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Financial Strength in Adviser Due Diligence

This Good Practice Guide is part of a planned series of guides that are being developed for members in collaboration with experts in their field and the Financial Conduct Authority.

Foreword

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Due diligence has become a hot topic in recent years.

This is in itself interesting and there is a range of contributing factors to the rise in prominence of due diligence, such as:

- Growing risk awareness and a risk culture across the market and amongst advisory businesses, provider operations and others such as outsourced administration, investment services and other functions
- Regulatory focus on such processes and their key and logical part in laying the foundations for positive customer outcomes
- Growing professionalism within advisory businesses, with the effects of RDR and the wider professional development of the sector
- Greater availability of component due diligence resources
- A natural extension of 'best advice' selection activities to other entities operating within a value chain, for more logical consistency.

In February 2015 we published our first Good Practice Guide in association with specialist due diligence consultancy Diminimis, on the subject of "Adviser research & due diligence on discretionary investment managers". This was an excellent articulation of both the issues around and requirement for due diligence and in laying out a best practice approach to due diligence in this outsourced investment sector. Albeit much of this approach is also applicable and valuable when giving consideration of other entities right across the provider landscape.

In this paper on "Financial Strength in Adviser Due Diligence" we have worked with experts AKG to drill down into one of the core ingredients of this due diligence and explain it in its applicability more widely for consideration across the broader provider landscape.

It will consider Financial Strength as a key consideration for selection and review, forming as it does a central pillar of due diligence. In this we should note at outset that it does not however equate to due diligence in its totality. Other aspects are also of key consideration.

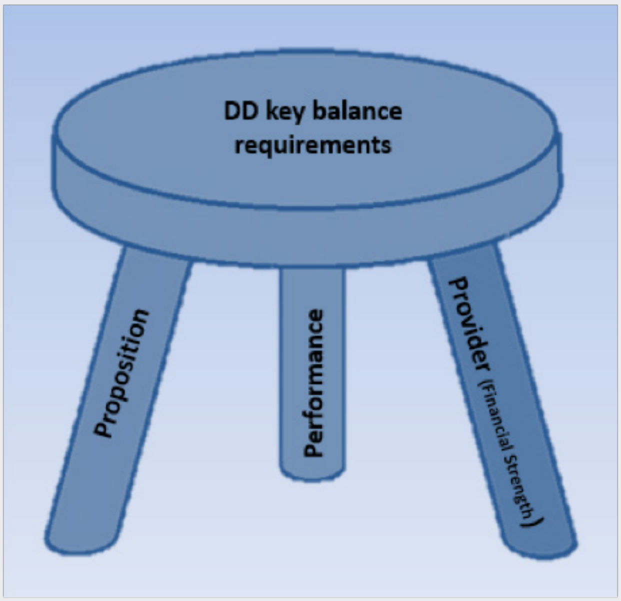
I hope you find this guide valuable in affirming or refining your own due diligence process; do take advantage of AKG's further free reports for PFS members.

Introduction

Financial strength supporting a balanced due diligence approach – Abstract I

Due diligence for most financial services sectors, when researching companies active in those sectors, comprises three keys aspects. Each one of these then contains a number of sub-factors and hence the diagram below is therefore a simplification of due diligence components, but it is a useful one.

So in delivering a 'balanced' research/selection viewpoint it can be considered as akin to a three legged stool, supporting a firm process and basis for decision.



Due diligence: balance

Financial strength represents a key facet of this broader due diligence approach. And often it is either a hygiene factor considered at outset or an initial hurdle, after the application of which (giving a viable population who have met a considered threshold and/or particular ingredient financial strength criteria considerations) further sensitivity in terms of other aspects can then be approached.

These 'other aspects' can be grouped together as:

- Performance/Rate
- Proposition (including service)/Features

Each of these will include numerous sub factors and potential measures and it is not the intention of this guide to discuss these comprehensively.
However in terms of flavour:

Performance/Rate – will include different measures for different entity types operating in different sectors. For example in the outsourced investment management arena DFMs will be assessed on external third party investment metrics such as the Private Client Indices produced by Asset Risk Consultants (ARC). In other areas of the market, such as protection, the competitiveness of rates to meet consumer requirements at an appropriate cost will be a factor.

Proposition – will similarly include numerous different measures for different entity types operating in different sectors. These are perhaps even wider than the performance/rate 'leg' as proposition will encompass aspects and measures for service and administration capability, features (product features, tax wrappers) charges and governance. Information on these areas being available from the assessed company itself (to varying degrees and often very varying!) and from third party specialists such as product research company Defaqto and others.

The financial strength component – a fundamental requirement

The broad regulatory focus of the FCA, within a mandate of consumer protection, is to rightly focus on positive customer outcomes. In many ways this is what good adviser practice within a foundation of initial and ongoing due diligence, or best advice selection to describe it another way, also seeks to achieve in how it concludes which providers and products/propositions/services will best serve clients' needs.

Thus we believe that a financial strength assessment as part of the due diligence process should have the following objective definition:

… to go beyond purely a consideration of solvency (albeit this will always be an important part of the mix) and consider in what format an organisation may be able to survive to meet the fair expectations of customers and their advisers. Expectations, which must include the experience encountered by these two groups, will therefore include ongoing operational abilities and performance.

In the past it has been a popular misconception to believe that financial strength is just about solvency and recovery of client assets. Clearly, as stated in this definition, these will be important factors, but to restrict financial strength consideration to that is to miss the point and underplay what client outcomes encompass.

Recovery of assets, for example in the event of platform failure, would follow but at what cost in terms of administrative expense and resource/time for the adviser and the potentially distressing service experience, delay, potential tax implications and uncertainty for the client. Consideration to avoid this has to be both good customer orientated practice and in fact similarly good business practice.

Assessment of financial strength, having been established as a relatively primary consideration can take a number of forms. Provider companies may be able to create individual resources to illustrate key metrics on the financial and related operational aspects of their business, delivering these via additional articulation in statutory documents such as Annual Report & Accounts and Pillar III disclosures, which can be useful to anyone considering financial strength.

They may also commission independent assessments of their business as a one off exercise, again making financial strength information, together with expert assessment and commentary available for consideration by advisers.

However, perhaps the most accessible and easily understood representation of financial strength comes through the application of a rating assessment.

As whilst the objective of financial strength assessment is relatively common sense based, as described above, the complexities and idiosyncrasies of companies lead to a requirement for assessments to be delivered in a comparable and digestible format. It will not be sufficient for an adviser to say that they have downloaded three years of a company's Report & Accounts, if when asked, the adviser cannot articulate how these compared to each other, a market peer group and associated thresholds.

The process of a company assessment that leads to a financial strength rating being attributed is therefore designed to deliver this aspect. However, it then remains important for an adviser to understand what the rating means and how it can be used. This is explored further overleaf.

Financial strength ratings explained

Ideally financial strength ratings and assessment for use in adviser due diligence and partner selection activity should be based on the perspective of clients and their advisers. Essentially they should be specifically designed for application by those selecting product providers for the delivery of products/propositions to meet the need of advised clients and their requirement for the assessment of financial strength to fit with this activity.

This is further manifest in the key definition of financial strength (for both ratings and assessment) previously provided. Namely, that the objective is to go beyond purely a consideration of solvency (albeit this will always be an important part of the mix) and consider in what format an organisation may be able to survive to meet the fair expectations of customers and their advisers. Expectations, which must include the experience encountered by these two groups, will therefore include ongoing operational abilities and performance.

This is often summarised as three key underlying questions relevant to an adviser and their clients:

- Will a company survive?
- If so, in what form?
- Are client expectations likely to be met?

Ratings sectors

The aim of financial strength ratings then is to assist advisers and others in the assessment of the relative strengths of individual provider and platform companies.

Companies and other entities are assessed and rated within specific peer groups or sectors. Such peer groups are fundamentally designed to reflect how customers and their advisers consider companies for use.

Companies appearing in more than one rating sector – Abstract II

As a result of the underlying focus on how customers and their advisers use companies, together with the fact that companies (individual corporate entities) can establish activity in different areas, it is possible that some companies may need to be assessed in more than one sector.

Thus the same individual corporate entity may be rated in one particular sector context or peer group and then again in another.

This approach delivers ratings on a sector by sector basis, which is more reflective of customer and adviser focused comparison requirements.

Care should be taken by users in considering the appropriate sector and therefore rating when this occurs. For example a single company might be used as a platform operator, but also itself act as the provider of a SIPP product wrapper. When considering that company in the delivery of the platform, then the rating within the Platform Operators rating sector should be used. However, when considering that same company for use in the delivery of the SIPP product wrapper (i.e. for accepting this business as a product provider), then the rating attributed to this company within the Life Companies, Friendly Societies & Similar Providers sector should be used.

Financial strength ratings for the life companies, friendly societies & similar providers sector and the offshore life company sector

In these sectors the concept of 'financial strength' starts with the fundamental issue of a company's ability to meet all of its guaranteed payments to policyholders, but extends beyond this by aiming to factor in the degree to which a policyholder's expectations are likely to be met – or even exceeded – in the long-term. For performance-related products, where the eventual return generally depends largely upon a company's success in consistently delivering superior investment performance, and in containing expense charges, a company's ability to meet expectations is likely to be heavily dependent upon whether or not it is able to sustain its operations in the relevant market, and whether or not it can maintain, or improve, its competitive position.

As a result, ideally, the evaluation of 'financial strength' should depend upon the type of product under consideration. A particular company may be judged as very strong in the context of one particular product line, but it may be weaker in another context. An illustration of this concept is a life company that currently only markets unit linked business, but which has a very small closed block of with profits business, written many years ago. Such a company may be judged as 'good' for unit linked business, whilst considered 'poor' in respect of with profits business.

Overall financial strength rating

The objective should be to provide a simple broad-brush indication of the general financial strength of a company. In addition to an assessment of the company's ability to meet all of its guaranteed payments to policyholders, the degree to which policyholders' expectations are likely to be met – or even exceeded – in the long term should be factored in. This involves an assessment of a company's ability to survive in its current form for the long term. The overall rating inherently reflects the mix of business in-force within the company, since different types of policyholder have different expectations, and the company's particular strengths and weaknesses in respect of its key product areas.

The rating takes into account those of the following criteria which are relevant (depending upon the company's mix of business in-force):

- capital base and free asset position
- with profits realistic balance sheet position
- structure (and size) of funds within the company
- parental strength (and likely attitude towards supporting the company)
- typical fund performance achievements, and
- image and strategy.

Rating sub sectors – Abstract III

Example – Holloway Friendly Societies

It is important to understand that whilst providers may in some instances (for example for some product lines or potential product lines) compete in a wider market and therefore need to be assessed on consistent basis within this wider market, there will be instances when they also fall within a more limited or narrower peer group.

Where this occurs it is important that rating users consider relativity within this sub-peer group as well as understanding the fact that lower levels of financial strength rating are perhaps a characteristic of all participants within that sub peer group.

An example of this is provided within the broader peer group of Life Companies, Friendly Societies and Similar entities, where a number of Holloway style friendly societies provide Holloway savings plans. These are not available from other providers, due to their nature and permissions. But all active societies in this market are relatively modest in financial strength terms.

Thus what shouldn't be the case is that all are dismissed from a financial strength perspective. Whilst modest ratings will inform understanding of their position, should client requirements dictate that the particular benefits of a Holloway style plan be required, then imposing a financial strength rating threshold that ruled out all active players would be counter-productive. Rather, whilst noting that an element of greater absolute financial strength might be given up, the relative strength within the sub-peer group should be considered. And hence still considering and understanding financial strength within a due diligence approach, but not derailing reasonable customer requirement and advice breadth.

Example – SIPP operators

Similarly the non-insured SIPP sector can sometimes require consideration aside from the broader pension market. Whilst in some exercises, for example income drawdown availability and terms, due diligence must consider these SIPP operators amongst the wider peer group of life companies and friendly societies operating in the pensions space, at other times consideration of their specific facets, for example commercial property purchase, will lead to them being reviewed as a separate sub-peer group. As per the above example this latter approach may be quite correct, so long as the relative strength position to the wider peer group is understood and the requirement for the sub-peer group can be articulated as part of the due diligence/selection process. Very often non- insured SIPP providers are smaller and relatively weaker than many of the very differently constituted life companies and friendly societies operating in the UK and in the same overall rating peer group.

Financial strength ratings for the platform operator sector

In the UK, financial advisers are also required to consider the financial strength of organisations such as platform operators that they might use within their business to deliver a service to clients.

Defining the extent and boundaries of the platform market or what organisations can be deemed to be platform operators can be difficult and regulatory bodies acknowledge that activities differ among platform models and that the core function of a platform service may evolve over time.

Following various policy statements the FSA (now FCA) introduced a definition of a 'platform service' as a service which:

- involves arranging and safeguarding and administering assets: and
- distributes retail investment products which are offered to retail clients by more than one product provider; but is neither:
- solely paid for by adviser charges; nor
- ancillary to the activity of managing investments for the retail client.

Platform financial strength rating

The objective should be to provide a simple broad-brush indication of the financial strength of a Platform Operator company. Platform operations are assessed in relative terms within a specific peer group of such entities. A company's ability to survive in its current form or an improved form for the long term in order to deliver on a user's reasonable expectations of experience will include expectations of service delivery and continued maintenance of appropriate infrastructure to deliver this service.

In consideration of the platform sector it is important to fully understand that the financial strength of a platform operator does not extend to that of any wrappers used in conjunction with or on it. See below abstract.

Platforms vs wrappers in financial strength – Abstract IV

Platforms are coming of age with increasing volumes of client assets being invested and managed via their use. Financial strength is a critical hygiene factor in the selection of a platform both from a client perspective and a business risk perspective for an adviser firm. Similarly, financial strength is a key selection requirement for any provider of a product wrapper utilised within a platform environment. However, whilst similarly important they are separate.

A platform will be rated or assessed relative to other platforms on the basis of its financial strength, according to a balanced scorecard of criteria. This information allows advisers to select an appropriate platform(s) for use in the client advice process and ongoing management.

Where a wrapper is then used, the financial strength of the provider of that wrapper needs to be considered. This provider will be rated or assessed relative to other such providers. Again using an appropriate balanced scorecard of criteria.

This is necessarily a two stage process. It is a two stage process where platform and wrapper providers are distinctly separate organisations. But it also a two stage process where both platform entity and wrapper provider sit within the same group and/or make use of the same brand.

This is a matter of assigning appropriate assessment to the different providers involved, where financial strength is a consideration. In the case of business placed within a wrapper on a platform, this being both the platform providing entity (which could fail or be impaired) and the wrapper providing entity (which could fail or be impaired). This can be a complex area as in some cases the same entity will provide both the platform and one or more wrappers. However the key here is still to use a two stage approach, given that different financial strength considerations may be relevant in different sectors. See Abstract II of this guide.

Data sources

Alongside regular interaction with assessed/rated companies (including liaison with companies' senior management teams where possible), a number of core statutory information resources are used within the rating and assessment process for the consideration of financial strength. Simply listed these include:

- Report & Accounts (and offshore equivalents)
- Returns to the PRA (for UK life companies and some friendly societies)
- Pillar III disclosures
- Press releases and market presentations/results announcements

A balanced scorecard approach to ratings: criteria and metrics

The following listing outlines some of the primary elements (criteria) which could be considered within an assessment process, where relevant.

Strategic appraisal

- Objectives
- Distribution focus
- Process
- Competitive position
- Company structure and its fit with strategy
- Performance against stated strategy – current and past
- Risks and risk controls – strategic, market and business risks

Financial appraisal

- Company structure
- Capital structure
- Use of capital/capital availability
- Solvency levels
- Expenses
- Business mix
- Margins
- Risk tolerance
- Risks and risk controls

Operational appraisal

- Company structure
- Management
- Servicing/administration
- Management of/coordination with independent companies e.g. outsourcing
- Customer focus
- Risk control – operational risks, including business continuity

Analysis of the group and other entities

- Group/ownership structure
- Where and how does the company fit in?
- Why? Is it core?
- Financial Support – past, present and in the future
- Capital availability to company

Relevant other entities – 'Collaborative', e.g.

- Technology providers
- Servicing/administration providers
- Counterparties
- Process
- Distributors

Key specific data items

A number of specific data items are considered for financial strength analysis within the wider criteria set. Examples of these data items are shown below. These include quantitative financial measures/data and qualitative (non-financial) elements, which are assessed within the rating process. These may be assessed at a brand, group or company level or at each of these levels.

Financial

- Capital resources
- CRR coverage ratio
- AuA
- Market share of AuA (%)
- Cash/liquid resources
- Current ratio
- Gearing
- Net assets/shareholders' funds/members' other interests
- Operating margin
- Pre-tax profit margin
- Expense ratio
- Cash generated

Non-financial

- Parental attitude
- Gp management (experience, skill, track record)
- Co management (experience, skill, track record)
- Distribution image
- Future strategy
- Clarity of strategy
- Delivery alignment to strategy
- Brand awareness and resilience
- Regulatory fines
- Management reputation and image
- BCP
- Service philosophy and achievement
- Service charter – clarity and scope
- Service performance (external)
- Service performance (internal)
- Market conditions

The position of parents, what entity is rated and why – Abstract V

The position of parents in financial strength analysis and rating is an interesting one and one which is often discussed with rated companies.

Parental strength is a very important criterion in financial assessment and rating. It includes, as might be expected, the capital resources of any parent entity or group (inclusive then of relevant sibling companies etc.) but in fact isn't just about the existence of capital. Rather it is a three track consideration, with these being:

1. capital (relevant capital held within the parent and sibling entities and its accessibility)

2. understanding (how well does a parent understand the business and market environment of any subsidiary?)

3. attitude (what can be discerned as to the attitude the parent has towards its subsidiary, most particularly in terms of likely support either in the short term or long term amidst changed circumstances?).

It's this latter area which is perhaps most interesting.

The spectrum here is significant. Many subsidiaries will rightly point to the supportive nature of their parent, perhaps evidenced by capital injections, resource allocation, and brand convergence amongst other things.

A committed parent is, in simple terms, seen as a good thing. Even more so if the parent is itself strong. The advantages this can bring to a subsidiary, either in its early years, or indeed for a mature business within a supportive environment, are significant.

However, there is also the flip side of the parental presence. Some parent institutions do not want to support subsidiaries and can be distinctly negative in their attitudes towards them.

As you might expect this can be particularly concerning from a financial strength perspective.

A recent extract from a parental group report and accounts provides an unusual but pertinent example in this respect. It illustrates where the factor of parental attitude can be a drag from a rating perspective. It also illustrates in some ways the different perspective of financial strength assessment, from the policyholder or customer (and adviser) perspective rather than that directed towards a shareholder or debt investor audience. The extract reads as follows:

"Although there is some uncertainty over the ability of the non-life insurance company, ….., to pay all its future liabilities, and consequently a possibility that the company may become insolvent, the directors believe that there would be no material disadvantage to the Group in that event. The Group is under no obligation to contribute further capital and does not intend to do so." Anonymised 2013 R&A extract.

Notwithstanding the fact that a different view might be taken in respect of a life company subsidiary to that of a non-life one, the attitude expressed here has implications for other companies in this particular group and sits in stark contrast to what might reasonably be sought from a policyholder or customer perspective, in contributing parentally to the financial strength of an assessed subsidiary.

Without doubt, in financial strength analysis, the parent is a key component, either positively or negatively.

In the example provided, albeit an extreme one, the strength of the parent is in fact being protected at the expense of the subsidiary. And so to take the former as a proxy for the latter could be very misleading. Care is always required in this respect, particularly when providers seek to establish the financial strength of an operating subsidiary by simply pointing to that of a parent or group. It cannot be overstated that this strength is an important factor but it is in no way the same as or a replacement for consideration of the operational company with which the client and adviser is contracting.

Private equity ownership – Abstract VI

One area of interesting debate in recent years has been around the financial strength impact of the ownership by private equity of many financial services providers, particularly where those operate in the provision of long term products.

Concern has particularly been expressed by advisers and the research functions of advisory businesses and rightly so.

There is a natural question of where a business is headed when in the ownership of private equity, which typically has the inherent purpose of later disposal for value realisation.

As a result of this very reasonable concern, financial strength analysis will, as much as possible, try to ascertain the different ‘disposal styles’ and intentions of any private equity owners. But assessment will also be guided by a key two stage question.

1. Is any potential sale likely to be made against the backdrop of a positive position for the private equity owner/fund? E.g. is there any distress and need for funds at this level or is there ongoing strength and liquidity etc?

2. Is any potential sale likely to be made against the backdrop of a positive position for the owned entity in question? E.g. is there any distress or difficulty being experienced by the company itself or is doing well in terms of business performance and potential with an attractiveness to potential market purchasers that would be of benefit to it?

Thus private equity ownership does not equal a bad parent or signify an area of weakness. Rather it necessitates other/different questions, and further scrutiny in the assessment process. And in many instances may be a suitable and positive ownership position for many companies in the short or medium term. Like many aspects it is about understanding the position rather than viewing as an absolute, black or white, perspective.

Key considerations for advisers when engaging with financial strength ratings

- Financial Strength Ratings are a key component of adviser due diligence and good practice suggests that they should be included by advisers in clear processes alongside other considerations such as proposition comparison and where relevant aspects like performance
- Ratings users should think about the peer group or in some instances sub-peer group of providers they are considering, reflecting on client requirements and potential outcomes
- Users should not make the mistake of simply taking a higher level (parent rating) as a pure proxy for a financial strength rating on the actual (subsidiary) company with which the business is being placed. It is an important factor but it is not the same thing
- When considering platform related solutions advisers should consider whether they need to be using an assessment of the platform operator itself and/or the provider of the relevant product wrapper where business is being placed (which may or not be the platform operator). Furthermore that they consider the relevant peer sector for the company under consideration
- In order to gain a deeper understanding of the companies with which they are planning to place business, or to verify selection for those with which they already place business, advisers should engage with the explanatory company profile reports which accompany the headline company ratings
- Assessments are typically carried out annually and so advisers should stay engaged with financial strength rating output on a regular basis and refresh their records of the financial strength rated attributed to companies and access updated reports on key business partners where necessary.

AKG reports

AKG reports tie the various strands of our assessments together. They provide a principal delivery mechanism for AKG information and they are typically the context in which many of our financial strength ratings are delivered, together with further background and supporting information for market use.

Across our rating sectors the reports provide a foundation for the selection of providers by an adviser and they also demonstrate a robust basis for such selection.

Free reports offer for PFS Members

To give a real flavour of the ratings and reports, AKG is pleased to offer PFS members the opportunity to receive 4 free reports. By providing 4 free reports this will give members the option of obtaining at least one report from each of AKG's current ratings sectors and has a total value (if they had been paid for) of over £100.

To obtain the free reports please

(1) register on line at **www.akg.co.uk**

(2) look through the list of individual profile reports (usual cost £28.20 inc. VAT each)

(3) email: **pfs.offer@akg.co.uk** with your PFS membership number, email address you used to register and selection of up to 4 reports. Reports will then be emailed directly to you.

Note: One free delivery per PFS member, up to a maximum of 2 members per firm.

Usage of AKG ratings

The guiding principles underpinning all of AKG's information are that it is:

- Accessible
- Comparative
- Independent

In terms of access, AKG works to ensure that advisers can interact with our ratings and report output in a number of ways.

Advisers can register for access to the AKG Rating Portal, an online facility where they can search for and view the financial strength ratings attributed to companies across our rating sectors. Similarly advisers can purchase AKG's individual company profile reports directly from **www.akg.co.uk**.

AKG's financial strength ratings can also be accessed via a number of product research and selection tools including those provided by Defaqto and Capita Financial Software.

AKG also works directly with banks and national/network adviser businesses on the construction of best advice panels and preferred business partner lists.

Through these various methods the AKG financial strength rating plays a pivotal role in the selection of products and partners across the financial services market.

About AKG and contact

AKG specialises in the provision of ratings, information and consultancy to the financial services industry.

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