

Insured Interest

Business partners to the insurance industry

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Plotting a path to Solvency II

The path to Solvency II may be paved with good intentions, but the FSA has emphasised that UK firms will have to demonstrate a good deal more than that in the lead up to implementation of the capital adequacy regime for European insurers and reinsurers.

What they will have to show is that they are embracing Solvency II wholeheartedly, and in the process enhancing their development of risk management and capital planning systems. And they will also have to start their implementation planning now, as the FSA is imposing an extended 'dry run' lead up to Solvency II implementation.

Solvency II will introduce a risk-based capital adequacy regime to apply to EEA insurers and reinsurers with gross premium income exceeding €5m or with gross technical provisions in excess of €25m. And to help UK insurers to prepare, the FSA has recently published a discussion paper entitled Insurance Risk Management – The Path to Solvency II, which outlines the main challenges that are likely to arise.

Highlighting key messages for UK firms, the FSA says that, in terms of demonstrating adequacy of financial resources, Solvency II is expected to go further than the 2004 ICAS reforms, with the result that compliance will require further development of firms' systems for capital planning and management of prudential risk and associated disclosure arrangements.

Solvency II permits firms to apply for approval to use full or partial internal models to calculate their regulatory capital requirements, as an alternative to applying the results of the standard formula. But firms who choose this option will be required to demonstrate compliance with several mandated tests and requirements, including the so-called 'Use Test'.

The FSA urges firms to ensure that they currently have in place appropriate governance arrangements, with an accountable individual nominated at board or senior management level, responsible for ensuring effective Solvency II implementation.

The move to Solvency II will involve a change in emphasis and approach for many insurers. Not least, it will require more formal, publicly available reporting of financial performance, governance and risk management, including completion of an Own Risk and Solvency Assessment (ORSA). This will have implications for actuarial, finance and IT functions.

The FSA requirement for all insurance businesses to have an actuarial function as part of the Solvency II regime will also represent a change for many UK firms.



The requirement is explicit about the roles that the actuarial function is required to undertake, some of which may not traditionally be within the remit of the actuarial work within some firms.

There will also be different public and supervisory disclosure requirements under Solvency II compared to current UK regulatory reporting requirements with new annual return formats and a Solvency and Financial Condition (SFC) report.

The FSA concludes that the risks of waiting before starting to plan for Solvency II implementation are "considerable in terms of non-compliance and/or being forced into costly high-risk programmes of work at short notice. So starting work now on a measured and flexible basis is the sensible course for regulators and firms alike."

Although implementation may seem a long way off, it may yet come too soon for the unprepared. It is also now likely that the draft Solvency II framework directive to be presented to EU finance ministers for approval in December will go ahead without the inclusion of many of the insurance groups' supervision rules, which has been an area of contention. Despite the late changes and potential for the timetable to over-run further, firms must start planning now, ensuring that internal resources and procedures are sufficiently compliant to withstand the much higher degree of public accountability which comes with Solvency II. This is not a compliance chore. Solvency II must be embraced wholeheartedly, and risk management embedded into day-to-day operational procedures.

Remuneration concern

The FSA has confirmed that it shares the current "widespread concern" that inappropriate remuneration schemes, particularly, but not exclusively, in investment banking and trading, may have contributed to the present crisis in the financial markets.

In a letter to CEOs, it notes, "It would appear that in many cases the remuneration structures of firms may have been inconsistent with sound risk management. It is possible that they frequently gave incentives to staff to pursue risky policies, undermining the impact of systems designed to control risk."

Noting that it has no wish to become involved in setting remuneration levels, the FSA says it nevertheless wants to "ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls, and with the firm's stated risk appetite."

The FSA urges all firms to consider their remuneration policies carefully, especially in light of recent market developments, and emphasises that if such policies are not in line with sound risk management, they are unacceptable. It sets out some examples of good practice, including taking into account risk management skills when awarding bonuses, and involving HR in setting compensation.

The FSA conducted a review of remuneration policies with London-based firms in September and plans to arrange further visits before the end of the year to all recipients of its letter. It concludes, "We would encourage firms to review compensation policies throughout the firm."

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Move to exemption system brings CFCs into focus

Recent proposals to reform the UK taxation of foreign profits have created considerable uncertainty and, indeed, contributed to the decision by a number of FTSE companies to relocate their headquarters to countries such as the Republic of Ireland and Luxembourg.

Large and medium-sized groups have strongly welcomed the announcement in the Pre-Budget Report that foreign dividends received on ordinary shares and most non-ordinary shares will be exempt from UK tax. But this exemption will be balanced by a targeted anti-avoidance rule and, more significantly, a cap on interest deductions by UK members of multinational groups by reference to the groups' consolidated net external finance costs. The rules which deny relief for interest incurred for unallowable purposes are also to be extended, and consequential changes will be made to the rules on Controlled Foreign Companies (CFCs).

This reform of UK rules governing CFCs was always going to be a quid pro quo attendant upon an exemption rather than "tax and relieve" system for foreign dividends. The exemption system will bring the issue of CFCs into sharper focus. The Pre-Budget Report notes that the government has deferred a decision on further reforms to CFC rules, and that consultation will continue through 2009.

When first published for consultation in mid-2007, the proposals concerning changes to the CFC regime as part

of the reform of taxation of foreign profits were widely condemned by industry in general, and by the insurance sector in particular, as being uncompetitive – and creating greater uncertainty than already existed – at a time when the UK taxation system was already firmly under the critical spotlight. Large numbers of UK insurance companies with significant offshore locations were clearly among those most exercised, and potentially most severely disadvantaged, by the proposed changes.

Since their introduction in 1984, the CFC rules have always been something of a deterrent rather than a tax-raising measure. However, following the European Court of Justice decision in the Cadbury Schweppes case and the Vodafone 2 case in the UK courts, the status of the UK's CFC legislation is unclear. Given that the government wishes to retain some kind of CFC provisions, we can expect further developments in 2009. Insurance companies with significant offshore representation must meanwhile watch and wait before deciding whether they need to respond to any changes.

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TCF preparedness

From 1 January 2009, the FSA will be looking for clear evidence in authorised firms' management information systems that they are consistently treating their customers in line with its clearly defined six consumer outcomes.



Insurers and intermediaries would be well advised to check their current TCF performance. If they are less than confident of their ability to demonstrate they are providing what is required of them in TCF terms, they should seek professional advice immediately.

The next Arrow visit will be too late.

Moore Stephens has developed a TCF healthcheck to assess a firm's TCF readiness and to provide constructive and cost-effective recommendations, based on comparisons with best practice. Our approach to the three-day work programme is that:

- we undertake a detailed test of the appropriateness of management information, focusing on how information is developed, measured and reported; the robustness of

the chosen methods of measurement; and what the firm does with the information;

- we assess whether the evidence demonstrates that the firm is consistently treating its customers fairly;
- we hold senior level discussions on the firm's approach to TCF to understand the use and understanding of the management information;
- we review customer treatment to test whether the management information accurately reflects what is happening;
- we then form an evidence-based judgement on the firms' overall culture and the quality of information being used to measure consumer outcomes, and assess if the firm is able to fully achieve the FSA's six outcomes.

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IT security healthcheck

One of the FSA's statutory objectives is the reduction of financial crime. To achieve this objective, the regulator is focusing strongly on information security.

In the insurance sector in 2007, Norwich Union was fined £1.26m by the FSA for failure to protect its customers' confidential details after fraudsters had used publicly available data to elicit confidential information from the insurer's call centres. In the financial services sector in the same year, Nationwide was fined £980,000 for information security lapses.

Threats to IT security and integrity may lurk in any number of areas of a company's day-to-day business practice. If allowed to go undetected, they represent a significant threat to security. The extent of such threat can be estimated by comparing performance against a simple checklist:

Organisation and responsibility

- Do you have clear and transparent responsibility for information security?
- Do you have an information security policy?
- Do you have procedures for detecting losses of customer data and for notifying them if you lose their data?
- Do you regularly train employees in information security obligations?

Access

- Do all users have unique username and password combinations?

- Do you restrict access to the internet and email for employees with access to customer data?

Data management

- Are your systems regularly backed up?
- Are laptops and portable media encrypted?
- Is significant computing equipment stored in a purpose-built machine room?
- Are formal procedures in place for the destruction of customer data? Does this include paper and electronic formats?

Compliance

- Do you audit those third-party suppliers who have access to your customer data, to make sure they meet your security requirements?
- Do you monitor whether your IT controls are working through your compliance function?

If you answer 'No' to even one of these questions, your business security may be under threat. While a checklist can only provide an indicator of this threat, if you'd like to understand your security threats, and what you should be doing to address them, in more detail, please contact us.

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Reducing the threat of fraud

Last year, a survey revealed that almost one in ten adults in the UK admitted that they had filed a fraudulent insurance claim at one time or another.

Today, given the crisis in world financial markets, it can be expected that the figure will be higher still. Indeed, an 80% increase in travel insurance fraud was recently highlighted as one of the more immediately discernible effects of the credit crunch, while members of the Association of Insurance and Risk Managers (AIRMIC) were warned that the credit crunch was potentially a breeding ground for fraud, and that they should expect higher levels of claims against liability policies.

Fraudulent and dishonest claims are a major problem for the insurance industry. Furthermore, the credit crunch may also impact on legitimate claims. A cargo of steel bars slightly wetted on a sea voyage from the UK to the Middle East, for example, might in a healthy economic climate be compensated by a reduced price agreed between buyer and seller. In a credit crunch, however, the more likely outcome is a major claim on insurers.

Fraudulent claims from policyholders are not the only concern for the insurance industry. There is fraud within firms and between firms to consider, and the FSA has recently said that it views organised fraud involving insurance claims as a key emerging risk.

The demands of the regulators and the requirements of Solvency II will increase the pressure on the insurance industry to show that it is doing all it can to detect and prevent fraud. Moore Stephens can help in a variety of ways by using analytical tools, actuarial analysis, and industry knowledge and expertise to detect potential instances of fraud and to help design and maintain systems and practices which minimise the risk of fraud occurring.

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Autumn events

A recent Moore Stephens survey showed that comparatively few firms are totally confident about what is expected of them under the FSA's TCF regime.

So it was encouraging to see a healthy turnout of more than 140 people for our TCF 'No rules, no benchmarks' seminar in November. Insurance Industry Group head Simon Gallagher and compliance consultant, Claire Crossley provided practical guidance on what the FSA is looking for and what firms need to do before the year end 2008 compliance deadline.

And in October, insurance industry clients participated in a test of their general knowledge at a Quiz Night led by quizmaster and Moore Stephens partner Stuart Markley.

With ten rounds of questions on a variety of topics, ranging from flags and symbols to children's classics, and a marathon round on Olympic venues, each team was required to be at its best to challenge for the winner's champagne prize.

Jokers were available so that participants could double up the points available on their strongest subject. Cheating was not tolerated, with the use of electronic devices blocked by switching off the venue's Wi-Fi connection. A closely fought contest was won by A Life of Riley, the team from Tindall Riley. Those who trailed in their wake comforted themselves with Einstein's dictum that imagination is more important than knowledge.

Who to contact

Simon Gallagher
Michael Butler
Anton Luck
Stuart Markley

Personal effects: Will Sullivan



Will Sullivan studied Spanish and Portuguese at university. He had no fixed idea of what he wanted to do in terms of earning a living, but he did know that he didn't want to be a teacher or a translator, which seemed the most likely career path for somebody with his skills and qualifications. Instead, in November 2005, he joined Moore Stephens as a trainee.

Now an audit senior, Will moved over to the Insurance Industry Group last year, and is greatly enjoying the varied and challenging

nature of the work. He explains, "When I first joined the firm I worked with a variety of different industry groups across the range of Moore Stephens clients. Now, it is good to be focused on one particular industry. We have a broad range of insurance clients, both large and small, and a great deal of my time is spent on site at clients' offices, providing audit and consultancy services for brokers, other intermediaries, and insurers. We have a strong teamwork ethic, and that helps make the job really enjoyable.

"At the moment, given the parlous state of the world financial markets, a lot of my time is spent monitoring clients' investment portfolios, helping them ensure their

money has been invested prudently and in the most advantageous way."

The great majority of Will's work is in London, but he does get the opportunity to travel, and to use his languages. Last year he went to Costa Rica to act as a translator during the Moore Stephens' audit of the state-run insurance company. This year he is going back, and hopes to take a more active role in the audit itself. "It is good to travel," says Will, "to experience new environments and business cultures and to get the chance to use my languages."

When Will is at home in Islington, he enjoys the cinema, and particularly likes a good foreign-language film. Asked if he is fluent in Spanish and Portuguese, he modestly claims, "I was when I left university".

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The devil's dictionary

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

R is for **regulation**.

The textbook definition

Regulation is a set of rules designed to control the conduct of those to whom they apply.

This content can be found at <http://www.investorwords.com/cgi-bin/getword.cgi?id=5950&term=regulation>

The alternative definition

For the insurance industry, regulation is the new *laissez-faire*. It started with Lloyd's, a coffee shop which made its fortune insuring Betty Grable's legs. In the old days – after bowler hats but before women – life was just a bowl of cherries. You could walk into the underwriting room at Lloyd's, ask a redcoat to call out 'Willis Faber Probyn' in a loud voice, and ten minutes later you had a 10% scratch on the most rotten old slip in the world, with cufflinks your only security. Not any more.

In the 1980s, a combination of asbestosis and Sir Peter Green ushered in the new era of regulation which

today extends to all parts of the UK insurance industry and some parts of East Anglia. Space and inclination prevent us from going into these in any detail whatsoever.

There are those who claim that the insurance industry is a healthier place thanks to regulation. But others maintain that regulation has ruined the business. Underwriters must now have enough money in the bank to cover their losses. Brokers have to treat customers fairly (what's THAT all about?). Claims fraud is generally frowned upon. City lunches have been pegged back to four hours, tops.

Forty years ago, a decent length of made-to-measure suiting on easy terms from John Collier and an aptitude for playing off-spin were pretty much all you needed to break into one of the top City broking houses. Now, you have to show that you know how to embed TCF procedures into the firm's business model.

Terms and conditions apply.

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