Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: PS18/2: Client money and unbreakable deposits

Lead regulator: FCA

Date of assessment: 4 May 2018

Commencement date: 22 January 2018

Origin: Domestic

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

Which areas of the UK will be affected? FCA-regulated firms that conduct designated investment business in the UK

Brief outline of proposed new or amended regulatory activity

Some investment firms reported increasing difficulty placing client money with banks. Industry feedback suggested this was partly due to the combined effects of liquidity rules for banks and a rule in the Client Assets Sourcebook (**CASS**) preventing firms from placing client money in bank accounts with unbreakable terms longer than 30 days (**30 Day Rule**).

There may be harm to consumers if a firm reaches a point where it is unable to deposit client money at a bank and a reason for this could be because it is burdensome and costly to the banks. This could result in client money being returned to clients rather than invested in line with the clients' instructions, including subscriptions in ISAs, or client money being deposited with banks that do not meet firms' due diligence requirements.

In CP17/29 we responded with proposed changes to the 30-Day Rule designed to ensure consumers continue to be appropriately protected by firms holding their client money. PS18/2 published feedback to CP17/29, our responses and final rules. In summary, we made the following changes:

- allow a firm to deposit an appropriate proportion of client money in client bank accounts with unbreakable terms between 31 and 95 days (**31-95 Day UDs**);
- require a firm that deposits client money in a 31-95 Day UD to comply with certain conditions[1]; and

[1] These conditions are set out on pages 8 and 22 to 24 of PS 18/2.

- require CASS small, medium and large firms[2] to report client money held in a 31-95 Day UD in their client money and asset return (**CMAR**)[3].

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

The changes affect FCA-regulated firms holding client money in relation to designated investment business. At 7 June 2017, 596 firms held client money in connection with designated investment business: 124 CASS small; 443 CASS medium and 29 CASS large.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2018	2018	10	953.0	-110.7	-553.6

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

Costs

We do not expect extending the permitted unbreakable term from 30 to 95 days to cause any cost to firms. Feedback both before and throughout the consultation confirmed that firms would find it easier to place client money in client bank accounts as a result of our proposals.

The conditions attached to allowing a firm to place client money in a 31-95 Day UD[4] and with reporting these in the CMAR may cause some costs. These are estimated as follows:

1. **Client disclosure**. Based on previous cost surveys[5], we estimated median one-off costs of £250 for CASS small and medium firms and £1,500 for CASS large firms during consultation. On this basis, we estimated the rule change would result in a total median one-off cost for industry of approximately £185,250 ((567 x £250) + (29 x £1,500)). We did not receive any evidence to change these estimates in consultation.

2. **Appropriate measures to manage risk of being unable to access client money when required**. We estimated minimal costs during consultation on the basis that firms are required to manage their own liquidity risk[6] and feedback from firms that they already have appropriate management to ensure sufficient liquid client money to meet client instructions. This was unchallenged in consultation.

3. **Written policy document setting out the maximum proportion of client money that would be appropriate for the firm to deposit in a 31-95 UD and the measures it will take to manage the risk of being unable to access client money when required**. Based on previous compliance cost surveys[7], we estimated median one-off costs of £192 for CASS small and medium firms and £240 for CASS

[2] CASS firm types are defined in accordance with CASS 1A.2.7R.
[3] SUP 16.14 requires CASS medium and large firms to report client money and asset holdings in the CMAR each month through Gabriel. CASS small firms are not subject to this requirement.
[4] These conditions are set out on pages 8 and 22 to 24 of PS18/2.
[5] Cost survey figures on disclosure to clients in CP13/5: Review of the client assets regime for investment business.
[6] BIRPU 12
[7] Based on previous compliance cost surveys, we estimated that this will take a compliance officer a maximum of four hours to complete at £48 per hour for CASS small and CASS medium firms (based on existing due diligence and risk management processes) and a maximum of five hours for CASS large firms (given their complexity).

large firms during consultation. On this basis, we estimated the rule change would result in a total median one-off cost for industry of approximately £115,824 ((567 x £192) + (29 x £240)). We also estimated minimal on-going costs, as firms would already be maintaining existing policies around liquidity risk management. We did not receive any evidence to change these estimates following consultation.

4. **Adding written policy document to the CASS resolution pack (CASS RP)[8]**. Based on previous CASS RP cost surveys[9], we estimated median one-off costs of £20 for CASS small firms and £30 for CASS medium and large firms during consultation. On this basis, we estimated the change would result in a total medium one-off industry cost of approximately £16,640 ((124 x £20) + (472 x £30)). We also estimated minimal on-going costs as firms would only need to update the CASS RP when updating the written policy. These estimates were unchallenged in consultation.

5. **Reporting 31-95 UDs in the CMAR**. We expected minimal one-off costs given the relevant firms already complete the CMAR monthly. Based on previous CASS RP cost surveys[10], we estimated on-going costs of £480 for CASS medium and large firms during consultation. On this basis, we estimated the rule change would result in a total on-going cost for industry of approximately £226,560 (472 x £480). These estimates were unchallenged in consultation.

6. **Familiarisation costs.** CP17/29 contained 28 pages of text, 8 of which were legal instrument. We assumed all firms must read and review the document and do a gap analysis of the instrument text. For familiarisation, we assume an average of 6, 4 and 1.5 compliance staff in large, medium and small firms respectively read the document at an estimated reading speed of 3 minutes per page/300 words per minute. For gap analysis we assume that 4, 2, and 1 legal staff in large, medium and small firms respectively review and implement the legal instrument.[11] Using standard FCA cost assumptions and salaries from the Willis Towers UK Financial Services Report including 30% overheads, we therefore estimate one-off costs of £352,000.

Benefits

Ease of placing client money

Pre-consultation feedback confirmed that allowing firms to place client money in a 31-95 Day UD would make depositing client money easier as banks should be more willing to accept client money on these terms. We expect the rule change will reduce the time and cost that firms spend in negotiating their banking arrangements. This time saving was not quantified in the original cost benefit analysis (**CBA**) and we do not attempt to quantify it here.

Interest earned on client money

The main benefit from allowing 31-95 UDs is the higher interest rate on these deposits. Based on pre-consultation feedback from CASS firms and banks, we estimated that CASS firms would be able to earn an interest rate of 25 to 35 basis points on a 31-95 Day UD.

Counterfactual

[8] CASS 10 requires a firm to keep certain documents and records relating to investment business client assets in a CASS RP. This is so they can be retrieved promptly if the firm fails – either as a going concern or a gone concern.
[9] Cost survey figures on CASS RP in CP11/16: Recovery and Resolution Plans. Using these figures, we estimated it would take an employee a maximum of one hour to complete at £20 per hour for CASS small firms and £30 per hour for CASS medium and large firms
[10] Cost survey figures in Annex 1 to CP11/16: Recovery and Resolution Plans.
[11] We assume standard gap analysis time of 4, 3 and 1 7-hour days per 50 pages of legal instrument for large, medium and small firms respectively, giving an estimate of legal staff hours at 18, 7 and 1 for CASS large, medium and small firms respectively for 8 pages.

Based on pre-consultation feedback, we understand that prior to the rule change the available interest rate on a 30-day UD was typically zero. We assume this was because of the cost of liquidity requirements on banks associated with such 30-day money.

We were not able to observe how much money was held in 30-day UDs prior to the rule change. Based on feedback to CP17/29 and individual rule modifications of the 30 Day Rule, in our published CBA in PS18/2 we estimated that firms would be likely to place between 10% and 50% of client money in a 31-95 Day UD. We assumed that all of this money was previously either held in 30-day UDs or otherwise, in either case without earning interest. This means all of the interest earned under the changes is taken to represent a benefit to the firms investing the client money.

We understand that firms rarely place client money in qualifying money market funds (**QMMFs**), the alternative to placing client money in a bank account[12]. For example, prior to the rule change, only 4 firms reported holding client money in a QMMF[13].

<u>Estimation of interest earnings on a 31-95 Day UD prior to rule changes coming into force</u>

Using the assumption of 25-35 basis points interest on between 10% and 50% of all client money held by CASS firms, our CBA estimated the interest earnings to be as follows:

CASS firm type	**No. of firms** [14]	**Average client money (£)**[15]	**Estimated interest per firm (£)**[16]	**Estimated interest for industry (£)**[17]
small	124	300,000	75 - 525	9,300 – 65,100
medium	443	72,000,000	18,000 – 126,000	7,974,000 – 55,818,000
large	29	3,000,000,000	750,000 – 5,250,000	21,750,000 – 152,250,000
Total	596	199,552,000	768,075 – 5,376,525	29,733,300 – 208,133,100

For the BIT score, we have taken a midpoint of the total range of benefits of £118,953,000.

<u>Indicative data on the actual use of UDs after the rule change show these estimates to be reasonable</u>

Our published CBA set out our best *ex ante* estimate of how far the firms affected would hold client money in 31-95 day UDs. The rule change came into effect on 22 January, and we now have some indicative data from actual use after that date, indicative data which show that the *ex ante* estimates reported above are a reasonable basis for this Impact Assessment.

Since the new rules came into force, 17 CASS medium and large firms have reported holding client money in a 31-95 Day UD[18]. This includes firms that held client money in such deposits prior to the rule change under a rule modification allowed on a case by case basis.

---

[12] Firms are only permitted to deposit client money in an account opened with an authorised bank, a central bank or in a qualifying money market fund (CASS 7.13.3R).
[13] This is based on the client money holdings reported by firms completing the CMAR for the December 2017 reporting period. We do not require CASS small firms to submit a CMAR so we do not know how many (if any) CASS small firms place client money in QMMFs.
[14] Figures as at 7 June 2017 of firms holding client money.
[15] Average client money holdings as at 7 June 2017 of firms holding client money
[16] This range reflects a firm depositing between 10% of client money in a UD earning interest on 25 basis points (0.25% x (10% of client money holdings)) and 50% of its client money in a UD earning interest on 35 basis points (0.35% x (50% of client money holdings)).
[17] Number of firms x estimated interest earnings per firm.

The proportion of client money held by the 17 firms in 31-95 Day UDs was £51,167,000 of £122,384,000, or approximately 42%[19]. This 42 per cent exceeds the 30 per cent ex ante estimate we made, and would suggest the benefits of the rule change are greater than we had estimated in advance. However, we recognise that the 17 firms may not be representative of all CASS firms, and that this initial response may not represent the final picture. Nevertheless, we consider that this further evidence on actual use validates the estimate we had made in the published CBA and have used again in this Impact Assessment.

Pass through to consumers

In our CBA in CP17/29, we estimated that a proportion of the interest earnings (assumed to be 10%) would be passed on to consumers[20]. This effect would be considered indirect under the Enterprise Act, and is therefore not accounted for here.

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

Link to the Policy Statement, https://www.fca.org.uk/publications/policy-statements/ps18-2-client-money-unbreakable-deposits

[18] This is based on the client money holdings reported by firms completing the CMAR from January to March 2018. We do not know if any CASS small firms have deposited client money in 31-95 Day UD as they are not subject to the CMAR requirement.
[19] (51,167,000 / 122,384,000) x 100
[20] A firm must notify clients in writing if it does not pay them all the interest on the client money (CASS 7.11.32R to CASS 7.11.33G).