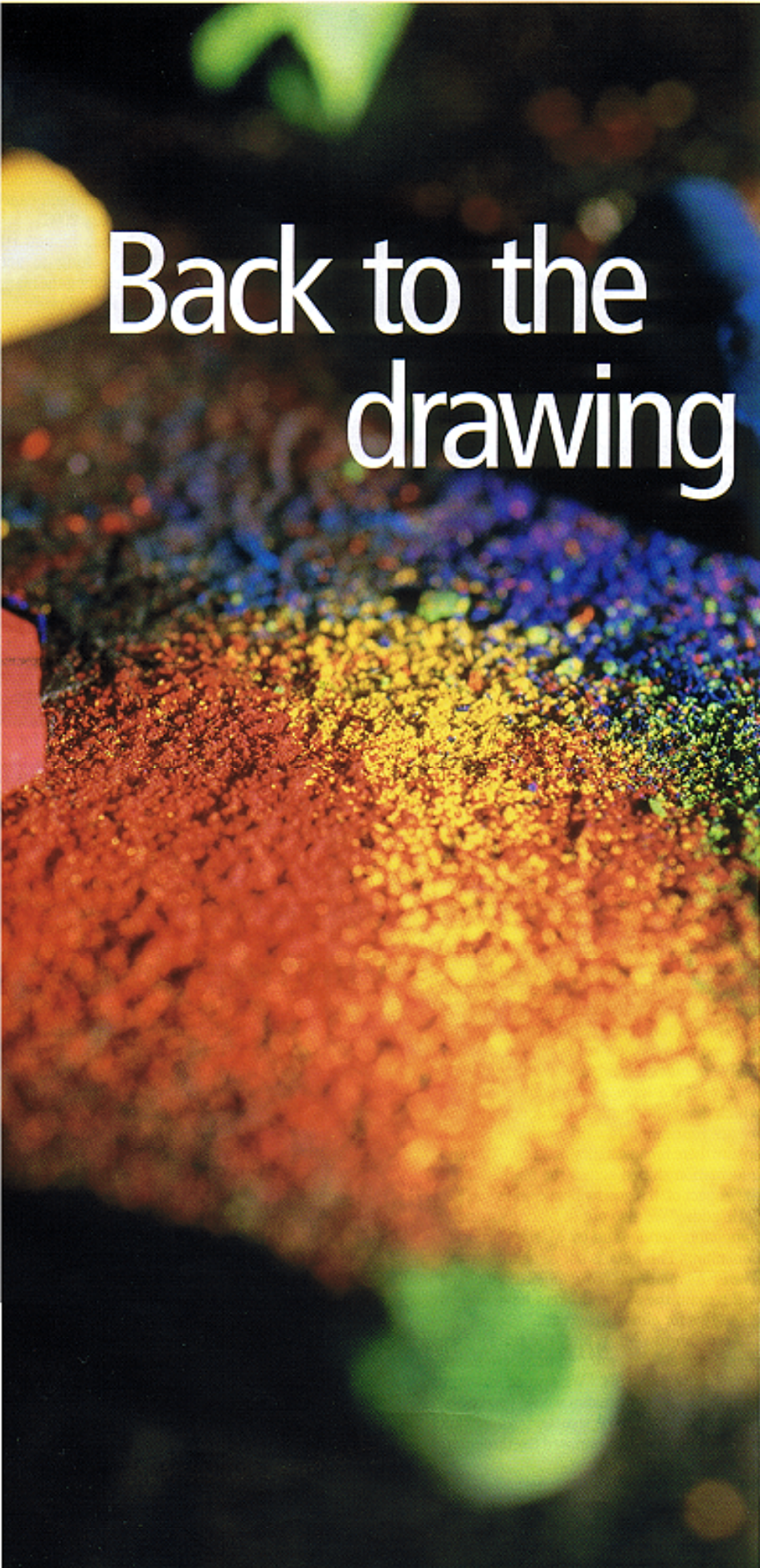




Back to the drawing board?

The FSA's purge on goodwill held as an asset means brokers need to draw a line through it on balance sheets, but as Ana Paula Nacif discovers, not everyone thinks the industry should simply chalk this up to experience.

INTERNATIONAL accounting standards adopted in 2004 allow listed companies to carry goodwill forward at full value on their balance sheet, but for general insurance brokers it is a different story. Come 14 January 2008, if they do not have enough tangible assets, brokers may need to embark on a clever piece of financial engineering or recapitalise to remain compliant in the eyes of the regulator.

When the current transitional arrangement expires, firms will be required to make a deduction from capital resources for the full balance sheet value of any goodwill held as an asset. That means brokers will not be able to secure debt against goodwill, which will restrict their ability to go through management buy-outs or to acquire other brokers without liquid assets.

The Financial Services Authority has admitted that about 600 brokers are likely to be affected. And some experts have labelled the rule 'absurd' and 'ill conceived', arguing that it is likely to squeeze smaller players out of the market to the benefit of established broker consolidators and acquisitive insurers.

The bottom line

Others believe the FSA is right in asking brokers to ensure their balance sheet shows enough tangible assets to guarantee the health of their business, as this means there is no risk of clients being left in the cold if intermediaries go out of business.

Despite the controversy, the FSA is showing no signs it will back down on its decision. And, with nine months to go, brokers with goodwill on their balance sheets need to get their act together quickly if they are to survive the new rule.

According to KPMG partner Tony Hulse, the simplest option for brokers is to recapitalise. "Brokers can also join together with a firm that has got the surplus capital. There is a lot of demand for business and brokers should not torture themselves trying to create capital when it is available in the market place. If they cannot go down that route they will have to eliminate goodwill from the balance sheet by considering some sort of financial restructuring."

The degree of financial engineering >20

necessary will depend on the size and nature of the business in question. But the basic principle is to set up a holding company, so that the goodwill is held by the new company rather than by the regulated firm. Mr Hulse says this is "just a paper exercise" but warns brokers to be wary.

He explains: "The financial engineering process needs to satisfy a lot of conditions and it is relatively complex, so brokers need to approach it with caution. Indeed, it may not be practical as the resources needed may not be present in the first place. But people should be very clear and not let advisers over complicate the situation."

Tony Cornell, proprietor of Cornell Consulting and former CGU head of broker relations, is not convinced that setting up a holding company will be a lifeline for many brokers, predicting instead that they will eventually end up closing down or selling up. "They would have to change the structure of their business and this would involve accountants, solicitors and paying extra tax — all of which would cost them money to produce exactly the same figure but in a more acceptable format."

Setting up a holding company is no panacea and Olly Loughton Scott, managing partner of corporate advisory firm IMAS, advises brokers to discuss the issue first with the FSA. "It is a grey area," he explains. "While, technically, the FSA regulates the trading company, clearly it also has an interest in the owners. We understand it may be looking at levels of debt in the whole business."

Even if financial engineering proves to be the solution for some brokers, the fact that the figures will just be shifted around has led some to believe that this paper exercise is futile both from the regulator's point of view and the client's.

Papering over the cracks

Grant Ellis, chief executive of the Broker Network, says: "It seems somewhat illogical that there are a couple of procedures a business can follow, one of which relates to having a holding company that allows no real change in circumstance but makes the regulated entity compliant. And the FSA also reserves the right to bring the whole company into calculation should it choose to. That means there is not certainty."

"Everybody accepts goodwill — accountants, banks, lenders," adds Mr Cornell. "Everybody except the regulator. That's the absurdity of this rule, and it was also brought in at a time when virtually every insurance company agrees to risk transfer."

Kieran Marsh, chief executive of Marsh Corporate Consulting, agrees, arguing that it is difficult to comprehend why the FSA is disallowing goodwill when international accounting standards say firms no longer have to write it off. "Goodwill can be reviewed on an impairment basis and can be carried forward at full value in the balance sheet. All listed companies from 1 April 2004 have adopted the new standards, including the FSA."

As for the argument that the new rule will protect clients, Mr Marsh replies: "Since 2005, up to 70% of brokers are operating solely under risk transfer arrangements, which gives their clients 100% protection in the event of a meltdown situation. Additionally,

operating under client money rules, the trust status of both statutory and non-statutory trust accounts, if operated correctly, give the client similar gold-plated protection."

On the other hand, Andrew Paddick, director general of the Institute of Insurance Brokers, argues that "acquired goodwill has never been an allowable asset on insurance broker balance sheets under any previous statutory regulatory regime, for example the Insurance Brokers Registration Council and, I believe, the non-statutory General Insurance Standards Council".

He goes further to explain that: "as there was a regulatory void between repeal of the *Insurance Brokers (Registration) Act* and the FSA's 'GI day', some brokers took advantage of the fact there were no accounting requirements during this period and put acquired goodwill on their balance sheets in order to offset loans. Some even created goodwill to conceal an otherwise insolvent business, such as where there had been a misapplication or fraudulent conversion of risk transfer funds held on behalf of insurers, which is still not revealed or properly accounted for under the FSA rules."

Because the FSA is standing by its decision, Mr Cornell suggests that trade bodies should lobby the government to reverse the regulator's intentions. "Trade associations should be more vocal; that's what they are there for," he emphasises. "It is a real problem and the next stage of this campaign should be going to the government and MPs to lobby for the rule to be changed."

Mr Paddick says he would support a full, and urgent, review of the relevant rules with a view to relaxation in accordance with generally accepted accounting principles, "so long as the regulated community's exposures to Financial Services Compensation Scheme levies are not adversely affected, which would mean *inter alia* properly accounting for risk transfer monies held".

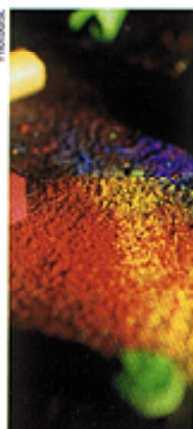
But the British Insurance Brokers' Association has no plans to pick up this fight. According to Steve White, Biba's regulation and compliance manager, the association has done everything it can to help brokers get up to speed with the new rules.

"We published guidance to all members," he says. "We have a compliance manual, which has information on goodwill, and we are continuing to work with the FSA to ensure there is consistency of knowledge and information shared across the market about the impact of the goodwill rule on firms."

He adds: "We also put in place a financial compliance service run by Marsh Corporate Consulting. This issue is not going to go away. The FSA's mind will not change and the date will remain the same. Brokers have known about this for almost five years."

According to Mr White, the transitional period was actually granted thanks to Biba's lobbying of the FSA. "We argued strongly with the FSA that brokers would need more time for goodwill to be removed. As a result of our lobbying, they imposed the three-year transitional period."

Others agree that brokers have had enough warning of these changes. Mark McIlquham, director in the financial services team at Deloitte, says the FSA has been consistently warning brokers that goodwill would become



inadmissible from next January, "as well as recently focusing on the quality of other assets on brokers' balance sheets, such as 'permanent' inter-company balances and unallocated cash held within debtors".

But he also warns that smaller independent brokers, who may not have previously thought about this issue, should do so to avoid having to negotiate and pay for expensive subordinated loans to maintain their compliance with the FSA's rule post-January 2008.

For some, however, the new rule is good news and those looking to acquire new business will be watching the marketplace. If the new rule does indeed prove to be a boost to consolidation, it remains to be seen how those looking to sell will choose to dispose of their operations.

"It will be interesting to see how the regulations affecting goodwill will be addressed by the intermediaries in the coming months," says Kenny Maciver, group acquisitions director at Towergate. "Those who do not wish to pay in or raise additional capital will look to divest, which increases the opportunity for insurers and consolidators. Prospective vendors will need to ask themselves who they want to turn to and there are inevitably pros and cons."

A stepping stone

He adds: "Overall, consolidators present a helpful step down the road to regulatory and operational security. Insurers may provide capital security but, historically, insurers have shown mixed appetite for distribution management and may have difficulties in retaining agencies with competing insurers."

The FSA, which has already sent 600 letters to businesses likely to be affected by the rule change, is advising firms to seek professional advice if they have a problem. "We are aware of a number of firms who have received professional advice to restructure their balance sheets to resolve the issue, including — where necessary — changes to, or the creation of, group structures," explains an FSA spokeswoman. "Senior management of the firm is responsible for ensuring that the firm has adequate financial resources."

The regulator says it will work with a firm inviting it to submit proposals to resolve the deficit, but the bottom line is that those who do not or cannot comply will lose their authorisation. "If a firm is unable to remedy the deficit, the FSA will cancel the firm's Part IV Permission," adds the spokeswoman.

Whatever road brokers with goodwill on their balance sheet decide to take, some believe the new rule will damage the dynamics of the present market. "It will stifle growth of brokers and new people coming into the market," Mr Cornell points out. "This is bad for the sector as it will stifle innovation and entrepreneurship that young people building their businesses bring to the industry."

And over the next few months, market behaviour may well reveal who are the winners and losers under the goodwill rule. "If you go back to pre-regulation when people could do what the heck they liked, you could count broker failures on the fingers of one hand," concludes Mr Ellis. "This was not a big problem and it has never been. We need to wait and see what happens after this rule, which is frankly ill-conceived."

POST