

Insured Interest

Business partners to the insurance industry

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Insurance industry contemplates tougher regulation

Regulation is now a much more significant requirement than at any time in the history of the financial services sector, and the indications are that the onus in this regard on service providers is set to become tougher still. Furthermore, the requirements will continue to go much deeper than merely paying lip-service to the regulations. Rather, they will call for properly embedded risk control procedures, and the ability to demonstrate that customers are being treated fairly.

In the UK, the Financial Services Authority imposed record levels of fines on businesses in 2008, totalling £22.6m – more than a five-fold increase on the previous year. And 2009 already looks like being another year of heavy penalties.

The insurance industry has featured significantly in these fines. Last year, for example, Hastings Insurance Services was fined £735,000 for failing to treat its customers fairly in relation to the cancellation of over 4,500 incorrectly priced insurance policies. Hastings had cancelled the policies, priced incorrectly due to an internal systems error, but failed to give sufficient consideration to paying the premium shortfall to the insurance provider or investigating other possible remedies.

The FSA found that the way in which the policies were cancelled and the service that Hastings gave to its customers following the cancellation showed that the firm had focused on the financial cost to itself and did not properly consider alternative remedies or the detrimental effect on its customers.

Meanwhile, this year has started badly for the insurance industry, with broking giant Aon having been fined £5.25m for failing to take reasonable care to establish and maintain effective systems and controls to counter the risks of bribery and corruption associated with making payments to overseas firms and individuals.

Significantly, fines in respect of Treating Customers Fairly (TCF), such as those in the case of Hastings, have been the largest imposed on insurance firms, with the exception of Aon. The FSA noted that the fair treatment of customers had not been embedded into Hastings' corporate culture, and stressed to all firms the importance of embedding TCF into their systems and procedures.

This will remain an FSA priority for the foreseeable future. Indeed, the FSA has issued a paper on consumer responsibility in an attempt to stimulate debate about how best to help and encourage consumers to better



consider their own interests. This could help counter-balance the perceived threat posed by increased regulatory control and intervention in the financial services sector.

The FSA expects regulated companies to know its customers, and to put in place systems which evidence that they are being treated fairly. If the customers themselves are better apprised of their needs and entitlements, it is probable that the potential for regulatory breaches, embracing everything from fraud, to mis-selling, to unfair treatment, will fall exponentially.

Regulation alone cannot remove financial risk from the business of insurance. But the upward trend in FSA fines would seem to confirm the need for regulatory control, and regulatory intervention is likely to increase in the sort of depressed economic climate in which today's insurers and their customers are operating. The challenge for today's insurance industry, and for today's regulators, is to achieve the right balance between necessary financial regulation and establishing within businesses a recognition of the need to embed proper risk management, TCF and governance principles into their culture. This cannot be achieved effectively through a tick-box mentality.

FSA arrows in on NEDs

The FSA has emphasised that non-executive directors – and particularly those who chair key committees – are among those who are likely to be interviewed during an ARROW visit.

Although non-executives are not expected to provide a detailed view of all company operations, the FSA has enumerated the following types of issues which they can expect to arise during an interview:

- whether you, and your fellow non-executives, have a good oversight of the risks facing your firm;
- how effective the controls are within the firm;
- the adequacy of the firm's infrastructure;
- what controls there are in place to ensure that business is conducted properly with customers and markets.

The FSA exerts pressure on executive management to ensure that non-executive directors are of a high quality, and expects those non-executives to challenge the executive board, where necessary. It expects non-executives to be honest and competent and to "ask the challenging questions, and to understand the business models and sources of profit in the firm, along with the risks which those entail".

If you agree to become a non-executive director, you must expect the FSA to assess your competence and to hold you accountable if you conduct yourself in a way which is below the reasonably expected standards.

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Solvency II – is yours a model business?

It has been said that a deadline is a negative inspiration, but that at least it's better than no inspiration at all. And for the insurance industry, the deadlines imposed for demonstrating compliance with the incipient EU Solvency II regime are becoming, if not inspirational, then uncomfortably close.

So what is the time frame leading up to inception of Solvency II, what challenges does the new regime pose for the insurance industry, and what help is available in meeting those challenges?

Solvency II introduces a risk-based capital adequacy regime which is due to take effect from October 2012. It requires all regulated firms with gross premium income above specified minimum levels to enhance their development of risk management and capital planning systems.

The FSA has imposed an extended 'dry run' leading up to implementation. By 31 March 2009, all firms must have reviewed their governance arrangements and nominated a board member or other responsible person to oversee Solvency II compliance. And by June, firms will have to present details of the internal capital model they propose to use to satisfy Solvency II requirements, failing which they will be required to use the FSA model, which can be expected to be more onerous and less flexible than any independently developed model.

Insurers face a variety of challenges in achieving Solvency II compliance, some of them entirely new to the insurance industry. But the biggest challenge is likely to revolve around the development of compliant internal models, or the customisation of existing models and – most importantly – the embedding of those models into their day-to-day business practices.

The architects of Solvency II describe an internal model as "A risk management system developed by an insurer to analyse the overall risk position, to quantify risks and to determine the economic capital required to meet those risks". The purpose of such a model, it adds, is to "fully integrate processes of risk and capital management within the insurer".

So what goes into a good internal model, one which can be embedded into the very fabric of the firm? The model must be capable of being used to make financial and general business decisions in the best interests of the company. It needs to be constructed in such a way that it can drill into specific areas of the business, rather than merely identifying the whole-account picture. In this way, it will be possible to establish the correct capital loading factor needed for a particular class of business to be profitable.

The internal model must have a high level of granularity, and the information generated must be



"By 31 March 2009, all firms must have reviewed their governance arrangements and nominated a board member or other responsible person to oversee Solvency II compliance."

capable of being fed back into underwriting, reinsurance, claims and other functions in order to create a better business and/or a better book of business.

Many companies in the insurance sector already have internal business models, but the empirical evidence to date suggests that these are generally not of the standard which will be required under Solvency II. Internal models must be embedded into the structure of everyday operations, and must be capable of anticipating changes in the industry or in the financial markets, or at least reacting to change – as, for example, in the case of the current credit crunch – quickly enough to protect the business.

Moore Stephens is uniquely placed to help companies with Solvency II compliance. It has the proven insurance industry expertise, and it has the necessary actuarial skills and the technical expertise to build and adapt internal models to the required level, and to provide third-party validation of existing systems. Without access to such resources, companies in the insurance industry may find themselves likened to the author Douglas Adams, who said, "I love deadlines. I especially like the whooshing sound they make as they go flying by."



Investing in mutuality

The effect of the ongoing crisis of confidence in the world financial markets has inevitably made itself felt in the marine mutual liability market, with all the P&I clubs suffering this year to a greater or lesser extent from poor returns from their investment portfolios.

The picture is decidedly gloomy. At this time last year, the clubs might have been forgiven for dreaming about a return to the halcyon days of double-digit returns on investments. Today, single-digit returns would be just fine.

Quite apart from punching a hole in the finances of the clubs and giving rise to a spate of additional calls on their members, this financial misery has stimulated debate about the role of investment income in the P&I market. There is an argument which says that shipowners would be better off not exposed to the uncertainties of the investment markets. But there is another argument which suggests otherwise.

Were it feasible to insure marine liabilities in the commercial market up to the sums now insured by the clubs and their reinsurers, it is likely that the effect of the credit crunch on shipowners, as reflected in their insurance premiums, would have been a great deal worse than under the mutual system. The strengths of mutuality are the same strengths they have always been, and indeed they may be perceived as greater still in times of financial crises. In the wider context of the financial markets, for example, there is currently growing interest in the advantages of mutuals over underperforming shareholder-owned banks.

The clubs are different from the proprietary insurance market. One of the things that makes them different is the fact that they are able to invest their members' money as part of the overall mutual philosophy

applied to insuring long-tail liability risks. This is not to say that the clubs will invest blindly into a black hole while the recession continues to exert its grip on the financial markets. Certainly, for the foreseeable future, the clubs' investment strategies might be conservative, particularly if free reserves decline and there is pressure on solvency margins as regulators throughout the world become more conservative themselves. But there is no reason to draw a line under investments per se, even though the current paucity of investment returns will concentrate the directing minds of the clubs on achieving break-even in terms of pure underwriting results over the next twelve months.

The clubs have shown, over very many years, their ability to create and manage a product which responds to their members' needs. There is every indication that they will continue to do so. Difficult times call for creative thinking. The clubs should be looking now at their business models, and making sure that they are capable of achieving their desired results. They should make sure they are using the very best technology in terms of underwriting and rating tools, and exploring whether it might be preferable in some cases to work in a slightly different way to reflect and accommodate changes in financial conditions and in the risk climate. But they should not panic, and throw the investment baby out with the bath water. And nothing in their history suggests that they will.

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Tax opportunities for some

The reduction in standard rate VAT announced in the recent Pre-Budget Report will affect all VAT registered businesses, and could also have a beneficial knock-on effect for the likes of smaller insurance brokers which are not VAT registered.

Overall, end-consumers should benefit from the rate change, although this presupposes that retailers will pass on to them the full benefit of the rate reduction. But those businesses which are not entitled to recover the VAT which they incur on expenditure are likely to be among the greatest beneficiaries. For them, it means an effective 2.5% reduction in the cost of purchases, and may even be an incentive to increase capital expenditure.

It should be noted, however, that HM Revenue & Customs is to introduce so-called 'anti-forestalling' legislation to prevent businesses using artificial

arrangements to obtain a lower VAT cost on supply transactions that will take place after the rate reverts back to 17.5%.

The Pre-Budget Report also confirmed that the small companies rate of corporation tax is to remain at 21% until 1 April 2010, when it will increase to 22%. Where possible, businesses, which enjoy the benefit of the small companies rate, should consider accelerating revenue and deferring expenditure, in order to benefit.

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Passing the test

The Moore Stephens insurance industry team comprises people who have either worked in the insurance industry at a senior level, or who have developed their knowledge and understanding of insurance in the workplace and through further study.

This year, for example, nine of the team sat the Lloyd's and London Introductory Market Test (LLMIT), a course developed by Lloyd's, the IUA, LIIBA and the LMA to enhance standards of knowledge, performance and customer care in the insurance industry.

LLMIT develops and tests awareness and comprehension of how business is traded in the London market and the roles and responsibilities of those involved. All nine passed; so congratulations to Alex Barnes, Bryony Hall, Chris Jones, Maya Manjrekar, Carole Skinner, Anna Shersheneva, Ben Slater, Charlie Walker and Dan Walsh.

The LLMIT pass mark is in the region of 70%. The examining board only discloses marks on application. Three of the Moore Stephens team dared to ask, and their percentages ranged from 89% to 93%.

Alex Barnes and Carole Skinner, meanwhile, also sat the Chartered Insurance Institute IF1—Insurance, Legal and Regulatory examination, the object of which is to develop knowledge and understanding of basic insurance principles and practice. They both passed, with marks in excess of 90%.

Who to contact

Simon Gallagher
Michael Butler
Anton Luck
Stuart Markley

Personal effects: Steve Williams



Steve Williams joined Moore Stephens last July as a senior manager in the IT assurance team. He brought with him extensive experience as a trained IT auditor and security consultant in the financial services sector, and a working knowledge of the insurance industry.

Before he started designing, implementing, operating and auditing IT controls, Steve spent four years at Loughborough University being

a space scientist and playing rugby. He dismisses the space science as "number crunching on a study of Aurora Borealis", but refuses to be so dismissive about the rugby.

Steve has hit the ground running as part of the Moore Stephens Insurance Industry Group. His first hand experience of working in a number of regulated industry sectors means he is only too aware of the potential threats which exist to IT security and data integrity. He says, "Such threats arise from a variety of sources, ranging from poor monitoring of staff access to personal email, to the lack of clear and transparent responsibility throughout the firm for information security, and the failure to audit third party suppliers who have access to the firm's customer data.

"The insurance industry is as much at risk as any other sector, and more so than some. Threats to IT security and integrity may lurk in a number of areas of a company's day-to-day business practices and, rather than focus on whether or not the equipment is working, firms need to ask themselves whether the systems are actually capable of providing the levels of security and control required. This is something which must be properly addressed, not least because one of the FSA's statutory objectives is to reduce financial crime."

Steve was born in a South Wales mining village, but these days lives in Kent with his wife and family. He describes his hobbies as "two very small children", and his interests as "two very small children". He is a keen sports fan, and admits that his real passion in life, the thing for which he evinces "undying love", is Welsh rugby. Steve says he is "inconsolable" when the national team loses. Join the club.

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The devil's dictionary

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

S is for **solvency**.

The textbook definition

Solvency is the financial ability to pay debts when they become due.

The alternative definition

Solvency is part of chemistry and involves a substance, usually a liquid, which is capable of dissolving another substance, usually a substance, thereby forming a solution – hence 'liquidity'. Liquidity is the opposite of insolvency, which is found in all parts of the world except Scotland, where it has been replaced by frugality. Frugality takes its name from a Scotsman visiting London who said, "Mon, I hadna' bin there above two hours went bang went sixpence".

Scotland is part of Europe, which plans to introduce a Solvency II regime in 2010 or 2012, whichever first

occurs. Solvency II is not just a regulatory burden. It can be a real performance burden as well. It has been likened to Basel II, which is Swiss and can be pronounced several different ways, all of them wrong. Basel has very little night life but holds a carnival every Monday after Ash Wednesday.

Solvency II has three pillows, each of which is made from memory foam which returns to its original shape at any time after 2012, but always before midnight. The pillows are non-allergenic, and therefore suitable for those who suffer from allergies.

The FSA website contains a list of FAQs on Solvency II, including 'What is the expected risk-based impact of a solvency framework?' and 'Can hiccupping make you fat?' Click on each pillow to find out more.

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