

LITTLEJOHN

# brokingbusiness

The newsletter for  
insurance brokers

**ISSUE 11**  
August 2010

## **'Dear CEO'**

What's key in the FSA letter

## **People risk**

Why the FSA is focused on human resources

## **Would you be ready?**

Investment interest in broking sector





## Welcome to Broking Business

Since the arrival of the coalition Government it's been clear that the role of the FSA is set to change. A more pivotal role for the Bank of England in relation to financial institutions, combined with the growing trend towards Europe-wide financial services regulation, will perhaps leave the FSA a much more consumer focused organisation.

**David Roberts**  
**Partner, Head of Broking**  
020 7516 2251  
droberts@littlejohnllp.com

So how will this affect brokers? The answer is hardly at all – at least for the time being. In fact Broking Business is dedicating most of this issue to interpretation of the FSA's crucial February 'Dear CEO' letter. I've focused on the issue of liquidity in my article: why it matters so much and how to maintain it, particularly into and out of client money accounts. Regular contributor John Gregson examines the letter's focus on non-financial resources – in particular how to minimise the enormous risk that people represent to firms.

Littlejohn partner John Needham takes a look at why brokers need to be extra smart to take advantage of the increased interest in investment into the sector, particularly from private equity funds. Would you be ready for M&A activity?



## 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.

020 7516 2284  
jneedham@littlejohnllp.com

### **New client money team at FSA**

Recently announced – alongside the news that two insurance brokers have been fined and banned from working in financial services for client money related offences – is the formation of the FSA's new client asset team. Although there is nothing to suggest the enforcement action taken against the two brokers signals an overall increase in the regulator's severity, it does indicate that client money is right at the top of its agenda. Littlejohn is hoping to work with this team in forthcoming months.

### **Emergency Budget impact on brokers**

The Chancellor announced a VAT rise to 20% from 4 January 2011, increasing brokers' irrecoverable VAT liability. Anti-forestalling measures were also introduced to prevent businesses such as brokers entering into prepayment or pre-invoicing structures for goods or services to be received on or after that date. These take effect from 22 June 2010.

Standard rate Insurance Premium Tax (IPT) will increase from 5% to 6% on 4 January 2011. The application of the increase will depend on whether the insurer is accounting for IPT on a premium received or premium written basis. The higher rate of IPT, applicable to travel insurance and certain insurance sold with motor vehicles and consumer goods, will mirror the VAT standard rate rise – increasing to 20% in January. Anti-forestalling measures are already in place.

### **Partner boosts Littlejohn's insurance team**

The addition of a highly-experienced seventh partner has made the Littlejohn insurance team one of the largest dedicated insurance advisory teams in the UK. Philip Alexander, former head of insurance at BDO, has been working with insurance brokers for more than 20 years.

### **FSA's financial crime review published**

The FSA has released a final report on its review of financial crime in small firms. The report concludes that, although firms were generally aware of certain requirements, they did not deal with sanctions or high risk situations adequately and did not have sufficiently effective controls in place. You can read the full report on the FSA website at [http://www.fsa.gov.uk/smallfirms/pdf/financial\\_crime\\_report.pdf](http://www.fsa.gov.uk/smallfirms/pdf/financial_crime_report.pdf)



## Mergers & acquisitions – room for optimism

Littlejohn's corporate finance team has been pounding the streets talking to private equity funders, banks and brokers. What's clear is that appetite for investment into the broking sector is on the up and likely to increase into 2011. John Needham comments.

For those intermediaries with the necessary ability, prospects are undoubtedly bright. Along with taking a far more open approach to acquisitions, a new breed of broker is clearly emerging. For example, there is general recognition that considerable cost-shaving can be done. And there's a growing willingness to invest in new technology. Forward-looking brokers are also well advised to move from the immediate bonus culture to equity participation and a share in future exit proceeds.

There is one key advantage in buying now if funding is available. Broker owners seem to be a bit more realistic about valuations, so they are coming down.

Although the big high street banks have pulled back from many sectors, lending to insurance entities is starting to flow, and private equity funds are providing more debt. This change in approach may mean that more deals are done because elusive bank debt is not required. Of around 15 funds we spoke to, all have shown interest in the sector and are open for business.

That the broking sector is attracting more interest is indisputable, but some lessons have been learnt from the heady days of mergers & acquisitions – and from the ensuing financial crisis. Simply going for business as usual is not an option. In particular, brokers need to be in the best possible shape before looking to start on an acquisition trail. They need to fill any skills gaps rapidly in order to build a complete management team. They must also have a clear business plan which shows genuine growth strategies, rather than reliance on brokerage engineering.

And, post acquisition, experience has shown that only those brokers who ensure there is speedy and complete integration of new businesses will be in a position to show they can make the grade – and be ready for further expansion.

*“Brokers need to be in the best possible shape before looking to start on an acquisition trail.”*



## 'Dear CEO' or 'How to stay the right side of the FSA'

Now that we've all had time to digest the FSA's February letter to insurance intermediaries, David Roberts considers the nitty gritty of its requirements.

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

020 7516 2251

[droberts@littlejohnllp.com](mailto:droberts@littlejohnllp.com)

Many of you will have seen the 'Dear CEO' letter of 23 February this year which focused, among other things, on the adequacy of GI brokers' financial resources. Why has the FSA felt it necessary to place more emphasis on this than previously? A key focus is on client money.

### The client money challenge

There's no doubt the FSA would like stricter adherence to the rules, and that is not easy to achieve in practice. Now that the Courts have made it clear that client money may be unprotected in the case of insolvency if the client money trust has not been run in accordance with the Client Assets (CASS) rules, it is easy to see why the FSA has increased its focus on ensuring that brokers don't become insolvent in the first place.

### The importance of management

The FSA is obviously right to emphasise that it is management's job to run the business so that it remains solvent. But the letter was explicitly critical of how some brokers are going about this. That said, the focus was less on adding to existing requirements and more on clarifying the FSA's view on systems and controls and good practice in two areas:

- assessment and management of current and future liquidity
- proper accounting for assets and liabilities, especially in areas where estimates and/or judgements have to be made.

Proper accounting should be a matter of basic good habits, so I'd like to focus here on liquidity.

### Liquidity, not solvency

In essence, the Dear CEO letter defines the liquidity requirement as the need for a broker to meet the

*"The FSA is obviously right to emphasise that it is management's job to run the business so that it remains solvent. But the letter was explicitly critical of how some brokers are going about this."*

commitments arising from its regulated activities as they fall due. It is a liquidity test rather than an accounting solvency test. For instance, a broker could be technically insolvent based on its balance sheet, but still able to generate positive cashflow if the technical insolvency is due to a liability to a parent company that's been subordinated to the interests of other creditors. Equally, a broker could have a solidly positive balance sheet, but still be unable to generate positive cashflow because not enough of its asset base could be converted to cash quickly enough to settle current liabilities.

It is important that brokers maintain sufficient liquidity in both client accounts and corporate accounts.

### Client account cashflows - two stages, two timelines

In client accounts, the inward and outward cashflows should normally be linked, and any surpluses due to the broker should be extractable according to the CASS rules. Most of a broker's inward cashflow is cash in settlement of insurance debtors that includes brokerage, and it's useful to consider this inward cashflow in two stages:

- receipt of premium cash (normally a mixed remittance, per CASS)
- matching of that cash at a transaction level (the FSA says this is required under CASS to crystallise the 'receipt' of the brokerage element).

But beware. These two stages often operate on separate timelines, driven by different factors. For instance, the receipt of premium cash is a matter of credit control between the broker and its clients. Out of that credit control process it should be possible to generate an evidence-based assessment of the time it takes the firm's debtors to pay.

However, the matching process is partly a matter of internal resource (financial and technical), and partly – and often more problematically – influenced by the accounting processes of clients and the nature of the contracts concerned. This means it's often much more difficult to predict how long it will take to turn a cash receipt into a matched cash receipt.

Where it is – or may be – really significant, you should also bear in mind the effect of any funding you have or are likely to undertake, including both voluntary arrangements (such as the payment of a claim before you receive claim monies from the underwriter) and involuntary flows (such as future premium instalments re aviation treaties).

#### **Corporate account cashflows**

For corporate accounts, the inward cashflows are mainly transfers from client accounts, and the outward cashflows are made up of expenses and capital expenditure – both normally straightforward to forecast. When it comes to expenditure, the FSA has highlighted a number of transactions which have not been reflected adequately in brokers' cashflow forecasts, although all are controllable internally and should therefore be possible to forecast. These include bonuses, dividends in and out, intra-group charges, capital expenditure, and investment cashflows.

#### **What brokers should watch**

Cashflow forecasting is a core skill in the financial management of any business, but for an insurance broker there is the added complication of forecasting cashflows into and out of client money accounts. Getting the balance right is key. While over-engineering a cashflow forecasting process rarely makes the information any clearer, over-simplification may not be the way to produce the forecasts needed to support management decisions on how to improve cashflow.

A good example would be if management put substantial effort into getting clients to make payments on account of complex treaty balances, without allocating those payments to transactions. The cash would be received into the client accounts, but could not be transferred out to corporate accounts. Why? Because without matching the receipts to transactions, it couldn't be shown that the brokerage element of any of the contracts concerned had actually been received.

*For more advice on interpreting the 'Dear CEO' letter, contact your usual Littlejohn advisor.*





## ‘Dear FSA’ – or how to respond to ‘Dear CEO’

Not only has the FSA been focusing on financial resources, it also has concerns about other aspects of the management of regulated financial service businesses. John Gregson looks at what these mean for brokers.

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.

020 7903 5755

[jg@advantagebroker.co.uk](mailto:jg@advantagebroker.co.uk)

The FSA’s ‘Dear CEO’ of February this year reminded insurance intermediaries that it is a continuing requirement of authorisation that firms are able, at all times, to demonstrate adherence to Threshold Condition 4 of COND 2 of the Handbook – ‘adequacy of resources’. The wider context of the requirement was also included in the same letter: ‘We also expect firms to be able to demonstrate that they have adequate non-financial resources’.

The FSA believes that this wider requirement is receiving insufficient attention and, as with failure to consider financial resources properly, has led to a number of firms underestimating future demands on their services – leaving them unprepared.

This poses a threat to the FSA’s statutory objectives, particularly that of maintaining consumer confidence in the industry. What type of non-financial resources does the FSA consider essential for insurance intermediaries to perform their regulated activities? The measure of adequacy, in our view at Advantage Broker, should be the setting and attainment of targets consistent with regulatory objectives.

### Why people are important

People are perhaps the non-financial resource that most captures the attention of the FSA, simply because ‘people’ present the greatest regulatory risk to all firms. Internal ‘people risk’ extends from board appointments, through a firm’s senior management team members, to all other staff performing a regulated activity. The FSA looks to see that, at all levels, a firm employs only people with integrity and has a sufficient number with the right competencies, in the right place, at the right time. Human resources must be adequate both now and to accommodate future plans.

### What to show the FSA

The ability to demonstrate adequacy in this area starts with the firm’s business strategy, supported by detailed business plans. These should address any additional staff numbers required to accommodate any planned expansion, especially in areas of customer contact. Sitting alongside business plans should be training and competency programmes, as well as ways of determining fitness and propriety both at recruitment stage and on an ongoing basis. Information demonstrating progress towards attaining targets in these areas should form part of the firm’s regular management information pack – alongside financial results.

At board level, the FSA requires firms to demonstrate that they have sufficient numbers of non-executive directors (NEDs) and that, together with other board members, they are competent to perform their role. As well as relevant business experience, the FSA will look for evidence that NEDs provide sufficient independence and challenge to the executive.

Members of senior management are another focus of the FSA’s attention. Firms must be able to demonstrate that the responsibilities for running the firm are properly allocated throughout the senior team, so that the risks associated with a firm’s operations are shared.

Since it’s critical that these resources are adequate for the future, the FSA will also expect to see evidence of succession planning for the firm’s key roles.

*“The resources of the person concerned must, in the opinion of the FSA, be adequate in relation to the regulated activities that he seeks to carry on, or carries on.”*

Threshold Condition 4 (COND 2.4)

**CEO checklist**

✓	I have articulated my firm's regulatory objectives to my senior team
✓	Each member of my senior team knows, and accepts accountability for, their area(s) of responsibility
✓	I support my chairman in assuring the ongoing competency of members of the board
✓	My firm's business strategy identifies the key non-financial resources we shall need to achieve regulatory success
✓	I have ensured that our headcount projections include adequate provision for expansion in our business
✓	Plans exist to ensure our IT systems remain adequate for our future business requirements
✓	I have included targets for all the non-financial resources my firm uses in my annual business plans
✓	Progress towards meeting these targets is included in my firm's management information pack, on at least a quarterly basis
✓	I have ensured that any risks to my firm arising out of reliance upon group resources have been identified and are being managed
✓	I ensure that a report on the continuing adequacy of my firm's non-financial resources is presented to the board on an annual basis and that a record of any ensuing discussions, including approval of the report, is recorded in the minutes

**The role of functional resources**

Functional resources may be sourced internally or externally. Where appropriate, this includes group resources. What will be considered adequate will depend entirely on the needs of the firm concerned, as identified in business plans.

The most frequently occurring internal functional resources are:

- oversight committees, such as risk, audit and operations
- compliance
- internal audit
- information technology
- HR support.

Externally, firms will have appointed auditors and may also use the services of:

- outsourcers, such as business continuity plan providers or IT services
- consultants
- Appointed Representatives or other agents.

Reports from each of these 'suppliers' (or, where relevant, from the results of any audits that have been carried out) together with commentary from the firm as to how well its regulatory targets associated with these resources have been achieved, form the basis of demonstrating adequacy in this area.

*"We also expect firms to be able to demonstrate that they have adequate non-financial resources."*

'Dear CEO' letter 23 February 2010

# 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](http://www.littlejohnllp.com) for a downloadable version of this newsletter and past editions.

This document is prepared as a general guide. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by the author or publisher.

Strong relationships, substantial partner involvement, honest answers and intelligent solutions from a dynamic team of accountants and advisors. **We work with you to deliver the best for your business.**

Littlejohn LLP  
1 Westferry Circus,  
Canary Wharf,  
London E14 4HD  
T 020 7516 2200  
F 020 7516 2400  
DX 42660 Isle of Dogs  
[www.littlejohnllp.com](http://www.littlejohnllp.com)

INDEPENDENT MEMBER OF  
**POLARIS**<sup>TM</sup>  
INTERNATIONAL