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brokingbusiness

The newsletter for
insurance brokers

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Welcome to Broking Business

At a time when banks are being pilloried for their lack of regulation, and quite rightly, insurance brokers may be wondering wistfully what a world with less regulation in their own sector would be like. This issue of Broking Business is packed with advice for keeping on the straight and narrow.

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"Rules are not necessarily sacred, principles are", Franklin D Roosevelt famously once said. He might have been talking about the FSA's 11 Principles of Business, which brokers ignore at their peril. Our regular contributor John Gregson, who advises firms on their FSA compliance, continues his guidance – this issue on two of those principles: conflicts of interest and market conduct.

It may sound obvious but one of the keys to competitive advantage is forward planning. The year 2012 may seem a

long way off – not least because there is still so much to do in London before the Olympics. But three years pass quickly and it's also the year when Solvency 2 – the new standards of accounting for insurance contracts – is planned to come into effect. Read our advice on getting ahead of this and IFRS developments planned for next year – see the centre pages.



In Brief

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Credit write-back guidance

The FSA has released guidance on credit write-backs. The guidance, which includes the effect of FSA regulation and the circumstances in which credit write-backs might reasonably be taken, is essential reading for any London market firm with potential issues in this area. We will bring you more in-depth analysis in the next edition of Broking Business. The guidance is available at www.fsa.gov.uk/pubs/other/write_backs.pdf

AIG troubles: good news for brokers?

In the London market, the reaction to insurance giant AIG's troubles has been mixed. Both brokers and insurers are happy to see new business come their way that was historically placed with AIG. But few are actually hoping for an all-out collapse of the world's largest insurer.

One benefit seems to be an increased awareness by some insurance buyers of their insurers' ratings and the terms of their policies. For example, they are clearer about cover in the event of a mid-year failure. Certainly, firms insured by AIG might now want to move or at least get more than one insurer on their policy.

Could it be that we are moving into a landscape where security and policy terms become a major marketing point – even to retail customers? We certainly may see an increase in the use of brokers, as firms or individuals want to understand more about the transactions they are getting themselves into.

Double rate benefits for 2009

Business may be scarcer than a year ago but two positive rate changes at the start of 2009 bring good news for brokers.

The series of risk losses in 2008, including Hurricane Ike and financial institution claims, combined with the perceived capital shortage, have guaranteed a halt to the premium rate slide. While some brokers have not yet felt the benefit across all classes, insurers have been quick off the mark to increase capacity for 2009 to take advantage.

Secondly those brokers transacting business in euros or dollars will have a useful boost to 2008/2009 earnings and associated year end currency assets. Most brokers we have spoken to see this as a windfall rather than a return to normal, but it's difficult to see the situation shifting in the short term given the downward trend in the UK economy and interest rates.

GI brokers: beware regulation

When it comes to the FSA's 11 Principles for Business, no-one is exempt. John Gregson continues his series of articles focusing on regulation. In this issue he looks at danger areas for GI brokers in 2009.

With 30 years' experience in the general insurance industry, **John Gregson**, CEO of Advantage Broker, currently advises firms on their FSA compliance. John was a Special Advisor to the FSA from 2006 to 2009.

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The FSA's latest Business Plan gives stark warnings for the GI broker market that only the rash (or foolish) would ignore. These concern 'conflicts of interest' on the one hand and 'market conduct' on the other.

Conflicts of interest

"The increased blurring of the distinction between insurers and intermediaries increases the need for conflicts of interest to be carefully managed... Although we do not currently consider additional measures to address conflicts of interest are required, we will continue to maintain close supervisory attention to their management, in particular on intermediaries with business models where the potential for conflicts is higher."

Firms, especially those that operate binding authorities from insurers or managing general agencies (MGAs), should already be implementing the requirements of the FSA's SYSC (Systems and Controls), as the rules and guidance on conflicts have recently been extended to apply to insurance mediation.

Expect, too, further developments when the subject has been reviewed at European Commission level and when the Law Commission publishes its proposals on reforms to insurance contract law.

Market conduct

"There will be no let-up in our work to mitigate the risks presented by market abuse or financial crime... We will use our powers to prosecute matters as criminal offences..."

In January the FSA fined Aon Ltd £5.25m for systems and controls failings that led to suspicious payments being made to overseas parties. In doing so they made it clear that involvement by UK firms in corrupt or potentially corrupt practices overseas undermines the integrity of our financial system and endangers the FSA's financial crime and market confidence objectives.

Otherwise, there is little evidence of activity by the FSA in the area of market abuse with regard to GI brokers. But the regulator is more likely to take action following its thematic work into conflicts of interest. 'Arbitrage', for example – in this case brokers using contingent fees to hide the true cost of their services when competing for business – might be considered 'market abuse' in the context of Principle 5. Similarly, last year some high profile 'team stealing' cases were reported in the press. Even when these are settled between the parties the FSA may take action if it feels the Principle has been breached, in effect tarnishing the reputation of the market as a whole.

So my advice for 2009 is to stay vigilant and keep your house in order.

Why brokers must be ahead of the game

Two planned developments – IFRS on accounting for insurance contracts (Phase 2) and Solvency 2 – will have a direct impact on insurers when they are introduced. David Roberts explains how brokers can gain competitive advantage.

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Changes that affect insurers also, inevitably, affect the way brokers do business. There's no doubt that brokers who plan to embrace, early on, the new standards for accounting for insurance contracts and the new regulations outlined in Solvency 2 stand to benefit over their competitors. It is now, three or four years ahead, that strategic thinking should begin.

Q: What are the key changes?

Accounting for insurance contracts under IFRS

Though a new standard under Phase 2 is not due to be finalised until 2011 at the earliest, there has been a discussion paper available since May 2007. However the ultimate requirements are in a state of flux. Here are the factors that will have a major impact on how insurers account for insurance contracts (premium income and claims):

- claims reserves are likely to be calculated as 'pure' best estimate less discount for timing plus possibly a risk margin
- the risk margin is not yet clearly established as a requirement and may vary from Solvency 2
- premiums – it is unclear whether general refinements to accounting for income recognition will impact insurers. Depending upon the outcome of this there may be changes to when a premium is recognised as earned and whether commission costs can be deferred.

Solvency 2

Solvency 2 is planned to be implemented across Europe in 2012. Though the outline is clear, the exact rules are still emerging. The change will impact less on UK insurers than on their European counterparts. This is because the UK's existing capital assessment regime already embodies a risk-based capital methodology, as will be required under Solvency 2. But Solvency 2 will also require:

- greater transparency regarding risk data held, enabling more detailed presentation to regulators, and increased disclosure requirements linked to IFRS
- even greater focus on risk-based capital, requiring more risk modelling.

Q: How will the changes impact on insurers' processes and decision-making?

Accounting for insurance contracts under IFRS

- insurers may change their view on what is attractively-priced business
- insurers will need more detailed information on risks, including those underwritten through binders, covers and facilities
- from an accounting perspective, the optimum policy periods may be influenced by risk performance
- results may be more volatile – likely to affect the supply of capital
- there may be no deferral of acquisition costs – if so insurers are likely to focus more on those costs.

Solvency 2

- capital requirements probably favour larger insurers (through diversification, extent of controls, and use of models)
- insurers will want to diversify risks accepted
- there may be an increased use of reinsurance to mitigate risk
- insurers are likely to want more control of the supply and pricing of business, which may lead to increased broker audits regarding business production and claims processes
- insurers may be more wary of volatile or poor risks, or new risk areas
- it may be easier to underwrite directly to EU companies, rather than through UK subsidiaries or branches
- insurers will need more detailed information on risks, including those underwritten through binders, covers and facilities
- insurers may want more control over credit/currency risk, which might affect settlement processes.

“We predict that insurers will soon be asking brokers to collect more detailed data presented in different and more functional ways”

“Anticipating the insurer’s issues will give the broker an extra edge when placing a risk”

Q: How do these changes affect brokers?

Both sets of changes require insurers to hold their data in a more detailed way in order to be able to produce the analysis that complies with the reporting requirements. The broker will almost certainly be one of the sources of this data.

At the moment, data supplied by brokers to insurers, especially on delegated authorities, is usually minimal and constrained by system limitations or data structures. We predict that insurers will soon be asking brokers to collect more detailed data presented in different and more functional ways. This will place a strain on many existing database structures and systems.

The broker who understands these requirements and provides relevant and clear analysis will be better placed to discuss the risk with the insurer. Equally if the broker understands how particular characteristics of a risk impact on the insurer under the new regime, they may be able to structure the risk so that it is more attractive – for example by splitting a 12-month contract into two 6-month ones. Anticipating the insurer’s issues will give the broker an extra edge when placing a risk.

Q: What should firms be doing?

- be aware of the new requirements likely to arise from these changes
- consider how risks will be accounted for by the insurer and what the good / bad risk characteristics are in this context
- start to develop new products and services to meet insurers’ requirements
- when considering upgrading systems, think about how any data structure changes will be dealt with
- closer to implementation dates, liaise with insurers to test changes in data collection and presentation that will make their lives easier.



Accounting policy review: debtors, creditors and cash

Jessica Wills continues her series of articles on accounting policies adopted by brokers. In this issue she considers how top UK firms measure up against accounting standards for disclosing insurance debtors, creditors and cash.

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Background to the review

We conducted a review based on the latest financial statements of 47 of the Top 50 UK firms* and compared their disclosures of insurance debtors, creditors and cash to the relevant UK accounting standards and guidance. Of the firms reviewed, 38 adopt UK GAAP and 9 IFRS.

To clarify the terms:

- **insurance debtors** represent premiums and brokerage/commissions/fees receivable from clients and claims receivable from insurers
- **insurance creditors** represent premiums payable to insurers and premium refunds or claims payable to clients
- **insurance cash** represents cash in transit between clients and insurers and cash attributable to the firms concerned but not yet transferred from client to corporate bank accounts.

Our review focused on:

- whether insurance debtors, creditors and cash are held on or off the balance sheet
- whether insurance debtors and creditors are presented gross or net
- the quality of disclosures relating to client money.

On or off the balance sheet

Under UK GAAP and IFRS, assets are defined as 'rights to future economic benefits' and liabilities as 'obligations to transfer economic benefits'.

There has been some debate over how the economic benefits reflected in insurance debtors and cash should be included on the balance sheet. The economic benefits arising from insurance debtors would normally be brokerage/commissions/fees receivable and advanced premiums/claims recoverable (funding). Benefits arising from insurance cash would include investment income attributable to the firm concerned. Corresponding insurance creditors should be recognised to the same extent as insurance debtors and cash.

The FSA believes balances held in client trust accounts, and corresponding debtors and creditors, do not legally belong to the firm and therefore should not be reflected as a firm asset but as a client asset. This is their requirement for RMAR reporting.

Our analysis shows that most firms include insurance debtors, creditors and cash on the balance sheet. This corresponds to guidance issued by the LMBC in 1995. It is also difficult for firms to run their accounting on a basis that deals separately with items of insurance debtors and cash that have differing economic benefits.

On or off the balance sheet disclosure	No. firms
Insurance debtors, creditors and cash are included on the balance sheet	33
Amounts receivable in relation to brokerage/fees/commissions are included on the balance sheet	1
Amounts receivable in relation to brokerage/fees/commissions and advanced premiums/claims and amounts payable in relation to cash received are included on the balance sheet	2
Amounts receivable/payable in relation to premiums where the firm has contractual rights to amounts receivable through credit agreements with policyholders are included on the balance sheet	1
Insurance debtors, creditors and cash are not included on the balance sheet	1
Amounts receivable in relation to brokerage/fees/commissions and amounts payable in relation to cash received are included on the balance sheet	3
Amounts receivable in relation to brokerage/commissions/fees and amounts receivable/payable in relation to business carried out under the Marine Insurance Act 1906 are included on the balance sheet	1
No accounting policy disclosed	5
Total	47

Gross or net

Under UK GAAP and IFRS, assets and liabilities are offset and the net amount presented in the balance sheet only if the firm:

- currently has a legally enforceable right to set off the recognised amounts and
- intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Our review shows that most firms do not disclose an accounting policy in this area. Moreover, some of the UK GAAP firms refer to FRS 5 rather than FRS 25 – which specifically deals with the offset of financial assets and financial liabilities.

Gross or net disclosure	No. firms
Shown gross unless net amount is due to/from the same party and the offset would survive insolvency of that party	6
Shown gross unless ability to insist on net amount can be assured beyond all doubt	3
Shown gross unless the net amount is legally enforceable	7
No accounting policy disclosed	30
Shown gross	1
Total	47

Client money

There is no specific guidance in UK GAAP or IFRS over client money disclosures. But we expect firms to respond to the FSA's regulation of client money by improving their financial statement disclosures in this area to ensure that users are adequately informed.

Our analysis shows that only 45% of firms reviewed currently disclose the amount of client money included in the balance sheet. This is surprising given the restrictions on these assets.

Gross or net disclosure	Yes	No	Total
	No. firms		
Description of client money disclosed	20	27	47
Amount of client money disclosed	21	26	47
Treatment of interest on client money disclosed i.e. retained by the firm as investment income	16	31	47

Examples of client money disclosures

"The company holds cash balances relating to insurance broking third parties which are held on trust and cannot be called upon on insolvency of the company."

"Funds held in connection with insurance broking transactions are generally required to be held in regulated bank accounts and are generally not available for purposes other than settling insurance broking transactions."

Time to act

Although this review shows that accounting policies adopted by firms are broadly consistent with accounting standards and across the industry, the accuracy and quality of disclosure could be improved.

Our recommendations:

1. Improve insurance debtor, creditor and cash disclosure, as these often represent the dominant figures on the balance sheet. Clarity means users are properly informed about the credit risks and regulated status of insurance assets.
2. Improve management information and reporting to help you separate out those balances in which there is economic benefit. This especially applies if your firm is considering moving to IFRS – you could take the opportunity to revise, improve or perhaps change disclosure of accounting policies in this area.

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Littlejohn is an independent, top 30 firm of chartered accountants and business advisors. A leader in providing accountancy and audit services to the London insurance market, the firm has operated in the sector for over a century. Littlejohn's specialists help clients to overcome the challenges faced by the industry through a comprehensive commercial and technical understanding of its workings, and a high level of partner involvement. Clients range from owner-operated firms to some of the biggest names in the broking world.

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