Debevoise & Plimpton

The Debrief

Consolidating Wealth: Implications of the FCA's Review of the Wealth and Advice Consolidation Vehicles

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INTRODUCTION/ BACKGROUND

The financial advice and wealth management sector continues to present strong opportunities for consolidation as advisor-owners seek succession or exit options as part of retirement planning. The increasing regulatory burden is placing greater pressure on smaller outfits, making it more difficult for them to remain competitive. At the same time, advisors are looking to offer a greater range of services and leverage enhanced technology to their customers on larger platforms.

However, with the growth of consolidation vehicles in the market, the Financial Conduct Authority ("FCA") has become concerned that the fast growth of these groups could result in poor client service and expose customers to failures. The FCA wants to support more sustainable growth. With that in mind, the FCA has completed its multi-firm review of consolidation in the financial advice and wealth management sector.

The FCA looked at a sample of groups acquiring independent financial advisors and established wealth management businesses. Whilst it found examples of good practice, it also identified some areas of concern.

This paper considers each of the key focusses of the FCA and the implications for transactions in this market. Whilst the FCA is not looking to implement changes to the rules, it is important for existing players, and groups looking to buy consolidators or carry out consolidation activity, to consider the issues identified by the FCA to avoid regulatory interventions.

KEY AREAS OF FOCUS

Group Debt Management

The FCA identified concerns with some firms having high debt levels, limited stress testing and short-term refinancing strategies. The FCA has seen heavy reliance on cash generation from regulated entities to service group debt without sufficient stress testing along with the assets of regulated entities being used to secure debt and, in some cases, guaranteeing a holding company's debt. This results in exposing firms to credit risks of the group and could potentially reduce the assets available for other potential creditors (i.e. customers) in the event of an insolvency elsewhere in the group.

Debt structures should be considered carefully by groups, considering whether sufficient stress testing has been done on the servicing of debt and the extent to which regulated entities are insulated from debt further up the group.

Group Risk Management

Consolidators often have a number of regulated entities within the group and those entities might share clients, revenue streams, control frameworks and back-office functions. However, the FCA identified that there can be inadequate recognition of risks affecting the group and firms may underestimate interconnected risks. As such, some consideration needs to be given by firms to their group risk frameworks.

Group Structure and Approach to Consolidation

The FCA highlighted the use of offshore holding companies to acquire businesses which may limit the applicability of FCA prudential consolidation requirements, despite being highly integrated businesses. The FCA has also highlighted the valuation of goodwill and other intangibles in its review and whether these are recognized appropriately (i.e. the FCA expects these to be deducted for the purposes of prudential consolidation).

Approach to Acquisitions and Integration

Whilst the FCA has identified firms that apply rigorous pre-acquisition due diligence, often with third party support, it has also identified some groups that do not even check basic compliance or that approach due diligence as a 'tick box' exercise.

This is a key area when looking at acquiring groups that have carried out material acquisitions in the past, especially the rigor of due diligence looking at back-book advice liabilities. Similarly, in looking at exits, demonstrating a comprehensive approach to due diligence will provide comfort to buyers that the group is not overly exposed to historic issues.

Integration of existing businesses is also an area that the FCA has focused on, noting that integration needs to be tailored to the relevant businesses and thought needs to be applied to advisor retention, service continuity and legacy issues.

Governance and Resourcing

The FCA is concerned that as these groups grow, senior management need to have the appropriate knowledge and experience for the expanded groups. As such, management teams need to have the necessary experience to manage larger groups or leadership needs to adapt as groups expand (training, recruitment etc.).

The FCA has also called out governance structures where it sees material decisions being made by unregulated boards and insufficient independent challenge on boards more generally. Thought therefore needs to be applied to having sufficient independent non-executive directors on boards of large consolidators.

Conflicts Management

Managing conflicts is always a concern in wealth businesses but consolidation brings its own challenges, particularly in vertically integrated groups, where the FCA has identified concerns with groups providing incentives to invest in group products.

Incentive structures need to be considered carefully and widely, particularly, in the context of earn-outs or other advisor reward structures which may be seen as inducements to cross-sell products that may result in poor customer outcomes.

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