CLB LITTLEJOHN FRAZER
Chartered Accountants

CLB LITTLEJOHN FRAZER'S NEWSLETTER FOR INSURANCE BROKERS ISSUE 6 **SEPTEMBER 2007**

broking**business**

Goodwill

How to prepare for January 2008

The right financier

Advice from Macquarie Bank on making the right choice

Plus

Credit writebacks, threshold conditions, tackling financial crime and other news

Welcome

Choosing the right people in your life is an essential skill. A partner who can make a long-term commitment; a doctor with a solid understanding of your symptoms; or a personal bank manager with a flexible approach. It's just the same at work. And in the rapidly changing world of insurance broking, you'll need the right financier to help you make decisions about the future of your business. Our centre spread feature provides advice on making that critical choice, straight from Macquarie Bank's Aden Nguyen.

Goodwill, a regular in the sector's headlines at the moment, is a major issue for some firms. There has been a lot of high level press coverage about it, pointing firms in the direction of their accountants or business advisers. In this issue of *Broking Business*, we provide some more in-depth analysis of the potential solutions to the goodwill problem.

For more advice on these or other broking issues, contact one of our team or email broking@clblf.com

In brief

Jessica Wills
Jessica is an audit manager in the firm's financial services division and a member of the broking team.

Threshold conditions

We understand that the FSA has been carrying out thematic reviews on threshold conditions, which may include examination of firms' capital resource position, potentially including balance sheet items other than goodwill. The FSA has already said it may look "beyond the financial position of the regulated firm and seek to review the strength of other group firms that the regulated firm is reliant on". Depending on the outcome we may see other more complex financial resource calculations for brokers more akin to other regulated firms.

Principles-based regulation

Driven by the move towards principles-based regulation, new Training & Competence rules have been issued as a policy statement and a consultation paper has been released on new Insurance Conduct of Business (ICOB) rules. Both measures will potentially make commercial sense for firms, but will bring uncertainty in terms of what can and can't be done. Over the next few issues of *Broking Business*, with the assistance of compliance consultant John Gregson, we'll be setting out some of the key changes and letting you know, in brief, how they are likely to affect your business.

Tackling financial crime

The FSA has announced a new reporting system for tackling financial crime in the insurance industry. Firms are encouraged to inform the FSA if they suspect any criminal activities or actions, whether by intermediaries or insurers. Examples of such activities include misappropriation of client money, failure to pass on premiums and issuing false cover notes. The FSA states that firms should contact the existing Firms Contact Centre – there are more details on the FSA website. We have already seen firms reporting on others who are benefiting from bad practice, so it is clearly a step that will be welcomed provided that it doesn't lead to further burdens.

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Navigating the **goodwill issue**

There has already been a great deal of press coverage surrounding the goodwill issue. *Broking Business* examines more closely some of the solutions already proposed and suggests some new ones.

David Roberts
As a partner in the firm's financial services division and head of the broking team, David specialises in advising the London insurance market. He is a regular commentator on market activity in the insurance press.

From 14 January 2008 goodwill will no longer be permissible as an asset in the regulatory capital requirement and resource calculation.

The FSA recognises that for some brokers this means that – unless they act to rectify the situation before January – they may not be able to meet the capital resources requirement. The FSA, BIBA and trade associations are offering guidance to firms likely to be affected by the change – and any firm aware that it will not be able to meet its resources requirement in January must in any case notify the FSA. But here we offer some practical suggestions for remedial action to avoid such a resource deficit arising.

The capital resources test can usefully be viewed as two separate components – the capital resources available and the capital resources requirement. Brokers can potentially find solutions to the goodwill problem in both these elements.

Level	Condition	Minimum Requirement
A	Insurance mediation not holding client money	Higher of £5,000 or 2.5% of income
B	Insurance mediation and holding client money (non retail)	Higher of £10,000 or 5% of income
C	Insurance mediation and holding client money (retail)	Higher of £50,000 or 5% of income

Capital resources requirement

Because financial resource requirements vary according to the level of service provided, a change in a firm's operations may serve to reduce the threshold for the capital resources that they need to demonstrate.

You may like to consider these options:

- Get another regulated firm to handle client money on your behalf. This could be done under a simple outsourced arrangement (and could move you from levels B or C to level A)

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Collaboration:
choosing the right financier

In the rapidly changing insurance broking market, having the right financier on board is critical to achieving your goals and securing your future. Macquarie Bank's Associate Director, Aden Nguyen, looks at how to assess potential lenders.

Aden Nguyen
Aden Nguyen, is Associate Director at Macquarie Bank. He has 13 years' banking experience, both in the UK and Australia. Macquarie's large Australian broking market has seen very similar trends to those we are currently observing in the UK.

The insurance broking market is a dynamic sector, characterised in recent years by change and consolidation. Brokers are wrestling with decisions about the future of their business: Do you sell to a consolidator? Remain independent? Make your own acquisition? Many will also be thinking about succession planning, recruitment, securing commercial property or refinancing existing borrowings to ensure they stay viable.

Whatever the challenge, one critical decision facing all brokers is choosing the right financier.

Collaboration for success

Most broking firms will require some form of debt to fund their business aspirations: they need a provider that understands their industry and supports their business plans. The broking firm and the debt provider have a mutual interest in seeing the firm succeed, so a collaborative relationship makes sense for everyone.

But the reality is often very different. Many brokers feel unsupported, saddled with a finance package that doesn't really meet their needs.

Over the years, brokers' feedback has confirmed that they want, above all, a knowledgeable debt provider committed to the long-term success of their business. They want to work with a financier that will lend against the value they have built up in their firm over many years.

Brokers are looking for a consistent but flexible approach in their business dealings, with long-term account managers, and for a financier who can bring new ideas and opportunities to the table.

The broking firm and the debt provider have a mutual interest in seeing the firm succeed, so a collaborative relationship makes sense for everyone

Securing the right debt provider

To secure the right debt provider, the prudent broker will look for the following qualities:

1. A solid understanding of the sector
Your account manager should have a thorough understanding of the current issues affecting brokers and the industry. If you find yourself explaining, to a potential debt provider, fundamental aspects of how an insurance broking firm works, these are unlikely to be the right people to value your business and provide a relevant finance package. Check whether your account manager specialises in insurance broking or works across a number of different industries.

2. A lending approach that suits you
You need to be comfortable with the way your financier values your business, the level of funding they offer and repayment conditions. Will they reward your profitable, well-run firm with higher levels of gearing or are their debt levels pegged on a standard non-flexible equation? Would they expect you to amortise any debt and, if so, would the rate they set place a strain on your cash flow and constrain your firm's ability to grow?

Flexibility is also key. How will they react to the changing circumstances of your business with regards to repayment terms?

Finally, are they happy to place significant reliance on the assets of your business or will they automatically seek your personal assets as security?

3. A long-term commitment
Has your debt provider worked with insurance broking firms through hard and soft markets? Your financier should be with you through thick and thin. You should be confident that they understand your long-term goals, are committed to helping you achieve them and will provide ongoing support.

4. A personalised approach
You will have a more productive, rewarding relationship with your financier if you have a dedicated account manager who knows the ins and outs of your particular situation. Look for a provider who gives you a direct line to your manager – not a call centre. Enquire about the average tenure of their account management staff and about how they ensure continuity if your account manager moves on.

Some of these factors will be more important to you than others: you need to identify your requirements and make sure your debt provider will deliver them.

The choice of financier is a key decision for any business – the right one can be critical to achieving your goals and securing your future.

Macquarie Bank has more than 20 years' experience of providing finance to insurance brokers. Their key product specifically for this market is loan financing for acquisition or succession purposes.

If you would like to discuss your requirements, please contact Adam Daniels or Aden Nguyen at Macquarie Relationship Banking on 020 7065 2252, or John Needham or David Roberts at CLB Littlejohn Frazer on 020 7987 5030.

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In brief

John Needham promotion

One of five new partners appointed by CLB Littlejohn Frazer this year, John Needham (pictured) – financial services specialist and member of the broking team – was promoted in June. John's experience covers audit, internal audit, corporate finance and regulatory work, and he participates in the ICAEW insurance intermediaries working party. Managing partner, Paul Hopper, commented, "John's promotion reflects our strong growth in the financial services market, particularly in the insurance sector". The addition of new insurance clients is playing a substantial part in the firm's overall growth.

Credit writebacks

The process of carrying out a credit writeback in the regulated regime requires careful consideration. In their latest feedback on client money in relation to credit writebacks, the FSA didn't say much, but our experience to date is that they have very strong views on what can and can't be done under the regulated regime. We expect further comment from the FSA in coming months and in the next issue of *Broking Business* we will give you our take on dealing with the issue of credit writebacks and the policies and procedures that you should have in place in order not to fall into any regulatory traps.

New small broker team

CLB Littlejohn Frazer has put together a new business advisory service for smaller brokers who want access to insurance experts but also need help with more routine accounting matters. The small broker team is led by our main broking team but is resourced from our business advisory team, which specialises in dealing with smaller owner-managed businesses. If you have a commission income of between £250,000 and £1,000,000, this may be the accounting service you have been waiting for. For more information please contact John Needham.

Autumn breakfast briefing

The tallest building in the City of London will be the venue for our next breakfast briefing. The briefing, in Tower 42, Old Broad Street, at 8.30am on Friday 5 October, will cover company valuation and succession planning. David Roberts, CLB Littlejohn Frazer's head of broking, will set out current valuation trends and key drivers. Aden Nguyen and Adam Daniels from Macquarie Bank will be talking about using debt financing as a tool in succession and business planning. We'll be sending out an invitation shortly but please put the date in your diary.

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- Get rid of your retail business if it is only a minor element of your book of business. You might get another broker to operate the retail business on your behalf and operate a commission share arrangement (this could move you from level C to level B)
- Establish risk transfer arrangements with other brokers or insurers, so that you no longer hold client money (this could move you from levels B or C to level A)

And of course consider your income: have you calculated your regulated income correctly and in accordance with the FSA Handbook rules?

Capital resources

Capital resources are essentially the net assets of the business as determined under UK GAAP. The non-inclusion (or disallowance) of goodwill removes an element of these net assets that accordingly needs to be replaced. In broad terms this can be achieved in two ways:

- Convert the goodwill (disallowable) into another form of asset (allowable); or
- Inject new assets into the business in the least inconvenient way.

Here's how these might work.

– Conversion of goodwill into another asset

Goodwill cannot be converted into another asset within the same entity; but if you transfer the goodwill to another entity, that goodwill can be 'swapped' for another form of asset in the form of a debtor or even cash. Transferring the goodwill to another regulated entity would simply transfer the goodwill disallowance to that entity instead. But the transfer can be done effectively by using a separate, unregulated group company – commonly a holding company, or an unregulated non-group company.

So you might set up a group company (or use a holding company), a relatively straightforward process, although you would need to consider taxation, operational issues etc.

Corporate structuring in four simple steps:

1. Formation of a new company (newco) with minimal issued share capital (to reduce the need for new funds) but with an authorised share capital that is higher than the oldco issued share capital.
2. Appointment of directors to the new holding company
3. Issue of shares from newco to the existing oldco shareholders on a like for like basis
4. Transfer of the goodwill from oldco to newco, either for cash (or other assets) or through the inter-company account.

Tax-related points to bear in mind:

- Newco is an additional associated company for corporation tax purposes. This may increase the marginal rate of corporation tax applicable and therefore the combined tax liability of the two companies
- You would be wise to get HMRC clearance for the share for share exchange described above
- You will need to prepare corporation tax returns for newco
- The goodwill should be transferred at net book value.

And operational issues:

- Dividends will have to be paid to investors from newco rather than from oldco. In order to achieve this, oldco will have to pay dividends up to newco
- Don't forget that an additional company will bring additional administrative burdens.

Or, rather than passing the goodwill to a group company, you might choose to pass the goodwill to a *non-group company*.

This arrangement might be accompanied by a commercial agreement whereby the firm (oldco) pays a license fee for the use of the goodwill from the other company. Inevitably there are some taxation issues to bear in mind here as well:

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- The income received in the separate firm under the agreement will be taxable. If the goodwill amortisation charged in that company is a similar amount to the income then the overall position should be tax neutral
- The charge for the use of the goodwill is potentially subject to VAT
- The transfer of the goodwill to the other firm should be tax neutral.

– Injection of new assets

The FSA has noted some ways of increasing capital resources in their new FAQs issued on 11 May. These are practical tips and cover most of the available options. We have a few more suggestions and also expand on some of those tips.

- Consider selling a small stake in the firm via the issuance of share capital. This could be a temporary arrangement with an undertaking to buy back the shares in the future.
- Consider a rights issue. If a director took out a loan to buy additional shares in the company, he should be able to claim tax relief on the interest on that loan on a personal basis, or an equivalent share buyback arrangement could be put in place including some compensation for the interest he incurred.
- Discuss options with other brokers and with insurers. Firms will need to consider how they account for any advances of brokerage or 'structural income': in some cases, due to accounting rules on income recognition, the cash advance may not increase the net assets of the firm if it cannot be included as income in the period.
- One of the simplest and most cost-effective ways to increase the capital resources available is the use of subordinated loans. This is subject to constraints set out in MIPRU 4.4.8 of the FSA Handbook which broadly states that, for firms that hold client money, subordinated loans and redeemable share capital are only permissible for regulatory purposes to a level of four times the net assets (as defined in the FSA Handbook) less the subordinated loan, redeemable share capital and goodwill. For firms that don't hold client money there is no restriction.
- If a firm's goodwill makes up a high proportion of its net assets, the use of subordinated loans is limited. Where the goodwill is actually greater than the net assets, a subordinated loan cannot be used at all.

A combination of the measures we've described above – coupled with planning to unwind the solution over a reasonable time period so that the funds used are not tied up permanently and shareholders are not disadvantaged in the longer term – should enable firms to resolve potential capital resources deficits.

If you would like more specific guidance on any aspect of dealing with the goodwill issue, please contact David Roberts or John Needham at CLB Littlejohn Frazer on 020 7987 5030 or email droberts@clblf.com or jneedham@clblf.com

CLB LITTLEJOHN FRAZER is an independent, top 30 firm of chartered accountants and business advisers. With in-depth expertise in many fields of tax, accountancy and finance, we work for clients ranging from large, listed corporates and SMEs to individuals, their families and their businesses.

Our dedicated financial services division offers extensive experience and expertise. Our particular strength is in the London insurance market, where we have worked for over 100 years. In this time, we have built up a comprehensive business and technical understanding of the workings of the industry, backed by detailed and practical knowledge of the unique challenges and issues faced by the insurance market.

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