

June Newsletter
Issue 6/2010

Editorial

As we know the new Government has now announced the demise of the FSA, placing the Bank of England in charge and establishing two new regulators: a prudential regulator under the Bank of England (the 'Prudential Regulation Authority'), and a new Consumer Protection and Markets Authority (CPMA). It's not clear where we fit in but it looks like we will fall under the CPMA. Some have thought that the FSA has been spending too much time on conduct of business regulation rather than prudential regulation so this new system, which adopts the system already used in countries like the Netherlands and Australia is set to redress the balance.

We know that a consultation paper on the new arrangements will be issued (allegedly) before the summer recess and primary legislation should be in place by sometime in 2012. However in a recent speech the FSA said "Importantly, the changes announced by the government are about regulatory structures, not the substance of what we do." Therefore for the moment it looks like it's business as usual!

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Further information on the issues in this newsletter, or any other issues which concern your business, can be obtained from

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FSA takes action over client money failings in two insurance brokers

The FSA has taken action against two insurance brokers - Delwyn Way of Shield Insurance Consultancy Ltd (Shield) and Adrian Shillaker of Griffiths McAlister Insurance Brokers Ltd (Griffiths McAlister) - for failing to adequately protect clients' money and assets.

Shield's director, Delwyn Way, has been fined £77,957 and banned from working in financial services for putting clients at risk by failing to ensure their insurance premiums were passed onto insurers. The fine covers the estimated amount of client money and assets that Way embezzled from Shield's client money account to fund business and personal expenses.

Griffiths McAlister's director, Adrian Shillaker, has been banned from working in financial services with immediate effect for knowingly transferring client money to Griffiths McAlister's business account to fund its business expenses. Shillaker also failed to ensure the client money was managed in accordance with the FSA's Client Money rules including failing to segregate client money from other funds. Shillaker's failings left customers at risk of losing their money. The FSA has also cancelled the permission of the firm.

Whilst these are clear examples of wrongdoing, verging on theft this just reminds us of the strong stance that the FSA is taking on client mismanagement.

On line notifications and applications (ONA)

The FSA has developed a new application and submission system for processing regulatory transactions such as approved persons and appointed representative applications. It replaces the current paper based processes and systems such as Firms Online. It is available for firms to use from June 7. After a transition period of around two months it will be compulsory for all firms who wish to submit relevant applications. After ONA has launched, firms can submit any of the following

applications using a secure, user friendly, online system:

- approved person;
- appointed reps;
- cancellations;
- variation of permission;
- waivers;
- standing data; and
- passports.

Further information can be found at: <http://www.fsa.gov.uk/Pages/Doing/Regulated/ONA/>

Duty of disclosure – a broker's duties

A recent case Jones v Environcom Ltd and Miles Smith serves to remind brokers of their role in ensuring that their clients fully understand the duty to disclose material facts and the fact that providing documentation to the client reminding them of the duty to disclose might not be enough.

The case surrounds a client who was given the appropriate reminders at renewal as well as a reminder that there was a continuing obligation to notify insurers of any material alteration of the risk. The client had a number of fires at their premises but not all of which were the subject of a claim. At the next renewal these incidents were not disclosed. More fires occurred prior to a major fire. Insurers rejected the claim on the grounds of non disclosure and issued proceedings seeking a declaration of non liability. The client counterclaimed joining its broker to the action as a third party, saying the broker had acted negligently in failing to warn it properly of the duty to disclose material facts.

The judge found that the broker was in breach of its duty although the breach had not caused the insured any loss. A broker must advise the client of its duty to disclose all material facts and explain the consequences of failing to do so. It must also indicate the sort of matters which ought to be disclosed and take reasonable care to elicit discloseable matters which the client might not think

necessary to mention. However the broker's duty does not extend to having knowledge of a client's detailed processes. This still remains the remit of the client.

Therefore any broker needs to 1) advise clients of the duty to disclose all material circumstances; 2) explain the consequences of failing to do so; 3) indicate the sorts of matters that ought to be disclosed as being material; and 4) take reasonable care to ensure that the person dealing with insurance at the client company fully understands the duty, even if this is stating the obvious. However for those that are acting as a wholesale broker they should understand that they also have responsibilities in ensuring that a retail broker understands the issues surrounding the duty of disclosure. A broker's management now also need to ensure that relevant staff are made aware of this case and ensure that they are warned of over reliance on standard reminders in relation to non-disclosure.

So what is an ARROW visit?

There seem to be a lot of misconceptions about ARROW and general FSA visits so I thought I would try to provide further information on the FSA's approach to visiting firms.

ARROW (Advanced Risk –Responsive Operating Framework) is a framework that the FSA has put in place and it covers all of its risks, firm-specific, thematic and internal. It has three main components:

- ARROW Firms: used when assessing risks in individual firms (sometimes known as 'vertical' supervision);
- ARROW Themes: used when assessing cross-cutting risks, i.e. those involving several firms or relating to the market as a whole (sometimes known as 'horizontal' work); and
- Internal Risk Management: used when assessing the operational risks that might impact the FSA.

Risks to the FSA's objectives are measured in terms of the impact that a particular negative event may have on a firm against the probability of that event occurring.

The FSA has three approaches to supervision:

Full ARROW – a full risk assessment of probability (all business risks and control risks) within the firm. The supervisory team has discretion to investigate any areas and issues during the assessment, to the extent they see fit. This is subject to challenge for proportionality by those validating the risk assessment internally.

All risk group scores in the risk assessment will be communicated to the firm in the ARROW letter.

ARROW Light – a reduced-scope risk assessment (matching the relatively low level of resources available), covering certain core areas and sectorally important issues only, unless other clearly identified significant risks need attention.

The Small Firms model – this is for low impact firms ('small firms'). Such firms do not have a specific relationship manager attached to them at the FSA. Instead, they are dealt with through the Firm Contact Centre. The FSA will not conduct regular firm specific assessments. Instead, they are subject to thematic reviews and to specific risk mitigation work triggered by remote monitoring of returns from firms and of information from other sources.

Firms which are classified as high impact are also subject to close and continuous supervision.

Firms can get an indication of what is likely to come up in the assessment from the pre-visit information request. Amounts of information will vary depending on what information already knows about the firm. So for example with an Arrow Light visit the information requested will probably be very limited (if any) and a number of general topics will be covered. We know what the FSA's hot topics are so you can probably make a good guess as to what will come up. A full ARROW visit will be pre-empted by a large information request as well as a decent amount of notice. This will be accompanied by a fuller programme of interviews.

The big question is what sort of visit will I get? The FSA uses certain base data that will initially determine any firm's impact score. So for insurance brokers

the impact metric is turnover (commission income). This is then weighted against a sector weighting that determines whether you fall into the category of low, medium low, medium high or high risk. If you are categorized as low impact you will not have an ARROW or an ARROW light visit but will be monitored via returns and potential thematic visits. Apparently the FSA said at a recent presentation that they would only be conducting full ARROW visits to those with income over £30m.

But at the end of the day a visit from the FSA is a visit from the FSA, no matter what it is called! But you should get clues from the information requested as well as the amount of advanced notice of the visit. However just remember they can look at what they want so they may deviate from the script – be prepared!

The FSA's Competence and Ethics CP

The FSA recently released this CP entitled simply 'Competence and ethics'. For the most part it does not have a direct impact on general insurance intermediaries since it refers to acceptable qualifications and imposing time limits for attaining qualifications. For general insurance we currently do not have any such requirements. However the CP proposes to provide guidance to the principles for Approved Persons on competence expectations for those holding Significant Influence Functions (SIF). It provides guidance to say that an approved person carrying out a SIF should take reasonable steps to satisfy themselves that each area of the business for which they are responsible has in place appropriate policies and procedures for reviewing competence, knowledge, skills and performance of staff. Obviously this needs to be considered in conjunction with the size and complexity of the firm.

There are also proposals to add additional descriptions of behaviour to those set out in APER under Principles 1 and 2 and are there to emphasis personal accountability. The FSA expects ethical behaviour to be considered as part of T&C requirements rather than just for Approved Persons.