

COMPLIANCE RULES



Welcome to the second edition of *Compliance Rules* for 2010.

BIBA's quarterly newsletter on all things regulatory is compiled using feedback from our members. If there is a regulatory topic you would like featured in a forthcoming edition, please let Steve or Vanessa know.

In this issue of *Compliance Rules*, we bring you our usual centre spread round-up of BIBA's regulation updates, together with a back page article from Jon Sperrin, Director, and Chris Gagg, Senior Manager, at Grant Thornton's Financial Services Group on Threshold Condition 4.

Client money – 'Dear CEO' letter and report

Those members that have attended our popular regional compliance forums will be well aware that the handling of client money and compliance within the rules of CASS 5 has always been at the top of the Financial Services Authority's (FSA's) list of priorities for our sector.

This was re-emphasised in January with the publication of a 'Dear CEO' letter to certain firms supervised in the FSA's Wholesale Firms division, together with a report on the findings of recent supervisory activity.

Members that have not yet had the chance are strongly

recommended to take a look at both the 'Dear CEO' letter and report, because the FSA is planning further thematic supervisory work on client money during 2010 and is taking an increasingly hard line approach to areas of non-compliance.

We have recently updated BIBA's Top 10 Tips on handling client money and would again recommend that those members that have not already done so, should work their way through these.

Final decision on changes to IPT

Members will no doubt have read by now that, following a concerted effort led by BIBA and the IIB, the Chancellor announced in the Budget that the scope of changes to IPT would not only be much narrower than that announced in the *Pre-Budget Report*, but that the implementation date would be 24 March 2010.

The revised scope is still the subject of some confusion, so here is a simplified explanation.

IPT will only apply to fees/charges if all the following four criteria apply:

- the policyholder is an individual buying in a personal capacity
- the contract with the policyholder (for which a fee is being charged) would not exist without the insurance contract

- the fee/charge is not negotiable by the customer
- the insurance premium is arrived at without a 'comprehensive assessment' of the customer's personal circumstances.

The IPT will be collected by the insurers and further details of how this will be facilitated will no doubt emerge shortly.

FSCS levies and review

The FSCS budget for 2010-11 has recently been published and while the threat of an immediate £20 million interim levy has been withdrawn, the year-on-year increase in annual levy for the general insurance B2 sub-class sees last year's levy of £8 million rise to a jaw-dropping £61 million.

These increases are focusing minds now on the FSA's fundamental review of the FSCS. The main issue will be how to separate the insurance intermediaries from those causing the FSCS the main problems, ie, those that have previously mis-sold payment protection insurance, and whether a way can be found to do so that creates a viable alternative.

BIBA is expecting the FSA to publish a consultation paper late in 2010, with any new rules taking effect from April 2012.



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REGULATORY ROUND-UP

FSA appoints CEO of new Consumer Financial Education Body

The FSA has appointed Tony Hobman as Chief Executive of the newly-created Consumer Financial Education Body (CFEB). The aim of the new body is to enhance the public's understanding and knowledge of financial services and their ability to manage their own money matters.

The CFEB will take responsibility for the national roll out of the Money Guidance service, delivered under the MoneyMadeClear brand, which the FSA to date has been overseeing. The service allows people to speak to trained money guides who will assist them with their money issues. A full national roll out of the face-to-face service is due to take place later in 2010.

Funding of the CFEB will come from several sources, including fees raised from firms authorised under the Financial Services and Markets Act, public funds and dormant accounts, and from relevant consumer credit firms through the levies they pay to the Office of Fair Trading. Further details about the mechanics of the CFEB can be found in Consultation Paper 10/5: www.fsa.gov.uk/pubs/cp/cp10_05.pdf

BIBA clarifies brokers' limitation of liability practice

BIBA has launched a new publication to provide clarification to brokers on the issue of limitation of liability when advising clients. The new publication entitled *Facts about limitation of liability* was driven by BIBA's London Market Region Committee (LMRC) and aims to help brokers to manage their financial risk and ensure that it is proportionate to client engagement.

Legal opinion was sought from lawyers Beachcroft LLP in order to produce the publication, which provides background on the regulatory and legal position, information

on what a limitation of liability clause or agreement might contain and what it should not contain. The publication is available on the BIBA website at:

www.biba.org.uk/BrokerContentDetails.aspx?ContentID=1602

Regulator looks to future challenges in *Financial Risk Outlook*

The FSA has published its *Financial Risk Outlook* (FRO) for 2010 outlining the main risks facing firms, consumers and the regulatory system as the immediate global economic crisis subsides and recovery gathers pace in some countries. The publication is one of the regulator's main methods of raising awareness about the major issues facing it and the regulated community in the next 12 months. This year's FRO focuses on four main areas:

- the macroeconomic background and outlook
- financial stability and prudential risks and issues
- retail conduct risks and issues
- market risks and issues.

A series of Sector Digests was also produced alongside the FRO, which can be accessed at:

www.fsa.gov.uk/pubs/plan/sdg_ins.pdf – *Insurance Sector Digest*, this contains a section on the risks facing wholesale insurance intermediaries.

www.fsa.gov.uk/pubs/plan/sdg_ri.pdf – *Retail Intermediaries Sector Digest*, this contains a section on the sustainability of the business model and the quality of advice as it relates to general insurance intermediaries.

www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2010.pdf

Building on the foundation of the FRO was the regulator's *Business Plan*, which sets out its work programme and priorities for 2010/11. Key areas of focus in the coming year: delivering effective supervision backed by credible

deterrence in enforcement; continuing to embed the organisational and cultural change needed to implement intensive supervision; the policy reform programme driven by the Turner Review and the wider policy agenda mandated by the European Union; playing a role in promoting financial stability. www.fsa.gov.uk/pubs/plan/pb2010_11.pdf

FSA proposes RMAR changes for intermediaries subject to MIPRU (CP10/10)

The FSA has published quarterly Consultation Paper CP10/10 which contains proposals for changes to the Retail Mediation Activities Return (RMAR) for insurance intermediaries around inter company debts.

The proposed changes will affect the RMAR Section A: Balance Sheet for insurance intermediaries subject to MIPRU (SUP). It will see affected firms having to complete an additional two new data fields on RMAR-A (balance sheet). The proposed changes to the RMAR will only affect firms which have a group structure and where there are borrowings from that group.

www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_10.shtml

FSA looks to enhance client asset protection in CP10/9

The FSA has published Consultation Paper CP10/9 which sets out changes to its client asset rules. The aim of the consultation is to ensure that clients have confidence their money and assets are safe and will be returned within a reasonable timeframe in the event that a firm becomes insolvent. The paper is of minimal interest to general insurance intermediaries.

The FSA said it will consider extending these proposals to general insurance intermediaries when it begins reviewing CASS 5 (Client money: insurance mediation activity) in the first quarter of 2011.

The consultation period on CP10/9 closes on

30 June 2010. The FSA intends to finalise rules in a policy statement in the third quarter of 2010.

www.fsa.gov.uk/pubs/cp/cp10_09.pdf

EU decision on Block Exemption Regulations

The European Commission has reached a final decision on the future of the Block Exemption Regulations (BER) after a review of the existing rules which exempt certain types of agreements in the insurance sector from the EU's general prohibition of practices restrictive of competition.

The Commission has adopted new rules which continue to exempt two forms of co-operation specific to the insurance sector, namely agreements in relation to joint compilations, tables and studies and co(re)insurance pools. This new regulation became effective on 1 April 2010.

The EC noted: "The review of the previous BER showed that neither agreements on standard policy conditions nor agreements on security devices are specific to the insurance sector. They are therefore excluded from the new BER. The Commission, however, plans to address both of these types of agreements under the EU Guidelines on horizontal co-operation agreements currently being reviewed."

The Commission said it would co-operate with national competition authorities, which have been closely involved in the BER review exercise, to ensure that insurance companies' pools assess correctly whether their agreements meet the exemption conditions and do not use the BER as a blanket protection.

Bribery Bill receives Royal Assent

The Bribery Bill received Royal Assent on 8 April as part of the so-called Parliamentary wash-up period, during which bills are passed before Parliament is dissolved ahead of a General Election.

The new Act replaces old and fragmented legislation with a modern and consolidated bribery law. The legislation creates offences of offering, promising or giving of a bribe and requesting, agreeing to receive or accepting of a bribe either in the UK or abroad, in the public or private sectors. It also creates a separate offence of bribery of a foreign public official in order to obtain or retain business.

Additionally, a new offence in relation to commercial organisations which fail to prevent a bribe being paid by those who perform services for or on behalf of the organisation has been created. It will, however, be a defence if an organisation has 'adequate procedures' in place to prevent bribery.

The new legislation is expected to come into force in October 2010, although its timing is determined by the publication of the formal guidance which must accompany the Act. This guidance should provide further insight into what constitutes 'adequate procedures'.

www.opsi.gov.uk/acts/acts2010/ukpga_20100023_en_1

The failure to put in place adequate anti-bribery controls exposes firms to significant legal and regulatory risks. The new Act and the first ever conviction of a British executive for corrupting foreign officials in order to land contracts should leave members in no doubt that the Government is cracking down on bribery. John Dougall, 44, a Senior Marketing Executive for medical products firm DePuy, pleaded guilty to conspiring to channel bribes of more than £4.5 million to Greek surgeons and was sentenced to a year in prison, despite playing a major role in helping the Serious Fraud Office (SFO) bring the case to court.

Transparency International, a global civil society organisation which is leading the fight against corruption, has developed a series of publications aimed at helping

businesses develop an anti-bribery policy. The organisation has published *Business Principles for Countering Bribery*, a useful tool for firms dealing with the challenge and risks posed by bribery.

www.transparency.org/global_priorities/private_sector/business_principles

There is also extensive information on the SFO's website, including information on how to report corruption.

www.sfo.gov.uk/bribery--corruption.aspx

FSA finalises new framework for financial penalty-setting (PS10/4)

The FSA's new framework for calculating financial penalties which could result in some enforcement fines trebling in size came into force on 6 March 2010. The new structured penalty-setting framework is set out in Policy Statement PS10/4 and is designed to bring greater consistency and transparency.

www.fsa.gov.uk/pubs/policy/ps10_04.pdf

New joint committee to enhance consumer protection

The Financial Ombudsman Service, the FSA and the Office of Fair Trading (OFT) are proposing a new joint consumer protection committee to identify emerging risks and mass claims in the market. The new co-ordination committee would identify any risks with the potential to turn into widespread problems, and determine fast and effective ways of dealing with them, whether through regulatory action or consumer complaints. Details are set out in Discussion Paper DP10/1. Comments about the paper should arrive no later than 10 June 2010.

www.fsa.gov.uk/pubs/discussion/dp10_01.pdf

FSA publishes proposed regulatory fees and levies for 2010/11 (CP10/5)

The FSA has published Consultation Paper CP10/05 on regulatory fees and levies for

2010/11 which explains how the regulator intends to raise its annual funding requirement. The FSA said its annual funding requirement needed to rise by 9.9 per cent to £454.7 million for 2010/11 if its enhanced supervisory programme and a substantial international regulatory reform agenda are to be delivered.

The paper also contains details of the 2010/11 Financial Services Compensation Scheme's (FSCS) management expenses levy limit (chapter 18) and the Financial Ombudsman Service's (FOS) general levy (chapter 19).

The paper includes two main proposals which were consulted on in CP09/26 and these have been incorporated into the FSA's fee rates calculation for 2010/11.

These are:

- the introduction of a new minimum fee for £1,000 for all authorised firms, which is aimed at recovering minimum specified regulatory costs
- moving to a straight line recovery of costs allocated to fee-blocks to calculate variable period fees that most firms pay above the minimum fee.

These measures are designed to introduce a fairer and more transparent fee structure which the FSA argues will mean 60 per cent of firms will pay less. Unfortunately, the changes do mean that around 87 per cent of the 40 per cent of firms having to pay more in fees will be in the A.19 general insurance intermediation fee block.

www.fsa.gov.uk/pubs/cp/cp10_05.pdf – CP10/05

www.fscs.org.uk/uploaded_files/Publications/Plan_and_Budget/Plan_and_Budget_2010-11.pdf – FSCS

www.financial-ombudsman.org.uk/publications/pb10/index.html – FOS

FOS helps smaller firms with video guide to complaints

The FOS has published a video guide for smaller firms. The quick guide briefly sets out

what a firm needs to do in the event of a consumer complaint about its business. The video guide can be found on the FOS website at: www.financial-ombudsman.org.uk/faq/smaller_businesses.html

Law Commission considers late payment damages and good faith

The Law Commission has issued the sixth in its series of issue papers looking at specific aspects of insurance contract law reform. The latest, entitled *Damages for Late Payment and the Insurer's Duty of Good Faith*, looks at whether an insurer should be liable for loss caused as a result of its unjustified refusal to pay a claim.

The paper is designed to encourage discussion before the Law Commission finalises its proposals in its next consultation paper (due in early 2011). Comments should be submitted before 24 June 2010.

www.lawcom.gov.uk/docs/late_payment_issues.pdf

Your Contacts

We hope that you will find this issue of *Compliance Rules* useful. If you have any comments about the content or have ideas for future issues, please contact either



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Crossing the threshold

The Threshold Conditions of the FSA's *Handbook* set out the minimum standards for becoming and remaining an authorised business. There are five main Threshold Conditions plus 'additional conditions.'

Threshold Condition 4 (TC4) requires that firms have adequate resources in relation to their regulated activities. The FSA defines 'adequate' as being sufficient in terms of quality, quantity and availability, and 'resources' as including both financial (eg, capital) and non-financial (eg, people).

The FSA's TC4 'Dear CEO' letter, dated 23 February 2010, to the insurance broking market requires firms to perform a TC4 assessment. While this letter largely focused on financial resources, it also provided a reminder that firms also need to ensure they have adequate non-financial resources.

Financial resources

A key purpose of a TC4 assessment is to determine the level and nature of financial resources and whether these are adequate given the nature of the business. It should be noted that a TC4 assessment may result in higher levels of capital being required than under MIPRU 4 – the specific rules around regulatory capital requirements.

In performing a TC4 assessment of financial resources, brokers should assess the following key areas:

- **client money** – any weaknesses in compliance with client money rules, eg failure to perform timely, complete, and accurate client money calculations
- **cash flow** – the impact of unallocated cash and legacy balances, and funding from client monies or from a firm's own resources. In addition, the impact upon cash and liquidity of the regulated entity in relation to any cash sweeps, eg where the firm is part of a group
- **credit control** – the adequacy of credit control processes including the timely collection of premiums, monitoring of aged debt, application of suitable bad debt provisions, timely payment

of premiums to market (particularly where a premium payment warranty or condition might apply)

- **treasury management** – the value and performance of any investments made by the business. In addition, where insurance business is dealt with in a foreign currency, how foreign exchange exposure is managed and mitigated
- **group companies** – the impact of intercompany balances on the regulated entity(ies), eg, what would happen if some or all of the intercompany balances had to be settled? Would the regulated entity(ies) still be able to meet regulatory capital requirements under MIPRU 4 and TC4? Intercompany balances could also include any subordinated loans provided to the regulated entity(ies)
- **acquisitions** – consideration of the TC4 position of an acquisition and how this will impact the overall position of the acquiring firm. A firm should consider TC4 within its financial and operational due diligence process
- **other liabilities** – the impact of other liabilities should be assessed. For example, any contingent liabilities (eg, an E&O) claim which could result in material creditor balances arising, and pension liabilities which require funding and could impact the going concern of a firm.

In order to perform a TC4 assessment, firms may consider the following approach:

- producing profit and loss, and cash flow forecasts as part of general business planning. Forecast financial positions should also be analysed, including compliance with regulatory capital rules. When producing such forecasts, firms should consider the key areas outlined above.
- identifying risks from the risk register and creating 'scenarios'. Potential financial impacts should then be assessed for each scenario. For example, a scenario could be the loss of a key producing

team or key client. The financial impact might be the loss of income but also the elimination of costs associated with the team or other servicing costs

- stress testing the financial forecasts by assessing the impact of the scenarios on profit and loss, cash flow, and overall solvency. In addition, firms should consider modelling 'worst-case' scenarios.

Finally, TC4 should be included as part of regular financial management information produced to the Boards of regulated firms.

Non-financial resources

The FSA's definition of 'resources' also includes all non-financial resources including personnel and other effective means to manage risk. The adequacy of a firm's people, and the operation of robust control measures, is key to a successful business and keeping the FSA satisfied that resources held are appropriate and proportionate.

The non-financial areas to be assessed for current and future adequacy include:

- **personnel** – this is one of the more critical areas for assessment and easier to measure quantitatively than qualitatively. Due consideration should be given to the personnel needed to deliver the current business and how effectively responsibilities are being discharged. Future changes, either through natural growth, acquisition or disposal, should feature in any TC4 assessment. The quality of recruitment, induction training and competency requirements are all important factors determining the quality of the resource base
- **back-office functions** – information technology (IT), human resources (HR), finance, and resources or functions delivering compliance and risk management. If a broker is sufficiently large to have an internal audit function, then this should also be included
- **information technology** – this includes the hardware in use, back-up arrangements, data security and disaster

recovery arrangements

- **premises** – this is perhaps the easiest of areas to assess as it's normally quite clear when firms are nearing the limits of the capability of their premises
- **acquisitions and disposals** – this can significantly impact resource needs. Assessment should determine the resource requirements, pre- and post-acquisition or disposal, and identify any resource gaps and how they might be dealt with.

Assessment criteria should fall under two main headings:

- **the quantity of resource** and, therefore, its ability to deliver day-to-day activities, operational plans or special projects
- **the quality of resource**, for example, whether the right people with the right skills are available.

In summary, TC4 assessment should not be undertaken purely at the requirement of the FSA but should ideally already be, or become, an intrinsic part of management's decision making when running the business.

When deciding on significant change within the business, management should ask themselves the question: *Do I have the resource to do this, or deliver this change, or is this a step too far?*

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