

LITTLEJOHN

brokingbusiness

The newsletter for
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Welcome to Broking Business

We now know that late next year the FSA will cease to be. But if you think that the regulatory environment is going to get easier under the new regime, think again.

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The Financial Conduct Authority (FCA) is one of three regulatory bodies taking over from the FSA, and the one that's relevant for insurance intermediaries.

Although, at the moment, there are no major changes expected when the FCA takes the reins in terms of required regulatory outcomes, we are not expecting it to be any more lenient. Meanwhile the FSA is now getting far more involved, making significant judgements about individual businesses as part of the supervisory process – and we expect this trend to continue.

Client money is, of course, still a hot topic and – according to research carried out on behalf of BIBA – is one of the two key risks presented by brokers. Another, particularly for MGAs, is Solvency II – don't think that this just affects insurers. See our centre spread and final article respectively for more guidance on these issues.

We hope you find this issue useful.



In Brief

John Needham is a partner in the firm's financial services division, specialising in insurance. He's also a member of the Littlejohn broking team, which caters for the needs of insurance brokers and other intermediaries.

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New partner

Philip Alexander has joined the Littlejohn insurance team as partner. He was formerly a partner with BDO, leading its insurance division. Philip brings a wealth of broker and insurer knowledge to the team and increases the number of dedicated insurance partners to six.

VAT on entertaining overseas clients

HMRC confirmed in March 2009 that its policy on business entertainment was under review following the European Court of Justice decision in the joined case of Danfoss and AstraZeneca. Last November HMRC announced that VAT could be claimed on entertaining overseas clients, but subject to stringent conditions that are likely to be challenged further. The legislation comes into effect in May 2011 and businesses are able to go back four years to reclaim VAT.

Instanda – new software

Business and technology strategy consultancy F2X has launched a new online service called Instanda www.instanda.com. It allows firms to build their own MGA online quote and fulfilment platform. The software is very simple to use and the service is delivered with an innovative charging structure. These features make it easier for firms to trial new products or services without potentially huge software development costs.

Client money assessment

RWA Group has launched an online client money gap analysis programme. It was developed with Littlejohn and Linn Maggs Goldwin and allows individuals and firms to assess the gaps in their client money knowledge. See www.theobeliskonline.com for a free trial.



Risk mitigation: the FSA is on your tail

Following ARROW visits over the last three years, the FSA has recently conducted a review of the risk mitigation programme (RMP) action points it issued. It makes sobering reading. John Gregson reports.

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The FSA's January communication¹ to smaller wholesale insurance intermediaries on the response it has seen to its RMP action points has relevance to the whole GI intermediary sector. It also suggests that the FSA's patience might be running out. And there isn't much time left before the Financial Conduct Authority (FCA) takes over – with new weapons in its armoury.

'Poor practice'

If you read between the lines of the FSA's recent publication you would be forgiven for concluding that the FSA is tired of waiting for GI intermediary firms to comply with its requests. It would seem that, with monotonous consistency, firms are failing to understand and act upon the key messages the FSA has been trying to get across to the sector since the beginning

of its regulatory regime. Phrases such as 'performing below acceptable levels'; 'poor practice'; and 'take action to address', signal, in our view, a new mood of 'you've been warned'.

FCA danger

The FCA will regulate GI intermediaries from next year. But beware: it will not start from scratch. Rather, it will carry on from where the FSA leaves off. All this means firms have little time to get their houses in order on these basic matters once and for all. And, given the recent announcement of the proposal to allow the FCA to publicise its actions during the early stages of an investigation, there is a huge and new reputational risk that should be avoided at all costs.

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¹ Smaller Wholesale Insurance Intermediaries Newsletter January 2011



Client money: why your choice of auditor matters

The FSA is getting stricter about the quality of client money audits. What has this got to do with broking firms? John Needham explains why getting a poor client money audit service can damage your business and provides tips for assessing your auditors.

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The FSA is putting the auditing profession under pressure to improve the quality of client money audits and is working on new ways for firms to report client money handling. In a number of cases, the FSA has visited brokers and, finding client money breaches, has requested the client money audit letter and found that a clean client money audit report has been issued. As a result the FSA has referred the audit firm involved to its corresponding regulatory body. This is clearly not a good situation either for the auditor or for the broking firm, since non-finance directors of broking firms frequently place a great deal of importance on a clean sign-off from their auditors.

There are two messages coming from the FSA:

- audit firms need to raise their game
- broking firms need to ensure their audit firm has the requisite expertise to carry out a client money audit.

Alarm bells

So how do broking firms assess whether their audit firm is up to the job? The answer is that it's very difficult. You would think it reasonable to expect the audit firm to tell you if it is not really able to sign a 'client money opinion' – but this is not always the case. One indicator that you may well have a problem is if your auditor fails to find any breaches. Our experience is that we very rarely sign off a client money audit without identifying at least some breaches. Indeed, at a recent seminar the FSA confirmed it will consider a broking firm that has never reported any rule breaches as a higher risk than one that clearly captures and reports minor ones.

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Making the choice

By way of guidance, we have compiled five questions and answers to help smaller firms assess whether their current auditor is up to the job.

1. How many client money audits for brokers does your auditor perform in person?

The answer should be more than one! Two things to check are:

- does the actual audit team do the audits? It may be that, across the network, they do a number – but it is the knowledge of the team doing your audit that is important.
- check that they are broker client money audits – as these are different from solicitors' or investment firms' client money audits.

2. Can they explain the difference in audit approach for a statutory trust and a non-statutory trust?

The audit of a non-statutory client money account is more complicated. The auditor has to provide an opinion on the systems and controls operating over the broking systems, and specifically confirm that the systems are capable of monitoring debtors and creditors at a policy/client level.

3. Do they know the difference between handling monies under risk transfer and handling client money?

Risk transfer monies are those held under risk transfer agreements with your insurers and are set out in the terms of business agreement with those insurers.

You can hold risk transfer monies with client monies, but only where you have relevant permission from the insurers.

If you hold risk transfer monies outside the normal client money trust, you should still operate a trust-style regime and carry out reconciliations. Some insurers require you to keep their monies in an insurer trust.

4. Are they aware of the latest FSA template for reporting client money issues?

The FSA has set out a new style standard report in a recent policy statement that can be adopted as best practice reporting. Firms will be required to provide comments on breaches identified and the auditor must also include breaches that were identified by the firm during the period.

5. Do they have a bespoke set of working papers?

The audit should test every aspect of your compliance with the CASS 5 client money rules, and the working papers for this are likely to be complex and lengthy. If the audit firm is part of an association or network of firms, it can generally take advantage of centrally-prepared material. But if it only has one or two client money audits, then it may not have developed bespoke working papers.

Where to go from here

If your audit firm starts to struggle with answering these questions, it may be time to start looking for another. Alternatively, you could insist the firm does a lot more research into the requirements of auditing your business. Not only will doing this protect you, but it also protects your auditors.

Don't forget that the client money opinion is separate from the main audit of the company's accounts.

Developments to watch

The FSA is consulting on new reporting requirements for firms handling client money. These are initially focused on investment firms but it is only sensible for brokers to take note and be guided by the direction of travel. The suggested new, more specific, reporting forms will include:

- the name of the auditor
- the balances in the accounts
- the number of accounts in use
- the banks used
- the client money reconciliation at the period end
- whether there were any breaches

Be prepared for more transparency.

If you would like further guidance on client money audits, please contact John Needham.



Risk mitigation: the FSA is on your tail (continued)

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Areas of focus

There are seven areas that regularly appear in RMPs – risks that, in the FSA's view, receive inadequate attention from the Boards of GI intermediaries.

- **Adequacy of resources**, both financial and non-financial, is not being assessed regularly enough or properly documented. This includes the recoverability of inter-company balances and charges over firms' assets.
- **Strategic planning** is either lacking, insufficiently documented, or not aligned with capital and business planning. Where strategic plans do exist, the FSA found that they are insufficiently stress-tested.
- **Client money** controls are inadequate generally. Specifically, client money calculations are not properly reviewed and, where breaches are discovered, they are not remedied sufficiently quickly.
- **Governance** issues continue to feature in the FSA's concerns, with Boards failing to provide adequate oversight. Lack of resource is an issue in the areas of compliance, risk management and internal audit. Where controls do exist, it is not always clear that they are properly integrated into firms' governance frameworks.

- **Risk management** is under-resourced, leading to infrequent reviews of firms' risk registers. Stress testing is unsophisticated and often limited to exchange or interest rate risk.
- Firms are not able to demonstrate that they are **treating customers fairly**. Boards are receiving insufficient management information and there is over-reliance on complaints data. There is also a lack of transparency with clients in the product selection process.
- **Control functions** such as internal audit are not always independent of compliance. Committees, where they do exist, meet too infrequently to exercise proper oversight.

All these areas are inter-connected and point to Boards not properly performing their regulated responsibilities collectively and individually. As the FSA concludes in its communication: "We regard the above to be examples of poor practice. We would expect any firm that recognises any of these issues as occurring in their own businesses to take action to address them".

Firms have been warned!

"Governance issues continue to feature in the FSA's concerns, with Boards failing to provide adequate oversight. Lack of resource is an issue in the areas of compliance, risk management and internal audit."



What Solvency II means for intermediaries

With preparations for the implementation of Solvency II well under way, it seems there will be a knock-on effect for intermediaries. Philip Alexander explains what needs to be done.

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For insurers, the effect of the new regulatory regime will be to assess a firm's solvency requirement by reference to the specific risks it is exposed to, with credit given for the way risk is measured, monitored and managed. The regulator's ultimate aim is that insurers have sufficient capital to reduce the risk of failure to an acceptably low level, increasing the level of protection for policyholders.

The Solvency II regime is expected to come into effect from 1 January 2013 and insurers are currently preparing for this. This is a costly exercise and a great deal of work is going on to model risk and establish minimum capital requirements. These are likely to increase, with possible implications for insurance intermediaries, particularly coverholders or MGAs who have the underwriting authority to bind risks on behalf of the insurer.

Insurers have been forced to analyse their book of business, the risks associated with it, and assess those parts of the book which are particularly capital intensive or which do not generate a sufficiently high return on capital.

Through this mechanism insurers can identify poorly performing parts of the account or more risky counterparties where action is needed. In some instances this might mean curtailing writing in certain areas and a coverholder might find itself with business and nowhere to place it.

Help for intermediaries

Intermediaries can protect themselves from this scenario by developing stronger relationships with their providers and understanding the methodology the insurer is using to model risk as well as the assumptions and judgements applied within the model. The intermediary can then decide whether it is possible to improve the quality of the data and information it provides in order to help the insurer refine its model to produce more accurate results.

For example, if the intermediary can produce granular risk information, as opposed to block bordereau data, in a form that is compatible with the insurer's Solvency II model, the insurer will get a better understanding of the book of business and the way it behaves. The insurer will then be able to take more informed decisions and this may have implications on the levels of capital they are required to hold.

But to generate the information required by the insurer, firms might need to invest in costly new systems and software.

Under scrutiny

Solvency II also delves down into operational risk. Unfortunately, because of the actions of a number of rogue coverholders and MGAs, insurers are likely to examine more closely the operations of those to whom they have delegated underwriting authority.

Insurers are going to be looking for much higher standards among coverholders and MGAs, and firms will be required to improve systems of internal control and governance. Failure to address this issue may result in insurers withdrawing or reducing capacity.

As with system enhancements, intermediaries will also have to bear the cost of improving the management, monitoring and administration of the delegated authorities.

So although Solvency II is a regulatory standard that mainly applies to insurance companies, there are repercussions for insurance intermediaries. The challenge for intermediaries will be to keep the costs down whilst at the same time improving their systems.

The key impacts for coverholders and MGAs are likely to be:

- The need to work more closely with their underwriting principals
- The need to invest in systems that generate data in the format required by underwriters
- Standardisation of information flowing between coverholders and insurers
- The need to review their governance processes and how these address operational risk
- Greater monitoring and review, through an enhanced coverholder audit process
- Consolidation of the intermediary sector as rising standards lead to increased costs.

LITTLEJOHN

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.

Visit our website at www.littlejohnllp.com for a downloadable version of this newsletter and past editions.

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