



Insured Interest

Business partners to the insurance industry

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Is the UK insurance industry treating its customers fairly?

A Moore Stephens' survey of UK insurers and intermediaries has revealed that less than half of respondents say that all their staff are aware of what is entailed in Treating Customers Fairly (TCF) and what the FSA is trying to achieve in this respect. Moreover, 40% of insurers have not yet incorporated TCF into their business strategy, and only 50% of respondents overall are "extremely confident" of meeting the FSA's year-end 2008 deadline for compliance.

Overall, 95% of all respondents reported that TCF information was discussed at board level. But only 8% of insurers, and 24% of intermediaries, said that TCF was reviewed on a monthly basis at board level. The role of senior management and the information they see - or do not see - can be critical. Indeed, the FSA has said "where senior managers play an active, directive role in setting out what the firm needs to do to embed fair treatment in the firm's operations, the firm develops a more realistic and effective measurement of it."

While 83% of intermediaries said they had management information and key performance indicators to clearly identify how customers were being treated fairly, only 69% of insurers said the same. The FSA insists that systems and procedures must be embedded in order to be able to assess performance.

A total of 54% of intermediaries, and only 16% of insurers, said that all their staff were fully aware of TCF and the FSA objectives, while 36% of insurers admitted that less than half their staff possessed such awareness.

Only 26% of insurers, and 37% of intermediaries, were able to report that all their employees had been trained in TCF. Just 2% of intermediaries and 9% of insurers reported that "all management" had been so trained.

Staff training, sales procedures, and documentation were the three types of management information reviewed most frequently at board level by both insurers and intermediaries. Overall, only 25% of respondents had reviewed IT as part of their TCF strategy, which is surprisingly low.

40% of insurers admitted that they had not yet incorporated TCF into their business strategy, as opposed to only 14% of intermediaries.

Overall, 38% of respondents said that TCF was written into staff objectives and/or job descriptions, while only 19% of both insurers and intermediaries said that priority was given to TCF when reviewing staff performance and agreeing bonus rewards.



The survey revealed that only 4% of insurers could claim that all their TCF-related work had been documented, compared to 20% for intermediaries. The FSA expects firms to have in place records which can demonstrate the TCF measures, reviews and challenges which have been undertaken.

Complaint letters and responses were the main type of documentation maintained by both insurers and intermediaries to evidence how customers were being fairly treated. Sales procedures, staff handbooks, and file reviews also figured high on the list in this respect.

The survey revealed that only half the respondents were "extremely confident" that they would be able to meet, by year-end 2008, the FSA requirement to "demonstrate to themselves and to the FSA that they are consistently treating their customers fairly". It is surprising to find that 38% of insurers and 50% of intermediaries admitted that the most challenging part of the TCF programme for them was "understanding the outcomes we need to achieve", because the FSA has clearly defined its six customer outcomes for consumers. Insurers and intermediaries would be well-advised to weigh these outcomes against their current TCF performance. The next Arrow visit will be too late.

FSA fine for failure to protect against identity fraud

The Financial Services Authority has fined Merchant Securities Group Limited for not adequately protecting its customers from the risk of identity fraud.

The FSA identified the following weaknesses, which resulted in a £77,000 fine:

- inadequate procedures were in place for verifying the identities of customers who contacted the firm by telephone;
- personal account numbers were included in routine letters; and
- back-up tapes containing unencrypted customer information were kept overnight at an employee's home.

The FSA stated, "Reducing financial crime in the UK is a priority for the FSA, and our recent data security report showed that many firms still need to do more to get it right. We will not wait until information has been lost or stolen before taking action against a firm".

It is vital that firms protect themselves and their customers from the risk of financial crime. They must ensure that adequate protection is in place and frequently test the robustness of their protection systems.

Moore Stephens has undertaken a range of advisory assignments to help clients comply with best practice in IT security, to ensure the integrity, confidentiality and availability of their data. We have also advised on effective fraud risk management and systems and controls reviews as part of compliance with the FSA regime.

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Internal audit operating in isolation

A Moore Stephens' survey has revealed that internal audit may be operating in too much isolation in some quarters of the UK insurance industry, and needs to continue to widen its remit beyond its traditional operational areas to include a broader range of skills, including business strategy.

The survey confirmed that the perceived independence of internal audit needs to be addressed. It showed that 28% of internal audit departments do not report to an audit committee or to the board.

The survey also revealed that respondents have a positive view of internal audit's effectiveness. Nine out of ten respondents said they felt that internal audit was offering "excellent", "very good", or "quite good" service to the insurance industry. However, there is a gap between how internal audit personnel perceive themselves and how others perceive their value. 55% of audit personnel believe they provide "extremely good value" compared with 15% of non-audit personnel.

While 42% of respondents said they used feedback from external advisers to assess whether their internal audit function was best in class, almost 30% either didn't know, or didn't care. Only one in four firms benchmarked their performance against that of competitors.

There was a wide divergence between underwriters and brokers over the approval of internal audit strategy. For all underwriters, the strategy, work plans and reports were approved by the audit committee, but this was the case for only one in five brokers. It is clearly unhealthy if internal audit feels compromised in any way by its reporting lines. It is certainly desirable for reporting lines to be into the audit committee, which is normally comprised of predominantly independent non-executive directors.

Asked to identify the most important internal audit areas for their business, both brokers and underwriters placed financial management at the top of the list, followed by regulatory compliance, risk management, claims, IT systems, business strategy, and customer care. Given the current economic climate, potentially steep reductions in investment portfolios and concerns over reinsurers' credit ratings, it was surprising that underwriters did not consider investments or reinsurance as a high internal audit priority, with both areas scoring just 3%.

While almost 60% of respondents believed that internal audit needed to be punching at a higher level, the ability to influence business strategy was not seen as one of the main benefits of the internal audit function. Rather, the focus was on operational and tactical benefits.

Over one-third of respondents perceived internal audit to be "extremely" or "very well" equipped with the necessary skills to go beyond its compliance role and integrate with risk management, HR, IT, underwriting and actuarial functions. But, again, there was a



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difference in perception in this regard between non-audit and audit personnel, with 45% of audit personnel believing they are well-equipped, against just 11% of non-audit personnel, the majority of whom consider that they are no more than "fairly well" equipped.

Simon Gallagher, head of the Moore Stephens Insurance Industry Group, says, "The FSA sees internal audit practice as an integral part of the insurance industry, from providing assurance on risk management to helping to establish effective control frameworks. But how many insurance firms can claim their internal audit functions are best of breed? The challenge facing internal audit is to take a global, more open, expansive and outward view, incorporating business strategy into its remit.

"The survey also identified somewhat surprisingly that despite the turbulent financial markets the focus for internal audit has remained on underwriting and the liability side of the balance sheet rather than on investment and asset risk. This is an area that will need to receive more focus over the coming months across the industry, including investment strategy risk and counterparty risks."

A copy of the survey report is available at www.moorestephens.co.uk.

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Could hybrid capital change the face of mutuality?

'Hybrid capital' and 'P&I clubs' go together like peaches and gravy. This is why the recent confirmation that the UK P&I Club had raised \$100m in subordinated debt aroused so much comment, and led to speculation that it might change the face of mutuality. But the fact that something is new - at least to the mutual market - does not make it bad.



Mutuality in P&I brings together people with a common need in search of common benefits. For P&I clubs, broadly speaking, that means having access to the reinsurance protection which the volume and nature of the business demands, and providing the high-quality service with

which the clubs have become synonymous.

Shipowners and operators don't like nasty surprises of the sort we have seen in the last eighteen months or so. Claims have escalated in size and number, the investment markets have suffered a significant downturn, and financial regulations have started to bite. No club has remained untouched.

Certainly since the early 1990s, most clubs have been grateful for good investment years to help offset - although not disguise - poor underwriting results. But the days of double-digit investment returns are now a long way off. And while there is no evidence to suggest that any of the clubs has been hit specifically

by the sub-prime crisis, today's volatile financial markets are just the sort which motivate regulators to raise the capital bar.

Shipowners and operators want stability and consistency from their P&I clubs. They do not want volatility in costs. In order to avoid that volatility, the clubs need to be much more adequately capitalised than at any time previously. Any doubts they may have entertained will long since have been settled by the EU Solvency II regime. More than ever before, stability and consistency demand capital adequacy, and the clubs are entitled to be inventive in terms of how they seek to achieve it.

There is no reason why P&I clubs and hybrid capital should not exist comfortably together. Indeed, we might expect more clubs to go down this route, sooner rather than later. It will not change the fundamental nature of mutuality any more than it has done in the fixed premium market.

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Fragmentation the new consolidation for brokers?

Consolidation has been the buzzword in the insurance broking sector for some time now. But a new trend, which might best be described as 'fragmentation', is beginning to emerge.

Increasingly, groups of broking expertise which, together with their business, can expect to attract the attention of big professional consolidators are starting to question the wisdom of going down what has recently been quite a well-trodden route. Instead, they are looking at the possibility of setting up new broking houses of their own, and applying for FSA accreditation. And it is not difficult to see why.

A group of individual brokers controlling business worth, say, £1m in annual brokerage, are not likely to secure any personal gain by throwing in their hand with a major consolidator. The financial rewards to be gained by setting up on their own, even when set off against start-up and operating expenses, are clearly attractive. And there are other factors which are influencing opinion.

Starting this year, the rules on the admittance of Lloyd's brokers have been relaxed, with the result that it is now

much easier to set up a new business than it was before. Also, largely because of the successful and aggressive approach adopted by professional consolidators, the business model for valuing broking houses has multiplied by a factor of two to three in recent years.

It is too early to say whether what we have seen is the start of significant fragmentation in the broking market, or whether it is little more than a transient phase. Only time will tell. But those brokers who are looking to set up new, FSA-registered businesses will need to seek professional advice on a number of issues, ranging from FSA and Lloyd's applications, through tax and payroll advice, to management accounting, risk assessment and IT security.

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New IT assurance senior manager

Steve Williams has joined Moore Stephens as a senior manager in the IT assurance team. He says, "Firms in the financial services sector are being fined substantial sums of money for IT control and security failings."

Steve has extensive experience of working in a number of regulated industry sectors, and has seen first-hand the threats to IT security and data integrity which can routinely exist.

"There is lots of good practice against which firms can benchmark their IT controls but, too often, they do not. Basic IT controls and checks are essential to modern businesses. But the focus tends to be on whether the equipment is working, rather than on whether the systems are set up to provide the levels of security and control required."

"Too often, IT control and security are nobody's job in particular, so the responsibility ends up with whoever in the IT department draws the short straw. This has to change, not only to meet regulatory demands but also to satisfy the risk management criteria which firms should be setting themselves. Increasingly, the services of an expert in this field are likely to prove invaluable."

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Personal effects: Robert Facer



Robert Facer joined Moore Stephens in March 2007 as a senior VAT manager. He is part of a team which covers all aspects of VAT compliance and consulting across Moore Stephens' client base, including the insurance industry.

Robert explains, "In the UK, insurance intermediaries are generally exempt from the payment of VAT, although there remains a continuing need for companies wishing to qualify for VAT exemption to demonstrate that they are truly supplying services which fall within the VAT definition of an intermediary.

"There is meanwhile a lack of harmony between the VAT rules in the UK and those in Europe, where the treatment of VAT can also vary as a result of different interpretations placed upon the rules by individual states. Draft proposals and directives are currently being prepared as part of a long-running review in Europe of VAT rules in the financial services sector. At the moment, industry is waiting to see what will happen, but it does seem likely that, when the European review is completed, significant changes to the UK VAT rules will be required to bring them into line with EU requirements. It would be fair to say that, in Europe, the current UK VAT exemptions are deemed to be broader than they should be."

Robert says there are potentially some major challenges ahead for the UK insurance industry involving VAT. He explains, "If certain insurance services, particularly so-called 'back office' functions, become liable for VAT, some sectors of the insurance industry in the UK may have to adopt a different structure to the one they operate under at the moment. Rather than outsourcing, which has been a popular option for many years, firms may opt to bring certain functions back in-house.

"At one time, there were a lot of VAT schemes that were designed to maximise VAT recovery, but in recent years HMRC has taken an aggressive attitude to what it deems to be VAT avoidance abuse. I am happy to be part of a team at Moore Stephens which has the experience and the knowledge to help clients maximise their VAT recovery, and to plan their VAT exposure, in a structured way which eliminates unpleasant surprises while keeping the regulators happy. Given ongoing developments in Europe, it would be surprising if the insurance industry's need for such expertise did not increase in the near future."

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The devil's dictionary

The seventeenth in a series looking at classic and alternative definitions of accountancy terms.

Q is for **quick ratio**.

The textbook definition

A quick (or acid test) ratio compares the amount of cash plus marketable securities plus accounts receivable to the amount of current liabilities.

The alternative definition

An acid (or litmus) test ratio is a dead metaphor which originated in olden times. Our knowledge of that day (Wednesday) is sketchy at best, but it seems as likely as sixpence that people used to test gold by putting acid on it. Do not try this at home.

Today, it is difficult to imagine any business passing the acid test. But the shortage of ready gold and acid has motivated banks to replace the acid test with questionnaires designed to elicit sensitive information from their customers.

A typical acid test questionnaire might read as follows:

- 1 Do you spend more than you earn?
- 2 Do you earn more than your butler?
- 3 Are you a mutual?
- 4 Is You Is Or Is You Ain't My Baby?
- 5 Have you ever been - or do you intend to be - inveigled by the Inland Revenue?
- 6 Do you turn red when exposed to acid?
- 7 Is there anybody living in your house called 'Cheeky'?
- 8 How are you?

If you answer 'Yes' to more than eight of these questions, you will probably turn blue under alkaline conditions, and will register over the PH range 4.5 at 25 degrees centigrade. You will have failed the acid test. Do not panic. Loosen all clothing, including your own. Breathe deeply and whistle Dixie.

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