

March Newsletter  
Issue 3/2010

Editorial

All the articles in this month's newsletter focus on topics that all readers should be aware of, given the FSA's activity over the past year. The overall recurring theme is that firms need to have competent, well structured, well informed Boards. They need to be well versed in the risks that could affect their businesses as well as being aware of all the issues that the FSA is taking an interest in. They need to know how those issues are being managed within their organisations. As we know the FSA is implementing its more intrusive approach so the likelihood of a visit has increased. Hopefully the comments made by LIIBA on the FSA staff and lack of fairness do not manifest themselves.

In this issue:

- **Speech by the FSA on corporate governance**
- **FSA publishes Financial Risk Outlook**
- **LIIBA annual report**
- **FSA Business Plan**

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

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## Speech by the FSA on Corporate Governance

In a recent speech the FSA set out its thoughts on corporate governance. Whilst this speech was given to the Building Societies Association, all the points will apply to any financial services firm. This article sets out their comments on three topics:

- 1) What does effective governance look like?
- 2) How does the FSA aim to embed effective governance in firms?
- 3) How do the FSA's processes work in practice?

### 1) What does effective governance look like?

The FSA noted that good governance will enable the Board to share a clear understanding of the firm's risk appetite and to establish a robust control framework to manage that risk effectively across the business, with effective oversight and challenge along the way.

For Boards that were operating well it noted that many of them were being led effectively from the top, where the chairmen were ensuring that:

- the Board had the appropriate and requisite level of skilled non-executives;
- the Board was actively encouraged to operate in a climate of constructive challenge – where non-executives ask executives the all-important 'why' questions; and
- the Board had a robust succession plan in place.

### 2) How does the FSA aim to embed effective governance in firms?

One of its key proposals in its recent Consultation Paper is to introduce a number of new, more specific, controlled functions within the Approved Persons Regime. (Controlled functions are the roles within a firm that have a particular regulatory significance.)

Within controlled functions, the FSA already has the significant influence

controlled functions (SIFs) to capture those individuals who, in its opinion, exercise a significant influence on a firm.

The SIFs cover many important roles under one broad heading, so currently one individual can carry out a number of roles under just one 'controlled function'. Some of these underlying roles are essential to effective governance. The current regime does not allow the FSA to segregate and capture specific key roles within governance structures. So it is looking to address this and is introducing a number of new, more specific, controlled functions that capture the key roles in organisations.

In future the FSA will be able to identify and assess the competence and capability of individuals performing these key roles.

### 3) How the FSA's processes work in practice

a) Application – firms need to conduct their own due diligence prior to submitting any application. Gone are the days of such applications being approved in a couple of days because a firm wants to make a public announcement.

b) Assessment of application – the FSA will check applications against its normal criteria of honesty, integrity and reputation; competence and capability; and financial soundness. However more focus will now be made on the second criteria.

c) Interview - in those cases where the FSA may decide to carry out an interview, several factors will help determine this: the type and size of firm, the role being applied for, the candidate concerned, and anything that the FSA may have concerns about with the application. The FSA noted that the types of candidates that it was more likely to want to interview are those from larger, more complex or risky firms, who are applying for senior roles.

4) **Ongoing review** - once approved, the performance and competence of persons performing SIFs will be reviewed as part of ARROW

assessments. Approval from the FSA to perform a controlled function brings with it a number of important responsibilities, including a duty to be aware of and comply with its regulatory requirements and expectations.

## **FSA publishes Financial Risk Outlook for 2010**

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. This year it has produced a series of Sector Digests and it has produced one for insurance with a section on wholesale insurance intermediaries. The section is less than 2 pages long but the following areas are highlighted:

### **Regulatory and legislative environment**

- The FSA's approach on transparency, disclosure and conflicts of interest in the commercial insurance market sets out five target outcomes for commercial customers. These outcomes have been developed in the knowledge that, although intermediaries are largely managing conflicts of interest appropriately, more should be done to improve transparency.

### **Key risks**

**Threshold Condition 4** - there is a risk that many insurance intermediaries cannot demonstrate they have adequate financial resources. Supervisory work frequently shows insufficient attention to threats to the financial viability of firms. Consequently some firms are not taking steps to guard against such threats or to develop management plans in case they happen. The FSA expects firms to undertake a regular Threshold Condition 4 assessment, so they can demonstrate that they have adequate financial (and non-financial) resources and, if necessary, make good any deficit.

**Client money** - there is a risk that wholesale insurance intermediaries have inappropriate controls and processes in place around the holding of client and insurer assets and are not always providing an adequate level of protection.

**Financial Crime** - current economic conditions heighten the risks arising from financial crime. These could include claimant fraud or internal fraud (in relation to client money or claims), as well as falsified insurance documentation and corruption amongst intermediary employees. Firms should ensure their control systems remain sufficiently robust to prevent financial crime wherever possible, and to quickly address it should it occur.

The FSA's key message is as follows:

"Firms should be making a realistic assessment of the amount of capital required to run their business effectively in order to ensure they meet threshold financial conditions appropriately on an enduring basis.

As with some firms in other sectors of the financial services industry, we are concerned that some wholesale insurance intermediaries have inappropriate controls and processes in place around client money and assets. We view the protection of client money and assets as a fundamentally important part of regulation, and firms should comply with the requirements set out in the Client Asset Sourcebook (CASS)."

### **Retail Intermediaries**

For retail intermediaries the main concerns surround practices where consumers are not in a position to assess the suitability, benefits and price of a product, particularly in the areas where this is sold alongside a non regulated product such as a mobile phone.

Also firms need to show adequate systems and controls to ensure that in difficult economic conditions this does not lead to staff acting fraudulently. Therefore firms need to ensure that their client money is adequately protected.

The FSA noted that it is concerned at the standard of compliance in network firms and the instances of poor monitoring procedures, inadequate levels of compliance resource and concerns over standards of due diligence carried out on incoming appointed representatives.

## **LIIBA Annual Report**

LIIBA has issued its annual report for 2009/2010. In relation to the FSA it notes that it has maintained a close working relationship despite the number of changes in the FSA's senior management team. In anticipation of the Opposition disbanding the FSA LIIBA has begun making representation to the Shadow Minister for the Treasury. It will be producing a short paper setting out some of the concerns that brokers have with the current regime.

LIIBA has also noted its concerns about the subjective nature of the regime, which can result in lack of fairness across the market and also its continued anxiety about the skills of the supervising staff. It hopes that a new regime would 'abandon the concept of gold-plating and tackle the unnecessary procedures that make the UK uncompetitive in foreign and particular European markets where regulation is less stringent'.

## **FSA Business Plan**

The FSA has released its 2010/11 Business Plan. It will be focusing on the following:

- Delivering effective on the ground supervision of firms;
- Putting intensive supervision fully in place;
- Delivering a credible deterrence philosophy;
- Policy reform such as the Turner Review and other key initiatives in response to the financial crisis;
- The wider policy agenda primarily mandated by the EU, in particular Solvency 2;
- The changes to the FSA's responsibilities in the Financial Services Bill. (If passed, this will change the FSA's remit and powers by adding a statutory objective on financial stability and it proposes removing its public awareness objective, which will be the responsibility of a new consumer financial education body.)