trustees agree.
- Another commonly used approach is to use regular premium life policies under trust to provide a lump sum on the death of an individual likely to leave an estate with an IHT liability. The tax-free proceeds payable outside the estate will be used to pay IHT on the estate. This technique is not necessary for people leaving their estates to their UK-domiciled spouses or civil partners. However, the possibility of both partners dying at the same time should be considered since the estate must then pass to a third party and potentially incur an IHT liability.

Example 2.8
An illustration will explain how life policies are used for this purpose:

Clive is single with no children of his own. He has total assets valued at around £550,000 which he wishes to leave to his two nephews.

He is advised that the potential IHT liability is £90,000 (£550,000 less the £325,000 NRB = £225,000 at 40% = £90,000 IHT). He wants to ensure that his nephews do not need to sell any of his assets to pay this IHT, not least because £500,000 of his assets are represented in the value of his home.

His financial planning adviser therefore recommends that Clive effects an own life policy with a sum insured of £90,000.

What basic type of policy would you recommend?

You could recommend any kind of whole of life policy which is suitable. However, a policy with increasing cover or a review of the policy at regular intervals might be most suitable to protect the estate against inflation.

Question 2.17
What other precaution would you take regarding Clive's policy?

The two basic uses of life policies in IHT planning are to:

- move value out of an individual's estate, but without giving immediate benefit to their desired beneficiaries; and
- provide a tax-free lump sum on death, sufficient to pay the potential IHT liability.

Finally, you should note that death benefits paid from most types of pension arrangement are paid under discretionary trust. As such, they will not usually be liable to IHT because they do not form part of the deceased's estate but instead will be paid by the trustees of the pension scheme directly to the beneficiaries.

Tightening up of IHT rules
There has been a general tightening of IHT rules over the years including rules penalising legal personal representatives who provide incorrect information or fail to report the setting up of non-resident trusts for a UK-domiciled person. Legislation has also effectively removed schemes under which donors give away the freehold of their home but continue to live there rent free and introduced a standalone income tax charge on benefits from pre-owned assets (Pre-Owned Asset Taxation – POAT).

Question 2.18
Surita wishes to leave her estate, valued at £800,000, to her three children. How can she minimise the impact of the potential IHT liability?

Summary
Estate planning is a complex area and not just a question of mitigating IHT. There are wider issues involved, not least ensuring that a person's assets will pass to the people whom they would wish to benefit.

Most clients do not want to pay IHT, but at the same time they are generally not prepared to take action that might reduce their current or future standard of living in order to save tax on their estate at death. Conversely, there are some clients who are very concerned about IHT planning and will give it a high priority. Those who are most motivated to do so tend to be:

- people who are reasonably affluent and feel they can afford to make bequests or lifetime gifts which may reduce their surviving partner's available income and capital; and
- clients who are in their 60s or older and more conscious of their mortality.

Sometimes individuals with relatively modest estates are very concerned about the impact of IHT; in contrast some very wealthy people are not concerned with leaving their children anything at all.

In most cases however, clients should be aware of:

- the impact of IHT on their estates;
- the scope of IHT planning that need not significantly reduce their income and capital available to them; and
- the importance of undertaking IHT planning sufficiently early.

Clients' attitudes to IHT planning will tend to evolve over the years as they come to appreciate the potential problems that may arise and the different ways that these can be approached.

G2 Tax planning

The amount of tax paid can make a big difference to the return on savings and investments and tax is an important aspect within financial planning generally. There are four main approaches to tax planning for investors:

- make the maximum use of tax allowances and exemptions;
- choose the most suitable investments according to the investor's own tax position;
- choose investments that provide tax-free returns; and
- choose investments that qualify for tax relief on the initial amounts invested.

The UK's tax system is complex and ever-changing; an adviser who is unaware of the tax implications of their recommended solutions to a client's needs will be giving a less than professional service. In particular clients will be justifiably attracted by:

- the tax concessions enjoyed by certain investment vehicles (e.g. ISAs and certain NS&I products);
- tax reliefs and benefits granted on contributions to pensions, venture capital trusts (VCTs), enterprise investment schemes (EISs), and seed enterprise investment schemes (SEISs); and
- the tax-free benefits available on, for example, qualifying life policies and sickness, redundancy, mortgage protection, income protection and long-term care policies.

Any one or more of these factors could well influence an adviser's recommendation to a client and an understanding of the principles of income tax, CGT and IHT together with an understanding of the tax treatment and use of different forms of packaged and pooled investments such as life assurance, pension products, open-ended investment companies (OEICs) and unit trusts is fundamental to financial planning.

Tax mitigation versus tax evasion

There is nothing wrong in arranging taxpayers' affairs so that they legitimately pay less tax (tax mitigation); however, tax evasion – the deliberate failure to provide full and accurate information to HMRC – is unacceptable practice and, furthermore, illegal.

As we have seen, tax planning need not consist of excessively complicated plans which are difficult for the client to understand. The best tax planning is simple, straightforward and legal, as the following checklist shows:

- Make sure all exemptions are used – many exemptions are renewed each tax year on 6 April, so remember to use them up each year.
- Make sure available allowances and reliefs are claimed; allowances for ISAs are per tax year, as are the personal savings and dividend allowances.
- Pay attention to the timing of transactions, particularly around the end/beginning of the tax year in April.
- Consider paying the maximum into available pension arrangements each tax year.
- When taking pension benefits, always consider taking the maximum tax-free PCLS (unless there is a very high guaranteed annuity rate (GAR) offered or IHT is likely to be an issue), even where it is solely an income that is required, as it is possible to make use of a purchased life annuity to turn the capital back into income at a more beneficial rate and with a lower tax burden, than with a compulsory purchase annuity.
- Generally, ensure that other tax-free investments, e.g. ISAs, are used to the maximum.
- Think about tax consequences before a transaction is carried out (such as single premium investment bond encashments).
- Make sure tax returns are completed on time and accurately.
- Make sure tax is paid on time to avoid interest and surcharges for late payment.
- Never recommend a scheme you do not understand.
- Try to keep planning flexible, in case tax law changes.
- Undertake a regular audit of the client's tax position.
- Do not persuade a client to do something they would otherwise not want to do just to obtain a tax advantage.

On the Web

The HMRC website is a useful source of information in all areas of tax planning: *www.gov.uk/government/organisations/hm-revenue-customs*.

Question 2.19

Many tax exemptions and contribution limits for tax-efficient investments are renewed at the beginning of a new tax year and this presents an excellent financial planning opportunity. When does the tax year run from and to?

Key points

The main ideas covered by this chapter can be summarised as follows:

Budgeting, managing debt and borrowing

- An adviser should know whether a client is living beyond their means or whether there is surplus income.
- The difference between income and expenditure gives the level of disposable income but the figure is likely to be very approximate.
- Clients will need to draw up a list of the people and companies to which they owe money; these should then be prioritised. Priority debts include mortgages, utilities and council tax. Debts of lesser importance include credit cards, overdrafts and personal borrowing.

Mortgages and loans

- There are two main types of loan: structured and unstructured.

Protection and protection products

- These are very approximate categories describing different stages in the average person's life:
  - childhood;
  - young single;
  - young partnered;
  - starting a family;
  - family with older children;
  - post-family/pre-retirement;
  - retirement.

State benefits

- The provision of State benefits affects the need for private, voluntary financial planning in two major ways:
  - receipt of State benefits may reduce the level of necessary private financial provision for illness, retirement or death; but
  - the low level of State benefits frequently emphasises the need for private financial provision.

Retirement planning

- Since October 2020, the State pension age for both men and women has been 66. The State pension age will then increase to 67 between 2026 and 2028.
- Occupational pension schemes are set up by an employer and can provide benefits on a defined benefit or defined contribution basis.
- Personal pension schemes are set up between the policyholder and the scheme provider. The policyholder decides how much they want to save.

Saving and investing

- Typically the phrase 'savings' refers to the regular investment of small amounts of money and 'investment' relates to lump sums.
- The main types of deposit-based savings account include the following:
  - savings;
  - cash ISA (individual savings account);
  - fixed notice;
  - fixed-rate bond (term accounts); and

Key points

- high-interest regular savings.

- There are several different types of pooled investment but the main ones are:
  - open-ended investment funds;
  - life assurance and pension funds;
  - endowments; and
  - investment trusts.
- An investment trust is a listed company with a set number of shares. It is allowed to borrow money to invest (called gearing). An investment trust is closed-ended.
- A derivative is not an investment in its own right but one that derives its value from the price of an investment to which it is linked.
- An ISA is not a product on its own, but a tax wrapper around a savings or investment product, which protects investors' interest from being taxed.
- An investor can open and contribute to multiple ISAs of the same type in the same tax year, except for Lifetime and Junior ISAs.

Estate and tax planning

- Inheritance tax (IHT) is potentially payable by the estate of anyone who is UK domiciled.
- There are four main approaches to tax planning:
  - make the maximum use of available tax allowances and exemptions;
  - choose the most suitable investments according to the investor's own tax position;
  - choose investments that provide tax-free returns;
  - choose investments that qualify for tax relief on the initial amounts invested.
- Tax mitigation is legal; tax evasion is not.
- The best tax planning is simple, straightforward and legal.

Question answers

2.1 The key information required is the income and expenditure, although to really understand the budget you will need a full breakdown on each.

2.2 It is important to take care when consolidating loans as part of a mortgage to ensure that clients will not simply run up further debts and make their position worse. They may also have incurred extra charges and costs and ultimately could lose their home if they persistently fail to make repayments.

2.3 A structured loan to buy a car is likely to be more expensive for three reasons:

- it is the higher-risk loan and interest rates increase with the risk of default;
- it is a structured loan and the interest on this type of loan tends to be higher; and
- it is an unsecured loan, unlike a mortgage.

2.4 The greatest need for protection usually occurs between the mid-20s and early 40s as this is the age range when most clients have families that are dependent on their income.

2.5 Not to do so is poor advice as it will provide more cover than required and increase costs and could breach FCA rules and the provisions relating to the fair treatment of customers.

2.6 A level term assurance will ensure that there is life cover in force for the whole amount of £10,000 should Janet die at any point in the ten-year term; also, as this product has no savings element all premiums charged are to fund the life cover, which results in a low premium. There would be no point in effecting a decreasing term assurance because the sum assured needs to be constant throughout. A convertible term assurance would be a ‘luxury’ since Janet knows precisely what the debt will be at the end of the ten-year term. A low-cost whole life policy would be inappropriate because the premium would be geared to a contract running much longer than ten years, adding extra cost.

2.7 Protection for mortgages and loans.

2.8 An assessment of income and capital is made to ascertain whether or not State benefits are payable.

2.9 State pensions and, for that matter, State benefits (where appropriate) are determined by the payment (or crediting) of sufficient NICs.

2.10 The advice would be to start saving now because this would give David 35 years in which to build up a pension fund. Consequently, the contribution level necessary is much lower than that for someone planning the same pension but who, at age 50, has only 15 years in which to make the necessary contributions.

2.11 35 qualifying years of National Insurance contributions are required for a full new State Pension.

2.12 A deduction will be made from an individual’s New State Pension for any time spent contracted out.

2.13
- Family income benefit: payable on death.
- Personal accident insurance or income protection insurance: payable in the event of ill-health preventing the individual from working.
- Personal pension: appropriate for providing an income and possibly a tax-free PCLS at retirement.

2.14 It is not possible to have both high investment returns and low risk. It is the job of the financial adviser to explain the nature of the compromise required and to manage their client’s expectations.

Question answers

2.15 The four main uses are as follows:

- As an emergency fund.
- To provide liquidity.
- As a fund to be used for future investment opportunities (good deals and topping up tax-exempt schemes such as ISAs).
- As an asset class in its own right for short, medium and long-term planning to balance the other asset classes in the portfolio.

2.16 No IHT is payable because both transfers between spouses (as long as they have a UK domicile) and to UK charities are exempt from IHT. As follows:

Estate = £975,000.

To spouse = £325,000 (no IHT as transfer between spouse).

To children = £325,000 (current NRB).

Balance of Estate = £325,000.

To UK charity = £325,000 (No IHT payable as transfers to UK charities are exempt).

If you did not get this answer, or are not familiar with all exemptions, you might like to visit *www.gov.uk/topic/personal-tax/inheritance-tax* and review your understanding of IHT before you move on.

2.17 It should be written in trust for the benefit of the nephews, to ensure that the death benefits do not get paid to Clive's estate when he dies. Benefits paid to the estate will increase its value for IHT purposes.

2.18 Surita could effect an own life whole of life policy written under trust with her children as beneficiaries to enable them to pay the tax bill.

2.19 The tax (fiscal) year runs from 6 April to 5 April in the following year.

3

Laws and legal concepts relevant to financial advice

Contents	Syllabus learning outcomes
Introduction	
A Legal persons	3.1
B Powers of attorney	3.1
C Law of contract and capacity	3.1
D Law of agency	3.1
E Ownership of property	3.1
F Bankruptcy and insolvency	3.2
G Wills and intestacy	3.3
H Use of trusts	3.3
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- discuss the various types of legal persons;
- explain powers of attorney;
- outline the law of contract and legal capacity;
- outline the law of agency;
- discuss the various forms of property ownership;
- describe how insolvency and bankruptcy work;
- describe the laws of succession and the principles of intestacy; and
- discuss the use and purpose of trusts and the role of trustees.

Introduction

The legal system of the UK has a major effect on the financial services industry. You should, therefore, be familiar with the main aspects of the system which impact on your clients. In this chapter we discuss the major types of business:

- sole traders;
- partnerships; and
- limited companies, including public limited companies.

We then go on to discuss powers of attorney; the laws of contract and agency; types of property and how it can be owned; bankruptcy and insolvency; the laws of succession, legal personal representatives and the administration of estates; and finally, the law of trusts and their use.

Key terms

This chapter features explanations of the following terms and concepts:

Binding	Binding unless repudiated	Good faith	Grant of Letters of Administration
Grant of Probate	Grant of Representation	Insurable interest	Joint ownership
Lasting power of attorney	Laws of succession	Legal personal representative	Official receiver
Power to contract	Trustee in bankruptcy		

A Legal persons

A1 Sole traders

The term ‘sole trader’ is used to describe a person who solely controls their own business, whether or not they employ other people. Sole traders are self-employed and are personally liable for the debts of their business. They have no contract of employment with an employer but may provide services for others under ‘contracts for services’.

As the law does not distinguish between the individual who owns or runs the business and the business itself, neither does His Majesty’s Revenue & Customs (HMRC). Thus, there is no tax on an unincorporated business that makes profits; instead, the tax is levied on the sole trader.

The profit of the business (i.e. gains made in the normal trade of the business) will be liable to income tax, payable by the sole trader. Capital gains of the business are treated as gains made by the individual and, therefore, liable to capital gains tax (CGT) – for example, sale of property or assets.

The self-employed pay income tax twice yearly directly to HMRC. National Insurance contributions (NICs) are paid either under Class 2 or Class 4, depending on the amount of profit made.

Although, as far as the sole trader is concerned, we cannot separate their personal tax liability from that of the business, we must separate the taxation of any employees from the sole trader.

Employees pay income tax under PAYE and Class 1 NICs, even though the sole trader they work for pays tax and NICs in a different way. Furthermore, where an employee is liable for Class 1 NICs, the sole trader is also liable to pay secondary Class 1 NICs as their employer.

Example 3.1

Britannia Carpets is the business name of sole trader John Wilson. It has made a profit in the current tax year of £40,000. What are John's tax liabilities?

The profits of John Wilson trading as Britannia Carpets are liable for income tax, CGT and Class 4 NICs. If John's profits had been below the lower annual limit (£12,570), he would not have had to pay Class 4 NICs.

As his profits are above the small profits threshold (£6,725), Class 2 NICs are considered by HMRC to have been paid. This protects John's NI record without him having to pay them. If his profits had been below the small profits threshold, John could have paid Class 2 NICs voluntarily to maintain his NI record.

John must also collect the income tax and Class 1 NIC from any employee's earnings (under PAYE) and pay secondary Class 1 NIC as the employer.

On the Web

You can find out more about the different classes of National Insurance, including the amounts payable at *www.gov.uk/national-insurance/national-insurance-classes*.

Be aware

You should ensure that you understand the principles behind this before continuing through the chapter, as we will be highlighting and commenting on the differences between the business types as we progress.

A2 Partnerships

Consider this…

What would the situation be if John Wilson trading as Britannia Carpets took on a partner to help him run the business?

Would this change the tax position for either John Wilson or Britannia Carpets, now the situation is John Wilson and Nadia Smith trading as Britannia Carpets?

The answer to this is that the tax and NIC situation largely remains the same. John is still self-employed even though the business is a partnership, and he will continue to pay income tax on the partnership's profits directly to HMRC. However, he will now only pay tax on his share of the partnership's profits – usually 50%, unless he and Nadia have agreed some other split of the profits. This same figure is also used to calculate John's liability to NICs.

Be aware

A partnership is not a separate legal person from the partners; it is merely the sum of the partners.

While each partner has unlimited liability for the trade debts of the partnership, they are solely liable for their own tax and cannot be held liable for any other partner's tax.

The situation regarding employees of the partnership is the same as when the business was solely owned by John Wilson.

This is the position regarding what might be called a 'traditional partnership'.

A3 Limited liability partnerships (LLPs)

A new type of partnership was introduced by the **Limited Liability Partnerships Act 2000**. Like companies, limited liability partnerships (LLPs) are separate legal persons and are subject to similar registration and accounting requirements. As the name suggests, an LLP also has limited liability like a company and the partners are not individually liable for the LLP's debts. Consequently, LLP status is attractive to professional firms that might face the risk of large liability claims.

For tax purposes, an LLP is treated like a traditional partnership so the partners are still self-employed and pay income tax and NICs on their share of the profits. LLPs do not pay corporation tax.

A4 Limited companies (Ltd)

Limited companies, in direct comparison to sole traders and partnerships, have a legally separate identity from the owners of the business (who, for limited companies, will be the shareholders in the business). As such, HMRC cannot look to those individual owners to pay tax on the company's profits – they must look only at the limited company itself.

Most large businesses are run as companies to gain the benefit of limited liability. The company is responsible for its own debts to the limit of its own assets. The managers, directors or shareholders of the company are not liable for the debts of the company unless (exceptionally) they are guilty of unlawfully trading – e.g. continuing to trade despite knowing the company was insolvent with the intention of defrauding creditors.

Companies cannot trade until they are registered with the Registrar of Companies and must supply specified information and yearly accounts to Companies House. This information is then made available to the public.

Limited companies can be identified by the presence after the name of the words 'limited' (Ltd) for a private company, or 'public limited company' (PLC) for a public company floated on the Stock Exchange. Thus, if John and Nadia in our example changed their partnership into a limited company (this is known as 'incorporation' of the business) then we would be referring to Britannia Carpets Ltd. There is no difference between a private limited company and a plc from a tax point of view, but a private limited company (as opposed to a PLC) is unable to advertise its shares for sale. It can only change hands as a result of a private agreement.

There are major tax differences between limited companies and unincorporated businesses (i.e. businesses which are not companies): limited companies pay neither income tax nor CGT; they do, however, pay corporation tax on all forms of profit made by the company (including capital gains).

Furthermore, now that Britannia Carpets Ltd has a separate legal identity, John and Nadia, even though they might own all of the shares in the company, are likely to become directors of that company. For tax purposes they are classified as 'office holders', which means that although they are like any other employee with their earnings chargeable to tax as employment income under PAYE, their liability to Class 1 NICs is taxed on an annual cumulative basis. This is to prevent them from altering their income flow to take advantage of the NIC system.

John and Nadia will no longer pay income tax directly to HMRC on their salaries from the business, and neither they nor the company is liable to NIC on business profits (although the company must still pay secondary Class 1 NIC on employees who are themselves liable to Class 1 NIC).

A5 Public companies (PLCs)

There are fewer differences between public and private companies than might be imagined. It is when a company becomes quoted on the Stock Exchange that the major distinctions arise because of the need to protect investors and follow the rules for quoted companies.

Requirements of PLCs include:

- A public company must have at least two directors, two shareholders and a company secretary.
- PLCs must state that they are public and a public company's name must end with the designation 'public limited company' or PLC.
- Public companies need an extra certificate from the Registrar of Companies after incorporation before they can start trading. To acquire this, PLCs must have allotted shares with a nominal value of at least £50,000 and the company must have received at least a quarter of the nominal value, i.e. at least £12,500 plus the whole of any premium.
- In a public company, the company secretary must be a member of a professional body or a person whom the directors recognise as being qualified for the position by way of experience or in some other way.

- Public companies must always lay their accounts and reports before a general meeting of the shareholders and hold annual general meetings. (Private companies can opt out of these arrangements.) Public companies must file their accounts within six months of the end of their accounting period and are not allowed to waive the requirement of audited accounts or to provide abbreviated accounts.
- Other requirements include the disclosure of shareholdings in the company and the release of information that might affect the share price.

A6 Types of legal persons

The following tables summarise the different types of legal persons and their responsibilities.

Ownership	
Sole trader	Any individual who solely controls their own business – 'self-employed', regardless of whether they employ others or not; no contract of employment, but may carry out 'contracts for services' to clients; no distinction between the individual who runs the business and the business itself.
Partnership	Owners are still self-employed.
LLP	Separate legal persons, subject to similar registration and accounting requirements – like companies.
Ltd/PLC	Legally separate identity from the owners of the business (the shareholders), who become 'employees' of the business.

Liability	
Sole trader	Personally liable for the liabilities of their own business.
Partnership	Each partner has unlimited, joint and several, liability for the trade debts of the partnership (not restricted to their share of profits).
LLP	Limited liability means that partners are not individually liable for the partnership's debts.
Ltd/PLC	The company is responsible for its own debts to the limit of its own assets.

Tax	
Sole trader	No tax on the unincorporated business – tax is levied on the owner instead; profits of the business liable to income tax and CGT through the owner; self-employed pay income tax twice a year, direct to HMRC; NI paid under either Class 2 or 4, depending on profits.
Partnership	Owners pay income tax on their share of the partnership's profits, direct to HMRC; they are liable on the same amount when paying NI Class 2 or 4, depending on profits; a partner cannot be held liable for any other partner's tax.
LLP	For tax, LLPs are treated like traditional partnerships; the partners are self-employed, pay income tax and NIC on their share of the profits; LLPs do not pay corporation tax.
Ltd/PLC	The shareholders do not pay tax on the company's profits, the limited company itself does; no difference between a limited company and a PLC for tax; major tax differences between a limited company and an unincorporated business (e.g. sole trader) – limited companies and PLCs do not pay income tax or CGT, but they do pay corporation tax on all forms of profit (including capital gains).

Reinforce

A PLC is distinct from a limited company because it may be floated on the Stock Exchange – this causes a series of differences due to the need for a PLC to protect investors and follow the rules for quoted companies when applicable.

Question 3.1

What is the major difference in the taxation of limited companies and unincorporated businesses?

B Powers of attorney

Under the **Powers of Attorney Act 1971**, a person can give power to another individual to act on their behalf – for example, in using bank or building society accounts, paying bills or buying and selling investments. This will be either a general power or specific to one or more areas. Examples of people who give others power of attorney include:

- someone who leaves the country for a long period;
- an elderly person who wants someone to handle their affairs for them.

Where there is a power of attorney, both the adviser and the life office/bank/investment firm etc. need to be clear what power this confers. This will be stated in the original power of attorney, which should also define how long the power of attorney is valid for and gives authority for the intended transaction. For example, an individual could establish a power of attorney whereby an individual or group of individuals are able to act independently or jointly.

An ordinary power of attorney only grants power while the individual is mentally capable of handling their own affairs and is withdrawn on mental incapacity. In the field of long-term care, the onset of mental incapacity often removes the power to act on behalf of an individual when it is most needed. This led to the introduction of the **Enduring Powers of Attorney Act 1985** and, subsequently, to the **Mental Capacity Act 2005**.

A power of attorney is also automatically revoked on the death or bankruptcy of the donor, or on the expiry of a specified time. In addition, the donor can cancel the attorney at any time.

B1 The Mental Capacity Act 2005

The **Mental Capacity Act 2005** came into force on 1 October 2007 and revised the law on mental capacity and enduring powers of attorney.

The Enduring Powers of Attorney Act 1985 was introduced to enable a person to hold a power of attorney which would continue in the event of the mental incapacity of the donor, called an Enduring Power of Attorney (EPA). While the individual has mental capacity, an EPA usually confers the same power as a normal power of attorney. If mental incapacity occurs, an EPA continues, unlike an ordinary power of attorney.

Every individual is assumed to have mental capacity unless otherwise established. An individual lacks mental capacity if they are unable to make a decision for themselves due to an impairment of, or disturbance in, the functioning of their mind or brain (permanent or temporary). An individual is unable to make a decision for themselves if they cannot:

- understand the relevant information;
- retain that information;
- evaluate that information in making the decision; or
- communicate that information.

In order to qualify as an EPA, the following requirements needed to be met:

- It had to be established before 1 October 2007 (a different type of power applies after this date).
- It had to be established while the individual had full mental capacity, was aged 18 or over and was not bankrupt.
- It satisfied the conditions of the Enduring Powers of Attorney Act 1985.

The attorney registers the EPA with the Office of the Public Guardian (OPG) when they believe the individual has lost, or is starting to lose, mental capacity.

For individuals who wished to retain control over their own affairs while they were mentally capable to act, it was possible to restrict the EPA so that the power did not come into effect until it was registered.

Powers can be general or restricted and attorneys can be individual or joint attorneys. It is important to note that EPAs do not cover the individual's attitude to health care provision, e.g. treatments they wish/do not wish to receive.

The rules governing EPAs are set out in that Act. There was a standard form that had to be used and notice of the registration must be given to at least the first three eligible family members from a list, e.g. spouse/civil partner, children, parents, siblings etc.

Once appointed, the attorney is expected to manage the individual's affairs in accordance with the principles of the Act. In general terms, attorneys are forbidden by the Act to use the power to make gifts. The power can be revoked by the individual at any time but once registered, the consent of the Court of Protection (COP) is required.

Question 3.2
What events will normally revoke an ordinary power of attorney?

B1A Lasting power of attorney

The Mental Capacity Act 2005 introduced the **lasting power of attorney** (**LPA**). This is an agreement where a donor can give their attorney(s) power to make decisions about their:

- personal health and welfare (such as long-term health care and treatment);
- property and financial affairs.

If the LPA is to cover both welfare and financial matters, then two separate documents are required (a **health and care decisions LPA** and a **financial decisions LPA**). The donor of the power(s) must be over 18 and have capacity. The attorney must be over 18 and not bankrupt.

The LPA must comply with regulations made under the Act and be registered with the OPG as soon as possible. The LPA must state that the donor and attorney have read the prescribed information and that the attorney understands their duties. There must also be a certificate from a prescribed person confirming that the donor understands the LPA and that there has been no fraud or undue pressure. A health and care decisions LPA includes the power to make decisions to give or refuse consent for medical treatment.

Under s.12, a financial decisions LPA cannot be used to make gifts except on customary occasions to persons related to or connected with the donor and gifts to charity which the donor might reasonably be expected to make, for example, birthday and Christmas gifts, and only then if the value is reasonable. Therefore, inheritance tax (IHT) planning via LPAs is rarely possible. However, the COP can authorise gifts not allowed under LPAs.

The donor can cancel an LPA if they have capacity. An LPA can also be revoked on the:

- donor's bankruptcy (but not as regards welfare);
- death or bankruptcy (but not as regards welfare) of the attorney, but only if they are the sole attorney;
- dissolution of marriage or civil partnership between donor and attorney; and
- attorney's incapacity, but only if they are the only attorney.

The COP can appoint a deputy to take care of a person who lacks capacity. This may be done in cases where there is no valid EPA or LPA. The deputy cannot make settlements of the person's property or exercise their powers as a trustee.

Advanced medical decisions made when the person had capacity and was over 18 are valid after loss of capacity.

Reinforce

The Enduring Powers of Attorney Act 1985 was repealed so that from 1 October 2007 there could be no new EPAs. However, EPAs can continue but must be registered with the OPG on the incapacity of the donor. They will be revoked by the bankruptcy of the donor or the attorney (if there is only one attorney).

On the Web

See *www.gov.uk/government/organisations/office-of-the-public-guardian* for further information.

Chapter 3

For reference only

C Law of contract and capacity

C1 Contract law

Refer to

See *Consumer Credit Act 2006* on page 6/35, for unfair contract terms

Life assurance policies are contracts in exactly the same way as contracts for every other trade or business. For a binding contract to exist the following conditions must be fulfilled:

- There must be an **offer** (that is, for example, the provider offering to insure a life) and an **acceptance** (the proposer agreeing to the terms quoted by the insurance company). Both parties must clearly understand the terms on which the contract is based.

Refer to

See *Offer and acceptance* on page 3/9 for further details on offer and acceptance

- There must be an **intention** to create a legally binding contract and both parties must have the **power to contract**.
- There must be **consideration** meaning that both parties must pay or stand to pay something to the other. For example, the policyholder pays the premium and the life office guarantees to pay the sum assured in the event of a valid claim.

However, in the case of life assurance contracts, the additional requirements of ***good faith*** and insurable interest also apply.

Good faith
Good faith can be defined as a positive duty voluntarily to disclose, accurately and fully, all circumstances material to the risk being proposed, whether requested or not. The principle applies equally to both the proposer and the insurer. In recent years, legislation has modified the requirements of good faith for both consumers (individuals applying for insurance to meet their personal needs) and non-consumers (commercial customers).

The **Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA)** governs the disclosure requirements for consumers. Under this Act, consumers have a duty to take reasonable care not to make a misrepresentation.

The **Insurance Act 2015 (IA 2015)** sets out the duty of a non-consumer. Their obligation is to make a fair presentation of the risk in a way that is reasonably clear and accessible to a prudent insurer.

Insurable interest
Insurable interest requires the proposer of a life contract, i.e. the party to whom the benefits will be payable, to have a financial interest in the life assured (on whose death the policy benefits will be payable). This interest must arise through a legal or equitable obligation.

C1A Contractual capacity

Some people are subject to rules restricting their capacity to contract. The main categories are minors, people who have a mental health condition, and those who were under the influence of alcohol or drugs at the time the contract was agreed.

Minors
Under English law a minor is a person below the age of 18 (**Family Law Reform Act 1969**). The main purpose of the rules which govern contracts made by minors is to protect them from their own inexperience which may lead them into agreements which are disadvantageous to them. The law also tries to avoid causing too much hardship or inconvenience to adults who deal with minors. Contracts made by minors fall into three categories:

- Contracts which are ***binding***, e.g. a contract of employment and similar agreements such as contracts of apprenticeship. The contract is binding if it is, on the whole, for the minor's benefit.
- Contracts which are ***binding unless repudiated***, e.g. a lease or partnership and the holding of shares in a company. The minor may cancel the contract either during their

minority or within a reasonable time afterwards. The minor is then freed from any further liability under the contract such as further rent payments.

- Contracts which are **not binding** on the minor. All other contracts fall into this category and include contracts to borrow money. Although these contracts do not bind the minor they do bind the other party, the minor can, therefore, sue if the other party does not keep to the contract. The minor does not have to cancel the contract to avoid liability – even if they do nothing they are not bound.

People with mental health conditions
Contracts made by those with mental health conditions are generally valid, although the contract can be avoided if they were unable to understand the nature of the agreement and the other party was aware of this inability. If the person's condition is so serious that their property has been made subject to control of the COP, contracts where they attempt to dispose of the property do not bind them, though they bind the other party. Someone with a mental health condition can ratify a contract that previously did not bind them, if they recover from their condition.

People under the influence of alcohol or drugs
The rules affecting people under the influence of alcohol or drugs are similar to those for people with mental health conditions. An intoxicated person can avoid a contract only if they were totally unaware of what they were doing and the other party knew this. Again, such a contract becomes binding if approved when the effects of the alcohol or drugs have worn off.

Question 3.3

Are contracts made by someone with a mental health condition invalid?

C2 Offer and acceptance

The general law of contract applies to life assurance, but with certain modifications. The offer is not made by an insurer's prospectus or advertisement. This is merely an 'invitation to treat' to receive offers.

The proposal form completed by the proposer is by law the offer. This is then considered by the life office, who may make any relevant enquiries and request medical evidence if necessary. The life office, if prepared to accept the risk, will then issue a letter of acceptance stating that it will issue a policy, provided that the first premium is paid within a specified time, and on the understanding that the state of health of the proposer remains unchanged.

The letter of acceptance is, at law, a counter offer, which the proposer can accept by paying the first premium. The legal authority for this is ***Canning v. Farquhar (1886)***.

Reinforce

Canning proposed for life assurance. The life office notified him that his proposal had been accepted at a stated premium, but that the policy would not take effect until the first premium had been paid. Before Canning paid the premium he fell off a cliff and was seriously injured. The premium was then sent in, but was refused by the life office. Canning subsequently died and a claim was made.

A court held that the life office was not liable because:

- the proposal and 'acceptance' did not constitute a binding contract, but were merely part of the preliminary negotiations; and
- as the 'acceptance' contained a new term – the amount of the premium – it was a counter offer which could not continue after the risk had changed since the statements in the proposal as to good health had become untrue.

Most regular premiums are paid by direct debit. In these cases it is considered that the receipt of a signed direct debit mandate is equivalent to receipt of a cheque for the first premium as far as offer and acceptance are concerned. Payment by debit/credit card (or even cash) also constitutes immediate acceptance.

FCA rules generally allow a policyholder a cooling-off period (the number of days for which depends on the product involved, typically these are 14 days or 30 days) in which to change their mind under their cancellation notice procedure. If the policyholder uses this right, premiums paid are usually refunded in full and the contract is cancelled.

D Law of agency

An agency is a contract whereby one party – the **agent** – agrees to do certain acts on behalf of another party – the **principal**.

Someone seeking insurance may use an independent financial adviser (IFA) to find the most suitable contract on the market for them. Under the law of agency the:

- IFA is the agent of the client and owes a duty of care to the client;
- IFA owes no duty to the insurer, but must comply with the relevant FCA rules; and
- client is responsible for the acts of the IFA.

If a material circumstance is disclosed by the client to the IFA, but the IFA does not disclose it to the insurer, there has been non-disclosure and the insurance contract may be void. Insurance companies are not responsible for the acts of IFAs.

On the other hand, an employee or a self-employed representative of an insurer is the agent of the insurer and the insurer is responsible for the agent's acts and omissions. So, if a client discloses a material circumstance to an insurer's agent and the agent does not pass this on to the insurer's underwriters, there has been no non-disclosure and the contract is valid. While the agent owes a duty of care to the insurer and must comply with the FCA rules, the insurer must ensure that all its agents comply with these rules and is responsible for any non-compliance.

Question 3.4
Under the law of agency, who does an IFA owe a duty of care to – their client or the insurer?

E Ownership of property

E1 Forms of ownership

In England, Wales and Northern Ireland property is usually owned either 'freehold' or 'leasehold'.

- Freehold means that both the building and the land it stands on is owned until such time as the owner decides to sell it or dies, in which case it becomes the property of their estate.
- Leasehold means that the land on which a building stands is not owned outright by the buyer. Instead, it is leased from the person who owns the freehold rights at a 'rent'. The lease is typically for 99 or 125 years. At the end of the term, the land and the building or buildings on it revert to the freeholder. For long leases, this distinction is academic; however, for shorter leases, it can be problematic.

Commonhold was introduced by the **Commonhold and Leasehold Reform Act 2002**. Its aim was to provide an alternative to leasehold and eventually to replace it. Owners of flats under commonhold are called unit-owners. They own their flats in perpetuity (as with freehold) and are members of a Commonhold Association. The Commonhold Association owns the land, the building and the common parts. Unit-owners have a vote in the operation of the Association, which is responsible for the management, maintenance, repair and servicing of the building.

Despite its advantages, commonhold has not become the preferred way to own properties in buildings that are occupied by multiple users, with many occupiers of leasehold properties continuing to own these on the basis of long leases and using the services of management companies for everyday maintenance.

E2 How types of ownership can affect lending decisions

If a property is owned freehold, it should not prove difficult to obtain a mortgage loan (assuming, of course, that all the other lending conditions are met) in normal credit market conditions.

However, if a property is held leasehold, most mainstream lenders will only consider lending if the lease has at least 25 years to run after completion of the mortgage term (many could require as many as 40 years). This ‘safety margin’ is required so that if the borrower defaults and the property has to be sold to repay the debt, it can still be sold at reasonable value. It could, therefore, be difficult to get a mortgage on a leasehold property with less than 60 or 70 years to run on the lease.

A lender will also want to be satisfied that there is a clear and legally binding agreement concerning financial responsibility for the repair and maintenance of the building.

Many lenders will only lend on leasehold flats because the terms of the lease will set out responsibility for common repairs. Flat owners within a block can be forced under the terms of the lease to share their part of the cost. With freehold flats, it can be difficult to ensure that all freeholders pay their fair share of repair costs.

To overcome the difficulties of leases running out, a leaseholder has the right to do one of two things:

- buy the freehold; or
- extend the lease.

Under the Commonhold and Leasehold Reform Act 2002, a leaseholder has the right to buy or extend the lease, provided they have lived in the property full-time for the last two years. The lease must have been for a period of 21 years or more.

The Act also introduced changes to freehold purchase and lease extension. These include the reduction of the number of leaseholders within a block of flats whose agreement is required in order to enforce the sale of the freehold from two thirds of all leaseholders to half.

Be aware

The **Leasehold Reform (Ground Rent) Act 2022** came into effect on 30 June 2022. It restricts ground rents on newly created long leases for houses and flats (with some exceptions) to an annual rent of one peppercorn. This is intended to represent no financial value.

This has been followed by the Leasehold and Freehold Reform Bill which aims to make long-term changes to improve home ownership for leaseholders in England and Wales by empowering them and improving their rights. The Bill is currently at Committee stage with the House of Lords.

E3 Joint ownership

When two or more people buy a house (or other types of assets) together, there are two possible ways in which the joint ownership can operate. In both cases each beneficial owner is as much entitled to possession of any part of the property as the other.

E3A Joint tenancy

Joint tenancy means that neither individual can sell without the other’s agreement. Each has an equal share of the property and when one dies, the survivor inherits the other’s share of the property without **probate** being needed and regardless of the provisions of any will. This is usually used where the joint owners are spouses/civil partners but may not be suitable for other partnerships, e.g. two friends buying a house together, especially where the deposit or monthly repayments are not shared equally.

E3B Tenancy in common

Refer to

See *Intestacy* on page 3/16 for more on intestacy

Here, each owner holds their share separately. They can dispose of their share as they wish and when they die their share goes to their estate, not to the other joint owner(s), and is disposed of according to their will or the law of **intestacy**. This can be useful when the joint ownership is not spouses/civil partners. Tenancies in common need not involve equal shares (unlike joint tenancies).

E4 Housing associations and Government schemes

E4A Shared ownership

These are schemes operated by housing associations at a local level. Purchasers buy a share of the property, usually 25%, 50% or 75%, with the remaining share being owned by the housing association. The purchaser pays rent to the housing association on their share. Usually, the terms of the lease issued by the housing association allow the purchaser to increase their share in the property (known as 'staircasing') by buying additional shares in the property, up to 100% ownership. It is possible to sell a shared ownership property and move elsewhere. Any new purchaser takes on the property at the existing owned/rented split with the option to then increase their ownership in the future, as above.

Question 3.5

What is meant by the term 'staircasing'?

E4B First Homes scheme

First Homes is a specific kind of discounted market sale and meets the definition of 'affordable housing' for planning purposes.

To be eligible for the scheme, purchasers must be first-time buyers with an annual household income not exceeding £80,000 (or £90,000 in London) in the tax year immediately preceding the year of purchase. The buyer must also have a mortgage or home purchase plan (if complying with Islamic law) to fund a minimum of 50% of the discounted purchase price.

Eligible buyers get 30% to 50% off the price of a home in their local area, which they don't have to pay back. The discount will apply when they sell, meaning they can only sell to first-time buyers. There is a property price cap of £250,000 in England (rising to £420,000 in London) after the discount is applied.

E4C Mortgage guarantee scheme

In a bid to transform Generation Rent into Generation Buy, a residential mortgage guarantee scheme was announced in the March 2021 Budget. The scheme was expected to end in December 2022 but has been extended until the end of 2025. It is aimed at increasing the availability of 91% to 95% loan-to-value mortgages. The Government guarantees the portion of the mortgage over 80%.

The maximum property value is £600,000 and mortgages must be arranged on a repayment basis. Both new build and existing properties are eligible. Second homes and buy-to-let properties are not.

F Bankruptcy and insolvency

Financial advisers occasionally encounter individuals and companies that are or have been in serious financial difficulties. Few would actively seek business in this area because the scope for financial planning is necessarily restricted; nevertheless, it is important to have a basic understanding of the rules for individuals and companies.

Be aware

Note that the term bankruptcy applies to individuals only; the term insolvency applies to companies.

F1 Individual voluntary arrangement (IVA)

As an alternative to bankruptcy, a debtor may succeed in making an **individual voluntary arrangement (IVA)**:

- To decide whether an IVA is acceptable, a creditors' meeting is called and a vote is taken. Creditors representing at least 75% of the debt owed need to vote in favour of the IVA proposal for it to go ahead.
- Once the IVA is approved, creditors are unable to take any legal action to recover the debt.
- Fees are payable, but they are included as part of the original monthly repayment when the proposal is agreed.
- An **insolvency practitioner** reviews the debtor's finances yearly and an annual progress report is sent to creditors.
- The debtor is notified when the IVA has ended.

The IVA can be cancelled if the debtor does not keep up repayments. Two fees are payable:

- a set-up (nominee) fee to cover the cost of setting up the IVA; and
- a handling (supervisor) fee each time a payment is made.

While the IVA is in progress the debtor will need to get permission from the insolvency practitioner to apply for credit. The debtor will not be able to get a mortgage and may only be able to borrow from less reputable lenders at high rates. The IVA is added to the **individual insolvency register** and is removed three months after it ends. It will also appear on an individual's credit reference agency report for a minimum of six years after it commences. A significant difference between an IVA and bankruptcy is that the debtor will not lose their home (although they may be asked to remortgage it if there is equity in there that can be used to pay off creditors).

If partners or sole traders are unable to pay debts as they fall due, they may be made bankrupt if their liabilities exceed their assets.

F2 Bankruptcy

Individuals who are unable to pay their debts and financial commitments are faced with the possibility of bankruptcy, under which virtually all their assets are taken and shared among their creditors.

When the bankruptcy ends, the debtor is largely free from those debts and can make a fresh start.

Bankruptcy is usually begun by the presentation of a petition to a court for a bankruptcy order by a creditor or creditors jointly and is governed by the **Insolvency Act 1986**, as amended by the **Enterprise Act 2002**. The court will only consider a petition where the creditor is owed at least £5,000 or a share of debts totalling at least £5,000. Before the court will make the order, the debtor's inability to pay the debt must be proved by showing that a statutory demand has not been complied with within 21 days or that a court order has not been enforced, e.g. bailiffs have been unsuccessful at obtaining their property (or equivalent value). You can also apply online to make yourself bankrupt if you cannot pay your debts and an insolvency practitioner can make you bankrupt if you break the terms of an IVA.

When a bankruptcy order has been made, the **official receiver** initially takes control of the debtor's property and will then decide if it is necessary to call a meeting of creditors to enable them to appoint an insolvency practitioner of their choice as ***trustee in bankruptcy* (TIB)**. The TIB's function is to realise and distribute the bankrupt's estate in accordance with the Insolvency Act 1986. All property owned by the debtor at the date of the bankruptcy order or subsequently acquired during bankruptcy will pass to the TIB.

Debtors can retain the 'tools of their trade', a vehicle if they need one for their employment and clothing, furniture and bedding belonging to themselves and their family.

The TIB's task is to convert the bankrupt's property into money which is used to pay their debts in the following order:

1.	**The cost of administering the bankruptcy**
	The cost of administering the bankruptcy has the highest priority for reimbursement from the debtor's property and includes the professional charges of the TIB.
2.	**Preferential debts**
	Preferential debts have priority over ordinary unsecured creditors. All preferential debts are treated equally. If there is insufficient money, each creditor will receive a percentage of the amount due to them. Preferential debts (usually companies in corporate bankruptcy) include: • Accrued holiday pay without limit owed to employees. • Wages of employees due in the last four months before the order, subject to a maximum amount per employee (currently £800). • Employer contributions to pension schemes outstanding for up to one year. **Secondary preferential debts** HMRC has a secondary preference for certain tax debts, VAT, income tax and employee National Insurance contributions (NICs).
3.	**Floating charges**
	Any creditor holding a floating charge over an asset, such as a debenture.
4.	**Unsecured creditors and other debts**
	Ordinary unsecured creditors can only be paid once the previous categories of debt have been paid in full. If funds are insufficient to pay these debts, they are treated equally, so each creditor will receive the same percentage of the amount due to them.
5.	**Debts to the bankrupt's spouse or civil partner**
	Any debts owed to a bankrupt's spouse or civil partner will only be paid after the debt owed to all other creditors has been repaid.

Bankruptcy normally means that creditors do not get all their money back.

F3 Effects of bankruptcy

Under the Enterprise Act 2002, bankruptcy normally continues for a twelve-month period, although culpable bankrupts (for example, someone who continued to trade though insolvent) may remain undischarged for longer than this. During this time, a number of disqualifications will apply including: disqualification from acting as a company director, obtaining credit above the prescribed limit (£500) without disclosing the fact of an undischarged bankruptcy, and certain professional disqualifications such as accountancy, financial services and banking.

On the Web

www.gov.uk/bankruptcy gives further information about bankruptcy matters.

Question 3.6

A court will only consider a petition for bankruptcy where a creditor is owed at least how much?

F4 Corporate insolvency

Compulsory liquidation begins with the submission of a winding up petition either online or by post (depending on the size of the company and the court to be used), usually on the grounds that the company cannot pay its debts. Liquidation is the process by which the existence of a company is brought to an end and its property administered for the benefit of creditors and shareholders.

The Official Receiver (OR) becomes the liquidator and will remain so unless the creditors decide to appoint an insolvency practitioner of their choice. The liquidator takes control of the company, collects in all its assets, pays all its debts and distributes any surplus between members. The company is then dissolved and struck off the Register of Companies. The terms liquidation, winding-up and insolvency all describe the process by which a company ceases to exist.

Alternatives to liquidation are:

- **administration**, where an administrator is appointed to run the company's affairs and aims and attempts to rescue the company as a going concern; and
- **voluntary arrangements**, whereby insolvency proceedings are avoided by substituting a satisfactory settlement of financial difficulties between the company and its creditors.

On the Web

The process of liquidating a company is covered on GOV.UK: *bit.ly/2x2xxDt*.

G Wills and intestacy

The disposal of a person's estate after death is governed by their will or by the law of intestacy if they have not made a will. The laws relating to wills and intestacy are called the ***laws of succession***.

G1 Laws of succession

If property is transferred from, say, Mr Jones to Ms Smith then we say that Ms Smith 'succeeds' to that property.

The laws of succession apply when beneficiaries succeed to property on someone else's death. Property cannot continue to belong to the deceased and legal principles lay down how and to whom the property of that deceased person is to be distributed. Any properties held solely by the deceased, along with certain assets which are held jointly, form the deceased's estate. The estate is the total value of a deceased's assets less any debts they owe (liabilities).

G1A A will exists

Refer to

See *Legal personal representatives (LPRs) and the administration of estates* on page 3/17

If the deceased had made a will this should state exactly which assets are left to which beneficiaries. It should also name the executors whose job it is to administer the will. Wills should be reviewed regularly to make sure they are still up to date.

If the deceased has made a will, then the law recognises their right to give their property to whomever they wish, and the law of intestacy (below) will not apply. This principle is modified by the right of dependants (for example, a spouse) to claim for reasonable provision under the **Inheritance (Provision for Family and Dependants) Act 1975**.

There are three major formalities required in the making of a valid will:

- **Writing**. The will must be in writing, including print or type as well as personal handwriting.
- **Signature**. The will must be signed by the testator (the person making the will) or by some person in the testator's presence acting under their direction if the testator is unable to write for whatever reason. Initials will suffice, as will a cross or some other mark.
- **Attestation**. The testator's mark or signature must be witnessed by two or more people present when the will is signed. These witnesses should be independent, meaning that neither they nor their spouse/civil partner should be a beneficiary of the will. Furthermore, the attestation by these witnesses must be made in the presence of the testator, unless they are eligible to witness via a live video link.

Be aware

This section should have highlighted to you not only the need for clients to make a will, but also the importance of financial advisers obtaining full and accurate details of the way in which assets are held by their clients.

G1B Revocation of wills

Ordinarily, a person can revoke their will by the making of a later will or deliberately destroying it with the intent to revoke it. A will is also automatically revoked (in full or part) on:

- **Marriage or civil partnership** – in full; unless the will states that it was made in anticipation of the marriage or civil partnership.
- **Divorce or dissolution of a civil partnership** – in part; as any bequests to the former partner will lapse (unless the will clearly states that divorce/dissolution will not affect any entitlement) – but the remainder of the will carries on being valid.

Furthermore:

- if a person revokes a will without making a new will, they will die intestate; and
- the appointment of a spouse or civil partner as an executor is cancelled by subsequent divorce/dissolution.

In general, it is advisable to make a new will on the breakdown of a relationship.

G1C Intestacy

People who die without having made a will are said to have died intestate (*bona vacantia*) and their estates are distributed according to the law of intestacy.

The intestacy rules in England and Wales are governed by the **Inheritance and Trustees' Powers Act 2014**.

If the intestate dies leaving:

1. Spouse/civil partner but no issue (e.g. children or grandchildren) – the surviving spouse/civil partner is the **sole beneficiary** of the intestate's estate.
2. Spouse/civil partner and issue – spouse/civil partner takes personal chattels (car, furniture, pictures, clothing etc.) plus a statutory legacy of £322,000 plus half of any balance outright. The surviving issue will take the other half of the remaining estate on reaching 18.

   The statutory legacy amount to the spouse/civil partner is reviewed every five years and generally increases by the Consumer Prices Index (CPI), rounded up to the nearest £1,000.

   Chattels covers all tangible movable property except for:

   - money or securities for money;
   - property used at the date of death by the intestate solely or mainly for business purposes; or
   - property held at the death of the intestate solely as an investment.
3. No spouse or civil partner – everything is taken by issue (children followed by grandchildren) then successively: parents; brothers and sisters; grandparents; uncles and aunts.
4. No relatives – if there are no surviving relatives, then:

   - the Crown (i.e. the Government acting for the State); or
   - the Duchy of Lancaster (if the deceased was resident in the Duchy of Lancaster); or
   - the Duchy of Cornwall (if the deceased was resident in the Duchy of Cornwall) takes all the remaining assets of the estate.

Example 3.2

Jim died in an accident intestate, leaving an estate of £520,000, a wife Jane and two young children, Tom and Annie.

Jane will receive Jim's personal chattels, the statutory legacy of £322,000, plus half of the balance of the estate (£99,000) **outright**. Tom and Annie will receive £49,500 each when they reach 18.

Jim's brother Bob died in the same accident. He was married, but had no children. He also had an estate of £520,000. His wife, Mary, will be the **sole beneficiary** of Bob's entire estate.

Question 3.7

What is intestacy?

G2 Legal personal representatives (LPRs) and the administration of estates

Persons who are named in a will as the executors are responsible for dealing with the deceased's estate. Where someone has not left a will and has died intestate, their estate is usually handled by their next of kin who are known as the **administrators**. Collectively, executors and administrators are known as **legal personal representatives (LPRs)**.

LPRs can use solicitors to administer the estate and the fees can be paid from the estate.

LPRs are personally liable for the payment of all debts and taxes from the estate; therefore, it is essential that there are sufficient funds available before making any distribution of the estate's assets and they should act as soon as possible to identify the estate's assets and liabilities at the time of death.

- If the deceased only had savings or premium bonds or had jointly owned land, property, shares or money that automatically passed to the surviving owners, then probate may not be needed. Otherwise, it is necessary to obtain a **Grant of Representation** of which there are two types, both issued by the **Probate Registry** – Grant of Probate and Letters of Administration.
- Executors must 'prove' the will in the Probate Registry in order to obtain the ***Grant of Probate*** which will enable them to administer the estate.
- Before receiving the Grant of Probate, executors of large estates must complete an HMRC account showing all assets of the deceased plus any gifts made in the last seven years. IHT may be due if the total of the estate, plus all non-exempt gifts in the previous seven years, exceeds the available nil rate and residence nil rate IHT bands and the IHT due (or at least a proportion of it) must be paid before the Grant of Probate can be issued. Once probate has been granted, the executors must distribute the estate's assets as directed by the will.
- Administrators of an estate where there is no will must apply to the Probate Registry for a ***Grant of Letters of Administration***. The procedure for this and paying IHT is similar to that described above for executors. When the administrators have paid the IHT and obtained the Letters of Administration, the estate must be distributed according to the law of intestacy.

Question 3.8

What are the two types of Grant of Representation?

H Use of trusts

A trust is a means of arranging property for the benefit of other people, without giving them full control over it. This is often done for those who could not otherwise appreciate or deal with the property correctly; for example, minor children. A family head may use a trust as a means of giving property to their family while retaining some control over it by being one of the trustees. Many trusts are set up for tax reasons.

H1 Trust law

A trust is a means by which someone (the **settlor**) gives away an asset for the eventual benefit of others (the **beneficiaries**); the actual control over that asset in the meantime is in the hands of someone else (the **trustees**) who look after the property in the interests of the beneficiaries; a settlor can also name themselves as either a trustee or a beneficiary, or even both. By naming themselves as a trustee, the settlor can maintain some element of control over the trust property. Although settlors can make themselves beneficiaries, it is usually unwise to do so because this will make the trust assets liable to IHT.

The trustees have the legal ownership of the trust property, but cannot treat it as their own personal property. The trustees must use the property for the benefit of the beneficiaries according to the terms of the trust.

In every trust there is therefore a division of ownership:

- The trustees possess the legal interest.
- The beneficiaries possess the beneficial or equitable interest. The beneficiaries can enforce their rights against the trustees by legal action if necessary.

A trust can be distinguished from a contract in that there need be no agreement between the person creating the trust and the beneficiaries, and there does not have to be any consideration. Much of trust law is now contained in the **Trustee Act 1925** and the **Trustee Act 2000**.

Question 3.9

Who has the legal ownership of trust property?

H2 Types of trust

H2A Ways a trust can come into existence

There are several ways a trust can come into existence, as outlined in the following table:

	Method	Example
Express trust	Intentionally and expressly created, usually by some written method such as a deed or a will. Called 'express' because the trust is expressly set out.	A trust of personal property can be made by an express oral declaration. A trust of a life policy is normally made by a declaration in writing, or a deed.
Implied trust	Not created expressly but implied from the actions or circumstances of the parties.	Where a partnership buys property and arranges for the conveyance to be to one of the partners only, who will then hold the property on trust for all the partners, even if there is no formal written document setting this out.
Presumptive trust	One person buys a property in the name of another. Similar to an implied trust.	Alice buys a house in the name of Benny; there is then a presumption that Benny holds it in trust for Alice.

	Method	Example
Successive trust	Property is held in trust for a succession of interests, taking effect one after the other.	A marriage settlement might provide for property to be on trust for a husband for his life, thereafter for his wife for her life, and on her death for the children of the marriage in equal shares. In this way the trust property is subject to a succession of interests. The final interest in a successive trust is called the ultimate trust. In the above example the ultimate trust would be for the benefit of the children. The husband's and the wife's interests are called life interests.
Constructive trust	Imposed by law, regardless of the intentions or presumed intentions of those involved.	Michael bought trust property from his brother Ted, who was acting in his capacity as a trustee of a family trust. They both knew the property was worth much more than the purchase price. When this breach was discovered, Michael had to pay back to the trust the profit he had made on the transaction.
Resulting trust	Arises where there is a failure of the trust on which the property is held. As the purpose of the trust can no longer be fulfilled, there is said to be a resulting trust for the settlor of the trust, and ownership of the property reverts to that person.	***Cleaver v. Mutual Reserve Fund Life Association*** (**1892**). A man took out a policy on his own life on trust for his wife, if living at his death, but otherwise for his estate. He was then murdered by his wife and the office faced a claim from the wife's assignee. It was held that it was against public policy to allow a person to benefit from their own criminal act, and this defeated the claim of the wife and anyone deriving title from her. The trust had therefore failed and there was a resulting trust of the policy monies for the husband's estate.

H2B Different types of trust

There are also a number of different types of trust, as outlined in the following table:

	Details	Example
Bare or absolute trust	The trustee's sole duty is to transfer the trust property to the appropriate beneficiary.	A claim under a **Married Women's Property Act 1882** policy for a single adult beneficiary, 'on trust for X absolutely'. The trustees receive the policy monies from the office and their sole duty is to transfer it to the beneficiary, often a spouse or civil partner.
Power of appointment trusts	A power exists to vary or appoint beneficiaries. This type of trust is very flexible, as it gives the trustees power to vary the beneficiaries according to family circumstances. It can cope with deaths and births in a way which a bare or absolute trust could not. Maximum flexibility can be retained if any appointments are made revocable. The power can be exercised only among the prescribed class of beneficiaries. Most life offices use a power of appointment trust as their standard trust form for the majority of circumstances.	'On trust for all or such one or more of my wife AB and the children of our marriage in such share or shares as the trustees shall from time to time by deed or deeds revocable or irrevocable appoint and subject to and in default of any such appointment and insofar as any such appointment shall not extend or shall fail for any reason on trust for my wife AB absolutely.' The power of appointment is given to the trustees for the time being to use at their discretion. The wording provides for a 'gift over' in case an appointment is never made. The 'gift over' beneficiary is sometimes called the 'default' beneficiary, and has the interest in possession for IHT purposes. The interest in possession is the right to any income of the trust, as and when it arises.

	Details	Example
Interest in possession trusts	A beneficiary has a present right to income from (or enjoyment of) the trust property. That beneficiary might (or might not) also be entitled to the capital.	An absolute trust clearly has an interest in possession, as does the life interest trust. It also includes the power of appointment trust, even though there the interest could be taken away by the trustees exercising their power of appointment.
Discretionary trusts	A power of appointment trust where there is no-one with current interest in possession.	'On trust for such of my children as the trustees shall in their absolute discretion appoint.' In such a trust no beneficiary has a right to anything, unless and until the trustees so decide.
Will trusts	Created by a will, as opposed to one created during the settlor's lifetime. Like anything else in a will, it only becomes effective when the testator dies. Once the testator dies the trust starts and normally the executors of the will are the trustees. While the testator is alive the will can be changed whenever they want and so any asset left in a will trust is still in the testator's ownership, is disposable by them and is subject to IHT as part of the estate.	A gift in a will to a minor is effectively a will trust until the child reaches age 18.
Statutory trusts	Specifically created by statute or law.	A common example is that a policy effected by a person on their own life for the benefit of their spouse/civil partner or children will create a trust under the Married Women's Property Act 1882. Trusts created under this Act and its Scottish and Northern Irish equivalents are sometimes known as statutory trusts. Another type of statutory trust is one created for minor beneficiaries under the **Intestates' Estates Act 1952**.
Pension scheme trusts	Occupational pension schemes must be set up under an irrevocable trust. An irrevocable trust can be created in three ways: • trust deed; • declaration of trust; or • deed poll or board resolution made to establish a trust. Each of these is a slightly different way to achieve the same ultimate outcome. In general, occupational pension schemes will have a trust deed, although at the outset the trust can be created by a declaration of trust or a board resolution. Personal pension schemes can also be set up under trust.	A declaration of trust to set up a pension scheme can be a simple declaration by the employer stating that it will set up a pension scheme to provide pension benefits for its employees. The operation of pension scheme trusts and the duties of pension scheme trustees are complex and not considered further here.

In addition to trusts created voluntarily, which are considered in this section, there are trusts created, at least in the main, involuntarily during bankruptcy proceedings. As explained earlier, the TIB is trustee of the bankrupt's property for the benefit of the creditors in general.

Question 3.10
What type of trust is most life offices' standard trust?

H3 Main uses of trusts

Trusts feature prominently in many life assurance arrangements. One advantage of trusts is that they can keep policy benefits outside a life assured's or pension scheme member's estate so that IHT is not payable on them.

Although the beneficiaries of bare or absolute trusts cannot be changed, flexible or discretionary trusts allow the trustees to retain some element of control over who will eventually benefit from the trust and to what extent. Trusts can, therefore, be used to fund for and mitigate IHT.

On the policyholder's death the benefits payable belong to the trust. This means they are separate from the policyholder's estate so there is no need to wait for the LPRs to obtain a grant of representation to enable the benefits to be paid. The trustees need only provide copies of the death certificate and trust deed to the provider and the benefits can be paid to them. Once paid, the trustees must use the money in accordance with the terms of the trust.

Occupational pension schemes must have trustees. The trustees are responsible for ensuring the necessary contributions are paid and invested, looking after the scheme's investments and paying the benefits when they are due. They must keep these contributions separate from the assets of the employer. Generally, the trustees will be the party HMRC regards as being the scheme administrator and responsible for the scheme's compliance with tax law.

Trusts are used in other pensions too. Some personal pension schemes are set up under trust and in these the trustees will fulfil a similar role to that of trustees in an occupational scheme. However, it is not a requirement that personal pension schemes have to be set up under trust and so there are other different ways in which they can be set up.

It is also possible for individuals to set up their own trust to deal with pension benefits in the event of their death.

H4 Creating and administering trusts

The most usual method of creating a trust is by the settlor (the property's original owner) executing a deed assigning the property, for example, to trustees A, B and C for the benefit of beneficiaries X, Y and Z. The deed will also set out the powers of the trustees and the rights of the beneficiaries. The deed will have to fulfil the normal requirements of a deed of assignment. It will have to be signed by the settlor and ideally also by the trustees to show their acceptance of their duties.

Trusts of life policies are usually created by a declaration of trust form supplied by the life office, but can be individually created by using a solicitor.

H4A The 'three certainties'

Whatever method is used to create a trust, the following '**three certainties**' must be present if the trust is to be valid (***Knight v. Knight* (1840)**):

- The words used must be on the whole imperative; that is, they must unmistakably show that a trust is intended. However, no special form of words is necessary. Using the words 'on trust for' would make it certain.
- The subject matter must be certain. The property to be subject to the trust must be specified.
- The objects of the trust, i.e. the beneficiaries, must be certain. This can be achieved simply by naming the beneficiaries: for example 'on trust for X, Y and Z absolutely'. It can also be achieved by describing the beneficiaries as a class: for example 'on trust for the employees for the time being of the XYZ Co. Ltd'. Whatever words are used to specify the beneficiaries, it must be possible to establish with certainty at any time exactly who are the beneficiaries. Therefore, although a class of beneficiaries may fluctuate from time to time (for example, the employees of the XYZ Co. Ltd) it is always possible to state at any time exactly who are members of that class. This certainty is not required if a trust is exclusively for charitable purposes.

H4B Variation of beneficiaries

The ability to amend the beneficiaries of a trust depends on the type of trust set-up. For example, a bare or absolute trust does not normally allow the beneficiaries to be altered once it is set up. Whereas a power of appointment (or flexible) trust allows amendments to the beneficiaries and some trusts are specifically designed so only the class of beneficiary is named which gives the trustees greater flexibility in the distribution of the trust fund.

H4C Trustees' duties and powers

The first duty of a trustee is to become familiar with the terms of the trust and then to gain control over the trust property. This is done by obtaining possession of the property or of whatever title documents represent it, such as share certificates. The trustees must also ensure that their names are entered as owners of the property on any relevant register: for example a company's register of shareholders or the Land Registry for a trust comprising registered land.

The trustee must then administer the trust property for the benefit of the beneficiaries, in the manner set out in the trust. A trust deed will normally give the trustees specific powers to deal with the trust property. For example, a trust fund containing a portfolio of shares will often give the trustees power to buy and sell shares as they think fit, in order to enable them to maximise the beneficiaries' funds by taking advantage of market opportunities.

The Trustee Act 1925 includes some statutory powers which can be exercised in addition to those expressly given in the trust:

- Section 31 gives trustees power to apply trust income to any infant beneficiary in order to provide for their maintenance or education.
- Section 32 gives trustees power to apply capital for the advancement of a beneficiary, even if that beneficiary's interest is contingent or liable to be defeated by the exercise of a power of appointment or revocation, or to be diminished by an increase in the class to which they belong. Any such payment would, however, have to be brought into account as part of the beneficiary's share if they later became absolutely entitled.

These powers can be varied by the wording of a trust.

A trustee has a duty to invest any trust money not immediately required to be paid out. Trust deeds often include powers to effect and maintain life policies.

In exercising their duties under a trust, trustees must use the utmost diligence to avoid any loss. If they depart from this standard of care, a court can hold them liable for any loss caused by a breach of this duty. Failure to act can amount to a breach of duty in some cases. However, when a trustee is exercising discretion as opposed to a duty, a different standard of care is required. This is to act bona fide with the diligence that a prudent man of business would use in managing his own affairs (***Speight v. Gaunt* (1883)**).

Trustees must keep proper accounts of the trust property and these must be produced and shown to the beneficiaries if required. The beneficiaries are also entitled to all reasonable information concerning any dealings and investments of the trust fund. Where a trust corporation is appointed as trustee, it will normally insist on there being a 'trustee charging clause'.

On the Web

Anyone acting as a trustee should familiarise themselves with the Trustee Act 2000 as this sets out the default rules for the investments made by trustees. For full details visit: *www.legislation.gov.uk/ukpga/2000/29/notes*.

H4D Appointment and removal of trustees

Generally, anyone aged 18 years and over, and legally capable of holding property, is allowed to be a trustee.

A trustee will be removed from trusteeship, or the trusteeship otherwise ended, if the trustee:

- resigns or dies;
- is removed or automatically retired under the provisions of the trust deed;
- is removed by the other trustees (if allowed by the trust deed);
- is removed in accordance with the Trustee Act 1925;
- is removed by a relevant court.

H4E Beneficiaries

It must be possible to ascertain the beneficiaries of a trust at any particular time. As long as this requirement is fulfilled, the beneficiaries need not be named but can be described. Often a beneficiary will be named but it is common for beneficiaries to be described as a class to gain extra flexibility.

Example 3.3

Elise has three children, Callie, Lou and Jacob and wants to set up a trust for them. She can choose to name them as beneficiaries, but if she then has another child, this child will not be able to benefit from the trust. However, if her trust is set up for 'all my children in equal shares', then future children could also benefit.

Types of beneficial interest

A beneficiary may have an absolute interest, a life interest, a reversionary interest, or a contingent interest. A life interest means that the beneficiary is entitled to the income from the trust property for life, but cannot touch the capital. A beneficiary who has a life interest is known as a life tenant. When a life tenant dies, their life interest ceases and the property passes to the holder of the reversionary interest (the remainderman). A reversionary interest is therefore the right to trust property after the termination of a life interest.

A contingent interest is one that is subject to a contingency and therefore may not come into possession.

Example 3.4

A trust set up by Sue states that Eric is the beneficiary providing he is alive when Sue dies. If on Sue's death Eric has already died then Jamie will benefit instead.

In this example Jamie has a contingent interest as he will only benefit if Eric has died before Sue.

A beneficiary under a power of appointment trust has a contingent interest in the sense that an appointment to them may not be made, or if made may be revoked.

A beneficiary can be a sole beneficiary or one of several joint beneficiaries. Joint beneficiaries will take equal shares unless the wording of the trust says otherwise.

Enforcing the trust

In general, the beneficiaries cannot exercise control over the trustees during the currency of the trust.

The trustee is bound by the trust wording and the rules of equity, but personal judgment (discretion) can be used in exercising the powers and duties involved. A trustee does not always have to consult the beneficiaries and comply with their wishes.

Nevertheless the beneficiaries do have methods whereby they can ensure that the trust is properly administered. One way is by using their right to insist that the trust accounts be audited by a solicitor or accountant. A beneficiary can also apply to the court for the determination of a specific question, or even for directions as to the general administration of the trust.

The beneficiaries can, in some cases, put an end to the trust under the rule in ***Saunders v. Vautier*** (**1841**). Under this rule, if the beneficiaries are all known, have reached the age of majority and there is no possibility of further beneficiaries, they can then direct the trustees to hand the trust property over to them absolutely. This can only be done if the beneficiaries are together entitled to the whole beneficial interest. When this is done it effectively puts an end to the trust.

A trustee who commits a breach of trust or acts fraudulently, will be liable for any loss caused to a beneficiary. An aggrieved beneficiary can, therefore, enforce their rights against such a trustee by legal action.

Question 3.11

What are the 'three certainties' required to create a trust?

Key points

The main ideas covered by this chapter can be summarised as follows:

Legal persons

- The term ‘sole trader’ is an individual who solely controls their own business, whether or not they employ other people.
- Sole traders are ‘self-employed’ and are personally liable for the liabilities of their businesses.
- A traditional partnership is where two or more self-employed people work together in the same business.
- The law does not distinguish between the individual(s) who owns or runs the business and the business itself, and neither does HMRC.
- There is no tax on an unincorporated business (i.e. a sole trader or a partnership) that makes profits; instead, the tax is levied on the individual owner(s).
- In direct comparison to sole traders and partnerships, limited companies have a separate legal identity from the owners of the business.
- HMRC cannot look to those individual owners to pay tax on company profits.
- There is no difference between a limited company and a PLC from a taxation point of view but a limited company (as opposed to a PLC) is unable to advertise its shares for sale.
- Limited companies and PLCs pay corporation tax on their profits and capital gains.

Powers of attorney

- Under the Powers of Attorney Act 1971 a person can give power to another individual to act on their behalf. For example:
  - someone who leaves the country for a long period of time;
  - an elderly person who wants someone to handle their affairs.
- Where there is a power of attorney, both adviser and life office, bank, investment firm etc. need to be clear what power this confers.
- A power of attorney is automatically revoked on death, bankruptcy or expiry of a specified time. The donor can also revoke the attorney.
- The Enduring Powers of Attorney Act 1985 was introduced to enable an attorney to continue to act in the event of mental incapacity of the donor.
- The Mental Capacity Act 2005 introduced a lasting power of attorney (LPA).

Law of contract and capacity

- For a binding contract to exist the following conditions must be fulfilled:
  - there must be an offer and an acceptance;
  - there must be an intention to create a legally binding contract and both parties must have the power to contract;
  - there must be consideration.
- However, in the case of life insurance contracts, there are the additional requirements of:
  - good faith, subject to the modifications brought about by legislation; and
  - insurable interest.
- Some people are subject to rules which restrict their capacity to contract:
  - minors;
  - persons with mental health conditions; and
  - those under the influence of alcohol or drugs.

Key points

Law of agency

- An agency is a contract whereby one party – the agent, agrees to do certain acts on behalf of the other party – the principal.
- Someone seeking insurance may use an independent financial adviser (IFA) to find the most suitable contract on the market for them. Under the law of agency:
  - the IFA is the agent of the client and owes a duty of care to the client;
  - the IFA owes no duty to the insurer, but must comply with the relevant FCA rules;
  - the client is responsible for the acts of the IFA.

Ownership of property

- In England, Wales and Northern Ireland property can be held:
  - freehold;
  - leasehold; or
  - commonhold.
- Joint ownerships can operate either as a:
  - joint tenancy; or
  - tenancy in common.
- Shared ownership schemes are operated by local housing associations.
- First Homes is a specific kind of discounted market sale.
- The mortgage guarantee scheme is aimed at increasing the availability of 91% to 95% loan-to-value mortgages.

Bankruptcy and insolvency

- The term bankruptcy applies to individuals; the term insolvency applies to companies.
- Bankruptcy typically continues for a twelve-month period.
- Liquidation is the process whereby the existence of a company is brought to an end and its property administered for the benefit of creditors and shareholders.
- Alternatives to liquidation are:
  - administration; and
  - voluntary arrangements.

Wills and intestacy

- The laws of succession apply when beneficiaries succeed to property on someone else's death.
- The estate is the total value of a deceased's assets.
- If the deceased has not made a will then they are said to have died intestate and the law of intestacy will dictate the distribution of the assets.
- There are three major formalities required in making a will:
  - writing;
  - signature; and
  - attestation.
- Persons named in a will as executors are responsible for dealing with the deceased's estate.
- When someone has died intestate their estate is usually handled by their next of kin, called administrators.
- Collectively, executors and administrators are known as legal personal representatives and in both cases their task is to administer the estate, collect any debts, pay any tax and distribute the assets.

Key points

- The rules of intestacy in England and Wales are governed by the Inheritance and Trustees' Powers Act 2014.

Use of trusts

- A trust is a means by which someone (the settlor) gives away an asset for the eventual benefit of others (the beneficiaries). The actual control over that asset is in the meantime in the hands of someone else (the trustees).
- There are several ways a trust can come into existence:
  - Express trusts.
  - Implied trusts.
  - Presumptive trusts.
  - Successive trusts.
  - Constructive trusts.
  - Resulting trusts.
- There are a number of different types of trust:
  - Bare or absolute trusts.
  - Power of appointment trusts.
  - Interest in possession trusts.
  - Discretionary trusts.
  - Will trusts.
  - Statutory trusts.
  - Pension scheme trusts.

Question answers

3.1 Owners of unincorporated businesses pay income tax and CGT. Limited companies pay neither but do pay corporation tax on their profits and gains.

3.2 Death, bankruptcy, expiry of the specified time or when the individual becomes mentally incapable of handling their own affairs.

3.3 No, although the contract may be voided by them if they were unable to understand the nature of the agreement and the other party was aware of this.

3.4 Their client. In contrast, an employee or self-employed representative of an insurer is the agent of the insurer and owes them a duty of care.

3.5 A housing association allows a purchaser to increase their share in a property by buying additional shares in the property, up to 100% ownership.

3.6 £5,000, or a share of debts totalling at least £5,000.

3.7 Intestacy occurs where a person has died without leaving a valid will.

3.8 Grant of Probate (Executors) and Letters of Administration (Administrators).

3.9 The trustees.

3.10 A power of appointment trust.

3.11 The words used, the subject matter and objects of the trust.


MyCII

4

The regulation of financial services

Contents	Syllabus learning outcomes
Introduction	
A Financial Services Act 2012	*4.3*
B UK financial authorities	*4.1*
C The role of international Governments in UK regulation	*4.3*
D Other UK regulators	*4.2*
E Additional oversight	*4.2*
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- identify and discuss the main provisions of the Financial Services and Markets Act 2000 (FSMA) and Financial Services Act 2012;
- identify and discuss the main regulatory authorities;
- discuss the role of Governments in regulation;
- outline the role of the Competition and Markets Authority (CMA);
- outline The Pensions Regulator (TPR)'s role on occupational pension schemes;
- outline the role of the Information Commissioner's Office (ICO); and
- outline the additional oversight measures adopted.

Introduction

The current financial services regulatory system is founded on three pieces of legislation:

- the **Financial Services and Markets Act 2000 (FSMA)**;
- the **Financial Services Act 2012**; and
- the **Bank of England and Financial Services Act 2016**.

The primary legislation which established the current regulatory environment is contained in the above. There are other laws which have had an impact on the UK financial services market, such as the **European Union (Withdrawal) Act 2018**, which onshored EU legislation prior to 31 December 2020.

The FSMA brought together the regulation of all sectors of the UK financial services industry under one regulatory system.

Its wide scope covered bank/building society deposit taking, investment schemes, mortgages and loans, and all contracts of insurance (including general insurance, pure protection policies and the Lloyd's market).

Regulated activities include dealing in, arranging, managing or giving advice on any of the listed activities. It also includes using a computer-based system for giving investment instructions.

The FSMA placed all regulated financial services and activities under:

- one regulator (the now disbanded **Financial Services Authority (FSA)**);
- one Ombudsman (the **Financial Ombudsman Service (FOS)**), which is responsible for the independent review of complaints brought to it by complainants to firms who remain unsatisfied with the outcome; and
- one compensation scheme (the **Financial Services Compensation Scheme (FSCS)**), which is responsible for compensation to customers where a regulated entity is unable to meet its liabilities.

Key terms

This chapter features explanations of the following terms and concepts:

Bank of England	Competition and Markets Authority (CMA)	Compliance support services	EU single market directives
European Securities and Markets Authority (ESMA)	Financial Conduct Authority (FCA)	Financial Policy Committee (FPC)	Financial Services Compensation Scheme (FSCS)
Information Commissioner's Office (ICO)	Insurance Distribution Directive (IDD)	Joint Money Laundering Steering Group Guidance 2017	Passporting rights
Prudential Regulation Authority (PRA)			

A Financial Services Act 2012

In 2013, changes to the regulation of the UK financial services industry were introduced under the provisions of the **Financial Services Act 2012**. As a result, the FSA was disbanded with responsibility for regulation being split between three bodies:

- The **Financial Policy Committee (FPC)** – a committee within the Bank of England responsible for watching for emerging risks to the financial system as a whole and providing strategic direction for the entire regulatory regime.
- The **Prudential Regulation Authority (PRA)** – sits within the Bank of England and is responsible for the stability and resolvability of systemically important financial institutions

such as banks, building societies and insurers. It does not seek to prevent all firm failures but seeks to ensure that firms can fail without bringing down the entire financial system. The PRA also places emphasis on a '**outcomes-based**' approach to supervision focusing on the external environment, business risk, management and governance, risk management and controls, and capital adequacy. The purpose of this approach to supervision is to allow the regulator to make judgments on what might happen in the future, rather than just what has already happened.

- The **Financial Conduct Authority (FCA)** – a separate independent regulator responsible for conduct of business and market issues for **all** firms, and prudential regulation of smaller firms (e.g. insurance brokerages, mortgage and financial advisory firms). The FCA is focused on taking action early before consumer detriment occurs. It uses thematic reviews and market-wide analysis to identify potential problems in areas like financial incentives. The FCA also reviews the full product life cycle from design to distribution with the power to ban products where necessary.

The reforms also clarified responsibilities between HM Treasury and the **Bank of England** in the event of a financial crisis by giving the Chancellor of the Exchequer powers to direct the Bank of England where public funds are at risk and there is a serious threat to financial stability.

A1 Bank of England and Financial Services Act 2016

The **Bank of England and Financial Services Act 2016** modified the Financial Services Act 2012. The 2016 Act puts the Bank of England at the heart of UK financial stability by strengthening the Bank's governance and ability to operate more effectively as 'One Bank'. On 1 March 2017, the PRA became part of the Bank, ending its status as a subsidiary, and a new **Prudential Regulation Committee (PRC)**) was established to supersede the former PRA Board as governing body. The PRC operates alongside the other two Bank committees, namely the FPC and the Monetary Policy Committee (MPC).

B UK financial authorities

The UK's financial authorities are:

- HM Treasury;
- the Bank of England (encompassing the Prudential Regulation Authority (PRA) and Financial Policy Committee (FPC)); and
- the Financial Conduct Authority (FCA).

They work together to ensure the smooth, efficient and effective running of the UK's economy and the financial sector.

B1 HM Treasury

HM Treasury is responsible for formulating and putting into effect the UK Government's financial and economic policy. HM Treasury's overall aim is to raise the rate of sustainable growth and achieve rising prosperity by creating economic and employment opportunities for all. Financial instability would adversely affect this aim.

The Treasury has representation on the FPC but it does not have operational responsibility for the FCA or the Bank of England. Work on financial contingencies raises issues of relevance to the Treasury that include:

- the economic disruption that would arise from financial instability;
- in the rare circumstances where conceivable – the cost, risk and benefit of a financial support operation involving provision of public capital or liquidity (sometimes termed a 'lender of last resort' operation);
- consideration of whether change in the law or institutional structures may be appropriate; and
- links with wider Government policy.

In particular, the Treasury ensures that the financial authorities' work links with the Government's wider framework for building resilience and dealing with contingencies.

B2 Bank of England

The Bank of England was founded in 1694, nationalised in 1946, and gained operational independence in 1997. Standing at the centre of the UK's financial system, the Bank is committed to promoting and maintaining a stable and efficient monetary and financial framework as its contribution to a healthy economy. Many other countries have a 'central bank' and the Bank of England is the UK's central bank.

On the Web
www.bankofengland.co.uk.

The Bank has responsibility for:

- settling of payments;
- functioning of UK markets;
- regulation of UK banks and larger financial firms; and
- provision of routine and emergency liquidity to the banking system.

The Bank has two core purposes:

- **Monetary stability**, i.e. **stable prices** and **confidence in the currency**. Stable prices are defined by the Government's inflation target (2% CPI), which the Bank seeks to meet through the decisions on interest rates taken monthly by the Monetary Policy Committee, explaining those decisions transparently and implementing them effectively in the money markets.
- **Financial stability**, i.e. **detecting and reducing threats** to the financial system as a whole. Such threats are detected through the Bank's surveillance and market intelligence functions. They are reduced by strengthening infrastructure and financial and other operations at home and abroad, including, in exceptional circumstances, by acting as **the lender of last resort**.

B3 Financial Policy Committee (FPC)

On 1 April 2013 an independent Financial Policy Committee (FPC) was established at the Bank of England. The FPC is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the Government. Its members consist of representatives from HM Treasury, the Bank of England, the PRA and FCA.

The FPC publishes a record of its formal policy meetings and is responsible for the Bank's bi-annual Financial Stability Report.

B4 Prudential Regulation Authority (PRA)

Refer to
See *Prudential Regulation Authority (PRA)* on page 5/3, for more on the PRA

The PRA is part of the Bank of England. It is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It is the prudential regulator for around 1,500 financial firms.

The PRA has a primary objective: to promote the safety and soundness of these firms and, specifically for insurers, an objective to contribute to the securing of an appropriate degree of protection for policyholders. There is also a secondary objective to facilitate effective competition.

In promoting safety and soundness, the PRA focuses primarily on the harm that firms can cause to the stability of the UK financial system. A stable financial system is one in which firms continue to provide critical financial services – a pre-condition for a healthy and successful economy.

The PRA will make forward-looking judgments on the risks posed by firms to its statutory objectives. Those institutions and issues which pose the greatest risk to the stability of the financial system will be the focus of its work.

The PRA has close working relationships with other parts of the Bank of England, including the FPC and the Special Resolution Unit.

The PRA works alongside the FCA in what is known as **dual regulation** (or a 'twin peaks' regulatory structure) in the UK.

B5 Prudential Regulation Committee (PRC)

The creation of the Prudential Regulation Committee (PRC) and the legal integration into the Bank of the Prudential Regulation Authority (PRA) were required by the **Bank of England and Financial Services Act 2016**. The PRC replaced the PRA Board as the governing body of the PRA, placing it on the same legal footing as the Monetary Policy Committee and the Financial Policy Committee.

As established by the Act and its terms of reference, the PRC consists of:

- the Governor of the Bank of England;
- the Deputy Governor for prudential regulation;
- the Deputy Governor for financial stability;
- the Deputy Governor for markets and banking;
- one member appointed by the Governor of the Bank with the approval of the Chancellor of the Exchequer;
- the Chief Executive of the Financial Conduct Authority; and
- at least 6 external members appointed by the Chancellor of the Exchequer.

On the Web
The terms of reference and current membership of the PRC can be found here: *www.bankofengland.co.uk/about/people/prudential-regulation-committee*.

B6 Financial Conduct Authority (FCA)

Refer to
See *Responsibilities and approach to regulation* on page 5/1 for more on the FCA

The FCA is an independent body (accountable to the Treasury) that regulates most of the financial services industry in the UK. In total it regulates the conduct of around 50,000 financial firms and is the sole regulator of 48,000 firms. It is responsible for the FOS, the FSCS and claims management companies (CMCs), as well as operating the UK Listing Regime for companies wishing to issue shares or bonds for sale.

The FCA has an overarching strategic objective, which is to ensure financial markets work well. To do this, the FCA follows three operational objectives and is also obliged to have regard to the regulatory principles when discharging its functions.

Operational objectives	Regulatory principles
The FCA has a wide range of rule-making, investigatory and enforcement powers in order to meet three operational objectives: • protecting consumers; • enhancing market integrity; and • promoting competition. Since 2023 the FCA has also had a secondary objective to facilitate the international competitiveness and growth of the UK economy in the medium to long term.	The FCA is also obliged to give regard to the eight regulatory principles: • efficiency and economy; • proportionality; • sustainable growth; • consumer responsibility; • senior management responsibility; • recognising the differences in the businesses carried on by different regulated persons; • openness and disclosure; and • transparency.

Question 4.1

Who are the UK financial authorities?

C The role of international Governments in UK regulation

Refer to

For more on the effects of the UK's departure from the EU, see *How global regulation impacts UK regulation* on page 1/9

Although the UK has left the EU it is important to note that EU regulations and decisions have been onshored and are now part of UK law by virtue of the European Union (Withdrawal) Act 2018. Therefore, when considering the financial services sector much of the EU-inspired regulation continues to apply (e.g. MiFID II). For international standards, for example Solvency II for capital setting, there is commercial expediency in maintaining comparable standards to allow the UK to compete internationally.

One area of significant change with Brexit was the loss of passporting rights which allowed firms to offer financial services products in the EU. ***Passporting rights*** arose under the EU single market directives. Under the directives, a regulated firm whose head office is in one EEA State is entitled to carry out an activity in another EEA State. It may either establish a branch or provide cross-border services into that EEA State, as long as it fulfils the conditions of the relevant directive. Passporting rights can be exercised after following certain notification procedures, and the rules of the home State regulator will apply to the passported activity. In anticipation of the loss of this flexibility, some firms established a subsidiary in an EU country to permit them to continue to trade with EU customers.

Be aware

Passporting to Gibraltar is still possible for UK firms. A firm may carry out activities it has permission to undertake in Gibraltar by:

- establishing a branch;
- appointing agents; or
- providing cross-border services.

The PRA is the lead regulator for outward passports for dual-regulated firms (those regulated by both the FCA and PRA).

Firms authorised in Gibraltar may also passport into the UK, either on a 'services' basis (if they have no physical presence in the UK) or on a 'branch' basis (if they have an office in the UK).

The transitional arrangement for passporting to Gibraltar was due to end in December 2023 but was extended until December 2024. This may be further extended until the Gibraltar Authorisation Regime is established.

From the end of the transition period, EEA passporting firms, those already passporting into the UK on 31 December 2020, were able to obtain temporary Part 4A permission to operate in the UK, pending permanent authorisation as Third Country Branches with a Part 4A permission.

A significant focus of EU activity has been on financial services, with a raft of directives (instruments which are binding on Member States but which they are allowed to implement in their own way) and regulations (instruments which apply uniformly across Member States) being implemented to tackle the regulation, supervision and distribution of financial products.

EU directives which have impacted the financial services industry in the UK include those creating the European single market for EU Member States and countries based in the European Economic Area (EEA), such as the following:

- Alternative Investment Fund Managers Directive (AIFMD).
- Banking Directives.
- Capital Requirements Directives.
- Consolidated Life Assurance Directive.
- Distance Marketing Directive.
- Fifth Money Laundering Directive (5MLD).
- Insurance Mediation Directive (IMD) and the Insurance Distribution Directive (IDD).
- Market Abuse Directive.
- Markets in Financial Instruments Directives (MiFID and MiFID II).
- Mortgage Credit Directive (MCD).
- Payment Services Directive.
- Recovery and Resolution Directive.
- Reinsurance Directive.
- Solvency II Directive.
- Third Non-Life Insurance Directive.
- Undertakings for Collective Investment in Transferable Securities (UCITS) Directives.

Examples of Regulations enacted:

- Capital Requirements Regulation (CRR).
- European Market Infrastructure Regulation (EMIR).
- General Data Protection Regulation (GDPR).
- Markets in Financial Instruments Regulation (MiFIR).
- Packaged Retail and Insurance-based Investment Products Regulation (PRIIPS).
- Sustainable Finance Disclosure Regulation (SFDR).

While the UK is now outside the EU, the introduction of post-Brexit legislation in the EU has continued to impact the UK financial services market.

Sustainable Finance Disclosure Regulation (SFDR)

The implementation of the EU SFDR, while not onshored by the UK Government, still resulted in most UK asset managers making appropriate disclosures about their funds in line with the EU standard. This is partly due to the need to have appropriate disclosures in place for EU customers and also due to pressure for appropriate disclosure from UK investors. This was needed while investors waited for the introduction of the Sustainable Disclosure Requirements (SDR) in the UK, which come into force in 2024.

The potential alignment between the UK SDR and EU SFDR was analysed by the FCA in Annex 1 of its consultation paper on the new SDR (CP22/20). However, there are fundamental differences between how they operate. The EU is currently consulting on changes to the SFDR which may bring it more in line with the UK SDR.

C1 Markets in Financial Instruments Directives (MiFID I and II)

The original **Markets in Financial Instruments Directive (MiFID I)** came into effect on 1 November 2007. MiFID I was the EU legislation that regulates firms which provide services to clients linked to 'financial instruments' (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded.

MiFID enhanced the regulatory framework to reflect developments in financial services and markets. The aim was to set out basic high-level provisions governing organisational and conduct of business requirements that should apply to firms. It also aimed to harmonise certain conditions governing the operation of regulated markets.

MiFID provided for:

- Wider scope: It widens the range of 'core' investment services and activities that firms can passport.
- Greater degree of harmonisation: MiFID set out more detailed requirements governing the organisation and conduct of business of investment firms, and how regulated markets operate.
- Facilitate cross-border business: MiFID improved the 'passport' for investment firms by drawing a clearer line between the respective responsibilities of home and host states.
- Capital Requirements: Most firms that fell within the scope of MiFID also had to comply with the Capital Requirements Directive (CRD) which sets requirements for the regulatory capital a firm must hold. Those firms covered by MiFID are subject to directive-based capital requirements.

Source: FCA

MiFID I was essentially a 'maximum harmonisation directive', as EU countries may not introduce rules that are stricter than those set in the Directive. It increased emphasis on senior management responsibility, and has played a major part in the EU's Financial Services Action Plan (FSAP), which was designed to help integrate Europe's financial markets.

It covers investment banks, portfolio managers, stockbrokers and broker dealers, corporate finance firms, many futures and options firms, and some commodities firms.

Overall, MiFID was adopted into the FCA Handbook and PRA Rulebook with few extra requirements. There are, however, some exemptions available which mean that some investment firms were not subject to MiFID. Many IFA firms – which only advise on and arrange investments for UK-based customers, do not hold or control clients' money or securities, and do not provide any investment service other than reception and transmission of orders or investment advice – may be exempted from the MiFID requirements. They are known as **Article 3 MiFID exempt firms** (see FCA Handbook PERG 13.5). This distinction still applies post Brexit.

Markets in Financial Instruments Directive II (MiFID II)
MiFID applied in the UK from November 2007, and was revised by **MiFID II**, which took effect on 3 January 2018, to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection. These regulations **remain in place** as part of UK law.

MiFID II extended the MiFID requirements in a number of areas including:

- new market structure requirements;
- new and extended requirements in relation to transparency;
- new rules on research and inducements;
- new product governance requirements for manufacturers and distributors of MiFID 'products'; and
- introduction of a harmonised commodity position limits regime.

For retail investment firms the main changes were in the areas of:

- disclosure of costs and charges;
- reporting of significant losses (greater than 10%) since the client's last valuation (for discretionary portfolios);
- product governance;
- describing advice services;
- structured deposits;
- suitability;
- recording conversations; and
- inducements.

Activity
Remember, not all investment firms are subject to MiFID. When might they not be?

C2 Insurance Distribution Directive (IDD)

Background
HM Treasury implemented the **Insurance Mediation Directive (IMD)** in January 2005, bringing non-investment insurances (i.e. general insurance and protection insurance) into the scope of financial regulation.

The IMD set common minimum standards across EU countries for the regulation of the sale and administration of insurance.

The **Insurance Distribution Directive (IDD)** came into force on 22 February 2016 and Member States, which included the UK, had to transpose the Directive into their own legislation by 1 October 2018. It remains in place as part of UK law.

The IDD's aim was to make it easier for firms to trade across borders, strengthen policyholder protection and provide a level playing field. It set out consumer protection provisions in insurance and the scope of regulation was increased to include all firms that sell, advise on, or conclude insurance contracts and those who assist in administering and performing them, including those that shortlist as part of a selection process (such as aggregators), or introduce insurance. However, just providing general information about insurance products, insurers or brokers without collecting such information has been excluded, as is providing data on potential policyholders to insurers/brokers.

The key provisions of the Directive are:

- **Professionalism**. All firms engaged in any of the activities covered by the Directive must possess appropriate knowledge and ability to complete their tasks and perform their duties adequately, such as: the insurance market; applicable laws governing insurance distribution; claims handling; complaints handling; assessing customer needs and business ethics standards/conflict of interest management. Staff must complete at least **15 hours** of professional training or development per year.
- **Commission disclosure**. Pre-contractual disclosure of the intermediary and the nature, not amount, of their remuneration (whether commission, fee or other type of arrangement). This would be waived for contracts involving large risks or for professional customers. The pre-contract disclosure regime will be extended to insurance undertakings. Firms must state what type of firm they are (intermediary or insurer) and whether they provide a personal recommendation. Firms that sell insurance on a non-advised basis must ensure that the products they are selling fulfil the customers most fundamental needs.
- **Harmonisation**. The IDD is a minimum harmonisation directive, allowing Member States to set stricter requirements ('gold plate') if they deem this necessary. This allowed the UK to maintain its rules for retail investment advisers under the Retail Distribution Review (RDR), for example.
- **Product governance requirements**. These are largely in line with the FCA's product governance requirements.
- A new category of insurance settler called **Ancillary Insurance Intermediaries**. This includes connected travel insurance providers that don't sell or introduce insurance as their main business, but still do so and therefore are subject to selling rules.
- New duties applicable to insurance companies that are selling products through companies that are not authorised by the FCA.
- A requirement for all general insurance firms in the retail and small corporate market to provide customers with **Insurance Product Information Documents (IPIDs)**. These are similar to the Key Features Documents, currently used by insurers.

Intermediaries who give advice on, or arrange insurance-based products (both investment and non-investment types), are subject to professional indemnity insurance (PII) requirements. The limits were increased in line with the European Index of Consumer Prices over the five-year period since the IMD came into force and will be again in the future.

The minimum limits for firms are still expressed in euros and, at the time of publication, are:

- €1,300,380 for a single claim; and
- the higher of €1,924,560 or an amount equivalent to 10% of annual income (subject to a maximum of £30 million) in aggregate.

C3 The Basel Accords and CRD

The original **Basel Accord** was agreed in 1988 by the Basel Committee on Banking Supervision. The 1988 Accord, now referred to as Basel I, helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required.

Basel II is a revision of the existing framework, which aims to make the framework more risk sensitive and representative of modern banks' risk management practices. It has been implemented in the EU via the **Capital Requirements Directive (CRD)** and Capital Requirements Regulation (CRR). It affects banks and building societies and certain types of investment firms. The new framework consisted of three 'pillars':

- **Pillar 1** of the new standards sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk.
- Under **Pillar 2**, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1 and act accordingly.
- The aim of **Pillar 3** is to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

The latest version of this legislation – CRD IV – came into effect on 1 January 2014. The aim of CRD IV was to implement the **Basel III** Accord across the EU in order to minimise the negative effects of firms failing by ensuring that they hold enough financial resources to cover the risks associated with their business.

CRD IV includes additional requirements for banks and investment firms in the following areas:

- the quality and quantity of capital;
- liquidity and leverage requirements;
- rules for counterparty risk; and
- enhanced capital buffers for systemically important businesses.

C4 Money Laundering Directives

The EU seeks to combat money laundering with the aim of improving the integrity of the financial system and implements this through a series of Directives. The **Fourth Money Laundering Directive (4MLD)** aimed to provide a common EU basis for implementing the revised Financial Action Task Force (FATF) recommendations on money laundering (first issued in June 2003). It also takes account of the new risks and practices which have developed since the previous directives and so replaces and supplements the First Second and Third Money Laundering Directives. 4MLD introduced some key changes to customer due diligence, particularly for domestic politically exposed persons (PEPs) and the registration of all UK trusts incurring a tax liability.

The Money Laundering Regulations 2017 (MLR) implemented the Directive in the UK. The MLR introduced new requirements that were not included in the previous regulations. New concepts such as simplified due diligence and enhanced due diligence allow firms to be more risk-based in their approach. There are also more detailed customer due diligence requirements.

In many cases, financial firms were already taking the measures that the MLR made mandatory. Much of what is prescribed by the MLR was already good industry practice.

The **Money Laundering and Terrorist Financing Regulations 2019**, implementing the **Fifth Money Laundering Directive (5MLD)**, came into force in the UK on 10 January 2020. The Regulations implemented additional controls which firms need to follow in their dealings with customers. Some areas of the legislation are aimed at non-financial services firms such as letting agents and art market participants, others relate to niche areas of the financial services market such as providers of cryptoassets and custodian wallets. The key areas include:

- The introduction of additional high-risk factors in assessing whether or not to conduct **enhanced due diligence**, seek additional information and conduct enhanced monitoring in certain cases. This is particularly important for customers in high risk third countries.
- **Ultimate beneficial ownership lists**, which were introduced under the Fourth Money Laundering Directive (4MLD), are enhanced and had to be made public within 18 months of the implementation of 5MLD. For the UK this meant the lists needed to be made public by early 2021 at the latest.
- Firms are required to update their records relating to the beneficial ownership of corporate clients and trusts and to understand their ownership and control structure. Any difficulties encountered in identifying the beneficial ownership need to be recorded.
- Firms are also required to report any discrepancies they identify in the ownership of corporate clients where this is differs from the information available on Companies House.
- The registration of all UK express trusts, not just those with a tax liability.

The Joint Money Laundering Steering Group
The **Joint Money Laundering Steering Group (JMLSG)** produces guidance to assist those in the financial industry comply with their obligations in terms of UK anti-money laundering and counter terrorist financing legislation. JMLSG Guidance 2020 replaces the earlier versions and is regularly revised to reflect the changes to the UK's legal framework.

Following Brexit, the JMLSG confirmed that certain aspects of its guidance require updating or reinterpretation. For example:

- The definition of 'third country' has become a country other than the UK, as opposed to outside the European Economic Area (EEA). EEA entities are therefore third country entities for anti-money laundering purposes.
- The same level of information is to be provided by UK Payment Service Providers (PSPs), regardless of whether funds are being transferred to/from EEA countries or any other third country.
- References within the Guidance to observing European Supervisory Authority (ESA) guidelines are no longer appropriate.

The Financial Action Task Force
The ***Financial Action Task Force (FATF)*** is an international organisation that **sets standards in the fight against money laundering and terrorist financing**. The EU translates these standards into EU law through money laundering directives which provide a common legal basis for the implementation of the FATF's Recommendations on Money Laundering.

C5 Alternative Investment Fund Managers Directive (AIFMD)

The scope of the AIFMD is broad and, with a few exceptions, covers the management, administration and marketing of **alternative investment funds (AIFs)**. Its focus is on regulating the alternative investment fund manager (AIFM), rather than the AIF.

An AIF is a 'collective investment undertaking' that is not subject to the UCITS regime, and includes hedge funds, private equity funds, retail investment funds, investment companies and real estate funds, among others. The AIFMD establishes an EU-wide harmonised framework for monitoring and supervising risks posed by AIFMs and the AIFs they manage, and for strengthening the internal market in alternative funds. The Directive also included requirements for firms acting as a depositary for an AIF.

C6 Mortgage Credit Directive (MCD)

The Mortgage Credit Directive is an EU framework of conduct rules for mortgage firms. We cover this Directive in greater detail in *Mortgage Credit Directive (MCD)* on page 6/21.

C7 Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs)

The aim of **PRIIPs** – which applied from 1 January 2018 – was to encourage efficient EU markets by helping investors to better understand and compare the key features, risk, rewards and costs of different PRIIPs, through access to a short and consumer-friendly Key Information Document (KID). How information in the KID should be calculated and presented is set out in the PRIIPs Regulatory Technical Standards (RTSs).

A person who advises a retail investor on a PRIIP or sells a PRIIP to a retail investor must provide the retail investor with a KID in good time before any transaction is concluded. In addition to advisers, this will impact intermediaries such as distributors.

New UK regulations on PRIIPs have been in force since 31 December 2022 and are one of the first examples of UK divergence from EU rules.

These new rules introduce new standards which clarify the scope of PRIIPs for corporate bonds and make it clearer that certain features of these instruments do not make them PRIIPs. They also introduce guidance to clarify what it means for a PRIIP to be 'made available' to retail investors.

The new UK PRIIPs rules also address the calculation of transaction costs, amend the relevant regulatory technical standards – replacing requirements and methodologies for presentation of performance scenarios in the KID with narrative information on performance – and correct the potential for inappropriately low summary risk indicators for some PRIIPs.

Question 4.2

Which body produces guidance to help those in the financial services industry comply with anti-money laundering obligations?

C8 Other global regulators

There are many global financial services regulators we could mention but their rules and regulations do not necessarily align with or influence the formation of regulation in the UK.

The FCA evaluates its own rules in comparison to those in the USA. Unlike the UK, which operates a principles or outcomes based regulatory system, the USA operates a rules based system. This approach to regulation uses specific statements to define the requirements which firms must meet and lacks the flexibility of the UK's approach.

Securities and Exchange Commission (SEC)
The SEC is an independent agency of the US Federal Government which regulates financial markets. Its mission is to protect investors and maintain fair, orderly and efficient markets and facilitate capital markets. The SEC aims to promote capital markets which inspire public confidence and provide an array of financial opportunities to retail and institutional investors in the USA.

Financial Industry Regulatory Authority (FINRA)
Where the SEC regulates financial markets, FINRA regulates the broker-dealers who operate in the US markets. It has many characteristics which are similar to the UK's FCA in that it creates rules around financial protections, the licensing of those who sell securities products, the regulation of financial advertising, and the establishment of suitability and relevant disclosure.

D Other UK regulators

Refer to

See *Consumer credit and rights legislation* on page 6/34, for more on the FCA's responsibility for consumer credit regulation

It might not always feel like it, but the FCA does not regulate all aspects of consumer regulation. A number of different bodies are responsible for competition and consumer protection, workplace pensions, data protection and anti-money laundering regulation:

Competition and consumer protection	The ***Competition and Markets Authority (CMA)*** promotes competition, within and outside the UK, for the benefit of consumers.
Anti-money laundering	Anti-money laundering powers and responsibilities are in the remit of the FCA (in respect of consumer credit financial institutions), and HMRC (in respect of estate agents).
The Pensions Regulator	The Pensions Regulator is responsible for the regulation of UK workplace pension schemes.

D1 Competition and Markets Authority (CMA)

The CMA works with HM Treasury and the FCA as an independent public body to ensure that competition between companies in the UK remains fair for the benefit of business, consumers and the economy as a whole.

Following the end of the Brexit transition period, the CMA has taken responsibility for transnational mergers and cartel cases over which the European Commission previously had exclusive jurisdiction.

The CMA has the following responsibilities:

- investigating mergers between organisations to ensure they don't reduce competition;
- investigating entire markets if it believes there are competition or consumer problems;
- taking action against businesses and individuals that take part in cartels or anti-competitive behaviour;
- protecting consumers from unfair trading practices; and
- encouraging Government and other regulators to use competition effectively on behalf of consumers.

The CMA has five strategic goals, which are:

1. **Delivering effective enforcement** – to deter wrongdoing, protect consumers and educate businesses.
2. **Extending competition frontiers** – by using the markets regime to improve the way competition works, particularly within the regulated sectors.
3. **Refocusing consumer protection** – working with its partners to promote compliance and understanding of the law, and empowering consumers to make informed choices.
4. **Achieving professional excellence** – by managing every case efficiently, transparently and fairly, and ensuring all legal, economic and financial analysis is conducted to the highest international standards.
5. **Developing integrated performance** – through ensuring that all staff are brought together from different professional backgrounds to form effective multi-disciplinary teams and provide a trusted competition adviser across the Government.

On the Web

For more information on the CMA, visit: *www.gov.uk/government/organisations/competition-and-markets-authority*.

D2 The Pensions Regulator (TPR)

The Pensions Regulator (TPR) is the UK regulator of **work-based pension schemes**. It seeks to be a strong, visible regulator that helps to build confidence in pensions savings. It works to ensure that pension schemes are adequately funded and run in the best interests of retirement savers – and that employers meet their obligations by enrolling staff into a pension scheme and making contributions.

The objectives of TPR are to:

- protect the benefits of members of occupational pension schemes;
- protect the benefits of members of personal pension schemes (where there is a direct payment arrangement);
- promote, and improve understanding of, the good administration of work-based pension schemes;

- reduce the risk of situations arising that may lead to compensation being payable from the Pension Protection Fund (PPF);
- maximise employer compliance with employer duties and the employment safeguards introduced by the **Pensions Act 2008**; and
- minimise any adverse impact on the sustainable growth of an employer in respect of defined benefit scheme funding.

TPR aims to prevent problems developing in the first place by being clear about its expectations in communications to trustees, administrators, employers and other parties. TPR is relentless in its pursuit of the best outcome possible for retirement savers, but they must also behave fairly and reasonably.

There is a duty on trustees, managers, administrators, employers and professional advisers to report breaches of law to TPR in writing as soon as reasonably practical. TPR can carry out inspections of premises and ask anyone to furnish information and documentation. Refusal to assist is an offence, as is providing false or misleading information.

TPR can prohibit a person from being a trustee of a pension scheme if that person is in serious or persistent breach of duties. TPR can suspend a trustee if, for example, they are involved in proceedings for an offence involving dishonesty or deception or are the subject of insolvency proceedings. TPR can also appoint a trustee for a scheme if this is necessary to ensure the proper running of the scheme. It can fine any individual up to £5,000, or a company up to £50,000, for a breach of the law. If necessary, it can wind up a scheme to protect its members.

TPR can get a court injunction to prevent any misuse of the assets of an occupational pensions scheme, and can also go to court for an order for restitution of assets for certain breaches of the law. It can require production of any documents from anyone connected with a scheme and appoint an inspector to investigate and question anyone involved with it.

Usually TPR succeeds in achieving the desired outcome by educating and engaging with its audiences. But it will not hesitate to invoke its regulatory powers where appropriate.

TPR is financed by levies on pension schemes. It may report a life office or IFA to the FCA if they give misinformation to trustees of a pension scheme or demonstrate a lack of relevant knowledge.

Registration

TPR maintains a register of all occupational and personal pension schemes, including auto-enrolment schemes, a register of trustees (those available to be appointed as independent trustees to pension schemes) and a register of prohibited trustees.

Climate and ESG

In 2023 TPR wrote to all schemes with more than 100 members to establish whether their Statement of Investment Principles (SIP), which they should have had in place since 2019, contained policies on stewardship and ESG considerations, including climate change. TPR has indicated that it will take enforcement action against all pension schemes that are not making appropriate disclosures.

From 1 October 2021, additional regulations came into effect for trustees of some pension schemes aimed at improving governance and reporting of climate-related risks and opportunities.

For schemes with more than £1bn of assets, as well as all trustees of UK authorised master trusts and authorised schemes providing collective money purchase benefits, TPR will be looking for evidence that they:

- take proper account of climate change when making decisions about the scheme;
- have carried out any analysis in a way that is consistent with the recommendations of the Taskforce for Climate Related Financial Disclosures (TCFD);
- have considered the potential risks and opportunities which climate change will bring to the scheme; and
- have decided what action to take based on the analysis.

On the Web

Further information on the requirements set by the DWP on the governance and reporting of climate change risk for occupational pension schemes can be found here: *assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1085852/governance-reporting-climate-change-risk-occ-schemes.pdf*.

Be aware

Appeals against decisions of TPR can be made to the General Regulatory Chamber of the First-tier Tribunal.

www.gov.uk/courts-tribunals/first-tier-tribunal-general-regulatory-chamber.

D3 Information Commissioner's Office (ICO)

From data protection and electronic communications to freedom of information and environmental regulations, the ICO is the UK's independent public body set up to maintain information rights in the public interest, promoting openness by public bodies and data privacy for individuals.

Refer to

See *Data protection legislation* on page 7/30 for more on the UK GDPR and DPA 2018.

The ICO's main duty is to oversee and enforce compliance with the **UK General Data Protection Regulation (UK GDPR)** and **Data Protection Act 2018 (DPA 2018)**. Data processing without required notification to the Information Commissioner or in breach of the Data Protection Principles is an offence punishable in a court of law. A court could award an individual compensation for a breach of the Act.

The ICO's oversight

The Privacy and Electronic Communications Regulations set out rules for people who wish to send electronic direct marketing (for example, e-mails and text messages).

The **Freedom of Information Act 2000** gives the right to obtain information held by public authorities unless there are good reasons to keep it confidential.

The **Environmental Information Regulations** give the right to obtain information about the environment held by public authorities, unless there are good reasons to keep it confidential.

Source: *ico.org.uk/*

Question 4.3

Which regulator is responsible for preventing the misuse of the assets of an occupational pension scheme?

E Additional oversight

The following persons have powers and duties over individuals and firms carrying out FCA-regulated activities:

E1 Senior management

Senior managers take overall responsibility for how a firm is managed. The way they manage the business is at the heart of making it work. When this goes wrong the rest of the business processes can follow suit. There may be, for example, poor supervision of staff, inadequate training and/or inappropriate advice.

The FCA expects the senior managers of all firms to assess the type of business undertaken by their firm and ensure they have appropriate procedures to prevent, identify and address any risks to the firm and its customers. This is made explicit in the Senior Managers and Certification Regime (SM&CR) set out in *SM&CR: background and overview*.

Senior managers have an overview of the business and some of the areas they should be considering include:

- providing leadership, e.g. by making the fair treatment of customers central to the behaviour and values of the firm;
- ensuring business decisions and priorities are aligned with the **fair treatment of customers** (principle 6) and the **Consumer Duty** (principle 12) principles and the six underlying consumer outcomes;
- ensuring that the firm has the right controls in place and that these are being used; and
- overseeing recruitment, training and competence, and the reward structure to ensure that the fair treatment of customers is an important part of staff behaviour and development.

A firm should have systems and controls that are ‘appropriate to its business’, i.e. according to its nature, complexity and size, as well as the risks that are associated with it. The systems should be regularly reviewed to make sure that they continue to be proportionate and appropriate. The systems and controls should cover such areas as:

- reporting lines and how responsibilities are delegated;
- the compliance function;
- the assessment of risks facing the business;
- management information;
- checking the honesty and competence of those working in the business, known as ‘fit and proper’ tests;
- monitoring systems and controls;
- the development and implementation of business and remuneration strategy;
- business continuity in the event of disaster or the loss of key personnel;
- maintaining their training and competency and that of the staff they manage; and
- record-keeping.

Refer to

See *Corporate culture and leadership* on page 10/4 for more information.

Management information (MI)

The FCA expects managers to get regular reports which are presented so that they can be easily understood and acted upon. It makes sense to repeatedly compile some of the same information over time so that trends and progress can be measured. Quite a lot of information is already put together by firms to analyse sales, revenue, costs, and the number of complaints and so on. MI can be used to look at the firm’s approach to its customers and can help to show whether it is treating customers fairly. For example, extracting information from key performance indicators (KPIs), such as looking for any trends suggesting a correlation between sales and income due, customer retention rates, customer satisfaction surveys etc.

For MI to be effective, managers should try to communicate the information to the workforce as a whole. When a problem is identified, managers are responsible for ensuring it is resolved. This should help the business make informed decisions and improve its practice in the future.

MI is also necessary so that senior managers and regulated firms are able to meet the FCA's reporting requirements (*Record-keeping, reporting and notification* on page 7/20).

The FCA identified in its 2024 thematic review of Retirement Income Advice the extent of the MI it expects firms to maintain.

E2 Compliance support services

Refer to

See *Principles-based regulation (PBR)* on page 10/3, for more on the FCA Principles

Firms are responsible for ensuring compliance with the regulatory system, whether or not they use a compliance consultant. Remember that using a consultant does not guarantee compliance. Firms **cannot contract out** their regulatory obligations and all firms need to meet the FCA Principles for Businesses.

External compliance consultants may provide useful services for a regulated firm. However, the FCA does not require firms to use a consultant, and many firms are happy to manage their own compliance with help from the FCA website and customer contact centre. However, firms must have a framework for:

- assessing and covering the risks to their business;
- meeting regulatory requirements; and
- checking the firm continues to be compliant.

E2A Compliance advice

Firms that use compliance services or are considering doing so are expected to conduct 'due diligence' to identify potential risks and ensure that a service provider is suitable.

Compliance is the firm's responsibility:

- If the FCA finds inadequate controls in a firm, it may take action against the firm, not its compliance consultant.
- The FCA expects a firm to act on any serious recommendations.
- Whether firms get compliance support or not, they remain responsible for meeting the FCA requirements.

Choosing the right service:

- It is important to consider what sort of support, if any, the firm needs.
- There are lots of different levels of service available including: initial risk assessment; business development; help with procedures; file audits; technical support; training; remedial work; and PII cover.
- Firms must be aware that if they only focus on one area, they may be missing important compliance issues elsewhere.

Assessing and monitoring consultants:

- As part of their due diligence, firms will want to ask potential consultants about their experience, skills and competence, and establish that they have the knowledge and resources to give them what they need.
- The FCA recommends that firms agree the standard of services they will receive from their consultant with a service level agreement. Firms should always receive details of the work carried out and of any recommendations made in writing.

Acting on recommendations:

- The FCA expects firms to implement the advice they are given if, having assessed for themselves, they decide it is appropriate.
- The FCA is more likely to take action against firms who breach the FCA requirements if they have failed to act on previous recommendations from a compliance consultant.

In summary:

- Compliance and controls are **always** the authorised firm's responsibility, **not** that of the compliance support service.
- The firm must have appropriate processes and controls in place and have a good understanding of the compliance processes and monitoring arrangements it operates.
- The firm cannot delegate its responsibility for compliance to another party, but it can get help to ensure its controls are appropriate.
- Firms should take action if any reviews undertaken by their consultants reveal weaknesses in their compliance with FCA requirements.

E3 Other persons

E3A Accountants

Accountancy firms can provide a number of services. However, FCA-regulated firms need to comply with specific rules and not every accountancy firm will have sufficient experience or knowledge of these to be able to provide the tailored advice required.

FCA-regulated firms are a specialist area for accountancy firms, so it is important to ensure any firm appointed understands the FCA regulations relating to capital adequacy (including subordinated loans and goodwill), financial reporting, record-keeping, and client assets (if applicable).

The FCA takes enforcement action against firms which are unable to comply with the capital adequacy requirements or which fail to submit regulatory reports, such as the Retail Mediation Activities Return (RMAR). The impact of poor advice on a firm's ability to continue trading can be dramatic.

The FCA requirements are over and above the normal accounting standards and other legal requirements, such as the **Companies Act 2006**, that all companies have to follow. The capital adequacy calculations are designed to ensure that FCA-regulated firms are able to meet liabilities when they are due, especially liabilities for claims from customers. Accounting standards and legal regulations are designed to ensure that financial information is presented in a true and fair manner by companies for their shareholders.

E3B Auditors

The view and report of an **external auditor** provides comfort to other users of that information.

Under the Companies Act legislation, incorporated entities (i.e. limited liability companies or limited liability partnerships) are required to appoint a statutory auditor who performs an annual external audit on the firm's accounts.

Firms are not required to appoint a statutory auditor who performs an annual external audit on the firm's accounts if they:

- meet the Companies Act criteria for the small companies audit exemption; and
- do not undertake any activity within the scope of the Markets in Financial Instruments Directive II (MiFID II), **Undertakings for Collective Investment in Transferable Securities (UCITS) Directive**, Banking Consolidation Directive or the Insurance Distribution Directive (IDD) and are not an e-money issuer.

FCA Handbook

SUP 3.1 sets out whether or not a firm requires an auditor.

Firms are required to appoint an auditor to report separately to the FCA on the firm's client assets if they are already required to appoint a statutory auditor for Companies Act purposes. Firms will also be required to have an FCA report if they have the formal permission to hold client assets.

Unincorporated entities (i.e. sole traders or a partnership) that do not have permission to hold client assets, have no need to have annual accounts audited. However, if the firm does have permission to hold client assets, then it must have its annual accounts audited.

In addition, for those firms which hold client money accounts, a separate client money audit and report must be carried out (subject to some exceptions for general insurance intermediaries holding small balances).

E3C Trustees

In exercising their duties under a trust, trustees must use the utmost diligence to avoid any loss. If they depart from this standard of care, the law will hold them liable for any loss caused by a breach of this duty. Failure to act can amount to a breach of duty in some cases. However, when a trustee is exercising discretion as opposed to a duty, a different standard of care is required. This is to act with the diligence that a prudent businessperson would use in managing their own affairs.

It should be noted that trustees of occupational pension schemes have more onerous requirements placed on them given the nature of their responsibilities.

Firms acting as, or involved with, trustee positions (e.g. in respect of client money 'trust' accounts) need to bear these requirements in mind.

Trustees, ESG and sustainability
There is a persistent myth that trustees' fiduciary duty to put beneficiaries' needs above their own prevents them from investing trust capital in line with ESG or sustainability factors, as they must maximise profit to the exclusion of other considerations.

The rules established by TPR for pension scheme trustees and the existence of charitable trusts suggest that a profit maximisation stance cannot be applied universally, particularly where certain investments would contradict the activities of a charity.

As trustees must exercise a duty of care when investing trust capital, and ESG and sustainability factors might be considered to be part of this duty of care, it is unlikely that a profit maximisation stance will stand up to scrutiny. Legal experts are warning of an increased litigation risk against trustees who do not take ESG and sustainability factors into account in their decision making.

Where settlors wish ESG or sustainability factors (e.g. investing in line with one of the SDR investment labels) to be taken into account in investment decisions, these should be incorporated into the trust deed to take precedence over 'pure' investment considerations.

Question 4.4
Why might the senior managers of a firm collect and monitor management information?

Key points

The main ideas covered by this chapter can be summarised as follows:

UK financial services regulation

- Prior to the Financial Services and Markets Act 2000 (FSMA), different parts of the financial services industry were regulated under different Acts. The objective of the FSMA was to bring together the regulation of all sectors of the UK financial services industry under one regulatory system.
- Regulated activities include dealing in, arranging, managing, or giving advice on any of the listed activities. It also includes using a computer-based system for giving investment instructions.
- In 2013, changes to the regulation of the UK financial services industry were introduced under the provisions of the Financial Services Act 2012. As a result, the responsibility for regulation was split between three bodies: the FPC, the PRA and the FCA.

UK financial authorities

- HM Treasury, the Bank of England (FPC), the FCA and the PRA are the UK's financial authorities.
- They work together to ensure the smooth, efficient and effective running of the UK's economy and financial sector.
- HM Treasury is the department responsible for formulating and putting into effect the UK Government's financial and economic policy. The Chancellor of the Exchequer is ultimately responsible for regulation in the UK.
- The Bank of England is the UK's central bank. Standing at the centre of the UK's financial system, the Bank is committed to promoting and maintaining a stable and efficient monetary and financial framework as its contribution to a healthy economy.
- The Bank has two core purposes:
  - Core purpose 1 – Monetary stability.
  - Core purpose 2 – Financial stability.
- The PRA, as part of the Bank of England, is responsible for prudential regulation of larger institutions such as banks and insurers.
- The FCA is an independent body that regulates the conduct of most of the financial services industry in the UK and is also responsible for the prudential regulation of smaller solo-regulated firms.

Role of the European Union (EU)

- The UK has now left the EU but regulations introduced during its membership still apply and have been onshored.
- The EU was originally an organisation designed to promote trade between its members with a view to creating a single market for all goods and services within the Union.
- MiFID and MiFID II are a major part of the European Union's Financial Services Action Plan (FSAP), which was designed to help integrate Europe's financial markets.
- The Fifth Money Laundering Directive (5MLD) aimed to enhance the beneficial ownership measures put in place by the Fourth Money Laundering Directive (4MLD) which provided a common EU basis for implementing the revised Financial Action Task Force (FATF) recommendations on money laundering.
- The Money Laundering and Terrorist Financing Regulations 2019 implement 5MLD in the UK.

Other regulators

- The Competition and Markets Authority (CMA) works with HM Treasury and the FCA as an independent public body to ensure that competition between companies in the UK remains fair for the benefit of business, consumers and the economy as a whole.

Key points

- The Pension Regulator's objectives are to:
  - protect the benefits of members of occupational pension schemes;
  - protect the benefits of members of personal pension schemes (where there is a direct payment arrangement);
  - promote, and to improve understanding of, the good administration of work-based pension schemes;
  - reduce the risk of situations arising that may lead to compensation being payable from the Pension Protection Fund (PPF);
  - maximise employer compliance with employer duties and the employment safeguards introduced by the Pensions Act 2008; and
  - minimise any adverse impact on the sustainable growth of an employer.
- The Information Commissioner's Office's main duty is to oversee and enforce compliance with the UK GDPR and DPA 2018.

Additional oversight

- Senior managers take overall responsibility for how a firm is managed and are held accountable for their actions.
- The FCA expects the senior managers of all firms to assess the type of business undertaken by their firm and ensure they have appropriate procedures to prevent, identify and address any risks to the firm and its customers.
- Firms cannot contract out their regulatory obligations, and all firms need to meet the FCA principles.

Question answers

4.1 HM Treasury, the Bank of England's Financial Policy Committee and Prudential Regulation Authority, and the Financial Conduct Authority.

4.2 The Joint Money Laundering Steering Group (JMLSG).

4.3 The Pensions Regulator (TPR).

4.4 Management Information may be collected to meet regulatory reporting requirements, to help managers understand trends in sales, revenue, costs and complaints and to help improve business practices.

5

Responsibilities and approach to regulation

Contents	Syllabus learning outcomes
Introduction	
A UK regulatory landscape	5.1
B FCA objectives	5.1
C Scope and powers	5.3
D Regulatory supervision and the risk-based approach	5.1
E Financial stability and prudential regulation	5.1
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- explain the regulators' objectives and powers;
- explain the FCA's role in prevention of crime, particularly market abuse and insider dealing;
- discuss the FCA's approach to supervision and the risk-based approach; and
- discuss the regulators' approach to financial stability and prudential regulation.

Introduction

The Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) are currently the key organisations responsible for financial services regulation in the UK. In this chapter, and in the one that follows it, we will consider their responsibilities and approach to regulation.

Key terms

This chapter features explanations of the following terms and concepts:

Compliance monitoring	Conduct supervision	Financial stability	Financial strength
Flexible portfolio firms	Free asset ratio (FAR)	Market abuse	Part 4A permission
Prudential regulation	Prudential Regulation Committee	Prudential supervision	Regulatory Decisions Committee
Regulatory supervision	Risk-based approach	Senior Managers and Certification Regime (SM&CR)	Upper Tribunal (Tax and Chancery Chamber)

A UK regulatory landscape

Following the passage of the **Financial Services Act 2012**, the Financial Services Authority was abolished in 2013 and the following regulatory bodies were established:

1. **Prudential Regulation Authority (PRA)**
   The PRA is responsible for promoting the safety and soundness of systemically important firms, including insurers, and ensuring policyholders are protected in the event of a firm's failure.
2. **Financial Policy Committee (FPC)**
   A committee within the Bank of England responsible for horizon scanning for emerging risks to the financial system as a whole and providing strategic direction for the entire regulatory regime.

   The FPC has the power to use so-called 'macro-prudential tools' to counteract systemic risk. To be clear, this is the risk of an entire market or financial system collapsing – not individual firms. The tools the FPC could use include imposing leverage limits on banks or enforcing particular capital requirements for given asset classes.

   The Bank of England is in charge of micro-prudential and macro-prudential regulation on top of its existing responsibilities for monetary policy. As a result it may be considered one of the world's most powerful central banks, alongside the US Federal Reserve, the European Central Bank, the Bank of Japan and others.
3. **Financial Conduct Authority (FCA)**
   The FCA has an overarching strategic objective to 'ensure that the relevant markets function well'.

Be aware

The creation of the **Prudential Regulation Committee (PRC)** and the legal integration of the Prudential Regulation Authority (PRA) into the Bank were required by the **Bank of England and Financial Services Act 2016**. The PRC replaced the PRA Board as the governing body of the PRA, placing it on the same legal footing as the Monetary Policy Committee and the Financial Policy Committee. The PRC makes the PRA's most important decisions.

Refer to

The FCA operational objectives will be covered in more detail in *FCA objectives* on page 5/7

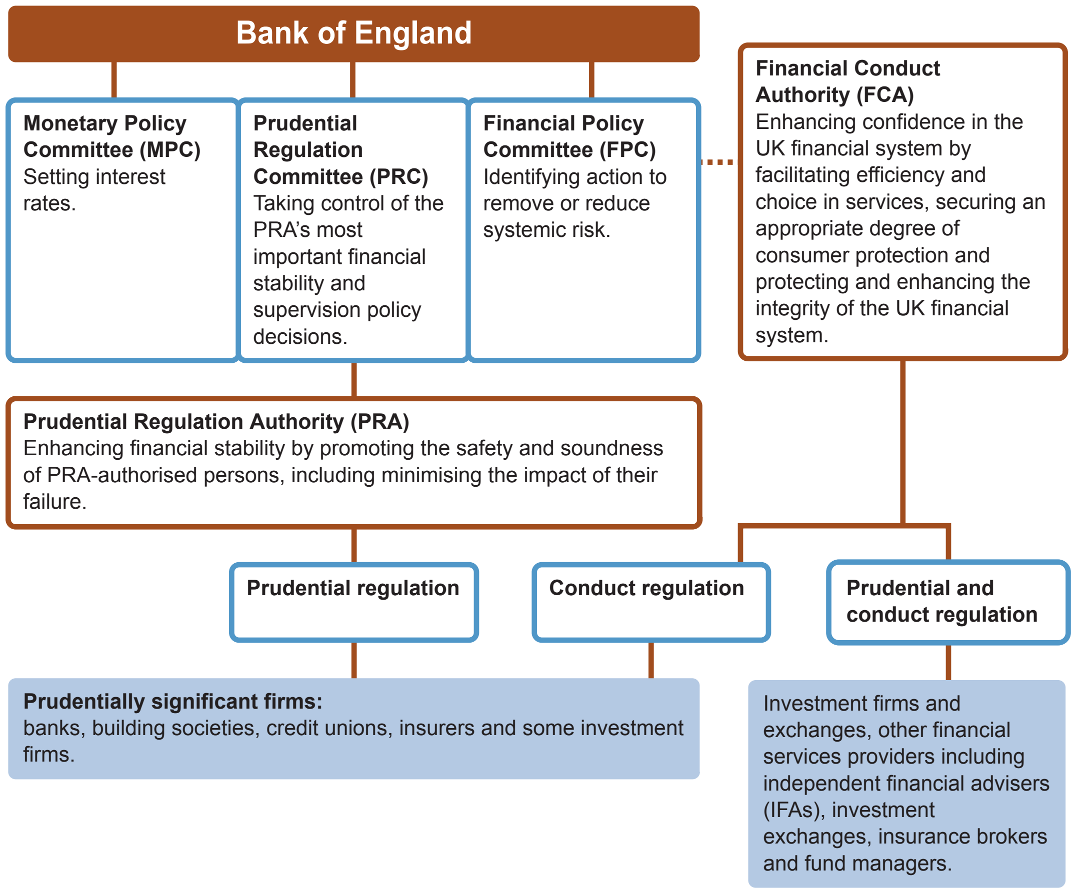
It also has three operational objectives:

- **Protect consumers**: to secure an appropriate degree of protection for consumers.
- **Protect financial markets**: to protect and enhance the integrity of the UK financial system.
- **Promote competition**: to promote effective competition in the interests of consumers.

A further secondary objective to facilitate the international competitiveness and growth of the UK economy was added in 2023.

The FCA takes a more proactive approach, including taking action early, before consumer detriment occurs.

Figure 5.1: The regulatory structure



Source: *HM Treasury*

A1 Prudential Regulation Authority (PRA)

A1A Overview

The PRA, part of the Bank of England, is responsible for the authorisation, prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It sets standards and supervises financial institutions at the level of the individual firm. It is governed by the **Prudential Regulation Committee (PRC)**.

The PRA has two primary objectives:

1. a general objective to promote the safety and soundness of the firms it regulates; and
2. an objective specific to insurance firms, to contribute to ensuring that policyholders and those who may become policyholders are adequately protected.

The PRA has two secondary objectives, to facilitate:

1. effective competition in the market for services provided by PRA-authorised firms; and
2. the international competitiveness of the UK economy and its growth in the medium to long term.

In promoting safety and soundness, the PRA focuses primarily on the harm that firms can cause to the stability of the UK financial system. A stable financial system is one in which firms continue to provide critical financial services – a precondition for a healthy and successful economy.

The PRA makes forward-looking judgments on the risks posed by firms to its statutory objectives. The institutions and issues that pose the greatest risk to the stability of the financial system are the focus of the PRA's work.

The PRA's requirement to facilitate competition is subordinate to its general objective to promote the safety and soundness of the firms that it regulates (and to its insurance objective).

It makes an important contribution to the Bank's core purpose of protecting and enhancing the stability of the UK financial system. There are also statutory requirements – Threshold Conditions – that firms must meet. These include firms maintaining appropriate capital and liquidity, and having suitable management.

The PRA stated in 2023 that the addition of the secondary objective to facilitate the international competitiveness and growth of the UK economy means that these factors will carry an additional weight in its decision-making process. The PRA believes that robust standards will contribute to this objective by reducing the likelihood and severity of financial crises and help create trust in the UK as a global financial centre.

The PRA advances its objectives using two key tools:

- **Regulation**: it sets standards or policies that it expects firms to meet.
- **Supervision**: it assesses the risks that firms pose to the PRA's objectives and, where necessary, takes action to reduce them.

The PRA's approach to regulation and supervision has three characteristics:

- A **judgment-based** approach: the PRA uses judgment in determining whether financial firms are safe and sound, whether insurers provide appropriate protection for policyholders and whether firms continue to meet the Threshold Conditions.
- A **forward-looking** approach: the PRA assesses firms against current risks, and also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it will generally aim to do so at an early stage.
- A **risk-focused** approach: the PRA focuses on those issues and firms that pose the greatest risk to the stability of the UK financial system and policyholders.

Be aware

The PRA's approach to supervision does not seek to operate a 'zero-failure' regime. Rather, the PRA aims to ensure that a financial firm which fails does so in a way that avoids significant disruption to the supply of critical financial services.

The PRA's most significant supervisory decisions are taken by the PRC – including the governor of the Bank of England, the deputy governor for financial stability, the chief executive officer of the PRA (and deputy governor for prudential regulation), and independent non-executive members. The PRC is accountable to Parliament.

A1B Policy

The PRA aims to establish and maintain published policy material that is consistent with its objectives, clear in intent, straightforward in its presentation and as concise as possible, so that it is usable by the senior management of firms.

A1C Global engagement

Banking and insurance are international industries and, to a large extent, the policy framework for supervising banks and insurance companies is agreed internationally. Therefore, effective international cooperation will be essential to the PRA's success.

The PRA attaches great importance to being an influential and persuasive participant in international policy debates, seeking to achieve agreement at the global level to the reforms necessary for a strong, coherent and clear prudential framework for supervision.

The PRA is actively involved in the work of the Financial Stability Board, the Basel Committee on Banking Supervision, the International Association of Insurance supervisors, and the Joint Forum. It uses these forums to advance its safety and soundness, and policyholder protection objectives.

As a consequence of the UK's role as an international financial centre, a key responsibility of the PRA is supervision of overseas firms operating in the UK, as well as UK groups operating abroad. The PRA engages actively with its overseas counterparts in supervising cross-border firms. To support this, the PRA maintains cooperation agreements including memoranda of understanding with overseas counterparts to enable the sharing of confidential information on cross-border firms. It participates in 'supervisory colleges' for firms with significant operations in the UK, and organises and chairs the colleges for UK firms.

A1D International legislation

Prior to January 2020 policy standards agreed internationally were implemented through EU directives or directly applicable regulations. The PRA now implements international standards directly. Although the ongoing involvement of the PRA in European regulation will be significantly reduced post Brexit, the PRA will continue to engage actively with relevant European institutions and EU regulators.

Consider this…

An existing market participant is detected breaking the rules, and concerns have been raised over the solvency of a life office. What can the PRA do?

A2 Financial Policy Committee (FPC)

A2A Scope and objectives

Run by the Bank of England, the FPC has responsibility for macro-prudential supervision. It is responsible for spotting the systemic risks 'attributable to structural features of financial markets or to the distribution of risk within the financial sector'. It is also responsible for identifying unsustainable levels of leverage, debt or credit growth.

Having identified the risks, the FPC has the power to take various policy measures to counteract them. Examples of so-called **macro-prudential tools** include:

- **Setting countercyclical capital buffers**: ensuring that banks increase their capital in the 'good times' so that they have protection for the bad. This should also have the effect of tempering lending during a boom and so dampening the effect of the credit cycle.
- **Variable risk weights**: enforcing targeted capital requirements on specific sectors or asset classes. This could include requiring banks to hold greater levels of capital against asset exposures that represent substantial risk.
- **Leverage limits**: limiting excessive build-up of on-and-off balance sheet leverage. Since measures of risk can be unreliable, a leverage ratio could act as a back-stop to risk-weighted requirements (such as a capital buffer).

As well as these financial stability considerations, the FPC also has a statutory obligation to limit the impact of its policies on economic growth.

A2B Governance

The FPC has 13 members; it is chaired by the Governor of the Bank of England, and includes the four deputy governors for monetary policy, financial stability, prudential regulation, and markets and banking. The executive director for financial stability also attends.

The chief executive of the FCA also sits on the FPC, as do five independent external members, appointed by the Chancellor and recruited in a similar manner to the current external members of the Monetary Policy Committee. The Government has noted the importance of external members having direct market expertise in areas such as insurance. 'The Government and the Bank of England are committed to ensuring an appropriate balance and breadth of expertise for both the interim FPC and the permanent body and will make all efforts to ensure this is the case.' The Committee also includes a non-voting member from HM Treasury.

A2C Accountability

The Treasury is able to provide the FPC with guidance in the form of a remit alongside its statutory objectives, to help shape its pursuit of financial stability. The FPC is required to respond to the Treasury's recommendations, setting out to what extent it agrees with the remit and what action it intends to take in response. However, according to the legislation, the FPC may reject any recommendations from the Treasury which it does not agree with. The Government also requires the FPC to publish a Financial Stability Report twice a year. The Government requires the FPC to publish a record of each FPC meeting within six weeks. These meeting records describe the FPC's discussions in broad terms, but without identifying the contributions of individual members.

A3 Financial Conduct Authority (FCA)

The FCA aims to ensure that business across financial services and markets is conducted in a way that advances the interests of all consumers and market participants.

Refer to
We will look at FCA objectives in more detail in *FCA objectives* on page 5/7

As mentioned earlier, the FCA has a single strategic objective and three operational objectives.

The competition duty states that the FCA must, so far as is compatible with the consumer protection and the integrity objective, discharge its general functions in a way which promotes effective competition in the interests of consumers.

The FCA is responsible for the regulation of a wide range of activities.

Refer to
For details of what the FCA regulates see *Regulated activities* on page 7/3

To support the FCA in its more proactive, interventionist approach, the Government gave it a product intervention power in the Financial Services Act 2012, which enables the regulator to act quickly to either ban or impose restrictions on financial products.

To complement and underline the principles of transparency and openness enshrined in the new regulatory framework, the FCA also has powers of disclosure to publish details of warning notices issued in relation to disciplinary action and a new power to take formal action against misleading financial promotions and disclose the fact it has done so.

A4 Prudential Regulation Committee (PRC)

The **Bank of England Act 1998** requires the Treasury, at least once in each Parliament, to make recommendations to the PRC about aspects of the economic policy of the government to which the PRC should have regard when considering how to advance the objectives of the PRA and when considering the application of the regulatory principles set out in the FSMA 2000.

The PRC's main contribution to this economic policy is by promoting the safety and soundness of firms, thereby maintaining and enhancing financial stability in the UK. The PRC should, as appropriate, work with the FPC, MPC and the FCA. A strong, stable and competitive financial system supports economic growth, facilitates productive investment and underpins the UK's position as an important global financial centre.

When the PRC considers how to advance the objectives of the PRA and apply the regulatory principles it should, where relevant and practical, take the following considerations into account, in their assessment of the costs, burdens and benefits of potential rules or policies.

Competition	The Government is keen to see more competition in all sectors of the industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models within the industry.

Growth	The Government wishes to ensure financial services markets make a positive contribution to sustainable economic growth in the UK economy in the medium and long term, through the facilitation of finance for productive investment and as a productive sector of the UK economy.
Competitiveness	The Government wishes to ensure that the UK remains an attractive domicile for internationally active financial institutions, and that London retains its position as the leading international financial centre. The Government considers that achieving this aim in a manner that is consistent with robust institutions and a resilient system will support its aims for sustainable economic growth.
Innovation	The Government is keen to see innovation in the financial services sector and how this can support the wider economy, through new methods of engaging with consumers of financial services and new ways of raising capital. This includes recognising differences in the nature and objectives of business models and ensuring burdens are proportionate.
Trade	The Government aims to encourage trade and inward investment to the UK that can help boost productivity and growth across the economy. This can be supported by improved competition opening the UK to new ways of doing things and being seen as a good place to do business.
Better outcome for consumers	The Government wants to see financial services work in the best interests of the consumers and businesses they serve. This is supported by improved competition in financial services and the securing of an appropriate degree of protection for consumers, including policyholders.

B FCA objectives

The FCA's objectives were set up under the **Financial Services and Markets Act 2000** (**FSMA**) as amended by the Financial Services Act 2012. The latter states that the FCA will have an overarching strategic objective to 'ensure that the relevant markets function well'.

Regulatory principles
In discharging its functions, the FCA is required to have regard to the following eight regulatory principles:

1. **Efficiency and economy**. The need to use its resources in the most efficient and economical way. The Treasury is able to commission value-for-money reviews of its operations which are important controls over its efficiency and economy.
2. **Proportionality**. The principle that a burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected to result. In making judgments in this area, the FCA takes into account the costs to firms and consumers. One of the main techniques FCA uses is cost-benefit analysis of proposed regulatory requirements. This approach is shown, in particular, in the different regulatory requirements that the FCA applies to wholesale and retail markets.
3. **Sustainable growth**. To ensure that there is a desire for sustainable growth in the economy of the UK in the medium or long term.
4. **Consumer responsibility**. The general principle that consumers should take responsibility for their decisions.
5. **Senior management responsibility**. A firm's senior management is responsible for its activities and for ensuring that its business complies with regulatory requirements. This principle is designed to secure an adequate but proportionate level of regulatory intervention by holding senior management responsible for risk management and controls within firms. Accordingly, firms must take reasonable care to make it clear who has what responsibility and to ensure that the affairs of the firm can be adequately monitored and controlled.
6. **Recognising the differences in the businesses carried out by different regulated persons**. Where appropriate, to exercise its functions in a way that recognises differences in the nature of, and objectives of, businesses carried out by different persons subject to requirements imposed by or under FSMA.
7. **Openness and disclosure**. Publishing information about regulated persons or requiring them to publish information, which underlines the importance of the FCA making market information available, with appropriate safeguards, to reinforce market discipline and the desirability of enhancing the understanding of members of the public in their financial matters.

8. **Transparency**. The FCA should exercise its functions as transparently as possible, which recognises the importance of ensuring that appropriate information is provided on regulatory decisions and also that the FCA should be open and accessible, both to the regulated community and the general public.

The FSMA 2000, as amended in 2023, also notes that when it comes sustainable growth, regulators should include progress towards compliance with the UK net zero emissions targets set out in the **Climate Change Act 2008** and the **Environment Act 2021**.

The purpose of the FCA objectives is to:

- provide political and public accountability. The FCA's annual report will contain an assessment of the extent to which it has met these objectives. Scrutiny of the FCA by Parliamentary Committees may focus on how it achieves its objectives;
- govern the way the FCA carries out its general functions, e.g. rule-making, giving advice and guidance, and determining general policy and principles. The FCA has a duty to show how the draft rules it publishes relate to its objectives; and
- assist in providing legal accountability. Where the FCA interprets the objectives wrongly, or fails to consider them, it can be challenged in the courts by judicial review.

B1 Operational objectives

B1A Protecting consumers

The objective to secure an appropriate degree of protection for consumers provides the FCA with a broad remit to protect consumers from actual or potential detriment. The FCA's powers provide greater scope to protect and enhance confidence in retail markets.

The FCA aims to intervene earlier in retail markets to protect consumers before they suffer direct effects as a result of failures in these markets. This duty to protect retail consumers requires a focus not only on firms' conduct towards them directly, but also on the knock-on effects and adverse implications that may result from activities in retail-related wholesale markets.

In providing appropriate consumer protection, the FCA also looks to use measures that promote competition. In the case of products or services, remedies directly focused on promoting competition – for example, by removing barriers to entry, search or switching – may not improve consumer outcomes because market power is not always central to the problem. An example is retail consumers' reliance on (often irrelevant) past performance in making investment decisions. In other circumstances, where measures that promote competition remedy both market power and information asymmetry, they can provide consumer protection. A good example, in relation to payment protection insurance, are measures taken on the bundling of insurance and credit at the point of sale.

Consumer Duty
Following the FCA's 'Approach to Consumers' in 2018, it published a consultation paper (CP21/13) in May 2021 on a new consumer duty. This was followed by a further consultation paper (CP21/36) in December 2021. These papers marked the development of the FCA's approach to protecting consumers. They were wide-ranging and set higher expectations for the standard of care firms provide. The final rules and guidance were published by the FCA in PS22/9 and FG22/5 in July 2022.

The FCA anticipated that the rules associated with the Consumer Duty would require a significant shift in the culture of some firms. The Duty introduced:

- A new **consumer principle**, providing an overarching standard of conduct.
- Cross-cutting **rules** and **outcomes** to support the consumer principle.

The aim is to give firms more certainty about the standards expected by the regulator and those that consumers can expect of firms.

Refer to
For more information, see *The Consumer Duty* on page 8/7

B1B Protecting financial markets

The FCA does not have explicit responsibility for financial stability. That is the responsibility of the Bank of England, the FPC and the PRA. As reflected in its strategic objective, however, and in the fact that its CEO is a member of the FPC, the FCA's supervision and other regulated activities is important to the arrangements in the UK for preserving stability. Like the PRA, the FCA is subject to FPC recommendations and directions on the use of regulatory tools in the pursuit of macro-prudential policy. There is a continuous exchange of views and information flow between these regulatory bodies.

In pursuing this objective, the FCA is concerned with a number of aspects. These include:

- the soundness and resilience of the trading infrastructure;
- the integrity of the financial markets, including the reliability of their price formation process and suitability of listing rules;
- combating market abuse; and
- addressing the extent to which the UK financial system may be used for the purposes of financial crime.

This objective is central to the FCA's supervision of the institutions that provide market infrastructure and the crucial role that they play in delivering capital and risk transfer mechanisms and creating confidence in the financial system.

B1C Promoting competition

The FCA seeks to promote competitive markets, both retail and wholesale, where consumers can make an informed choice of products or services. However, the FCA may also decide that there are some retail markets where consumers cannot exercise an informed choice; for example, because of structural features, such as consumer behaviours, including powerful biases in their decision-taking which firms can readily exploit. Here, interventions to promote choice will be successful only if the FCA can tackle the underlying characteristics of the market.

The FCA needs a sound economic understanding of the way relevant markets operate so that its regulatory interventions will promote competition and will effectively address the problems identified. This requires an approach to financial services markets that is significantly different to that of the FSA, both analytically and culturally.

The FCA's competition objective means that:

- firms must compete for business by offering better services, better value and types of products customers want and need;
- prices offered are in line with costs; and
- firms will innovate and develop new products over time. The FCA will draw a distinction between 'good' innovation that meets consumers' genuine needs and other types that exploit consumers.

The FCA states that it will normally choose the most competitive measure available, as long as it is compatible with its duties as a whole.

Competition concurrency

The FCA has concurrent competition powers. This means it can:

- under the **Competition Act 1998**, enforce against and fine for breaches of domestic and EU competition law prohibitions on anti-competitive agreements (for example, cartels) and abuses of a dominant position; and
- under the **Consumer Rights Act 2015**, make a market investigation reference to the Competition and Markets Authority (CMA).

These competition powers may also be exercised by the CMA with regard to financial services and other sectors of the economy. This means that, in respect of financial services, the CMA and the FCA will have 'concurrent powers' and the FCA will be a 'concurrent regulator'. These powers are in addition to the FCA's ability to use FSMA powers in pursuit of its competition objective.

B1D Facilitating international competitiveness and growth of the UK economy

The FCA's secondary objective – 'to facilitate the international competitiveness and growth of the UK economy in the medium to long term' – only applies when the regulator is advancing its existing objectives and only to its general functions. These include rule-making, giving general guidance and determining policies.

International competitiveness is a measure of how well the entire UK economy:

- achieves positive sustainable, economic outcomes;
- attracts international business to the UK; and
- enables effective competition by UK-based firms in international markets.

Ensuring effective competition in the financial services market in the UK helps to create more robust firms and should make the UK a more attractive market in which to do business, supporting the economy's international competitiveness.

C Scope and powers

C1 Scope

Any business or individual wishing to carry on one or more regulated activities, by way of business, must apply to the relevant regulator for direct authorisation (unless they can abide by the terms of exclusion or are exempt). This is called applying for ***Part 4A permission*** as set out in the FSMA.

The PRA authorises institutions that accept deposits or which accept insurance contracts while the FCA authorises smaller firms which, for example, advise on and sell investments and/or home finance activities and/or general insurance.

Looking at the FCA in more detail, it has the following powers over individuals and firms carrying out regulated activities:

Enforcement matters	• To impose penalties for market abuse. • To carry out investigations. • To take disciplinary action against authorised persons. • To instigate criminal proceedings for offences under the FSMA.
Supervision matters	• To make rules including those for: conduct of business; client money; financial promotions; and fighting money laundering. • To require an authorised person to provide information or documents. • To regulate changes of control over UK authorised persons. • To keep the Lloyd’s insurance market under review. • To cooperate with other regulators.
Authorisation matters	• To grant, vary and cancel authorisations and permitted activities. • To approve individuals to perform certain senior management and controlled functions, to issue codes for their conduct and take action for misconduct. • To be represented in court in cases of banking or insurance transfers. • To authorise unit trusts. • To recognise overseas collective investment schemes. • To recognise investment exchanges and clearing houses. • To maintain a public record of authorised persons and prohibited persons.

The FCA’s main role and activities

- **Direct authorisation and regulation of the UK financial services system.**

  This role includes:

  – Authorising businesses.
  – Prudential regulation – making sure that many authorised businesses are financially sound.
  – Regulating the conduct of business.
- **Monitoring the activities of the various recognised bodies.**

Chapter 5

These recognised bodies include:

- Recognised investment exchanges, such as the London Stock Exchange.
- Recognised overseas investment exchanges, such as NASDAQ.
- Recognised clearing houses, such as CREST.
- Designated professional bodies, such as the Law Society and the Institute of Chartered Accountants in England and Wales.

- **Policing the financial services system.**

  This role includes:

  - Stopping firms and individuals from carrying on unauthorised investment business.
  - Preventing certain individuals from being employed in or becoming representatives of authorised firms.

C1A Accountability

The FCA oversees most of the financial services industry and has considerable powers at its disposal.

The FCA has a kind of 'policing' role in pursuing unauthorised businesses that are operating illegally, e.g. unauthorised investment advisers. It has the power to shut down these businesses and bring criminal prosecutions against those responsible. The logic behind this is that the activity they are carrying out should require them to be regulated and, if they were, the FCA would have oversight of them.

Some financial services, such as occupational pension schemes, are not regulated by the FCA. In addition, some businesses that may appear to be offering financial services, such as buy-to-let property clubs, fall outside the FCA's scope.

Consider this…

- The FCA can act against individuals who are not authorised by it if, for example, it thinks they are trying to 'rig' the market in some way. What kind of activity might the FCA feel compelled to stop or prevent in this case?
- The FCA can also act against market trends it views as unfavourable to consumers by issuing general guidance to all firms in the market. It has done this on subjects such as endowment reviews, split capital investment trusts, single premium payment protection insurance and reviewable life policies. Can you think of an initiative that is an example of guidance for the whole market?

The FCA is answerable to the Treasury for the way it carries out its duties, and the Chancellor of the Exchequer bears ultimate responsibility for the regulatory system. The FCA is required to make an annual report to Parliament and is also subject in some measure to the:

- Upper Tribunal (Tax and Chancery Chamber) – formerly the Financial Services and Markets Tribunal;
- CMA; and
- Complaints Commissioner.

The FCA is required to maintain **Practitioner, Consumer, Smaller Businesses** and **Markets Panels** to represent the interests of all these groups. It must consider the views of these panels but does not have to take any action recommended by them.

The FCA Practitioner Panel

The FCA Practitioner Panel replaced the FSA Financial Services Practitioner Panel (FSPP). Its remit is to represent the interests of practitioners in larger firms, and to provide industry input to the FCA to help it meet its strategic and operational objectives.

The Panel sees its main role as a 'critical friend' of the FCA. It aims to speak across all sectors offering input at a strategic level on important policy issues.

The FCA Smaller Business Practitioner Panel

The Panel's remit is similar to that of the former FSA's Smaller Businesses Practitioner Panel, in fact the majority of members transferred across. The FCA has a statutory duty to establish and consult the Panel on the extent to which its policies and practices are consistent with its general duties.

The Panel represents the interests of practitioners in small or medium size firms across the range of FCA regulated activities. Its remit is to provide industry input to the FCA to help it meet its strategic and operational objectives from a smaller business standpoint.

The Chairman of the FCA Smaller Business Practitioner Panel is also a member of the FCA Practitioner Panel. This helps to coordinate industry views given to the FCA, and ensure that smaller firms' perspectives are considered during the FCA Practitioner Panel's deliberations.

The FCA Markets Practitioner Panel
The statutory role of the MPP is to represent the interests of practitioners who are likely to be affected by the exercise of the FCA's functions relating to markets (including its duties as the listing authority) in relation to short selling powers and the regulation of recognised investment exchanges.

The Panel's remit is to represent the interests of financial market participants, and to provide input to the FCA in order to help it meet its strategic (ensuring that the relevant markets function well) and operational objectives.

The Financial Services Consumer Panel (FSCP)
The FSCP is an independent statutory body, set up to represent the interests of consumers in the development of policy for the regulation of financial services. It represents the interests of consumers by advising, commenting and making recommendations on existing and developing FCA policy and practices. It speaks on behalf of consumers by reviewing, monitoring and reporting to the FCA on the effectiveness of FCA policies and practices. Members of the panel are recruited through a process of open competition and reflect a broad range of relevant expertise and experience.

C2 Enforcement and discipline

The FCA's Enforcement Division investigates when firms breach FCA rules or the provisions of the FSMA.

The FSMA allows the FCA to take action such as:

- withdrawing a firm's authorisation;
- disciplining authorised firms and people approved by the FCA to work in those firms;
- requiring skilled persons reports (**section 166 reports**) on any aspects of regulatory compliance (whether for diagnostic, monitoring, preventative or remedial purposes);
- imposing penalties for market abuse;
- applying to the Court for injunction and restitution orders; and
- prosecuting various offences.

Skilled persons review

Where the FCA is concerned about aspects of a firm's activities or wants to obtain further information, it can do so through a third party known as a skilled person.

The skilled person may be used for diagnostic purposes, to assess and measure risk, for monitoring and tracking of risk and to prevent or limit risk, as well as to respond to risks which have materialised.

If the FCA decides to implement a skilled person's review, this is likely to be prompted by a specific requirement for information or expert advice following an event. It may also form part of the FCA's regular monitoring of a firm.

More information on the use of skilled persons can be found in the Handbook at SUP 5.3.

The FSMA also gives the FCA powers to take action under the insider dealing provisions of the **Criminal Justice Act 1993** and the **Money Laundering Regulations 2017 (MLR)**. The FSMA gives the FCA the tools needed to do the job of enforcement – including the power to interview people and require them to hand over documents. It also sets out the circumstances when the FCA is allowed to use those powers.

The FCA also investigates people who are carrying on regulated activities – such as giving investment, mortgage and/or insurance advice – without authorisation. This is described by the FSMA as **a breach of the general prohibition**. As a prosecuting body, the FCA takes a serious view of such criminal offences. Those breaking the law risk imprisonment and other sanctions.

The FCA also works with other regulatory bodies and law enforcement agencies, such as the police, both in the UK and abroad. They work together to ensure that issues are taken forward by the right authority.

The FCA takes a risk-based approach in selecting which cases to pursue: this includes considering its Regulatory Objectives, the Principles of Good Regulation and its Referral Criteria. The FCA needs to consider carefully what course of action would be a proportionate response, exercise a common standard of fairness in the use of its powers and act in a manner consistent with the Human Rights Act 1998.

Enforcement staff members are the ones to prepare and recommend action in individual cases. These are then considered by a separate committee of the FCA, called the ***Regulatory Decisions Committee (RDC)***.

Settlement is possible at any stage of the process. All settlement decisions are made by two senior members of FCA staff. The RDC is the decision-maker for enforcement matters that do not settle. RDC members come from a wide range of backgrounds reflecting the interests of industry and consumers. The independent **Upper Tribunal (Tax and Chancery Chamber)** handles appeals in the decisions process for those who do not agree with the RDC's decision.

On the Web

You can explore various FCA notices and decisions by using the 'I want to find' menu at: *www.fca.org.uk/publications*.

Warning lists, intended to help consumers avoid companies carrying out regulated activities without authorisation, can be found here: *www.fca.org.uk/consumers/warning-list-unauthorised-firms*.

C3 Enforcement in the civil and criminal courts

The FSMA gives the FCA powers to deal with misconduct by firms and individuals who are members of the regulated community. Some of these powers however, (for example those relating to market abuse) also apply to persons outside the regulated community. In addition, the FCA can take proceedings in the civil and criminal courts to deal with misconduct relating to regulated activities.

Broadly speaking, civil law defines the rights of parties in a transaction while criminal law defines the rights of the public and their safety. In civil law, enforcement is by the parties themselves while criminal law is typically enforced by the State in terms of prosecution. The remedies of civil law is normally in the form of damages, which means compensation to the innocent party while the punishment of criminal law is usually more severe, ranging from fines through to imprisonment.

Civil action

The FCA can issue civil proceedings in the High Court against firms and individuals, including those who are not members of the regulated community. There are several civil actions that they can pursue – the main ones include:

- **Asking the High Court to grant injunctions.**

  These are orders which forbid a person from continuing or repeating certain types of misconduct. Injunctions could be sought for example, to:

  – prevent a person from conducting regulated activities without authorisation;

  – prevent a person from making misleading statements in breach of the FSMA;

  – stop unlawful financial promotions; or

  – prevent a person from committing market abuse.

  Injunctions are forward looking, in that they are designed to protect against a risk that a person may commit a breach at some point in the future.

- **Ordering the payment of restitution.**

  The FCA can make an application to the Court if a person has breached a relevant requirement under the Act and profits have been generated or loss caused because of the breach. If they are successful then the Court can order that person to repay any profits and to compensate victims for any loss. In support of an application for restitution, the FCA can ask the Court to grant asset-freezing orders to prevent defendants from disposing of their assets before the restitution is made.
- **Granting insolvency orders.**

  The FCA can apply to the Court for a winding-up order or an administration order against any firm which is or has been authorised or which is or has been carrying on regulated activities without the necessary authorisation (known as 'breaching the general prohibition'). Similarly, for individuals, the FCA can ask the Court for a bankruptcy order against an individual who is or has been approved or is or has been breaching the general prohibition.

Criminal proceedings

The FCA has the power to prosecute several specific offences relating to regulated activities. Some of these are 'summary only' and can only be dealt with by the magistrates' courts. Others are 'indictable' and can be heard in the Crown Court where a jury will decide the verdict. Yet other offences are 'either way' and may be heard in a magistrate's court or the Crown Court. Some of the offences are punishable only by a fine; others carry a maximum penalty of seven years imprisonment.

The offences cover a range of misconduct including:

- falsely claiming to be FCA-authorised;
- carrying on a regulated activity without authorisation;
- making misleading statements to induce investments; and
- failing to cooperate with FCA investigations.

Market abuse

Market abuse is improper conduct that undermines the UK financial markets or damages the interests of ordinary market participants. Market Abuse is covered in the MAR section of the FCA Handbook.

FSMA s.118 created civil penalties for market abuse which run parallel to the criminal offences.

The criminal offences are making a misleading statement and engaging in a misleading course of conduct for the purpose of inducing another person to exercise or refrain from exercising rights in relation to investments.

In addition, Part V of the Criminal Justice Act 1993 sets out the criminal offence of **insider dealing**. The FCA is a prosecuting authority for the criminal offence of insider dealing (as defined in the Criminal Justice Act 1993). Insider dealing is where individuals use, or encourage others to use, information about a company which is not generally available, to deal for their own financial advantage. In other words, they have received information through inside contacts and use it to make a profit or avoid a loss.

The civil offence, as defined in s.118 of FSMA, can be any of several types of behaviour. These were further updated through the **Market Abuse Regulation 2016** which was onshored into UK Law in 2020. The behaviours include:

1. **Insider dealing**. When an insider deals, or tries to deal, on the basis of inside information.
2. **Unlawful disclosure**. Where an insider improperly discloses inside information to another person or selective briefing of information by those in positions of responsibility.
3. **Manipulating transactions**. Trading, or placing orders to trade, that gives a false or misleading impression of the supply of, or demand for, one or more investments, raising the price of the investment to an abnormal or artificial level.
4. **Manipulating devices**. Trading, or placing orders to trade, which employs fictitious devices or any other form of deception or contrivance.
5. **Dissemination**. Giving out information that conveys a false or misleading impression about an investment or the issuer of an investment where the person doing this knows the information to be false or misleading.

6. **Misleading behaviour and distortion**. Behaviour that gives a false or misleading impression of either the supply of, or demand for, an investment; or behaviour that otherwise distorts the market in an investment.

The criminal offences of making misleading statements or engaging in a course of misleading conduct and insider dealing are punishable by a maximum of **ten years' imprisonment or an unlimited fine**. The civil disciplinary regime allows for a wider range of penalties to be imposed. The FCA may impose a financial penalty or make a public statement about the behaviour. Also, the FCA can apply for an injunction restraining market abuse or an order for restitution.

It is FCA policy to pursue through the criminal justice system all those cases where a criminal prosecution is appropriate. These will be cases where:

- there is enough evidence to provide a realistic prospect of convicting the defendant; and
- a criminal prosecution is in the public interest, considering the seriousness of the offence and the circumstances surrounding it.

Money laundering
From the Fourth Money Laundering Directive (4MLD) supervisors have been required to have the power to impose effective, proportionate and dissuasive sanctions for non-compliance with the Regulations. The FCA is able to:

- Levy penalties on registered businesses that are in breach of the Money Laundering Regulations.
- Prosecute an officer of a registered business that is in breach of certain of the Money Laundering Regulations. Conviction may result in imprisonment for up to two years, a fine, or both.

Plus there are more formal statutory offences:

- The acquisition, possession, use, concealment, disguise, conversion, transfer or removal of criminal property, or assisting another person to do these things, is an offence under the **Proceeds of Crime Act 2002 (POCA)**, punishable by up to **14 years' imprisonment and/or an unlimited fine**.
- The failure to report any knowledge or suspicion, or any reasonable grounds for knowledge or suspicion, of a person laundering the proceeds of criminal conduct, or failing to report any reasonable grounds for suspecting terrorist funding, is an offence punishable by up to **five years' imprisonment and/or a fine**.

D Regulatory supervision and the risk-based approach

The FCA's approach to regulation can be summarised as follows:

Product intervention and governance: the FCA aims to be more proactive and 'intervene earlier in the product's life span and seek to address root causes of problems for consumers'. Powers include temporary intervention rules and product pre-approval.

Super-complaints: the FCA is able to review and react to detailed submissions by consumer groups on behalf of a large number of customers in particular markets such as payment protection insurance (PPI) and extended warranties.

Competition powers: the FCA's competition objective is 'to promote effective competition in the interests of consumers' as set out in *Promoting competition* on page 5/9.

Example 5.1
A good example of FCA intervention at a late stage is its implementation of the British Steel pension redress scheme. While it did not intervene in time to stop wrongdoing from taking place, due to the scale of the problem, it has implemented a redress scheme for people who were given poor advice. *www.fca.org.uk/consumers/british-steel-pension-redress-scheme*.

Chapter 5

For reference only

D1 FCA approach to supervision

'Supervision' is the term the FCA uses to describe its day-to-day regulatory relationship with authorised firms; the process of monitoring and regulating firms to ensure they are complying with the regulatory requirements.

Be aware

The FCA's approach to supervision was previously set out in SUP 1A of the Handbook. However, this section was removed in its entirety in March 2024. At the time of writing, the FCA's approach to supervision is set out online and not included in the Handbook: *www.fca.org.uk/publications/corporate-documents/our-approach-to-supervision*.

The FCA has adopted a forward-looking, **risk-based regulatory approach** for authorised firms. It focuses on three key areas:

- reducing and preventing serious harm;
- setting and testing higher standards; and
- promoting competition and positive change.

The FCA doesn't treat all firms in exactly the same way. It supervises firms by grouping them together as a portfolio. Risk is at the heart of everything the regulator does. It affects the way the FCA conducts itself and how it looks at firms – firms are individually risk assessed and greater regulatory effort is expended on higher risk firms. Risk is, therefore, embedded throughout FCA regulations and the requirement for firms to manage risk and establish appropriate control systems is constantly mentioned.

In practice, this means that the FCA wants to make markets work effectively to deliver benefits to firms and consumers. The FCA's risk-based approach concentrates on the big risks and is accepting that some failure neither can, nor should, be avoided. Potential risks are prioritised **using impact and probability analysis**, and it then decides upon an appropriate regulatory response. In other words, what approach the FCA will take and the resources it will allocate to mitigating the risk.

Risk assessment

In simple terms, the FCA assesses the risk after looking at the sector where the firm is operating; the volume of transactions; the type of product being sold; the type of customer being dealt with; and the likelihood and impact of the customer suffering a financial disadvantage should they not be treated properly by the regulated firm.

D1A Conduct supervision

Firm categorisation has been based on 'fixed portfolio' or 'flexible portfolio' since 2015. Each portfolio is made up of firms with similar business models. Fixed portfolio firms have been subject to a programme of firm or group-specific supervision, while flexible portfolio firms have been subject to a more event-driven, reactive supervision and thematic issue or product supervision only.

Fixed portfolio firms are a small population of firms (out of the total number regulated by the FCA) that, based on factors such as size, market presence and customer footprint, require the highest level of supervisory attention. These firms are provided with **dedicated supervisory oversight** and are supervised using a continuous assessment approach.

The majority of firms are classified as **flexible portfolio firms**. These firms are supervised through what has been a **largely reactive** combination of market-based thematic work and programmes of communication, engagement and education activity aligned with the key risks identified for the sector in which the firms operate. These firms use the FCA Customer Contact Centre as their first point of contact with the FCA, as they are not allocated a named individual supervisor. Contact Centre staff should have the expertise to deal with the majority of issues and queries, and these will be passed on to the appropriate supervision area where necessary. While the supervision of flexible portfolio firms has been largely reactive in the past, the FCA aims to be more proactive in its approach to being an effective regulator, as set out in its strategy.

FCA supervision principles
The FCA's approach to supervision is formed on the following supervisory principles which are designed to complement the Principles for Businesses (*FCA Principles for Businesses (PRIN)* on page 6/4):

- **Forward-looking**. The FCA aims to act to prevent poor conduct before harm materialises. It will assess firms' business models and strategies against current and emerging risks and try and reduce or prevent these from materialising.
- **Outcomes-focused**. The FCA may see systematic harms emerging and aims to move quickly to stop them from occurring. This will include addressing the underlying cause of harmful culture and business practices. Where necessary it may involve referral for investigation. If harm requires redress for affected customers, the FCA will implement redress schemes, engage directly with firms or work with other bodies such as the FOS.
- **Proportionate and evidence-led**. The FCA focuses on key drivers of conduct likely to cause harm and will give greater attention to those firms which it believes pose the greatest risk to its objectives.
- **Transparent**. The FCA aims to be clear with firms and individuals about the good and poor practice it observes. An example of this would be the publication in FG24/3 of the non-Handbook guidance on the Anti-Greenwashing Rule in April 2024.
- **Integrated and coordinated**. The FCA will share information with other regulatory bodies such as the PRA, FOS and NCA, as well as with international regulators.

The FCA's three pillar supervision model
Prior to the removal of SUP 1A in March 2024 the FCA's published supervision work was based around three pillars of activity, which drew on its ongoing analysis of each industry sector and the risks within them. The FCA's 'issues and products' work (or thematic supervision) and responses to specific events fed into its proactive work with firms and allowed it to design its supervision strategies.

1. **Proactive firm/group supervision**. This is designed to assess a firm's conduct risk, asking the question: 'Are the interests of customers and market integrity at the heart of how the firm is run?' It entails business model and strategy analysis and embedding the Consumer Duty, including governance and culture, product design, sales and transaction processes and post-sales services. The FCA takes a forward-looking approach and uses its judgment to address issues that could lead to damage to consumers or markets, with clear personal accountability for firms' senior management.
2. **Event-driven, reactive supervision**. Supervisory activity in response to issues that are emerging or have recently happened. This is the flexible element of how the FCA will allocate its supervisory staff so that resources are devoted to situations and firms of heightened risk to consumers. For example, whistle-blowing, alleged misconduct or a spike in reported complaints.
3. **Thematic approach – issues and products supervision**. The FCA looks at risks and issues in each sector to analyse current events and investigate potential drivers of poor outcomes for consumers and markets. It does this on an ongoing basis, so it can address risks before they can cause widespread damage. These could be issues like a trend for a particular business practice or a problem with a certain product.

While these three pillars are no longer in the Handbook following the removal of SUP 1A, they are still helpful in understanding the FCA's historical approach to supervision. We should anticipate that future regulatory developments will follow a similar model based on the principles noted above.

Earlier intervention
The FCA has powers of intervention to **prevent detriment occurring**. This aligns with its forward-looking principle. The Financial Services Act 2012 confirmed a number of regulatory initiatives to shift the balance from tackling the symptoms of consumer detriment to the 'root causes'.

Examples include:

- banning products (applies to the retail sector):
  - where the FCA identifies a serious problem with a product or product feature, it is able to take timely and necessary steps to ban it,
  - the FCA can temporarily intervene to stop a product being mis-sold without prior cost-benefit analysis or consultation valid for up to twelve months in relation to retail customers only.
- withdrawing misleading financial promotions:
  - the FCA is able to take action in relation to misleading financial promotions,
  - it is also able to disclose the fact that enforcement action against a firm or individual has commenced,
  - it is required to alert a firm to its proposed course of action, and to allow for and consider representations by firms before publishing any details of its action.
- publication of enforcement action:
  - the FCA continues to proactively enforce against firms who mis-sell. The objective is to improve product offerings to consumers by bring more enforcement cases and pressing for tougher penalties, and being more willing to pursue cases against individuals including senior management,
  - the FCA is allowed to publish the fact that a warning notice has been issued about a firm as well a summary of the notice. This new power is available to both the FCA and PRA,
  - in making a decision about whether or not to disclose the warning notice, the regulator must consider a number of factors including whether publication of the information would be unfair to the person to whom the warning notice relates,
  - indeed, the Government could repeal the early warning notices power if at some point in the future, the power or use of it is deemed to be contrary to the public interest'.
- market intelligence gathering and research:
  - the FCA has a **Risk and Compliance Oversight Division** that 'combines research into what is happening in the market and to consumers with better analysis of the type of risks where they appear' – this acts as the 'radar' of the organisation,
  - it identifies and assesses risks to consumers and create a common view to inform the FCA's supervision, enforcement and authorisation functions,
  - while relying on existing sources for evidence including consumer groups, the media and ongoing market monitoring and analysis, they also make more use of the consumer action line.

Chapter 5

For reference only

On the Web
FCA guidance on whistle-blowing *www.fca.org.uk/firms/whistleblowing*.

The FCA's thematic and proactive approach
The FCA published a thematic review on **consumer harm** in January 2021. It looked at areas of the investment market it considered to be causing harm and noted that:

- Many serious harms lie outside its regulatory perimeter, such as online scams originating overseas.
- Consumers, particularly vulnerable ones, are less likely to understand the risks or detailed nature of what they are entering into and less likely to know what to do when things go wrong.

The outcomes of this review are reflected in the FCA guidance on the fair treatment of vulnerable customers and the Consumer Duty.

Another recent thematic review published in March 2019 was about **debt management** where the FCA aimed to test whether firms within the debt management sector were meeting expected standards, treating their new and existing customers fairly, and delivering appropriate outcomes, particularly for vulnerable customers. There was emphasis on the quality of debt advice given to new and existing customers and to those transferred from other firms, and the services provided to debt management plan customers.

The FCA findings focused on 3 key themes:

1. **Culture** – most commercial firms focused appropriately on customer outcomes and managing customer risks from within firms' businesses. The fact that the FCA had put the sector under scrutiny and intervention appeared to be a significant reason for changes in the firms' culture.
2. **Quality of advice** – The FCA noted an improvement in the quality of advice since an earlier review in 2014/2015 but asserted that firms need to work harder to make sure they consistently deliver good outcomes. Most firms were reaching the standards for most of their customers. However, there were still examples in all firms of inconsistent practices and some customers that had received poor advice and unsuitable recommendations.
3. **Administering debt management plans** – although firms were devoting more time and resources to administering debt management plans, particularly on engagement with customers to carry out their annual review, there was still scope for improvement. For example, adapting the suitability of the customers' debt management plans to reflect changes to customers' circumstances.

The FCA gave specific feedback to the firms reviewed and in one case there was sufficient concern to commence an enforcement action. Other firms are expected to review the report and consider whether any of the findings could relate to their practices. By this method of a focused review the FCA is able to give an opinion on best practices to all firms in a sector. (Source: *bit.ly/2IwYx0j*)

The FCA has also recently undertaken thematic reviews on 'The effectiveness of Independent Governance Committees and Governance Advisory Arrangements (2020)' and 'Understanding the Money Laundering Risks in the Capital Markets (2019)'.

Thematic review of Retirement Income Advice
The FCA conducted a comprehensive review into retirement income advice in 2023 which was published in full in March 2024. The aims of the review were to:

- Understand how the retirement income advice market is functioning post introduction of pension freedoms in 2015.
- Understand whether firms' approaches to pension advice consider the specific needs of customers who are drawing down their pension funds (decumulation).
- Consider whether customers are being given appropriate advice when accessing their pension savings and to take appropriate action to tackle any harms identified.
- Develop future areas of regulatory focus.

The review identified some key areas for improvement in:

- income withdrawal strategy and methodology;
- risk profiling;
- advice suitability;
- periodic review of advice suitability; and
- controls.

In particular, the FCA has highlighted that the way some firms use cash flow models to demonstrate the suitability of their advice may be deeply flawed and that there is a serious lack of necessary information to demonstrate recommendations in general are suitable.

On the Web
Retirement Income Advice thematic review: *www.fca.org.uk/publication/thematic-reviews/tr24-1.pdf*.

Authorisation and approvals
When authorising a firm, the FCA assesses whether it meets the minimum standards required for authorised firms and continues to meet the Threshold Conditions. The FCA focuses on the nature, scale and complexity of the regulated activities that the firm seeks to carry out, whether it has appropriate resources, the suitability of the individuals involved, the proposed business model, governance and culture, as well as the systems and controls that the firm intends to put in place regarding:

- risk management;
- product governance;
- end-to-end sales processes; and
- prevention of financial crime.

The FCA also works closely with the PRA in considering applications to approve individuals for roles which have a material impact on the conduct of a firm's regulated activities. The FCA seeks to assess that applicants have a good understanding of how to ensure good outcomes through:

- corporate culture;
- conduct risk management; and
- product design.

Accountability

- The FCA is required to report annually to the Government and Parliament.
- There is oversight of the FCA's work by a board appointed by the Government with a majority of non-executive directors.
- The Act contains a provision for independent reviews on the efficiency and effectiveness of the FCA's use of resources.
- A requirement for the FCA to make a report to the Treasury in the event of a regulatory failure and where this failure was due to the FCA's actions.
- However, it is noted that the obligation to publish a report, and the desirability of transparency, should not impede or prejudice the FCA's ability to pursue enforcement investigations. In such circumstances, publication would be delayed until enforcement action is completed.

Engagement with consumers

- The FCA seeks to build a better understanding of consumer behaviour, needs and experiences to shape how it designs its interventions.
- The FCA also engages more with consumers directly, including through social media, consumer bodies, road shows, focus groups and face-to-face contact.
- The FCA collects and analyses consumer information from other sources, such as complaints, including those investigated by the ombudsman, and external commercial, academic and public interest research.

Transparency and disclosure

- The FCA has put in place four statutory panels representing the views of consumers, regulated firms, smaller regulated firms and market practitioners.
- The FCA uses consultation as part of the rule-making process and seeks to develop more effective ways of getting feedback on proposals, including from consumers and their representatives.
- The FCA publishes more information about its views on markets (key trends, products and services) and the comparative performance of a firm.
- The FCA recognises that necessary restrictions on disclosure exist in UK and EU law (at least for the duration of the transition period).
- Where disclosure of information would be incompatible with the FCA's objectives, the FCA will not have to disclose information.

D1B Prudential supervision

The FCA is responsible for the prudential regulation of over 18,000 firms, including asset managers, financial advisers, mortgage and insurance brokers, essentially everyone other than banks, building societies, credit unions, insurers or large investment firms. Firms must all meet the general solvency requirements and at all times be able to meet their liabilities as they fall due. Specific capital resource and prudential requirements are complex and depend on whether the firm is a(n):

- article 3 exempt MiFID financial adviser;
- mortgage intermediary or insurance broker;
- MiFID investment firm;
- insurer; or

- friendly society.

As with conduct supervision, prudential supervision goes beyond a quantitative analysis of firms' financial resources. The FCA considers systems and controls, governance arrangements, and risk management capabilities including the risk of misconduct.

In essence, the FCA assesses how well a firm understands the risks it is running, how well placed it is to manage those risks, and how well it can avoid large, unexpected costs.

Be aware

The FCA is currently consulting on additional capital requirements for Personal Investment Firms (PIFs). The current proposals, outlined in CP23/24, seek to identify how much additional capital PIFs should hold to ensure they are able to address any liabilities they might have for past advice. The proposals outline the following four-step process which firms will need to implement:

- Step 1: Firms must identify potential redress liabilities.
- Step 2: Firms should then quantify potential redress liabilities, taking into account the expected redress, PI cover and a probability factor.
- Step 3: Firms then must set aside capital by deducting potential redress liabilities from capital resources.
- Step 4: If the firm is undercapitalised after setting aside capital, an asset retention requirement applies.

The asset retention requirement outlined in step 4 would require firms to retain assets in order to bolster their capital position. The FCA has also proposed additional capital reporting requirements to be included in these measures which will not only consider cases where there is a known need for redress but potential cases. It is possible that these proposals will not be implemented in their current form. However, PIFs should anticipate that some change to the capitalisation requirements for PIFs will be implemented in the short term, as the FCA sees this as an opportunity to reduce pressure on the FSCS and align the capital requirements of these firms with the Consumer Duty.

You can find out more about the consultation and its potential impact here: *www.fca.org.uk/publications/consultation-papers/cp23-24-capital-deduction-for-redress*.

D1C Compliance monitoring

The mere existence of rules does not ensure they will always be adhered to, so the FCA has monitoring procedures in order to ensure compliance, and the identification and disciplining of those who fail to comply. In this regard the FCA operates as a reactive and a proactive regulator. It is **reactive** in that it receives a regular flow of information from regulated firms, including:

- accounts and auditor statements;
- business volumes;
- sources of business; and
- complaints statistics.

If any of this information gives cause for concern, the FCA makes the appropriate response, such as opening an investigation and/or taking disciplinary action. The FCA also supplements this with information requests on specific issues, such as firms’ involvement in the defined benefit pension transfer market. The FCA can also react to any concerns expressed by the:

- Consumer Panel;
- Practitioner Panel;
- Competition and Markets Authority;
- Complaints Commissioner;
- Financial Ombudsman;
- media;
- Government; or
- individual complainants.

The FCA is a **proactive** regulator in the sense that it has a regular programme of inspection visits for regulated firms as part of its enforcement regime. The programme works on a ‘risk to the public’ basis combining the scale and the type of business involved. An inspection visit can vary from a desk review of a small IFA firm’s procedures to a team of officers working for over a month at a large insurance company.

FCA enforcement officers will check the compliance systems at a firm to ensure their adequacy and they must be given access to all the documents, files and personnel they request. Areas typically checked are: **business operations**, **personnel matters** and **customer matters**.

Figure 5.2: Compliance monitoring

Business operations

- senior management, responsibilities and business culture
- permission for all activities
- effectiveness of compliance department
- fair treatment of customers
- record keeping
- financial promotions
- complaints system

Personnel matters

- appointment procedures for ARs and employees
- procedures for certification
- procedures for individual registrations for controlled functions
- competence of advisers
- control of inducements
- training and competence systems
- conduct rules training

Customer matters

- giving customers ‘client agreements’
- suitability of recommendations to customers
- suitability letters
- key features production
- post-sales confirmations
- projection calculations
- production of cancellation notices
- client money systems
- anti-money laundering procedures

At the end of the visit, a report will be prepared detailing any remedial work necessary. The firm must then take the required action within the specified time limits.

The FCA can also undertake ‘mystery shopping’ exercises. Additionally, FCA enforcement officers can visit any premises without notice, and question staff who will be obliged to cooperate. The FCA can obtain a warrant to enter and search premises and take documents by force if necessary. If the FCA believes that it is appropriate, it can take disciplinary action against firms and individuals. Disciplinary action can be publicised to encourage other firms or individuals not to make the same mistakes.

Question 5.1

What is the maximum penalty for failing to report a suspicion of laundering the proceeds of crime?

D1D Internal compliance monitoring

Each authorised firm should also have its own compliance monitoring procedures. This is necessary to avoid or reduce accidental rule breaches and problems with **FCA inspection visits**. The firm's compliance officer is primarily responsible for all aspects of FSMA compliance and should be a director or senior manager who in turn reports to the firm's governing body. In larger firms, the compliance officer will typically have a compliance department to assist in this work, and the department may well be quite large. Compliance departments have grown more than most other departments in large financial services businesses over the last decade.

Most types of firms are required to have a Senior Manager hold the formal **'Compliance Oversight' senior management function (SMF16)**. While this is not currently a requirement for firms only providing mortgage advice (although proposals for this to apply have been made) and insurance intermediaries, senior management must effectively have delegated the functions of this role to appropriate individuals.

The compliance department should keep a regular check on all the procedures likely to be monitored so that there should be no surprises on an FCA inspection visit. The department may even have control over functions such as advertisement checking, fact-find checking, suitability report checking and training. The department may also carry out inspection visits on branches, ARs and individual advisers.

As already stated, a failure to monitor compliance adequately could lead to:

- disciplinary action by the FCA;
- unwelcome publicity; and/or
- a resulting decline in business.

Consider this…

Who is the compliance officer in your firm?

Are you aware of the monitoring programme your firm has in place?

Question 5.2
In what sense is the FCA a reactive regulator?

D2 PRA supervision

On 1 April 2013 the PRA became responsible for the prudential regulation of banks, building societies, credit unions, insurers and major investment firms. It aims, through its supervision, to develop a rounded, robust and comprehensive view of these firms, to judge whether they are being run in a safe and sound manner, and whether insurers are protecting policyholders appropriately.

Consistent with its focus on key risks to its statutory objectives, the PRA divides the firms it supervises into four categories of 'potential impact', and the frequency and intensity of supervision applied to firms varies in line with this. The scale of a firm's potential impact depends on its size, complexity and interconnectedness with the rest of the financial system. For insurers, it also takes into account the size (including number of policyholders) and type of business undertaken.

The PRA also varies the resource it applies to firms based on their proximity to failure and resolvability, given the possible adverse effects of disorderly firm failure on its objectives. The PRA does not operate a zero-failure regime, but seeks to ensure that any firms that do fail do so in a way that avoids significant disruption to the supply of critical financial services. Judgments about a firm's proximity to failure are captured within the PRA's Proactive Intervention Framework, which is designed to ensure that the PRA identifies and responds to emerging risks at an early stage.

Under this approach, firms that are unlikely to have a significant impact on the PRA's objectives on an individual basis, but which still have the potential to cause significant disruption collectively (for example, small credit unions or insurers), will be supervised on a portfolio basis and examined individually only occasionally – for example, where a risk has crystallised. By contrast, large, complex firms will be subject to detailed supervision at an individual-firm level and will have a named supervisory contact.

E Financial stability and prudential regulation

E1 International financial stability

The **Financial Stability Board (FSB)**, in its own words:

> promotes international financial stability; it does so by coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies. It fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions.
>
> The FSB, working through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities.
>
> Source: *www.fsb.org*

The mandate of the FSB is to:

- assess vulnerabilities affecting the financial system and identify and oversee action needed to address them;
- promote coordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;
- undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for and support the establishment of supervisory colleges;
- manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms;
- collaborate with the IMF to conduct Early Warning Exercises; and
- promote member jurisdictions' implementation of agreed commitments, standards and policy recommendations, through monitoring of implementation, peer review and disclosure.

As obligations of membership, members of the FSB commit to pursue the maintenance of financial stability, maintain the openness and transparency of the financial sector, implement international financial standards, and agree to undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports.

The FSB, working through its members, seeks to give momentum to a broad-based multilateral agenda for strengthening financial systems and the stability of international financial markets. The necessary changes are enacted by the relevant national financial authorities.

E2 UK financial stability

A stable financial system is a key ingredient for a healthy and successful economy. People need to have confidence that the system is safe and stable, and that it functions properly to provide critical services to the wider economy. It is important that problems in particular areas do not lead to disruption across the financial system.

The Bank of England has a statutory objective to '**protect and enhance the stability of the financial systems of the United Kingdom**'. The Bank does this through the PRA and its risk assessment and risk reduction work, market intelligence functions, payments systems oversight, banking and market operations (including, in exceptional circumstances, acting as lender of last resort), and resolution work to deal with distressed banks.

The Bank's financial stability role is set out in a Memorandum of Understanding between the Bank and the FCA. A high-level committee from the Bank, the FCA and representatives from HM Treasury – the Financial Policy Committee (FPC) – meets regularly, focusing on managing systemic risk and protecting financial stability.

The **Banking Act 2009** increased the responsibilities, powers and role of the Bank. A key part of the Act was the creation of the Special Resolution Regime to provide the tripartite authorities with a framework to deal with failing banks. The Act gave the Bank a statutory financial stability objective and created the FPC to advise on and monitor the nature and implementation of the Bank's financial stability strategy. In addition, it formalised the Bank's oversight of payment systems and introduces a new framework for the issue of Scottish and Northern Ireland banknotes.

Growing cross-border financial activity heightens the importance of UK authorities working effectively with counterparts in other countries. The Bank has regular contact with central banks, regulators, and other authorities outside the UK that have an interest in the maintenance of financial stability. It also participates in the activities of key international bodies involved in global financial stability work, such as the FSB. It remains to be seen how this will change after the Brexit transition period.

The FCA's strategic objective is to make sure that markets function well and is required to cooperate appropriately with the Treasury, the Bank of England and other relevant bodies in pursuing this objective. The **Financial Services Act 2010** requires the FCA to have and review a financial stability strategy. It enables the FCA to gather information from entities including unregulated entities for financial stability purposes. It also requires the FCA to consider the impact that international events and circumstances could have on financial stability in the UK.

Question 5.3
Which UK regulatory body has specific responsibility for financial stability?

E3 Prudential regulation

The adequacy of a firm's financial resources needs to be assessed in relation to all the activities of the firm and the risks to which they give rise, and so the rules apply to a firm in relation to the whole of its business. A firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

Reinforce

Remember that the PRA *prudentially* regulates banks and insurers, while the FCA prudentially regulates smaller, solo-regulated firms and regulates the *conduct* of all firms.

Adequate financial resources and adequate systems and controls are necessary for the effective management of prudential risks. **Senior Management Arrangements, Systems and Controls (SYSC)** set out general rules and guidance on the establishment and maintenance of systems and controls.

Capital resources

Principle 4

Principle 4 requires a firm to maintain adequate financial resources. The FCA (and PRA where applicable) is concerned with the adequacy of the financial resources that a firm needs to hold in order to be able to meet its liabilities as they fall due. These resources may include both capital and liquidity resources, as set out in the various prudential sourcebooks.

The FCA Handbook and PRA Rulebook set out provisions that deal specifically with the adequacy of that part of a firm's financial resources that consists of capital resources. The adequacy of a firm's capital resources needs to be assessed both by that firm and the appropriate regulator. Through their rules, the FCA/PRA set minimum capital resources requirements for firms. They also review a firm's own assessment of its capital needs, and the processes and systems by which that assessment is made, in order to see if the minimum capital resources requirements are appropriate. The FCA/PRA may impose a higher capital requirement than the minimum requirement as part of the firm's **Part 4A permission** where this is deemed appropriate by them (see *Capital adequacy* on page 6/11).

A firm should have systems in place to enable it to be certain whether it has adequate capital resources to comply with the requirements at all times. This can be tested via a risk identification and management process, and stress and scenario testing of its risk assessments. Consistent with its approach in other areas, the FCA/PRA require the process to be documented. **These tests should be performed, at a minimum, annually** and FCA/PRA guidance suggests that they **should be performed more regularly should a significant change in future expectations occur suddenly**. This does not necessarily mean that a firm needs to measure the precise amount of its capital resources on a daily basis. A firm should, however, be able to demonstrate the adequacy of its capital resources at any particular time if asked to do so by their regulator.

E3A Financial strength of regulated firms

The regulators monitor the financial strength of regulated firms, in particular:

- banks;
- building societies;
- friendly societies;
- insurance companies; and
- fund managers.

They would not allow these institutions to continue to accept new business if their financial strength fell below minimum standards. However, this monitoring does not guarantee their continued strength.

The events of late 2008 and early 2009, which saw the UK Government intervene in order to recapitalise certain banks, illustrates the importance of financial strength.

All of the institutions listed above must make their financial data open to public scrutiny via their accounts and regulatory returns. Advisers can then make a judgment on their financial strength.

The financial strength of a bank or building society may well be reflected in the terms they offer. Major high-street banks tend to have lower interest rates than smaller firms which are less secure, although, as events have shown, the large high-street banks are not necessarily immune from these capital security issues.

One important measure for a life office is its **free asset ratio (FAR)**. This can be obtained from an office's regulatory returns. The FAR is the surplus assets held by a life office over the value of its liabilities expressed as a percentage of its total assets.

$$\text{FAR} = \frac{\text{Total Assets} - \text{Liabilities}}{\text{Total Assets}} \times 100$$

Question 5.4

Some advisers will consider FARs when recommending a life or pension office. Recently, however, its value as a comparator of financial strength has been called into question and advisers would be advised to look beyond FARs and consider other factors. What do you think these other factors might be?

Ratings

There are various **ratings agencies** which specialise in giving strength ratings to financial institutions. Their ratings are publicly available and much used by advisers for selecting providers and by providers themselves in their marketing material.

Question 5.5

An insurance company has total assets of £10,000,000 and liabilities of £8,000,000, what is its free asset ratio?

Key points

The main ideas covered by this chapter can be summarised as follows:

The UK's financial services regulatory landscape

- The FCA and PRA are the designated competent authorities under the European single market directives for banking, insurance, investment business, and other financial services including insurance intermediation.
- The FCA has authorisation, enforcement, supervision and rule-making functions in relation to the firms it regulates.

FCA objectives

- The FCA's three operational objectives:
  - Protecting consumers.
  - Protecting financial markets.
  - Promoting competition.
- The FCA's eight regulatory principles:
  - Efficiency and economy.
  - Proportionality.
  - Sustainable growth.
  - Consumer responsibility.
  - Senior management responsibility.
  - Recognising the differences in the businesses carried out by different regulated persons.
  - Openness and disclosure.
  - Transparency.

Scope and powers

- Any person wishing to carry out one or more regulated activities by way of business, must apply to the appropriate regulator for direct authorisation (unless they can abide by the terms of exclusion or are exempt). This is called applying for Part 4A permission as set out in the FSMA.
- The FCA and the PRA are answerable to the Treasury for the way they carry out their duties; the Chancellor of the Exchequer bears ultimate responsibility for the regulatory system.
- The FCA/PRA between them oversee the whole financial services industry and have considerable powers at their disposal.
- The FCA's Enforcement Division investigates when firms breach FCA rules or the provisions of the FSMA.

Regulatory supervision and the risk-based approach

- The FCA adopts a 'risk-based' regulatory approach for authorised firms.
- As a general principle, the FCA supervises firms according to the risks they present to its statutory objectives.

Financial stability and prudential regulation

- The international Financial Stability Board (FSB) has been established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.
- The FSB, working through its members, seeks to give momentum to a broad-based multilateral agenda for strengthening financial systems and the stability of international financial markets.

Key points

- The adequacy of a firm's financial resources needs to be assessed at least annually, and more frequently if necessary, in relation to all the firm's activities and associated risks. The rules apply to a firm in relation to the whole of its business.

Question answers

5.1 The maximum penalty is five years' imprisonment and/or a fine.

5.2 The FCA receives regular reports from its authorised firms that give information on matters such as accounts, auditors' statements, complaint statistics etc. If any information received gives rise to concern, then appropriate action will be taken.

5.3 The Bank of England has a statutory responsibility to 'protect and enhance the stability of the financial systems of the UK'.

5.4
- Does the life office have a strong parent company?
- Has it been in business for a long time?
- Is it expanding so that it does not have to sell assets at a bad time to pay current claims?
- What is its claims history?
- Does it have exposure to complex financial instruments or failing subsidiaries which might impact on its financial stability?

5.5 The free asset ratio is 20%.

$$\frac{£10,000,000 - £8,000,000}{£10,000,000} \times 100$$

6
The FCA Handbook

Contents	Syllabus learning outcomes
Introduction	
A High Level Standards (HLS)	5.2
B Prudential Standards (PRU)	5.2
C Business Standards	5.2
D Regulatory Processes	5.2
E Redress	5.2
F Other FCA Handbook material	5.2
G Consumer credit and rights legislation	5.2
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- explain how the FCA authorises firms and the responsibilities of firms;
- explain the different types of financial adviser, their responsibilities and restrictions;
- outline the concept of capital adequacy;
- explain the different categories of customer under the FCA's COBS rules;
- outline the requirements of rules on terms of business, client agreements and client money;
- explain the status of advisers and status disclosure to customers;
- give an outline of the ICOBS rules;
- give an outline of the MCOB rules; and
- discuss the basic provisions of the Consumer Credit Acts 1974/2006.

Introduction

The FCA Handbook is the body of rules by which the FCA operates. We will look at different sections to understand the requirements for regulated firms. We will also consider other regulatory and legislative material in the areas of consumer credit and unfair contracts, to see how the FCA's responsibilities intertwine with these other sources of regulation.

The content of the FCA Handbook and PRA Rulebook is summarised below:

- The FCA Handbook contains a glossary and many assorted sourcebooks, rulebooks, guides and manuals across nine subject blocks, such as high level standards, prudential standards, business standards etc.
- The PRA Rulebook contains a glossary and five subject blocks.
- Some of the subject matter reflects the fact that FCA will be prudentially regulating a large number of small firms, and the PRA will carry out some conduct of business regulation.

On the Web

For ease of use, the FCA and PRA have separate websites for the Handbook and Rulebook: *www.handbook.fca.org.uk/handbook* and *www.prarulebook.co.uk*.

The FCA Handbook

The FCA Handbook sets out a firm's main regulatory obligations. It is the collective term for the various sourcebooks and handbooks that make up the body of FCA rules for regulated firms. All the rules are made under powers given to the FCA by the **Financial Services and Markets Act 2000 (FSMA)**, and are binding. Legal instruments remain the definitive version of any rules made.

We will look at each section of the FCA Handbook in detail, but for now they are summarised in the following table:

Section	What does this cover?
High Level Standards	The standards applying to all firms and approved persons.
Prudential Standards	This sets out the prudential requirements for firms.
Business Standards	The detailed requirements relating to firms' day-to-day business.
Regulatory Processes	The manuals describing the operation of the FCA's authorisation, supervisory and disciplinary functions.
Redress	The processes for handling complaints and compensation.
Specialist Sourcebooks	Requirements applying to individual business sectors.
Listing, Prospectus and Disclosure	UK Listing Authority rules.
Handbook Guides	This section contains guides to the Handbook aimed at giving a basic overview of certain topics. It is designed to point firms in the direction of material in the Handbook applicable to them.
Regulatory Guides	These are guides to regulatory topics.
Glossary	The meaning of defined terms used in the Handbook.

Key terms

This chapter features explanations of the following terms and concepts:

Annual funding requirement	Capital adequacy	Common platform requirements	Complaints Commissioner
Code of Conduct (COCON)	Conduct of Business Rules (COBS)	Fixed overhead requirement	Initial disclosure document
Part 4A permission	Periodic fee	Principles for Approved Persons	Remuneration principles
Senior Management Arrangements, Systems and Controls (SYSC)	Special project fees	Specialist Sourcebooks	Standard terms

A High Level Standards (HLS)

The first section of the FCA Handbook, 'High Level Standards' contains the **regulatory obligations for all firms, senior management and approved persons**.

Sourcebook or Manual	What does this include?
PRIN Principles for Businesses	A general statement of the main regulatory obligations of the firm.
SYSC Senior Management Arrangements, Systems and Controls	Rules and guidance on how key responsibilities for managing the business should be allocated among the firm's senior management team and the systems and controls the firm should have in place.
COCON Code of Conduct	Rules about conduct and to whom they apply. This covers most employees of all firms covered by the senior management and certification regime (SM&CR firm), except approved persons.
COND Threshold Conditions	The minimum standards the firm must satisfy to become and remain authorised by the FCA.
APER Statements of Principles and Code of Practice for Approved Persons	This sets out the conduct requirements for approved persons. These are primarily people carrying out a senior management or customer facing function in a firm which is NOT covered by the senior management and certification regime (a non-SM&CR firm), e.g. appointed representatives (ARs).
FIT The Fit and Proper Test for Employees and Senior Personnel	This sets out the criteria which the FCA uses to assess whether an individual is suitable to perform a senior management or certified function.
FINMAR Financial Stability and Market Confidence	Provisions relating to financial stability, market confidence and short selling.
T&C Training and Competence	These set out detailed competence requirements such as exam requirements, for advisers, their supervisors and those that oversee certain administration functions.
GEN General Provisions	This sets out some of the underlying legal framework to FCA regulation and requirements regarding statutory status disclosure.
FEES Fees Manual	The fees provisions for funding the FCA, Financial Ombudsman Service (FOS), Financial Services Compensation Scheme (FSCS) and Money and Pensions Service (MaPS).

A1 Main regulatory obligations for firms

A1A Threshold Conditions (COND)

The Threshold Conditions are the minimum conditions that a firm must satisfy at all times if it is to retain its ***Part 4A permission*** to conduct investment business in the UK. The Threshold Conditions are:

COND 2.2 Location of offices. If the person concerned is a corporate body constituted under the law of any part of the United Kingdom, its head office and its registered office must be in the United Kingdom. Note that when the FCA uses the expression 'person', this could be a company, partnership, or individual person.

COND 2.3 Effective supervision. A person must be capable of being effectively supervised by the FCA, having regard to all the circumstances.

If the person concerned has close links with another person (the '*close link*'), the FCA must be satisfied that those links are not likely to prevent the FCA's effective supervision of the person and, if it appears to the FCA that the *close link* is subject to the laws, regulations or administrative provisions of a territory which is not an EEA State ('the foreign provisions'); that neither the foreign provisions, nor any deficiency in their enforcement would prevent the FCA's effective supervision of the person.

COND 2.4 Appropriate resources. The resources of the person must be appropriate in relation to the regulated activities that they carry out or seek to carry out and the non-financial resources of the person must be appropriate in relation to the regulated activities that they carry out or seek to carry out, having regard to the operational objectives of the FCA.

The resources of the person concerned must, in the opinion of the FCA, be adequate in relation to the regulated activities that they seek to carry on. In reaching that opinion, the FCA may take into account the person's membership of a group and any effect which that membership may have; and have regard to the provision they make and, if a member of a group, which other members of the group make in respect of liabilities (including contingent and future liabilities); and the means by which they manage and, if a member of a group, which other members of the group manage the incidences of risk in connection with their business.

COND 2.5 Suitability. The person concerned must satisfy the FCA that they are a **fit and proper person** having regard to all the circumstances, including their connection with any person; the nature of any regulated activity that they carry on or seek to carry on; and the need to ensure that their affairs are conducted soundly and prudently.

COND 2.7 Business model. A person's business model (that is, their strategy for doing business) must be suitable for a person carrying out the regulated activities that they carry out or seek to carry out. The matters which are relevant in determining whether the person satisfies this condition include:

1. whether the business model is compatible with the person's affairs being conducted, and continuing to be conducted, in a sound and prudent manner;
2. the interests of consumers; and
3. the integrity of the UK financial system.

A1B FCA Principles for Businesses (PRIN)

The **FCA Principles for Businesses** are a general statement of the fundamental obligations of all authorised firms under the regulatory system. The PRIN sourcebook also contains additional rules regarding the Consumer Duty in PRIN 2A.

Refer to
See *FCA Principles for Businesses (PRIN)* on page 10/2 for more detailed coverage of PRIN and *The Consumer Duty* on page 8/7 for more detail about PRIN 2A.

A1C Senior Management Arrangements, Systems and Controls (SYSC)

The senior management of authorised businesses must have an adequate structure of systems and controls for the business. The partners, directors and senior managers need to understand their responsibilities, which should be formally written down.

Senior management arrangements (SYSC 2)
Each firm should appoint individuals to be personally responsible for the senior management functions within the firm. The records should show who is personally responsible for what function. Overall responsibility is pinned on the firm's chief executive or equivalent.

Systems and controls (SYSC 3)
A firm should have systems and controls that are 'appropriate to its business', i.e. according to its nature and size, as well as the risks that are associated with it. The systems should be regularly reviewed to make sure that they continue to be appropriate. The systems and controls should cover such areas as:

- reporting lines and how responsibilities are delegated;
- the compliance function;
- the assessment of risks facing the business;
- management information;
- checking the honesty and competence of those working in the business;
- monitoring systems and controls;
- the development and implementation of business and remuneration strategy;
- business continuity in the event of disaster or the loss of key personnel; and
- record-keeping.

These are dealt with under the 'common platform requirements'.

Common platform requirements	
Regulated firms must comply with the common platform requirements. In broad terms, the common platform requirements are:	
General organisational requirements (SYSC 4)	The firm must have robust governance arrangements including clear organisational structure and reporting lines, effective systems for the identification and management of risks, and appropriate administrative, accounting and information processing systems. The firm must also have experienced and reputable management, appropriate internal management practices, and allocation of responsibilities.
Employees, agents and other relevant persons (SYSC 5)	Personnel employed by the firm must have appropriate skills, knowledge and expertise to carry out the functions allocated to them.
Compliance, internal audit and financial crime (SYSC 6)	The firm must have and maintain appropriate policies and procedures to enable the firm to comply with its regulatory responsibilities. Where appropriate and proportionate to the nature and scale of the firm's activities, an independent internal audit function must be maintained. The firm must also establish and maintain appropriate systems and controls to enable it to identify and manage money laundering and other financial crime risks.
Risk control (SYSC 7)	The firm must establish and maintain adequate risk management policies and procedures that identify the risks to the firm's activities and, as appropriate, establish the level of risk the firm is prepared to tolerate.
Outsourcing (SYSC 8)	Where appropriate, the firm must ensure that it takes appropriate measures to avoid undue additional operational risks arising through any outsourcing arrangements. Outsourcing will not be undertaken where this materially affects the firm's internal controls and prevents the FCA from monitoring the firm's compliance with its regulatory obligations.
Record-keeping (SYSC 9)	A firm must arrange for orderly records to be kept of its business and internal organisation, including all services and transactions undertaken by it. These must be sufficient to enable the FCA to monitor the firm's compliance with the requirements under the regulatory system, and in particular to ascertain that the firm has complied with all obligations with respect to clients.

Common platform requirements	
Conflicts of interest (SYSC 10)	The firm must have appropriate systems to identify and manage conflicts of interest between the firm (including its staff and, if any, its appointed representatives) and a client or between one client and another client.
Recording telephone conversations and electronic communications (SYSC 10A)	A firm must take all reasonable steps to record telephone conversations, and keep a copy of electronic communications, that relate to their activities in financial instruments.

Other systems and controls

Here is a selective look at some of the other systems and control requirements that mainly concern just the larger banks and insurers.

Whistle-blowing (SYSC 18)

Workers who 'blow the whistle' on their employers should be protected if they are aware or suspicious of various activities (or their concealment) such as crimes, failure to comply with laws, miscarriages of justice, risks to health and safety or the environment. Firms must have procedures for whistle-blowing to someone in the firm or to the FCA, and should make staff aware of them. This is a requirement of the **Public Interest Disclosure Act 1998**.

> **Be aware**
>
> The FCA launched a campaign in 2021 called *In Confidence, With Confidence* which aims to encourage individuals working in financial services to report potential wrongdoing to the FCA. Details of the campaign can be found here: *www.fca.org.uk/firms/whistleblowing/speaking-fca*.

Remuneration and performance management (SYSC 19F)

SYSC 19F.1 provides remuneration rules for firms which do not fall within the MiFID investment firms category. The chapter dictates that firms providing investment services to clients must ensure they do not remunerate or assess the performance of staff in a way that would conflict with the duty to act in the best interests of clients.

Specifically, firms must not make any remuneration arrangements, such as sales targets, which could provide an incentive to staff to recommend a financial product to a retail client when there is a more suitable product available.

MIFIDPRU Remuneration Code (SYSC 19G)

The remuneration policies and practices detailed in SYSC 19G apply to SNI and non-SNI MIFIDPRU investment firms. These firms must establish, implement and maintain remuneration policies and practices which cover all aspects of the MIFIDPRU Remuneration Code.

The following requirements apply to all remuneration policies:

- **Proportionality**. They must be appropriate for the nature, scale and complexity of the risks inherent in the business.
- Policies must be **gender neutral** and firms are reminded of the prohibition of discrimination based on an individual's protected characteristics under the **Equality Act 2010**. Remuneration policies should be compliant with this legislation.
- **Risk management, business strategy and avoiding conflicts of interest**. Policies must be consistent with sound risk management, in line with the firm's strategy, objectives and long term interests, including risk appetite, culture and values, and must contain measures to avoid conflicts of interest, encourage responsible conduct and promote risk awareness.

Additional risk controls (SYSC 21)

This chapter mainly applies to banks and insurers included in the FTSE 100 index (and similarly complex firms) and is not considered further.

References (SYSC 22)

This chapter concerns the obligations which apply to firms on getting, giving and updating references for the employment of staff.

Be aware

SYSC 22 Annex 1 contains a template which must be used by SM&CR firms when considering the employment of an individual in a certified function: *www.handbook.fca.org.uk/handbook/SYSC/22/Annex1.html*.

Senior Managers and Certification Regime (SYSC 23–27)

These chapters concern the rules of the Senior Managers and Certification Regime (SM&CR) and their application:

- SYSC 23 – Introduction and classification.
- SYSC 24 – Allocation of prescribed responsibilities.
- SYSC 25 – Management responsibilities maps, handover procedures and material.
- SYSC 26 – Overall and local responsibility.
- SYSC 27 – Certification regime.

Further details on these requirements can be found in *Overview of SM&CR* on page 7/7.

Insurance distribution (SYSC 28)

This chapter covers the specific knowledge, ability and good repute requirements for carrying out insurance distribution activities, including record keeping.

Regulated funeral plan activities (SYSC 28A)

This chapter covers the good repute and record keeping requirements for those who deal in or advise on regulated funeral plans.

A1D Financial Stability and Market Confidence (FINMAR)

This sourcebook contains provisions relating to financial stability, market confidence and short selling.

FINMAR 2 sets out rules and provides guidance in relation to short selling in order to promote the FCA's statutory objectives of 'protecting consumers' and 'enhancing financial integrity'. It is relevant to any entity to which the short selling regulation applies, regardless of whether they are regulated by the FCA.

Short selling regulations impose measures to stop or limit short selling of financial instruments where the price has fallen significantly during a single day's trading, to prevent markets becoming 'disorderly'. For example, the FCA may impose restrictions on short selling where:

- there are violent movements in price;
- there is evidence of unusual or improper trading; or
- there are unsubstantiated rumours or false information.

A1E Training and competence (T&C)

Refer to

See *Training and competence (T&C)* on page 7/21, for more information on training and competence

The FCA training and competence requirements apply to:

- those that provide advice, e.g. general insurance advisers, investment advisers and mortgage advisers;
- the people who supervise them; and
- overseers (the first line managers in life office departments such as those that handle new business and claims).

T&C has a number of important elements such as the need to demonstrate competence, undertake continuous professional development and achieve appropriate exams before providing advice. These areas are all covered in more detail in *Core regulatory principles and rules* on page 7/1. The fact that they form part of the FCA's High Level Standards means that the FCA regards these as an important part of its objectives.

Question 6.1

Why has the FCA used its powers to restrict short selling?

A2 Main regulatory obligations for individuals

Code of Conduct (COCON) (See *Code of Conduct (COCON)* on page 10/6)	This makes rules of conduct for employees in SM&CR firms.
FCA Statements of Principle and Code of Practice for Approved Persons (APER) (See *Statements of Principle for Approved Persons* on page 10/9 and *Code of Practice for Approved Persons* on page 10/9)	The FCA also has **Principles for Approved Persons**, i.e. those subject to individual registration in non-SM&CR firms such as Appointed Representatives.
Fit and Proper Test for Employees and Senior Personnel (FIT) (See *The Fit and Proper test for employees and senior personnel (FIT)* on page 10/10)	A senior manager or individual subject to Certification must be (and remain) **fit and proper** for their function.

A3 Other obligations

A3A General Provisions (GEN)

This sourcebook sets out some of the underlying legal framework to FCA regulation and requirements regarding statutory status disclosure and also covers the following:

Referring to approval by the FCA
The firm or any member of staff or other person acting on behalf of the firm will not, except where required by the rules of the FCA to do so, either expressly or implicitly claim that the firm's affairs have the approval of the FCA.

Emergencies
If an emergency arises that makes it impracticable for the firm to comply with a particular rule, which could not be avoided by the firm taking all reasonable steps and which is outside of the firm's control, the firm will not be considered to be in contravention of that rule. Under this rule, an individual is able to cover for a senior manager without first being approved, where the absence is temporary or unforeseen, and the appointment is for a period of less than 12 weeks.

These provisions will apply for as long as:

- the emergency exists; and
- the firm continues to deal with the effects of the emergency, attempts to comply with the rule and takes all necessary measures to mitigate any consequential losses to its clients.

The firm will notify the FCA of the emergency and the steps being taken to deal with the consequences of the situation as soon as possible.

Statutory status disclosure
It is a requirement that all authorised firms disclose their statutory status in every letter (or electronic equivalent) sent to a retail client. It is also good practice to include the status disclosure on business cards but it is not necessary in text messages.

The firm must identify its regulator, i.e. where this is the FCA, for authorised firms the prescribed wording is:

> 'Authorised and regulated by the Financial Conduct Authority.'

Appointed representatives of FCA authorised firms must state:

> '[Name of AR] is an appointed representative of [Firm] which is authorised and regulated by the Financial Conduct Authority.'

Professional firms (such as law firms), which are also regulated by their own professional bodies and which carry out both FCA regulated and non-regulated activities, are permitted to add words to the relevant required disclosure only if the firm has taken reasonable steps to satisfy itself that the presentation will be clear, fair and not misleading and likely to be understood by the intended recipient.

Use of the 'FCA' acronym

In the above disclosure statements, 'Financial Conduct Authority' should not be abbreviated to FCA.

FCA logo

Although the FCA has its own logo, authorised firms are no longer able to use this on any of their own materials (as was the case with the FSA logo) in line with GEN 5.1.3A. This is worth noting given the wording of the GEN 5 Annex 1 still makes extensive reference to the FSA logo even though any licence to use it ceased in 2014.

The 'Keyfacts' logo

keyfacts®

A firm must not use the keyfacts logo other than as and when it is required or expressly permitted to be used by the rules, and in accordance with the general licence granted by the FCA. It can only be used in documents prescribed by the FCA for use with customers, i.e. policy summaries, key features documents, mortgage illustrations, risk and features statements and financial information statements.

A firm must take all reasonable steps to ensure that the keyfacts logo is not reproduced on any document that the firm, or any person acting on its behalf, provides to a customer unless the reproduction is required by the rules.

Insurance against financial penalties
The firm will not enter into or claim under an insurance contract that is intended to indemnify the firm against all or part of a financial penalty imposed by the FCA or otherwise under the FSMA.

The firm is permitted to enter into and claim under an insurance contract that indemnifies it against the costs of defending FCA enforcement action or costs the firm may be ordered to pay to the FCA.

Charging consumers for telephone calls
A firm which operates a telephone line for the purpose of enabling a consumer to contact the firm in relation to a contract that has been entered into with the firm, must not bind the consumer to pay more than the basic rate for the telephone call.

A3B Fees (FEES)

The FCA is an independent, non-governmental body which is funded by levies on the financial services industry. The FCA has a number of fee blocks which group together firms carrying out similar regulated activities, reflecting the fact that they pose similar risks to FCA objectives. A firm may fall into one, or more than one, fee block, depending on the scope of its permission.

The FCA receives no funds from the public purse; broadly, it uses three main types of fee to finance its activities:

Application fees contribute to the cost of processing applications for authorisation or recognition, or requests for significant variations to the permission of firms that are already authorised.

What are application fees?
Any firm applying to the FCA for authorisation has to pay an application fee. These were simplified in 2022 and start at £2,500, with higher levels of fees for firms seeking permissions beyond advising and arranging.

The FCA also charges an application fee where currently authorised firms seek significant variations to their permission. Application fees must be paid whether or not the application is successful and are not refundable. This reflects the fact that the FCA commits resources to applications when they are received, so all applications have a cost to the FCA regardless of their outcome.

An authorised firm may seek to significantly vary the scope of its permission, and that variation, if granted, may cause it to fall into new fee blocks it was not allocated to before the variation. In these cases, a variation of permission (VoP) fee is payable, charged at 50% of the equivalent application fee that a new firm falling into the new fee block(s) would pay. A flat fee of £250 applies to all other VoP applications to add any regulated activities but which do not result in the firm being allocated to one or more additional fee blocks.

Periodic fees are paid annually, to provide most of the funding that the FCA requires to undertake its statutory functions.

What are periodic fees?
The FCA uses periodic (annual) fees to recover the costs it expects to incur in undertaking its functions. The FCA **Annual Funding Requirement (AFR) is derived each year from the FCA's budget.** This total figure is split into an AFR for each fee block, using the FCA's internal costing system. For example, the permission granted to a firm advising on investments would mean it is allocated to fee block A13. A firm arranging home finance would be allocated to fee block A18. A firm carrying out general insurance mediation would typically be allocated to the A19 fee block. If a firm is carrying out multiple activities, it would be allocated to all respective fee blocks and pay a fee in each based on the annual income for that business component.

The scale on which a firm undertakes activities is measured by each fee block's **tariff base**. The tariff base is a 'size of business' measure. The FCA has stated that the tariff base for the A13, A18 and A19 fee blocks will be based on the income a firm earns in the previous year, ending 31 December, from carrying out its trade in those respective areas.

By applying the tariff base to its business a firm obtains its own 'individual tariff data'. The periodic fees for the firm can then be calculated by combining the firm's individual tariff data with the fee tariff rates for each fee block it falls into. So, the fee calculation is:

Periodic fee = (tariff base data for firm) applied to (fee block tariff rates)

The fee tariff rates for each fee block are in the FEES Annexes.

Special project fees meet the costs that the FCA incurs dealing with a range of activities that it undertakes as a result of a request from a fee-payer; for example, insurance company re-organisations, large mergers and demutualisations.

Payment of fees

Annual notification of fees

Firms should also be aware that in January of each year the FCA produces a consultation paper indicating the proposed fee rates for the coming financial year (1 April–31 March).

The FCA Board makes the final fee rates for the financial year in May (with the exception of application fee rates which are made in March, before the beginning of the financial year). Firms should expect to receive a periodic fee invoice in June/July each year.

In June each year the **FCA Consolidated Policy Statement** on FCA fee-raising arrangements is updated. This document provides further detail on FCA fee policy, and you will find it on the FCA website.

In 2005 the FSA had entered into a commercial arrangement with Premium Credit Ltd, whereby firms will be allowed to pay their annual fees by instalments. This scheme has now been adopted by the FCA.

Activity

Spend some time considering the various fees which may apply to a range types of firms. If you are not sure, then conduct some research using the FEES Manual on the FCA website: *www.handbook.fca.org.uk/handbook/FEES*.

FOS, FSCS and Money and Pensions Service (MaPS)

Firms are also subject to fees and levies imposed by the FOS, FSCS and MaPS. These are consulted on and collected in tandem with FCA fees and levies.

In recent years, there have also been interim FSCS levies made in addition to the standard levies to cover the costs of claims.

B Prudential Standards (PRU)

The second block of the FCA Handbook, 'Prudential Standards', sets out the **prudential requirements for firms** (in broad terms this means a firm's **Financial Framework**).

Sourcebook or manual	What does it include?
MIFIDPRU Prudential sourcebook for Investment Firms	The rules about the financial requirements non-MIFID-exempt firms need to have in place, e.g. capital requirements.
MIPRU Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries	The rules about the financial safeguards the firm needs to have in place, e.g. capital requirements and professional indemnity insurance (PII) requirements.
IPRU-INV Interim Prudential sourcebook for Investment Businesses	The prudential and notification requirements for non-MIFIDPRU investment firms (e.g. investment management firms), unless they are a collective portfolio management firm.
INSPRU	The Prudential sourcebook for Insurers.
IPRU-FSOC **IPRU-INS**	There are two other Interim Prudential sourcebooks for Friendly Societies and Insurers.
GENPRU	This handbook has been largely removed from use but still contains capital requirements for cross-sector groups.

B1 Capital adequacy

Regulated firms are subject to financial resources requirements and must maintain enough resources to cover the risks that result from the way in which they conduct their business.

Different types of firms have different financial requirements and need to meet different tests:

- Large organisations such as insurance companies and banks are subject to very rigorous monitoring of their financial position and are prudentially regulated by the PRA.
- Most larger firms are subject to the Investment Firms Prudential Regime (IFPR), the FCA's new approach to capital requirements now the UK has left the EU. These rules (in the MIFIDPRU handbook) require firms to undertake detailed risk assessments and stress-testing scenarios to establish what level of financial resources it is appropriate for them to hold. Some small intermediary businesses are currently exempt from these rules and, as such, are not required to undertake such a rigorous assessment.
- Intermediary businesses are subject to a variety of financial tests that vary according to the firm's category, size and activities that it carries out.

Example 6.1

Some typical intermediary firm requirements

Prudential Category	Capital Resource Requirements
MIFIDPRU firm Such as firms with portfolio management permissions not holding client money or assets with AUM of less than £1.2 billion	Minimum capital requirement: £75,000 (See MIFIDPRU 4.4) Other higher levels of capital are required for firms with different permissions, such as dealing on their own account Fixed overheads requirement: 25% of fixed overheads (see MIFIDPRU 4.5)
Exempt MiFID firm Small personal investment firms (PIFs)	Base CRR: £20,000 (from 30 June 2017) Variable CRR of 5% of income (from 30 June 2016) (Additional capital is required for those also giving mortgage advice)

Note: Due to the large variations of capital requirements for different firms in the MIFIDPRU handbook, these are very much simplified.

All firms must have accounting records that allow them to be able to demonstrate their compliance with the financial resources requirements at any time. These records must be complete and up to date.

In all companies, capital (the organisation's funds not allocated to meet its short-term liabilities) is required to fund day-to-day operating costs and the development/growth of the company. It also funds investment in new projects and provides a buffer which can be drawn on should trading result in a loss. For example, a life company needs to maintain capital both within its with-profits funds and on its own account to ensure that the reasonable expectations of policyholders are met and unexpected shocks (stock market falls, mis-selling problems etc.) can be survived.

Over time, regulators have established increasingly rigorous capital requirements for authorised firms to help create and maintain a stable marketplace and also to protect consumers. In particular, there are detailed solvency requirements for insurance companies now overseen by the PRA.

Capital requirements

Firms need to have a clear understanding of:

- how much capital they have at any point of time;
- how much capital they need to support targeted volumes and types of business;
- how much capital they need to meet both current and future regulatory capital requirements; and
- what they will do in the event of having too much or too little capital for planned business volumes.

Capital can be quantified in a number of ways depending on how individual or types of assets and liabilities are valued or incorporated/excluded from the calculation. To ensure consistency there are detailed rules governing the valuation of a firm's assets and liabilities and rules as to what assets are allowed to make up a firm's regulatory capital (note that these rules and valuation bases can be quite different from the financial accounting and reporting standards used by firms in reporting to investors).

All FCA regulated firms are required to report their calculations to the FCA regularly (mostly either biannually or quarterly) as part of their statistical and reporting obligations. These figures are monitored by the FCA as part of its ongoing monitoring and supervision of individual firms. Obviously, firms with barely adequate regulatory capital or only a moderate surplus over the minimum are of concern, and a firm's management should monitor the adequacy of their firm's capital on an ongoing basis and, if in any doubt, report this to the FCA.

Activity

Spend some time considering the capital adequacy requirements for your firm. If you are not sure then conduct some research using Prudential Standards sourcebooks on the FCA website:

www.handbook.fca.org.uk/handbook/IPRU-INV/13/13.html.

www.handbook.fca.org.uk/handbook/MIFIDPRU/1/1.html.

www.handbook.fca.org.uk/handbook/INSPRU/1/1.html.

Reinforce

Capital tiers

The rules continue to correspond to the capital tiering structure of the CRD. Under these rules, capital is divided into three categories or tiers. These reflect the loss absorbency and permanence of the capital.

For example, equity share capital, generally considered to be the most loss-absorbent and permanent capital a firm can hold, is contained within Tier 1, while short-term subordinated debt, which is much less permanent and has low loss absorbency, is contained within Tier 3. As the degree of permanence and loss absorbency decreases so does the quality of that capital from a regulatory perspective.

www.handbook.fca.org.uk/handbook/IPRU-INV/5/8.html.

A firm will need to make various deductions at different stages when it calculates its capital resources. This is to reflect the fact that capital may not be available to the firm or that assets are of an uncertain value.

Different capital instruments vary in the protection they offer a firm and its customers, so restrictions or limits are placed on the amount of capital a firm can hold in lower tiers of capital.

Refer to

The FCA is currently consulting on the capital requirements for PIFs. For more information, see: *Prudential supervision* on page 5/20.

B2 MIFIDPRU

MIFIDPRU deals with investment firms subject to the IFPR and covers specific elements relating to the capital resources calculations, such as credit risk, market risk, concentration risk, counterparty risk and liquidity. Some firms may also have additional capital requirements under IPRU-INV.

B2A Liquidity

The rules (in MIFIDPRU 6) are designed to require those firms caught by them to ensure that their business model has sufficient amounts of liquid capital built in and that the firm will be able to continue to function if certain external stresses are applied. They require firms to:

- be self-sufficient and maintain adequate liquid resources;
- put in place and maintain enhanced systems and controls for the management of liquidity risk; and
- cover a proportion of any guarantees provided to clients.

B3 MIPRU

MIPRU sets out the professional indemnity insurance (PII) and CRRs for home finance providers and intermediaries, and general insurance intermediaries.

B4 IPRU-INV

IPRU-INV sets out the PII and CRRs for simpler investment firms, being further divided into authorised professional firms, collective portfolio management firms and personal investment firms. This sourcebook also covers important information on the additional capital required for firms with exclusions or excesses applying to their PII.

Activity

There are two other Interim Prudential sourcebooks for friendly societies and insurers.

Find out the main requirements that these sourcebooks spell out and make a brief summary of them to add to your notes.

C Business Standards

The third section of the FCA Handbook, 'Business Standards', contains the detailed requirements relating to firms' day-to-day business conduct:

Sourcebook or manual	Contents
COBS Conduct of Business	The Conduct of Business requirements applying to investment firms.
ICOBS Insurance: Conduct of Business	If the firm does insurance mediation activities, these are the requirements relating to how the firm must deal with customers. (See *Regulatory rules for non-investment insurance advice (ICOBS)* on page 6/16.)
MCOB Mortgages and Home Finance: Conduct of Business	If the firm does mortgage and home finance business, these are the requirements relating to how the firm must deal with customers.
BCOBS Banking Conduct of Business	If the firm does banking business, these are the requirements relating to how the firm must deal with customers.
CMCOB	The Conduct of Business sourcebook for claims management firms.
FPCOB	The Conduct of Business sourcebook for funeral plan activities, both for providers and intermediaries.
CASS Client Assets	The FCA requirements relating to holding client assets and client money. (These rules do not apply to home finance intermediaries holding only home finance 'client money'. Insurance intermediaries have to comply with CASS chapter 5 only.)
MAR Market Conduct	Code of Market Conduct, Price Stabilising Rules, Inter-Professional Conduct, Endorsement of the Takeover Code, Alternative Trading Systems, what is acceptable market conduct and what is market abuse.
PROD Product Intervention and Product Governance	The purpose of PROD is to improve firms' product oversight and governance processes and to set out the FCA's statement of policy on making temporary product intervention rules.
ESG	Environmental, Social and Governance sourcebook.

C1 Regulatory rules for investment advice (COBS)

This section deals with the main chapters of the **Conduct of Business Sourcebook (COBS)** which are relevant to most investment firms. Further information about the additional COBS chapters is included in chapters 7 and 8, as detailed below:

- **COBS 3:** Types of clients (see *Types of clients* on page 8/26).
- **COBS 4:** Communicating with clients, including financial promotions (see *Financial advisers: responsibilities and restrictions* on page 8/12).
- **COBS 5:** Distance communications (*Financial advisers: responsibilities and restrictions* on page 8/12).
- **COBS 6:** Information about the firm, its services and remuneration (see *Status disclosure and charges* on page 8/30).
- **COBS 8:** Client agreements (see *Client agreements* on page 8/30).

- **COBS 9:** Advice and know your customer rules (see *Advice and know your customer rules* on page 8/19).
- **COBS 11:** Dealing and managing (see *Status disclosure and charges* on page 8/30).
- **COBS 13:** Product disclosure (see *Communicating with clients, including financial promotions* on page 8/16).
- **COBS 15:** Cancellation (see *Clients' cancellation rights* on page 8/34).
- **COBS 16:** Reporting and record-keeping (see *Record-keeping, reporting and notification* on page 7/20).

C1A Purpose of the COBS rules (COBS 1)

Most of the FCA rules affecting the day-to-day work of investment advisers are contained in the COBS rules. The purpose of the COBS rules is to set out detailed guidance on how staff and representatives of regulated businesses should deal with customers. COBS incorporates the MiFID requirements (see *Markets in Financial Instruments Directive II (MiFID II)* on page 8/24) and also introduces a more principles-based regime for regulated firms.

The COBS rules apply to all regulated life and pension and investment businesses, as well as to banks and building societies in their investment activities. Many rules only affect specific regulated activities and some cover how regulated firms should carry on unregulated activities. They apply mainly, however, to investments that were previously regulated under the Financial Services Act 1986 – for example, most long-term insurance and unit trusts. For this reason, they have limited application to deposit-taking and pure protection life insurance. Home finance and general insurance business are subject to separate Conduct of Business sourcebooks.

C1B COBS obligations (COBS 2)

Inducements

A firm must take reasonable steps to ensure that it does not offer, give, solicit or accept an inducement, or place business in any way likely to conflict to a material extent with any duty owed to customers. For packaged products (life and pension policies, open-ended investment companies and unit trusts), volume overrides of commission for intermediaries are forbidden. Legacy commission can only be paid to the intermediary responsible for the sale unless:

- the intermediary responsible for the sale has passed on its right to the commission to the recipient;
- another firm has given advice on investments to the same customer after the sale; or
- it relates to the sale of a packaged product by a direct offer advertisement to a customer of the firm.

Indirect benefits

The FCA has many other rules on benefits, designed to prevent intermediaries being swayed in their recommendations by incentives other than straight monetary amounts. The rules, thus, seek to ban many indirect benefits and 'under-the-table' payments and services.

Goods and services guidelines	
Selling	• product literature without the intermediary name can be supplied; • product promotion to enhance customer service is allowed; • intermediary seminars can be attended by provider staff for genuine business purposes.
Gifts/extras	• a provider can give advice on its products but not generally; • IT hardware can be given only as part of a software project; • gifts and hospitality of a 'reasonable de minimis value' are allowed, such as food and drink during a business conference, meeting or seminar; • providers can run seminars for intermediaries but cannot pay expenses; • providers can pay 'reasonable fees' to intermediaries who participate in market research.

For reference only

Chapter 6

Goods and services guidelines	
Communications	• a provider can pay reasonable travel and accommodation costs for an intermediary visiting a UK office to understand the provider's administrative systems or when accompanied by a client or prospective client; • a provider can supply pre-paid envelopes such as for forwarding completed medical reports or client agreements.
Training	• training facilities can be supplied (with or without charge) if the provider makes them generally available for intermediaries; • the provider can pay or contribute to any reasonable travelling or accommodation expenses of the intermediary for this training.

Providers can supply goods and services to intermediaries, either free or for a charge, in accordance with the above guidelines.

In order to satisfy the client best interest rule the provider will, where realistic, make the benefits generally available for all intermediaries.

Records of any benefits given to an intermediary **must be kept for at least five years**.

Question 6.2

What does COBS incorporate and introduce?

C2 Regulatory rules for non-investment insurance advice (ICOBS)

We will now look at a brief summary of the **Insurance Conduct of Business Sourcebook (ICOBS)**. This, as the name suggests, applies to the sale of insurance products such as home, contents, motor and pet insurance. It also covers some protection products (which don't have an investment content) such as pure life insurance, income replacement insurance and private medical insurance.

C2A General standards

The selling and marketing of general insurance and pure protection life insurance is regulated by the FCA's ICOBS rules.

The ICOBS rules reflect the more principles-focused and risk-based approach the FCA wants to establish. Many of the detailed rules were removed and replaced with **high-level guidance**. One of the key differences in the new rules, and a good illustration of the FCA's risk-based approach, is the application of different rules to different product types. In order to enable this, the ICOBS handbook introduces three product categories: general insurance products, pure protection (term assurance, income protection and critical illness cover) and payment protection insurance (PPI).

ICOBS is divided into nine chapters as follows:

ICOBS 1: Application.

ICOBS 2: General matters.

ICOBS 3: Distance communications.

ICOBS 4: Information about the firm, its services and remuneration.

ICOBS 5: Identifying client needs and advising.

ICOBS 6: Product information.

ICOBS 6A: Product specific rules.

ICOBS 6B: Home insurance and motor insurance pricing.

ICOBS 7: Cancellation.

ICOBS 8: Claims handling.

Under ICOBS, insurers and intermediaries require authorisation to carry out regulated activities and an insurer must make sure that any intermediary it deals with is also authorised. The rules distinguish between consumers and commercial customers (who get less protection) and vary according to whether the sale is with or without advice. The rules apply to renewals as well as new business, as general insurance policies are normally one-year contracts not permanent ones.

Before offering any advice, an intermediary must supply the client with **initial disclosures** and/or **terms of business (ToB)**, giving details of the services offered and their authorisation status. An intermediary using a panel must also have available for clients a list of insurers with which it deals. It must also advise the client whether it is representing them or acting on behalf of the insurer.

The intermediary must then obtain details of a client's circumstances and needs, including existing policies, and give the client a statement of those needs together with reasons for any recommendations (this is known as a '**demands and needs statement**').

The above paragraph does not fully apply to sales made without advice (known as non-advised sales), however the intermediary must still collect sufficient information about the client to be sure that they are eligible to claim the benefits under the policy, and they must provide the client with a brief statement of demands and needs, setting out what the policy covers.

Where recommendations are made, these must be suitable and the intermediary must explain the duty of disclosure of material facts and its importance.

There are product disclosure rules relating to policy details, including claims and compensation. Policy documents must contain all contractual terms and conditions.

A **cancellation notice** must be sent for all life policies and life annuities except for:

- traded life policies;
- life policies for six months or less;
- policies where the customer, at the time they sign the application, is habitually resident in an EEA State other than the UK, or outside the EEA and is not present in the UK;
- pure protection contracts effected by the trustees of an occupational pension scheme, an employer or a partnership to secure benefits for employees or the partners in the partnership; and
- policies issued to corporate bodies (other than pension scheme trustees).

The cancellation period for general insurance is 14 days and 30 days for pure protection contracts and PPI.

Policies without cancellation rights

There are no cancellation rights for:

- travel or similar short-term policies lasting less than one month; or
- policies where performance has already been completed.

The client must be given notice 'in good time' (usually 21 days in practice) of renewal terms or when the insurer is declining to renew the contract.

Refer to

See *The Fit and Proper test for employees and senior personnel (FIT)* on page 10/10, for more on conflicts of interest

In any claim the intermediary must inform the client if it is acting for the insurer as well and carefully manage any **conflicts of interest**. If the intermediary acts for the client it must do so with **due skill, care and diligence**.

Clients must be given guidance on claims procedures and the insurer must handle claims fairly and promptly. If a claim is rejected the reasons why must be clearly explained. The insurer must not unreasonably reject a claim. Unless there is evidence of fraud, the insurer must not refuse a claim on grounds of **non-disclosure** of a material fact that a retail customer could not reasonably be expected to have known.

Be aware

The **Consumer Rights Act 2015** (see *Unfair contract terms and the Consumer Rights Act 2015* on page 6/36) has a requirement to 'perform a service within a reasonable time'. This legislation adds another dimension for insurers to consider, in addition to the ICOBS requirement that claims should be managed 'promptly'. We will consider this legislation in more detail in *Consumer Credit Act 2006* on page 6/35.

Question 6.3

ICOBS introduces three product categories. What are these?

C3 Regulatory rules for home finance advice (MCOB)

The FCA is responsible for the regulation of mortgage lending and advising, home reversion plans, and sale and rent back (SRB) agreements.

We will now look at the Mortgage Conduct of Business Rules (MCOB) and how they apply to practitioners in the home finance industry.

C3A Mortgages

Mortgage firms that require regulation are those which carry out regulated activities and they, therefore, fall into one or more of the following categories:

- lenders;
- administrators;
- arrangers; and
- advisers.

The way in which firms and individuals operate will have an effect on how the MCOB applies to them:

- **Direct authorisation** – the firm or individual will be wholly responsible for complying with MCOB and other FCA requirements.
- **Appointed representative** – the responsibility for compliance lies with the principal (who could be a lender, a network or an intermediary).
- **Introducer status** – the firm or individual merely passes on 'leads' to an authorised person who will pay the introducer for that lead. The introducer does not require FCA authorisation as they themselves will not be advising the client.

In addition, there are three ways in which a mortgage intermediary can bring customers and lenders together. The customer must be clear on which type of service is being provided. The intermediary can deal with:

- the whole market;
- a limited number of lenders; and/or
- a single lender.

Regulated mortgage contracts

The FCA regulates mortgage contracts where the:

- lender provides credit to an individual (or trustees);
- obligation is secured by a legal first mortgage on land in the UK; or
- **at least 40% of the property is to be used as a dwelling** by the borrower or a related person.

It includes where the loan is secured on a second or subsequent charge and consumer (not commercial) buy-to-let mortgages.

This means that where the borrower is a company (e.g. a commercial mortgage for the purchase of an office block, whether for occupation or buy-to-let) the contract is not regulated.

Information versus advice

The FCA has different regulatory requirements for **information** and **advice** and it is important to understand the differences.

Information is accurate and neutral facts about a mortgage with no comment or opinion given as to its merits relative to other products or options. This would include:

- explaining the terms and conditions of several mortgages;
- comparing interest rates or features and benefits; and
- using scripted questions or decision trees to help a client decide what the best product or option for them would be.

Advice involves giving an opinion on the merits of a **particular product** and/or its suitability for a **particular customer**. This therefore does **not** include:

- making a general recommendation to switch from, say, a fixed mortgage to a variable mortgage; or
- general advice on the advantages and disadvantages of borrowing in order to buy a property, compared with renting.

As we have seen, one of the FCA's core principles is that firms must pay due regard to the information needs of its clients and communicate information to them in a way that is **clear, fair and not misleading**. The MCOB rules set out detailed guidance as to what a firm needs to do to comply with this principle. For example, in order to ensure that there is uniformity in the market as to the meaning of various terms, firms must use *standard terms* and meanings in their communications with customers such as:

- Early repayment.
- Higher Lending Charge.
- Lifetime mortgage.

Principle 6 requires that a firm must pay due regard to the interests of its customers and treat them fairly. Customers must not feel pressed into effecting a mortgage nor should they feel committed to effecting a mortgage contract until they have had a chance to fully consider the illustration and mortgage offer. An example of a breach would be where the customer is presented with an illustration, offer and mortgage deed together, and asked to sign the mortgage deed when there is no need to do so at that time.

Other rules
The MCOB also contains rules on:

- qualifying credit promotions;
- real time and non-real time credit promotions;
- advising and selling standards;
- disclosure requirements;
- suitability;
- calculation of **annual percentage rate (APR)**; and
- responsible lending, charges and arrears and repossessions.

C3B Home purchase plans, home reversion plans or regulated sale and rent back agreements

Firms must ensure that the interests of customers under home purchase plans, home reversion plans or regulated sale and rent back agreements are protected to a reasonable standard.

The steps that a firm might take to protect its customers' interests will depend on a number of factors, including the nature and structure of the arrangement and the jurisdiction in which the property is situated. If it is not possible to achieve reasonable protection then a firm should not enter, arrange or administer the plan.

Home reversion plans
These are one type of equity release scheme (the other is **lifetime mortgages** - see *Equity release* on page 2/7). They are generally aimed at older homeowners and are designed to enable them to benefit from the value of their homes without having to move out of them.

A home reversion firm either buys the customer's home or a part of it at a discount to the market price, or arranges for someone else to do so. In return the customer gets a cash lump sum or an income. The home, or the part of it they sell, now belongs to someone else, but the customer is allowed to carry on living in it until they die or move out. If the customer gets a cash lump sum they may decide to invest this to provide an income.

A home reversion can be a useful way of releasing equity from a home but can also be a high-risk product, so the customer must be sure it is right for them. These plans have significant implications for tax, benefits, inheritance and long-term financial planning.

There are two key points to note when selling home reversion schemes:

- Consumers should get clear, concise and consistent information about the firm's services and the products on offer (including appropriate risk warnings) so they can make informed choices.
- Consumers should get good quality advice and be sold suitable products which take account of their circumstances and needs.

Sale and rent back (SRB)
The SRB market involves individuals selling their home, usually at a discount, and obtaining an agreement to remain in the property for a set period. Typically, this would be through an assured short hold tenancy, in the past often of only six to twelve months.

The rules are designed to help protect consumers. The FCA wants to prevent high-pressure and inappropriate sales, and help consumers understand SRB products so they only enter into one where it is an appropriate and sustainable solution.

The full SRB regime applies by:

- ensuring consumers have better security of tenure through a fixed-term tenancy agreement of at least five years;
- requiring that in every sale firms check that the consumer can afford the deal and it is right for them – non-advised sales will not be allowed;
- requiring firms to make sure that the consumer has checked their ongoing entitlement to benefits;
- introducing a cooling-off period of 14 days to give consumers more time to make decisions;
- banning cold calling and prohibiting firms from dropping promotional leaflets through letter boxes;
- prohibiting the use of emotive terms like 'fast sale', 'mortgage rescue' and 'cash quickly' in promotional literature;
- requiring firms to provide consumers with additional information to help them make informed decisions; and
- ensuring that an independent valuation is carried out where the valuer owes a duty of care to the consumer in all sales.

C3C Mortgage Market Review (MMR)

The MMR was the biggest set of reforms to regulation since residential mortgages became subject to statutory regulation in 2004. The review sought to provide a more stable, and fairer lending environment so that borrowers were less likely to get into negative equity or default on their loans. On 16 May 2016, the FCA published the findings of its Responsible Lending Review into mortgage lending decisions.

The ramifications still continue to be felt, the most significant of which is that lenders are allowed to disregard some of the stringent requirements when lending on an interest-only basis when they are lending to existing interest-only borrowers wishing to borrow or to vary their existing loan without undertaking additional borrowing - see MCOB 11.7.3. The new rules are now fully embedded in lenders' processes and practices on new lending.

On the Web
More information on the MMR can be found on the FCA website: *bit.ly/2KIzXwj*.

Among the changes which were introduced was the introduction of an **affordability assessment** and obligation on lenders to make sure that borrowers could afford to service and repay the loan they were taking out; self-assessment of affordability would no longer be possible. Existing borrowers now have tighter rules on new borrowing.

Lenders are required to ensure that they do not treat 'trapped' borrowers (MCOB 11.8) who are unable to borrow on a new mortgage any less favourably than they would treat other customers with similar characteristics. Lenders are allowed – but not required – to apply transitional provisions (MCOB 11.7) when lending to borrowers who already had mortgages before the new MCOB rules came in.

Essentially, these allow lenders to 'switch off' some elements of the new affordability requirements as long as the borrower does not increase the size of their loan, and the change would be in the borrower's best interests.

Most mortgage transactions must now be advised, although execution-only sales are still possible in some situations, with advice compulsory for those in vulnerable groups.

C3D Mortgage Credit Directive (MCD)

The **Mortgage Credit Directive (MCD)** was an EU framework of conduct rules for mortgage firms which applies equally to first and **second charge mortgages** – so second charge mortgage regulation has moved from the consumer credit regime into the mortgage regime.

To undertake second charge mortgage business, lenders, administrators and brokers have to be authorised and hold the correct permissions. The FCA also has powers to register and supervise firms carrying out consumer buy-to-let (CBTL) activity, as defined in the Government's legislative framework.

Adoption of the Directive resulted in some important changes to the MCOB rules, which mean that firms:

- need to provide a binding mortgage offer and seven-day (minimum) reflection period;
- need to give an adequate explanation of a product's essential features; and
- are subject to new disclosure requirements.

Disclosure

The rules require firms to issue a **European standardised information sheet (ESIS)**. This is a mandatory product disclosure document that has replaced the key facts illustration (KFI).

Note: This document is still referred to as an ESIS in MCOB despite the UK no longer being part of the EU.

Adequate explanations
Firms must provide an adequate explanation of the proposed mortgage contract and any ancillary services. The explanation must include the:

- pre-contract information;
- essential features of the product; and
- potential impact on the consumer (including the consequence of default).

The manner and extent of the explanation can vary depending on the circumstances of the sale. Firms should consider how an adequate explanation is provided for both advised and execution-only sales.

Commission disclosure
If firms are paid by commission, they must tell consumers that they have the right to ask for information on the commissions paid by different lenders. Firms must also ensure that they have access to relevant market data to allow them to respond to such a request.

Remuneration
Remuneration of advisers cannot be contingent on sales targets.

Second charge mortgage business
If an existing mortgage-holder wishes to borrow more, the rules require firms to make the customer aware that other forms of borrowing are available that may also meet their needs. Firms are not required to provide advice on the suitability of possible alternative options if these are outside the scope of service they have chosen to offer.

Firms' existing mortgage permissions permit them to arrange or advise on second charge mortgages and are now treated the same as first mortgages so provides must comply with disclosure requirements.

These include the need to:

- explain a product's essential features and the firm's disclosures adequately; and
- give customers an ESIS disclosure document.

Advice must be given if there is interactive dialogue between the firm and the customer during the sale, or if debt consolidation is the main purpose of the loan. Firms must recommend a product, or products, that are suitable for the customer based on an assessment of their needs and circumstances. If there is no suitable product, firms cannot recommend the product that is 'least worst'. However, firms do not have to recommend a single most suitable product.

Qualifications
The FCA requires mortgage sellers and advisers to obtain a relevant **Level 3 qualification**.

C4 Client assets and client money (CASS)

C4A Client assets

There are rules for the safeguarding of client assets designed to restrict the co-mingling of the firm's assets and clients' assets in order to minimise the risk of clients' assets being used by the firm without the clients' agreement, or being treated as the firm's assets in the event of insolvency. Thus, in general terms, a firm must **segregate clients' assets** from its own, in particular, by recording the legal title to the assets in the name of a client, a nominee company or a custodian.

All investment business client asset holding firms are required to create a 'CASS Resolution Pack' (CASS RP).

The CASS RP promotes the speedier return of client money and assets (CMA) to clients, once a firm has failed, by ensuring that vital CMA information is readily accessible to the Insolvency Practitioner appointed to that failed firm.

C4B Client money rules

The most important section of these rules is the client money rules.

These rules apply to firms which receive or hold money from or on behalf of a client. They do not apply to life offices, friendly societies or banks. Client money comprises cash and/or cheques payable to an intermediary.

A firm must hold client money **separate from its own money** in a client bank account. The money must normally be paid into the client bank account by close of business the next working day.

The client bank account must be so designated and be with an approved bank. This ensures that the money in the account is effectively **held on trust for the clients** and not available to the creditors of the firm if it becomes insolvent.

Interest on client money belongs to the client unless agreed otherwise. Client money reconciliation must be done 'as often as is necessary' and at least at intervals of no more than 25 days, with discrepancies corrected by the end of the day on which the reconciliation is performed.

CASS small firms don't need to complete a client money and asset return (CMAR). If a firm is or becomes a CASS medium or large firm holding client money equal to or over £1 million and/or assets equal to or over £10m, they must:

- complete a CMAR via RegData every month; and
- make a director or senior manager responsible for CASS (SMF18).

Many intermediaries do not have the authority to handle client money and so must ensure that all cheques or other payments for investments arranged are payable directly to the product provider. In these circumstances, they do not need client money accounts.

Firms with client money permissions have additional responsibilities under the SM&CR, including the allocations of specific responsibilities concerning the safeguarding of client assets to a sufficiently skilled senior manager.

Consider this…
Do you know if this is relevant to your firm?

C5 Market conduct (MAR)

The FCA includes in its Code of Market Conduct prohibitions on:

- disseminating false or misleading information;
- giving a false or misleading impression; and
- making artificial transactions.

Refer to
See *Enforcement in the civil and criminal courts* on page 5/13, for more on market abuse

The Market Conduct (MAR) handbook refers extensively to the **Market Abuse Regulation 2016**. This legislation identifies market abuse offences such as insider dealing and market manipulation. The MAR handbook includes examples of market abuse, as well as exclusions and behaviour which should not be considered market abuse. There are no FCA rules which permit or require a person to behave in a way that amounts to market abuse.

Example 6.2
An example of market abuse would be someone tipping shares which they have already bought hoping that the resultant increased demand will send the price up, enabling them to make a profit.

The FCA can impose **unlimited fines for market abuse**.

Consider this…
Why would the FCA not want to put limits on the levels of fines which can be imposed for market abuse?

C6 Product Intervention and Product Governance (PROD)

Product intervention rules are rules made under FSMA which apply to specific products (or types of products), product features or marketing practices relating to specific products. They may be made without consultation but are limited to a maximum duration of 12 months and are referred to as 'temporary product intervention rules'.

Product oversight and governance refers to the systems and controls firms have in place to design, approve, market and manage products throughout the product's life cycle to ensure they meet legal and regulatory requirements. Good product governance should result in products that:

1. meet the needs of one or more identifiable **target markets**;
2. are sold to clients in the target markets by **appropriate distribution channels**; and
3. deliver appropriate client outcomes.

PROD doesn't just apply to the design and manufacture of products. The manual was extended as a result of **MiFID II** in 2018. PROD 3.3 requires product distributors (such as advisers) to:

1. **understand** the financial instruments they distribute;
2. **assess** the compatibility of the financial instruments with the needs of the clients to whom they distribute investment services, taking into account the manufacturer's identified target market; and
3. ensure that financial instruments are **distributed only when in the best interests of the client** (in line with COBS 2.1.1R(1)).

This was extended in 2023 to include consideration of the requirements in ESG 4 regarding the distribution of products with sustainability labels.

C7 Environmental, social and governance (ESG)

The ESG sourcebook sets out rules and guidance concerning a firm's approach to environmental, social and governance matters. The sourcebook was greatly extended in 2023 with the inclusion of ESG 3, 4 and 5 which are related to the Sustainable Disclosure Requirements (SDR) as published in PS23/16.

Disclosure of climate-related information (ESG 2)
ESG 2 rules and guidance on the disclosure of climate-related financial information are consistent with the four recommendations set out by the Task Force on Climate-related Financial Disclosures (TCFD) in its final report. The recommendations fall under the following four categories:

Governance	Strategy	Risk management	Metrics and targets
Disclose the organisation's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.	Disclose how the organisation identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

On the Web
Recommended disclosures are given under each recommendation and are found on p. 14 of the TCFD report:
assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf.

Sustainability labelling, naming and marketing (ESG 4)
SDR introduced four sustainability labels which firms can apply for permission to use on their investment funds:

- Sustainability Focus.
- Sustainability Improvers.
- Sustainability Impact.
- Sustainability Mixed Goals.

The use of these labels by a firm must be constantly reviewed. If the criteria for using the label are no longer met, a firm must cease doing so as soon as reasonably practicable. Periodic reviews should take place at least every twelve months and these should be recorded. When a manager identifies that it no longer meets the prerequisites for a label, it must give notice to investors.

Where a manager uses a sustainability label, it must be done in a way that is not misleading, doesn't claim that the FCA has approved the use of the label in relation to a product or indicate that a sustainability product has been approved or endorsed by the FCA. Managers are also prohibited from publishing any information in relation to the use of or description of a sustainability label which contradicts the information that has been published by the FCA.

While these rules may seem to be more about the requirements of product manufacturers, such as investment managers, they also place additional regulatory requirements on the distributors of sustainability products which may include advisers.

When communicating with clients about a sustainability product which uses a sustainability label, firms must:

- Ensure that retail clients are provided with access to the appropriate **consumer-facing disclosure** produced by the manager for that product.
- Communicate the same label that the manager is using in relation to that product when displaying the labels digitally or in any other means of communication with a client.
- Update any financial promotions regarding sustainability products to reflect changes made by the manager.

When an adviser recommends an investment which is domiciled overseas and therefore not subject to UK regulations but contains the restricted terms detailed in ESG 4.3.2, it must include the following warning:

> *This product is based overseas and is not subject to UK sustainable investment labelling and disclosure requirements.*

Criteria for applying for a sustainability label
All sustainability products which use a sustainability label must meet the following criteria:

- **Explicit objective**: Have an explicit sustainability objective which aligns with the specific label it wishes to use and is clear, specific and measurable.
- **70% Rule**: Have at least 70% of the gross value of the assets invested in accordance with the sustainability objective (with some exceptions such as for investments which are still being fully deployed).
- **Robust standards of sustainability**: Assets must be selected in line with a robust evidence-based standard that is 'an absolute measure of environmental and/or social sustainability' (ESG 4.2.4 R).
- **No conflicts**: Where a product invests in assets which are not in line with its sustainability objective, these must not have attributes which conflict with that objective.

Where managers are using an index tracking methodology, they must only use one whose methodology aligns with the sustainability objective and meets the above criteria.

Managers have a detailed set of rules which they need to adhere to in order to ensure that the sustainability characteristics of the investments they select and manage are sufficiently robust to meet the labelling criteria. This includes any stewardship activities they might undertake and the resources required.

Stewardship

The United Nations Principles for Responsible Investment (UNPRI) define stewardship as 'the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend.'

In other words, it is the exercise of influence over the companies in which the investment manager invests, either through exercising voting rights or in interactions with the board and senior management of an investee company.

Stewardship may take different forms depending on the types of assets in which a manager invests. Managers must have a stewardship strategy which outlines how their stewardship activities will deliver the necessary sustainability objectives. Where it plays a significant role firms are expected to develop key performance indicators (KPIs) relevant to the outcomes they expect to achieve.

Specific criteria for each of the four labels are set out in ESG 4.2.12–19.

Label	Criteria
Sustainability Focus	This label can be used where the sustainability objective is consistent with investing in assets that are environmentally and/or socially sustainable, determined using a robust, evidence-based standard.
Sustainability Improvers	This label can be used where the product's sustainability objective is consistent with investing in assets that have the potential to improve environmental and/or social sustainability over time, determined by the potential of those assets to meet a robust evidence-based standard that is an absolute measure of environmental or social sustainability. They must also: • Identify the timeframe over which the assets are expected to meet the standard. • Identify targets over the short and medium terms for improvements in the sustainability of the product or assets. • Obtain evidence to confirm that the assets have the potential to meet the standards required.

Label	Criteria
Sustainability Impact	This label can only be used where the product's sustainability objective is consistent with the aim of achieving a pre-defined, positive, measurable impact in relation to an environmental and/or social outcome. It must also specify a: • theory of change, describing how its investment activities and the product's assets will contribute to achieving a measurable impact in line with the standards required. • robust method to measure and demonstrate that the investment activities undertaken and the product's assets are achieving measurable positive environmental or social impact.
Sustainability Mixed Goals	This label can be used when the manager wishes to invest in line with two or more of the 'focus', 'improver' and 'impact' labels. The manager must also identify how much of the fund's assets will be invested in line with each of the above and that they meet the requirements.

The anti-greenwashing rule (ESG 4.3.1)

The rule applies to all firms when communicating with clients or conducting financial promotions, regardless of whether they are undertaking sustainability business.

Firms must ensure that any reference to the sustainability characteristics of a product or service are:

- consistent with the sustainability characteristics of the product or service; and
- fair, clear and not misleading.

A manager has additional requirements when undertaking business with retail clients and using any of the following terms, either in the naming of a fund or in a financial promotion about the characteristics of the product:

- ESG;
- environment, environmental or environmentally;
- social or socially;
- climate;
- sustainable or sustainability;
- green;
- transition;
- net zero;
- impact;
- responsible;
- sustainable development goals (SDGs);
- Paris-aligned; and/or
- any other term which implies that a sustainability product has sustainability characteristics.

(Source: FCA ESG 4.3.2)

The rules also stipulate that the above terms can only be used when making short factual statements, which are not financial promotions, or where making statements not intended to refer to or describe the sustainability characteristics of a sustainability product. This would not apply, for example, when discussing the economic 'impact' of a change in interest rates. While managers who are using sustainability labels can use the terms in the naming of their funds, the use of 'impact' is restricted to those using the sustainability impact label.

On the Web

The FCA published additional guidance on the anti-greenwashing rule in April 2024 to help firms understand their requirements: *www.fca.org.uk/publications/finalised-guidance/fg24-3-finalised-non-handbook-guidance-anti-greenwashing-rule*.

Firms should also be aware that the Advertising Standards Authority (ASA) has published guidance on misleading environmental claims and social responsibility through the Committee of Advertising Practice (CAP). This guidance is relevant to firms that may be undertaking work in this area, regardless of whether their activities are covered by the anti-greenwashing rule: *www.asa.org.uk/resource/advertising-guidance-misleading-environmental-claims-and-social-responsibility.html*.

Non-labelled products
Managers who are not applying for the use of a label for a fund, but are still undertaking sustainability business, are allowed to use the terms provided they produce additional disclosures. They are still not allowed to use the terms 'sustainable', 'sustainability' or 'impact' in the name of the fund or in referring to the characteristics of the product. These funds must also have appropriate disclosure documents, including customer-facing disclosures regarding their sustainability characteristics. The disclosures must also include an explanation of the sustainability labels, their purpose, that the fund does not have a label and an explanation of why a label is not used.

Disclosure of sustainability-related information (ESG 5)
Managers of sustainable funds (both those with and without labels which use the words listed in ESG 4.3.2) must produce additional disclosures for the investments they offer. These include consumer-facing disclosures and pre-contractual disclosures.

Consumer-facing disclosures (ESG 5.2)
These must be no more than two A4 pages in length and include the sustainability product's sustainability objective, clearly signposted as its 'sustainability goal'. It must contain a summary of the following:

- Any material effect on the financial risk and return of the product as a result of the investment strategy being used to achieve the sustainability objective.
- The product's progress towards its sustainability objective.
- Any negative environmental or social outcomes that may arise in pursuit of the sustainability objective.

The disclosures must also specify the label the manager is using in relation to that product, along with clearly specified wordings as set out in ESG 5.2.2(6)R.

The manager must include a summary of the investment policy and strategy in relation to the sustainability characteristics in plain English. It should include the:

- manager's sustainability approach;
- sustainability characteristics of assets in which the product will and will not invest; and
- types of assets which the product invests in for reasons other than the sustainability objective (such as derivatives for hedging currency exchange risks).

The disclosure must also explain the manager's approach to stewardship and the key performance indicators or metrics that are being used to assess whether the product is meeting its sustainability objectives.

Be aware

When involved in the distribution of sustainability products, distributors (including advisers) must ensure that retail clients are provided with access to the consumer-facing disclosure relevant to any products.

Pre-contractual disclosures (ESG 5.3)
These disclosures are more detailed and contain additional information, such as whether the manager is a signatory to the UK Stewardship Code, or the index tracking methodology used in the case of an indexing investment.

As this disclosure is more technical, it does not have the same plain English requirements as consumer-facing disclosures.

Sustainability reports (ESG 5.4)
Managers of sustainability funds must produce an annual sustainability report, whether or not they use the FCA labels. Managers are also required to produce a sustainability entity report at a firm level which may intersect with the TCFD disclosure requirements in ESG 2.

The purpose of the sustainability report at a product level is to demonstrate the product's progress towards achieving its sustainability objective and its performance against relevant KPIs. Where explanations to retail clients are required, reports should include relevant contextual information on how they should be interpreted, as well as any assumptions used. In the case of sustainability impact funds, there are additional requirements to demonstrate how the product's assets are making progress towards measurable, positive environmental or social outcomes.

D Regulatory Processes

Refer to
Regulatory processes are dealt with in more detail in *Core regulatory principles and rules* on page 7/1

The fourth section of the FCA Handbook, ‘Regulatory Processes’, contains the manuals describing the **operation of the FCA’s supervisory and disciplinary functions**:

Sourcebook or manual	What does this include?
SUP Supervision	This manual sets out what the FCA does to ensure that firms are complying with their requirements, including the requirements on what information you need to report to the FCA and when.
DEPP Decision Procedure and Penalties	A description of the FCA’s procedures for taking statutory notice decisions, the FCA’s policy on the imposition and amount of penalties and the conduct of interviews.

D1 Decision procedure and penalties (DEPP)

The FCA can both react to events or may be proactive in taking the initiative.

Enforcement
As set out in *Scope* on page 5/10 and *Enforcement in the civil and criminal courts* on page 5/13, the regulator can investigate problems with, or suspicions about, firms and take appropriate action. It is the distributor's responsibility to ensure retail clients receive access to consumer-facing disclosures for sustainability products.

Question 6.4

When an adviser is involved in the distribution of a sustainability product, whose responsibility is it to ensure that retail customers have access to the consumer-facing disclosures?

Disciplinary action
The FCA can take several types of disciplinary action against both firms and individuals, including:

- making public announcements;
- levying fines;
- setting conditions on future business;
- obtaining a court injunction;
- ordering compensation to customers;
- withdrawing authorisation; and/or
- prohibiting individuals from carrying on regulated activities.

There are a number of offences under the FSMA for which the FCA can institute prosecutions. These include:

- carrying on a regulated activity without authorisation or exemption;
- falsely describing oneself as authorised or exempt;
- promoting an investment unless authorised, or the promotion is approved by an authorised person;
- breaching a prohibition order;
- failure to cooperate with an FCA investigation or falsifying, concealing or destroying documents in connection with an FCA investigation;
- failure to inform the FCA of a change of control of an authorised firm; and
- giving materially false or misleading information to the FCA.

Fines

The FCA has stated that firms must not use insurance to pay FCA fines and that an individual's fine cannot be met by the firm (i.e. it must therefore be borne by the individual alone).

If you want to know how often the FCA issues fines, click here: *www.fca.org.uk/news/news-stories/2020-fines*.

Disciplinary action has been taken by the FCA over a wide range of topics. Examples include:

- giving what turned out in hindsight to be poor advice on pensions;
- failing to properly control sales forces;
- failing to prove that endowments were correctly sold to mortgage borrowers;
- losing records;
- supplying false information;
- selling PPI policies to individuals who were not covered by the terms of the insurance;
- providing false or fraudulent information on mortgage applications;
- failing to submit RegData reporting regulatory returns;
- failing to protect client assets, especially client money; and
- failing to deal with complaints properly.

These measures are sometimes known as **regulatory sanctions** to distinguish them from criminal prosecutions.

Refer to

See *Ethics and professional standards* on page 11/1 for more on professional ethics

It is also an offence under s.397 to:

- make a statement, promise or forecast known to be misleading, false or deceptive in a material particular;
- dishonestly conceal any material facts; or
- recklessly make (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular, if this is for the purpose of inducing another person to enter into, or offer to enter into, or refrain from entering into a regulated investment or to exercise, or refrain from exercising rights under a regulated investment.

Any offence by a company is also an offence by an officer of the company if it was done with the officer's consent, connivance or is attributable to the officer's neglect.

D1A Notification requirements

Under the FSMA 2000 the FCA is required to notify any person who is the subject of an investigation by its officers that the investigation is under way. The notice must state the reason for the investigation and the provisions under which the investigator has been appointed. If there is a change in the scope or conduct of an investigation and the person under investigation is likely to be significantly prejudiced if not made aware of this, then written notice of the change must be given. This can happen, for example, if a person is likely to incriminate themselves inadvertently by not knowing of the change in scope.

Exceptions to this notification requirement include the investigation of possible insider dealing, market abuse or misleading statements plus breaches of the restriction on financial promotion or promoting collective investment schemes. In these instances the investigator may not know the identity of the perpetrator at the outset of the investigation, or may be looking into market circumstances rather than investigating a particular person or persons.

D1B Upper Tribunal (Tax and Chancery Chamber)

The Upper Tribunal (Tax and Chancery Chamber) (formerly known as the Financial Services and Markets Tribunal – as set up under s.132 of the FSMA) is the appeal body for those aggrieved by decisions of the FCA. The Upper Tribunal is an independent judicial body which hears references arising from certain decisions and supervisory notices issued by the FCA.

Examples of the kinds of decisions which may be referred to the Tribunal include:

- disciplining authorised firms and approved persons;
- varying a firm's permission to conduct certain or all regulated activities;
- matters relating to market abuse;
- withdrawing individual approval; and
- making prohibition orders banning people from employment relating to certain or all regulated activities.

The Upper Tribunal is part of HM Courts & Tribunals Service, an executive agency of the Ministry of Justice. Following an appeal it can uphold the FCA's decision or overrule it. Any person aggrieved by a decision of the Tribunal can appeal against it to the Court of Appeal, but only on a point of law.

E Redress

Refer to

The issue of redress within the regulatory framework is covered in detail in *Core regulatory principles and rules* on page 7/1

The fifth section of the FCA Handbook, 'Redress', contains the processes for handling complaints and dealing with compensation:

Sourcebook or manual	What does this include?
DISP Dispute resolution: Complaints	The procedures a firm will need to have in place to handle any complaints made by its customers and the rules that apply to firms subject to the Financial Ombudsman Service (FOS). (See *Financial Ombudsman Service (FOS)* on page 7/36)
CONRED	This part of the Handbook relates to consumer redress schemes. A consumer redress scheme is a set of rules under which a firm is required to: • investigate whether it has failed to comply with requirements applicable to an activity it has been carrying out; • determine whether the failure has caused (or may cause) loss or damage to consumers. If it has caused (or may cause) loss or damage, the firm must determine what the redress should be and make that redress to consumers. CONRED 2 specifically covers the Arch Cru investment funds and their suitability.
COMP Compensation	Information on the Financial Services Compensation Scheme (FSCS), which is the scheme to compensate customers if the firm responsible for their loss is not able to pay the claim. (See *Financial Services Compensation Scheme* on page 7/38)

Chapter 6

E1 FCA Complaints scheme

The FCA has set up arrangements, as required by the FSMA, for investigating complaints made against it. Complaints may be made by anyone directly affected by its actions or inaction – that is, regulated firms, individual employees of firms, listed companies, consumers etc.

The FCA will not investigate complaints about:

- rules or guidance;
- firms it regulates; or
- the actions or inaction of the Financial Ombudsman Service, the Financial Services Compensation Scheme or the Money Advice Service.

Those who are unhappy with the response they receive to a complaint made to the FCA can refer this to ***The Financial Regulators Complaints Commissioner***. The Commissioner's role is to independently review complaints about the actions or inaction of the UK's current financial services regulators, the FCA, the PRA and the Bank of England (but only in respect of its oversight of the banking clearing houses and payment schemes), and also the Payments Systems Regulator.

The Commissioner's report following a referred complaint may include recommendations to the FCA, for example, that it makes an *ex gratia* payment to the complainant. However, the FCA decides whether to do so. The Commissioner publishes an annual report on its work to which the FCA issues a response.

Complaints against the FCA, PRA and Bank of England

The complaints regime for the FCA, PRA and Bank of England includes the following:

- Regulators must deal with complaints within four weeks and, where that is not possible, will arrange a timetable with the complainant.
- The FCA will process complaints submitted centrally even if the complaints are about one of the other regulatory bodies.

Be aware

The FCA is proposing a revised version of the complaints scheme. The consultation was undertaken in 2020 and the outcome is pending at the time of writing.

F Other FCA Handbook material

F1 Specialist sourcebooks

This section of the FCA Handbook contains the requirements applying to some individual business sectors.

These are:

- 'Collective Investment Schemes' (COLL), the requirements for collective investment schemes (which replaced the previous CIS);
- 'Credit Unions' (CREDS), the new requirements applying to credit unions from January 2012 (replacing the old CRED);
- 'Consumer Credit' (CONC), the specialist sourcebook for credit-related regulated activities;
- 'Investment Funds' (FUND), the requirements for firms covered by AIFMD;
- 'Professional Firms' (PROF), the requirements applying to professional firms (whether exempt or authorised);
- 'Regulated Covered Bonds' (RCB), the requirements relating to regulated covered bonds; and
- 'Recognised Investment Exchanges and Recognised Clearing Houses' (REC), the requirements applying to recognised bodies.

F2 Listing, prospectus and disclosure rules

The UK listing rules are:

- Listing Rules (LR), the UK listing rules.
- Prospectus Regulation Rules (PRR), the UK listing prospectus rules.
- Disclosure Rules and Transparency Rules (DTR), the UK listing disclosure rules.
- Product Disclosure (DISC), the sourcebook containing additional rules and guidance from the FCA following its amendments to the UK rules for Packaged Retail Investment Products (PRIIPs).

Product Disclosure and PRIIPs

With the development of the DISC rules, the FCA sought to redress any uncertainty over whether products fall within the definition of a PRIIP, particularly certain types of debt securities, and to detail the disclosure required.

While the DISC handbook provides information on what may or may not be a PRIIP under certain circumstances, the rules and guidance for key investor information are provided in the COLL sourcebook.

F3 Handbook Guides

These are aimed at giving a basic overview of certain topics. They point firms in the direction of material in the Handbook applicable to them. The guides include:

- 'Energy Market Participants' Guide (EMPS);
- 'Oil Market Participants' Guide (OMPS);
- 'Service Companies' Guide (SERV); and
- 'General guidance on Benchmark Submission and Administration' Guide (BENCH).

F4 Regulatory Guides

The principal guides are summarised below.

The Wind-down Planning Guide (WDPG)
This is intended to help firms (especially those of a smaller size or a simpler operating model) to develop an effective wind-down plan. It aims to enable a firm to cease its regulated activities and achieve cancellation of its permission with minimal adverse impact on clients, counterparties or wider markets.

It includes scenarios in which the firm undertakes a strategic exit, as well as unexpected crises or insolvency that makes the firm unviable.

A wind-down plan can also help a firm to assess if it would have adequate resources (e.g. capital, liquidity, knowledge and manpower) to wind down in an orderly manner, especially under challenging circumstances.

The WDPG also includes a handy Quick Reference Guide (WDPG APP 1–12) which is there to help firms put the theory of wind-down planning into action.

The Enforcement Guide (EG)
This describes the FCA's approach to exercising the main enforcement powers given to it by the FSMA and by the Consumer Rights Act 2015.

Part 1 contains:

- an overview of enforcement policy and process;
- the FCA's approach to enforcement;
- the use of its main information gathering and investigation powers; and
- the conduct of investigations, settlement and publicity.

Part 2 contains an explanation of the FCA's policy concerning specific enforcement powers, such as its powers to:

- vary a firm's Part 4A permission on its own initiative;
- make prohibition orders; and
- prosecute criminal offences.

It also includes powers which the FCA has been given under legislation other than the FSMA.

Financial Crime: a guide for firms (FCG)
This is important to all financial services firms and their advisers as it explains steps that firms can take to reduce the risk of being used to further financial crime, and by doing so help themselves to meet relevant legal obligations.

It contains guidance, in the form of self-assessment questions and examples of good and poor practice, which firms can use to assess and improve their existing approaches to meeting their legal and regulatory obligations in relation to financial crime.

It is therefore important for a firm to be aware of the guidance it contains and, where appropriate, to consider how to translate it into more effective policies and controls.

Be aware

The Guide does not contain rules and imposes no additional requirements on firms – so a firm won't have to 'comply' with its contents.

Financial Crime Thematic Reviews (FCTR)
This contains various thematic reviews carried out on different sectors such as:

- FCTR10 –The Small Firms Financial Crime Review (2010); and
- FCTR11 – Mortgage fraud against lenders (2011).

The Perimeter Guidance Manual (PERG)
The purpose of this manual is to give guidance about the circumstances in which authorisation is required, or exempt person status is available, including guidance on the activities which are regulated under the act and the exclusions which are available.

The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)
This presents the FCA's views on what the combination of Principles for Businesses and detailed rules require respectively of providers and distributors in certain circumstances to **treat customers fairly**.

It is not, and does not seek to be, a complete exposition of all of a provider's or a distributor's responsibilities to the customer or to each other.

The MiFID II Onshoring Guide (M2G)
This guide contains two different guides for firms dealing with the post-Brexit onshoring of the **Markets in Financial Instruments Directive (MiFID)** in two areas:

M2G 1	Onshoring for trading venues and data reporting service providers	• This guide sets out an overview of the FCA's approach to onshoring of the MiFID II Directive in the MAR and REC sourcebooks. • Onshoring, for these purposes, refers to the process by which law deriving from EU legislation at IP completion day is retained or adapted post IP completion day. • The guide focuses on the regulatory regime in MiFID II for UK trading venues (as defined by 2(16A) MiFIR which comprises UK regulated markets, multilateral trading facilities and organised trading facilities, but not systematic internalisers) and UK data reporting services providers (DRSPs).

M2G 2	Onshoring of senior management arrangements and systems and controls obligations	• This guide sets out an overview of the FCA's approach to the onshoring of the MiFID II Directive in the SYSC sourcebook. • It focuses on the regulatory regime for UK firms and is aimed at UK MiFID investment firms, i.e. investment firms that would require authorisation under MiFID and credit institutions carrying out MiFID business, and MiFID optional exemption firms. (The latter comprises advisers or arrangers who do not hold client money or assets and meet other conditions imposed under article 3 MiFID II, so as to be exempt from the Directive's full application.) • This guide is useful in identifying which elements of the Handbook apply to **UK MiFID firms and 'optional exempt' firms**.

Other guides

The Regulatory Guides section also contains:

- The Collective Investment Scheme Information Guide (COLLG); and
- The Unfair Contracts and Consumer Notices Regulatory Guide (UNFCOG).

G Consumer credit and rights legislation

G1 Consumer Credit Act 1974

Refer to

Anti-money laundering and data protection law are covered in *Core regulatory principles and rules* on page 7/1

This Act affects persons, individual or corporate, **who provide any form of credit or advice on the obtaining or repayment of debt**. Many financial advisers will have a consumer credit license, e.g. if a client inherits money and has an outstanding mortgage, any advice they receive to repay this (in whole or part) is covered by the Consumer Credit Acts. Debt restructuring services are also included in this definition as they are effectively advice on the repayment of debt.

Agreements involving credit of not more than £25,000 are regulated by the Act, although some provisions apply to other loans. Some specified bodies, including insurance companies, can apply for exemption if such loans are secured on land. Building societies are specifically exempt.

Further exemptions were given by the **Consumer Credit (Exempt Agreements) Order 1989**. However, even exempt agreements cannot escape the Act entirely; requirements such as provisions regarding advertising, quotes and extortionate bargains will still apply. **Firms seeking to offer consumer credit must now be authorised by the FCA**.

Be aware

An intermediary tied to an insurance company under the **Financial Services and Markets Act 2000** must apply for their own licence – they are not covered by the insurance company's licence.

Some of the most important provisions of the Act are set out below:

- The form and the content of advertisements and quotations for loans and mortgages are regulated, including a requirement for the true APR to be quoted. In calculating the APR, lenders must now take account of all charges involved in arranging the loan. Furthermore, the lender is obliged to give the borrower all relevant information about the agreement and its operation. The exact formula for calculating the APR is set out in regulations made under the Act.
- The customer must receive one copy of the agreement for their own records when they are given or sent the agreement to sign. If, as often happens, the agreement is not actually made when they sign it, then they must be given a second copy later.

- Other provisions of the Act regulate the contents of the loan agreement itself. In particular there must be **cooling-off provisions** which allow the borrower sufficient time to change their mind and, if so desired, withdraw from the loan agreement. These cooling-off regulations give the borrower even more time for re-consideration if the loan is secured on land or property. They must be sent a copy of the agreement at least seven clear days before the actual agreement for signature is posted to them. During this time, and for a further period of seven days, the lender must not approach the client, so as to allow them time for further thought free from all possible selling pressure.
- In other cases, the borrower's **cancellation rights** extend to certain loans (not including those signed on the lender's own premises) where the right to cancel extends for five days after the borrower receives their second copy of the agreement.
- Credit reference agencies are required to disclose information held about a consumer and to correct any inaccuracies.
- Finally, there are provisions which stipulate the action which a lender is allowed to take, and the procedure which they must follow, to enforce a loan agreement and demand full repayment of the loan where a borrower defaults on regular repayments.

Be aware
Mortgage lending, mortgage and equity release advice are also regulated by the FCA.

G2 Consumer Credit Act 2006

The **Consumer Credit Act 2006** modified the 1974 Act in a number of ways:

- It changed the definition of the 'individual' entitled to protection from not just being a natural person, but to also include 'a sole trader, a small partnership (having three or fewer partners) and an unincorporated association'.
- A court can vary a credit agreement if it is unfair to the debtor.
- The jurisdiction of the FOS was extended to the consumer credit regime.
- **The £25,000 limit is removed** and replaced by exemption for loans over £25,000 for the purposes of a business carried on by the debtor and an exemption for high net worth debtors. The definition of a high net worth debtor is specified in regulations.
- Debt administration services and credit information services became regulated.

G2A FCA regulation of consumer credit

Any firm engaged in consumer credit activities must be regulated by the FCA.

Consumer credit includes hire purchase, credit card issuers, payday loan companies, pawnbrokers, debt management and collection firms and providers of debt advice.

Peer-to-peer (P2P) lending
The FCA considers that consumers borrowing or lending via peer-to-peer platforms should be provided with enhanced protections. Therefore, the FCA regulates peer-to-peer lending under the new regulated activity of 'operating an electronic system in relation to lending'.

In 2019, the FCA introduced additional rules to improve standards in P2P lending, including:

- an appropriateness assessment, to assess an investor's knowledge and experience of P2P where no advice is being given to the investor;
- minimum information requirements platforms need to provide to investors;
- clarifying what governance arrangements, systems and controls lending platforms must have;
- strengthening rules on wind-down plans for P2P platforms; and
- restricting marketing of platforms, to protect less-experienced investors.

This rule change (PS19/14) also makes MCOB and other elements of the Handbook applicable to P2P platforms that offer home finance products, where at least one of the investors is not an authorised home finance provider.

G2B Consumer Credit Directive

The **Consumer Credit Directive (CCD)** applies to all consumer credit agreements regulated under the Consumer Credit Act (other than agreements secured on land), but with modifications for certain types of agreement.

G3 Unfair contract terms and the Consumer Rights Act 2015

The **Consumer Rights Act 2015** reformed and simplified UK consumer law. The Act consolidated the rules previously laid down by the **Unfair Terms in Consumer Contracts Regulations 1999** and the **Unfair Contract Terms Act 1977**. It made things clearer for consumers, setting out the rights and the remedies available to them if things go wrong. The Act complements the **EU Consumer Rights Directive**.

The Act states that if a term of a contract is not transparent or prominent, it can be assessed for unfairness. A term is:

- **transparent**, if it is expressed in plain and intelligible language; and
- **prominent**, if it is brought to the consumer's attention in such a way that an average consumer would be aware of it.

The Act defines an average consumer as one who is 'reasonably well informed, observant and circumspect'.

To avoid challenges for unfairness, insurers need to ensure that the significant terms included in their insurance contracts with consumers, such as personal insurances, meet the rules on transparency and are communicated in a prominent fashion. If a contract term is deemed unfair it will not be binding, although consumers are still within their rights to rely on a term if they wish to do so.

These rules cover both the consumer contract (the policy itself) and notices, such as renewal invitations and customer promotions.

G3A The role of the FCA

Under the Consumer Rights Act 2015, the FCA is responsible for considering the fairness of standard terms in financial services contracts issued by FCA-authorised firms, or appointed representatives of firms that undertake any regulated activity. This means that the FCA is responsible for considering the fairness of terms in many types of financial services contracts, including those relating to:

- mortgages;
- general insurance;
- bank, building society and credit union savings accounts;
- life assurance;
- pensions; and
- investments/long-term savings.

If the FCA considers the Competitions and Markets Authority (CMA) to be better placed to deal with the matter, it will pass the case to the CMA for it to decide whether action is required and, if so, what is appropriate.

Refer to

See *Competition and Markets Authority (CMA)* on page 4/13 for more information.

Key points

The main ideas covered by this chapter can be summarised as follows:

High Level Standards (HLS)

- The Threshold Conditions are the minimum conditions that a firm must satisfy at all times if the firm is to retain its Part 4A permission to conduct investment business in the UK.
- The senior management of authorised businesses must have an adequate structure of systems and controls for the business.
- The partners, directors and senior managers need to understand their responsibilities, which should be formally written down.
- Each firm should appoint individuals to be personally responsible for the senior management prescribed responsibilities within the firm.
- Under SYSC a firm should have systems and controls that are ‘appropriate to its business’, i.e. according to its nature and size, as well as the risks that are associated with it.
- Firms must have procedures for whistle-blowing to someone in the firm or to the FCA, and should make staff aware of them.
- The GEN sourcebook sets out some of the underlying legal framework to FCA regulation and requirements regarding statutory status disclosure and also covers the following:
  - Referring to approval by the FCA.
  - Emergencies.
  - Statutory status disclosure.
  - The FCA logo.
  - The ‘Keyfacts’ logo.
  - Insurance against financial penalties.
  - Charging consumers for telephone calls.

Prudential Standards (PRU)

- The second block of the FCA Handbook, ‘Prudential Standards’, sets out the prudential requirements for firms (in broad terms this means a firm’s financial framework).
- All businesses must meet a general rule requirement that they are able to meet their financial obligations as and when they fall due.
- MIFIDPRU deals with the capital requirements of investment firms and covers specific elements relating to the capital resources calculations, such as: credit risk, market risk, concentration risk, counterparty risk and liquidity.
- MIPRU sets out the professional indemnity insurance and capital resources requirements for home finance providers and intermediaries, and general insurance intermediaries.
- IPRU-INV sets out the professional indemnity insurance and capital resources requirements for simpler investment firms. This sourcebook also covers the enhanced requirements for exempt CAD firms.

Business Standards

- The purpose of the Conduct of Business Sourcebook is to set out the detailed rules for how staff and representatives of regulated businesses deal with customers.
- The COBS rules apply to investment advisers.
- The ICOBS rules reflect the more principles-focused and risk-based approach the FCA is seeking to establish. These apply to general insurance advisers and insurers.
- The MCOB rules apply to practitioners in the home finance industry, e.g. mortgage advisers and lenders.

Key points

- The CASS rules help to safeguard client assets. A firm must segregate clients' assets from its own.
- Client money rules apply to firms which receive or hold money from or on behalf of a client.
- They do not apply to life offices, friendly societies or banks.
- Client money comprises cash and/or cheques payable to an intermediary.

Regulatory Processes

- Disciplinary action can be taken against firms and authorised individuals by the FCA resulting in a fine, orders for compensation to customers, withdrawal of authorisation etc.
- The Upper Tribunal (Tax and Chancery Chamber) is the appeal body for those aggrieved by FCA decisions.

Redress

- The Financial Regulators Complaints Commissioner's role is to investigate complaints and report to the complainant and the FCA.

ESG

- All firms should be aware of the anti-greenwashing rule and how this might impact their financial promotions.
- Substantial additional rules apply to the development and distribution of sustainability-related investments.
- Distributors, including advisers, of sustainability products must ensure that retail clients are provided with access to the relevant consumer-facing disclosures for investments.

Other FCA Handbook material

- The sixth section of the FCA Handbook, 'Specialist Sourcebooks', contains the requirements applying to some individual business sectors.
- The seventh section of the FCA Handbook, 'Listing, Prospectus and Disclosure', contains the United Kingdom listing rules.
- The eighth section of the FCA Handbook comprises 'Handbook Guides'.
- The ninth and final section of the FCA Handbook, 'Regulatory Guides', contains the guides to regulatory topics.

Consumer credit and rights legislation

- The Consumer Credit Act 1974 regulates the form and content of advertisements and quotations for loans and mortgages including a requirement for the true APR to be quoted.
- The FCA regulates consumer credit.
- The FCA has powers under the Consumer Rights Act 2015 to challenge unfair terms in standard form consumer contracts.
- While the CMA is the principal enforcer of the Act, the FCA is a 'qualifying body' under the Act.
- The Consumer Rights Act consolidates the rules previously laid down by the Unfair Contract Terms in Consumer Contracts Regulations 1999 and complements the EU Consumer Rights Directive, implemented in the UK through the Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013.
- The FCA is responsible for considering the fairness of terms in many types of financial services contracts, including those relating to:
  - mortgages;
  - general insurance;
  - bank, building society and credit union savings accounts;

Key points

- life assurance;
- pensions;
- investments; and
- long-term savings.

Question answers

6.1 In order to promote its statutory objectives of ‘protecting customers’ and ‘enhancing financial integrity’.

6.2 COBS incorporates the MiFID requirements and also introduces a more principles-based regime for regulated firms.

6.3 General insurance products, pure protection (term assurance, income protection and critical illness cover) and PPI (payment protection insurance).

6.4 It is the distributor's responsibility to ensure retail clients have access to consumer-facing disclosures for sustainability products (ESG 4.1.16(2)).

7

Core regulatory principles and rules

Contents	Syllabus learning outcomes
Introduction	
A Regulatory authorisation	*5.2*, *6.1*
B Senior Managers and Certification Regime (SM&CR)	*6.1*, *9.3*
C Record-keeping, reporting and notification	*6.1*
D Training and competence (T&C)	*6.1*
E Combatting money laundering and financial crime	*6.2*
F Data protection and security	*6.2*
G Complaints rules and procedures	*6.3*
H Financial Services Compensation Scheme	*6.3*
I Protection for pensions	*6.3*
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- explain the rules on authorisation, approved persons and controlled functions, record-keeping and TC;
- discuss the FCA's rules for dealing with complaints and compensation;
- explain the FCA's disciplinary and enforcement procedures; and
- explain legislative requirements on anti-money laundering and data protection.

Introduction

In this chapter we return to some of the areas covered in *The FCA Handbook* on page 6/1 and provide more detail of the principles and rules set out under the regulatory framework.

We first consider the activities for which permission under the **Financial Services and Markets Act 2000 (FSMA)** is required, and then look at the role of senior management functions under the new **Senior Management & Certification Regime (SM&CR),** which was fully implemented in December 2019.

The training and competence (TC) requirements for individuals are then considered before turning to look at the anti-money laundering requirements that apply to firms operating in the financial services industry. We also consider the UK's data protection requirements and the need for data security.

Finally, we will consider the methods of redress available to customers, with a review of the complaints handling rules and the supporting regime that exists to provide compensation to customers who may have suffered losses.

Key terms

This chapter features explanations of the following terms and concepts:

Authorised professional firms	Capital adequacy rules	Certified function	Compliance officer
Conduct rules (COCON)	Customer due diligence (CDD)	Data Protection Principles	Designated professional body
Exempt professional firms	Financial Services Compensation Scheme (FSCS)	Grandfathering	Money laundering reporting officer (MLRO)
Prescribed responsibilities	Recognised professional body	Record-keeping	Regulated Activities Order
Reporting requirements	Scope of Permission Notice	Senior Management & Certification Regime (SM&CR)	Senior management functions (SMFs)
Statement of responsibilities (SoR)	Statutory time limit standards	Suspicious activity reporting	

For reference only

Chapter 7

A Regulatory authorisation

Under s.19 of the FSMA it is an offence for someone to carry out a regulated activity unless the person is **authorised** or **exempt**. This is called the **general prohibition**. Authorised persons (firms and individuals) can only carry out the activities permitted by the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA). This means that a firm that was authorised as an independent financial adviser only could not suddenly provide deposit taking services, without obtaining permission for that extra activity.

A breach of s.19 may be a criminal offence and punishable on indictment by a maximum term of two years imprisonment and/or a fine.

A1 Firms authorised prior to the FSMA

Firms previously authorised under the **Banking Act 1987**, the **Insurance Companies Act 1982** and by the Securities and Investment Board or the Self-Regulating Organisations (SRO) under the **Financial Services Act 1986** were automatically re-authorised by the then FSA for their previously authorised activities. (These authorisations have been recognised by the FCA and PRA since 1 April 2013.)

Firms previously authorised by a **recognised professional body (RPB)** under the Financial Services Act 1986 were not 'grandfathered' in, and needed fresh authorisation to carry on arranging, managing or dealing in particular investments. Most solicitors and accountants who were previously authorised by their former RPB are no longer authorised because they did not like the 'heavy touch' FSA style of regulation.

Grandfathering generally does not apply to activities not previously regulated by the FSA (such as mortgage lending, for example) where authorisation has to be obtained.

A2 Authorisation of new firms and activities

Reinforce

Remember, as we saw in *Prudential Regulation Authority (PRA)* on page 5/3, the PRA is responsible for authorising systemically important firms such as banks and insurers and regulating them for prudential requirements while the FCA is responsible for regulating their conduct of business.

The FCA is responsible for authorising smaller firms such as financial and insurance intermediaries and regulates them for both prudential requirements and conduct of business.

Any new firm wishing to undertake regulated activities, and any pre-existing regulated firm wishing to undertake a regulated activity it is not currently permitted to do, must apply to the appropriate regulator for authorisation. The firm cannot start that business until it has received authorisation, and the regulator can grant authorisation or refuse it at its discretion.

A firm refused authorisation can appeal to the **Upper Tribunal (Tax and Chancery Chamber)** – see *Upper Tribunal (Tax and Chancery Chamber)* on page 6/30.

When applying for authorisation a firm must disclose any information about which the regulator could reasonably expect notice.

Does the firm need to be authorised?

Whether a firm's proposed business requires it to apply for authorisation to carry on regulated activities depends on the activities proposed. For most smaller firms, this would typically include intermediaries selling investments and/or home finance activities and/or general insurance. For each regulated activity a firm must also identify with which investment type(s) the activities will be concerned.

The activities and specified investments are detailed in the **Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO)**, as amended, which is secondary legislation under the FSMA.

A2A Regulated activities

Specified activities are defined in **Part II of the RAO** and include:

Banking	• accepting deposits; and • issuing electronic money.
Home finance	• advising on home finance activities; • arranging home finance activities; • entering into and/or administering a home finance activity; and • agreeing to do most of the above activities.
Insurer	• effecting or carrying out contracts of insurance as principal; and • assisting in the administration and performance of a contract of insurance.
Scheme operator	• establishing, operating or winding-up collective investment schemes and/or stakeholder pension schemes.
Investment intermediary	• advising on investments; • providing basic advice on stakeholder products; • arranging deals in investments; • managing investments; • dealing in investments (as principal or agent); and • safeguarding and administering investments.

For reference only

Chapter 7

Insurance intermediary	• advising on investments; • arranging deals in investments; • dealing in investments as agent; and • assisting in the administration and performance of a contract of insurance.
Investment management	• managing investments; • managing a UCITS; and • managing an AIF.
Credit-related	• entering into a regulated credit agreement as lender; • credit broking; • debt counselling; and • debt administration.

Be aware

Home finance activities include regulated mortgage contracts, home reversion schemes, home purchase plans and regulated sale and rent back agreements.

Specified investments are defined in **Part III of the RAO** and include:

- deposits;
- electronic money;
- rights under a contract of insurance;
- shares etc.;
- Government and public securities;
- certificates representing certain securities;
- units in a collective investment scheme;
- rights under a personal/stakeholder pension scheme;
- greenhouse gas emission allowances and emission allowances;
- options, futures and contracts for differences;
- life policies;
- funeral plan contracts;
- non-investment insurance contracts;
- rights under regulated mortgage contracts;
- rights under a home reversion plan;
- rights under a home purchase plan;
- regulated sale and rent back agreements;
- rights under a credit/consumer hire agreement; and
- rights to or interests in investments.

On the Web

You can find the full list here: *www.legislation.gov.uk/uksi/2001/544/contents*.

Business test

Under s.22 of the FSMA, for an activity to be a regulated activity, it must be carried out '**by way of business**'. Whether or not an activity is carried on by way of business is ultimately a question of judgment that takes account of several factors (none of which are likely to be conclusive). These include the degree of continuity, the existence of a commercial element, the scale of the activity and the relative proportions which the activity bears to other activities carried on by the same person but which are not regulated.

The nature of the particular regulated activity that is carried out will also be relevant to the factual analysis.

Exclusions

Exclusions are provisions that turn otherwise regulated activities into unregulated activities. So if a firm can rely on exclusion for an activity, it would not require authorisation to carry it out.

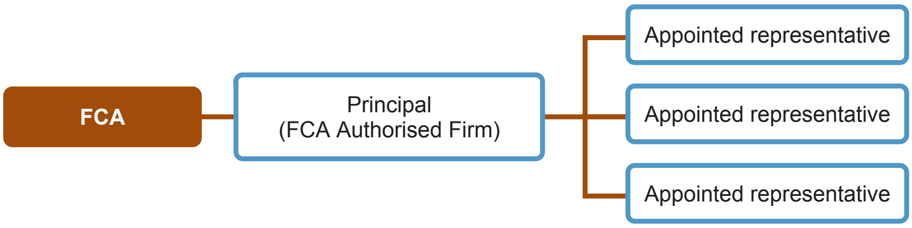
Examples of exclusions include:

- Introducer exclusion; and
- Overseas Persons exclusion.

Other registrations
The FCA is also responsible for the registration of firms under the **Money Laundering Regulations**, as well as the licensing of consumer credit activities.

A3 Exempt status

A firm has an exempt status (from s.19 of the FSMA) if it has a contract with an authorised firm whereby that authorised firm has accepted responsibility in writing for its activities. The contract must comply with various regulations and can restrict the permitted business. Such firms are called **appointed representatives (ARs)** and the authorised firm is known as the 'principal'. The principal is liable for the acts and omissions of the appointed representative (for business covered by the contract) as if they were its own.



Appointed representatives of MiFID investment firms may also be known under their alternative title of **tied agent**.

Many insurance companies had various firms of ARs who, in regulatory terms, were viewed as part of the life office's own sales force. The AR might be a specialist firm just selling life insurance, or could be a firm with a main business in its own right selling insurance as an ancillary activity to its core business (e.g. a Building Society or Estate Agent).

An AR could be a full AR – able to give advice on and arrange investments – or just an introducer appointed representative (IAR) restricted to merely making introductions and distributing advertisements. See *Appointed representatives (ARs)* on page 7/17 for more information on appointed representatives.

Professional firms that are a member of a **designated professional body (DPB)** do not need FCA authorisation for regulated activities which are incidental to their professional services. For example, a solicitor would not need authorisation for assisting a policyholder to make a claim under a life policy, and an accountant would not need authorisation for advice on the taxation of an investment as these are incidental to their professional services. Such firms are known as **exempt professional firms (EPFs)** and are listed separately on the Financial Services Register.

However, FCA authorisation would be needed if a firm of solicitors or accountants wanted to advise on life policies or arrange investments. They would then become directly authorised by the FCA as **authorised professional firms (APFs)**.

DPBs include the three law societies, the four accountancy bodies, the Institute of Actuaries, the Royal Institution of Chartered Surveyors and the Council for Licensed Conveyancers.

Other bodies that are exempt from authorisation include:

- the Bank of England;
- local authorities; and
- various Government bodies.

Question 7.1

For which regulated activities do DPB member firms not require FCA authorisation?

A4 Applications

Any person wishing to carry out one or more regulated activities by way of business must apply to the appropriate regulator for direct authorisation (unless they can abide by the terms of exclusion or are exempt). This is called applying for **Part 4A permission** as set out in the FSMA.

Be aware

To apply for authorisation, a firm will need to complete the type of application form that applies to its type of firm. This may typically be:

- **Retail intermediary** – financial adviser, home finance intermediary, insurance intermediary or connected travel insurance intermediary.
- **Wholesale investment firm** – simple or complex securities and futures firm, adviser and arranger of wholesale funds, or investment management firm (including those firms who wish to establish and/or operate a collective investment scheme).
- **Insurance firms** – insurance special purpose vehicles, Lloyd's managing agents or insurers.
- **Consumer credit firms** – lenders, brokers or consumer hire.
- **Other provider firms and deposit takers** – bank, mutual, home finance provider, personal pension scheme provider, credit union, claims management company or electronic money issuer.

New insurance firms must apply to the PRA for authorisation. The PRA will assess them from a prudential perspective and will determine whether they meet the **Threshold Conditions** (including whether they hold capital sufficient to cover the risks they run). At the same time the FCA will assess them from a conduct perspective. The PRA will lead and manage a single administrative process. Smaller firms such as financial intermediaries will apply to the FCA for authorisation.

Before a firm can carry out a regulated activity, the regulator must be satisfied that the firm can meet and continue to meet the minimum standards, called Threshold Conditions, and that the persons running the firm are **fit and proper**.

The regulator will make a decision under the ***statutory time limit standards*** which are within the earlier of six months of receiving a complete application, or twelve months of receiving an incomplete application.

Once an application is successful the regulator will write to the firm confirming their authorisation and enclosing the ***Scope of Permission Notice***. This is the formal Part 4A permission and will set out when the permission starts, which regulated activities they have permission to carry out and any requirements or limitations included.

On the Web

After the regulator grants an application for Part 4A permission, it will update the public record – the Financial Services Register – with a general description of the regulated activities that the firm has permission to carry out. The Financial Services Register can be accessed at: *www.fca.org.uk/register*.

Change of legal status

If a firm is authorised and it is thinking of changing its legal status, e.g. from being a partnership to a limited company, the new legal entity must apply for authorisation. This is because the FSMA does not permit the authorisation to be transferred from one legal entity to another.

However, HM Treasury amended s.32 of the FSMA in 2007 to help partnerships and unincorporated associations considering applying for authorisation following a change in their membership. In particular, it means that the remaining partner of a two-person partnership can continue carrying on regulated activities through that firm's existing authorisation in the event of the death or resignation of the other partner. In the case of larger partnerships, where there is either an increase or decrease in the number of partners, continuity of authorisation will be maintained providing that the partners are succeeding to the business of the firm.

A5 Responsibilities of regulated firms

Authorised firms are responsible for the conduct of all their employees, agents and ARs. The firm must ensure that those for whom it is responsible (a product provider is not responsible for the acts or omissions of an intermediary) comply with all requirements of the FSMA and the rules made under it. A regulated firm must not use the services of an individual prohibited by the PRA/FCA.

Authorised firms must have systems in place to manage the risks they are subject to. These vary according to the type of business but include ***capital adequacy rules***. Firms have to keep abreast of all relevant changes to the business environment and do their best to reduce and/or control the risks these present. For insurance companies, this includes maintaining an adequate solvency margin and reinsurance arrangements (control environment). It should be understood, however, that some things are beyond any firm's control (e.g. tax law changes) and it is not possible for a business to guarantee it will always survive no matter what occurs.

An authorised firm must ensure that all of its individuals carrying out **senior management functions (SMFs)** (or controlled functions **in non-SM&CR firms**) are approved. An individual can cover for a Senior Manager for up to twelve weeks over twelve months without approval where the absence is temporary or reasonably unforeseen. As soon as it becomes apparent that the individual will be performing the function for more than 12 weeks the firm should apply for approval.

An authorised firm is responsible for any advice given by its representatives. If such advice is in breach of the FSMA or FCA rules, the authorised firm is liable to compensate the client for any loss sustained as a result of the advice. However, the mere fact that an investment has lost value does not give rise to any duty to compensate as this may be due to factors unconnected with the quality of the advice (for example, a stock market crash).

If a firm gives improper advice, that will usually be a breach of FCA rules. If the client complains, the firm will have to make appropriate restitution or pay compensation. If they do not, the client could complain to the Financial Ombudsman Service which can force the firm to make restitution or pay compensation. The complaint could also lead to disciplinary action from the FCA, particularly if it was part of a pattern of similar cases rather than an isolated error.

Most firms, and specifically all authorised investment firms, will have a nominated ***compliance officer*** (SMF 16), usually assisted by a compliance department, in order to ensure that all the myriad rules are complied with.

Question 7.2
Natalia's investment portfolio loses 50% of its value due to a stock market crash. Is she entitled to compensation from her adviser?

B Senior Managers and Certification Regime (SM&CR)

B1 Overview of SM&CR

The **Senior Managers and Certification Regime (SM&CR)** replaced the Approved Persons Regime, changing how people working in financial services are regulated. This new regime was applied to banks and insurers (regulated by both the PRA and FCA) from March 2016 and from December 2019 also applies to solo-FCA regulated firms.

SM&CR aims to reduce harm to consumers and strengthen market integrity by making individuals more accountable for their conduct and competence.

As part of this SM&CR aims to:

- encourage a culture of staff at all levels taking personal responsibility for their actions; and
- make sure firms and staff clearly understand and can demonstrate where responsibility lies.

The rules on individual accountability have been introduced following changes set out in the **Financial Services (Banking Reform) Act 2013**. This Act was based on recommendations to improve professional standards and culture within the UK banking industry, as put forward by the Parliamentary Commission on Banking Standards.

The rules will make it easier for firms and regulators to be clear about who is responsible for what. Clear individual accountability should focus minds, drive up standards, and make firms easier to run and supervise. If things go wrong, senior managers will be held accountable for when they are at fault for misconduct that falls within their area of responsibility. Individuals working at all levels within relevant firms will also be held to the appropriate standards of conduct, known as COCON (see *Code of Conduct (COCON)* on page 10/6).

The key aims of the SM&CR are as follows:

- Encourage greater clarity of responsibilities.
- Improved corporate governance demonstrating clearer accountability for decision making.
- Ensure that responsibility is clear and that firms don't rely on collective board responsibility.
- Identify who really runs the firm (i.e. senior management) removing or at least limiting parent company involvement in a regulated firm.
- Give the FCA a sound framework against which to take enforcement action against individuals when serious issues occur.
- Place the responsibility of 'authorising' those who undertake significant harm functions, such as an investment adviser, on the firm rather than the FCA (this is known as certification).

B1A Key features of the SM&CR rules

Senior Managers Regime	This focuses on the most senior individuals who hold key roles or are responsible for whole areas of relevant firms. Firms need to: • ensure each senior manager has a 'Statement of Responsibilities', setting out the areas for which they are personally accountable; • introduce a 'Firm Responsibilities Map' that knits these together; • ensure that all senior managers are pre-approved by the regulators before carrying out their roles; and • ensure those who hold a senior management function are assessed for Fitness and Propriety at least annually. The Government has also implemented a 'statutory duty of responsibility' on senior managers captured by the regime and this means senior managers will be required to take the steps that it is reasonable for a person in that position to take, in order to prevent a regulatory breach from occurring. This further strengthens the 'individual accountability' the regime intends to embed.

Certification Regime	This applies to 'material risk-takers' (i.e. staff who are subject to the Remuneration Code) and other staff who pose a risk of significant harm to the firm or any of its customers (e.g. staff who give investment or mortgage advice or who administer benchmarks). Firms need to identify all certified individuals and then: • assess them as fit and proper; • issue a certificate to each affected employee to this effect; and • have procedures in place to re-assess the fitness and propriety of certified staff on an annual basis, including the requirement to issue an annual certificate to confirm this. The SM&CR replaces the APER functions (such as the customer facing CF30) for directly authorised firms. As a result, the FCA will no longer approve these individuals and it has become the remit of the firm to confirm that the individual is fit and proper to undertake the role. This places a great deal of responsibility on the employer to ensure sufficient evidence is in place to support this internal approval (certification).
Conduct Rules	These are high-level rules (set out in COCON) that apply directly to nearly all staff (apart from ancillary staff, e.g. catering staff). Firms must ensure that staff who are subject to the rules are aware of them and how they apply to their jobs.

Note: The SM&CR replaces many of the previous 'approved person' functions, such as the customer-facing CF30. A limited number of firms who are not SM&CR firms and appointed representatives will still have controlled functions (see *Appointed representatives (ARs)* on page 7/17).

Be aware
Existing approved persons were not required to go through a fresh round of pre-approval in order to be 'grandfathered' into the new regime, unless their responsibilities under SM&CR were different to those they had held under the previous regime.

B2 Application of SM&CR

SM&CR is applied to solo-regulated firms in a proportionate manner by dividing firms into three categories:

- **Limited scope firms** – These are smaller firms which are subject to fewer requirements than core firms. For example, sole traders and authorised professional firms such as accountants and solicitors.
- **Core firms** – firms that do not qualify as Limited Scope or Enhanced will be subject to the baseline regime, which is a pared-back version of the SM&CR for banks.
- **Enhanced firms** – the largest, most complex, or riskiest firms are subject to additional requirements above the baseline Core regime, more akin to the requirements for banks. Examples are:
  - significant IFPRU firms;
  - large CASS firms;
  - asset managers with assets under management (AUM) of £50bn or more (calculated as a three-year rolling average);
  - firms with total intermediary regulated business revenue of £35m or more per annum (calculated as a three-year rolling average);
  - firms with annual revenue generated by regulated consumer credit lending of £100m or more (calculated as a three-year rolling average); and
  - mortgage lenders and administrators (that are not banks) with 10,000 or more regulated mortgages outstanding.

Activity
The FCA has provided a flow chart to help firms establish the category they fall into. Try using the chart to see where your employer is placed: *www.handbook.fca.org.uk/handbook/SYSC/23/Annex1.html*.

For reference only

Chapter 7

The additional requirements for Enhanced firms include:

- Additional senior management functions – a broader set of roles specific to a larger firm that require registration.
- Additional prescribed responsibilities – functions associated to those wider roles that need to be allocated to a senior manager.
- Overall responsibility requirement – a senior manager is responsible for ensuring all prescribed responsibilities are properly allocated to competent individuals.
- Responsibilities maps – a replacement for the governance map. An organisation chart who sets out who performs what functions.
- Handover requirements – an obligation for a senior manager leaving a role to provide adequate notes of key topics and current matters to the successor.

B3 Senior Managers Regime

Under SM&CR, controlled functions (CFs) which existed under the Approved Persons Regime (see *Approved Persons Regime* on page 7/18) were replaced by **senior management functions (SMFs)** in SM&CR firms. These can be divided into **governing functions**, **required functions** and **systems and controls functions**, as outlined in table 7.1.

Table 7.1: Designated senior management functions of solo-regulated firms

SMF no.	Function	Type of function
1.	Chief Executive	Governing
2.	Chief Finance	Systems and Controls
3.	Executive Director	Governing
4.	Chief Risk	Systems and Controls
5.	Head of Internal Audit	Systems and Controls
7.	Group Entity Senior Manager	Governing
9.	Chair of the Governing Body	Governing
10.	Chair of Risk Committee	Governing
11.	Chair of Audit Committee	Governing
12.	Chair of Remuneration Committee	Governing
13.	Chair of the Nominations Committee	Governing
14.	Senior Independent Director	Governing
16.	Compliance Oversight	Required
17.	Money Laundering Reporting Officer	Required
18.	Other Overall Responsibility	Required
19.	Head of Third Country Branch	Governing
21.	EEA Branch Senior Manager	Other High-Level Management
24.	Chief Operations	Systems and Controls
27.	Partner	Governing
29.	Limited scope function	Required

Be aware

Not all SMFs apply to every firm. The list of those SMFs which may apply to a 'Core' firm, along with brief descriptions are listed in a table in the following section.

Some SMFs, such as Head of Business Area and Credit Union SMF and Head of an Overseas Branch will only apply to very large firms.

The Limited Scope Function (SMF29) applies only to Limited Scope firms.

For reference only

Chapter 7

Be aware

Although investment advisers were Approved Persons under the Approved Persons Regime (CF30 – Customer Facing), under SM&CR investment advisers, home finance advisers (mortgage advisers), and general insurance advisers are classified as **certified roles**.

Disciplinary powers

The individual registration system under SM&CR and Approved Persons gives the FCA (and PRA if applicable) disciplinary powers over the individual as well as the firm.

Approval of an SMF or an approved person can be withdrawn if it is decided that an individual is no longer **fit and proper** for that function. Individuals can be fined or a prohibition order can be made against them, which would effectively ban that person from working in any regulated activity.

The FCA has stated that it will only discipline an individual for personal culpability where behaviour was deliberate or fell below a reasonable standard. It has also stated that it would not discipline for vicarious liability (i.e. the situation where an employee is held responsible for the failings of their employer).

A person is guilty of misconduct if, while an SMF or approved person, they fail to comply with COCON (or a Statement of Principle under the approved persons regime) (see *Code of Practice for Approved Persons* on page 10/9) or is knowingly concerned in the contravention by a firm of a requirement in the FSMA or the PRA Rulebook/FCA Handbook.

An individual will continue to be accountable after ceasing to be an SMF or approved person, although the regulator may not bring proceedings after three years from when it first knew of the misconduct. (It should be noted that there is no limitation on the period during which the regulator may first discover that misconduct.)

As we will see in the following sections, SM&CR requires firms to show that all staff who are covered by the Senior Managers and Certification Regime meet fit and proper requirements.

B3A Senior management functions of a core firm

The SMFs that apply will depend on the type of firm and whether they are:

- Limited Scope;
- Core; or
- Enhanced.

The following table includes the SMFs which might apply to a **Core** firm, depending on its governance structure (i.e. limited company or partnership).

Function name	Description
Governing function	
SMF1 – Chief Executive	The person(s) with responsibility, under the immediate authority of the governing body, for the conduct of the whole of the business (or relevant activities). Note that although the Chief Executive is the most senior member of an executive team, it does not mean that a firm's governing body cannot allocate specific responsibilities to other Senior Managers.
SMF3 – Executive Director	A director of a firm, other than a Non-Executive Director.
SMF27 – Partner	A partner in a firm, other than a limited partner in a partnership registered under the Limited Partnership Act 1907.
SMF9 – Chair of the Governing Body	The person with responsibility for chairing, and overseeing the performance of the role of, the governing body of the firm.
Required function	
SMF16 – Compliance Oversight	This is the person responsible for the compliance function in the firm and reporting to the governing body on this.
SMF17 – Money Laundering Reporting Officer	This is the person who has responsibility for overseeing the firm's compliance with the FCA's rules on systems and controls against money laundering.

Further information on the senior management functions which apply to enhanced and limited scope firms can be found in SUP 10C.4 of the FCA Handbook.

B3B Allocation and documentation of responsibilities

The clear allocation of responsibilities is a key part of the SMR. A key challenge is ensuring that all documents are consistent, kept up to date, and that records of current and previous versions are maintained. It is also crucial for firms to check that there are no gaps in responsibility or accountability.

The responsibilities framework operates as follows:

- Senior managers must be allocated any relevant '**prescribed responsibilities**' (Core and Enhanced firms) – not all of these are mandatory and some only apply if relevant to the firm.
- Enhanced firms also have an overall responsibilities obligation – to ensure that a Senior Manager has overall responsibility for every activity, business area and management function across the firm.
- Prescribed responsibilities should be allocated to individuals performing certain SMFs, and certain prescribed responsibilities should ideally be allocated to non-executive directors.
- **Each prescribed responsibility should be held by one person**. Firms can only share a prescribed responsibility in very limited circumstances, such as a job share, where a particular area of a firm is run by two senior managers or when a departing Senior Manager and incoming Senior Manager are working together temporarily as part of a handover.

Notably, the lists of prescribed responsibilities for Core and Enhanced firms under the extended SM&CR are shorter than the list for banks. For instance, they do not include the Prescribed Responsibilities relating to the firm's culture.

Prescribed responsibilities for a core firm	
Reference	**Description**
(a)	Performance by the firm of its obligations under the SMR, including implementation and oversight.
(b)	Performance by the firm of its obligations under the Certification Regime.
(b-1)	Performance by the firm of its obligations in respect of notifications and training of the conduct rules.
(d)	Responsibility for the firm's policies and procedures for countering the risk that the firm might be used to further financial crime.
(z)	Responsibility for the firm's compliance with CASS (if applicable).
Authorised Fund Managers (AFMs)	
(za)	Responsibility for an AFM's assessments of value, independent director representation and acting in investors' best interests. This PR only applies to AFMs.

A full list of the prescribed responsibilities which may apply to firms can be found in the SYSC section of the FCA Handbook: *www.handbook.fca.org.uk/handbook/SYSC/24/Annex1.html*.

Statements of responsibilities

Each Senior Manager must have a **Statement of Responsibilities (SoR)**, which must be pre-approved by the FCA (Pre-approval was not required for any SMF grandfathered into the regime) using a template SoR to set out:

1. Any prescribed responsibilities allocated to the individual; plus
2. Any other relevant responsibilities.

Other points to note:

- The SoR is meant to be concise, factual and self-contained.
- The SoR must be updated and resubmitted whenever there is a 'significant change'.

- For enhanced firms, SoRs are complemented by the Responsibilities Map, which is designed to reflect the firm's overall governance and management arrangements, and to ensure that there are no accountability gaps.
- The FCA has not specified that acting in accordance with the Consumer Duty should be an additional prescribed responsibility. However, it has stated in FG22-5 (10.10) that it expects firms to have a champion at board level who ensures the Duty is discussed regularly and raised in all relevant discussions.

The FCA has provided a form for solo-regulated firms in SUP 10C Annex 10D which must be submitted where an individual is applying for a Senior Management Function. It provides the structure required of a Statement of Responsibility.

Consumer Duty responsibility
The FCA wants firms' boards and senior management to take their responsibilities under the Consumer Duty seriously.

Firms are expected to have a champion at board or equivalent governing body level, ideally a non-executive director. This is not a 'prescribed responsibility' under SM&CR and firms are allowed the necessary flexibility to establish the role in their firm's structure in a way they see appropriate.

The primary role of the champion is to support the board in raising the Consumer Duty regularly and in all relevant discussions, challenging the firm's governing body on how it is embedding the Duty at all levels. Firms' boards have collective responsibility under the Consumer Duty. The presence of the firm's champion at board level does not excuse them from this.

B3C Duty of responsibility

Senior managers have a statutory 'duty of responsibility'. This means that if a firm breaches an FCA requirement, the senior manager responsible for that area could be held accountable if they didn't take reasonable steps to prevent or stop the breach. A senior manager may be found guilty of misconduct if the FCA can prove that the Senior Manager did not take reasonable steps to prevent a regulatory contravention in an area for which he or she is responsible from occurring or continuing.

Other aspects of regulation which impact senior managers are:

The regime for branches	The FCA rules apply the same principles to branches of foreign banks, but tailor them to account for the different governance structures in branches (notably that the ultimate board will likely reside overseas). For branches of European banks the rules also reflect the split of responsibilities between the FCA as the 'host state regulator', and the European 'home state regulator', as set out in EU law. The final rules for branches apply the certification and conduct rules to individuals where they are performing activities from the UK establishment.
Remuneration	The FCA have made changes to the Remuneration Code to encourage more effective risk management and better align individual decision making with good standards of conduct.
Whistle-blowing	Rules to strengthen whistle-blowing systems and controls in firms and to promote a culture where people can speak up took effect in September 2016. These rules apply to deposit-takers (meaning banks, building societies and credit unions) with assets over £250m, Solvency II insurers and PRA-designated investment firms. Whistle-blowing rules also apply to all UK MiFID investment firms regarding the implementation of MiFID rules.

B4 Certification Regime

B4A General

The Certification Regime covers specific roles or functions (see table below) which are not SMFs but can have a significant impact on customers, such as financial advisers and mortgage advisers.

Unlike under the Approved Persons regime, which was in place for solo-regulated firms before December 2019 and is still in place for non-SM&CR firms, **the FCA will not approve**

For reference only

Chapter 7

people for these roles, so it is up to the firm to check their initial suitability to perform the role and confirm this annually.

The objective of the Certification Regime is to reinforce that firms, and not the regulator, are responsible for ensuring that staff are fit and proper, competent and capable to do their job.

The FCA is particularly concerned that in assessing if a person is fit and proper (see *The Fit and Proper test for employees and senior personnel (FIT)* on page 10/10) to perform a certification function, a firm must consider whether that person:

- has obtained a qualification (where relevant);
- has undergone, or is undergoing, training;
- possesses a level of competence; or
- has the personal characteristics, required by general rules made by the FCA.

B4B Certification functions

With the introduction of SM&CR the FCA has removed a number of the Controlled Functions which previously applied under the Approved Persons Regime and replaced these with a list of Certified Functions.

Function	Details
Significant management function (formerly CF29)	This includes individuals with significant responsibility for a business unit. These important roles can seriously impact the way the firm conducts its business and are not limited to revenue-generating business areas.
Proprietary traders	All proprietary traders are covered by the Certification Regime.
CASS Operational Oversight Function (formerly CF10a)	The CASS Operational Oversight Certification Function covers oversight of the operational effectiveness of a firm's systems and controls for client money and assets.
Functions subject to qualification requirements	This includes, for example, mortgage advisers, retail investment advisers and pension transfer specialists. The full list is set out in the FCA Training and Competence sourcebook.
The client dealing function	This function applies to any person dealing in or arranging investments with clients, including retail and professional clients and eligible counterparties. This includes: • financial advisers and mortgage advisers; • people who are involved in corporate finance business; • people who are involved in dealing or arranging deals in investments; • investment managers; and • other staff that deal directly with clients or customers, such as paraplanners. This does not include individuals who have no scope to choose, decide or reach a judgment on what should be done in a given situation, and whose tasks do not require them to exercise significant skill.
Anyone who supervises or manages a Certified Function (directly or indirectly), but isn't a Senior Manager	This makes sure that people who supervise certified employees are held to the same standard of accountability. It also makes sure a clear chain of accountability between junior certified employees and the Senior Manager ultimately responsible for that area. For example, if a firm employs a customer-facing financial adviser, every manager above them in the same chain of responsibility will have to be certified (until the Senior Manager approved under the SMR is reached).

Function	Details
Material Risk Takers	The concept of Material Risk Takers (also known as Remuneration Code staff) already exists for firms under our remuneration rules (SYSC 19). They are a category of staff that all firms under AIFMD, UCITS, IFPRU and BIPRU are already required to identify under the FCA remuneration regime. (These firms need to consider all types of risk when identifying their Material Risk Takers, including those of a prudential, operational, conduct and reputational nature. All of these Material Risk Takers will be covered by this certification function.)
Algorithmic trading	This function includes people with responsibility for: • approving the deployment of a trading algorithm or a material part of one; • approving the deployment of a material amendment to a trading algorithm or a material part of one, or the combination of trading algorithms; and • monitoring or deciding whether the use or deployment of a trading algorithm is or remains compliant with the firm's obligations.

Not all of these Certified Functions will apply to all firms, even those who fall under the 'Enhanced' definition of an SM&CR firm.

Paraplanners
Paraplanners potentially fall into the category of people who need to be certified, however, FCA rules provide firms with flexibility to exercise their own judgment on whether roles require certification. As there are different definitions used for the role of paraplanner, whether certification is required is determined by the duties of the individuals concerned and the potential impact they may have on customers.

Paraplanners who have the scope to choose, such as those involved in the selection of firms' investment panels, centralised investment propositions, undertaking due diligence, or deciding the investments to be used for clients, might be rightly considered to fall into the client dealing function. A firm's decision whether to certify a paraplanner involved in these activities might depend on the level of autonomy and independent judgment the paraplanner brings to the decision-making process.

Consider this…
Does your firm have anyone working in Certified Functions who are not Financial Advisers?

B4C The Directory

Firms are required to report the names of individuals performing Certification Functions to the FCA. These are published in a central Directory which is part of the Financial Services Register. This includes details of:

- all directors and senior managers;
- all staff certified as fit and proper by their firm; and
- other important individuals who undertake business with clients and require a qualification to do so.

These are known as **Directory Persons**.

SM&CR firms were required to have certified/assessed their staff and submitted the relevant information to the FCA for inclusion in the Directory before 31 March 2021.

The Directory contains the following information:

- employer details;
- restrictions applying to a firm's regulated activities;
- individual's name;
- individual reference number (IRN);
- relevant roles held;
- start and end dates of each role;
- regulatory sanctions and prohibitions; and
- date information was last updated.

For individuals performing customer facing roles and those requiring qualifications this also includes:

- type of business the individual is qualified to undertake;
- workplace locations;
- customer engagement methods; and
- memberships of relevant accredited bodies.

B4D Certificates

A key part of the Certification Regime is the issuing of certificates by the employer of certified individuals. The FCA has not set a template for certificates, however they must:

- be issued by the Senior Manager with responsibility for this prescribed function.
- refer to **each of the certification functions** that an employee carries out for a firm. For example, where an individual undertaking a client dealing function (such as giving financial advice) also supervises those who perform a certified function (if they are not a Senior Manager), these would both be included.

Note that Senior Managers who perform certification functions are also required to be certified.

Although appointed representatives do not fall directly under SM&CR, certification may still apply to employees of appointed representatives in some cases as set out in SYSC 27.4.1.

B5 Conduct rules

The FSMA gave the FCA powers to set conduct rules for all individuals at authorised firms, not just those in senior management positions or customer-facing staff such as advisers. The conduct rules set out what the FCA believes to be 'basic standards' of good personal conduct. They apply to any regulated and unregulated financial services activities, including any activities carried out by a firm in connection with a regulated activity.

There are two tiers of conduct rules, those applying to senior managers and those which apply to most employees. A full list of conduct rules can be found in *Code of Conduct (COCON)* on page 10/6.

The conduct rules apply to all:

- senior managers;
- certified functions;
- non-executive directors who are not senior managers; and
- other employees, except ancillary staff.

Be aware

The FCA does not consider para-planners, administrative or support staff as 'ancillary' and so they are bound by the conduct rules. Ancillary staff are defined as those roles that could undertake similar work in any business, e.g. catering staff or receptionists.

Training

Firms are required to train all relevant staff on how the conduct rules apply to their role and there is a specific responsibility for this held by a senior manager.

Breaches
Breaches of the conduct rules must be reported to the FCA.

- Breaches of the conduct rules for Senior Managers must be notified to the FCA within 7 days of concluding any disciplinary action. Disciplinary action would include:
  - issuing a formal written warning;
  - suspension or dismissal; and
  - reduction in or recovery of remuneration.
- For other roles the firm must report to the FCA every year on any breaches. This report must be made regardless of whether there have been any breaches.

B6 Appointed representatives (ARs)

Be aware
Non-SM&CR firms and appointed representatives and those people that work for them in certain roles specified by the FCA are still subject to the previous Approved Persons regime.

General
An appointed representative is exempt from authorisation under the FSMA if it has a contract with an 'authorised person', a firm known as the 'principal'. As a result, a principal firm takes full responsibility for all of the ARs actions or inactions related to regulated business. Where the principal is a **MiFID firm**, the AR will be known as a '**tied agent**'.

Intermediaries and other networks whose 'members' are, for the purposes of the FSMA, appointed representatives or tied agents commonly use this structure.

Appointed representatives are permitted to undertake the limited activities only, typically:

- advising on investments; and
- arranging deals in investments.

An AR can be a 'full' AR, able to give advice on investments/home finance or, in the case of non-investment insurance, an **introducer appointed representative (IAR)**. The permitted business of an IAR is restricted to merely making introductions and distributing advertisements on behalf of the principal.

No AR may be appointed if at the time it is also authorised. There can be **no 'dual statuses' as both authorised and exempt** under the FSMA.

ARs are not permitted to hold client assets for longer than is necessary to deal with them (which must not exceed 28 days) and in no circumstances may they hold client money.

Appointment
Before a firm appoints a person as an AR (other than an IAR) and on a continuing basis, it must establish on reasonable grounds that:

- the appointment does not prevent the firm from satisfying and continuing to satisfy the threshold conditions;
- the person:
  - is solvent, otherwise suitable to act for the firm in that capacity, and
  - has no close links which would be likely to prevent the effective supervision of the person by the firm;
- the firm:
  - has adequate controls over the person's regulated activities for which the firm has responsibility; and
  - is ready and organised to comply with any other applicable requirements.

Directors (or equivalent) and senior managers (or equivalent) of the AR must also be approved persons, and are subject to the same requirements and controls as all approved persons (Note that only one approved person is required for insurance firms that are secondary intermediaries). Advisers appointed by appointed representatives are subject to the **Approved Persons Regime (APER)** and must be approved by the FCA. The requirements for approved persons are similar in many ways to those covered by SM&CR – individuals need to pass 'fit and proper' requirements and satisfy conduct requirements. However, SM&CR covers a much wider range of roles and people and advisers at SM&CR firms are certified by the firm. An adviser appointed by an AR must be approved by the FCA and would hold the CF30 (customer) function.

The principal must have accepted responsibility in writing for the AR's activities. This contract can restrict the types of business that the AR is permitted to undertake. No AR, or any of its financial advisers, may commence any regulated activity until the required contract has been signed by both parties. The principal must notify the FCA no later than ten business days after the appointment of the AR takes effect.

Multi-principals
A firm carrying on investment business may only be the AR of one principal firm. Mortgage business ARs may have a separate principal for different classes of business (e.g. standard mortgages v. equity release products), and for insurance business an AR may have any number of principals. If the proposed AR is, or is intending to become, the AR of another principal firm(s), it will be necessary for each principal to enter into a *multiple principal agreement* with all the other such principal firms.

One principal, who must act as the lead principal, will be responsible for handling all complaints from the clients of an AR in respect of advice given, irrespective of which principal it is agreed any liability for this advice falls.

Termination
If the contract is terminated by the principal it will advise the AR in writing that the contract has been terminated, and that it will no longer be permitted to undertake regulated business unless alternative arrangements are to be made. The FCA must be notified within ten business days of the termination of an AR's contract.

Oversight of appointed representatives
The FCA published new rules in 2022 regarding the effective oversight of appointed representatives. This is intended to prevent appointed representatives' misconduct undermining safe market operations. Under these rules, principal firms must:

- Apply enhanced oversight of their ARs, including ensuring they have adequate systems, controls and resources.
- Assess competence and capability of individuals at ARs.
- Assess and monitor the risk any ARs pose to consumers. This level of oversight should be the same as they would undertake for their own business.
- Review information on the AR's activities, business and senior management on an annual basis.
- Be clear on the circumstances when they should terminate an AR relationship.

These rules also increase the regulatory reporting requirements for principal firms in respect of their ARs, requiring that they notify the FCA 30 days in advance of any new AR appointments and that they provide complaints and revenue information to the FCA regarding each AR relationship on an annual basis.

On the Web
Further information on improvements made to the Appointed Representatives Regime can be found in PS22/11: *www.fca.org.uk/publication/policy/ps22-11.pdf*.

B6A Approved Persons Regime

Be aware
Non-SM&CR firms and appointed representatives, including those people who work for them in certain roles specified by the FCA, are still subject to the previous Approved Persons Regime.

The Approved Persons Regime, which predates SM&CR, remains in place for appointed representatives (and a small number of exempt firms who are not governed by SM&CR). It was and remains a very important aspect of the regulatory scheme introduced by the FSMA.

It is important to remember the following distinction:

- The **authorised person** – the business that carries on regulated activities such as providing investment advice. The authorised person could be a company, partnership or sole trader. (In the case of an appointed representative this would be the principal firm which is regulated by the FCA).
- The **approved person** – the individual who has been approved to carry out one or more of the controlled functions within the business, either as a senior person or as someone who advises customers on investments.

Individuals undertaking a '**controlled function**' within an appointed representative firm must be individually approved and registered. Controlled functions are those which involve:

- a significant influence on the conduct of an authorised person's affairs; and/or
- dealing with customers in connection with regulated activities.

The five main groups of FCA-controlled functions include four that are **significant influence functions**, which can only be performed by approved persons. These are:

- **governing functions**; and
- **significant management functions**.

The remaining controlled function group is the **customer-dealing function**.

The list of controlled functions is significantly reduced from that which applied when the Approved Persons Regime applied to all FCA regulated firms.

Type	No.	Function
Governing functions*	1	Director
	2	Non-executive director
	3	Chief executive
	4	Partner
	5	Director of unincorporated association
Customer-dealing function	30	Customer function
* FCA governing functions		

The customer function or CF30 may be any of the following:

- Advising on investments, other than a non-investment insurance contract (but not where this is advising on investments in the course of carrying out the activity of giving basic advice on a stakeholder product), and performing other functions related to this such as dealing and arranging. Note that, unlike SM&CR, a mortgage adviser or general insurance adviser would not be a CF30 role and so is not subject to FCA approval.
- Giving advice to clients solely in connection with corporate finance business and performing other functions related to this.
- Giving advice or performing related activities in connection with pension transfers, pension conversions or pension opt-outs for retail clients.
- Giving advice to a person to become, or continue or cease to be, a member of a particular Lloyd's syndicate.
- Dealing, as principal or as agent, and arranging (bringing about) deals in investments with, for, or in connection with customers where the dealing or arranging deals is governed by COBS 11 (Dealing and managing).
- Acting as a 'bidder's representative' (in relation to bidding in emissions auctions).

C Record-keeping, reporting and notification

C1 Record-keeping

The standard periods of record-keeping under the COBS rules differ according to the type of firm and the nature of the records, however they can be summarised as follows:

- **Indefinitely** – for pension transfers, pension opt-outs and FSAVCs (free standing additional voluntary contributions).
- **Five years** – for life policies and pension contracts, although financial promotions for such products should be retained for **six years**.
- **Five years** – in most other cases, although non-MiFID firms are only subject to a three-year requirement in some circumstances.

C2 Reporting and notifications

The FCA requires firms to keep them informed of developments.

C2A Reporting requirements

The FCA requires regular returns, including those showing:

- Details of shareholdings and the control (broadly, holdings of at least 10%) of limited companies.
- Information about people and organisations with which the business has close links (broadly, holdings of at least 20%), such as subsidiary or sister companies.
- Financial resources.
- Types of business written.
- Breaches of conduct rules.
- Clients assets (CASS).
- Complaints received by the firm.

On the Web
www.handbook.fca.org.uk/handbook/SUP/16/12.html .

Electronic reporting is carried out via the **RegData system**.

As we have seen already, firms are required to provide at least annual detailed information regarding the level of capital held. This is just one of the regular statistical and financial reports which regulated firms are required to submit. They cover a wide range of topics and there are detailed requirements as to what should be included and the format/frequency for the reports to be submitted (usually quarterly, six monthly or annually). The reporting rules are an extremely important tool as they enable the regulators to build up a picture of the activity in regulated firms and to monitor those activities.

Reports
Reports cover such matters as:

- firms' annual accounts and financial statements;
- the amount held in client bank accounts;
- the value of clients' assets which are in a discretionary portfolio manager's possession;
- the numbers of staff undertaking different roles within the firm;
- the types of business being undertaken; and
- the number of complaints received and persistency statistics (which enable the FCA to get some idea of the quality of the selling by representatives).

Persistency is defined as the percentage of an insurance company's already written policies remaining in force, without lapsing or being replaced by policies of other insurers. The rules on persistency for product providers apply to both regular and single premium life and pension contracts (with certain exceptions such as term assurance and those cancelled from the outset or 'cooled off' under the cancellation notice procedure) and set out the method of calculation by comparing the number of contracts remaining in force at the end of the year with those sold during that year. The product provider must report persistency figures over the first four years of contracts annually to the FCA, broken down by sales channel and type of contract. The FCA will then publish aggregate data.

In the case of complaints, firms must twice a year submit statistics of the number of complaints received, broken down according to the category of product type in line with the form stipulated in DISP 01 Annex 1. Firms must report the number of complaints:

- closed by the firm within three days of receipt;
- closed after three days but within eight weeks of receipt;
- closed more than eight weeks after receipt;
- the total number closed; and
- the total number upheld.

Firms must also report the total number of complaints outstanding at the end of the reporting period and the total number of complaints opened during the reporting period.

All reports must be submitted within 30 working days of the end of the reporting period. This tight reporting regime allows a close eye to be kept on the number of customer complaints being received across all regulated firms and alerts the FCA to possible problems within individual firms or with a particular product type. Firms monitor complaints levels as an indicator of good conduct to customers.

If the FCA identifies a problem with a particular firm it may launch an investigation. Should concerns arise about a particular type of business the FCA could undertake a series of ‘thematic visits’, focusing on that particular business type, or they could issue general guidance to the market to try and improve awareness and encourage firms to address the problems themselves. This can be seen in the FCA's thematic review of Retirement Income Advice.

Firms that fail to submit the required returns will find themselves in enforcement and possibly subject to having their authorisation removed. There is also the likelihood of fines being imposed for merely being late with returns.

C2B Notification requirements

The FCA’s principles require firms to deal with the regulator in an open and cooperative way. This is set out in FCA principle 11, as well as being a requirement of individuals through the conduct rules, both for senior managers and those in non-senior management roles.

11. Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.

The FCA leaves it to firms to decide what, when and how they should notify the regulator of matters about which it should reasonably expect to be kept informed. There are certain specific rules and guidance:

- The FCA would expect to be told immediately about any matter that could have a significant regulatory impact, serious fraud or crime, a major FCA rule breach or the firm’s insolvency.
- Changes to core information should normally be provided with reasonable advance notice, such as changes of name, address or legal status.
- Where the firm discovers that it has mistakenly given incorrect information to the FCA, the regulator should be notified immediately.

D Training and competence (T&C)

Detailed **training and competence (T&C)** rules only apply to retail business (both MiFID and non-MiFID), however, the T&C regime is still recommended as good practice for all business. The rules no longer apply to firms domiciled outside the UK where these are ‘passported in’ firms.

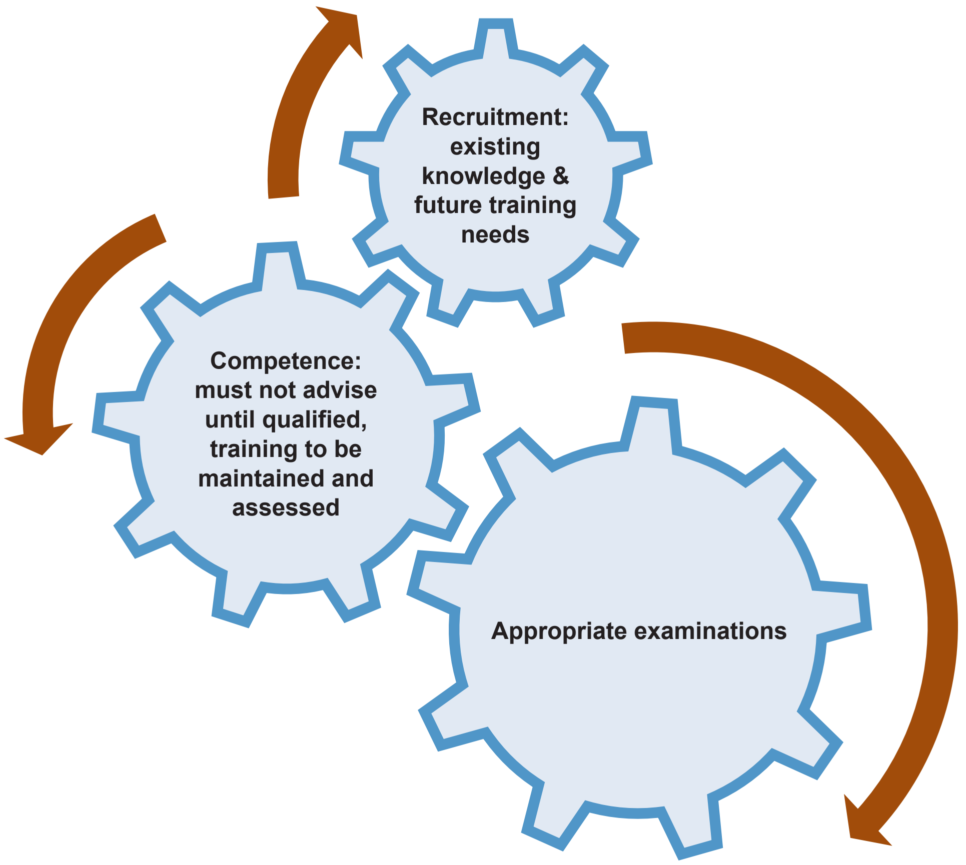
The T&C rules are designed to ensure that firms’ employees are (and remain) competent for the work they do and are properly supervised. Competence must be regularly reviewed and the level of competence must be appropriate to the business. As we saw in the last chapter, when we say employees, specifically we mean:

- those that provide advice, e.g. investment advisers, mortgage advisers and general insurance advisers;
- those that supervise them; and
- overseers – selected management roles in key administration functions such as claims and processing new business.

Senior managers and other staff are not subject to the T&C requirements, but they are subject to SM&CR and other requirements. If they are supervising those in roles covered by T&C then they will also be subject to the same requirements. The roles covered by T&C are listed in the FCA Handbook at T&C Appendix 1.

The key areas of the T&C requirements are as follows:

Figure 7.1: T&C rules process



D1 Recruitment

When recruiting individuals to deal with retail clients, the firm must take into account the knowledge and skills of the individual, their current role, and obtain sufficient information about their previous activities and training. (This would include any appropriate qualifications.)

Where recruiting for a certified or senior management role a firm should follow the steps outlined in SYSC 22, using the regulatory reference template in SYSC 22 Annex 1.

If an employee deals with retail clients, the firm must determine the employee's training needs and organise training to meet those needs. Training must take account of changes in the market, products, legislation and regulation.

D2 Competence

An employee must not engage in or oversee an activity unless they have been assessed as competent in that activity or are under supervision. An employee must not deal with retail clients (even under supervision) until they have passed the regulatory module of an approved examination (e.g. R01) and have an adequate level of knowledge and skills.

A firm must ensure that **an employee assessed as competent maintains that competence**. Supervisors of employees advising retail clients on products must also pass an appropriate approved examination and have the knowledge and skills to act as a supervisor. This also includes the ongoing requirement to complete **35 hours of appropriate continuous professional development** (CPD), at least 21 of which must be **structured**.

Records of training must be kept for:

- at least three years for non-MiFID firms and five years for MiFID firms from the cessation of the employee's appointment; or
- indefinitely for pension transfer specialists.

For these purposes, 'employees' includes self-employed representatives and appointed representatives and their employees.

Records should include:

- Knowledge gaps and what will be done to fill them.
- How training undertaken filled these gaps.

What should CPD cover?
All CPD activities should:

- Be relevant to the individual's role and any anticipated changes to it.
- Maintain knowledge with reference to current qualification standards.
- Contribute to professional skills and knowledge.
- Address identified gaps in technical knowledge.
- Have written learning objectives based on learning needs and documented learning outcomes.
- Be measurable and suitable for independent verification by an accredited body (such as the CII).

What is structured and unstructured CPD?
Structured CPD is an activity designed to achieve a **defined learning outcome**. Activities may include seminars, lectures, conferences, workshops or courses, webinars and completing appropriate e-learning. Examples of unstructured CPD activities include:

- conducting research relevant to the individual's role;
- reading industry or other relevant material; and
- participating in professional development coaching or mentoring sessions.

Be aware

CPD activities completed by a regulated adviser, which do not relate to acting as an adviser, should not be counted towards required CPD hours.

Duration of activities
Activities of a very short duration are unlikely to be viewed as relevant, such as short e-learning modules. However, if these are undertaken as part of a block of short activities, the block as a whole may be considered appropriate CPD, if it can be demonstrated to be relevant.

Additional CPD requirements
Additional CPD must also be recorded for specific activities. Advising on pension transfers and opt-outs, which requires an additional fifteen hours of appropriate CPD, nine of which must be structured, must be recorded each year following qualification. At least five hours of this additional CPD requirement must be given by an external independent provider.

This is different to the CPD requirements from the **Insurance Distribution Directive (IDD)** which require anyone selling insurance to complete at least 15 hours of CPD per year. This CPD can be included within the 35 hours already required but must be on relevant subjects to count.

On the Web

The CII's CPD scheme rules can be found here: *www.cii.co.uk/learning/cpd/cpd-scheme-rules/*.

D3 Appropriate examinations

There is a list of appropriate examinations published by the FCA in TC Appendix 4. Threshold qualifications are separately required for advising on investments and home finance products, but not for non-investment insurance activities as yet.

The level 4 professional exam (e.g. the CII's Diploma in Regulated Financial Planning consisting of the R01 to R06 exams) standards are the threshold requirement for advising on investment products.

For mortgage advisers, there is a requirement to obtain an appropriate level 3 qualification, although there are no specific time limits for attaining this.

For various specialised activities, such as **discretionary management** and **occupational pension transfers**, there are further specific approved examinations which must be passed first. Other specialist areas such as **long-term care insurance** and **equity release** also need additional exams to be passed.

An employee must not be assessed as competent for such an activity unless they have passed each module of the extra approved examination.

Those entering the industry as investment advisers have 48 months to complete the investments Level 4 examinations. Firms can choose to limit the number of attempts or the amount of time an individual is allowed in order to pass an appropriate examination. In practice, many firms will not allow anyone to give investment advice until after the appropriate qualification has been fully completed, though this is not universal.

Be aware

The requirement to complete the level 4 examinations within 48 months applies to someone acting as an investment adviser, not to those who are not undertaking this role prior to qualification.

Question 7.3

An employee of an FCA regulated firm advising retail clients should obtain ongoing training in which areas?

Activity

As you will see in the FCA table of appropriate qualifications (*bit.ly/2R5L4k8*), several qualifications can be appropriate for an activity. Which qualification is appropriate for your role? What qualifications would be appropriate for roles you wish to do in the future?

D4 Supervision

All advisers need to be supervised. Supervisors need to pass an appropriate qualification, if they supervise a trainee adviser who deals with retail clients on retail investment products (e.g. life policies) or P2P agreements, where that employee has not yet been assessed as competent. Supervisors should have the appropriate **technical knowledge, assessment and coaching skills** to be a supervisor.

Be aware

As detailed in TC 2.1.4 (G) and TC2.1.5 (R), an appropriate qualification does not mean the supervisor must have passed a specific supervisory qualification; rather one which is considered appropriate (as set out in TC App 4.1 Appropriate Qualification tables) for the regulatory activity of those being supervised.

How closely the individual is supervised will depend on their experience and whether they have been assessed as competent. **The level and intensity of supervision should be**

significantly greater before competence is achieved than afterwards. The FCA expects supervision to involve more than just file checking. There must be clear procedures and measures so that firms can demonstrate what level of oversight is appropriate for each employee based on their competency and experience.

D5 Reporting

Firms are responsible for reporting changes in an individual's competence status, along with various other ethical matters, directly to the FCA.

A firm must notify the FCA as soon as it becomes aware, or has information that suggests, any of the following have or may have occurred:

- An adviser, who has been assessed as competent, is no longer considered competent.
- An adviser has failed to attain an appropriate qualification within the time limit prescribed.

Be aware

Attainment of an appropriate qualification within the prescribed time limit relates to the time limits set out in TC 2.2A. Firms must ensure that employees do not carry out specific regulated activities without first attaining the relevant regulatory module of an appropriate qualification (e.g. R01 Financial services, regulation and ethics). The employee must achieve the complete qualification within the stated timescales. Firms may shorten these timescales if they wish and also limit the number of attempts a candidate can make.

- An adviser has failed to comply with COCON (or a Statement of Principle for approved persons).
- An adviser has performed a regulated activity before having demonstrated the necessary competence and without appropriate supervision.

SM&CR information on certified individuals is reported on an annual basis. Under the FCA principle of open and honest reporting, if a serious breach occurs then the FCA would expect to be informed immediately.

E Combatting money laundering and financial crime

Money laundering is the process by which criminals convert illegally obtained money into apparently legitimate funds. Nearly all money laundering is facilitated by the abuse of legitimate financial processes and services. Money laundering enables criminals to profit from organised, large-scale crime under a veil of respectability. Large-scale money laundering is usually a three-stage process:

- **Placement** of illicit cash through bank/building society deposits, and life assurance policies or other packaged investments such as unit trusts. In this way, the launderers turn illicit cash into payments from respectable financial institutions.
- **Layering** involves a series of transactions intended to conceal the origins of the illicit money. With the aid of false names and fictitious transactions, cash moves swiftly through a bank account, into an insurance policy (or other packaged investment) surrendered early to criminal associates who engage in currency transactions and the purchase of bearer bonds to provide security for legitimate loans from reputable banks.
- **Integration** is the process by which laundered money is finally converted into the proceeds of a legitimate business or investment portfolio.

Figure 7.2: The stages of money laundering

Placement → Layering → Integration

Financial services businesses are most likely to be involved at the placement and layering stages. For example, the launderer may open a bank account in a false name, withdraw the proceeds to buy an investment bond (or other packaged investment) in another name, surrender it early and transfer the 'clean' proceeds to another person's account overseas.

Money launderers are often highly organised and can be extremely sophisticated. They operate using both individual and company names. They often split large sums of money into many small single premiums or regular contributions to avoid suspicion. Even personal pension contributions can be used for money laundering.

The amount of illicit money laundered annually is enormous and a number of estimates can be used in order to measure the scale of the problem. The United Nations Office on Drugs and Crime suggests that money laundering is equal to 2–5% of global GDP. This range is often used to estimate the size of the money laundering problem in the UK.

The National Crime Agency (NCA) states that, although there are no exact figures, there is a realistic possibility that the scale of money laundering in the UK annually is in the hundreds of billions of pounds.

There is concerted international pressure to identify money laundering activities and to trace the perpetrators. The UK is a member of the Financial Action Task Force (FATF) and is committed to legislation to combat money laundering.

E1 Proceeds of Crime Act 2002

The initial principal UK statute in the fight against money laundering is the **Proceeds of Crime Act 2002 (POCA)**, although this has been amended on a number of occasions, most recently by the **Criminal Finances Act 2017**. The legislation creates a number of criminal offences:

- to conceal, disguise, convert or transfer criminal property or remove it from the UK;
- to be concerned in an arrangement to facilitate the acquisition, retention, use or control of criminal property; and
- to acquire, use or possess criminal property.

It is also an offence to fail to disclose known or suspected cases of money laundering in the course of business in the regulated sector.

The regulated sector includes:

- deposit taking;
- money changing;
- dealing, arranging, advising on or managing investments;
- arranging and advising on home finance;
- arranging and advising on general insurance; and
- effecting or carrying out contracts of long-term insurance.

Disclosure must be to the **National Crime Agency (NCA)**. For regulated firms, where a firm has a money laundering reporting officer (MLRO), disclosure is made by this person and not by the person who initially raises suspicion.

It is an offence to let the subject of a money laundering disclosure know they are being investigated.

On the Web
www.nationalcrimeagency.gov.uk.

E2 Money Laundering Regulations and JMLSG Guidance

The **Money Laundering Regulations 2017** implement the requirements of the EU's Fourth Money Laundering Directive, since supplemented by the Fifth Money Laundering Directive, which came into force in the UK in January 2020.

Guidance on the interpretation of the regulations is provided by the **Joint Money Laundering Steering Group (JMLSG)** which is made up of leading Trade Associations in the industry under the chairmanship of the Bank of England.

There is an emphasis in the 2017 Regulations on the adoption of a risk-based approach by regulated firms to the carrying out of their obligations. This means that firms/practitioners are expected to form a view on the level of risk presented by prospective customers and by particular situations and to determine, on the strength of this assessment, the extent of the compliance work they need to carry out.

The regulations also provide for a wider range of businesses to be covered and now include:

- credit and financial institutions (including life insurance companies, financial advisers, saving and investment firms, deposit takers and bureaux de change);
- auditors, accountants, tax advisers and insolvency practitioners, independent legal professionals, trust or company service providers, estate agents, casinos and high value dealers (dealing with goods with a transaction value greater than €15,000); and
- leasing companies, commercial finance providers and safe custody services.

Important areas of the regulations are:

Policies and procedures
These must be put in place to minimise the risk of the firm being used for money laundering/ terrorist financing purposes and a ***money laundering reporting officer (MLRO)*** **(SMF 17)** must be appointed to act as a central point for reports of suspicious activity. The MLRO will then decide whether to report those suspicions to the NCA. For firms to which its rules apply, the FCA expects that a firm's MLRO will be based in the UK and requires that person to have a level of authority and independence within the firm, and access to sufficient resources and information, to carry out their responsibilities.

As stated above, the overall approach taken should be risk-sensitive and procedures should be put in place to cover the areas of customer due diligence, reporting, record-keeping, internal control, risk assessment and monitoring of compliance.

Customer due diligence (CDD)
CDD involves verifying the identity of the customer (and the beneficial owner, if different) and obtaining information on the purpose and intended nature of the business relationship.

The circumstances under which client due diligence checks must be carried out were extended under the 2017 Regulations. CDD checks must be carried out when the regulated firm establishes a business relationship; carries out an occasional transaction; suspects money laundering or terrorist financing; or if there are doubts about the integrity of previously obtained customer information. Firms must ensure that clients or prospective clients are not subject to financial sanctions.

A firm may apply **simplified due diligence (SDD)** measures in relation to a particular business relationship or transaction if it determines that, taking into account its risk assessment, the business relationship or transaction presents a low degree of risk.

If the customer is not present for the transaction, further enhanced CDD measures are required, such as the production of additional documents to establish identity, confirmation of identity from an appropriate financial institution or payment through an account with a credit institution in the customer's name. This is also the case where the customer is a **politically exposed person (PEP)** or from a **high risk third country**.

On the Web

For more information on the approach to take in identifying a 'low degree of risk', including cash and stocks and shares ISAs and regular savings schemes, explore the JMLSG Guidance (Parts 1–3). The Part 1 guidance at Section 5.4 covers SDD: *jmlsg.org.uk/guidance/current-guidance/*.

FCA has published specific guidance on the treatment of PEPs for Anti-Money Laundering purposes which can be found at: *www.fca.org.uk/publication/finalised-guidance/fg17-06.pdf*.

Ongoing monitoring
Regulated firms are obliged to conduct ongoing monitoring of business relationships, therefore they are expected to scrutinise transactions to ensure that they are consistent with their previous knowledge of the client and their risk profile.

Identification procedures
For individuals, this is a two-stage process: firstly identifying the client by obtaining information such as name, address and date of birth, and secondly, by verifying this information through the use of reliable independent documents or information.

The JMLSG guidance states that acceptable documentation is:

- A Government-issued document with the customer's full name and photo with either the customer's date of birth or residential address. Acceptable documents include a valid passport, valid photocard driving licence, national identity card or firearms certificate.
- If the Government-issued document does not include a photo, then secondary evidence of address is required such as a utility bill, bank or building society statement or a recent mortgage statement from a recognised lender. If a member of staff has visited the client at home, a record of this visit may constitute evidence of corroborating the individual's residential address.
- Sufficient checks should be made of the documentary evidence to satisfy the firm of the client's identity (checking of spelling of names, photo likeness, matching addresses etc.).

For clients other than individuals, the firm must obtain information that is relevant to the entity such as company registration number and registered address and evidence that individuals have the authority to act for the business. Verification must be from reliable independent sources.

Proof of identity should be obtained as soon as possible and transactions should not be completed until this has been provided.

Any verification difficulties should be reported in the first instance to the MLRO.

Electronic Identity Verification (EIDV) is increasingly being used to identify clients. These systems use public and private databases to confirm an individual is who they claim to be. They use personal information such as name, date of birth, National Insurance number and address. The result of trying to confirm an individual's identity could be a match, non-match or partial match. Verifying someone's identity using EIDV can be relatively quick and flag up any inconsistencies.

When using electronic sources or digital identity services, firms should ensure they are able to demonstrate they have both verified that the customer exists and satisfied themselves that the individual seeking the business relationship is the individual being verified.

Staff awareness and training
Firms are required to take appropriate measures to ensure that all staff are made aware of the relevant legislation and regulations and have received training on identification and verification of clients' identity and how to recognise and deal with transactions which may be related to money laundering/terrorist financing. **Retraining for existing staff must be carried out at regular intervals**.

Enforcement
Enforcement powers include the right to enter and inspect premises and take copies of any relevant documents. Designated authorities may impose 'appropriate' civil penalties. 'Appropriate' is defined as being effective, proportionate and dissuasive. If partners or directors are personally responsible for failure to comply with regulations they may be fined (up to an amount not exceeding the statutory maximum), imprisoned for up to two years, or both. In this case they would not also be liable to a civil penalty.

Suspicious activity reporting (SAR)
Firms must appoint an MLRO (SMF17) who is required to make reports to NCA where they know, suspect or have reasonable grounds for knowing or suspecting that a person is engaged in money laundering or terrorist financing. **Staff within the business must report such matters, which are made in confidence, to the MLRO**. They should **not** report them to the NCA directly. Examples of suspicious activity would be where:

- the client is using intermediaries to protect their identity or hide their involvement;
- there is a sudden significant improvement in a client's finances but they are unable to explain where the money came from; or
- money is paid by a third party who does not appear to have any connection with the client.

The UK Financial Intelligence Unit receives over 460,000 SARs each year. Many of these are submitted via the NCA's SAR portal.

While you may not be the individual responsible for filing SARs at your firm it is important to understand how this process works.

On the Web
The NCA's SAR Guidance can be found here: *www.nationalcrimeagency.gov.uk/what-we-do/crime-threats/money-laundering-and-illicit-finance/suspicious-activity-reports*.

Be aware
The abbreviation SAR is used to refer to both suspicious activity reporting and, in the context of data protection, to a Subject Access Request.

Firm annual reporting
There is a need for an authorised firm to undertake an annual review of its anti-money laundering systems and processes by obtaining a report from the MLRO.

Record-keeping
Firms are required to keep records of a client's identity verification for five years after the end of the customer relationship or five years from when the transaction was completed. Records can be kept as original documents, photocopies, or in computerised or electronic form. Records should also be kept of internal/external reports and decisions as part of the suspicious activity reporting.

Protection measures
To aid the detection of money laundering it is important to protect the person who reports their suspicions. This is typically covered by a firm's whistle-blowing procedures. The NCA must know who they are because they may need to obtain further information from them in pursuing their investigations. Outside the investigation however, their names will be concealed and they will not be called upon to give evidence.

Financial sanctions
It is a criminal offence to make payments, or allow payments to be made, to targets on the sanctions list maintained by HM Treasury. This includes dealing directly with targets, or dealing with targets through intermediaries such as lawyers or accountants.

Firms need to have an appropriate means of monitoring payment instructions to ensure that no payments are made to targets or their agents. In the regulated sector this obligation **applies to all firms**, not just to banks.

On the Web
The full HM Treasury sanctions list can be found at:*www.gov.uk/government/publications/financial-sanctions-consolidated-list-of-targets/consolidated-list-of-targets*.

Be aware
The FCA is currently consulting on changes to the Financial Crime Guide. The proposed changes may have some impact on advisory firms, particularly those with any involvement in distance transactions or with cryptoassets, but all firms should consider that they could become victims of cyber crime. The FCA has included extensive guidance for firms which will be useful regardless of whether the changes to the Guide are implemented.

You can find out more about the consultations here: *www.fca.org.uk/publication/consultation/cp24-9.pdf*.

E2A Civil recovery
The Proceeds of Crime Act established the **Assets Recovery Agency (ARA)**, now part of the NCA, to confiscate from criminals the proceeds of their crimes (for example, by obtaining a court order empowering it to sell a defendant's assets). The ARA also had wide powers to obtain financial information and these powers could be used in relation to life policies and other investments. It could also take over HMRC's function to tax profits or gains of criminal conduct.

Question 7.4
What are the three stages of money laundering?

F Data protection and security

F1 Data protection legislation

'Data protection legislation' is a generic term for the **UK General Data Protection Regulation** (**UK GDPR**) and the **Data Protection Act 2018** (**DPA 2018**). They both govern the processing of personal data in the UK.

DPA 2018 mirrors much of what is contained in the UK GDPR and makes some modifications. For example, parts of the UK GDPR do not apply to processing by law enforcement authorities. In addition, from age 13 parental consent is not needed to process data online.

Who does the legislation apply to?
It applies to all persons in the UK who process personal data other than for domestic purposes. It gives data subjects rights and places obligations on data controllers and data processors.

For example, both controllers and processors are required to ensure that their data processing is secure. Significant fines have been imposed for security breaches, and there have been a number of out of court settlements of claims for damages from affected data subjects who have banded together to obtain group litigation orders.

What information does the legislation apply to?
It applies to **personal data**. This is any information from which a living individual can be identified, either directly or indirectly. The information is not limited to names and identification numbers or to photographs or addresses. A large shoe size may be someone's personal data if there is an individual in an organisation known to have big feet. An IP address may be personal data.

It is important to remember that information may become personal data if a person becomes identifiable when data is combined with other information that subsequently comes into the possession of an organisation.

Personal data that has been effectively anonymised is no longer personal data and falls outside the data protection legislation.

It is well known that the legislation governs the processing of electronic data (known as automated processing). It is less well known that it also governs the processing of personal data in a manual filing system. For example, the failure to shred documents may be a data security breach in some circumstances. Leaving a file in a taxi is a well-known example of a security breach.

Sensitive personal data
The legislation creates special categories of personal data so as to provide additional safeguards for sensitive information. The categories are:

- race or ethnic origin;
- political opinions;
- religious or philosophical beliefs;
- trade union membership;
- genetic data;
- biometrics (where used for ID purposes);
- health information;
- information about sex life; and
- sexual orientation.

Data Protection Principles

Personal data must be processed in accordance with the seven Data Protection Principles. They are:

1. **Lawfulness, fairness and transparency**.
   - There must be a lawful basis for processing personal data. Any unlawfulness, whether it is a breach of the data protection legislation or not, will be a breach of this principle.
   - Data should be processed fairly which means it should be processed in ways that people would reasonably expect.
   - Organisations must be clear, open and honest with individuals about the personal data they are processing and why and how they are doing it. This may be achieved with the publication of a privacy notice.
2. **Purpose limitation**. Data should not be processed for reasons other than those for which the information was obtained in the first place. For example, personal information provided when a person registers with an online retailer should not be provided to third parties without the person's consent.
3. **Data minimisation**. Organisations must use the minimum amount of data required to fulfil their purposes. They must process no more information than they need. For example, is a date of birth really necessary?
4. **Accuracy**. Data should be accurate and kept up to date. This includes granular detail such as addresses.
5. **Storage limitation**. Information must be kept no longer than is necessary to achieve its purpose. For example, is there a justification for keeping an entire file for six years? Can some sections of it be destroyed before then?
6. **Integrity and confidentiality**. Organisations must ensure that they have appropriate security measures in place to protect the data they hold.
7. **Accountability**. Organisations must take responsibility for what they do with personal data and how they comply with the other principles. They should keep records to demonstrate compliance. Providing accessible information to individuals about the use of their personal information is a key element of compliance; most organisations do this via a Privacy Notice, which can usually be found on their website.

For reference only

Chapter 7

Lawful processing

The processing of personal data is unlawful unless one of the legal bases set out in the legislation applies. This means that organisations need to identify a legal basis for the processing.

1. **Consent**

   Consent must be freely given, specific, informed, and an unambiguous indication of the individual's wishes. It must be quite distinct from other terms and conditions; it must be given for an identified purpose; and there must be some form of positive opt-in. It cannot be inferred from silence, pre-ticked boxes or inactivity. Organisations need to make it as simple for people to withdraw consent as it was to give it. It is advisable to find an alternative legal basis where possible.
2. **Contract**

   The processing is necessary to give effect to a contract with an individual, or because they have asked the organisation to take specific steps before entering a contract.
3. **Legal obligation**

   The processing is necessary for a firm to comply with the law (other than contractual obligations).
4. **Vital interests**

   The processing is necessary to protect someone's life. This basis is limited in scope and generally only applies to matters of life or death.
5. **Public task**

   Public authorities rely on this basis where they need to process personal data 'in the exercise of official authority' or perform a task in the public interest. Organisations in the private sector may also rely on this basis where they are exercising official authority or carrying out tasks in the public interest.

6. **Legitimate interests**

   The processing is necessary for an organisation's legitimate interests or the legitimate interests of a third party, unless there is a good reason to protect the individual's personal data which overrides those legitimate interests.

   Legitimate interests may be commercial interests and businesses often rely on this basis. If they do, they must identify the legitimate interest and ensure they are processing the personal data for that purpose. They must also check that the processing is necessary to achieve that purpose.

   Finally, it is important to carry out a balancing test to assess whether the interests of the individual and their right to privacy override the legitimate interests of the organisation.

Rights

Individuals have the following legal rights under the legislation:

Right to be informed	• Individuals have the right to be informed about the collection and use of their personal data. • The information provided must include the purposes for processing the personal data, the retention period and who it will be shared with. • Information must be provided to individuals at the time the personal data is collected from them.
Right of access	• Individuals have the right to find out if an organisation is using or storing their personal data. • They also have a right to receive a copy of their personal information. • They can exercise this right by submitting a subject access request (SAR). An SAR can be made verbally or in writing. • A company should respond to a SAR within one month; it can take an additional two months if the request is complex. • This right corresponds to the transparency principle which organisations are required to adopt.
Right to rectification	• Individuals have the right to have inaccurate personal data rectified or completed if it is incomplete. • An individual can make a request for rectification verbally or in writing. • A company has one month to respond. • This right corresponds to the accuracy principle.
Right to erasure	• Individuals have the right to have their personal data erased, also known as 'the right to be forgotten'. • The right is not absolute and only applies in certain circumstances. • An individual can make a request for erasure verbally or in writing. • The organisation has one month to respond.
Right to restrict processing	• Individuals have the right to request the restriction or suppression of their personal data. • When processing is restricted, an organisation is permitted to store the personal data, but not use it.
Right to data portability	• Individuals have the right to transfer personal data from the IT system of one organisation directly to another in a safe and secure way – when changing banks, for example. • This right allows data subjects to use applications or services to find a better deal.
Right to object	• Individuals have the right to object to the processing of their personal data in certain circumstances. • They have an absolute right to stop their data being used for direct marketing. • Organisations may be able to continue processing personal data despite an objection if they can establish a compelling reason for doing so. • An individual can make an objection either verbally or in writing. There is one calendar month to respond.

Rights in relation to automated decision making and profiling	• An individual has the right not to be subject to a decision based solely on automated processing, including profiling. • Processing is 'automated' where it is carried out without human intervention and where it produces legal effects or significantly affects the individual. • Individuals must be able to obtain human intervention, including an explanation of the decision, and be able to challenge it.

Accountability and governance

Data controllers are required to demonstrate compliance with the data protection legislation. They are required to have certain policies and procedures in place, including a risk register where data breaches are entered.

Organisations need to maintain documentation to evidence their processing activities and to implement appropriate security measures. Where personal data is sensitive or high risk a data protection impact assessment will be advisable. They are also need to ensure there are written agreements in place between them and any processors they engage. Certain terms are mandatory in these agreements. The appointment of a data protection officer may be recommended.

International data transfers

To ensure that the level of protection afforded to individuals by the UK GDPR is not undermined, the data protection legislation governs the transfer of personal data from the UK outside the EU to third countries or international organisations.

Breach notification

Organisations must report data breaches to the **Information Commissioner's Office** (**ICO**) where there is likely to be a risk to data subjects. If the risk is high, the data subjects must be alerted to the breach.

Be aware

For the most serious data breaches, the ICO may levy fines of up to £17.5m or 4% of annual global turnover if higher.

On the Web

ICO: *https://ico.org.uk/*

Be aware

Some online data processing services are based outside the UK. Before using such services you should consider whether you have made appropriate disclosures to data subjects about the possible transfer of their data overseas and the potential loss of protections which may ensue, even if the companies claim to be compliant with the UK's data protection legislation.

For reference only

Chapter 7

F2 Data security

Firms should consider the following points in reviewing their data security:

What is client data?

Client data is any personal information held in any format. Examples include national insurance records, address, date of birth, family circumstances, bank details and medical records. Information must be kept secure because fraudsters can use it to commit crimes such as identity theft.

What are the main risks?

There are a number of ways client data can be compromised. There is also a misconception that this is purely an IT issue.

Have you, for instance, considered the physical safety of your business premises? Do you have a signing-in book for visitors and can someone else see who has already signed in? Do you supervise visitors while they are on the premises?

Another risk concerns the vetting of new staff. In the past it has been discovered that when hiring administrative staff – especially junior administrative staff – many firms carry out only basic reference checks. However, administrators often have access to a great deal of client data.

Your firm should take a risk-based approach to reducing financial crime and should enhance recruitment checks where appropriate. You may wish to consider credit checks and criminal record checks on individuals with access to large amounts of client data.

There are many other ways that data can be compromised and the FCA would encourage firms to seek further information if they need it.

What about the risks posed by third-party suppliers?
Many firms employ third-party suppliers to carry out IT support, office cleaning and/or security. This can lead to a situation where people from outside the firm can have access to client data, especially if the staff leave confidential information on their desks.

Firms should carry out due diligence on third-party suppliers before hiring them. They should try to establish what their vetting procedures are and ensure they have a good understanding of the firm's security arrangements.

Remember: outsourcing to a third party does not mean firms have outsourced their obligations to look after client data.

Good data security policies in practice
Having good data security policies and appropriate systems and controls in place will go a long way to ensuring client data is kept safe. However, firms need to ensure that staff understand the policies and procedures and the firm keeps up-to-date with staff moves.

For instance, when someone moves to a role where they will not require access to client data, do their IT permissions take account of this? Are staff trained to ensure they understand why they should follow policies and procedures? Is there an individual at the organisation with responsibility for data security?

G Complaints rules and procedures

If a client wishes to make a complaint it **should be made in the first instance to the firm that provided the relevant investment or service**. Complaints about a sale made by an employee or representative of an insurer should be made to the provider.

G1 Complaints procedures

The FCA rules in DISP 1.1A. 12–14 require every authorised firm to have and publicise an appropriate written complaints handling procedure to deal with complaints from eligible complainants about its provision (or non-provision) of a financial services activity. If another party is the subject of the complaint it should be referred to them promptly and the complainant so informed.

The FCA defines a complaint as:

> '...any oral or written expression of dissatisfaction, whether justified or not, from, or on behalf of, a person about the provision of, or failure to provide, a financial service… which: alleges that the complainant has suffered (or may suffer) financial loss, material distress or material inconvenience; and relates to an activity… which comes under the jurisdiction of the Financial Ombudsman Service.'

A firm must refer in writing to the availability of its complaints procedure at, or immediately after, the point of sale. It must publish details of its procedures, supply a copy on request and supply a copy to complainants. The firm may also display in each of its branches a notice indicating that it is covered by the **Financial Ombudsman Service (FOS)**.

Refer to
The FOS is covered in more detail in *Financial Ombudsman Service (FOS)* on page 7/36

Dealing with a complaint
The FCA rules require that once a complaint has been received, a firm must investigate it 'competently, diligently and impartially'. It should assess 'fairly, consistently and promptly' the subject matter of the complaint, whether the complaint should be upheld and what remedial action and/or redress may be appropriate.

Firms are required to nominate a senior individual (someone in a governing function such as a director/chief executive/partner) to have responsibility for the complaints handling function within the firm. The FCA believes that requiring the individual to hold a governing function will mean they have the necessary degree of influence within the firm to ensure sufficient resources are allocated to complaints handling and that they will be able to exert pressure on other parts of the business to take appropriate action where failures are leading to complaints.

Firms are also required to keep records of analysis and decisions taken by senior personnel in response to complaints. According to the rules, firms will need to meet FCA requirements in establishing the root cause of complaints and have the appropriate processes in place to run this kind of analysis.

Where the firm has reasonable grounds to be satisfied that another firm may be solely responsible for the complaint it may refer the complaint to the other firm promptly. This referral must be made in writing and will usually be within five business days of the date of complaint. The original firm will inform the complainant of this action in writing and will include the other firm's contact details.

Rapid resolution complaints
Where complaints are addressed by the firm in the first instance (so-called 'rapid resolution' complaints), the period for dealing is **three business days**. A complaint may be considered resolved if the complainant has indicated their acceptance of the response made by the firm, neither the response, nor the acceptance need be in writing.

Where the firm considers the complaint to be resolved on this basis they must send the complainant a summary resolution communication which:

- refers to the fact that the complainant has made a complaint and that the matter is considered to be resolved;
- tells the complainant that they have the right to refer the matter to the FOS;
- indicates whether time limits for doing so will be waived;
- provides the FOS website address; and
- refers to the availability of further information on the FOS website.

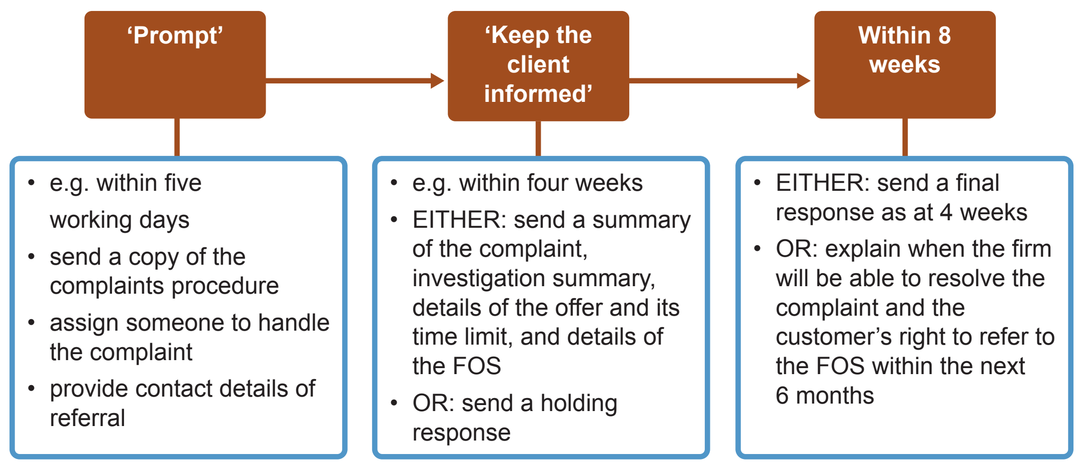
Responses
If the complaint cannot be resolved in three working days, in order to keep the client informed a firm must send the complainant **a prompt written acknowledgement** providing early reassurance that it has received the complaint and is dealing with it. Following this, the firm must keep the complainant informed of progress and the measures being taken to resolve the situation. After eight weeks there should be a final response.

The final response must be notified to the complainant along with their right to refer the matter to the FOS within six months. If the complaint is upheld, the firm must make an offer of appropriate compensation or remedial action. If the complainant accepts this, it should be the end of the matter. If the complainant thinks the offer is insufficient, they can still refer the matter to the FOS.

The FCA expects that almost all complaints will have been substantively addressed within eight weeks, if this is not possible a firm must send a written response explaining why and indicating when it expects to provide a final response and stating that the complainant can now refer their complaint to the FOS within six months.

On the Web
www.handbook.fca.org.uk/handbook/DISP.

Figure 7.3: Good practice in handling complaints



When a complaint refers to MiFID business, records must be kept for five years, otherwise for three years. A firm must supply complaints statistics to the FCA twice a year. This is done through the **RegData** online reporting system.

Question 7.5

Derek, a retail client of firm ABC regulated by the FCA, wishes to make a complaint about financial advice he has received from Richard, one of ABC's advisers. To whom in the first instance should he complain?

Complaints data

Firms which receive 500 or more complaints in a six-month period have to publish their complaints handling statistics and information twice a year. The FCA uses this information to publish a consolidated list of complaints data covering all affected firms twice a year.

G2 Financial Ombudsman Service (FOS)

The **Financial Ombudsman Service (FOS)** is a free, independent and impartial service that deals with unresolved disputes. Membership is compulsory for all authorised firms, including intermediaries.

The full rules and guidance relating to the handling of complaints, and on the operation of the FOS, are contained in the FCA Handbook in the **Dispute Resolution: Complaints (DISP) Sourcebook**. The FCA requires all firms to have a written complaints procedure. This procedure must include a notification to the complainant that they have the right to take the complaint to the FOS if they are not satisfied with the firm's final answer.

The FOS only deals with disputes from eligible complainants. The list of eligible complainants includes:

- consumer;
- micro-enterprise with fewer than ten employees and a turnover or balance sheet total of no more than €2m*;
- charities with an annual income of less than £6.5m;
- trustees of trusts with a net asset value of less than £5m;
- small businesses with an annual turnover of less than £6.5m and fewer than 50 employees or a balance sheet total of less than £5m; or
- guarantors.

*(This value is in euros as 'micro-enterprise' is an EU defined term.)

Before a complainant can take their complaint to the FOS they must have exhausted the internal complaints procedures within the organisation or intermediary, and still be dissatisfied with the outcome. Any legal proceedings that are under way must be withdrawn prior to the complainant approaching the FOS as the FOS will not become embroiled in legal proceedings.

The complainant can refer their complaint to the FOS within the earliest of:

- **six months** of the date on the firm's letter advising the claimant of its final decision regarding the complaint;
- **six years** after the event complained about; or
- **three years** after the complainant knew, or should have known, that they had cause for complaint.

Once these have expired, the organisation or intermediary can object to the FOS taking on the complaint on the grounds that it is 'time-barred'. The FOS is able to consider complaints outside these time limits in exceptional circumstances, such as cases involving pension transfers and opt-outs. It can also review cases outside the time limits if the organisation agrees.

The FOS can require the parties to the complaint to produce any necessary information or documents and failure to do so can be treated as contempt of court. All authorised firms must cooperate with the FOS. The FOS must investigate the complaint and aim to answer the complaint within three months. It may give the parties an opportunity to make representations and then hold a hearing. Most disputes handled by the FOS are resolved through mediation or informal adjudication by a caseworker or adjudicator. However, both parties have a right of appeal to the initial outcome, in which case one of the panel of ombudsmen will make a final decision.

The FOS will reach a decision based on what is fair and reasonable in all the circumstances, taking into account the law, FCA rules and guidance and good industry practice, including relevant ABI statements and codes of practice. The FOS is not bound by the law or legal precedent and will make a judgment on the merits of each case. The aim is to ensure that customers are treated fairly and that the law is not used as an excuse to avoid paying fair claims. However, the FOS does aim to be consistent in the way it deals with particular types of complaints. Redress can be awarded in two ways:

- A '**money award**', telling the firm what specific sum of money it should pay the customer to cover any financial losses they have suffered as a result of the problem they have complained about. The maximum monetary award the FOS can require a firm to make to a complainant is outlined in the following table:

Limit of award	Date complaint referred to the FOS	Date act or omission occurred
£430,000	On or after 1 April 2024	On or after 1 April 2019
£195,000	On or after 1 April 2024	Before 1 April 2019

The FOS may recommend a higher figure, if appropriate, but this will not be binding on the firm. The FOS may also decide that the firm should pay interest on top of any compensation due. This is calculated at a rate of 8% per year, unless the claim relates to a period before April 1993.

On the Web

You can view the full range of figures here: *www.financial-ombudsman.org.uk/consumers/expect/compensation*.

- A '**directions award**', telling the firm what actions it needs to take to put things right for its customer. This could include, for example, directing the business to:
  - pay an insurance claim that had earlier been rejected;
  - calculate and pay redress according to an approach or formula set by the regulator; and/or
  - apologise personally to the customer.

The decision (with reasons) must be notified in writing to the complainant and the respondent (the firm about which the complaint is made). The complainant must then accept or reject the decision within the time limit specified by the FOS.

If the complainant accepts the decision it is binding on the respondent. If the complainant rejects the decision it is not binding and they are free to pursue the matter in court. If the complainant does not respond to the FOS's decision letter it is treated as a rejection and the respondent is not bound by the decision.

The FOS is funded by both:

- a general levy paid by all firms; and
- a case fee payable by the firm to which the complaint relates.

Question 7.6

What is the current maximum monetary award that the FOS may give for a complaint arising today for advice given after 1 April 2019?

H Financial Services Compensation Scheme

The **Financial Services Compensation Scheme (FSCS)** was established under s.212 of FSMA to compensate claimants where a regulated firm or individual is unable to satisfy claims against them in connection with regulated activities.

The claim must be made by an eligible claimant for:

- a protected deposit;
- a protected insurance contract; or
- protected investment business.

Protected deposits are basically deposits at UK branches.

Protected insurance contracts are ones issued through an office in the UK, another EEA State, the Channel Islands or the Isle of Man, if the risk is situated in one of these countries. For life and pension policies the risk is situated where the policyholder is habitually resident at the date the policy was effected.

Protected investment business is:

- any investment business carried out by the firm with the claimant, or as agent for the claimant;
- the activities of a manager or trustee of an authorised unit trust if the claim is made by a unit-holder; or
- the activities of an ACD (authorised corporate director) or depository of an OEIC if the claim is made by the holder, provided that the business was carried on from a UK office.

In order to get compensation, a claimant must be eligible. An **eligible claimant** is any person except those specified in the FCA Handbook at COMP 4.2, for example:

- overseas financial services institutions;
- pension and retirement funds;
- supranational institutions, governments and central administrative authorities;
- provincial, regional, local and municipal authorities;
- large companies;
- large partnerships;
- alternative investment funds; and
- large mutual associations.

The FSCS must decide whether the firm is in default, meaning it is unable (or is likely to be unable) to satisfy protected claims against it. The FSCS can require a firm to produce information and documents for this purpose, and that power extends to any insolvency practitioner handling the firm's bankruptcy or liquidation.

If the FSCS judges that a firm is in default it must pay compensation to all claimants affected by the default. The limits of compensation for each claimant are as follows:

Deposits	• 100% of the first £85,000 per person per authorised firm (£170,000 for joint accounts). • There is also a target of a seven-day payout for the majority of claimants and the remainder within 20 days. • Certain temporary high balances of up to £1 million for 6 months from the date of deposit.
Investments	• From 2019, 100% of the claim, up to £85,000.
Long-term insurance	• Product providers – 100% of the claim with no upper limit. • Intermediaries – 90% (in certain cases 100%) of the claim with no upper limit.
General insurance	• Compulsory insurance – 100% of valid claims or unexpired premiums, with no maximum. • Non-compulsory insurance – 90% of the claim with no upper limit.
Home finance mediation (mortgages etc.)	• 100% of the claim, up to £85,000.
Pensions	• Insured personal pension/pension provider – 100% of the claim. • Annuities – 100% of the claim. • SIPP operator – 100% of the claim up to £85,000.

Note: These figures are per person per institution. It is important to recognise that certain financial institutions are merely trading names/styles of one company, so compensation would only be available once. This would be the case where deposits are held with two deposit-taking banks but both are operated under the same banking licence.

Example 7.1

If a married couple had £140,000 deposited with a bank that failed, they would receive the full amount back under the FSCS as this is within the limit (£85,000 x 2 = £170,000). If the deposit was only owned by only one of the couple, the maximum that would be returned is £85,000 so they would have lost the remaining £55,000.

FSCS deposit protection limit for temporary high balances

Depositors with temporary high balances are covered up to £1m for six months from the date on which the money is transferred into their account, or the date on which the depositor becomes entitled to the amount, whichever is later. This is to ensure that depositors are protected when they deposit funds as a result of specified events until they have had sufficient time to spread the risk between institutions to appropriately protect these funds. The specified events include funds received including following the sale of a home or funds received from a divorce settlement or inheritance.

Note: FSCS will not confirm eligibility of a temporary high balance unless/until a bank or building society fails.

Details of temporary high balance eligibility can be found here: *www.fscs.org.uk/making-a-claim/claims-process/temporary-high-balances/*.

The costs to the FSCS would be minimal if, for example, a small intermediary that did not handle client money went bankrupt. However, the costs could be enormous if a large bank or insurance company became insolvent.

The FSCS is funded by a levy on authorised firms. The latest model introduced five new broad classes, based on five identifiable industry sectors: deposits, investment, life and pensions, general insurance, and home finance. There will be two sub-classes in each broad class, divided along provider and distributor lines – with the exception of the deposits class.

Each sub-class will have a limit (or threshold) on what it could be required to contribute to compensation claims in each year. If a sub-class reaches its annual threshold the other sub-classes in their broad class would be required to contribute to any further compensation costs (again up to a limit). Once a broad class has reached its threshold, other classes will be required to contribute according to their class size.

The FSCS also has a duty to try to make arrangements to secure continuity of insurance for long-term insurance policyholders by transfer of the business to another insurer. It must also try to safeguard the policyholders of insurance companies in financial difficulties.

The FSCS may decide to reduce compensation if there is evidence of contributory negligence by the claimant, or if paying the full amount would provide a greater benefit than the claimant might reasonably have expected, or greater than the benefit available on similar investments with other firms. Any bonus on a with-profit policy is not part of a claim unless declared prior to the liquidation of a life office. If the FSCS considers that the benefits under a long-term insurance are excessive it must refer the contract to an independent actuary. If the actuary agrees the benefits are excessive then the FSCS can reduce the claim.

Personal representatives can claim on behalf of a deceased person, and trustees can also claim on behalf of the trust.

On the Web
www.fscs.org.uk.

I Protection for pensions

Various schemes exist to help protect the rights of pension holders. They cover advice, complaints, regulation and compensation.

Refer to
See *The Pensions Regulator (TPR)* on page 4/13 and *Money and Pensions Service (MaPS)* on page 8/5.

I1 The Pensions Ombudsman

When someone has tried to resolve a problem with their pension and is not satisfied with the outcome, they can ask **The Pensions Ombudsman** to help.

This is an independent organisation set up by law to investigate complaints about pension administration. It can also consider complaints about the actions and decisions of the Pension Protection Fund.

It looks at the facts without taking sides, and it has legal powers to make decisions that are final, binding and enforceable in court. Its service is free.

The Pensions Ombudsman is funded by grant-in-aid paid by the DWP. The grant-in-aid is largely recovered from the general levy on pension schemes administered by the Pensions Regulator.

On the Web
www.pensions-ombudsman.org.uk/.

I2 The Pension Protection Fund (PPF)

The **Pension Protection Fund (PPF)** exists to provide compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the pension scheme to cover the PPF level of compensation.

Notable examples of pension funds managed by the PPF include those of Carillion, Hoover and Toys ‘R’ Us. Currently the PPF manages pensions for over 295,000 individuals and manages £32.5bn in assets. The purpose of the PPF is to ensure that an employee of a company that has ceased trading will continue to receive pension payments for the funds held under a pension scheme, even though their employer has ceased trading.

The PPF is a statutory fund run by the Board of the Pension Protection Fund, a statutory corporation established under the provisions of the Pensions Act 2004 and part of the Department for Work and Pensions. To help fund the PPF, compulsory annual levies are charged on all eligible schemes.

The PPF is one of the largest pension fund managers in the UK and actively invests the assets of the PPF. They appoint a wide range of fund managers and maintain oversight of the funds under management.

The PPF is also responsible for the Fraud Compensation Fund – a fund that will provide compensation to occupational pension schemes that suffer a loss that can be attributable to dishonesty.

On the Web
www.ppf.co.uk/.

Key points

The main ideas covered by this chapter can be summarised as follows:

Regulatory authorisation

- Under s.19 of the FSMA 2000, it is an offence to carry out a regulated activity unless authorised or exempt – the general prohibition.
- New firms wishing to undertake regulated activities must gain authorisation before starting the business; existing authorised firms wishing to undertake a regulated activity for which they are not currently permitted must gain authorisation for the new activity.
- Regulated activities are:
  - Banking activities.
  - Insurance activities.
  - Investment activities.
  - Home finance activities.
  - Credit-related activities.
  - Scheme operator activities.
- Various bodies are exempt from authorisation:
  - the Bank of England;
  - the European Central Bank;
  - the central banks of European Economic Area (EEA) States;
  - local authorities; and
  - various government bodies.

Senior Managers & Certification Regime (SM&CR)

- The rules apply to all PRA-authorised entities and most FCA-regulated firms.
- Key features of the regime are:
  - Senior Managers Regime;
  - Certification Regime; and
  - Conduct Rules (COCON).
- Under the Senior Managers Regime, senior managers:
  - have increased personal accountability and more clearly defined roles;
  - must have Statements of Responsibility, detailing individual responsibilities; and
  - must not carry out a senior management function (SMF) without approval from the FCA.
- The Certification Regime concerns certification by the firm of its key function holders, including annual review of their fitness and propriety, competence and capability to carry our their roles.
- The Conduct Rules concern the business-wide application of good conduct principles to improve the customer experience.

Training and competence (T&C)

- T&C rules are designed to ensure that advisers are properly supervised and that they and their supervisors, as well as those in senior management roles are and remain competent for the work they do, and are properly supervised.
- Firms must regularly review employees' competence and make sure that their level of competence is appropriate for the business that the individual and the firm undertake.
- An appropriate Level 4 exam is required to be deemed competent as an investment adviser.
- Once competent, 35 hours annual CPD is required, of which 21 hours must be structured CPD.

Key points

- Records of training must be kept:
  - for at least three years for non-MiFID firms and five years for MiFID firms from the end of the employee's appointment; or
  - indefinitely for pension transfer specialists.

Appointed representatives (ARs)

- A firm (appointed representative) is exempt from authorisation if it has a contract with an FCA authorised firm (principal) whereby that firm has accepted responsibility in writing for its activities.

Approved Persons Regime

- This still applies to non-SM&CR firms and appointed representatives.
- Individuals undertaking a 'controlled function' must be individually approved and registered.

Combatting money laundering and financial crime

- Money laundering is the process by which criminals convert money obtained illegally into apparently legitimate funds.
- Large-scale money laundering is usually a three-stage process:
  - Placement.
  - Layering.
  - Integration.
- The principal UK statute in the fight against money laundering is the Criminal Finances Act 2017 which replaces the Proceeds of Crime Act 2002 (POCA).
- POCA created a number of criminal offences as follows:
  - to conceal, disguise, convert or transfer criminal property or remove it from the UK;
  - to be concerned in an arrangement to facilitate the acquisition, retention, use or control of criminal property;
  - to acquire, use or possess criminal property.
- CDD involves verifying the identity of the customer (and the beneficial owner, if different) and obtaining information on the purpose and intended nature of the business relationship.
- Firms are required to take appropriate measures to ensure that all relevant staff are made aware of the relevant legislation and regulations and have received appropriate training.
- Firms are required to keep records of customers' identity verification for five years after the end of the customer relationship or five years from when the transaction was completed.
- POCA established the Assets Recovery Agency (ARA) to confiscate from criminals the proceeds of their crimes. Suspicions of money laundering must be reported to the NCA.

Data protection and security

- The UK General Data Protection Regulation (UK GDPR) and the Data Protection Act 2018 (DPA 2018) both govern the processing of personal data in the UK.
- The UK GDPR and DPA 2018 give data subjects rights and place obligations on data controllers and data processors.

Complaints rules and procedures

- FCA rules require all regulated firms to have and to publicise an appropriate written complaints handling procedure.

Key points

- A complaint for this purpose is any expression of dissatisfaction, whether oral or written and whether justified or not which alleges that the complainant suffered financial loss, material distress or material inconvenience.
- The Financial Ombudsman Service (FOS) acts as the ombudsman for all complaints against authorised persons carrying out regulated activities.
- If the FOS finds for the complainant, it can award compensation for any loss and/or order the firm involved to take remedial action.

Financial Services Compensation Scheme (FSCS)

- The Financial Services Compensation Scheme (FSCS) exists to compensate claimants where authorised persons, or their ARs, are unable to satisfy claims against them in connection with regulated activities where a firm becomes insolvent.

Protection for pensions

- Various other schemes exist to help protect the rights of pension holders. These cover the areas of advice, complaints, regulation and compensation.

Question answers

7.1 Activities which are purely incidental to their professional services.

7.2 No, Natalia will only be entitled to compensation if the advice she received was in breach of the FSMA/FCA rules.

7.3 Changes in the market, products, legislation and regulation.

7.4 Placement; layering; integration.

7.5 He should complain in the first instance to firm ABC. If he is unable to gain satisfaction, then he may refer the matter to the FOS.

7.6 £430,000 for complaints referred to the FOS from 1 April 2024 onwards for acts or omissions by firms on or after 1 April 2019.

8

The regulatory advice framework

Contents	Syllabus learning outcomes
Introduction	
A Sources of information, guidance and advice	*7.1*
B Client relationships and adviser responsibilities	*7.1*
C Monitoring and reviewing clients' plans	*7.2*
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- explain the relationship between the adviser and the client;
- outline the regulatory responsibilities of an adviser to their clients; and
- explain the need to monitor and review client plans.

Introduction

In this chapter we will consider the regulatory advice framework as it works in practice for the consumer.

We will look first at the regulated advice standards and the obligations these place on firms. Next, we will consider the client relationships and the adviser responsibilities associated with these. Included are the types of clients, fiduciary relationships, clarity of service provision and charges, limitations and cancellation rights.

Lastly, we will run through the monitoring and reviewing of clients' plans and being able to take account of relevant changes.

Key terms

This chapter features explanations of the following terms and concepts:

Best execution	Client agreements	Cold calling	Consumer Duty
e-Commerce Directive	Eligible counterparty	Execution-only	Independent advice
Insistent clients	Key information document (KID)	Know your customer	Limited advice
Money and Pensions Service (MaPS)	Non-advised sales	Non-real time financial promotions	Professional clients
Real-time financial promotions	Restricted advice	Retail client	Services and costs disclosure

A Sources of information, guidance and advice

It is important that individuals have access to information, guidance and advice. These help them to understand the array of products available to meet their financial planning needs and to have sufficient knowledge about their existing policies.

Whether an individual requires access to all three will be driven by their specific needs and experience of financial planning.

A1 Product information disclosure

These rules regulate the information given to a client to make them aware of all the details of an investment.

Within the life and pensions sector, product information is made available to individuals through key features, key information and key investor documents, product key facts illustrations and factsheets.

Be aware

Key features, key information and key investor documents: explain to customers the main features of any financial products that they are considering buying in a format that is easy to follow.

Key features illustrations: provide customers with information specific to their circumstances. They will include a personalised quote showing how much has been invested and typical scenarios in relation to returns or proceeds.

Factsheets: tend to be more specific in content. They focus on fund breakdowns, investment performance and how the investment is managed.

A1A Key features, key information and key investor information documents

For packaged retail and insurance-based investment products (PRIIPs), the FCA rules require a **key information document (KID)**. For non-PRIIP packaged products, it's a **key features document (KFD)**. Collective investment scheme investments currently have a **key investor information document (KIID)**.

Every product provider must produce the appropriate document for each of its relevant products. This could be hard copy or in electronic format but it must be produced to the same standard as its marketing material. The document must be given to every retail client before the application form is completed, although a product provider is not responsible for this for sales made by intermediaries. This rule applies for new sales only; however, where a variation to an existing life policy or pension scheme (e.g. increasing the premium) is made the customer must be provided with sufficient information about the variation to understand the consequences of it. Where a relevant product is sold without a written application, the key features, key information or key investor information document must be sent immediately after the sale.

Note that there are some special rules for occupational pension schemes, self-invested personal pensions, pension income withdrawals, cash ISAs, traded life policies and stakeholder pensions.

Information document	
The KFD/KID/KIID document must include such details as required by the FCA rules, for example: • nature of the investment; • aims of the investment; • risk factors; • information on performance; • charges; • principal terms of the investment; • cancellation or withdrawal rights; • compensation arrangements; and • procedure to be followed for complaints. • Information required by the Solvency II Directive (life policies only).	The **Solvency II Directive** required information includes the following: • Name of life insurer. • Address of the head office or branch concerned. • Solvency and financial condition information. • Definition of each benefit and option. • Policy term. • Means of termination. • Means of payment of premiums and duration. • Means of calculation and distribution of bonuses. • Indication of surrender and paid up values and whether they are guaranteed. • Premiums. • Unit linking details. • Cancellation rights. • Tax arrangements. • Complaints arrangements. • Law applicable.

Be aware

Following the UK's departure from the EU, the requirement to issue KIIDs (or KIDs for PRIIPs) is subject to UK law rather than European regulation as a result of onshoring. The **Finance Bill 2020** amended some aspects of the UK PRIIPs Regulation, including the requirement to provide KIDs and how these would be produced:

- Methodology for past performance scenarios will be set by the FCA, as past performance may give an overly optimistic impression of future performance.
- HM Treasury was given the power to extend the use of KIIDs for UCITs funds until December 2026. These were due to be replaced by the KID in December 2021. The extension allows the UK to prepare its own framework for investment product disclosure.

Packaged retail investment products (PRIIPs) key investor information documents (KIDs)

In March 2022 (PS22/2) the FCA took the first steps to improve retail disclosure requirements following the UK's exit from the EU. Many of these changes impact only product providers in the way the PRIIPs' KIDs are produced, however, financial advisers also need to understand the implications of these changes.

Under the new rules, the FCA removed the requirement for PRIIPs' manufacturers to display performance scenarios in the KID, as these were resulting in information that was potentially incompatible with the need to be accurate, clear, fair and not misleading. In order to mitigate the risk of incomparable products, the FCA introduced a **narrative description** of disclosure, which should give product manufacturers the flexibility to accurately disclose factors which could impact on a product's returns.

Past performance information is still a requirement of these documents, but the FCA will consider this as part of its consultation with HM Treasury on the wider review of retail product disclosures.

A key change from previous regulations is the treatment of venture capital trusts (VCTs) with regard to the risk score shown on the KID. In order to prevent consumer detriment, under the new rules VCTs must have a minimum risk score of 6 (out of a possible 7).

A1B Projections

Whenever a firm produces a projection of future benefits the projections rules apply. This could be in an advertisement, letter, key features/key information/key investor information document or post-sale confirmation.

The projection must be based on a reasonable number of realistic simulations and assumptions which are supported by objective data. It must contain a risk warning to explain that the figures are only examples and are not a reliable indicator of future results, and where gross figures are used, the effects of any charges must be shown.

A1C Pure protection life policies

Before entering into the contract, providers of pure protection life policies must send the customer the information required by the Solvency II Directive. A record of this must be kept for six years.

Pure protection policies are long-term insurance contracts, other than reinsurance, where the:

- benefits are payable only on death or incapacity due to injury, sickness or infirmity; and
- contract has no surrender value, or the surrender value does not exceed the single premium, and there are no conversion or extension options which might cause it to fail any of the previous tests.

Thus, it mainly applies to term assurance and income protection insurance. These are covered by the Insurance: Conduct of Business Sourcebook (ICOBS) rules.

A1D With-profits business

Every life office carrying on with-profits business must have a principles and practices of financial management (PPFM) document setting out how they manage their with-profits business.

Reinforce
Product information helps to ensure that customers have a clear view of what they are purchasing or investing in.

Activity
Can you find the PPFM for an insurance company? What information does it contain? Would it be easy for a consumer to understand?

A customer's use of these documents is determined by the way in which they receive them. This leads us to the next section which focuses on the key differences between guidance and advice.

A2 Financial guidance

Guidance involves providing a customer with information on a product so that they can make an informed choice on how to progress.

Informed choice

A customer makes an informed choice when they receive information (not advice) on a product and use this to decide whether or not to proceed. It does not involve a product recommendation as the information provided to the customer is not personalised to their circumstances.

Guidance can be split into two categories:

- **Provider guidance**: product information supplied by one of the provider's representatives directly to the customer.
- **Generic guidance**: generic information given to an individual on a type of product, as opposed to a specific product from a provider.

The Government introduced changes to pensions law in April 2015 which have led to more choice on what retirement benefits can be taken and how. This has left many feeling vulnerable in this area and caused a significant increase in the number of individuals who require guidance. As advice remains unaffordable for a large percentage of the population, there has been a greater focus on the availability of quality guidance.

A2A Money and Pensions Service (MaPS)

The need for guidance has culminated in the creation of the ***Money and Pensions Service (MaPS)***, a single financial guidance body created from the three existing providers of Government guidance.

Be aware

The **Financial Guidance and Claims Act 2018** set up the Money and Pensions Service (MaPS) to provide the services previously offered to consumers by The Pensions Advisory Service (TPAS), Pension Wise and the Money Advice Service.

The MaPS website is: *www.maps.org.uk*.

As part of its move to amalgamate the services offered by the previous bodies, in June 2021, MaPS launched its consumer-facing brand MoneyHelper. This brings all the information provided by the previous advice services under one brand. TPAS and the Money Advice Service ceased to exist, while Pension Wise continues as a service offered by MoneyHelper.

The MoneyHelper website is: *www.moneyhelper.org.uk/en*.

MaPS has a statutory function to develop a national strategy on financial capability, debt and financial education. Its intent is to have a long-lasting impact across the UK, improving people's ability to manage their own money effectively and avoid falling into debt. By promoting financial inclusion and financial capability, the expectation is that fewer consumers, especially vulnerable ones, will experience financial difficulty.

MaPS was launched in 2019 and published its UK Strategy for Financial Wellbeing in early 2020. The service has five core functions:

Pension guidance	To provide information to people about workplace and personal pensions.
Debt advice	To provide people in England with information and advice on debt.
Money guidance	To provide free, impartial guidance to enhance people's knowledge and understanding of money and financial matters.
Consumer protection	To work with Government and the FCA to protect consumers.
Strategy	To work with the financial services industry, devolved authorities and the public and voluntary sectors to develop a national strategy to improve people's financial capability, help them manage debt and provide financial education for children and young people.

Pension Wise, part of MoneyHelper, is a free, impartial Government service, supplied over the phone, face to face and online. It is available to individuals over the age of 50, with defined contribution pension schemes that require them to decide how to take their benefits in retirement. Individuals can get help about:

- what they can do with their pension pot;
- how to shop around and compare providers for the best pension income;
- what to look out for with taxes and fees;
- how to avoid pension scams; and
- the importance of taking the time to make sure their money lasts as long as they do.

A3 Fair treatment of customers

The FCA requires that the fair treatment of customers is evident at all levels within firms; it must be seen to be addressed in complaints handling and the treatment of customers by staff at all stages of their dealings with the firm. Product providers are required to take this into account with their product design.

There are six positive consumer outcomes that firms should strive to deliver to ensure fair treatment of customers:

1. Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
2. Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
3. Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
4. Where consumers receive advice, the advice is suitable and takes account of their circumstances.
5. Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.
6. Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

It is the role of advisory firms to ensure that they implement procedures to achieve these outcomes.

In essence, the fair treatment of customers is simple – firms must focus on delivering the six outcomes and recording evidence that they are doing so. In practice, this means firms should:

- look at their business and identify all of the fair treatment of customers outcomes that are relevant to them; and
- ensure they have appropriate systems in place – using MI or other sources – to measure whether they are delivering all the identified outcomes.

Firms may find it helpful to consider where there are specific risks to the fair treatment of customers when they are assembling their evidence, look at what the evidence is telling them – and act on it.

Evidence could come in a variety of forms, for example, conventional MI, results of compliance checks, and senior management assessments of call-centre traffic or press coverage. In fact, anything that provides sound and reliable information on whether a firm is treating its customers fairly could, in principle, be used as evidence. The evidence does not necessarily have to be structured around the fair treatment of customers outcomes, but firms must be able to demonstrate through their evidence that they are delivering those outcomes.

A further area of concern in relation to the fair treatment of customers is the need to create greater levels of financial inclusion in the UK. Advisory firms need to be aware of this important issue so it can be taken into account at all stages of the financial planning process. To achieve this, all firms and their employees need to have an understanding of what financial inclusion is and the barriers that prevent it.

Reinforce

In a financially inclusive society all individuals, regardless of their background or income, have access to useful and affordable financial products and services. This includes access to financial planning products which give people peace of mind, protect against financial hardship and build financial resilience.

A4 The Consumer Duty

The *Consumer Duty* came into force from 31 July 2023 for new and existing products and services and from 31 July 2024 for closed books of business. These rules aim to improve consumer outcomes by ensuring all firms consider the needs of retail clients and explicitly set 'a higher standard of care across all retail markets' (FCA CP21/36).

A4A Consumer Duty overview

Background to the Consumer Duty

The FCA had initially highlighted ways in which firms cause consumers harm. For example, by providing:

- misleading information, preventing consumers from understanding and properly assessing products and services;
- products and services which are not fit for purpose;
- products and services which do not represent fair value to the consumer;
- poor customer service; and
- exploiting information asymmetry and vulnerability.

While acknowledging that consumers should take responsibility for their decisions, the FCA notes that it is important to provide a higher level of protection for retail customers as they:

- Have a weaker bargaining position in the relationships with firms.
- Are susceptible to cognitive and behavioural biases.
- May lack the knowledge, experience or expertise in relation to products offered to them.

The FCA recognises the existence of information asymmetries between firms and retail clients. While everyone may be subject to behavioural biases to some extent, there is a need for firms to protect retail customers where possible from making poor choices as a result of these biases.

The Consumer Duty proposes three significant steps to help address these issues:

- The consumer principle.
- Overarching cross-cutting rules.
- Four outcomes.

The consumer principle (principle 12)

> Principle 12: A firm must act to deliver good outcomes for retail clients.

This principle applies to firms and their dealings with retail clients and overrules existing duties laid out in principles 6 and 7 and the fair treatment of customers outcomes. It sets a higher standard for the behaviour expected of firms when dealing with retail clients. If a firm is considered in breach of principles 6 or 7 in relation to its dealings with a retail client, that behaviour is also likely to be in breach of principle 12.

The focus of principle 12 means firms need to act to deliver good customer outcomes and put customer interests at the heart of what they do. Firms must obtain and maintain a suitable understanding of consumer behaviour and how products and services function. This is necessary to demonstrate that expected outcomes are being achieved. Where outcomes are not achieved firms need to address this. They also need to consistently challenge themselves to ensure their actions are in line with delivering good outcomes.

While principle 12 puts the consumer at the heart of the business, the FCA has clarified that it should not change the nature of the relationship between the firm and its customers, nor does it create a fiduciary relationship where one would not otherwise exist.

Conduct rule

The FCA introduced a new individual conduct rule to coincide with the introduction of the Consumer Duty.

Rule 6: You must act to deliver good outcomes for retail customers.

This rule applies in addition to the other individual conduct rules when dealing with retail clients.

Cross-cutting obligations

In line with principle 12, firms are required to adhere to the following rules. They must:

- Act in good faith towards retail customers.
- Avoid causing foreseeable harm to retail customers.
- Enable and support retail customers to pursue their financial objectives.

The FCA sees each of these as an essential element of the level of care firms should provide.

The needs of customers with characteristics of vulnerability have been woven into these rules. The FCA regularly draws attention in its guidance (FG22/5) and in the rules (PRIN 2A.2) to how each element requires firms to consider customer needs, particularly those with specific needs.

Four outcomes

The Consumer Duty includes four outcomes which firms must incorporate into their approach to dealing with retail customers:

- **Products and services** (PRIN 2A.3) – are specifically designed to meet the needs of consumers and sold to those whose needs they meet.
- **Price and value** (PRIN 2A.4) – the price of products and services represents fair value for consumers.
- **Customer understanding** (PRIN 2A.5) – consumers are equipped to make effective, timely and properly informed decisions about financial products and services.
- **Customer support** (PRIN 2A.6) – meets the needs and interests of consumers without undue hindrance, enabling them to realise the benefits of products and services.

The purpose and application of the Consumer Duty

The FCA calls on firms to consider how they behave **at every stage of the customer journey**. They are required to consider the needs, characteristics and objectives of customers, including those with characteristics of vulnerability. Firms are required to act to deliver good customer outcomes as well as understand and evidence whether these outcomes are being met.

Firms need to comply with the duty in full for existing and future products and services. They must have reviewed all products and services against all aspects of the duty prior to the end of the implementation period and on an ongoing basis. Any issues identified must be addressed before the relevant product or service can be sold to new customers.

Manufacturers and distributors

The duty has different requirements for firms depending on whether they are the manufacturer or distributor of a product or service. The terms are broad but can loosely be described as:

Firms	Role	Examples
Manufacturers	Create, design and develop products or services.	An advisory firm's service proposition. Where a firm is manufacturing a product or service it will need to demonstrate that it meets the Consumer Duty's requirements.
Distributors	Offer, sell, recommend or advise on products and services.	An advisory firm recommending a product or investment solution manufactured by another firm.

Firms	Role	Examples
Co-manufacturers	Set the parameters of a product and commission another firm to build it.	An advisory firm commissioning a discretionary investment management firm to design and build an investment solution. The advisory firm would stipulate the criteria to be used in the design of the product. Where firms collaborate in this way, they must have a written agreement in place to comply with the rules. This must outline each of their roles and responsibilities regarding the product or service being co-manufactured.

The FCA does not provide precise definitions of these terms. They are deliberately kept broad to include all aspects of manufacture and distribution, as firms may be any or all of these depending on the product being considered.

Where a firm acts as a distributor or co-manufacturer it will need to rely on information from other parties in the distribution chain, so should ensure it keeps the Consumer Duty in mind when undertaking any due diligence. Despite this, firms are only responsible for their own activities and do not need to oversee the actions of other firms in the chain.

Example 8.1

A platform provider designs an investment ISA product wrapper to be used with retail clients. In this case the platform provider is the manufacturer.
The platform provider does not allow retail customers to apply directly. They must go through an adviser. The adviser is the distributor.

The adviser recommends an investment solution within the ISA, which is a discretionary model portfolio service, specifically designed with its firm's approach to investment and risk in mind. The adviser is both the distributor and the co-manufacturer of the investment solution, alongside the investment manager.

For reference only

A4B The cross-cutting rules (PRIN 2A.2)

The cross-cutting obligations apply at all stages of the consumer journey, across the life cycle of a product or service. It is therefore important that firms keep products and services under regular review and consider the impact of any changes they make in light of these rules.

Act in good faith towards retail customers (PRIN 2A.2.1)
Firms must act in good faith towards their customers. This is characterised by honesty, fairness, openness and consistency, and supports the other cross-cutting rules by focusing on the *intent* behind the firm's actions.

A firm would not be considered to be acting in good faith if it:

- sought to exploit customers' behavioural biases to gain outcomes more favourable to the firm;
- promoted products or services in a way that misled customers about the benefits;
- disguised the risks of a product or service; or
- adopted systems or processes which frustrate customers switching to other products.

Avoid causing foreseeable harm to retail customers (PRIN 2A.2.8)
Firms must avoid causing foreseeable harm to their customers through actions or omissions. This could occur both in the firm's relationship with a customer and through its involvement in the product's distribution chain. Whether harm is foreseeable depends on if a firm, which is acting reasonably, would be able to predict or expect a harmful result from a product or service.

Examples of foreseeable harm include:

- customers not being able to cancel a product or service because the process to do so is too complicated;
- products being distributed to a different market from that for which they were designed and whose needs they do not meet; and
- consumers with characteristics of vulnerability being unable to access a product or service because support processes have not been designed to be accessible.

Enable and support retail customers to pursue their financial objectives (PRIN 2A.2.14)
Firms must act to enable and support customers to pursue their financial objectives. The FCA believes customers can only take responsibility for their actions when they are enabled to make informed decisions by firms.

Firms need to determine what is within their control when it comes to enabling and supporting clients. Firms providing advisory or discretionary services would understand more about a customer's objectives than a firm offering an execution-only service, so would need to act on that knowledge.

Examples of poor practice would include:

- designing products with unclear or complicated features that cannot be understood by clients in the target market; and
- charging unreasonable exit fees which discourage clients from leaving products and services that are no longer right for them.

A4C The four outcomes

The cross-cutting rules outlined above can apply to each of the following four outcomes. We shouldn't forget when reading this sourcebook that, in the context of PRIN 2A, products include services.

Products and services
The FCA has identified harms from poorly designed and inappropriately distributed products and services. In order to meet the products and services outcome firms must:

- ensure the design of products and services meets the needs, characteristics and objectives of customers of an **identified target market**;
- ensure the intended distribution strategy for their products and services is appropriate for that target market; and
- carry out regular reviews to ensure products or services continue to meet the needs, characteristics and objectives of the target market.

The identification of the target market for each product and service is, therefore, an integral part of achieving this outcome. The rules require firms to identify the target market at a 'sufficiently granular level'. This must include consideration of the characteristics, risk profile, complexity and nature of the product or service. The FCA suggests that a test for whether the target market has been appropriately identified would be to consider if that market would include groups of customers whose needs, characteristics or objectives would be incompatible with the product.

Examples of insufficient target market assessments include:

- Investments which are appropriate for a target market based on compatible risk tolerance but a client group has no capacity for loss.
- Investment products with no defined sustainability characteristics being used with clients who have specific sustainability requirements they wish to be taken into account.

The rules apply to every product or service a firm markets or distributes. This means they apply to existing and new products and services, and any changes to products and services a firm plans to make. The duty will also have to be considered when withdrawing a product or service and the impact of this decision.

Firms involved in the distribution of products and services (an advisory firm is the distributor of its own services and other firms' products) must be aware of the need to avoid causing foreseeable harm, manage conflicts of interest and ensure the needs, characteristics and objectives of the target market are taken into account. This means that distributors need to fully understand the products that they are distributing, the target market they are designed for and the characteristics of that target market.

Price and value

The key focus of the price and value outcome is on ensuring the price a customer pays for a product or service is reasonable compared to the benefits they will receive. This can be seen to be closely linked to the products and services outcome, as if a product or service has been poorly designed or is not distributed appropriately, it is unlikely to provide fair value to the customer.

Fair value is about more than just price. The FCA aims to use the duty to tackle factors that can result in products and services which are unfair or of poor value to customers. A product or service which does not meet any of the customer's needs, which causes foreseeable harm or does not support them in achieving their objectives, is unlikely to offer fair value, regardless of the price.

Firms should consider the following in assessing whether a product or service offers fair value:

- the nature of the product or service and the benefits it will provide;
- any limitations of the product or service; and
- the **total price** the customer will pay, including all applicable fees and charges over the lifetime of the relationship.

They will also need to consider various factors when considering the reasonableness of the price, such as:

- the cost of designing and distributing the product or service;
- the market rate for comparable products and services and how the proposed charges compare to these; and
- whether alternatives are available offering similar outcomes for a significantly lower price.

It is up to firms to decide how they assess this, but it is important they are able to **demonstrate** that there is a reasonable relationship between the total price and the benefits to the customer.

Customer understanding

The purpose of the customer understanding outcome is to enable firms to support their customers in making informed decisions. The FCA has highlighted that customers can only be expected to take responsibility for their decisions when firms communicate in a way that enables them to understand the products and services.

The new rules retain the obligation from principle 7 for firms to communicate information in a way which is clear, fair and not misleading but are designed to go further than this. Under the duty firms are required to:

- Support customers' understanding by making sure communications meet their needs and are **likely to be understood** by the intended recipients (the target market granularity referred to above).
- Tailor communications to ensure they **account for the characteristics** of the intended customers, making sure specific vulnerability characteristics are taken into account.
- Tailor direct communications with clients to meet the information needs of the specific customer and ask if they understand and have any questions.
- Test, monitor and adapt communications to ensure they support customers' understanding and good outcomes.

A firm's communications must:

- meet the information needs of retail customers;
- be likely to be understood by retail customers; and
- equip retail customers to make effective informed decisions.

It is important when communicating with customers that advisers put themselves in the customer's shoes and think about whether their communications provide sufficient information to enable informed decisions.

Customer support
The FCA expects firms to provide support that meets their customers' needs before, during and after purchasing a product. This support should allow the customers to make use of the products and services they purchase, enabling them to achieve the outcomes they seek.

The customer support outcome requires firms to:

- design and deliver support which meets the needs of customers, including those with characteristics of vulnerability;
- ensure customers can use the product or service as can reasonably be anticipated;
- take steps to mitigate the risk of harm, giving customers the opportunity to understand and assess their options, including associated risks;
- remove unreasonable barriers;
- monitor the level and quality of support provided; and
- ensure they do not disadvantage particular groups of clients, including those with characteristics of vulnerability.

Firms should ensure the support they provide avoids causing customers foreseeable harm and consider how their service might cause harm. This could include the impact of poor or slow service, inaccessible websites and a lack of support channels for those who cannot access services online or in person.

On the Web
It is not possible to summarise all the implications of the Consumer Duty but you may wish to explore the topic further to gain a deeper understanding of this important regulation. As well as the rules and guidance contained in the PRIN 2A sourcebook, further information can be found here: *www.fca.org.uk/publication/policy/ps22-9.pdf* and *www.fca.org.uk/publication/finalised-guidance/fg22-5.pdf*.

A5 Financial advisers: responsibilities and restrictions

Information about the firm
The FCA's conduct of business rules impose disclosure requirements on firms when selling certain retail investment products (there are also similar obligations when selling mortgages and general insurance). These disclosures typically cover details of the service that the firm offers and the cost of this service.

Financial advisers are required to provide information to their clients about their status, the nature of their advice and how they are paid in a way that is **fair, clear and not misleading**.

Services
A firm must ensure that retail clients are informed on a timely basis whether advice is **independent** or **restricted**.

A5A Independent financial advisers

Firms describing their advice as independent must assess a sufficient range of relevant products that are sufficiently diverse in terms of type and issuer to ensure that the client's investment objectives can be suitably met.

A firm presenting itself as providing independent advice may provide broad and general advice, or specialist and specific advice (focused independent advice).

An adviser offering focused independent advice can present themselves as being independent, but they must make it clear to their client that the independence relates to a specific advice area. This might be advising only a particular group of clients such as those with specific ethical, sustainable or socially responsible preferences.

Using the word 'independent' in a firm's name is limited to those firms offering an independent service.

To meet the 'independence' requirement:

- certain FCA-mandated products might be excluded, e.g. some unregulated collective investment schemes (UCIS) and traded life policy investments (TLPIs);
- certain multi-manager investment fund recommendations may be inadequate;

- firms using product panels must also allow the use of off-panel recommendations;
- using a single platform may be insufficient;
- model portfolios/centralised investment propositions must still cater for clients' individual circumstances; and
- firms do not need to be able to offer pension transfer and/or long-term care insurance advice.

A5B Restricted financial advisers

'Restricted advice' is defined as 'a personal recommendation to a retail client in relation to products which is not independent advice'. In other words, if a personal recommendation does not meet the standard for independent advice, then it is restricted advice.

The areas of 'basic advice' and 'simplified advice' also fall within 'restricted advice', as do single- and multi-tied advisers and restricted whole of market advisers.

If any retail investment adviser within a firm provides restricted advice, the firm should not hold itself out as providing independent advice for its business as a whole (however, this does not mean that trainees result in a restricted status).

Single-tied advisers
Such firms can only consider and recommend the products of one provider. They can recommend different types of product, such as life assurance, pensions and investments, but all the products will be from the same provider.

Single-tied advisers are often employed by the provider. A product provider must ensure that its representatives do not advise on a product unless it is issued by the firm or another member of its marketing group. A provider firm must ensure that its representatives can sell all its packaged products, although it can restrict a representative on grounds of competence provided they can refer the client to another representative of sufficient competence.

Where a single-tied tied adviser identifies a situation where they have no product which will meet the client's needs, they should inform the client they have nothing suitable. They may also introduce the client to an independent financial adviser. There must be no product bias in the remuneration of a provider's representative and they cannot refer retail clients to an intermediary in breach of the inducement rules. A product provider must ensure that its representatives do not lead a retail client to believe that they can give advice on any other products.

Be aware

Independent advisers should also be aware that the products and services they offer through something like a centralised investment proposition or centralised retirement proposition might not be appropriate for all clients. Advisers should never recommend a solution to a client, which is not suitable for their individual circumstances, simply because it is the firm's preferred solution. This process, known as shoehorning, is bad advice.

Multi-tied advisers
These firms can arrange ties with a number of product providers, enabling them to offer a wider range of products and providers than a single-tied adviser, but without the need to consider all product providers. The job of a multi-tied adviser is to find the most suitable product for the client from the range of providers to which the firm is tied. Some multi-tied advisers are tied to one provider for each product they deal in, whereas others may be tied to more than one provider for a particular product type.

Restricted (or 'non-independent') advice must meet the same suitability, inducement, adviser charging and professionalism standards as independent advice. The key difference in the requirements is in disclosure. In its written disclosure, a firm that provides restricted advice must explain the nature of the restriction. A firm must also provide oral disclosure if it engages in verbal interaction with a retail client.

The rules allow firms flexibility in how they describe their restricted advice services, so long as they are being fair, clear and not misleading in their communications. A firm can, for example, explain that it reviews the whole market for the particular products on which it gives advice, if this is an accurate description of its service. A firm should not, however, give the impression that it has restricted its product range to those products that are most suitable for a particular client.

Restricted whole of market advisers
These are restricted in terms of the types of products they can advise on, but offer impartial advice that considers all providers of those products. The adviser must explain exactly how their advice is restricted.

Question 8.1

What should single-tied advisers do if they do not have a suitable product within their provider's product range?

Bancassurance
A life office owned by a bank whose products are sold by the bank is often called a bancassurer. Bancassurance may also be used to describe the situation where a bank is a tied adviser of a life office even if it does not own it.

A5C Advice Guidance Boundary Review

Recognising that not enough people in the UK are currently benefitting from financial advice, in November 2022 the FCA introduced a consultation in CP22/24 about a new approach to the provision of financial advice on investments, the Core Investment Advice Regime. This proposed approach would have allowed both restricted or independent advice firms to offer a service for customers with a lower qualification threshold than full advice. It received limited support from the financial services community and in August 2023 the FCA decided to incorporate this, and the feedback on the proposals, into a new consultation.

The Advice Guidance Boundary Review policy paper (DP23/5) was published in December 2023. It is the FCA's current response to the challenges of the Edinburgh Reforms which set out the Government's ambition for the UK to be the world's most innovative finance centre. This discussion paper sought views from financial services market participants and consumer groups on how to address issues around the advice gap, as well as providing targeted support and simplified advice.

The FCA has not abandoned the ideas which were present in the Core Investment Advice proposals. It believes a form of simplified advice, which enables firms to support clients with simpler needs in a way that is commercially viable, is still needed.

On the Web
You can find out more about the Edinburgh Reforms at: *www.gov.uk/government/collections/financial-services-the-edinburgh-reforms*.

The FCA discussion paper is available here: *www.fca.org.uk/publications/discussion-papers/dp23-5-advice-guidance-boundary-review-proposals-closing-advice-gap*.

Be aware
It is important to note that these changes, which may be very important for the profession in years to come, remain only at the consultation stage at the time of writing.

A5D Remuneration

The RDR required that from 31 December 2012, all remuneration in respect of investment advice, whether initial or ongoing, be in the form of a fee and structured as a customer agreed remuneration called **adviser charging**. This means that advisers now set their own charging structures based on the level of service they provide, as they can no longer receive commission set by product providers.

The FCA does not set rules for what a firm's charging structure should look like. Examples of charging methods include hourly rates, a fixed fee, percentage charges or a combination of these. However, the FCA does have the following fee-related requirements:

- A firm should not charge different rates for different providers that could both be suitable for the customer's needs.
- Adviser charges must be disclosed to the client upfront using some form of price list or menu of costs.
- Fees should be commensurate with the level of service provided, and any agreement must make clear the services that the adviser will provide.
- Ongoing charges can only be levied where an ongoing service is provided and the client has agreed to this service.
- Fees should be disclosed in monetary terms, even if the fees equate to a percentage of the investment value – for example, 2% of £100,000 would be £2,000.
- Advisory fees can still be deducted by the provider in the form of charges and passed back to the advisory firm. This is called 'facilitation'.

In line with the 'price and value' outcome of the Consumer Duty, services should always provide **fair value** to clients. While this does not stipulate a fee, there should be a clear relationship between the price charged and the benefit to the consumer. The implementation of the Duty has seen many firms rethink the way they charge for their advice.

Be aware

The FCA proposal for targeted support under the Advice Guidance Boundary Review may see services offered without explicit charges being applied in a similar manner to the pre-December 2012 framework.

A6 Stakeholder products and 'basic advice'

The basic advice rules were introduced in 2005 to enable firms to provide simpler and lower-cost advice to consumers on a range of stakeholder products using pre-scripted questions. The range of stakeholder products includes a:

- short-term deposit-based stakeholder product;
- medium-term collective or life stakeholder product; and
- long-term stakeholder pension scheme.

A firm providing basic advice must explain why it chose the stakeholder product. It must give the client a list of the products and providers that appear in the range on offer if the client asks them for this information.

Upon first contact with a retail client, they must be given the basic advice initial disclosure information and an explanation of how the advice will be paid for and the fact that any commission will be disclosed.

With stakeholder products, there is no requirement to 'know your customer'; so a full fact-find is not completed; instead the scripted questions must be asked regarding debt levels, investment objectives, tolerance of risk and pension rights. The recommended stakeholder product **only has to be suitable, not the most suitable**.

Providers of the medium-term investment product and pension product can charge a maximum annual management charge of 1.5% of the value of the plan/pension each year reducing to 1% after ten years. These charging structures mean that stakeholder products may now be more expensive than those offered elsewhere in the market.

When a firm provides basic advice on a stakeholder product, it must not hold itself up as acting or advising independently.

Question 8.2
What three products are included in the stakeholder product range?

A7 Communicating with clients, including financial promotions

Be aware
In addition to the following, firms must also ensure that from 31 July 2023 their communications with retail customers achieve the Consumer Duty outcomes.

The overriding consideration in all communications concerning regulated business is that they are 'fair, clear and not misleading'. The financial promotions rules in COBS 4 apply to investment business communicating or approving a financial promotion, other than promotion:

- of qualifying credit, a home purchase or home reversion plan;
- in respect of a non-investment insurance contract;
- of an unregulated collective investment scheme (firms may not communicate or approve such promotions); and
- in relation to a credit agreement, a consumer hire agreement or a credit-related regulated activity.

Financial promotions of the following are not covered, as banking, home finance and insurance financial promotions are subject to their own distinct sets of rules and sourcebooks:

- deposits;
- general insurance;
- home finance business;
- pure protection life assurance; and
- reinsurance.

The rules are aimed at marketing promotions, such as advertisements and general promotions, and **do not apply** to:

- communications to one recipient only;
- specific products for a specific recipient;
- personal quotations or illustrations; and
- a promotion containing only: the name of the firm, a contact point, a logo, a brief factual description of the firm's activities, fees and products.

'**Real time**' financial promotions are those done in the course of a personal visit, face-to-face conversation, telephone conversation or other interactive dialogue. '**Non-real time**' financial promotions are all others, such as static advertisements.

The FCA makes a distinction between written and non-written financial promotions. In general terms a non-written financial promotion is equivalent to a real time financial promotion, while a written financial promotion is equivalent to a non-real time financial promotion. Any postings on **social media** are also subject to the financial promotion rules.

Individuals preparing financial promotions should also be aware of the additional requirements set out in the anti-greenwashing rule concerning financial promotions in ESG 4.3.1R and the additional guidance the FCA has published on the matter.

General financial promotions and advertisements

A7A Non-real time financial promotions

Approval
Before undertaking a non-real time financial promotion a firm must have an individual with the appropriate expertise check it meets the rules.

Therefore, all advertisements should be checked and approved by the compliance officer or someone in the firm's Compliance Department. Any promotions which cease to be compliant must be withdrawn.

Promotions with an extended 'shelf-life' should be regularly reviewed to ensure they remain compliant.

Records
A firm must keep a record of all its non-real time financial promotions for the standard periods detailed in COBS 4.11:

- indefinitely for a pension transfer, pension conversion, pension opt-out or FSAVC;
- six years for life and pensions contracts;
- five years for all others in the case of a MiFID or MiFID optionally exempt firm, or three years for a non-MiFID firm.

The record must include a copy of the item and the name of the individual who approved it.

Content
A non-real time financial promotion must contain the name of the firm and its address or contact point.

A firm must take reasonable steps to ensure that a non-real time financial promotion is **fair, clear and not misleading** in line with COBS 4.2. Those containing comparisons must compare investments objectively, quoting any sources, and on a like-for-like basis.

The promotional purpose must not be disguised or misrepresented. A financial promotion for a product which places a client's capital at risk must state the risks involved.

Past performance
A specific non-real time financial promotion that mentions **past performance** must state in the main text unambiguously that **past performance should not be seen as an indication of future performance**. The data must be relevant and for a sufficient period to provide a fair and balanced indication of the performance. Any past performance information should make clear the period of time to which it relates but the information should normally be based on the actual performance of the fund for the entire period.

Referring to tax
If any information refers to a particular tax treatment, a firm must ensure that it prominently states that the tax treatment depends on the individual circumstances of each client and may be subject to change in the future.

A7B Real-time financial promotions

A firm must take reasonable steps to ensure that an individual who makes a real-time financial promotion on its behalf:

- does so in a way which is **fair, clear and not misleading**;
- makes clear the purpose of the promotion at the start and identifies themselves and their firm;
- if the communication was not previously agreed with the recipient, check that the recipient wishes them to proceed and stops if not;
- gives the recipient a contact point;
- does not communicate at an unsocial hour, or on an unlisted telephone number, without permission.

A7C Direct offer financial promotions

Direct offer financial promotions must contain sufficient information to enable a person to make an informed assessment of the investment or service. Promotions must include:

- confirmation that the firm is authorised and/or regulated by the FCA;
- the full name and address of the person offering the investment and, if different, the full name and address of the firm communicating or approving the promotion;
- if the promoter cannot hold client money, the name of the person to whom payment should be made;
- details of any charges and expenses; and
- details of any commission or remuneration payable by the firm to another person.

In addition, potential customers should also receive, where relevant:

- confirmation that the firm can be contacted for advice (if there is any doubt about the suitability of the investment an IFA should be contacted if the firm does not offer advice);
- a general description of the nature and risks of the investment; and
- a summary of the taxation of the investment and the taxation consequences for the average investor.

A promotion of a packaged product must contain the information required by the **product disclosure rules**.

A promotion must provide a general description of the nature and risks of the investment in order for the recipient to make an informed decision as to whether the investment is suitable for them.

Where the promotion mentions tax treatment it must also contain a warning that tax levels and reliefs depend on individual circumstances and can change.

A7D Unsolicited real-time financial promotions

Unsolicited real-time promotions are often termed **cold calling**. This must not be done unless the recipient has an established customer relationship with the firm, or the promotion relates to a generally marketable packaged product which is not a higher volatility fund (or a life policy linked to one).

If a cold call is properly made the adviser must, in the early stages of the call, offer the client the opportunity to terminate the call.

A7E E-commerce

If a firm does business online or even advertises online, it is subject to the e-commerce rules in COBS 5.2 (and other relevant sourcebooks such as ICOBS and MCOB). The main provisions are as follows:

- Certain minimum information must be easily, directly and permanently accessible, i.e. name, geographic address and e-mail address for contact.
- FCA status disclosure must be given together with disclosure of its Financial Services Register number.
- There must be clear information as to the services provided.
- Customers must be clearly told how to place an order.
- Customers must have a means of identifying and correcting input errors prior to making an order.
- Orders must be acknowledged without delay, although they do not have to be accepted.

All the normal Conduct of Business rules also apply.

Question 8.3
What is the distinction between real time and non-real time financial promotions?

A8 Advice and know your customer rules

A8A Know your customer (KYC)

Before making a personal recommendation to a retail client, or acting as an investment manager for one, a firm must ensure that it is in possession of sufficient personal and financial information about that customer relevant to the services it has agreed to provide. Thus, under the **know your customer (KYC)** rules, an adviser (regardless of the scope of advice offered) must collect relevant information in the process called **fact-finding**.

For investment business, this must include the customer's:

- knowledge and experience of investments, including the types of products and transactions with which they are familiar;
- financial situation, including the source and extent of regular income, liquid assets, investments, property and regular financial commitments;
- risk tolerance/attitude to risk and ability to bear losses in the case of investment business;
- objectives;
- the purpose of any investment;
- the length of time they wish to hold an investment; and
- any religious, ethical or sustainability criteria they would like taken into account (see *Ethical, religious and sustainability preferences* on page 8/37).

Relevant information would include:

- any characteristics of vulnerability;
- age, marital status and dependants;
- income and expenditure;
- existing insurance, investments and pensions;
- needs and priorities; and
- taxation situation.

Full details of income (and expenditure) are especially important (including the amount that is actually disposable) as this may affect:

- eligibility for State benefits;
- attitude to risk;
- capacity for/ability to bear loss;
- income tax and CGT rates; and
- affordability of any recommendation.

If a client declines to give details on a subject (particularly income), the adviser should record this on the fact-find and any suitability report for future reference. Depending upon the amount and nature of information withheld, the adviser should not provide a recommendation and should consider whether it is appropriate to continue doing business with the client. Firms should not encourage clients to avoid disclosing relevant information.

Once these facts have been found, an analysis can proceed of each of the client's financial planning needs so that the adviser can prepare recommendations in line with these needs and the customer's personal priorities.

Many firms have fact-find forms for their advisers to complete to show the relevant facts were ascertained before the sale. These forms can then be kept as evidence in case of a complaint or regulatory review. The client does not have to sign the form although this is often done. The fact-find could be on paper or stored electronically, but should be maintained in a durable medium and, if necessary, able to be reproduced on paper.

If an adviser is revisiting a client for whom a fact-find has already been completed, the information should be updated with any changes to the client's circumstances – it should never be assumed that nothing has changed. A record must be kept of this information for the standard periods. Where a firm arranges a pension opt-out or pension transfer from an occupational pension scheme for a retail client it must keep a clear record indefinitely, even if no advice was given or the advice was not to transfer.

Activity

Think about the reasons why a client might not be prepared to provide certain financial information. What impact might the failure to disclose information have on the suitability of the advice given?

A8B Suitability of advice

Refer to

See *Suitability* on page 9/10 for more information

A firm must take reasonable steps to ensure that it does not make any personal recommendation to a retail client, or effect a discretionary transaction for them, unless it is suitable for the customer with regard to their personal and financial circumstances and objectives.

A tied firm must not make a recommendation unless it has a suitable product in its range (including any adopted ones) and if none is suitable then none should be recommended. A multi-tied firm must not make a recommendation unless it has access to a suitable contract from the providers to which it is tied.

These are often called the **suitability rules**.

Suitability reports and statements

A firm is required to provide a retail client with a suitability report (in a durable medium such as a letter), if the firm is recommending that the client:

- buys or sells all or part of a holding in a regulated collective investment scheme or an investment trust via an investment trust savings scheme or wrapped in an ISA;
- takes up an insurance-based investment product;
- buys, sells, surrenders, converts, cancels or suspends premiums or contributions to a personal or stakeholder pension contract;
- elects to make income withdrawals or an uncrystallised funds pension lump sum payment;
- purchases a short-term annuity;
- enters into a pension opt-out; or
- takes up a life policy following a personal recommendation by the firm.

The suitability report must at least:

- specify the advice given and how it meets the preferences, objectives and other characteristics of the client (or in the case of an insurance contract, the client's demands and needs);
- explain why the firm has concluded that the recommended transaction is suitable for the client, having regard to the information provided, including the client's knowledge, experience and capacity for loss; and
- explain any possible disadvantages of the transaction for the client.

It must also contain a summary of the main consequences and give the client such details as are appropriate according to the complexity of the transaction.

In the case of investments, the suitability report must draw clients' attention to information on whether the recommended product or service is likely to require them to seek a periodic review.

Pension scheme availability

For a personal pension, stakeholder pension scheme or a free standing additional voluntary contribution (FSAVC), the report should explain why it considers the choice of scheme to be at least as suitable as any facility for making additional contributions to an occupational pension scheme, group personal pension scheme or group stakeholder pension scheme available to the client.

For a personal pension scheme it must explain why it is considered at least as suitable as a stakeholder pension scheme.

Timing
A firm must provide the suitability report to the client in the case of:

- investment, **before the transaction is concluded**;
- a personal pension scheme or stakeholder pension scheme that is not a life policy, where the rules on cancellation (COBS 15) require notification of the right to cancel, **no later than the fourteenth day after the contract is concluded**;
- a pension transfer or pension conversion, in good time **before the transaction is effected**;
- a life policy, **before the contract is concluded** unless the necessary information is provided orally or immediate cover is necessary; or – in the case of a personal pension scheme or stakeholder pension scheme, where the rules on cancellation (COBS 15) require notification of the right to cancel, no later than the fourteenth day after the contract is concluded; or
- in any other case, when or as soon as possible after the transaction is effected or executed.

The use of technical terms which the client might not understand should be avoided, to ensure the communication is fair, clear and not misleading, unless they are fully explained in the report.

The report is not required where:

- a firm acting as investment manager for a retail client makes a personal recommendation relating to a regulated collective investment scheme;
- the client is habitually resident outside the UK and not present in the UK when consenting to the proposal form to which the personal recommendation relates; and
- a personal recommendation is made to increase a regular premium to an existing product or to invest additional single premiums to an existing packaged product, where previous single premiums have been paid.

Suitability rules

There are further specific suitability rules for pension transfers and opt-outs, and for withdrawals of pension ‘freedoms’ income (income withdrawal).

For example, if a firm makes a personal recommendation in relation to a pension transfer or pension conversion, it must provide the client with a suitability report and, except where the only safeguarded benefit involved is a guaranteed annuity rate, **a one page summary at the front** of the suitability report.

For reference only

Chapter 8

Suitability of recommendations
Proper adherence to the ‘know your customer’ principle is vital to meeting the requirements of the ‘suitability’ rules.

The regulator’s prime concern is that genuine client interest rather than adviser remuneration should determine the adviser’s proposals.

Some guidelines to be followed in making ‘suitable’ recommendations are:

- To give considered advice which has been arrived at conscientiously and in the client’s best interest.
- Each need should be quantified and the shortfall between the need and the client’s existing provision identified.
- Client's wants (as opposed to needs) should be appropriately prioritised.
- Client knowledge and experience, risk tolerance and risk capacity should be taken into account.
- Investment objectives, growth, income, time horizons, debt and credit management and repayment should all be considered.
- An overall strategy and rationale to achieve the client's objectives should be present.
- Any benchmarking or performance measures against which the proposed solutions will be tested on an ongoing basis should be agreed.

- Affordability and other suitability considerations, including any ethical, religious, socially responsible or sustainability preferences should be taken into account.
- For each quantified need, the adviser should research suitable products from the range available to them.
- By comparing products with the client's circumstances, the adviser can identify the most suitable product for each need by a process of elimination.
- In presenting recommendations, the adviser must see that the client understands the disadvantages as well as the benefits of each product recommended and the practical effects of any risks involved.
- If past performance is used to illustrate investment projections, it must be made clear that past performance is no guarantee of future performance.

The adviser must exercise skill and care in the formulation of recommendations to clients and prospective clients, taking account of all the considerations discussed above and whether they meet the outcomes the client is seeking.

Existing investments
We saw earlier that a client's existing assets and policies must be taken into account when quantifying the amounts required to meet client needs. The client's existing life insurance contracts and other savings may well reduce the need for further cover. Pensions, State benefits and completion of mortgage repayment may all reduce the capital or income required to maintain the client's standard of living in future. Similarly, money held on deposit may well influence investment decisions.

Retain or surrender?

Existing investments, including life insurance policies, often provide a dilemma for advisers: whether to advise retention or surrender of those investments. The dilemma is both ethical and legal.

Ethics demand that the decision must be in the client's best interest and uninfluenced by consideration of the adviser's fees or other earnings.

The rules demand that advisers do not 'churn' a client's investments and life assurance policies.

A recommendation to retain an existing product is still a recommendation.

Refer to

Turn to *Ethics and professional standards* on page 11/1 for more about ethics

On the great majority of occasions, the adviser should recommend a continuation of existing assurance contracts unless these are either clearly unsuitable for the client's circumstances or in some way merit replacement with a new contract. With **term assurances**, the premium can sometimes be bettered by a similar contract with an alternative insurer, however, this becomes more difficult as clients get older and may be impossible if they have underlying health conditions. If, unusually, an adviser does recommend a client to relinquish a long-term contract, they should explain the implications of that course of action to the client. In particular, if such action is envisaged, the effect of early surrender must be quantified. Care should always be taken to inform the client clearly whether all or part of the premiums paid will be lost if early surrender takes place.

If improper advice is given leading a client to cancel a contract and suffer financial loss as a result, the client has a right to claim against the adviser's firm for the extent of that loss.

In the case of investments, an existing contract may need to be retained for tax purposes. For example, where surrendering the contract could cause an unnecessarily high liability to income or capital gains tax, where the situation could be managed down over a period of years to improve the outcomes for the client.

Duty of care
All advisers and their firms have a duty of care to clients at all stages of the sales process.

This duty of care extends not only to the formulation of a recommendation but, importantly, to the adviser's duty to ensure that their client understands the nature of any risks inherent in that recommendation. This has been enhanced with the outcomes required by the Consumer Duty. For example, that the client's capital may not be returned in full, or that the selected level of life cover may not be sustainable throughout the term of the contract unless premiums are increased.

Investments and life assurance change rapidly and are so diverse in nature that the adviser must keep up to date to remain well informed.

The level of advice and adviser care appropriate to each client varies with the client's existing knowledge and experience of the investment business being discussed.

If an adviser is unable to provide suitable advice or a suitable product they should make that clear to the client. They should never make a recommendation that is unsuitable for the client's needs.

Unsuitable transactions
It may be that after an adviser has carried out the fact-find and made suitable recommendations to the client, the client disagrees with the recommendations. The client may then instruct the adviser to effect a transaction which the adviser believes to be unsuitable. There is no rule saying that the adviser must arrange the transaction or that they cannot, although if the transaction relates to a complex financial instrument (e.g. a warrant or derivative) the firm must firstly assess the appropriateness of the transaction for the client.

Consider this…

You have been working on behalf of Norah for some time. Her circumstances are such that you have recommended she invest into an ISA to take full advantage of her allowance for the current tax year. You have recommended she invest in funds that meet with her more cautious attitude to risk, as has been her profile for a number of years.

Consider what you would do if Norah disagreed with your recommendations and was determined to enter into a transaction which you felt was manifestly unsuitable, for example, investing into funds or entering into an investment vehicle that carries an extremely high degree of risk and completely contradicts her risk profile.

You could simply decline to arrange the transaction. Although this might alienate the client, it may be the safest course for the adviser and the client. For example, a pension transfer from a good occupational scheme with large employer contributions to a personal pension with no employer contributions. This might be so manifestly disadvantageous for the client that you would not want to be involved in any way.

On the other hand, you could decide to go ahead and arrange the transaction as instructed. This might be more likely if the disagreement was minor, for example, about the exact fund for an investment. However, it would be important to record the disagreement and get the client to countersign it. This would be valuable protection in the case of a subsequent complaint or regulatory investigation. Insistent customers are covered in more detail in *Types of service* on page 8/31.

Application forms
Best practice is for a client to be encouraged to complete their own application form. There can then be no doubt as to who has given any required information and that the client knew exactly what they were applying for. This is especially appropriate in applications for life assurance because of the duty to take care not to make a misrepresentation. If a material circumstance is not disclosed, it renders the contract potentially void, meaning that a claim may not be paid.

Many clients are unable (or unwilling) to complete the forms themselves. There is no rule preventing an adviser from helping a client to complete an application form, however, the adviser should ensure that the client reads the form and agrees with the information. It might be wise to get the client to sign a statement to this effect in case of a subsequent dispute.

The application form itself should always be signed by the client, unless the adviser has a valid power of attorney for the client (in which case there is a risk of a significant conflict of interest arising). Advisers should never forge a client's signature as this is a criminal offence which would be taken seriously by the adviser's firm and the FCA and could easily lead to dismissal, disciplinary action and prosecution.

Client understanding of risk and clear communication

Firms must take reasonable steps to ensure that a retail client understands the nature of the risks involved in a recommended investment. Therefore, the suitability report should always explain the risks associated with any investment recommended.

Ascertaining a client's true attitude to risk is critical for any adviser in assessing suitability and making an investment recommendation.

Risk should be explained in terms that a particular client can understand. Clients with less experience or knowledge of investments will need a detailed and clear explanation of inherent risk with recommendations being made.

Individual clients may have different appetites for risk at different times in their life, dependent on their circumstances and investment objectives. Firms may have ongoing relationships with clients where they will review a client's portfolio of investments on a periodic basis and will need to be mindful of the fact that the client's risk appetite may change over time. In explaining why a recommendation is suitable, for example in a suitability report or periodic assessment of suitability, the adviser will normally make reference to why a recommendation is consistent with the client's attitude to risk and their understanding of risk.

Ensuring such understanding will enable firms to make appropriate recommendations, improving the quality of advice and reduce the risk of future complaints.

Risk tolerances on a standard fact-find with a scale, for example of 1 to 10, will often have little meaning to clients. Many firms use stochastic risk profiling tools to deliver an impartial and unbiased assessment of the client's risk profile. These can vary from the very complex (50+ questions) to the very simple (5 questions). Firms will often undertake extensive due diligence on such tools to ensure they are providing an appropriate assessment and that the outcomes can be effectively mapped across to the investment solutions they offer.

Advisers will need to hold in-depth discussions with each of their clients to explain what their risk profile means and how any definition relates to risks that are real to them, perhaps covering aspects like, but not limited to: capital security, shortfall risk, interest rate risk, inflation risk, regular income withdrawals, charges, penalty fees, age, family commitments, the need for income and/or growth, whether there is an investment target and the investment time horizon.

In making recommendations firms should look at the client's risk profile and take into account their existing portfolio, e.g. if a client's risk profile suggests that, say, 10% of their portfolio should be in higher risk assets, the firm must take account of what assets are already held in making a recommendation.

In addition to understanding a client's risk appetite (their tolerance of or preference for risk), a recommendation for any investment (including those within pensions) must take into account the client's capacity for risk (otherwise known as capacity for loss). Unlike risk appetite, this is not subjective and must be objectively assessed by the adviser. There are different ways in which this might be achieved. Some advisers make comprehensive use of cashflow modelling tools to look at different scenarios.

It is important to remember that a client may have a large risk appetite but may not have the appropriate capacity to take risk. In such circumstances, it may be necessary to recommend that a client takes less risk for their own protection.

Reinforce

Remember: when a firm communicates information to a customer, it must take reasonable steps to communicate in a way which is **fair, clear and not misleading**, having due regard to the client's knowledge and experience.

A9 Markets in Financial Instruments Directive II (MiFID II)

MiFID first applied in the UK from November 2007, and was revised by **MiFID II**, which took effect in January 2018, to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection. MiFID II extended the MiFID requirements in a number of areas:

The scope of MiFID II is broad. Its requirements apply to firms providing investment services (such as investment advice) to clients relating to MiFID financial instruments (such as shares, bonds, units in collective investment schemes, and derivatives). Some requirements also apply to firms when they sell, or advise clients in relation to, structured deposits.

Many **financial advisers** (who do not hold client assets or money) are classified as exempt from MiFID. These advisers are known as 'Article 3 firms' and are referred to as 'MiFID optional exemption firms' in the updated rules. MiFID II has the same exemption, but Article 3 firms are now subject to a number of requirements derived from MiFID II including a range of authorisations, conduct of business and organisational requirements – but not the whole range of requirements to which MiFID investment firms are subject.

For **retail investment firms** the main requirements are in the following areas:

Disclosure of costs and charges that relate to their retail recommendations	Indications of expected (ex ante) costs and charges need to be provided pre-sale, and details of the actual costs and charges need to be provided post-sale (ex post), where applicable on at least an annual basis. These need to be aggregated, and expressed both as a cash amount (£) and as a percentage (%).
Product governance	Advisers (as distributors) need to consider, amongst other things, the rules around information sharing between distributors and manufacturers. For example, advisers need to gather information from manufacturers on the products on which they advise; and they should consider how best to feed information back to manufacturers on how the product is meeting the needs of the target market in order to help with the manufacturer's regular product reviews.
Describing advice services	The FCA has adopted the MiFID II concept of independent investment advice. This means that firms describing their advice as independent must assess a sufficient range of relevant products that are sufficiently diverse in terms of type and issuer to ensure that the client's investment objectives can be suitably met. For firms providing investment advice to retail clients in the UK, this means being in a position to advise on all types of financial instruments, structured deposits and other retail investment products.
Structured deposits	Firms that wish to carry out certain regulated activities, such as advising on or arranging investments, in relation to structured deposits will need this investment type in their permissions.
Suitability	There were a number of important areas regarding the suitability rules for advice on MiFID financial instruments and structured deposits provided by MiFID investment firms and Article 3 firms. • A recommendation to hold a MiFID financial instrument is subject to the suitability rules and requires a suitability report. • Where firms are offering a periodic assessment of the suitability of their advice, this assessment must be carried out at least annually.
Recording conversations	All MiFID firms must record, and keep a copy of, all telephone and electronic, conversations with a client that relate to the reception, transmission or execution of an order, including those that are intended to result in transactions. Article 3 retail financial advisers have the option of either recording the telephone conversation or making a contemporaneous note. However, the note must contain the: • date and time of the call; • identity of the participants; • initiator of the call; and • any relevant information about the client order, including the price, volume, type of order and when it will be transmitted or executed.
Inducements	MiFID II introduced inducement bans for firms providing independent investment advice and portfolio management services. The FCA has implemented these new bans alongside, and in such a way as to broadly reflect the application of, the existing RDR adviser charging rules. This means, for example, that for firms providing advice to retail clients in the UK, the ban applies both in respect of the provision of independent and non-independent (restricted) advice, and in such a way as to prevent rebating. Firms to which the new MiFID II inducement bans apply may only accept certain minor non-monetary benefits. These may include 'hospitality of a reasonable de minimis value' (provided that certain conditions are met). However, note that the list of potentially acceptable minor non-monetary benefits does not include 'sporting and cultural events'.

Be aware
Some firms use transcription services to transcribe recordings of conversations with clients. Firms doing so should ensure that they satisfy the appropriate data protection requirements.

Reinforce
Remember a recommendation to hold a MiFID financial instrument is subject to the suitability rules and requires a suitability report. Where firms are offering a periodic assessment of the suitability of their advice, this assessment must be carried out at least annually.

A10 The Insurance Distribution Directive (IDD)

The **Insurance Distribution Directive (IDD)** is an update to and revision of its predecessor the Insurance Mediation Directive (IMD). The IMD specified conditions for the initial authorisation and ongoing regulatory requirements for insurance and reinsurance intermediaries. It was designed to encourage cross-border competition between intermediaries and also to ensure appropriate levels of protection for insurance customers across the European Union (EU). Following the legislative process the IMD2 was amended and renamed the Insurance Distribution Directive (IDD). The IDD became effective on 1 October 2018.

The IDD aimed to enhance consumer protection when buying insurance (including general insurance, life assurance and **insurance-based investment products (IBIPs)**), and to support competition between insurance distributors by creating a level playing field. Consequently, there are particular aspects of the IDD that apply to a general insurance intermediary and aspects that apply to an investment firm.

The IDD covers the initial authorisation and ongoing regulatory requirements for insurance and reinsurance intermediaries. However, the application of the IDD is wider; covering organisational and conduct of business requirements for insurance and reinsurance undertakings. The IDD also introduces requirements in new areas, including product oversight and governance, and enhanced conduct rules for IBIPs, where its stated intention is to more closely align the customer protections with those provided by MiFID II.

Be aware
The Insurance Distribution Directive established the level of continuous professional development (CPD) required for those recommending insurance products at 15 hours per year. For investment advisers, who already have an obligation of 35 hours per year, this can be included within their existing requirement but must be on relevant subjects.

B Client relationships and adviser responsibilities

The FCA creates rules for business standards (COBS, ICOBS, MCOB, PROD and ESG), sets competency standards and ensures that the high standards required by law are met. Advisers are obliged to operate within these rules when establishing and maintaining the adviser/client relationship and at all times advisers have a duty of care to their clients, particularly retail clients, as established in the Consumer Duty and PRIN 2A.

B1 Types of clients

Investment business
There is a requirement for a firm to take reasonable steps to establish whether the client categorisation for investment business is either a:

- retail client;
- professional client; or
- eligible counterparty.

The requirements for disclosure and the protection afforded to retail clients are considerably higher than for the other two categories.

Many of the COBS rules distinguish between various types of customer as follows:

Retail clients are not eligible counterparties or professional clients and are offered the greatest amount of protection under FCA rules.

Firms also have a higher duty of care to retail clients, as established in *The Consumer Duty* on page 8/7. This is required at the highest level of regulation through principle 12 (see *FCA Principles for Businesses (PRIN)* on page 10/2) and conduct rule 6 (*Code of Conduct (COCON)* on page 10/6).

Professional clients can either be 'per se' or 'elective' professional clients.

A per se professional client is classified by virtue of their characteristics. The following clients, while not eligible counterparties, would automatically be classified as **per se professional clients**:

- a credit institution;
- an investment firm;
- other authorised or regulated financial institutions;
- an insurance company;
- a collective investment scheme or its management company;
- a pension fund or its management company;
- a commodity or commodity derivatives dealer;
- a local authority;
- any other institutional investor;
- for MiFID business a large undertaking meeting two of the following size requirements on a company basis – balance sheet total of €20m, net turnover of €40m and/or own funds of €2m; and
- for non-MiFID business, a large undertaking meeting a range of conditions relating to legal structure, size and funding as stated in the FCA Handbook at COBS 3.5.2.

Elective professional clients do not satisfy the above criteria but are treated as professional clients rather than retail clients.

In order for a firm to classify a retail client as an elective professional client it must conduct a qualitative assessment (known as 'the qualitative test') of the client's expertise, experience and knowledge, in order to ensure that they are capable of making their own investment decisions and understanding the risks involved. In respect of MiFID business, it is also necessary to undertake a quantitative analysis of the customer, assessing their previous investment transaction history, employment history and the value of investment assets held by the client ('the quantitative test'). At least two of the following criteria must apply to meet the quantitative test:

- the client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters;
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000; and
- the client works or has worked in the financial sector for at least one year in a professional position which requires knowledge of the transactions or services envisaged.

Eligible counterparty can only be applied to clients in respect of 'eligible counterparty business', including:

- dealing on own account (for example, where the firm buys blocks of shares using its own funds and subsequently sells these on to clients); and
- arranging, execution, or receipt and transmission of orders (for example, where the firm carries out deals at the request of clients).

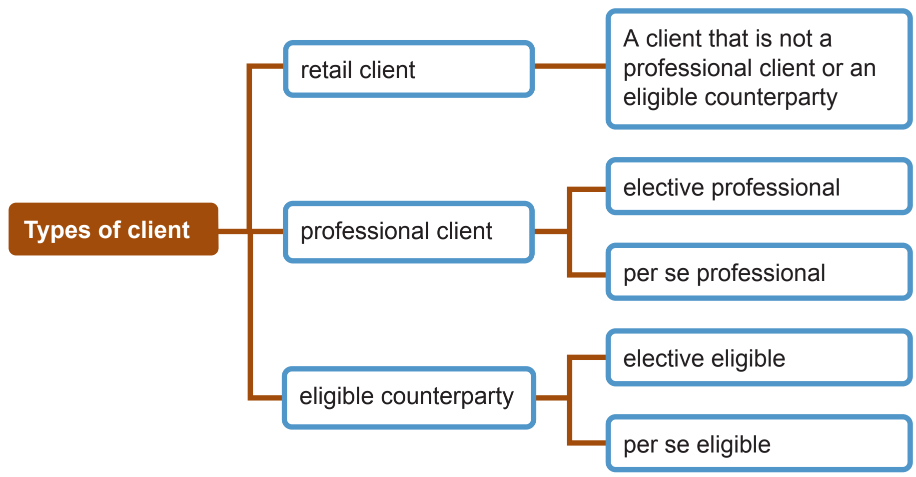
Firms are able to classify clients as eligible counterparties if the service they provide to them is limited to those set out above, however, the client must also fulfil certain criteria as detailed below. Like professional clients, eligible counterparties can be either elective or per se. The following list of clients can be categorised as **per se eligible counterparties** subject to the above requirement:

- an investment firm;
- a credit institution;
- an insurance company;
- a collective investment scheme or its management company;
- a pension fund or its management company;
- another authorised financial institution;
- national governments;
- central banks; and
- supranational organisations.

Some clients who are professional clients but are not per se eligible counterparties can be classified as elective eligible counterparties. However, clients who are treated as elective professional clients in relation to MiFID business cannot be recategorised as elective eligible counterparties.

Financial advisers are unlikely to classify any clients as eligible counterparties since the services they provide are unlikely to be limited to eligible counterparty business.

Figure 8.1: Classifying clients



Liability for loss

Contravention of a rule is not an offence and does not legally void any resulting transactions. However, it can result in an authorised person being liable to any private person who suffers a loss due to the rule breach. For this purpose, a private person is an individual or a corporate body (unless it suffers the loss in the course of any kind of business), but not a government, local authority or international organisation.

Question 8.4

Which category of investment client is afforded the greatest protection under the FCA's rules?

Types of clients in insurance business	
ICOBS rules apply to different categories of client in different ways. The categories of client recognised under ICOBS are:	
Consumer	A consumer is any natural person who is acting for purposes which are outside their trade or profession.
Commercial customer	A commercial customer is a customer who is not a consumer.
Customer (i.e. both)	A customer refers to both consumers and commercial customers.

Types of clients in home finance business
Home finance business under MCOB has only one class of clients who are simply termed 'customers'.

B2 Fiduciary relationships

In dealing with clients, firms must keep in mind the overriding principles of duty of care, confidentiality and primacy of the clients' interests. Some particular examples of note are as follows:

- **Fairness to clients**. The firm has an overriding duty to act honestly, fairly and professionally towards its clients, above all others.
- **Relationship with product providers**. The firm's relationship with product providers is that of an intermediary, providing advice on the products offered by the providers, and arranging contracts for its clients. The firm acts as **agent for the clients** in these transactions, not as agent for product providers.
- **Conflict of interest and material interest**. Where an adviser is aware of a conflict of interest or a material interest, or where an adviser is not aware but another employee becomes aware subsequently, a disclosure of that interest must be made in writing to the client, wherever possible before any transaction is arranged.

  For the avoidance of doubt, conflicts and material interests will include:

  – dealing as principal;
  – dealing as agent for more than one party;
  – recommending a transaction to buy or sell an investment where another client has already given instructions to buy or sell in the same investment; and
  – acting as a broker fund adviser.
- **Exclusion of liability**. Firms must not seek to exclude or restrict any duty or liability they may have to a client under the regulatory system. This applies whenever they make any written or oral communication to a client in the course of, or in connection with, regulated business. Firms must not exclude or restrict any other duty or liability when they are communicating with a retail client unless it is reasonable to do so. Firms also need to bear in mind their obligations under the **Consumer Rights Act 2015**.
- **Clear, fair and not misleading communication**. When firms communicate information to a client, they must take reasonable steps to communicate in a way that is clear, fair and not misleading. This is a requirement in **COBS, MCOB and ICOBS**. However, MCOB and ICOBS are more prescriptive about the terms that must or must not be used.
- **Firms holding themselves out as independent**. A firm must not hold itself out to a client as acting independently unless it intends to provide personal recommendations to that client on retail investment products that satisfy the 'standard for independent advice' required.
- **Inducements and commissions**. Firms must ensure that they, or anyone acting on their behalf, do not conduct business under arrangements that are likely to result in a material conflict with the duty to its customers. This includes any inducement being given or received by an unregulated associate. There are similar requirements in COBS, ICOBS and MCOB but the nature of business covered results in specific requirements for each.
- **Charging customers for handling their complaints**. Any provision seeking to charge customers, or to recover costs, for dealing with complaints before the FOS, is unjustifiable, as this could deter customers from exercising their right to refer the dispute to the FOS. In most circumstances, the FCA would consider such a clause in a firm's terms of business to be unfair under the Consumer Rights Act 2015 and in direct contravention of the rule in DISP 1.1A.16 for investment firms. In addition, such a clause

is, in its view, inconsistent with FCA principle 6, which requires that firms pay due regard to the interests of their customers and treat them fairly.

B3 Status disclosure and charges

B3A Status disclosure

On first contact with a retail client where advice or arrangements in packaged products are contemplated (i.e. before fact-finding takes place), a firm must provide a client with specific information about the firm and its relationship with the client, including:

- the name and address of the firm and the contact details necessary to enable a client to communicate with it;
- the methods of communication to be used between the firm and the client;
- the firm's regulatory status (i.e. that it is authorised and regulated by the FCA);
- whether the firm is acting as an appointed representative or as a tied agent of an authorised firm;
- the firm's status as 'independent', 'focused independent' or 'restricted' (explaining the nature of the restriction);
- details of the services to be provided;
- details of how the firm is paid;
- details of loans and ownership;
- how to complain;
- coverage by the Financial Services Compensation Scheme (FSCS); and
- a summary of the firm's conflicts of interest policy.

Where a fee is to be charged, the client's agreement to this must be obtained before the firm starts to act. Under a 'fee only' arrangement, in respect of pre-2013 'legacy' investment business written, where any trail commission is taken by the firm, that commission must be transferred to the client by reducing the fee, increasing the investment, or direct payment to the client. However, the firm can still agree with the client (in writing) that it will retain any trail/renewal commission if it is small relative to the overall fees, and it would be disproportionate for the firm to have to account for it to the client.

Firms which operate with a range of retail investment products must produce a record of the range for distribution to retail clients on request.

This information will be confirmed in writing in the **initial disclosures**. Firms must create their own disclosures format to provide this information.

This information does not have to be given in the following circumstances:

- where the information has already been given to the client and is still valid;
- where the initial contact is by telephone – the equivalent information must be provided over the phone and later confirmed in writing; and
- for execution-only transactions in non-life packaged products.

B3B Charges

Before doing business the firm must disclose in writing to a retail client the basis of its charges and the nature or amount of any other income receivable by it (or its associate) due to that business.

Before arranging a retail investment product for a retail client, a firm must disclose any remuneration payable by it to its employees or agents, and any remuneration received by it.

For remuneration of employees and agents, a firm must put a proper value on any benefits or services provided as well as cash. These benefits include cars, loans, pensions and any support services that could not be provided for an IFA. The remuneration disclosed for a provider's representative could therefore, be much greater than the actual fees paid.

B3C Client agreements

A firm must provide a retail client with a **client agreement** (sometimes referred to as the **Terms of Business**) before conducting the business, or immediately afterwards where the business was concluded using a means of distance communication which prevented the firm from doing so. For example, a client agreement need not be provided beforehand if the business is conducted by telephone.

For a professional client, the client agreement must be provided within a 'reasonable period' of the start of conducting business. Client agreements are **not** required for:

- direct offer financial promotions; and
- life offices selling life and pension policies as a principal.

Activity

Client agreements must set out in adequate detail the basis for conducting the business such as:

- commencement;
- regulation by the FCA;
- investment objectives; and
- restrictions.

What else do you think should be included?

The others are: services provided; payment; status; the giving of instructions; accounting; withdrawal rights; conflicts of interest; risk warnings; complaints; compensation; termination.

Records of client agreements must be kept for the requisite period; being whichever is the longer of:

- five years; or
- the duration of the relationship with the client; or
- in the case of a record relating to a pension transfer, pension conversion, pension opt-out or FSAVC, indefinitely.

The object of these rules is to ensure that clients know exactly what sort of firm they are dealing with, the services provided and the likely procedures and costs.

B3D Types of service

Best execution

The principle of best execution applies mainly to firms dealing in stocks and shares. It does not apply to life or pension contracts or collective investment schemes. The firm must take all sufficient steps so that the transaction is carried out on the best terms available, including price, speed, cost, likelihood of execution and settlement.

Put succinctly: a stockbroker will normally obtain the highest price for a selling client and the lowest price for a buying client.

Execution-only

Be aware

Execution-only must not be confused with best execution as they are entirely separate practices.

An execution-only sale is one in which an investor states exactly what they want and does not ask for or receive any advice. It is rare in the life and pensions field as most clients do not know exactly what product they want or from which provider. It is much more common in the field of stocks and shares where many clients know exactly what they want; for example: 'sell my 1,000 shares in ABC plc' or 'buy £10,000 worth of shares in XYZ plc'.

Where the client's request for an execution-only transaction relates to a complex financial instrument the firm is required to assess the appropriateness of this transaction for the client.

The adviser's function in execution-only cases is limited to arranging the deal, and the fact-finding and suitability rules are, therefore, not relevant. This also means that the client would lose the ability to refer any subsequent complaint to the FOS as no advice was given.

> **Be aware**
> Pension transfers out of a defined benefit scheme with a value over £30,000 require sign off by a regulated financial adviser with appropriate qualifications, and a personal recommendation must be made. As such they cannot be dealt with on an 'execution only' basis.

Limited advice
It is always possible for a client to ask for limited advice rather than a full financial review. **This is not the same as execution-only as advice is still being given**. The adviser should record on the fact-find or elsewhere that the client only requested advice on a particular subject, e.g. 'the client requested advice on inheritance tax planning only and did not want advice on any other subject'. While it may be appropriate for a firm to offer advice limited to a specific set of client needs (e.g. a saving or investment vehicle, or retirement planning), as long as this is disclosed to the client, firms should be wary of providing 'limited advice' in the form of providing information and opinion rather than making a specific recommendation. In the past, the **Financial Ombudsman Service** (**FOS**) has taken the view that an adviser must either give no advice and have no responsibility for a product's suitability (execution-only) or be duty bound to provide full and suitable advice, regardless of the client's specifications.

Non-advised sales
No personal recommendation is made to the client who must, however, still receive sufficient information on the product to enable them to make an informed decision as to whether it meets their own objectives, demands and needs.

An example of making a non-advised sale could be where:

- the client decides or knows the specific product they want – this could be in a similar way to an 'execution-only' sale of an investment product; or
- the firm offers information on a range of products for the client to make their own informed decision.

Question 8.5
What is the difference between execution-only and best execution?

Insistent clients
The FCA Handbook (COBS 9.5A) provides guidance on insistent clients. In practice, there may be occasions where the client wishes to take a different course of action from the one the firm recommends and wants the firm to facilitate the transaction against its advice. When a client does this they are commonly referred to as an **insistent client**.

An insistent client is characterised as follows:

- the firm has given the client a personal recommendation;
- the client decides to enter into a transaction which is **different to that recommended by the firm** in the personal recommendation; and
- the client wishes the firm to facilitate that transaction.

If firms have an insistent client then they need to ensure they:

- provide advice that is suitable for the individual client (i.e. the normal advice process);
- clearly explain the risks of the alternative course of action; and
- be clear that the client's actions are against the firm's advice.

Following the initial suitability report, if the client does not agree with the advice given, a second letter reiterating the advice should then also be issued to the client. Only if the client still wishes to proceed after this should the firm then consider consenting to arrange the transaction. If the firm does consent to arrange the transaction, and **the firm does not need to do so**, good practice would be to obtain from the client a written document in their own words, instructing the firm to arrange the transaction and preferably including the client's reasons for this request in the face of the firm's advice to the contrary.

When issuing the second letter, the firm must **not** enclose any material, such as product disclosure documents or application forms, that would only serve to undermine the content of that letter.

Finally, the firm may wish to confirm to the client in writing that the transaction has been arranged on the client's specific instructions, that it is contrary to advice given by the firm and highlight the implications of transacting on this basis (e.g. that the transaction may not be suitable for the client's circumstances).

B4 Limitations and referrals

A firm must be able to recognise the extent of its own authority and/or expertise and seek further assistance where necessary. Some particular pointers to bear in mind when considering these limitations are as follows:

- reliance on others;
- reliance on information;
- insufficient information;
- execution-only transactions; and
- introducer organisations.

More information is provided below:

Reliance on others
FCA **principle 2** requires firms to conduct their business with 'due skill, care and diligence'. Conduct of business rules indicate the extent to which firms can meet this requirement by relying on others. Firms may generally rely on another competent person not connected with the firm to provide them with information in writing to meet their own obligations to obtain information, and vice versa. This is providing that firms can show that it was reasonable to do so. Firms may also send information to a third party (unconnected with the firm) on the instructions of the client. 'In writing' includes the use of electronic media to make communication.

Be aware

Where information has been provided by a third party, good practice would be to contact the client to verify the information.

Reliance on information
A firm is entitled to rely on the information provided by its clients unless it is aware that the information is manifestly out of date, inaccurate or incomplete.

Insufficient information
If a firm does not obtain the necessary information to assess suitability (or if the client declines to provide any or all of the information contained in the fact-find and this results in the firm being unable to assess suitability), it must not make a personal recommendation to the client or take a decision to trade for them.

However, the firm will be permitted, at the client's request, to deal with the client on an execution-only basis.

Execution-only transactions
If firms arrange an execution-only transaction (a transaction where no advice is sought or given), they will not normally need to obtain personal or financial information or assess the appropriateness of the transaction. However, firms may still need to do **anti-money laundering checks** and provide a statement of demands and needs in relation to any life policy business.

Introducer organisations
Organisations that introduce business to a firm will fall into one of four categories:

Authorised by the FCA	Organisations that are authorised by the FCA are subject to the same rules as the firm. It is therefore important to establish which party will be responsible to the client for compliance with the rules.

Regulated by a Designated Professional Body (DPB) (e.g. the Law Society, Institute of Chartered Accountants in England and Wales)	Organisations that are authorised by a DPB are subject to similar, if not the same, rules as the firm. So, it is important to establish which party will be responsible to the client for compliance with the rules.
Exempt firms	Exempt firms will typically be appointed representatives of other firms. The firm may decide to only accept introductions from IFA appointed representatives that are not a product provider appointed representative.
Not FCA-authorised	This category will include professional firms which have chosen not to be authorised by the FCA/regulated by a DPB, and firms which are not regulated by a professional body (e.g. estate agents). Such firms are not subject to any FCA rules in respect of their business (although they might be subject to other rules which are not relevant to their dealings with the firm).

Whatever the source of referrals, it is important that the host firm has proper agreements in place to cover both regulatory aspects and any necessary commercial arrangements.

B5 Clients' cancellation rights

Some investments give a client a right to cancellation after the sale or a right to withdraw pre-sale.

Table 8.1: Cancellable investment agreements

14-day cancellation period	30-day cancellation period
• Cash ISA. • Units in a regulated collective investment scheme (including those purchased as part of a wrapper or pension).[1] • Transferring a child trust fund (CTF).[1] • Opening or transferring an ISA.[1] • An enterprise investment scheme (EIS).[1] • Designated investments (including those mentioned above) when sold at a distance.[2]	• Life policy (including a pension annuity, a pension policy or within a wrapper, e.g. ISA). • A personal or stakeholder pension contract. • Pension transfer. • Variations of existing personal or stakeholder pensions by electing to take income withdrawals. • Personal recommendations for a Lifetime ISA (non-distance).

Notes:

For life policies purchased as part of a wrapper, the 30-day cancellation right will apply to the entire arrangement (i.e. to the wrapper and the policy). For contracts to buy units in regulated collective investments as part of a pension wrapper the 14-day cancellation right will apply to the entire arrangement (i.e. to the wrapper and the policy).

[1] These cancellation rights apply where a personal recommendation has been made and the sale was not made at a distance (e.g. if the advice was given face to face).

[2] This excludes any contract where the price depends on fluctuations in the financial market outside of a firm's control, for example: options, swaps, contracts for difference, foreign exchange transactions, and units in collective investments.

Activity

Several exemptions to the right to cancellation exist and the right to cancel will vary in some circumstances.

Give some thought to what these could be.

Examples include:

- where a second ISA or EIS is entered into with the same ISA/EIS manager on the same terms as an ISA/EIS from the previous tax year;
- pension annuities or pension transfers (and relevant variations) – the firm can, in certain circumstances, choose to operate a pre-sale right to withdraw (known also as the 'cancellation substitute') rather than a post-sale right to cancel;
- EISs or a non-packaged product such as an ISA or CTF, where it has been explained that no cancellation rights or withdrawal rights will apply;

- EISs or ISAs, where the right to cancel has been replaced with a seven calendar day, pre-contract right to withdraw;
- SIPPs, where the customer has elected to waive their cancellation rights;
- some specific pension contracts;
- some units in regulated collective investment schemes in certain circumstances; and
- traded life policies sold on a non-distance basis.

The period of cancellation begins on either the date of the conclusion of the contract (or in the case of a life policy on the date the client is informed that the contract has been concluded), or, if later, the day the client receives the terms and conditions and other pre-contractual information.

Where there is a right to cancel, the product provider must give the client **written notice** of this before the agreement has been concluded, or if that is not possible, immediately afterwards. The cancellation notice must be sent by post or electronically.

The cancellation notice must state that there is a right to cancel, specify the duration of the right and the steps the client must take to cancel. It must also specify the consequences of cancellation, including any shortfall the client may have to bear.

If the provider does not send post-sale cancellation details when required, the client can cancel at any time and will not be liable for any shortfall. There is no right to cancel:

- a contract for or funded (wholly or in part) from a pension transfer;
- a pension annuity due to commence within a year and a day of the contract or a variation of one with similar commencement; or
- the exercise of an option to make income withdrawals;

to the extent that the right to cancel is replaced with a pre-contract right to withdraw the consumer's offer of at least 14 calendar days. The combined period of the right to withdraw and any residual right to cancel must be at least 30 calendar days.

Exercising a cancellation right
A client can exercise a cancellation right by serving notice on the provider by post or in any other manner the provider states is acceptable. The right is only valid if served on the provider (or its AR) within the time limit but if sent by post it is treated as served when posted, not when received. The provider must keep records of cancellation and withdrawal for the standard periods.

A firm does not have to accept notice of cancellation of a pension annuity if any annuitant under it has died before notice is given.

If a client cancels a contract the provider must refund any payment the client has made to it (or its agent). The provider can deduct any money paid by it plus any shortfall. Shortfall is any market loss produced by a drop in unit prices since allocation. It only applies to single payment life policies, pension contracts, unit trusts and OEICs where the cancellation notice was sent by the provider at the correct time.

Record keeping
The provider firm must make adequate records concerning the exercise of a right to cancel or withdraw and retain them:

- **indefinitely** in relation to a pension transfer, pension opt-out or FSAVC;
- **for at least five years** in relation to a life policy, pension contract, personal pension scheme, stakeholder pension scheme or lifetime ISA; and
- **for at least three years** in any other case.

Question 8.6
What is the standard cancellation period for a pension contract?

B6 Clients with characteristics of vulnerability

Delivering positive customer outcomes is especially important for those with characteristics of vulnerability. These are people who require an additional duty of care, typically on account of their age, state of health or current circumstances (e.g. being recently divorced or bereaved). The FCA has embedded consideration of vulnerable circumstances in every part of the Consumer Duty rules.

In the past, some firms automatically treated a client over a certain age as a ‘vulnerable customer’. This would not be considered best practice as it is not treating the client as an individual. However, firms may still have automatic triggers for when they consider a client to be *potentially* vulnerable, until such time as they identify this not to be the case. This process would trigger stricter procedures around how advice is provided, so the client is not exposed to unnecessary risk.

Some groups of customers, such as those who are older, may have common characteristics of vulnerability. For example, advisers who arrange equity release products for typically elderly clients have strict guidelines to ensure clients fully understand the implications and have not been unduly influenced by external parties.

The FCA defines a customer with characteristics of vulnerability as 'someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care’.

Vulnerability can come in many forms and the FCA views vulnerability as a spectrum of risk. **All customers are at risk of becoming vulnerable at some points in their life**. Drivers of vulnerability could include poor health, certain life events, and low levels of resilience or capability. The characteristics associated with the drivers of vulnerability appear in the following table:

Health	Life events	Resilience	Capability
Physical disability	Retirement	Inadequate (outgoings exceed income) or erratic income	Low knowledge or confidence in managing finances
Severe or long-term illness	Bereavement	Over-indebtedness	Poor literacy or numeracy skills
Hearing or visual impairment	Income shock	Low savings	Poor English language skills
Mental health condition or disability	Relationship breakdown	Low emotional resilience	Poor or non-existent digital skills
Addiction	Domestic abuse (including economic control)		Learning difficulties
Low mental capacity or cognitive disability	Caring responsibilities		No or low access to help or support
	Other circumstances that affect people’s experience of financial services, e.g. leaving care, migration or seeking asylum, human trafficking or modern slavery, convictions		

Source: FCA FG21/1 Guidance for firms on the fair treatment of vulnerable customers

Although some consumers may display characteristics of vulnerability and be at greater risk of harm, this does not mean that they will suffer harm, particularly if firms act with appropriate levels of care.

The need for the adviser to ensure a vulnerable consumer fully understands the advice process is paramount. Providing information via different media or allowing vulnerable customers the flexibility to take more time to make decisions might be beneficial. If they are still unable to understand the implications of the advice, then the involvement of other family members or a power of attorney may be appropriate.

Firms should consider the characteristics of vulnerability in their target market when designing services and how they distribute products.

On the Web

For FCA publications, see:

Occasional paper on consumer vulnerability: *bit.ly/2hiox3D*.

February 2021 guidance on the fair treatment of vulnerable customers: *www.fca.org.uk/publications/finalised-guidance/guidance-firms-fair-treatment-vulnerable-customers*.

For resources from Financial Vulnerability Taskforce, see: *consumerduty.org/helpful-resources/guides-support*.

B7 Ethical, religious and sustainability preferences

Many clients have preferences they want taken into account in their financial affairs. This is becoming more evident in investment and pension business and also in choice of banks and insurance providers. Advisers need to recognise the importance of these issues to clients.

The FCA Financial Lives 2022 survey identified that 74% of respondents agreed that environmental issues are very important to them, yet only 23% were 'very aware' of responsible investments. Among those with pensions or investments, 62% were interested in making responsible investments in the future, with younger adults marginally more likely to invest this way. Advisers should be aware this is important to clients and incorporate it in their assessment of whether a product or service is suitable.

The FCA noted in PS23/16 that customers find it difficult to identify products which meet their specific sustainability preferences. The new labelling rules introduced in ESG 4 (see *Environmental, social and governance (ESG)* on page 6/24) should help consumers understand the market better. However, advisers need to be asking appropriate questions of clients to **fully understand any preferences** and to ensure that the advice they give is suitable and aligned with the customer's objectives.

COBS 6.2B.16 states that a firm might target a particular product market, such as ethical and socially responsible investments, however, understanding these preferences and how they may impact the suitability of advice given is the **responsibility of all advisers**.

The FCA states clearly in PS23/16 that the Consumer Duty requires firms to enable and support retail customers to pursue their financial objectives 'including where customers have sustainability-related needs and preferences as part of their investment objectives'.

Example 8.2

Ethical: Some clients may wish to avoid investments with links to arms manufacturing, tobacco, alcohol, gambling or pornography.

Religious: Others may have religious beliefs that influence how they interact with financial services, such as Muslim investors avoiding products where interest is charged or received.

Sustainability: Some people are concerned how their investments affect environmental and sustainability issues and may not wish to invest in companies with high carbon emissions engaged in the extraction of oil, gas or coal.

On the Web

The CII's Green Finance Companion Guide to the Code of Ethics: *www.cii.co.uk/media/10129409/green-finance-companion-guide.pdf*.

Selected findings from the FCA Financial Lives 2022 survey: *www.fca.org.uk/publication/financial-lives/fls-2022-consumer-investments-financial-advice.pdf*.

C Monitoring and reviewing clients' plans

C1 Ongoing monitoring and reviews

The client should be aware of how the professional relationship will continue in the future. It should also be clear to them what they are paying for and how the ongoing review process will work. Clients' needs and circumstances change over time and it is important to ensure that the planning and advice is updated in the light of these circumstances. Effective ongoing reviews may also help identify where a client has developed characteristics of vulnerability and requires additional support.

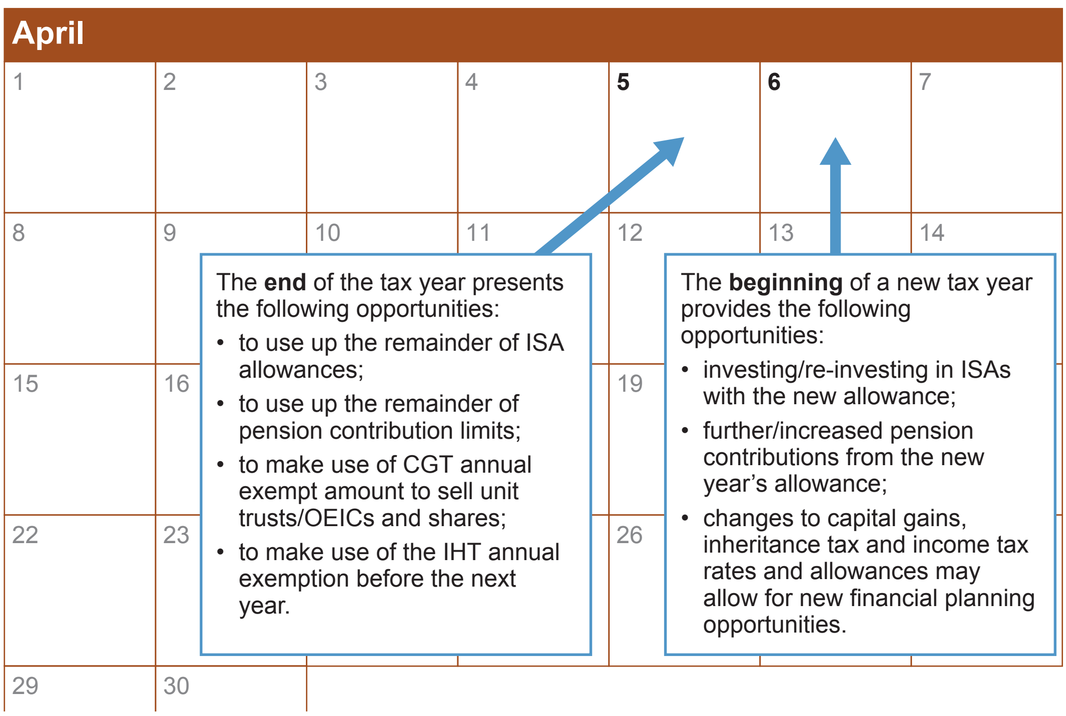
Under MiFID II, where firms are offering a periodic assessment of the suitability of their investment advice, this assessment must be carried out **at least annually**. Otherwise, there are no specific rules that relate to the frequency that a client's position should be reviewed and much of this will be down to the service offered by the firm in their client agreement/ terms of business. This has been reinforced under the Consumer Duty with the need to ensure that where a firm has an ongoing relationship with a client it acts to avoid foreseeable harm throughout the lifecycle of that product or service.

The importance of ongoing monitoring and periodic reviews of suitability has been further highlighted in the FCA's thematic review of Retirement Income Advice, particularly as investment-based income solutions such as flexible access drawdown expose clients to ongoing investment risk. The FCA noted that the failure to provide an ongoing service where one may be necessary risks compounding the impact of poor advice.

Some firms clearly state that the relationship with the client is solely for the duration of the one piece of advice. The reason for this is to remove the liability to provide ongoing advice. If the client considers that they have been put in a poor position due to the lack of ongoing advice, the firm can refer to its terms of business to avoid liability (although this will not always be considered valid). It is unlikely that this defence will hold up to the standards of the Consumer Duty, although a firm is unlikely to be held accountable for a product that no longer meets a client's needs, if those needs change, and there is no ongoing advice relationship. That said, most firms state that they are happy to restart the advice process each time the client requests it or may offer reviews on an ad hoc basis.

Clearly, it is not possible to see all clients at the same time but the beginning and end of the tax year are one opportunity for review to ensure clients are making the most of their available allowances.

Figure 8.2: Review opportunities – end of tax year



Care should be taken when trying to undertake reviews near the end of the tax year given the potentially tight timescales for submitting ISA and pension contributions, as well as tax implications of investment sales across tax years (if handled incorrectly). Most advisory firms now see clients on a rolling annual basis to incorporate the MiFID II requirement that they are seen at least annually and to avoid foreseeable harm under the Consumer Duty. This also helps to spread the workload across the year.

At each meeting it is important to review the information the firm holds about the client (the fact-find) and record any changes that have taken place. Some firms have used shortened versions of their fact-find with fewer questions, however, this may miss the opportunity to capture important information. Certain issues, such as the client's financial situation, needs and objectives, risk profile and capacity for loss, must be re-checked at every meeting as they have such a fundamental impact on the advice given.

Apart from re-checking important issues, there are a number of key life changes that are likely to have a significant impact on past and future advice. Such events are:

- marriage/civil partnership;
- separation/divorce/change of partner;
- birth/adoption of a child;
- moving home/purchase of a second property;
- change of employment/promotion/redundancy;
- accident or illness;
- death of a close relative/inheritance; and
- pending retirement.

In addition, important developments can take place in the fiscal, investment and economic environment which can affect clients:

- Tax changes can mean that clients may be faced with new problems or opportunities. A change of government could leave some clients better off and others worse off because of changed tax liabilities or the introduction of new tax reliefs.
- Investment developments can create or reduce opportunities. For example, an increase in interest rates generally makes borrowing more expensive, depresses equities and fixed-interest securities and makes annuity rates more attractive.
- Developments such as the introduction of new products can provide clients with greater choice in their financial planning.

The need for a regular client review is always there, but other reasons can arise from the client’s personal circumstances and from external developments and/or product requirements.

Clients' needs **will change over time** and financial advice is an ongoing process concerned with identifying and satisfying both current and future needs and desired outcomes. The success of adviser/client relationships is largely determined by the extent to which those needs and wants are met. Regular reviews are central to achieving this.

Extra reviews

While it is good practice to schedule regular reviews, it is also important to remember that clients will sometimes require advice generated by changes in their lives.

The better the relationship with the adviser, the more likely the client will be to turn to them, rather than to their bank, accountant or solicitor. Some advisers find it useful to send regular newsletters to maintain a link with a client. Other firms arrange opportunities for clients to meet their adviser at informal social gatherings or at seminars with visiting experts. In either case, maintaining the link in the client's mind between the adviser and the provision of advice can prove very successful.

Question 8.7

How often should a client receive a periodic assessment of the suitability of advice under MiFID II regulations?

Key points

The main ideas covered by this chapter can be summarised as follows:

Sources of information, guidance and advice

- It is important that individuals have access to information, guidance and advice. These help them to understand the array of products available to meet their financial planning needs and to have sufficient knowledge about their existing policies.
- Every product provider must produce a key features, key information or key investor information document outlining the main features of its products in a format that is easy to follow.
- The Money and Pensions Service (MaPS) is an organisation formed from three existing providers of government guidance – Pension Wise, the Money Advice Service and the Pensions Advisory Service.
- The FCA Consumer Duty aims to improve outcomes for retail customers by requiring a higher standard of care.
- A firm must ensure that retail clients are informed on a timely basis whether advice is independent or restricted.
- The overriding consideration in all communications concerning regulated business is that they are 'fair, clear and not misleading'.
- The rules are aimed at advertisements and general promotions and do not apply to:
  - communications to one recipient only;
  - specific products for a specific recipient;
  - personal quotations or illustrations; or
  - a promotion containing only: the name of the firm, a contact point, a logo, a brief factual description of the firm's activities, fees and products.
- 'Real time' financial promotions are those done in the course of a personal visit, telephone conversation or other interactive dialogue.
- 'Non-real time' financial promotions are all others, such as advertisements.
- A firm must keep a record of all its non-real time financial promotions for the standard periods:
  - indefinitely for a pension transfer, pension conversion, pension opt-out or FSAVC;
  - six years for life and pensions contracts;
  - five years for all others in the case of a MiFID firm, or three years for a non-MiFID firm.
- Unsolicited real time promotions are often termed 'cold calling'. This must not be done unless the recipient has an established client relationship with the firm, or the promotion relates to a generally marketable packaged product which is not a higher volatility fund (or a life policy linked to one).
- Under the so-called know your customer rules, an adviser (regardless of the scope of advice offered) must collect relevant information in the process called fact-finding.
- The suitability report should always explain the risks associated with any investment recommended.

Client relationships and adviser responsibilities

- The FCA creates rules for the conduct of business (COBS), sets competency standards and ensures that the high standards required by the law are met.
- The requirements for disclosure and the protection afforded to retail clients are considerably higher than for professional clients and eligible counterparties.
- Before doing business the firm must disclose in writing to a retail client the basis of its charges and the nature or amount of any other income receivable by it (or its associate) due to that business.
- Before selling a retail investment product to a retail client, a firm must disclose any remuneration payable by it to its employees or agents, and any remuneration received by it.

Key points

- The principle of best execution applies mainly to firms dealing in stocks and shares. It does not apply to life or pension contracts or collective investment schemes.
- Execution-only must not be confused with best execution as they are entirely separate practices.
- An execution-only sale is one in which an investor states exactly what they want and does not ask for or receive any advice.
- It is always possible for a client to ask for limited advice rather than a full financial review. This is not the same as execution-only as advice is still being given.
- Where a customer wishes to act in a manner contrary to the advice provided by a firm, they might be called an ‘insistent’ client.

Monitoring and reviewing clients’ plans

- Ideally, review meetings should take place at least once a year, e.g. the beginning and/or end of the tax year.
- Under MiFID II, where firms are offering a periodic assessment of the suitability of their advice, this assessment must be carried out at least annually. Otherwise, there are no specific rules relating to the frequency of review; the Client Agreement will outline the individual firm’s approach.
- There are no specific rules relating to the frequency of review; the Client Agreement will outline the individual firm’s approach.
- It is important to review the fact-find at each meeting and record any changes that have taken place, some firms use a shortened version of the fact-find with fewer questions.

Question answers

8.1 They should inform the client they have nothing suitable. They may also refer the client to an independent financial adviser.

8.2 A short-term deposit-based stakeholder product, a medium-term collective or life stakeholder product; and a long-term stakeholder pension scheme.

8.3 Real time: these are promotions carried out in the course of a personal visit, telephone conversation or other interactive dialogue.

Non-real time: all other promotions, such as advertisements.

8.4 Retail client.

8.5
- Execution only – customer receives no advice.
- Best execution – a firm must take all reasonable steps to obtain the best result for a client order for a transaction of the kind and size concerned.

8.6 30 calendar days (unless the terms of the contract give a longer period).

8.7 Under MiFID II, where firms are offering a periodic assessment of the suitability of their advice, this assessment must be carried out at least annually. Otherwise, there are no specific rules that relate to the frequency that a client's position should be reviewed.

9

Client advising skills

Contents	Syllabus learning outcomes
Introduction	
A Communicating	2.1, 8.1
B Gathering information	2.1, 8.1
C Assessment and analysis	2.1, 8.1
D Conclusions and recommendations	2.1, 8.1
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- explain the obligations that the financial services industry has towards consumers;
- explain how to conduct a fact-find to gather the information required to provide suitable financial advice;
- identify client demands and needs and possible solutions to meet them;
- explain how to assess the affordability and suitability of a course of action; and
- outline the skills required to communicate and adapt advice for customers with different capacities and needs.

Introduction

In this chapter we examine the range of skills required when advising customers.

We start with a brief look at the communication requirements between a firm and its clients before running through the essential adviser skills. These skills are the gathering of relevant information, analysing and assessing that information and, finally, making appropriate recommendations to the customer.

Key terms

This chapter features explanations of the following terms and concepts:

Affordability	Assessment and analysis	Assets	Client's demands and needs
Evaluating attitude to risk	Existing arrangements	Financial details	Financial objectives
Liabilities	Monthly income and expenditure	Oral presentation	Pension arrangements
PIPSI	Planning and objectives	Prioritising demands and needs	Quantifying demands and needs
Recommendations and reports	Suitability	Written report	

A Communicating

Under the Consumer Duty, communications with clients must equip them to make effective, timely and properly informed decisions about financial products and services. The firm should give consumers all the information they need to assess:

- the options available to them;
- the costs, risks and benefits of those options; and
- which would meet their needs and offer fair value.

The information should be given at the right time and in an understandable way.

A1 Information about the firm

Whether giving advice on mortgages, insurance or investments, most FCA regulated firms have to give clients information about their services and all firms have to give information about their costs.

This is important information and will help clients understand the service they are being offered and the cost of that service. Firms must make sure that clients read it and ask questions about anything they don't understand.

Clients can also use this information to decide if the service a firm offers is right for them and to help them shop around to find the firm they want to deal with.

Key information given includes:

- details about the service offered, including the basis on which the firm provides financial advice (e.g. independent or restricted); and
- information about the cost of the service on offer.

A2 Information about recommended products

After an adviser has discussed the client's personal goals and recommended a product to them, they will receive information about the product in writing.

This written information is important – it tells clients what they need to know to help them decide whether to go ahead with the product the adviser has recommended.

Clients should be encouraged to take time to read documents they get about a recommended product and make sure they are satisfied that it is suitable for them before making any commitment. They should use the information they get to shop around for the right deal for them.

Mortgages	General insurance	Investments
• A 'European Standardised Information Sheet' (ESIS) is provided by all lenders for easy comparison of products. • The document summarises the most important features and costs of a mortgage in a standard way.	Depending on the policy, the information a client can expect will include: • what the insurance policy covers; • what it does not cover (the exclusions); • any limits or restrictions; and • other important features they need to know about before they make up their mind.	The key information document/key investor information document gives details of the product and should answer questions about: • the aim of the investment; • the client's commitment; • how the client's payments are invested; • the main risks; • the tax position; • fees and charges and their effect on the investment.

Question 9.1

What does the Consumer Duty require a firm to do regarding communications with clients?

B Gathering information

B1 Fact-finding

The purpose of fact-finding is to gather relevant information, so a financial adviser can determine a client's demands, needs and objectives and recommend suitable products to meet them.

The importance of the fact-find

The FCA requires a financial adviser to keep fact-find information on file when giving advice to a new client. If a client is given further advice there is a requirement to ensure the fact-find information remains correct. If facts have changed, it is very important that the fact-find is updated and, even where the facts remain the same and no changes are required, this must be documented.

Refer to

For an example of a fact-find, which you can view with the commentary below, see Appendix 2.1 on RevisionMate (*ciigroup.org/login*)

The purpose of all fact-finds is the same but their appearance and structure may differ markedly between adviser firms and, even more so, between the range of businesses that use them (insurance companies, direct sales forces, banks and building societies and independent intermediaries).

The fact-find should be fully completed. If a client is not prepared to give information, a comment should be recorded on the fact-find. This will demonstrate that all areas have been addressed with the client.

In addition to hard facts, a typical fact-find seeks to determine the client's attitudes and opinions about their financial situation and their future hopes and aspirations. In this way, an adviser can form a picture of whether the client is more concerned about protecting what they already have or saving for a future objective.

In your R01 examination, you will not be expected to remember all of the example fact-find, but you should note the main parts and purpose of the questions.

B1A Part 1: Basic details

Part one of a typical fact-find covers general information about the client and their circumstances, including name, address, relationship status and health.

The client's relationship status will help the adviser begin to assess the client's possible financial demands and needs during extended illness, or on death, and also their tax position.

Consider this…

A less obvious use of this part is to determine the country of domicile and residence of the client. Why do you think this would be?

Domicile and residence are key factors in determining liability to UK taxes.

Questions regarding the client's state of health and whether they are a smoker are included in fact-finds to ensure that complete and correct information is obtained for life insurance quotes (i.e. smoker or non-smoker rates). They are also used to assess a client's eligibility for such policies, for example, someone in very poor health might not be eligible for life insurance but, equally, may become eligible for an enhanced annuity at retirement.

B1B Part 2: Family details

This part will give the adviser a better idea of the client's financial dependants, e.g. partner, children or elderly dependants, for whom they might want death and/or sickness benefits to be paid. From a marketing point of view, and subject to data protection rules, the names supplied within this part might also form the basis of a list of referrals from the client in due course.

B1C Part 3: Employment details

Information regarding current and previous employers or self-employment, current salary and employer benefits (if any) is crucial to the adviser's consideration of the client's situation, as it reveals the level of earned income which might be lost during illness or on death.

In addition, it reveals the extent of life, sickness and medical cover provided by the client's employer so that, when added to any State benefits payable in these circumstances, the shortfall can be identified, quantified and a proposition put to the client in respect of appropriate insurance policies.

B1D Part 4: Other professional advisers

This part looks at the other professionals the client uses, or is likely to use, for financial advice and which (if any) will be consulted about the adviser's recommendations.

The adviser might decide that one or more of these professionals should be consulted before the client takes any action. For example, where the adviser is providing pensions or taxation proposals, the client's accountant could be consulted; for investment proposals it could be their stockbroker; or for proposals relating to a client's estate or will their solicitor.

A collaborative approach

Financial advisers may see the existence of other professional advisers as a threat to a possible sale, but this attitude should be avoided. A commitment to working with other professionals rather than against them will inevitably lead to a higher standard of advice for the client.

B1E Part 5: Income and expenditure

This part serves many purposes but particularly to determine whether the client is spending more than their income, indicating if they are likely or able to save or invest more money on a regular basis.

The surplus income (or deficit) is a key figure in the analysis of the client's circumstances.

Discussion, not assumption

The adviser should not assume that a client, who is spending all of their income, will not want or be able to afford premiums for financial protection policies or make savings once the situation has been discussed.

It is very important with this part to ensure that the true position is recorded.

B1F Part 6: Assets

This part requires the client to list used assets and invested assets. Used assets include their house and personal belongings which, though of significant value, cannot easily be used for investment purposes or to subsidise lost earnings due to illness.

Consider this…
What do you think details of a client's invested assets will indicate to the adviser?

The invested assets could give an indication of the client's attitude to risk. For example, heavy investment in equities could signal an adventurous investor, whereas reliance on bank and building society accounts could signal a very cautious investor. Other aspects of their requirements that might be revealed include short-term or long-term demands and needs, and the pursuit of an active or passive investment strategy.

B1G Part 7: Liabilities

With particular emphasis on details of their mortgage (if any), this part seeks to ensure that a client's liabilities could be met if they were to die or if their earnings ceased due to illness or accident.

The adviser will also seek to confirm whether the client's mortgage repayment method is the most suitable for their circumstances or if it should be restructured.

Priority should be given to the repayment of short-term, high-cost credit. The adviser may be able to identify certain loans which could be re-financed to reduce the client's outgoings and/or reduce the rate of interest they are paying on their debts. Care must be taken, however, in view of the penalties of switching from one method to another and the cumulative effects of consolidating debt on repayment amounts.

Finally, the adviser will be able to compare the client's total assets against their total liabilities in order to ascertain their net worth or net liability. This is calculated by deducting all liabilities from the total value of their assets.

B1H Part 8: Life insurance

A client may have more than one source of life insurance. For example, they may have death-in-service cover from their employer, mortgage protection insurance for their mortgage and/or a level term of family income policy to protect their standard of living in the event of early death.

Existing arrangements
The client should rarely be advised to surrender an existing contract or allow one to lapse, except in extreme circumstances where a particular policy or investment is entirely inappropriate for their demands and needs.

B1I Part 9: Health insurance

A client's employer may provide sick pay, in which case it is important to find out how much is payable and for how long. This information can then be used to ensure that any income protection policy recommended has the correct deferred period so that unnecessary cover is not purchased.

B1J Part 10: Regular savings

Some clients may already save regularly into, say, a deposit account or ISA. These savings may or may not be intended for a specific purpose. Depending on the client's objectives, the adviser may need to think about recommending savings plans such as to help pay future school or university fees.

B1K Part 11: Pension details

This is an important part in identifying whether the client can expect to enjoy a reasonable standard of income in retirement. It is important the adviser ensures that the client's answers are as accurate as possible. Although few clients will be fully aware of the exact nature of the pension scheme offered by their employer, it is possible to obtain written details at a later stage from the employer to help complete the questions.

Any obvious areas of shortfall should be briefly highlighted and discussed with the client at this point. The adviser should carefully note the client's responses, as perceived indifference could lead the adviser to gear their eventual recommendation more towards shorter-term savings. However, any shortfall should be emphasised and the importance of adequate and timely provision for retirement stressed.

B1L Part 12: Inheritances

Checking whether a client has a valid will and whether its provisions meet their current needs is essential. For older, wealthier clients, a history of their lifetime gifting will give a truer picture of the value of their estate, an indication of whether there may be a need to mitigate an IHT liability on death, and whether writing life insurance policies under trust would be helpful. Anticipated inheritances may indicate a need for future financial planning.

B1M Part 13: Attitude to risk

Once risk profiling has taken place, the client's attitude to risk can be recorded alongside their capacity for loss. Thoughts on sustainable and responsible investing may be recorded here too.

B1N Summary of the fact-find

The fact-find should work in conjunction with supplementary questions and provide the key information that enables the adviser to formulate a comprehensive recommendation, taking all the relevant circumstances into account. Quite often the process of asking questions will also have prompted the client to think more deeply about their demands, needs and aspirations.

The end result should be the start of a financial plan that will address the client’s demands and needs in the most efficient and affordable way.

Part	Key information
Basic details	• Helps to ascertain tax liabilities, e.g. country of domicile and residence, relationship status, health etc.
Family details	• Financial dependants to whom benefits may be paid in the event of death or illness.
Employment details	• Level and security of income. The extent of cover provided by employer and the State to identify any shortfall.
Other professional advisers	• Depending on the proposed course of action, other professionals the client may wish to consult, e.g. a stockbroker about investments.
Income and expenditure	• Indicates ability to save regularly. Identification of a surplus or deficit is key.
Assets	• Used (e.g. house) and invested, investment requirements.
Liabilities	• Emphasis on any mortgage to ensure liabilities could be met if earnings stop. Net worth = Assets – Liabilities.
Life insurance	• Determines the ability to meet financial protection needs from existing sources.
Health insurance	• Determines the ability to meet financial protection needs from existing sources.
Regular savings	• Identifies the purpose of regular savings (if any) and whether regular savings need to be put in place to achieve future goals.
Pension details	• Assesses current provisions and highlights areas of shortfall.
Inheritances	• Identifies whether a valid will is in place, whether inheritances are anticipated and the need for IHT planning.
Attitude to risk	• The level of risk the client is prepared to take, capacity for loss and ESG concerns.

Activity

If you haven't already done so, review your firm's standard fact-find and if possible take a look at some completed examples.

Question 9.2

Under which part of the fact-find would you see details about a client's capacity for loss?

C Assessment and analysis

C1 Identification of demands and needs and possible solutions

Client's demands and needs

Most clients will have five key demands and needs that are broadly related to the key life stages:

- **Protection** – capital protection (i.e. a lump sum) to provide for dependants in the event of death or serious illness and to repay outstanding loans and commitments – especially important in the early stages of settling down and having a family.
- **Income protection** – income protection in the event of accident or ill health for the same reasons as protection and broadly relating to the same life stage.
- **Pensions** – covers all aspects of the provision for income or capital during retirement or when paid employment ceases.
- **Savings** – the production of capital by the regular investment of surplus income. This can relate to a range of life stages from the early days of financial independence through to long-term relationships and on to pre-retirement; savings can be for immediate access or long-term goals such as retirement.
- **Investment** – the investment of lump sums to protect from inflation and increase their value. It is usually only later in life that significant lump sums become available, e.g. from inheritance, windfall, the sale of a business or tax-free lump sums from a pension.

PIPSI

These demands and needs have been presented in priority order and the mnemonic 'PIPSI' can be used to remember them.

During the fact-finding process, the adviser will have taken notes to establish the strengths and weaknesses of the client's situation and identify any areas giving the client cause for concern. They may have asked:

- If the client is expecting to receive any inheritances.
- Whether there is a need to provide for known expenditure in the future.
- To what degree the client is satisfied with their current investments.
- The level of risk they are prepared to take to achieve their financial objectives.
- What prompted them to take out any life and sickness cover.
- What made them decide how much to contribute to their pension.

The answers to these questions will have provided further information and help the adviser make suggestions for restructuring aspects of the client's finances. For example, moving investments out of deposit accounts and into equity-based investments or making use of tax-free products, such as ISAs or certain NS&I products.

While some clients may think they know what their demands and needs are, the role of the financial adviser is to establish what they actually are in a methodical manner.

A process should be followed so that each need is:

- identified;
- discussed;
- quantified; and
- prioritised.

C1A Identification of potential demands and needs

The potential demands and needs will become apparent as part of the fact-finding process. The client may also have ideas of their own as to what these are but other factors such as income and expenditure, assets and liabilities and a commitment to dependants highlight most of the potential areas.

The adviser should take this a step further by quantifying potential needs through looking at possible income and capital shortfalls on death and by costing out the objectives and aspirations of the client, including those relating to pensions, based on a percentage of current earnings.

C1B Discussion of demands and needs

After identifying the client's potential demands and needs, the adviser should then discuss further to define those which are important to the extent that they may wish to take positive action. A series of questions can help in this respect, e.g.:

- Have they considered the financial impact of long-term illness, a birth or death in the family, or redundancy?
- How would they manage?
- What items of expenditure could they cut back on to reduce the shortfall in income?
- Will they be able to enjoy a reasonable standard of living in retirement?

This enables the client to either reject the perceived need or accept the fact that there is a potential weakness in their financial planning.

C1C Quantifying the demands and needs

Having identified the most important demands and needs to the client, the next stage is to quantify that weakness.

The best way to do this is to ask appropriate questions, e.g.:

- By how much will the client's income reduce if they are unable to work due to illness?
- How much lower will their income be when they retire?
- How much capital will they need in five years' time to buy a new car?

It is important to quantify the answers to these questions in terms of the actual income or capital required.

C1D Prioritising the demands and needs

At this stage in the process we have the following:

- A list of potential demands and needs that a client in their position may have. These may have been quantified by using generally accepted assumptions.
- A priority order that is generally recognised by the financial services industry as being appropriate for most clients.
- A refined list of demands and needs discussed at length with the client where they have identified what they consider to be important to them. This may be missing some of those demands and needs deemed important by the adviser.
- An analysis of the quantifiable aspects of the demands and needs the client feels are appropriate to their situation.

The challenge of prioritising
One of the most difficult tasks in financial services is to take the potentially conflicting information gathered and come up with a list in priority order of the demands and needs that should be met and any quantifiable aspects to them.

It is likely that considerable discussion will be required to achieve this. It is the responsibility of the adviser to ensure that all the potential demands and needs are considered together with the reasons why. If the client chooses not to acknowledge that there is a need or does not wish to take action to deal with it, this is acceptable but should be recorded as part of the advice process. This will protect the adviser if a client subsequently feels that a need should have been covered.

It is also highly unlikely that most people will have enough income or capital to pay for all the recommendations decided on, so it may be necessary for the adviser to ask the client to prioritise their demands and needs. At this stage reference can be made to the generally accepted priority order (PIPSI).

In the end, the client may prioritise their actions in any way they wish but the job of the adviser is to explain the recommended order. After this, if the client still wishes to follow their own priorities, then this should be fully documented for the adviser's protection.

C1E Documentation of demands and needs

It is important to work through the steps above in a planned and comprehensive manner. To aid the process it is highly recommended that the adviser uses a questionnaire to ensure that a structured picture of the client's personal and financial preferences is built up. The questions that make up this questionnaire can be in a separate document, but are often conveniently placed towards the end of the main fact-find and this makes considerable sense. It allows the 'hard' facts (names, dates, amounts) from the first part of the fact-find to be kept separate from the 'soft' facts (feelings, views and opinions) in the second part.

Question 9.3

Mr and Mrs Grey have a number of financial demands and needs but cannot afford to satisfy them all. They ask you to advise them. What should you do?

C1F Evaluating attitude to risk

Before assessing demands and needs and devising possible solutions there are several other soft facts which need to be examined. The most important of these is risk.

Investment risk is a complex subject and few people fully understand all the implications of risk and its effects. However, it is important that advisers use the fact-find to clarify the client's:

- understanding of investment risk;
- ability and willingness to make risk investments;
- understanding, knowledge and experience of investment types; and
- financial capacity for loss on any investments made.

It is necessary to assess a client's attitude to risk by the careful use of questions.

Detailed discussions

It is not enough to ask a client to rate their attitude to risk on a scale of one to ten. The subject must be explored in more detail.

Computer-based risk profiling tools ask the client a series of questions, the answers to which help assess the client's attitude to risk. They also provide a clear audit trail of the questions asked and responses given.

The client must be fully aware of the potential for financial loss, as well as gain, with any recommended investment. In all cases the client's views on risk should be recorded.

Capacity for loss refers to the customer's ability to absorb falls in the value of their investment. If any loss of capital has a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk they are able to take.

C2 Assessment of affordability and suitability

As part of the advice process it is paramount that any financial planning solutions that are put in place can be maintained for the required period. If this is not the case, the costs involved in setting up the plans, and possibly the contributions made up to the time where the client can no longer afford to continue, could be lost.

The key information regarding the affordability of the product and all aspects relating to its suitability must be recorded in writing and given to the client in the form of a **suitability report**.

C2A Affordability

Where the recommendation is for a regular premium policy, it is important to ensure that it is affordable on an ongoing basis. The income and expenditure part of the fact-find will provide this information. Where a full analysis of all income and outgoings has been done, it is usually possible to determine whether there is a healthy margin of surplus income. Where the income and expenditure part merely states a figure as income available for expenditure, it is important to double-check. It is worth explaining to the client (and recording their response) the importance of maintaining premiums.

Confirm

It is important to have confirmation that the client is both willing and able to maintain the premiums of a recommended product.

Where affordability of premiums is very tight but cover is essential, you should also discuss whether a form of waiver of premium option (if available) on the contract would be of benefit. However, waiver of premium usually only covers the cost in the event of being unable to work through illness or accident and most schemes have a six-month waiting period before cover starts. The option will usually be at additional cost to the plan.

C2B Suitability

It is important when recommending a product that all aspects of its suitability are discussed. This would include the following:

- **Tax**. The tax treatment of the plan should be appropriate for the tax status of the client.
- **State benefits**. The plan should complement a client's eligibility for State benefits and not lead to entitlements being lost (unless it is clearly to the client's advantage to forgo them).
- ***Client's demands and needs***. The product should fulfil an identified financial need.
- **Client's objectives**. The product should help the client to achieve one or more of their financial or personal objectives.
- ***Affordability***. The cost of the product should be affordable by the client.
- **Term of product**. The term of the product should be appropriate to meet the client's demands and needs and other financial objectives.
- **Investment risk**. Where there is an investment element to the product, the client's attitude to risk should be taken into account and reflected in the investment fund underlying the product; in addition, the product and the risks should be comprehensible based on their understanding, knowledge and experience.
- **Sustainable and responsible investing**. Where the client has a preference for sustainable and responsible investing, this should be taken into account in both the choice of provider and the underlying investment plan.
- **Risk warnings**. Another key element of suitability is that the risks involved with the planning aspects of the recommendation should be clearly explained to the client so they can ensure that they are acceptable.

It is possible that it will be necessary to compromise on one or more of these factors. There will always be a balance of priorities to be made and while the recommended course of action should still be appropriate, any areas where the plan is not suitable should be clearly discussed and the results of the discussions recorded.

Question 9.4

What should be done to ensure that a recommended course of action is affordable?

D Conclusions and recommendations

Having considered the individual aspects of the client's financial situation, the adviser must finally organise the recommendations into a complete recommendation for the client's consideration. As with fact-finding, good practice in making product recommendations requires a combination of **efficient procedures** and high **ethical standards**. Advisers must always be prepared to adapt the style and content of their presentation/report in order to be more easily understood by clients with different capacities and needs, for example, a client whose first language is not English. This recommendation can be in any form. However, there are fixed rules about what the report must cover.

The FCA is concerned about due diligence as previous thematic work and instances of consumer harm have shown that the poor quality of an advisory firm's research and due diligence is one of the three root causes for poor consumer outcomes.

Research and due diligence refers to the process carried out by the firm to assess:

- the nature of the investment;
- its risks and benefits; and
- the provider (to establish whether they believe it appropriate to entrust the provider with client assets).

The firm needs to understand these factors to judge whether the solution is suitable.

What constitutes a reasonable level of research and due diligence will differ depending on the adviser's recommendation and the needs of the client. Although the objective of research and due diligence is the same across different investments, services and providers, there will be differences in the time and effort taken to achieve it. For example, it will usually take less time to assess a product from a familiar provider investing in familiar assets. Correspondingly it will usually take longer to assess a product from a provider with which the firm is not familiar or which invests in assets the firm has not researched before.

When firms carry out research and due diligence they should consider whether they can rely on the information supplied by the provider, such as marketing material. Firms can rely on factual information provided by other regulated firms as part of their research and due diligence process, for example, the asset allocation. However, they should not rely on the provider's opinion, for example, on the investment's risk level.

If providing independent financial advice, you must also:

- make an adequate comparison of product providers across the market to be able to select the most appropriate one; and
- retain sufficient evidence of the research carried out to support your recommendation and explain to your client why a particular provider, fund or portfolio of funds was selected.

D1 Oral presentation

The oral explanation will probably be longer than the written content of these documents and will explain the advantages and disadvantages of each of the adviser's recommendations. Presentation skills are critical in securing acceptance of recommendations and presentations should be a **two-way communication** in which the client is fully involved by the adviser.

Consider this…

Why do you think open-ended questions (how?/why?/what?) such as: 'What do you think about that, Mr X?' or 'How do you feel about the proposals, Mrs Y?'; alongside straightforward checking questions: 'Are you happy about that part of the proposals, Mr Z?' are important?

These are very important to allow the client to express their own thoughts, views and opinions. Closed questions (when?/where?/who?) are used to gain specific information and facts. Both **open** questions and **closed** questions have a place in the overall process and if carefully used can quickly establish all the information required.

D2 Written report

In general, clients find it easier to read a technical report if the adviser follows certain **guidelines** – in particular:

- The language should be as simple as possible **without the use of jargon** for its own sake. Where technical terms cannot be avoided, they should be clearly explained.
- Sentences and paragraphs should be reasonably **short**, so that they can be read quickly and with the minimum of effort.
- Headings and sub-headings should be used to break reports up into **logical sections** enabling both the adviser and client to find their way around the report quickly and easily.
- While there is a temptation in a written report to highlight all the positive aspects of the advice given or of a particular product, it is very important that a **balanced view** is presented.

Clarity
Both the advantages **and the disadvantages of a recommendation** should be clearly displayed.

The key written document when giving advice is the **suitability report**. It is an FCA requirement and, importantly, forms an excellent written record of the recommendation for both adviser and client to refer to.

The following general format for the report is recommended:

1. The report should start by stating the names of the client(s) and the particular aspects of their financial situation which have been noted by the adviser. For example:
   - the current balance between income and expenditure;
   - the likelihood of receiving substantial lump sums, e.g. bonuses and commissions at irregular intervals;
   - the investment balance of the existing portfolio (noting the risk profile of the clients);
   - their longer-term financial aims; and
   - other important details (such as plans for starting a family, for example).

   However, a full reproduction of the fact-find should be avoided. The adviser should attempt to concentrate on the demands and needs priorities which have guided their final recommendation.

   The purpose of this section is to allow the client to correct any of the adviser's misconceptions which would, of course, then affect the basis of the adviser's recommendation.
2. Following a statement of these considerations, the report should then **specify the demands and needs** which are not currently being met by the client's resources and existing arrangements.

   This section of the report, when discussed with the client, will allow an adviser to confirm that the client appreciates the nature and the extent of their demands and needs. Without this part of the report, the adviser could fall into the very common trap of making recommendations to answer demands and needs of which the client is not fully aware. They are unlikely to 'buy' into the answer to a problem that they do not know exists!
3. In the next section, a note should be included of any need which has been identified but not resolved by the recommendation with the reason for this omission. This might be because of:
   - the absence of any appropriate method of answering the need (for example, redundancy protection to cover a client's total income);
   - because the adviser's firm is not able or authorised to provide a solution; or
   - perhaps because the client is unable or unwilling to pay for its implementation.

4. The next section makes formal recommendations, briefly detailing the way in which each of these recommendations will answer one or more of the client's demands and needs listed in the last section.

   The **cost of implementing** each of the recommendations must be specified, as must any **commission**, **fees** or **equivalent costs** for each contract. The effect of charges on the cash benefits of each product over a series of years must be included (but this is usually covered in the illustration).

   The report on the benefit structure should also show the **tax treatment of contributions and benefits**, such as the tax relief available on pension contributions, or the further tax liability (if any) for taxpayers on investments.
5. The fifth section should give clear reasons as to why the investment/insurance company that was recommended was chosen. This should relate to its **history**, **financial strength**, **product range** and the **quality of the service** it offers. This section is particularly important if the new policy is a replacement for a previous one and a full explanation of the **commercial considerations** combined with the reasons why the new plan is more appropriate than the former one should be included.
6. The sixth section should examine any risks that there may be in following the recommendation. Where there is an underlying investment, the **client's risk profile** and the process used to determine the asset allocation and funds chosen should be clearly stated. It is usual practice now to comment on the risk profile of each fund chosen.

   It is common to then group all the **risk warnings** together in a paragraph before the final summary.
7. The final section should summarise the whole recommendation, briefly setting out the details contained in the previous sections, and ending with any final comments relating to the overall effect of implementing the total recommendation. It might also specify or suggest the next action to be taken to implement the recommendation (for example, the date and time of the next discussion between the adviser and client).

D3 Summary

In summary, the report should give all relevant details of the recommendation, consistent with striking a balance between the desirability of comprehensive information and client-friendly brevity.

This report will contain the basis of the adviser's recommendations and be a **reference document** on the focal points of the discussion between themselves and their client.

Professionalism demands that all explanations and all answers to questions should be accurate and honest. **Any risks to be borne by the client should not be minimised**. Any commercial considerations or additional costs to the client should be clearly identified, explained and justified.

The client's choice
Finally, clients should not be put under any pressure to accept proposals about which they are unconvinced or which they cannot afford.

Question 9.5
What are the main guidelines that should be followed with written communications to the client?

Key points

The main ideas covered by this chapter can be summarised as follows:

Communicating

- Communications with clients must equip them to make effective, timely and properly informed decisions about financial products and services.
- Whether giving advice on mortgages, insurance or investments, most FCA regulated firms have to give clients information about their services and all firms have to give clients information about their costs.

Gathering information

- The purpose of fact-finding is to gather the relevant information to allow a financial adviser to determine a client's demands, needs and objectives. The key parts are:
  – Basic details.
  – Family.
  – Employment.
  – Other professional advisers.
  – Income and expenditure.
  – Assets.
  – Liabilities.
  – Life insurance.
  – Health insurance.
  – Regular savings.
  – Pension details.
  – Inheritances.
  – Attitude to risk.
- The fact-find should be fully completed and if a client is not prepared to give information a comment should be recorded on the fact-find.

Assessment and analysis

- There are five key needs that a client will have:
  – Protection.
  – Income protection.
  – Pensions.
  – Savings.
  – Investment.
- The mnemonic PIPSI can be used to remember them.
- As part of the process, demands and needs must be:
  – identified;
  – discussed;
  – quantified; and
  – prioritised.
- It is important when recommending a product that all aspects of its suitability are discussed including:
  – tax;
  – State benefits;
  – client’s demands and needs;
  – client’s objectives;
  – affordability;
  – term of product;

Key points

- – investment risk;
- – sustainable and responsible investing; and
- – risk warnings.

Conclusions and recommendations

- Having considered the individual aspects of the client's financial situation, the adviser must finally organise the recommendations into a complete recommendation for the client's consideration.
- Research and due diligence refers to the process carried out by the firm to assess:
  - the nature of the investment;
  - its risks and benefits; and
  - the provider.
- This recommendation can be in any form. However, there are fixed rules about what the report must cover.

Question answers

9.1 A firm should give consumers, at the right time and in an understandable way, all the information they need so that they can make a decision on:

- the options available to them;
- the costs, risks and benefits of those options; and
- which would meet their needs and offer fair value.

9.2 Attitude to risk.

9.3 You should prioritise their demands and needs in consultation with them and recommend products to satisfy those demands and needs in order of priority.

9.4 Refer back to the income and expenditure part of the fact-find to ensure any surplus income will continue to be available to fund the recommended action.

9.5 The report should use simple language and avoid the use of jargon. Any complex terms should be explained. Sentences and paragraphs should be short so they are easy to read. Headings and sub-headings should be used to enable the client to find their way easily around the report. All comments should balance both the positive and negative aspects of the advice given and products recommended.

10

The FCA's use of principles and outcomes-based regulation

Contents	Syllabus learning outcomes
Introduction	
A FCA Principles for Businesses (PRIN)	*9.1*
B Corporate culture and leadership	*9.2*
C Main regulatory obligations for individuals	*9.3*
Key points	
Question answers	

Learning objectives

After studying this chapter, you should be able to:

- outline the role of the FCA's Principles for Businesses and how they affect regulated firms;
- identify types of corporate culture and leadership;
- examine how different corporate cultures influence behaviour; and
- describe the demands placed on individuals in firms, both in terms of regulatory obligations and their responsibilities regarding conflicts of interest.

Introduction

In this chapter we will consider the FCA's use of principles and outcomes-based regulation to **promote ethical and fair outcomes**. We will look first at the FCA Principles for Businesses and the obligations these place on firms. Next we will consider the corporate culture and leadership aspects of the way firms are organised. Lastly, we will run through the responsibilities that rest with approved persons and the need for integrity, competence and fair outcomes for clients, including dealing with conflicts of interests.

Key terms

This chapter features explanations of the following terms and concepts:

Code of Conduct (COCON)	Code of Practice for Approved Persons	Competence and capability	Conflicts of interests
Financial soundness	Honesty, integrity and reputation	Intensive supervision	Outcomes-based regulation (OBR)
Principles for Businesses (PRIN)	Principles-based regulation (PBR)	Statements of Principle for Approved Persons	

A FCA Principles for Businesses (PRIN)

The FCA ***Principles for Businesses (PRIN)*** are twelve general statements of the fundamental obligations of all authorised firms. These principles are also mirrored in the PRA Rulebook's 'Fundamental Rules', with numbers 1 to 4, 8 and 11 being most relevant to its area of responsibility. All authorised firms must comply with the principles at all times. In the event of any conflict between FCA rules and principles, the FCA principles will take precedence. The principles are high-level standards that will apply even if there are no rules or procedures for a particular situation.

For reference only

Principles for Businesses (PRIN)

Principle	Detail
1. Integrity	A firm must conduct its business with integrity.
2. Skill, care and diligence	A firm must conduct its business with due skill, care and diligence.
3. Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial prudence	A firm must maintain adequate financial resources.
5. Market conduct	A firm must observe proper standards of market conduct.
6. Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients	A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers: relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with regulators	A firm must deal with its regulators in an open and cooperative way and must provide appropriate disclosure to the FCA in respect of anything relating to the firm of which the regulator would reasonably expect notice.
12. Consumer Duty	A firm must act to deliver good outcomes for retail customers.

Note: The PRA applies Principles 1 to 4, 8 and 11 only.

Be aware

The FCA has introduced a new principle 12 as part of the Consumer Duty. This is effective from 31 July 2023 and applies to all relationships with *retail* clients.

Principle 12 sets higher standards than principles 6 and 7.

Principles 6 and 7 do not apply where principle 12 applies (PRIN 2A1.3).

If the firm becomes aware, or suspicious, of any material breaches, or breaches of PRIN by an individual or the firm as a whole, the ***compliance officer*** (SMF16) is bound to inform the FCA and implement remedial action to prevent any similar breaches.

The principles provide tangible standards to achieve compliance with **Threshold Condition 5** (Suitability), although the principles do not exhaust the requirements of Threshold Condition 5.

While compliance with the principles is not guaranteed to demonstrate compliance with Threshold Condition 5, non-compliance with the principles will tend to show non-compliance with the Threshold Condition and call into question whether the firm remains fit and proper.

The need to comply

A breach of the principles is likely to result in disciplinary action by the FCA against the firm.

Ethics are often expressed and applied as principles. The FCA's Principles for Businesses, Principles for Approved Persons and conduct rules are founded on ethics.

Refer to

Ethics and professional standards on page 11/1 covers ethics and *Fair treatment of customers* on page 8/6, gives more detail on the fair treatment of customers

For example, FCA Principles for Businesses set the tone with principle 1: 'A firm must conduct its business with integrity.' Other key Principles refer to 'due skill, care and diligence' (principle 2); 'treat them [customers] fairly' (principle 6); 'clear, fair and not misleading' (principle 7); 'manage conflicts of interest fairly' (principle 8); and 'act to deliver good outcomes for retail customers' (principle 12).

A1 Principles-based regulation (PBR)

The FCA's approach is underpinned by the belief that it is neither possible nor desirable to write a rule to cover every situation a regulated firm might encounter. Instead, the FCA focuses on the principles in the FSMA. These set out in general terms the types of behaviour it expects of firms and individuals (for example, 'A firm must conduct its business with due skill, care and diligence').

Many in the financial services industry, particularly at senior level, support this approach. However, the FCA's experience is that many of those operating in compliance or legal departments within regulated firms have yet to become comfortable with it, and consistently seek detailed guidance on how to interpret the principles in specific situations. The FCA expects that the understanding of how to operate in a more flexible, principles-based regime will evolve over time. In practice there are few (if any) firms to which the entire rulebook applies, but the FCA believes there is scope to reduce it and is looking at ways of achieving this. Failure to apply the principles prescribed can alone be reason enough for the FCA to take enforcement action against firms.

A2 Outcomes-based regulation (OBR)

Following the financial crisis, the then FSA back-tracked on PBR and developed a further regulatory approach known as **intensive supervision**.

That new approach was designed to deliver 'outcomes-based' regulation (OBR). The essence of OBR was about the regulator making judgments on what might happen in the future, rather than acting solely on observable facts.

Underpinning the approach was the belief that the most effective way to make judgments about the risks that firms and consumers will face in the future is through the **integrated assessment of risk**. This integrated approach to analysing risk at an individual firm level, with supervisors being supported by sector analysis and high-quality technical advice from specialists in prudential and conduct risk, has been demonstrated by the events of the financial crisis as the most effective way to carry out firm supervision. The concept of having supervisors who are seen to specialise in either prudential or conduct of business supervision was outdated.

The FCA's OBR approach can be seen in its development of the Consumer Duty.

Risk analysis

The supervisor's role should be to act on a firm-specific basis as an integrator of risk information, and as the focal point for the analysis of risk posed by the firm's business model.

This type of analysis needs to assess both prudential and conduct information.

For example:

In assessing the prudential risks in the UK mortgage market, the regulator needs to identify both the funding risk and the risk caused by the product and sales practices. While in many cases (such as with Payment Protection Insurance) the way to identify mis-selling practices before they are widespread is through business model analysis, the inspection-based approach, by definition, only detects mis-selling after it has occurred.

This integrated supervisory approach underpins Intensive Supervision and the **Supervisory Enhancement Programme (SEP)**.

B Corporate culture and leadership

B1 Corporate culture

The FCA believes these drivers are likely to have a significant influence on management and staff behaviour, and therefore on consumer outcomes:

Key cultural drivers	Positive indicators
Leadership Senior management must give middle management enough direction and ensure they monitor them.	Fair treatment of customers is central to the behaviour and values of all managers; they communicate messages about the fair treatment of customers effectively, and apply appropriate controls and monitoring to ensure that the fair treatment of customers is delivered by their staff.
Strategy Senior management must still allocate enough time and resources to deliver, even when they may be focused on other business priorities.	The firm has a clear vision which supports the fair treatment of customers. This is reflected within the formulation and implementation of strategic decisions (including change management programmes and outsource arrangements). The firm's risk appetite reflects customer considerations.
Decision making and challenge Policies or procedures must receive enough challenge; a formal process needs to be in place and the environment must be conducive to challenge by staff or customers.	Decision making at all levels reflects the fair treatment of customers. The firm uses staff, customer and other external feedback where appropriate, with timely action. The interests of customers are properly balanced against those of shareholders (and other customer groups).
Controls Firms must identify, collect, interpret and use relevant management information (MI) to monitor effectively and to demonstrate that they are treating their customers fairly.	The firm has controls, including MI, that aim to ensure and demonstrate the fair treatment of customers. These controls are integral to the firm's risk framework.

Key cultural drivers	Positive indicators
Recruitment, training and competence Performance management plans must include objectives for the individual's role and set out the behaviours and actions expected in order to reflect the strategy of the firm.	Management make positive behaviours and attitudes to the fair treatment of customers a key criterion in the selection of staff. They also make effective training and the maintenance of staff knowledge, behaviours and values core to the business. Managers use performance management to develop their staff in the fair treatment of customers, identifying and acting on poor performance and rewarding good performance.
Reward Management incentive schemes must not place heavy emphasis on targets associated with driving profit, increasing income, cutting costs or growing the business. The fair treatment of customers must be given significant weight compared to other targets.	The firm's reward framework (including incentive schemes) throughout the business is transparent, recognises quality and supports the fair treatment of customers.

B2 Leadership

Leadership at all levels sets the tone of an organisation (the 'tone from the top'), driving the behaviour of staff and the quality of decisions. Strategy sets the direction and priorities of the business and the focus for management. Controls, including **management information (MI)**, are essential to satisfy managers (including senior managers) that the firm is delivering fair outcomes for consumers. An organisation's approach to performance management and reward drives the behaviour of staff and enables management to assess the quality of the performance of an individual.

It is generally agreed that the 'tone at the top' (the values and behaviour of the board and senior management) plays a major part in setting and reinforcing the ethics of any business. This behaviour, '**walking the talk**', can be as significant as structural and organisational factors (such as targets and information management) in shaping the ethos of a firm.

On the Web

www.fca.org.uk/news/speeches/getting-culture-and-conduct-right-role-regulator.

In the original guidance on Treating Customers Fairly (TCF), now known as the **fair treatment of customers** (FTC), leadership was cited as a key variable and examples of good and poor practice given:

Fair treatment of customers – Good practice	
Demonstrating a commitment to FTC	In a number of firms, the CEO or senior management demonstrated their commitment to FTC by providing clear messages in presentations, including: • video broadcasts for staff in remote locations; • appearing in internal website downloads; and • posters and booklets. These communications explained what FTC meant for the firm, the challenges they faced, and provided regular feedback on their progress.
Implementing strong FTC leadership	In one firm, the CEO had established two clear FTC-related objectives for all staff. The strategy, policies and procedures were driven by these objectives and supported by clear direction from senior management. This created the right conditions for a good FTC culture to evolve.
Maintaining high FTC standards	One firm discovered that an ex-adviser had tampered with client records and spent considerable time and money pursuing the matter through the courts in order to make it clear to all staff that behaviour that acted against clients' interests would not be tolerated.
Listening to and acting on staff feedback	Two firms made it possible for staff to give anonymous feedback to senior management if they believed that FTC policies were insufficient or not being followed.

Fair treatment of customers – Poor practice	
Failing to identify the meaning of FTC	The senior management of some firms had failed to identify or articulate what FTC meant for specific areas of the business or the business as a whole. There was a lack of communication on this matter between those in senior and middle management.
Inappropriately delegating FTC	In some firms, senior management established FTC visions and values but delegated their implementation to middle management without adequate direction or monitoring. In the absence of this guidance there was a lack of coherent strategy filtering down to staff and therefore a risk of unfair consumer outcomes.
Ineffective communication	One firm had a large call centre in a satellite office, separate from the head office location of senior management. Head office staff received key messages on FTC directly from senior management, but the call centre staff were given these messages by junior staff members following a training session. Inconsistent delivery can lead to miscommunication of key messages.
Producing outcomes inconsistent with the strategy	In some firms, middle management have established processes/procedures which are inconsistent with the firm's FTC strategy. One firm had a customer charter, including statements of how the firm would put their FTC values into practice, but this was not delivered by staff in customer-facing positions.
Failing to identify and deal with FTC risks	In one firm, the CEO and COO were concerned with the capabilities of a number of the firm's advisers; the Compliance Director also received a report highlighting potentially serious risks with the advice given to customers. The Sales Director, however, did not consider there to be any problems with his staff. There was no indication that senior management knew how to deal with these differing opinions on the quality of staff.

Consider this…
How is the 'tone from the top' at your firm? How could it be improved?

Be aware
While FTC still applies, where retail customers are concerned the more stringent requirements of the Consumer Duty came into effect on 31 July 2023.

B3 Corporate governance

It is increasingly useful to see **governance, risk management and compliance (GRC)** as a part of a whole system of corporate governance. This operates to communicate the company's values, collect relevant information, and connect risk to compliance and ethical issues on a principles-based approach.

Question 10.1

Can you name three of the six cultural drivers that are likely to influence management and staff behaviour?

C Main regulatory obligations for individuals

As we have seen, ethics are often expressed and applied as principles. Much like the Principles for Businesses (PRIN), the FCA's ***Code of Conduct (COCON)*** and **Statements of Principle and Code of Practice for Approved Persons (APER)** are founded on ethics. Think of the principles as indicators of good conduct and best practice.

C1 Code of Conduct (COCON)

The FCA's new, high-level standards of behaviour apply to almost all employees who are customer facing or who have oversight responsibilities for staff in financial services firms. Some conduct rules apply to all employees, while others only apply to senior managers.

The conduct rules are intended to drive up standards of individual behaviour in financial services. They represent a meaningful change in the standards of conduct the FCA expects from those working in the industry. By applying the conduct rules to a broad range of staff, the FCA aims to improve individual accountability and awareness of conduct issues across firms.

FSMA requires firms to train their staff so that they know how the conduct rules apply to them. Firms must also notify the FCA when they have taken formal disciplinary action against a person for breaching a conduct rule.

The following table shows FCA **COCON 2.1 Individual conduct rules** and examples of practices that do **not** comply with the rules.

Rule 1	You must act with integrity.	**Examples of poor practice** • Misleading or attempting to mislead a customer, the FCA/PRA, the firm for whom the person works. • Falsifying documents. • Mismarking the value of investments. • Misleading others about the credit-worthiness of a borrower. • Providing false or inaccurate information. • Destroying or attempting to destroy documents relevant to misleading a client, the FCA or PRA. • Recommending an investment where the person knows that they are unable to justify its suitability for the customer. • Preparing inaccurate records or returns. • Misusing the assets of a client. • Not paying due regard to the interests of a customer.
Rule 2	You must act with due skill, care and diligence.	**Poor practice – all staff** • Failing to inform a customer, their firm (or its auditors) of material information where the individual was aware or ought have been aware. • Failing to explain the risks of an investment to a customer. • Failing to disclose to a customer charges or surrender penalties of an investment product. • Recommending or providing advice on a transaction without an understanding of the risk of the transaction. • Failing to secure a client's assets. • Continuing to perform a function despite having failed to meet the standards of knowledge and skill required. **Poor practice – managers** • Failing to take reasonable steps to ensure the business for which the manager is responsible is controlled effectively. • Failing to take reasonable steps to adequately inform themselves of the affairs of the business for which they are responsible. • Failing to maintain an appropriate understanding about an area of business delegated to an individual.
Rule 3	You must be open and cooperative with the FCA, the PRA and other regulators.	• Failing without good reason to inform the regulator of information they are aware of in response to questions from the regulator. • Failing to attend an interview or answer questions from the regulator. • Failing to supply the regulator with documents or information when asked or required to do so.
Rule 4	You must pay due regard to the interests of customers and treat them fairly.	• Failing to explain the risk of an investment to a customer. • Failing to disclose to a customer charges and surrender penalties of an investment product. • Providing inaccurate information to customers. • Recommending a investment without grounds for considering it to be suitable. • Providing the customer with a product which is different from that which they have applied for, where the customer doesn't understand the difference. • Failing to acknowledge or seek to resolve mistakes when dealing with customers. • Failing to provide clear terms and conditions for a product or service.

Rule 5	You must observe proper standards of market conduct.	• Manipulating or attempting to manipulate a benchmark or market.
Rule 6 (from 31 July 2023)	You must act to deliver good outcomes for *retail customers*.	• Failing to act in a way that delivers good outcomes for retail customers, such as offering services which are poor value for money or which customers buy but cannot make use of.

This table shows FCA **COCON 2.2 Senior manager conduct rules** and examples of **good** practice.

Rule SC1	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.	**Examples of good practice:** • Setting appropriate risk controls for the type of business being conducted. • Fully assessing the impact of a change in strategy in a high risk business area. • Reviewing the areas for which the senior manager is responsible. • Setting appropriate job descriptions and ensuring staff have them. • Ensuring that business areas have appropriate policies and procedures. • Ensuring that vacancies are appropriately covered. • Ensuring there is an orderly transition if handing over to another senior manager.
Rule SC2	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.	• Ensuring all staff are aware of the need for compliance. • Taking steps to ensure that the business area has operating procedures and systems with well defined steps for complying with requirements. • Taking reasonable steps to ensure that any breaches are dealt with in a timely and appropriate manner. • Reasonable recommendations made by external review are implemented in a timely manner.
Rule SC3	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.	• Only delegating where there are reasonable grounds for believing that the delegate has the competence, knowledge, time and skill to manage the issue. • Taking steps to ensure that delegation is appropriately documented and reporting lines are clear.
Rule SC4	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.	• Reporting to the FCA (or PRA) all information which they would reasonably require, or which has been specifically requested, in good time.

There is further specific guidance on what constitutes proposed compliance with these rules in COCON 4.

Activity

Can you think of any other examples of good or poor behaviour? Which conduct rules would these relate to?

C2 Statements of Principle for Approved Persons

Although most firms will now be included in the SM&CR to which the Code of Conduct (COCON) applies, the Statements of Principle and Code of Practice for Approved Persons (APER) still apply to FCA Approved Persons of firms which are not SM&CR firms or are appointed representatives. Approved Persons are those individuals carrying out controlled functions and therefore subject to individual registration.

The Statements of Principle for Approved Persons applies only to the extent that a person is performing a controlled function for which approval has been sought and granted. All approved persons are subject to principles 1–4, while only those carrying out '**accountable higher management functions**' are subject to the additional principles 5–7.

Be aware
An **accountable higher management function** is an FCA controlled function that is a significant-influence function.

The FCA **Statements of Principle for Approved Persons** are as follows:

Principle	Detail
1. Integrity	An approved person must act with integrity in carrying out his accountable functions.
2. Skill, care and diligence	An approved person must act with due skill, care and diligence in carrying out his accountable functions.
3. Market conduct	An approved person must observe proper standards of market conduct in carrying out his accountable functions.
4. Open and cooperative	An approved person must deal with the FCA, the PRA and other regulators in an open and cooperative way and must disclose appropriately any information of which the FCA or the PRA would reasonably expect notice.
5. Organisation and control	An approved person performing an accountable higher management function must take reasonable steps to ensure that the business of the firm for which they are responsible in their accountable function is organised so that it can be controlled effectively.
6. Skill, care and diligence in managing	An approved person performing an accountable higher management function must exercise due skill, care and diligence in managing the business of the firm for which they are responsible in their accountable function.
7. Compliance	An approved person performing an accountable higher management function must take reasonable steps to ensure that the business of the firm for which they are responsible in their accountable function complies with the relevant requirements and standards of the regulatory system.

Source: *www.handbook.fca.org.uk/handbook/APER/2/1A.html*

C3 Code of Practice for Approved Persons

The ***Code of Practice for Approved Persons*** is issued for the purpose of helping to determine whether or not an approved person's conduct complies with a principle. The Code sets out descriptions of conduct which, in the FCA's opinion, do **not** comply with the relevant Statements of Principle.

Be aware
Deliberate conduct of the types described in the following table would **not** comply with each relevant Statement of Principle. Many of those are similar to the COCON rules we have already seen.

Principle 1: Integrity	Misleading (or attempting to mislead) by act or omission.
Principle 2: Skill, care and diligence	Failing to pay due regard to the interests of a customer, without good reason.
Principle 3: Market conduct	Failure to comply with the **Market Abuse Regulation 2016** or relevant market codes and exchange rules.

For reference only

Principle 4: Open and cooperative	Failing without good reason to: • inform a regulator of information of which the approved person was aware in response to questions from that regulator; • attend an interview or answer questions put by a regulator, despite a request or demand having been made; or • supply a regulator with appropriate documents or information when requested or required to do so and within the time limits attaching to that request or requirement.
Principle 5: Organisation and control	Failing to take reasonable steps to apportion responsibilities for all areas of the business under the approved person's control.
Principle 6: Skill, care and diligence in managing	Failure of the approved person to take reasonable steps to adequately inform themselves about the affairs of the business for which they are responsible.
Principle 7: Compliance	Failing to take reasonable steps to implement (either personally or through a compliance department or other departments) adequate and appropriate systems of control to comply with the relevant requirements and standards of the regulatory system in respect of its regulated activities.

The Code also sets out certain general factors which are to be taken into account in determining whether an approved person's conduct complies with a particular principle.

- In determining whether or not the particular conduct of an approved person within their controlled function complies with the Statements of Principle, the following are factors which, in the opinion of the FCA, are to be taken into account:
  – whether that conduct relates to activities that are subject to other provisions of the Handbook; and
  – whether that conduct is consistent with the requirements and standards of the regulatory system relevant to their firm.
- In determining whether or not the conduct of an approved person performing an accountable higher management function complies with Statements of Principle 5 to 7, the following are factors which, in the opinion of the FCA, are to be taken into account:
  – whether the approved person exercised reasonable care when considering the information available to them;
  – whether the approved person reached a reasonable conclusion that they acted on;
  – the nature, scale and complexity of the firm's business;
  – the role and responsibility of an approved person performing an accountable higher management function; and
  – the knowledge the approved person had, or should have had, of regulatory concerns, if any, arising in the business under their control.

C4 The Fit and Proper test for employees and senior personnel (FIT)

An individual in a senior management or certified position under SM&CR or an approved person under the Approved Persons Regime must be (and remain) fit and proper for their function under the following criteria:

- **Honesty, integrity and reputation**
  The FCA bases its judgment on individuals' records on a number of areas, including criminal, civil or disciplinary proceedings, their employment record and past dealings with regulators.
- ***Competence and capability***
  Individuals have to show that they have met the FCA's requirements for training and competence, and can perform their senior management or certified function. They must also demonstrate that they are suitable for the role by their experience and training.
- **Financial soundness**
  The individual should be financially sound in terms of both their current status and their past record.

These tests for senior managers are conducted by the FCA which determines whether an SMF is 'fit and proper' for a role. For a certificated role, it is the firm that conducts the checks.

For senior managers, a firm must maintain a **clear, appropriate and recorded** apportionment of significant responsibilities. There must also be appropriate systems and controls and an effective compliance system under a director or senior manager.

Individuals must keep their regulatory responsibilities clearly in mind at all times. If they neglect or deliberately ignore these responsibilities the FCA may take disciplinary action against them. This could result in **financial penalties**, the loss of their job, and perhaps curtail any prospect of future employment in the financial services industry.

If a firm believes that a person is no longer fit and proper it must take the appropriate action and inform the FCA immediately. For example, if it was found that an adviser had misappropriated a client's money, then the firm would be expected to dismiss the adviser and inform the FCA.

Question 10.2

What are the criteria used to assess whether an approved individual is fit and proper?

C5 Conflicts of interest

Senior management should be fully engaged in all aspects of conflict identification and management, and take a broad view of the risks posed to their business. This means that responsibility for conflict identification and management is allocated clearly to accountable individuals, and that controls to mitigate conflicts are reviewed on a regular basis. Relevant management information should be available to support this process.

Firms often perceive conflicts of interest in too narrow a manner, or to be solely about remuneration. Senior management are responsible for ensuring that the broad spread of **conflict risk** to which their firm is exposed is addressed, including latent and emerging conflicts. They should also make informed judgments about the materiality of the conflict risk. This should take place within a business culture that supports the management and mitigation of conflicts of interest. A formal conflicts policy should be put in place or, where already in place, reviewed, with firms clearly setting out how they propose to prevent conflicts and mitigate those identified.

Activity

Locate and review your firm's conflicts policy. How robust is it? Could it be improved?

While avoiding conflicts is linked with observation of the duties of agency, intermediaries should also ensure that they consider the wider issue of dealing with clients in a manner that is fair. The FCA expects firms to take a critical view of how conflicts may affect the fair treatment of clients and to respond accordingly, consistent with the fair treatment of customers initiative. Clear guidance should be in place for staff on how to recognise a potential issue and when to escalate matters to senior management.

Conflicts of interest mitigation

Some conflicts policies start with an attempt to define what constitutes a conflict. Firms should consider whether a definition may be either too narrow (for example, tied to remuneration issues), or too general, in that it is a conflict where the interests of the intermediary differ from the interests of the client. An alternative approach is to start with a general definition of a conflict of interest followed by an analysis of how this may apply in common business situations.

Some procedures attempt to tie all documents relating to personal and corporate conflicts into one overarching framework. Other approaches have an array of different conflict-related documents (i.e. principles for dealing with clients, senior management conflicts policies or staff ethics guides) which are not always consistent with one another. An alternative approach to handling conflicts is to start with a high-level conflicts framework, with subsequent consistent sub-manuals relevant to the appropriate business area.

While all staff in an intermediary should be aware of conflicts and should be responsible for conflicts arising out of their own conduct, the overall conflicts policy should be owned by a member of the board or senior management, with regular reporting, backed by strong management information, highlighting exceptions. In many cases, firms do not have a director responsible for the conflicts policy, and reports to the board or senior management are either sporadic or on a case-by-case basis.

Smaller intermediaries may not have an internal audit (IA) function. Where an IA function is not present, a strong culture of consistent internal acceptance-checking of files by an individual not involved in the placement of the business is one method of ensuring that risks arising out of conflicts have not crystallised. The approach of some small firms to handling conflict identification is through regular file reviews with senior staff showing a serious approach to making sure exceptions are monitored, followed up, and managed effectively.

Key points

The main ideas covered by this chapter can be summarised as follows:

FCA Principles for Businesses (PRIN)

- The Principles for Businesses (PRIN) are as follows:
  1. Integrity.
  2. Skill, care and diligence.
  3. Management control.
  4. Financial prudence.
  5. Market conduct.
  6. Customers' interests.
  7. Communications with clients.
  8. Conflicts of interest.
  9. Customers.
  10. Clients' assets.
  11. Relations with regulators.
  12. A firm must act to deliver good outcomes for retail customers.
- The FCA's approach is underpinned by the belief that it is neither possible nor desirable to write a rule to cover every specific situation or need for decision that a regulated firm might encounter.
- Instead, the FCA focuses on the principles set out in the FSMA.
- Failure to apply the principles prescribed can alone be reason enough for the FCA to take enforcement action against firms.
- Following the financial crisis, the then FSA had back-tracked somewhat on principles-based regulation (PBR) and developed a further regulatory approach known as Intensive Supervision.
- The new approach was designed to deliver outcomes-based regulation (OBR).
- The essence of OBR was about the regulator making judgments on what might happen in the future, rather than acting solely on observable facts.

Corporate culture and leadership

- The key cultural drivers are: leadership; strategy; decision making and challenge; controls; recruitment and training and competence; and reward.
- Leadership at all levels sets the tone of an organisation, driving the behaviour of staff and the quality of decisions.
- In the FCA's guidance on the fair treatment of customers, leadership is cited as a key variable.

Main regulatory obligations for individuals

- The FCA conduct rules for individuals include:
  - acting with integrity;
  - acting with skill, care and diligence;
  - being open and cooperating with the FCA and other regulators;
  - treating customers fairly and according to their interests; and
  - observing proper standards of market conduct.
- The FCA conduct rules for senior managers include:
  - ensuring the business they are responsible for is controlled effectively;
  - ensuring the business complies with requirements and regulatory standards;
  - ensuring that delegation of responsibility is to an appropriate person and overseen; and

For reference only

Key points

- – disclosing appropriately any information about which the FCA or PRA would expect notice.
- The FCA COCON rules apply to most employees in SM&CR firms. The Code of Practice for Approved Persons applies to certain roles in non-SM&CR firms, such as appointed representatives, and is issued for the purpose of helping to determine whether or not an approved person's conduct complies with a Statement of Principle.
- Relevant employees (such as those in certified roles) and senior managers must be fit and proper for their function under the following criteria:
  - honesty, integrity and reputation;
  - competence and capability; and
  - financial soundness.
- A formal conflicts policy should be put in place or, where already in place, reviewed, with firms clearly setting out how they propose to mitigate the conflicts identified.
- The FCA expects firms to take a critical view of how conflicts may affect the fair treatment of clients and to respond accordingly, consistent with the fair treatment of customers initiative.

Question answers

10.1 The cultural drivers are: leadership; strategy; decision making and challenge; controls; recruitment and training and competence; and reward.

10.2 Honesty, integrity and reputation; competence and capability; and financial soundness.

Revision Courses

Effective preparation is key to exam success

Accelerate your exam performance with our online interactive revision courses.

Our interactive online revision courses for insurance and personal finance units are designed to help you feel more prepared for your exam by covering key areas of the syllabus and areas likely to be tested. There will also be a focus on exam style questions and debriefs to support you.

An effective and productive online training course is delivered by highly experienced and qualified trainers, ensuring all candidates are fully engaged to maximise the learning experience. The focus and support provided by a live virtual training course can really make a difference with preparation for your exam.

Discover our range of revision courses here:
cii.co.uk/learning/further-learning-and-support/revision-courses/

Chartered Insurance Institute
Standards. Professionalism. Trust.

11

Ethics and professional standards

Contents	Syllabus learning outcomes
Introduction	
A Ethics in financial services	*10.1*
B Putting ethics into practice	*10.1*, *10.2*
C Evaluation and outcomes	*11.1*, *11.2*
D Stakeholders and corporate social responsibility (CSR)	*10.1*
E Ethical scenarios	*10.2*, *11.2*
Key points	

Learning objectives

After studying this chapter, you should be able to:

- describe the role that ethics plays in financial services;
- describe the influence of ethical culture and professional ethics in achieving this;
- identify the components of an ethical framework for a firm; and
- apply the appropriate steps to resolving an ethical dilemma.

Introduction

In this chapter we explain the role and importance of ethics in financial services. We focus on how ethics can be put into practice in a financial services business, from identifying core values and ethical issues, to embedding and evaluating a values-led culture. Ethical standards in regulation and building professionalism are discussed, as well as the roles of corporate social responsibility.

Key terms

This chapter features explanations of the following terms and concepts:

Corporate social responsibility (CSR)	Embedding ethics	Ethical dilemmas	Ethics codes and value statements
Ethics in financial services	Evaluation and outcomes	Leadership on ethics	Management information
Professionalism and ethics	Regulatory initiatives	Whistle-blowing	

A Ethics in financial services

A1 Ethics and its position in the regulatory framework

Ethics in a business context can be summed up as being about 'the application of ethical values to business decisions'. There are three points to note about this definition:

- It talks about 'application', which means actually doing something. It is measured by actions, not words.
- It refers to 'ethical values'. Not all values used by firms are ethical ones like 'trusted'; some are business values like 'innovative'.
- It refers to business decisions, which covers not just behaviours, but the decisions we take at work as well.

Some aspects of business ethics have been enshrined in laws and regulations, adopted by society to reflect the standards they believe to be important for business people to uphold. Other aspects of business ethics have not been formalised in this way, with the public recognising that opinions and priorities change, and views on whether something is ethical or not can change too. At the same time, the law does not adapt as quickly as public thinking can about what is seen as 'right' or 'wrong' behaviour.

You can see, therefore, that ethics and regulations are connected, but not the same. Ethics has a wider scope than regulations: people might judge something as unethical, even though it did not breach any regulations. Equally, just abiding by the regulations does not mean you will be judged to be ethical. Ethics is more than just complying with the law.

> Ethics comes before the rules, during the rules and after the rules.
>
> Professor Luciano Floridi, University of Oxford

In this section we will be looking at the role that ethics plays in the regulation of financial services.

Ethics has always been at the heart of financial services legislation. This is because ethics sustains honesty and integrity, which in turn builds trust, which in turn makes markets work more efficiently, which in turn produces better outcomes for all. This is illustrated by the following diagram:

The regulation of financial services is based upon a set of principles setting out the fundamental obligations of all firms under the regulatory system. There are twelve 'Principles for Businesses', discussed in *Principles-based regulation (PBR)* on page 10/3, again the influence of ethics can be seen across these rules.

The influence of ethics is evident across many of these principles. It is at the forefront of principles 1 (Integrity) and 6 (Customer Interests), and a key part of principles 7 (Communications with Clients), 8 (Conflicts of Interest), 9 (Customers – relationships of trust) and 12 (Consumer Duty). Indeed, it would be fair to say that ethics is reflected in every one of the principles, even principle 4 (Financial Prudence) and principle 11 (Relations with Regulators). This perhaps explains why the term 'ethics' isn't referred to in any of the principles – the term is a little too pervasive when you are working at the level of principles. Instead, the FCA prefers to draw attention to a range of behaviours.

The Principles for Businesses apply to regulated firms. Individuals have ethical standards set for them through the conduct rules in the **Senior Managers and Certification Regime (SM&CR)**. These rules apply to all individuals in regulated firms, with the exception of ancillary staff such as cleaners and security personnel.

Refer to
SM&CR outlined in *Overview of SM&CR* on page 7/7

The conduct rules represent a set of enforceable rules that set basic standards of good personal conduct, against which the FCA holds people to account. The intention is to improve standards of individual behaviour in financial services from the top down and the bottom up.

So will compliance with these conduct rules mean that an individual can be deemed ethical? The answer is 'not necessarily'. Compliance with regulatory initiatives is important but not the same as a firm or individual being ethical. Compliance can be summed up as being about rules and regulations: it's 'what you have to do'. Ethics, on the other hand, is 'what you should do'. It's about people going beyond rules and regulations to act on the values of their firm and profession. Sometimes those two things might be closely aligned. At other times, ethical expectations might be much higher than what the regulations require of an individual or firm.

Consider the Code of Practice for Approved Persons. It sets out descriptions of conduct which, in the FCA's opinion, do not comply with the relevant Statements of Principle for Approved Persons. Yet, while compliance may be framed in this way, ethics cannot be. Remember the definition of ethics in a business context: 'the application of ethical values to business decisions'. It requires action to be taken. This is quite different to action not being taken.

Nevertheless, the SM&CR regulatory framework is important from an ethical perspective. Here are five features that help put individuals on a more ethical path:

- The greater emphasis on the responsibilities of senior executives and the accountability of individuals for the decisions they take. These responsibilities include the development and embedding of an ethical culture in their firm's day-to-day management.
- Firms are required to assess the extent to which individuals possess the necessary level of competence, knowledge and experience to abide by these conduct rules.
- The conduct rules continue to emphasise the importance of integrity, and of acting with due skill, care and diligence.
- Any delegation of responsibilities must be to an appropriate person and properly overseen. You can delegate your responsibility, but you cannot delegate your accountability.
- Firms are required to ensure the independence, integrity and effectiveness of their whistle-blowing procedures, and the protection of staff raising concerns. This includes the appointment of a whistle-blowing champion.

Integrity
The FCA does not define what it means by terms such as integrity. Instead, it expects firms to consider a range of factors and incorporate them into their ongoing assessment and reporting. In this way, the firm is more likely to understand what integrity means to their particular firm and more able to then apply it.

The **Retail Distribution Review (RDR)** introduced a series of reforms around professional standards in the retail investment market. These encompassed qualifications, continuing professional development and ethical standards, delivered through accredited bodies. A specific task for accredited bodies is to issue advisers with an annual statement to evidence that they have met the new professionalism requirements.

The CII is one such accredited body and issues **'Statements of Professional Standing'** to retail investment advisers who:

- confirm that they adhere to its code of ethics;
- hold the required qualifications for the activities they undertake;
- have completed the appropriate continuous professional development; and
- comply with the relevant conduct standards.

On the Web
The CII/PFS has its own Code of Ethics and companion guide, see:

www.cii.co.uk/media/9223937/cii_code_of_ethics.pdf and *bit.ly/3mRysid*.

Try measuring yourself against some of the questions it asks members to consider.

A2 Business benefits of ethics

Business ethics make good business sense for the firm, for the practitioner and for the sector as a whole. This is because a strong ethical culture helps to build trust and confidence among consumers and, as a result, increases their engagement with financial services firms and products.

Surveys find that consumers often view customer service through an ethical lens. Asked to describe what 'good customer service meant' in financial services, most consumers refer to it as 'honesty' and as 'doing what they said they would do'. So, a firm may invest in answering phones quicker, or sending letters out sooner, but the customer is actually more interested in that firm's honesty and fulfilling of promises. This indicates consumers are interested in ethics, although they rarely use that term themselves.

The trust that ethics can build in a firm should help to both attract new customers and retain existing ones. Achieving this relies on ethics being practised at both the individual employee level and the corporate level.

A business that is trusted by its clients should see its revenues increase (as cross-selling becomes easier) and its expenses decrease (as acquisition costs drop). Over time, this creates greater returns to shareholders. That is why business ethics makes good business sense.

Note, however, that an ethical firm is not the same as a firm selling ethical products. Some firms market specifically 'ethical' investments or products, but this is a particular segment of the market and outside the scope of this chapter.

A3 Ethical issues in financial services

The financial services market is complex, both in terms of the products and services on offer and the chain of agents and suppliers that deliver them. The market has sometimes struggled to achieve the necessary standards in the face of this complexity and, as a result, has encountered a number of ethical issues. For example:

- unclear and overly technical documentation;
- sources of remuneration and the use of inducements;
- conflicts of interest and the sale of unsuitable products;
- inadequate handling of complaints; and
- insufficient attention to financial inclusion.

In the past, regulations were introduced to deal with such difficulties, but the rules tended to focus on controlling processes rather than addressing the ethical issues behind the problem. Increasingly, regulators are focusing on the culture and values of the firm and practitioners that drive these behaviours, as well as the outcomes they generate.

A4 Ethical initiatives by the regulator

The regulator has an influential role to play in how ethical issues are addressed. This points to the somewhat fluid boundary in financial services between what is '**ethical**' (what we should do) and what is '**compliant**' (what we have to do). If the regulator feels that consumers are not experiencing the right outcomes from financial services firms, then it will consider addressing this through its regulatory powers.

The Consumer Duty is a significant step in this direction. While the regulator recognised that good practice had been present, it also felt that firms had not been consistently and sufficiently prioritising good consumer outcomes.

The Consumer Duty focuses on the outcomes consumers experience by:

- explicitly setting a high standard of care across all retail markets;
- extending rules focused on product governance and fair value;
- focusing on market practices that interfere in consumer decision making;
- ensuring firms consider the needs of their customers and how they behave; and
- requiring all firms to focus on good customer outcomes and whether those outcomes are met.

Fairness is an example of an ethical issue being delivered through the Consumer Duty. Up until recently, the notion of a fair price was one set by a competitive market, and a firm's focus on fairness was primarily around how it treated customers. Now, however, delivering fair value is something that firms will find under considerable regulatory scrutiny.

Vulnerable consumers have become a particular concern for regulators. They are defined as 'someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care'. Vulnerable consumers may be significantly less able to represent their own interests. They may have non-standard needs, and may be more prone to certain behavioural biases that negatively impact their decision making. As a result, they are more likely to experience, among other things, financial exclusion, disengagement with the market and mis-selling. How firms respond to such consumers, in terms of products, distribution and service, has now moved from a matter of public concern to an issue firmly on the regulator's agenda.

Access to insurance is an issue for a spectrum of consumers, including (but not limited to) those who are vulnerable. Access is defined as 'the ability of consumers to engage with and use the financial products and services they need over their lifetime'. Access problems can emerge at different life stages and also as a result of social and technological change.

Pressure from consumer groups and professional bodies has helped bring regulatory attention to the wide range of problems that can be encountered. Their aim is to ensure that the financial services sector is as inclusive as possible.

Data ethics and AI are developing issues that raise important questions about how data and analytical software are put to use in sectors such as financial services. They encompass a range of ethical concerns, including:

- **Consent** – How explicit and specific is the consent being sought? How informed is the customer about what they are being asked?
- **Privacy** – Should data provided in one situation then be used in another quite different situation? Should some types of data be used at all?
- **Equality** – Are people with protected characteristics being treated fairly? Is this happening at the group as well as the individual level?
- **Transparency** – How clear is it to the customer what influenced the decision on the cover they were seeking? What level of explanation can reasonably be given to them?

As digital technologies become more and more important for the sector's development, concerns such as these need to be carefully considered by firms. They are sometimes highlighted in the media, so it is important they are properly understood.

A key feature of how individual firms recognise and respond to the ethical challenges outlined above is the firm's culture. Culture is a key part of the regulator’s thinking in relation to behaviours and decisions.

A5 Ethics and culture

In its simplest form, culture is about ‘how things get done round here’. The FCA defines it as 'the habitual behaviours and mindsets that characterise an organisation'. It is made up of shared assumptions held by a group of people working together about how to engage with customers, how to tackle problems, how to bring in business, and so on. For example, if there is a shared assumption among a firm’s employees about client information being kept confidential, or about ensuring products are suitable for clients, then this will make a big difference to the integrity of the firm and the trust people have in it.

The regulator has identified four key components to a firm’s culture:

- **Purpose**: this is about two things. On one level, it is a description of what the firm has set itself to achieve through the products and services it delivers. On another level, it is about how the firm then goes about having that purpose tangibly drive the decisions made at all levels.
- **Leadership**: a firm's culture will be influenced by its style of leadership. It is often referred to as the ‘tone from the top’. This involves the leadership being clear about the types of behaviours it wants from people at the firm and then modelling those behaviours. The firm’s directors are certainly important in giving such leadership, but so are managers in the middle.
- **Rewarding and managing people**: these are the practices in the organisation that tell people what they need to do to be successful. They concern how people are recruited, rewarded and promoted. They send signals about how the firm expects its people to behave.
- **Governance**: this is about how the firm organises itself and how this influences the decisions being made within it. It works at the level of formal governance involving boards and senior management. It also works throughout the systems and controls being used to shape and monitor those business decisions.

These types of management behaviour have been emphasised by the regulator in a series of interventions to point firms towards a more ethical culture, such as:

- influencing the composition of management;
- influencing the incentives for good behaviour;
- requiring high standards of effective risk management;
- influencing the training and competence regime; and
- deterring poor behaviour.

On the Web

The CII has published a series of guides on ethical culture:

- 'Building trust through ethical culture: A guide for SME firms': *www.cii.co.uk/84323*.
- 'Ethical Culture: Developing a culture of responsibility in a regulated environment': *www.cii.co.uk/39598*.
- 'Ethical Culture: The challenge for insurance marketers': *www.cii.co.uk/research/2016/may/ethical-culture-the-challenge-for-insurance-marketers*.

A6 Whistle-blowing

From time to time, people at work can become concerned about something they see or hear. This might involve relatively minor incidents of misconduct that can be easily resolved through normal company channels. On the other hand, the wrongdoing might seem too serious or pervasive for reporting through those normal channels.

These more serious incidents could be a sign of financial or reputational trouble for a firm or perhaps even of criminal wrongdoing. Reporting such concerns can seem daunting at times, yet knowing how best to bring them to the firm's attention is important.

Speaking up in this way is often referred to as 'whistle-blowing'. The whistle-blower could be raising a concern about a dangerous activity, a serious risk to the business, malpractice in how an activity is being undertaken or wrongdoing in how the organisation is being run. They could be an employee, director or contractor, or a temporary or former worker.

Definition of whistle-blowing

Whistle-blowing is the raising of a concern, either within the workplace or externally, about a danger, risk, malpractice or wrongdoing that affects others.

Whistle-blowing can save lives, jobs, money and reputations. It alerts firms to problems and allows them to take action, hopefully before the consequences become too serious.

Many financial services firms are subject to detailed regulations on whistle-blowing, covering policies, procedures, reporting and oversight. Each firm must appoint a whistle-blower's champion with overall responsibility for the firm's compliance.

Some whistle-blowers can be reluctant to report concerns within their own firm and so the FCA has established a whistle-blowing team to receive such reports on a direct basis. They have specific powers to investigate such concerns and apply any necessary sanctions.

On the Web

The CII has published guidance on whistle-blowing: *bit.ly/2X1GDfl*.

B Putting ethics into practice

B1 Ethics frameworks

A firm works at a number of different levels to embed ethics into its business. The ethics framework this forms can be summarised as follows:

- **Commitment** – in the form of statements of values and codes of ethics.
- **Leadership** – the role played by executives and managers.
- **Operational** – the policies, procedures and toolkits for employees to use.
- **Oversight** – the way in which progress is monitored and reviewed.

Running through these four levels and linking them together is the firm's ethical culture or 'how things get done round here'. That ethical culture will influence how a lot of everyday decisions are made. Each firm will have an ethics framework (formal or informal) that reflects its own particular approach to doing business and the ethical culture its staff work to. Firms may also work together in order to raise ethical standards across their business sector: for example, through their support for professional organisations such as the CII and PFS.

B2 Ethics codes and value statements

Ethics codes set out a commitment to ethical standards in high-level terms. They are used by firms for their employees, professional bodies for their members and, occasionally, trade bodies and regulators for companies working in a particular sector. Ethics codes set out realistic and practical standards for how business should be conducted, while also recognising the challenges being faced and the aspirations that have been set.

Ethics codes should be written with clear links to the ethical values held by the firm (or professional body etc.) involved. Values statements generally sit above ethics codes and set out a small number of key attributes that the firm looks to its people to uphold. Examples of typical ethical values are integrity, trust and fairness. More specific guidance on particular ethical issues, such as handling conflicts of interest or financial inclusion, can be found in standalone policies. Together, these have the overall effect of linking very practical steps (for example, a procedure for conflicts of interest) with strategic aspirations (for example, a value such as integrity).

Professional bodies, such as the CII and PFS, have their own codes of ethics and upholding those ethical obligations is a condition of continued membership. The CII/PFS codes have five core duties, requiring each member to:

- comply with the code and all relevant laws and regulations;
- act with the highest ethical standards and integrity;
- act in the best interests of each client;
- provide a high standard of service;
- treat people fairly, regardless of age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion and belief, sex and sexual orientation.

The codes explain each of these five core duties in more detail and supports this with a list of questions that allow members to explore their practical meaning. The CII's Code of Ethics also forms part of the UK's regulatory framework. The CII has been accredited to issue the Statements of Professional Standing (SPS) that retail investment advisers are required to hold. Abiding by the CII Code of Ethics is a condition for being issued with, and retaining, an SPS from the CII.

B2A Examples from firms

Firms often have values statements and ethics codes that reflect their corporate culture and what is distinctive about them. These complement similar codes at the professional and sector levels. Here are some examples:

Berry and Oak Ltd – Values

- Growth.
- Quality.
- Integrity.
- Respect.
- Care.
- Enthusiasm.

Robson Lister Wealth Management – Values

- We always do the right thing.
- We are proud.
- We strive to be the best we can.
- We care.
- We value our local community.

Aviva plc – Values

- Care.
- Commitment.
- Community.
- Confidence.

Activity

Compare your firm's values statement and ethics code with the examples given.

How do they compare?

Is your firm's ethics code consistent with how it carries out its business?

B3 Embedding ethics

The commitments and aspirations set out in a firm's values statement and ethics code need to be turned into tangible outcomes for customers, employees and other stakeholders. That can be challenging at times to achieve, for firms often face difficult decisions that can stretch their capacity and commitment. It is also a continuous process, not a one-off: ethics is a journey, not a destination.

Does the way in which this is done count? Some firms will take active steps to 'do the right thing' because they believe it is good for their customers and so for their business. Others may 'do the right thing' because they worry about getting into trouble with the regulator if they do not. Also, there may be those for whom doing the right thing is little more than a marketing ploy or public relations exercise. Over time, the way in which a firm embeds its ethics code into how its people work will count. Being superficially ethical is hard to maintain when under the constant gaze of customers and employees. Problems emerge as it becomes easier for employees to speak up and 'blow the whistle', while social media allows customers to share their experiences more easily.

Embedding ethics means that it has to be practised at all levels of a business, coherently and consistently across all functions and across a wide range of situations. Mistakes will sometimes be made and firms need to be open about these and learn from them. That involves not only teaching people about ethics through continuous professional development, but also showing them how best to handle ethical problems and make better choices next time round.

The embedding of ethics needs to take place on a number of different levels, with leadership being widely acknowledged as the starting point.

B3A Leadership on ethics

Leadership on ethics relies on five key steps:

1. **Understand the language of ethics**. You cannot lead on ethics unless you can speak that language and have practised it in everyday work situations.
2. **Craft a clear ethical vision for your firm**. You cannot lead on ethics unless you know where you are going. This means understanding the ethical risks posed by your business and reflecting on how your firm goes about its work.
3. **Be good at shaping the way in which your people make decisions**. This will allow you to influence the ethical culture within your firm, so that it becomes aligned with the ethical vision you have set for it.
4. **Remove the hurdles that get in the way of your people making ethical decisions**. People will need help from time to time to take some tough decisions in line with your ethical vision.
5. **Set an example when it comes to ethical decisions and ethical behaviour**. If you do not set an example, employees will take the cue and not bother either.

Remember that most misconduct in corporate settings is not done by 'bad people' doing bad things, but by good people making poor choices, usually when under pressure or when allowed to get away with excuses.

Ethical leadership tackles those causes of misconduct head on, by setting the ethical vision and building the means by which to achieve it. Ethical leadership can sometimes be a challenge, for changing behaviours within a firm takes time and is not always easy to implement. Yet without it, existing patterns of behaviour ('that's the way it's always been done here') will persist and trust in the business will not improve.

Other terms associated with ethical leadership are 'tone from the top' and 'walking the talk'. It is important, however, to understand these as more than just personal attributes of senior directors. As the above five points make clear, setting an example is only one of five steps.

The regulator sees its ‘fair treatment of customers’ initiative as a cultural issue, with leadership as one of the key factors influencing that culture. Among the examples of good practice set out in its guidance on fair treatment and corporate culture was how:

In a number of firms, the Chief Executive or senior management demonstrated their commitment to ‘fair treatment of customers’ by providing clear fair treatment messages in presentations (including video broadcasts for staff in remote locations) and appearing in internal website downloads, posters and booklets. These communications explained what fair treatment meant for the firm, the challenges they faced, and provided regular feedback on their progress.

B3B Operational steps

The operational dimension to embedding ethics into how a business operates covers an array of management tools. These turn the vision and leadership at the top of the firm into something tangible for its people to work with. So while codes and value statements tell people what the firm wants them to achieve, it is important to then equip those same people with tools to help them deliver that achievement. Here are some of the more common tools used by firms:

Policies. These take a particular aspect of a high-level commitment and explain it in more detail. For example, larger firms will have a policy about tackling bribery, while most firms will have a policy on business gifts and hospitality.

Procedures. These explain what should be done in particular situations; for example, how a certain type of conflict of interest should be mitigated, or how a new product is assessed on financial inclusion.

Training. This can cover an array of topics, from the values statement itself, through to the policies and procedures that support it, and just as importantly, how to handle situations that do not fit within existing policies and procedures.

Job descriptions. These turn all this into something specific to be done in a particular job; for example, that an underwriter should take account of fairness when designing a product and setting its pricing.

Human resources. This department plays an important role in integrating ethical competencies into job descriptions and ensuring that ethics is a consistent influence on decisions relating to promotions, rewards and discipline.

Communications. These make sure that a consistent message is spread across the business, telling people: what to do and why; what has been achieved with what benefits; and what challenges have been faced with what impacts.

Performance management. This assesses progress, both individually and across the firm, towards the objectives and targets that have been set for ethics, allowing the right type of support to be provided where needed.

Tools like these are common in larger firms but less common in smaller firms. Yet the need to achieve similar results, albeit in a less structured format, remains. Every firm has its own particular culture and that culture will have an ethical dimension to it. To deliver on obligations around fairness, and on commitments around integrity, every firm, big and small, has to ensure that its ethical culture is a supportive influence.

B3C Governance, risk management and compliance

A commitment to practise ethics, be it by a firm or an individual, is only as good as the actual steps taken to deliver it. Firms have sometimes come unstuck after putting value statements, code of ethics and operational processes into effect, but not then making sure that their people have actually been following them. Equally, individuals may have a strong personal commitment to integrity, but then fail to appreciate how to reflect that in the work they do and the decisions they make.

So, an important part of any ethics framework is how a firm arranges the oversight and governance of its commitments, including its ethical ones. This uses a number of different processes:

- **Governance**: this determines how the firm is structured and managed; for example, whether ethics is a separate function or aligned with compliance or human resources.
- **Risk management**: this determines what risks the business is exposed to, how they add up and what to do about them. Ethics would be one such risk, on its own or as part of the firm's overall reputation.
- **Compliance**: this determines whether the business is conforming to the stated requirements, both those set internally and those set externally (such as laws and regulations). It manages the use and effectiveness of control mechanisms.
- **Internal audit**: this provides an independent check that governance, risk management and compliance are being properly undertaken.

Ethics and compliance are sometimes aligned within an organisation, yet they are different. If compliance is about 'what a firm has to do' (in terms of laws and regulations), then ethics is about 'what a firm should do' (in terms of 'doing the right thing'). Some standards of behaviour have of course been enshrined in law (such as in the Bribery Act 2010), but others have been left open to interpretation according to the social priorities of the time and to reflect changes in public opinion. Aligning ethics and compliance is fine, so long as they are not thought of as one and the same thing.

B3D Effective oversight

The various elements of a firm's ethics framework can be presented very neatly on paper, but their value to the business relies on their proper implementation. Board directors need to be looking for evidence of implementation and be equipped with questions to test the veracity of what is being presented to them. In larger firms, such questions can also be deployed by senior management, to ensure that their instructions have been understood and acted upon.

Here is a sample of such questions arranged around the aforementioned elements of an ethics framework:

Codes of ethics and values statements

- Does the firm compile evidence of what is being done in support of these commitments?
- Have employee surveys included questions about the firm's code of ethics?
- Can employees access guidance that explains the code of ethics in more detail?
- Are employees given guidance about how to report something in contravention of the code of ethics?

Ethical leadership

- Have senior managers received training in the key ethical issues facing the business?
- How does the current strategy link into the ethical vision that has been set for the firm?
- Are there examples of when the firm has acknowledged an ethical challenge that it is facing?
- Can senior management give examples of positive and negative aspects of the firm's ethical culture?

Operational initiatives

- Do appraisals include questions about what each employee has done in support of the firm's values?
- Have those whose work touches on the firm's key ethical risks been trained in those issues?
- What reports does the firm compile about disciplinary cases relating to breaches of the code of ethics?
- Do the firm's procedures on conflicts of interest give clear and comprehensive instructions on mitigation?

Governance, risk management and compliance

- Has managerial responsibility for ethics been clearly organised within the firm?
- How do we ensure that suppliers and business partners share our views and obligations on ethics?
- What factors are most crucial to the effectiveness of the controls in place for our key ethical risks?
- Has the internal audit's schedule looked at ethical issues and, if so, how were they chosen?

Activity

Where do you think your firm's strength lies in the ethics framework? What does it need to improve?

B3E Practising with case studies

In *Governance, risk management and compliance* on page 11/10 we explained how compliance and ethics differ; compliance is more about 'what we have to do' and ethics is more about 'what we should do'. This means that compliance is usually quite clear cut: you can do this, but not that. Ethics on the other hand often involves situations where the options are not so clear cut.

So how do employees make decisions in such circumstances?

The ethics framework outlined above can help: thinking about the principles set out in the code of ethics, for example, or recalling what your chief executive may have said in the introduction to the ethics training course you went on. You can look at policies and procedures to find out what to do, but they may at times feel too detached from the particular circumstances you are confronted with.

Such circumstances often arise from what customers ask of you. They are looking for a personalised response, not one from the rulebook. Yet it is also important that your decision takes account of the professional and corporate codes of ethics you work within. How do you bring together those customer needs and professional ethics so as to make 'the right decision'? It is a question that matters to customers, who have been found in surveys to describe 'what good customer service looks like' as 'honesty' and 'doing what they said they would do'.

A good way to prepare for such situations is through ethical case studies. These are short scenarios in which there is a choice to be made. Here are six short ethical case studies for you to practise with (there are also more detailed ones later).

Consider this…

You work in the compliance part of a large wealth management firm. A recording is sent to you anonymously, which appears to be of a conversation between two of your firm's staff. They seem to be discussing the weak controls in one area of the firm and how they might be taken advantage of.

Questions

Do you make use of the recording? If so, what might you do first?

Consider this…

Your brother is a journalist in the business department of an evening newspaper. It must be a slow news day, for he has just rung your private mobile to ask about rumours of a takeover involving two insurers. You reply that you've heard nothing. Your brother eventually concedes that there is not much of a rumour yet, but wants you to give him some good reasons why it should go ahead.

Question

What do you say to him?

Consider this…

You have a new job as a financial consultant in a medium-sized firm of independent financial advisers. In your first week of employment you are asked to familiarise yourself with the firm's IT systems. To your surprise, you come across some correspondence appearing to admit that the firm mis-sold a certain type of bond over the previous twelve months and is now going back over client fact-finds, so that the mis-selling might not look so obvious. You are aware that the regulator has recently been visiting several other local firms, scrutinising their selling practices.

Questions

Do you alert anyone to your discovery? If so, whom?

Consider this…

You are employed in the customer services department at a small financial services firm. You receive a complaint from a customer who claims that he has been wrongly debited for something he was told he would not be charged for. You confirm with the customer that this will be dealt with and move to amend the on-screen details. However, you remember your supervisor talking last week about how close it was to the firm's end-of-year targets and that no one was to action any customer refunds until the customer had complained more than once about the same matter – even though you know this is contrary to your department's procedures. You know that your calls and entries are now being routinely monitored.

Questions

Do you action the customer's complaint? What are the issues you need to consider?

Consider this…

You've just started work at a mid-sized firm of independent financial advisers and are getting towards the end of your induction training. It's clear the firm has its product favourites and relies on these for delivering much of its sales. As a result, you've been told to just tick all other boxes on the client fact-find as 'not applicable'.

Question

Does this make sense to you?

Consider this…

You are in charge of a well-regarded local office, part of a financial planning firm with a reputation for honesty and integrity. A close family friend is worried about her son's job prospects and urges you to take him on, even though there are other, more suitably qualified candidates for the advertised role.

Question

What would you say to your friend?

B3F Professionalism and the embedding of ethics

Professionals have an important role to play in embedding an ethical culture within their firm.

From the very start, their membership of a professional body, such as the Personal Finance Society (PFS), puts them under a duty to consider the wider public interest. Equally, several of the steps outlined in the 'ethical framework' above are also features of their relationship with their professional body, for example:

- a code of ethics that provides a clear ethical vision for the insurance sector;
- understanding the language of ethics, through the provision of training courses in ethics and ethical issues;
- shaping the way in which people make decisions, through guidance material on ethical culture;
- case studies and ethical dilemmas that allow members to better prepare for difficult choices.

As a result, members of professional bodies, such as the CII and PFS, are more likely to be comfortable thinking about the ethical issues associated with a particular business situation. They are more likely to have put that thinking into practice. This, therefore, gives them opportunities to be a force for positive change within their firm; for example, by:

- being open about the ethical challenges they face and happy to seek the advice of a critical friend;
- being more willing to raise concerns about something that they think is wrong;
- giving advice to colleagues who are facing a difficult choice;
- being a voice for honesty and integrity within their firm; and
- giving their visible support to sector-wide initiatives like ‘access to insurance’.

B4 Ethical dilemmas

Implementing an ethics framework involves time and effort, and it can at times be challenging. It is also something that needs regular attention, as market conditions and customer expectations evolve. In that time, some difficult ethical situations can emerge, requiring particular skills to ensure that the right choice is made. So, how can you recognise such ethical dilemmas when they occur?

Ethical dilemmas arise from a tension between two or more sets of values. These values can be those of your firm and your professional body; they could equally be your own personal values, or those of society at large. For example, your firm might emphasise loyalty and teamwork, but there may be occasions when this might not sit comfortably alongside a professional value like acting in the best interests of the client.

This could create tension in one of two ways. Firstly, two values could be in conflict. For example, a firm may put particular importance on openness, but find it hard to resist using some confidential information that one of its employees has found out about a competitor. Secondly, there could be tension from having to prioritise one value over another. For example, a firm may expect its redundancy plans to be kept confidential, but this may not fit comfortably with an employee’s loyalty to certain colleagues or their personal commitment to the local community.

All of those values could be important, so which should be put first? Ethical dilemmas can sometimes be wrapped up in loyalties, principles and personal interests. This can turn them into something of a minefield, so being prepared for how to tackle them helps avoid problems arising. You can tackle ethical dilemmas using a simple, three-stage process. When weighing up an ethical dilemma, ask yourself these three questions:

- What ethical values can I recognise in this situation? It may be helpful to take account of personal values, corporate values and/or professional values.
- What is the dilemma formed by the tension between those ethical values, and how does that dilemma look from the perspective of my firm, my profession and the public at large? Express this in clear, unequivocal terms.
- What options do I have and which one most effectively resolves the tension between those different values?

In weighing up those options, you could consult with a trusted colleague, or view the choice you have from the perspective of someone you look up to, but who is outside of your firm. How do they see the dilemma and the option you are considering choosing? Also, you can imagine how your choice of option would appear to a group of family and friends, discussing it with them around a dinner table: is it something you would be happy putting your name to?

C Evaluation and outcomes

C1 Evaluation

A firm's ethics framework is only as good as the outcomes it achieves. This is an ongoing process that needs to be evaluated on a regular basis. The principal business tool for doing so is **management information (MI)**, which is information collected during a period of business activity, for use by management to make informed decisions about how to direct those activities.

MI about ethics can be built up through identifying:

- the ethic risks to be addressed and/or the ethical objectives to be achieved;
- the required inputs and the desired outputs associated with those risks/objectives; and
- the quantitative and/or qualitative measures that best reflect those inputs/outputs.

This means looking at several types of information. This will include both what employees are doing and how customers are responding, for example:

- levels of employee engagement with ethics-related training;
- survey feedback on how employees feel supported in making ethical decisions;
- the diversity profile of the firm and the community in which it is located;
- levels of customer complaints; and
- persistency ratios across different lines of business.

The information could be a direct measure or an indirect measure. For example, customer complaints and ethical feedback in employee surveys are direct measures of ethics, while persistency ratios and engagement with ethics training are indirect measures of ethics. Both direct and indirect measures are of value if put together with thought and attention.

The regulator has provided guidance on management information (MI) relating to the fair treatment of customers. It is based around four principles: the MI has to be accurate, timely, relevant and consistent. For example, for file reviews as a measure of ethical risk relating to sales practices:

- Accuracy – data points should be clear and commentary correctly attributed.
- Timely – carried out at the right point in the business cycle to achieve the review objective.
- Relevant – targeted to deliver actionable insight so that the right people can act accordingly.
- Consistent – carried out at suitable intervals so that trends can be clearly identified.

Assessing how well the management information is achieving the aims it is being collected for can be illustrated through the following examples:

Sales volumes: Good MI would show sales volumes by product line per month, so that the firm can spot unusual variances against sales objectives. This helps identify mis-selling risks. Poor MI would lump all product lines together into one figure, making any surge or drop in the sale of a particular product unclear.

Customer complaints: Good MI would identify the root cause of individual complaints, and aggregate those causes to identify common patterns. This helps identify fairness issues. Poor MI would be based only on complaints thought to be justified and would fail to show underlying causes or common patterns.

Employee ethics training: Good MI would show duration and topics, as well as levels of assessed understanding. This helps track the capacity of staff to make ethical decisions. Poor MI would simply be a count of employees so engaged.

Remember that MI is produced not just for use by management. It should be shared with the people around whose performance it is based. This feedback raises awareness, which in turn facilitates change so that ethical outcomes are achieved. Team meetings, performance reviews and planning sessions are typical settings for doing so.

C2 Outcomes

MI should ultimately inform a firm about the outcomes being achieved. So, while a firm can track the effort it is putting in through measures of input, it is measures of outcome that tell it how effective those inputs have been. For each of the ethical risks and/or ethical objectives that the firm is concerned with, it should identify the outcomes it wants to achieve.

With an ethical risk like fairness, the regulator has identified the outcomes it wants firms to achieve:

- **Outcome 1**: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- **Outcome 2**: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- **Outcome 3**: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- **Outcome 4**: Where consumers receive advice, the advice is suitable and takes account of their circumstances.
- **Outcome 5**: Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
- **Outcome 6**: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

Outcomes like these are the result of a range of behaviours and actions. Management information can give some insight into how well the firm is doing, but a firm can also learn a lot by reflecting upon how those behaviours and actions are supported by practices with the firm. The regulator has set out examples of what it sees as positive and negative behaviours in relation to the fair treatment of customers. Here is a selection from those relating to 'decision making':

Positive behaviours	Element of decision making	Negative behaviours
Where decisions are taken that affect customers, the decision maker always gathers the relevant information. This includes feedback from customers and staff where this will help ensure a fair outcome for customers.	Informed	Unfair decisions are taken because insufficient information has been gathered. Decision makers do not consider or investigate relevant feedback from staff or customers.
Individuals have the confidence and authority to take the decisions required of their role and understand when they need to escalate the decision. This includes circumstances where a flexible approach provides a fairer result for a customer.	Empowered	Individuals lack confidence or misunderstand their authority leading them to be indecisive or make unfair decisions (e.g. a failure to recognise an individual customer's circumstances).
Management have created a culture where staff can challenge decisions made about customer issues. The firm recognises challenge from customers and acts on this when it is fair to do so.	Open to challenge	Staff members do not feel they can challenge decisions which they think are not fair to customers. There are inadequate mechanisms to allow challenges from customers. Challenges from customers are dismissed without consideration.

Firms often look to the regulator to understand what actions they should take in relation to a particular ethical issue, such as the fair treatment of customers. This can however often leave open the question of how far they should take those actions. Should they do so only to the extent of being compliant with regulations, or should they go further?

This raises a question about whether 'to be compliant' and 'to be ethical' are different. They are different. Compliance can be summed up as being about rules and regulations: it's 'what you have to do'. Ethics on the other hand is 'what you should do'. It's about people going beyond rules and regulations, to act on the values of their firm and profession.

People will go that extra measure because they feel ‘it’s the right thing to do’ for that client or work colleague. And, it is often an easier thing to do than people imagine. Employees facing difficult situations often find it easier to distinguish between what is right and wrong about something, than between what is compliant and non-compliant. Here are some examples contrasting ethical and compliant outcomes:

Issue	Ethical outcomes	Compliant outcomes
Customer understanding	The product is communicated according to standards for comprehensibility, reading age, visual accessibility and layout. The standards are pre-tested to ensure overall understandability. As a result, customers know what they're covered for and the value of what they are buying.	To be transparent, everything in the policy is written in simple and understandable language. The policy documentation is extensive and comprehensive. As a result, the risk of mis-selling remains, with customers reluctant to engage with a product of such length.
Product design	Representative customers in the target market are asked for insight into their needs and priorities, with feedback taken into product design. This is turned into an ongoing process to ensure that the right outcomes are being achieved. As a result, customers experience products aligned with their interests and needs. They can easily identify the value they will gain from buying them.	The needs and characteristics of customers in the target market are based upon relatively generic understandings, topped up with more granular information where thought necessary. As a result, it is not easy for customers to identify the main areas of cover from the many extras packaged with it. Customers remain doubtful that the product has met their needs.
Customer support	Customers are engaged directly in the weighting given to different metrics for customer support. This ensures that their priorities are embedded in support processes across all channels. As a result, customers feel supported when it is needed most and have greater confidence that they will be looked after.	A wide variety of metrics are monitored, including call waiting times, resolution times and call transfer accuracy. These are then used to determine any barriers to good customer outcomes. As a result, customers experience 'stop start' support and lose confidence that the firm understands where their real needs lie.

D Stakeholders and corporate social responsibility (CSR)

D1 Stakeholders

The fair treatment of customers is important, but so is the fair treatment of employees and suppliers. To ensure that fairness really is at the heart of how a firm works, it should be universally applied. So, who would this cover?

The success of a business relies on all sorts of people. These people are often referred to as the stakeholders of the firm. A widely-used definition of stakeholders is:

> ‘Those individuals or groups who are affected by the company and its activities, as well as those individuals or groups who can themselves affect the company and its activities.’

An example of a stakeholder who is affected by a company and its activities would be employees. An example of a stakeholder who can themselves affect a company and its activities would be clients. Note that in both these examples, there is the potential for ‘who is affecting whom’ to be reversed, reflecting the symbiotic nature of many stakeholder relationships.

It is through identifying and then engaging with its stakeholders that a firm learns how well its working practices and performance are supporting its corporate values and reputation for integrity. At the same time, such engagement provides the company with an important opportunity to explain to stakeholders about issues and trends that are important to how it goes about its business.

D2 Corporate social responsibility (CSR)

Engaging with stakeholders in this way is called corporate social responsibility (CSR). CSR has become the framework for firms to engage with a range of stakeholders on important issues.

The first steps that firms should take are to identify their stakeholders, prioritise them and focus on their important issues. This is often referred to as a materiality assessment. It is important to remember that in conducting a materiality assessment, the firm needs to consider not only what issues are important for its business, but also what issues are important for its key stakeholders. That is why getting your materiality assessment right involves standing back from the firm and seeing it as how others might see it.

A large firm may have a dozen or more stakeholders, while small firms focus on only a handful. The most common ones are customers, employees, the environment and communities. So what might be the important issues for stakeholders like employees? A firm might look to its human resources processes for such issues, drawing on performance management reviews and employee appraisals. While these are relevant, employees themselves are just as likely to be interested in the respect with which they are treated, the openness of the firm's culture and the fairness of remuneration and promotion. A joint issue for employees and communities could be how inclusive a firm is being in its recruitment practices.

Clearly there is more to CSR than simply telling employees how good you are: they want to hear what you have to say on things that are important to them. A good CSR programme will draw both together.

It is important for a firm, big or small, to understand the point of CSR. It is not to win community awards or to produce a nice CSR report. These things can come out of a CSR programme, but are not themselves its ultimate aim. The point of CSR is to improve the firm's performance. It does this by improving how the firm listens and responds to its stakeholders and how it then turns what it has learnt into better ways of working. Out of this emerges a firm more in tune with its business environment and more confident in the ability of its people to recognise and respond to change.

Some people may wonder whether CSR is really worthwhile: might it distract management from getting on with 'doing business'? This depends on how you see your firm. Consider this: without clients, the company would have no one to work for; without shareholders or employees, it would have no capacity to deliver its product or service; and without a local community, it would have no employees or base to work from. A firm would be non-existent without its stakeholders. CSR provides a framework through which to engage with them.

D2A Practical steps

Here are twelve steps to take in designing and implementing a CSR programme:

1. Identify all your stakeholders.
2. Prioritise those stakeholders who matter most.
3. Establish what issues are important to those key stakeholders.
4. Understand how those issues could influence your business.
5. Understand where you presently stand on those issues.
6. Estimate where your stakeholders expect you to be on those key issues and, from this, how your present position compares with this (this shows you how much you need to improve).
7. Understand the level of resources (time, money, experience and authority) you have available.
8. Decide how to use those resources to best effect in achieving improvements on key issues.
9. Implement improvements and monitor progress.
10. Over time, communicate with those key stakeholders about how you are doing on those key issues.
11. Every so often, have someone check that your CSR programme is working as you would expect.

12. Tell people about how your business has improved as a consequence of its CSR programme.

Larger firms should expect to undertake each of these steps; smaller firms may wish to focus on crucial steps such as 3, 7, 8, 9 and 10 above, focusing on one issue each for customers, employees, the environment and communities.

E Ethical scenarios

Each of the following eight scenarios is designed to encourage you to think about the ethical dimension of a particular work situation. They all involve an employee, an employer and a product, but those things are secondary to the primary purpose of each scenario, which is to explore the actions of people and the behaviours they display. It is in those behaviours and actions that the ethical dimension exists.

It is important therefore when considering an ethical scenario, be it in an exam or in revision material like this, to mentally take a step back from the products and services you are familiar with and to focus instead on the people and why they are doing what they are doing. You need to consider the situation from different perspectives (such as those of the client or the employer), not just your own. And you need to think in terms of the values you are looking to be demonstrated, such as honesty and integrity. You might want to ask yourself questions like: ‘Does that course of action increase or decrease trust in the person involved?’ or ‘How would this look on the front page of tomorrow’s paper?’

Work through the scenarios and consider what you think would be the ethically appropriate response to each, based on the information in this chapter. You may find it useful to note down your thoughts and any information that helped in making your decision as you go along.

E1 Scenario 1: Explaining the cover

You work at a bank, in its financial planning division. Some months ago, your manager asked you to branch out into selling critical illness cover. You’ve gone through the various training and compliance hoops needed to sell such cover and are now beginning to notch up some good sales figures. The clients you’ve been targeting have in the main been quite open to such cover and the questions they’ve asked have been pretty straightforward. Today, however, was different when one client you were meeting turned out to have had some medical training before changing career. He started asking questions about how different illnesses were covered and what needed to be disclosed. This put you in a bit of a muddle, especially when you couldn’t find the answers in the key features document.

What would be the ethically appropriate way of proceeding under such circumstances?

a. Tell the client that everything that’s important for them to know about is in the key features documents you’ve given to them.

b. Supplement the key features document with points you can recall from some articles you’ve read in the trade press.

c. Turn the client’s attention to the price, as that’s clearly a big thing for them.

d. Call upon a more experienced sales person for an answer to the client’s questions.

E2 Scenario 2: Some interesting news

You’re a financial adviser at a leading firm of independent financial advisers. You’ve just come out of a meeting with a potential prospect, a local farmer, during which he’s asked you to advise on how best to invest a significant sum of money he’s expecting to receive in the near future. It’ll be good business for your firm, but also good news for the town in which you’re based, which has been buzzing with rumours about the possibility of a big new retail park being developed on the outskirts of town. It doesn’t take much to put two and two together and realise that the big supermarket is on its way after all. It so happens that your brother-in-law works for the local newspaper and, like everyone else in town, has been following this story with interest. He’s sure to give you some good PR in return for a little whisper in his ear about this farmer. However, you have a nagging feeling that somewhere in the myriad of rules you work under, there’s something you should pay attention to. Back at your office, you jot down the four things that come to mind, remembering that it’s sure to be about confidentiality.

Which of the four things you jot down is correct?

a. This is about market sensitivity – as you see it, the information can only be confidential if it's going to affect a share price.

b. This is about market practice – as far as you're concerned, confidentiality is based upon the extent to which firms in the market follow a particular practice.

c. This is about honesty and integrity – you need to consider if this is something that you'd be happy to talk openly about, such as at the family gathering this weekend.

d. This is about the client relationship – as you understand it, confidentiality doesn't apply until the farmer has bought something from you.

E3 Scenario 3: Chasing better returns

You work for a firm of independent financial advisers and are in a meeting with one of your bigger personal clients. It's not going well, with the client clearly unhappy at the returns his portfolio has been achieving. What seems to really upset him is paying out for your fees and losing money at the same time. He complains that the fees are too high and should be reduced. You try and move the conversation away from the fees issue and onto the bigger picture of what influences portfolio returns. He's interested, but remains focused on how he can get back to the returns enjoyed up until recently. He starts talking about economic growth in different parts of the world and articles he read recently about the returns that investments in those countries have produced. These haven't been the sort of funds that the client has been interested in before, so you see an opportunity to move beyond fees and talk about something more upbeat. Before doing so however, you wonder if you're doing things in the right order.

What would be the ethically appropriate way of proceeding under such circumstances?

a. Sort out the situation on fees, as it's something the client will keep returning to.

b. Get out the 'attitude to risk' paperwork and talk the client through it.

c. Show the client some literature for the funds that he's interested in.

d. Talk the client through the amazing piece of software your firm is using to pick the best performing funds.

E4 Scenario 4: Targets and sales

You work in the financial planning arm of a leading high-street bank, based in one of its bigger branches. A couple of months ago, you attended a regional training session, at which you were given details of a new terminal illness product that the bank was going to be promoting. It looked a fairly straightforward product to sell, but with the bank having invested in some heavy advertising, the targets your branch has been set look very high. You can't help but think about what the bank's intranet site has to say about the fair treatment of customers: a target like that doesn't seem to help.

You decide to give it all you've got over several weeks and see how sales go, but in the end the targets still seem to be pretty impossible. Then you hear that another branch in your region has been steaming ahead and meeting its targets without any problems. However, there's also a rumour that they're been doing this by targeting customers who already have the more expensive critical illness cover and selling them this terminal illness cover as a cheaper alternative. You know the two covers are not the same, so something fishy could be going on. Whatever the case, you know your own sales figures will soon start to look pretty pathetic in comparison, with all sorts of repercussions if you don't sort them out. Several options come to mind.

Which would be the ethically appropriate way of proceeding under such circumstances?

a. Put your head down and get on with it as best you can; after all, what can you do if it's just a rumour?

b. Raise your concerns with the bank's compliance department and leave it with them to sort out.

c. Go back to your regional manager and point out that these targets could be putting the firm's fair treatment of customers at risk.

d. Speak to a colleague about these targets and try to work out how to increase sales without creating a 'fair treatment of customers' risk.

E5 Scenario 5: Pension clients

You work at a firm of independent financial advisers, providing clients with advice on pensions. Your firm has recently taken over the business of another firm in a nearby town, following the retirement of its founding partner. The firm you've taken over came with some pension business and you've been asked to take a look at it to make sure that everything is in order. You go through each file, making sure that all the usual things are in place: attitudes to risk have been well documented, personal circumstances carefully established and cost comparisons clearly set out. After several hours work, you're happy that all the business was placed as it should have been. You're ready to get back to work on some new business but before doing so, you check to see if there's anything else that needs attending to on these old files.

What would be the ethically appropriate next step for you to take?

a. Send them some information about you and your firm so they know who to get in touch with should they need anything.

b. Check them for cross-selling opportunities.

c. Target the older cases and arrange to meet with them for a review.

d. Pack up the files and get back to addressing the needs of your own clients.

E6 Scenario 6: A tricky sale

You work for a firm of independent financial advisers. It's a medium-sized firm keen to grow its corporate business and you've been in charge of delivering that growth for the last twelve months.

Today you're having lunch with the finance director of a money-remitting company, a relationship you've been cultivating for quite a while. The lunch seems to be going very well and you're really building up a personal rapport with the FD. The conversation turns to favourite sports and you're left in no doubt about his love of football. He talks at some length about the excitement of an FA Cup Final at Wembley and it's clear from some big hints he drops that if you can get him some tickets, he'll give you the group scheme business you've been hoping for. Having made his point, the FD rounds off the lunch and leaves for another appointment, leaving you mulling over what to do.

You know that the group scheme proposal you've been assembling for the company is very strong, so it seems to boil down to the tickets as to whether or not you win the business. Then you realise that one of the teams in this year's final has its shirts sponsored by an insurer you hadn't been going to use on this proposal, but with whom you have a great relationship.

Could your friend there help you out on the ticket side if you helped them out on the business side? You set off back to your office, trying to work out what the right way forward is. What would be the ethically appropriate way of proceeding under such circumstances?

a. Approach the insurer and do a deal with them around the business and the tickets.

b. Arrange for some tickets to be delivered to the client; after all, they cost far less than what you'll earn from this sale.

c. Report the incident to your firm's compliance officer.

d. Just ignore the FD's hints, put in your proposal anyway and move on to the next prospect.

E7 Scenario 7: A frustrating client

You're a financial adviser at a leading high-street bank. The client you're meeting today is one you've been finding more than a little frustrating. While you've done business with many elderly clients like this, your patience can get stretched when they take so long to make a decision. And this particular client deserves a gold medal for indecisiveness: he just hasn't been able to make a final decision about which product to buy. In previous meetings, you've gone through the key features documents for several products with him, but he always seems to have question after question. You suspect the questions are just a cover for not making a decision, so you've gone to this meeting determined to close this particular piece of business once and for all. The client starts to focus on one particular product and then starts to read the small print. Fearing even more questions, you make a 'throwaway comment' about how popular this product has been, so much so in fact that you've heard it'll soon have to be withdrawn, probably any day now. The ploy works, for the client puts the policy document aside and agrees to sign up for it.

From an ethical point of view, what's the key thing to bear in mind here?

a. It's important for an adviser to make sure that the client has some cover in force. Exactly which cover is secondary, for there are so many standard clauses around these days.

b. It's important for an adviser to make sure the client has understood the key features document; the detail of the policy is for the client to read in their own time.

c. It's important for an adviser to work with clients who can make the best use of the adviser's time.

d. It's important for an adviser to provide clients with the time and information to make informed decisions.

E8 Scenario 8: A busy time

You work for a leading firm of financial advisers. It's mid-December and everyone is focused on their year-end targets. You're no exception and that's why the client you're about to meet is so annoying. A relationship manager in your firm's business finance section has told you to contact this client, and while the product she's seeking is quite straightforward, the medical history you're told she's presenting is far from so. Setting up this policy is sure to be long-winded, time consuming and it's bound to make your targets that bit more difficult to hit. You find it all very frustrating. You know the wider business relationship with your firm is very good, so she's bound to place the business through you anyway. If only you could get her to do it in the new year! You give her a ring with the intention of setting up a meeting, but while exchanging pleasantries, you pick up on her comments about how busy this time of the year is.

From an ethical point of view, what would be the most appropriate next step?

a. Do the client a 'favour' by suggesting she leaves the paperwork for this policy until after the new year. Juggling Christmas and a policy like this would be just too stressful for her.

b. Mention that in your experience, the underwriter is more likely to give her better terms in the new year and suggest meeting up then.

c. Mention the importance of this type of cover in light of her medical history and suggest meeting up shortly to go through the paperwork.

d. Mention that it would be a pity to get all the paperwork together for this policy for it to then end up being delayed in the Christmas post.

E9 Ethical scenarios 1–8: responses

Scenario 1: Explaining the cover
The ethically appropriate way of proceeding under such circumstances would be response **D**. Providing the client with correct information about the circumstances under which benefits would or would not be paid is fundamental to the fair treatment of customers. When you put the client's interest first, the measure of importance is what they want to know, not what is set out in a key features document. The fact that in this case the client was more informed about illnesses than is usual doesn't change that.

Scenario 2: Some interesting news
The ethically appropriate response is **C**. All other responses are examples of an incorrect understanding of client confidentiality. The prospective client has given you this information in confidence and you should treat it as such. It would be unethical to divulge it to a third party, such as your brother-in-law, without the prospective client's prior and informed consent. Using that information for your personal advantage, as you're contemplating, would only make a bad situation worse. The 'local nature' of the unfolding events makes no difference to your obligations to treat such information as confidential.

Scenario 3: Chasing better returns
The ethically appropriate way of proceeding under such circumstances would be response **B**. While the client would like to improve the returns from his portfolio, that's not the same as saying he's willing to accept more risk. The starting point is to establish if his attitude to risk has changed. If it has, he needs to understand the possible consequences of taking a less cautious approach. If it hasn't, he needs to understand the possible consequences for his portfolio. As his adviser, it's your responsibility to explain this to him and in so doing,

provide him with the type of professional support that he should value. Although the client's concern regarding fees needs to be addressed, you should be guided by your professional standards and to deal with the issue of fees ahead of his attitude to risk would not be ethically appropriate.

Scenario 4: Targets and sales
The ethically appropriate way of proceeding under such circumstances would be response **B**. While other responses (such as C and D) have merit, response B is the most important of the four because it is about providing the right people with information that customer detriment could already be happening as a result of how the terminal illness product could be being sold. It is then the firm's responsibility to investigate and if necessary, inform the FCA and implement remedial action. The decision here is between responding to the possibility of an actual and current ethical breach, and responding to minimise the possibility of future ethical breaches. Both are important, but the first of the two is the one to address first.

Scenario 5: Pension clients
The ethically appropriate way of proceeding under such circumstances would be response **C**. Responses B and D put the interests of you and your firm first. While response A does consider the interests of the client, it is a very passive approach, requiring the client to take the initiative. Response C involves taking a proactive approach to putting the best interests of the client first. Your review would have identified that some, perhaps all, of the other firm's clients were in need of a review of their portfolio to ensure that it continued to suit their present circumstances and attitude for risk. Taking the initiative in this way is good for your clients and good for your firm.

Scenario 6: A tricky sale
The ethically appropriate way of proceeding under such circumstances would be response **C**. This is because there are significant legal and regulatory issues at play here. The FD of the money-remitting firm has sought a bribe from you. Responses A and B therefore expose both you and your firm to prosecution under bribery legislation. Response D may seem innocuous, but turning a blind eye in such circumstances could have serious implications for you. Both you and the FD, as well as both of your firms, are regulated by the FCA and their rules require incidents such as these (even if not acted upon) to be reported to them.

Scenario 7: A frustrating client
The ethically appropriate response is **D**. It is the only one in which the client is being treated fairly. It seems that underlying the adviser's frustration with people who take longer to make a decision than the adviser thinks necessary, is a preconception that this is a particular problem of elderly clients. It is however a characteristic of many people across all age bands and this needs to be respected. This adviser is likely to approach all elderly clients with an expectation of frustration and, as a result, the advice being given and the approach to giving it could suffer. While the adviser is finding the client frustrating, it is possible that the client is also finding the adviser frustrating, for example by not being able to explain the products properly. Tricking a client into making a decision is dishonest and could, at best, backfire on this adviser's reputation for trustworthiness, at worst put their job at risk.

Scenario 8: A busy time
The ethically appropriate response is **C**. It is the only one in which the client's interests are clearly being put first. She may worry about the points you raise in scenarios A and D, but what she then does in response is a decision she must make, not her professional adviser. There could be a grain of truth in the timing point raised in response B, but it does not on its own constitute a reason for delaying meeting with her. Response B is clearly not the 'most appropriate next step' from an ethical point of view.

Overview
Now that you have worked through the scenarios and considered the options provided, assess your own responses and think carefully about how you came to those conclusions. Learning how to reflect upon a scenario in this way is important because the exam questions you will ultimately have to answer will not necessarily look the same as these eight scenarios. Ethical dilemmas come in many shapes and sizes, so you need to focus less on their presentation and more on an approach for reflecting upon what is happening in them.

On the Web
You can also find more ethical scenarios in the 'Practical Guide to the PFS Code of Ethics': *www.thepfs.org/media/9224216/pfs_code_of_ethics_practical_guide.pdf*.

Key points

The main ideas covered by this chapter can be summarised as follows:

Ethics in financial services

- Ethics in a business context can be summed up as being about 'the application of ethical values to business decisions'.
- Ethics lies at the heart of financial services legislation. This is because ethics sustains honesty and integrity, which in turn builds trust, which in turn makes markets work more efficiently, which in turn produces better outcomes for all.
- Culture is about 'the habitual behaviours and mindsets that characterise an organisation'. An ethical culture helps build trust and confidence among consumers and, therefore, increases engagement in financial services.
- Many of the difficulties faced by the financial sector have centred on ethical issues, both in retail and wholesale markets, such as:
  - unclear and overly technical documentation;
  - sources of remuneration and the use of inducements;
  - conflicts of interest and the sale of unsuitable products;
  - inadequate handling of complaints; and
  - insufficient attention to financial inclusion.

Ethics in practice

- Firms need to work at a number of different levels in order to embed ethics into how they carry out their business. The ethical framework that this forms can be summarised as follows:
  - commitment – in the form of statements of values and codes of ethics;
  - leadership – the role played by executives and managers;
  - operational – the policies, procedures and toolkits for employees to use; and
  - oversight – the way in which progress is monitored and reviewed.
- Professional bodies, such as the CII and PFS, have their own ethics codes and upholding those ethical obligations is a condition of continued membership. The CII/PFS codes have five core duties, requiring each member to:
  - comply with all relevant laws and regulations;
  - act with the highest ethical standards and integrity;
  - act in the best interests of each client;
  - provide a high standard of service;
  - treat people fairly, regardless of age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion and belief, sex and sexual orientation.
- The operational dimension to embedding ethics into how a business operates covers an array of management tools. These turn the vision and leadership at the top of the firm into something tangible for its people to work with.
- Ethical dilemmas offer a useful way of practising how to handle the more difficult ethical decisions. Ethical dilemmas arise from a tension between two or more sets of values.

Evaluation and outcomes

- A firm's ethical framework is only as good as the outcomes it achieves. This is an ongoing process that needs to be evaluated on a regular basis through management information. While a firm can track the effort it is putting in through measures of input, it is measures of outcome that tell it how effective those inputs have been.
- Management information (MI) about ethics can be built up through a series of steps:
  - identifying the ethic risks to be addressed and/or the ethical objectives to be achieved;

Key points

  - the required inputs and the desired outputs associated with those risks/objectives; and
  - the quantitative and/or qualitative measures that best reflect those inputs/outputs.
- MI should cover both what customers are doing and what employees are doing. Some examples are:
  - levels of employee engagement with ethics related training;
  - survey feedback on how employees feel supported in making ethical decisions;
  - levels of customer complaints; and
  - persistency ratios across different lines of business.

Stakeholders and corporate social responsibility (CSR)

- Customers should be treated fairly, as should other stakeholders such as employees and suppliers. Firms often introduce corporate social responsibility (CSR) programmes to bring together what they are doing in support of each important stakeholder. The main stakeholders are customers, employees, communities and the environment.
- The point of CSR is to improve the firm's performance. It does this by improving how the firm listens and responds to its stakeholders and how it then turns what it learns into better ways of working.

Appendix 1
Abbreviations

AIFMD	Alternative Investment Fund Managers Directive
APER	Statements of Principle and Code of Practice for Approved Persons
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
CASS	Client Assets sourcebook
CMA	Competition and Markets Authority
COBS	Conduct of Business sourcebook
COCON	Code of Conduct
COLL	Collective Investment Schemes sourcebook
CONC	Consumer Credit sourcebook
CRD	Capital Requirements Directive
CRED	Credit Unions sourcebook
DEPP	Decision Procedure and Penalties manual
DISP	Dispute Resolution: Complaints sourcebook
EG	Enforcement Guide
ELM	Electronic Money sourcebook
FEES	Fees manual
FINMAR	Financial Stability and Market Confidence sourcebook
FIT	Fit and Proper Test for Approved Persons sourcebook
FPC	Financial Policy Committee
FS	Feedback Statement
FSAP	Financial Services Action Plan
FSMA	Financial Services & Markets Act 2000
GEN	General Provisions sourcebook
GENPRU	General Prudential sourcebook
ICOBS	Insurance: Conduct of Business sourcebook
IFPRU	Prudential sourcebook for Investment Firms
IDD	Insurance Distribution Directive
INSPRU	Prudential sourcebook for Insurers
IPRU-FSOC	Interim Prudential sourcebook for Friendly Societies
IPRU-INS	Interim Prudential sourcebook for Insurers
IPRU-INV	Interim Prudential sourcebook for Investment Businesses
MCOB	Mortgages: Conduct of Business sourcebook
MCD	Mortgage Credit Directive
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries
MLR	Money Laundering Regulations
MMR	Mortgage Market Review

NCA	National Crime Agency
PERG	Perimeter Guidance manual
PRA	Prudential Regulation Authority
PRC	Prudential Regulation Committee
PRIN	Principles for Businesses sourcebook
REC	Recognised Investment Exchanges and Recognised Clearing Houses sourcebook
SERV	Service Companies – special guide
SM&CR	Senior Managers and Certification Regime
SMR	Senior Managers Regime
SUP	Supervision manual
SYSC	Senior Management Arrangements, Systems and Controls sourcebook
TC	Training and Competence sourcebook

Cases

C

K

S

Legislation

S

T

U

Index

R

S

T

U

V

W