

Insurance Evolution

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The Walker Review: The rise of risk

Sir David Walker has come, seen and delivered his draft review of corporate governance in banking and other financial industry entities (BOFIs). Whether or not he will conquer depends largely on the outcome of the period of consultation which now follows. A final version of the report is due some time in November.

Note the crucial letters OFI in the acronym BOFI. Although originally commissioned by the Prime Minister as a review of corporate governance in banking, its terms of reference were extended so that the Review should also identify where its recommendations are applicable to other financial institutions, including insurers.

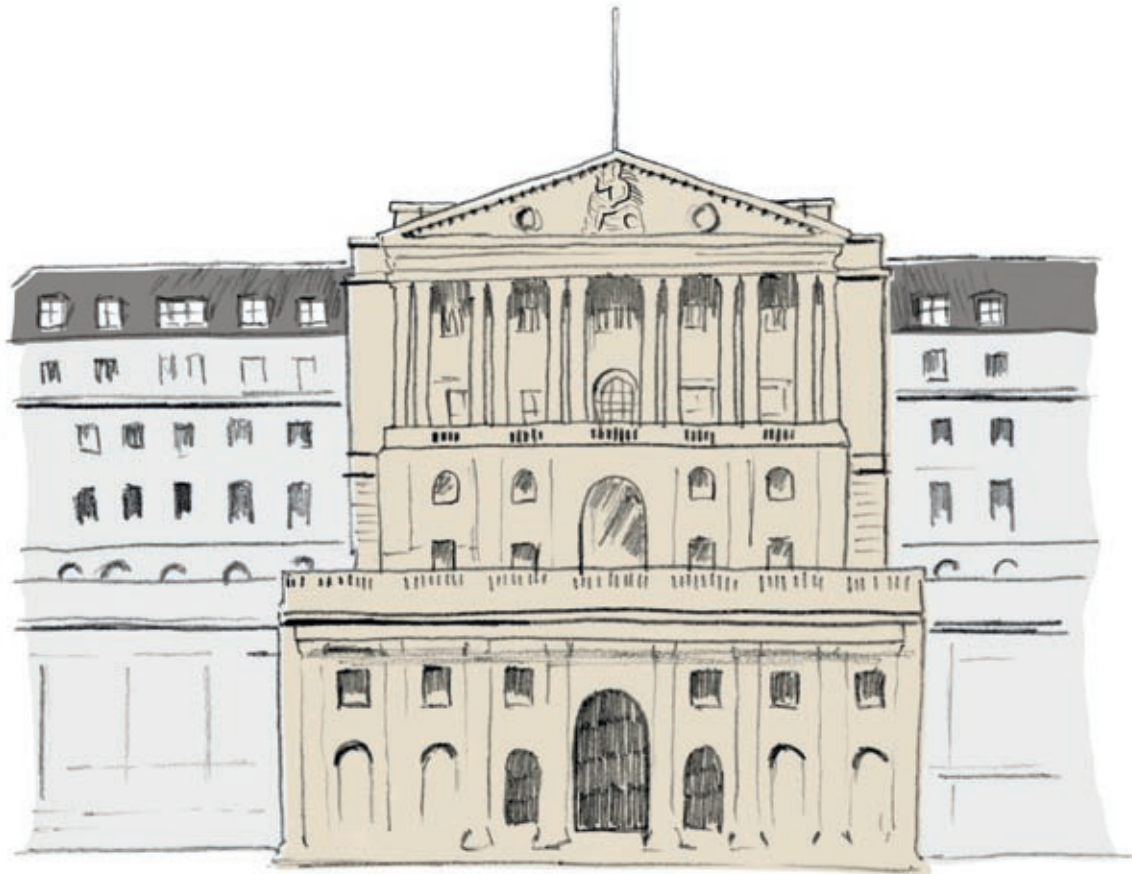
So far the response to his report has been largely positive. The British Bankers Association, the Association of

British Insurers and the Institute of Directors welcomed the vast majority of Sir David's 39 recommendations which cover board size, composition, qualification, function and performance evaluation, as well as the role of institutional shareholders and remuneration.

On top of all this good stuff, thirteen pages (chapter 6) of this 142 page document are devoted to the governance of risk. Walker intends that these

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findings should, as well as applying to banks, apply to listed life assurers. He leaves the question of their relevance to other financial institutions open, although we see no reason why they should not apply just as equally to general insurers.

The five specific recommendations relating to risk are welcome. Why? Because they will help to raise the profile of risk management, on an enterprise-wide basis, in BOFIs and move the focus of the board away from disclosure as a means of expediting its obligations. CROs and their teams should be in a much stronger position to influence key decisions and put their discipline at the heart of the way businesses operate. It is a significant step forward for risk management in the financial services industry.

The biggest single challenge that in-house risk functions have faced has been the lack of senior management support. If Walker's recommendations are implemented, this will no longer be the case, and the place of risk within

financial services organisations will receive a significant boost.

If you are a risk manager, or a CRO, struggling to establish your discipline within your organisation then Walker's words on page 11 of the report should whet your personal risk appetite:

board-level engagement in the high-level risk process should be materially increased with particular attention to the monitoring of risk and discussion leading to decisions on the entity's risk appetite and tolerance.

His five key recommendations on risk stem from this:

1. the suggestion that there should be a board level risk committee separate from the audit committee
2. the idea that each firm should have a CRO, with a place at the top table (reporting into CEO or FD and the board level committee)
3. the need for the board level committee to have access to expertise
4. the concept that the board level risk

committee should oversee the due diligence of any transaction

5. the proposal that the board level risk committee's annual report should be included in the company's annual report.

But it's not just the headline recommendations that will flood the aorta of the average risk manager with bubbling red blood cells. The risk governance proposals are spiced up by a number of eye-catching supporting suggestions.

On the question of the composition and role of the board risk committee, Walker suggests that the CEO might be excluded from the board risk committee so that it can have an 'open and wide-ranging discussion without the sometimes dominating presence of the CEO.'

Another welcome suggestion is that materials presented to the committee 'should be in succinct format, highlighting major issues.' All too often risk MI of BOFIs is voluminous and

lacks focus on key issues. Indeed the paper recommends that if a CRO is unable to commission such information he/she is probably not the right person for the job.

Walker expects the committee to influence the way executives are incentivised by advising the remuneration committee on risk measures that should be included in the packages of the executive team.

Risk appetite is given prominence, as is the need for the committee to focus on current and future risks, by contrast with the audit committee, which tends to be backwards-looking.

If all this is not enough, the CRO is to have total independence from business units but must get more involved in risk managed by group functions, noticeably the treasury. Given how powerful treasurers tend to be, this may give rise to some interesting organisational dynamics.

And just to underline how senior the CRO should be, he/she should report to the CEO or FD, as well as the board risk committee. In line with Audit Directors, he/she should have access to the Chair of the Audit Committee and, as is often the case for the company secretary, should only be removed from office by the prior agreement of the board. Pay and status must reflect the seniority of the role. In a final boost, Walker wants any 'residual attitudes' whereby business units resist the CRO to be quashed.

So in one fell swoop Walker has:

- lit the torch in support of sensible MI: focused and clear, not hundreds of pages of waffle
- developed a powerful board level committee to focus exclusively on risk and to challenge executives around risk management
- legitimised the idea of risk as a performance measure for executives
- reiterated the importance of risk appetite
- given CROs a place at the top table with enabling reporting lines and potentially enhanced pay and status.

The Walker Review is a credible and timely attempt to empower the risk management discipline, as well as to provide greater clarity to board and executive as to the right status and profile for risk in the business. This is a very welcome move and, although much of the press coverage has suggested that Walker is simply enshrining existing good practice, the chapter on risk governance, at least, is a major step forward and should be embraced by companies and their shareholders.



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And so to embed...

The advent of Solvency II will bring a multitude of challenges to the insurance sector. However, for those insurers intending to seek authorisation for an internal model, surveys and expert comment regularly identify the 'use test' as one of the biggest challenges.

According to the Solvency II Directive, the use test is the requirement for an insurer to demonstrate that 'the internal model is widely used in and plays an important part in' the running of the business. This requirement is enshrined in the text of the Solvency II directive and, if an insurer is unable to satisfy this test, its internal model will not be approved and it will be forced to calculate its regulatory capital requirement using the standard formula.

In order to satisfy the use test, insurers will need to demonstrate to the regulator that they have successfully embedded their risk management processes in the business and that they utilise their internal model widely. But what does this actually mean? What does embedded risk management look like? How should an insurer go about putting it in place? And will it actually do them any good?

Why should you want to embed risk management processes?

To address the last question first, it is tempting to think that an insurer should embed their risk management process purely because of the regulatory imperative. However, insurers who tackle this process just to tick a regulatory box are unlikely to derive any substantial benefit and may, through setting their aspirations to mere compliance, actually increase their chances of failing the use test.

As luck would have it, however, the good news is that there are huge benefits

to be derived from embedding. It will provide all levels of management with a deeper understanding of the business. This will enable them to specify more meaningful and focused management information which will support informed risk taking leading to better management decisions and, ultimately, improved profitability.

Those insurers that want to embed risk management processes are cognisant of the range of benefits that exist such as improved efficiency through cost savings, more effective capital allocation, improved profitability and a reduced cost of capital. These organisations recognise that the principles of integrated risk and capital management contained in the Solvency II directive make sound business sense and can improve their understanding of the business. This will deliver competitive advantage through improved performance measurement using more focused and meaningful management information that is valued, used and requested by management at all levels in the organisation. Many do not see regulation or red tape but a once in a lifetime opportunity to overhaul the way they run their business allowing them to revisit and review their business model, their staffing and skills resource, to redefine the core management information that they require to run the business successfully and to assess the IT systems and infrastructure to support this.

Getting started

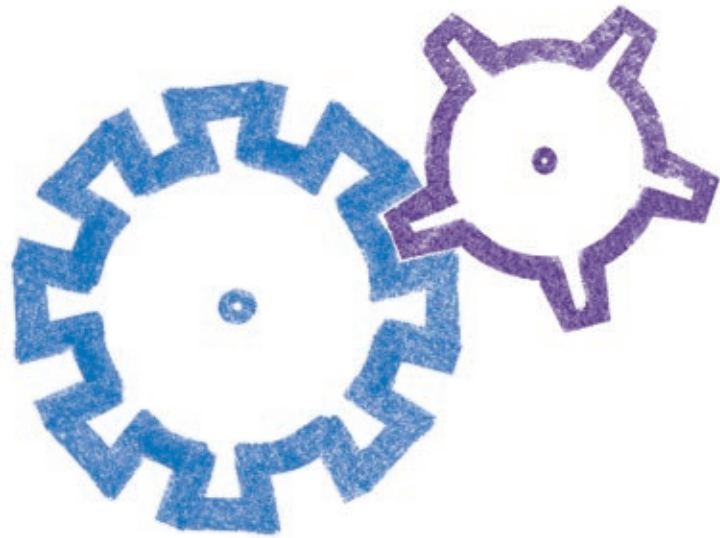
So, having convinced yourself of the benefits, how do you go about realising them? As a first step, the executive management of insurance companies need to ask themselves some fundamental questions:

1. What evidence will be acceptable to the regulator to demonstrate that we have a fully embedded risk management process?
2. How widely used and how important a role does our internal model fulfil in the course of conducting regular business?
3. How do we demonstrate to the supervisor that our internal model is used by management to measure and manage risk in the business?

What might good embedding look like?

The simple answer is business as usual. Those insurers who have successfully embedded their risk management processes will be able to highlight standard operating procedures that are inherent in their day-to-day activities (such as pricing, underwriting, reserving, claims management and investment management) that are also recognised as sound (risk) management, which are, in other words, good management control and stewardship of the business. Some examples of typical evidence in this regard are:

- board meeting minutes reflecting consideration of risk issues in executive decisions



- records of internal model re-runs and how the results were taken account of in any subsequent business decision
- demonstrating adherence to underwriting guidelines
- evidence that the criteria requiring model re-runs have in fact been triggered.

These are fairly obvious examples and insurers need to go further than this to identify existing evidence of an embedded risk management process and culture and develop such evidence where it does not already exist. This draws together business as usual, standard operating procedures, policies and procedures, risk appetite and comprehensive limit structures.

It is clear that the more separately identifiable an insurer's risk management policies and procedures are, the farther away they will be from their objective of embedding these within the business. However, if risk management is embedded, the insurer faces two key challenges:

1. For the executive management, the operational management and the Chief Risk Officer of the organisation to recognise those elements in their business as usual policies and guidelines that are also recognised as sound (risk) management practices and to articulate that to the regulator.
2. To educate the supervisor as to the sound (risk) management operating procedures and policies that are

engrained within their normal business practice.

Guidance

Guidance has recently been issued on how insurers can comply with the use test. Consultation Paper No. 56 (CP56) from the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) sets out core principles for demonstrating the use test. The foundation principle states that "the undertaking's use of the internal model shall be sufficiently material to result in pressure to improve the quality of the internal model". The ability and willingness of senior management to use the output of the internal model will be fundamental in demonstrating adherence to this principle. A corner stone of this will be management's understanding of the internal model. If they don't understand it they won't use it! And this understanding needs to be displayed by all levels of management, not just the very top of the organisation or the risk professionals.

CP56 proposes the following nine subordinate principles, supporting the foundation principle, to assist insurers in assessing their compliance with the use test:

1. Senior management shall be able to demonstrate an understanding of the internal model.

2. The internal model shall fit the business model.
3. The internal model shall cover sufficient risks to make it useful for risk management and decision making.
4. The internal model shall be widely integrated with the risk management system.
5. The integration into the risk management system shall be on a consistent basis for all uses.
6. The internal model shall be used to support and verify decision making in the undertaking.
7. The internal model will be used to calculate the Solvency Capital Requirement (SCR) at least annually and also when there is a significant change to the undertaking's risk profile.
8. The internal model shall be used to improve the undertaking's risk management system.
9. Undertakings shall design the internal model in such a way that it facilitates analysis of business decisions.

What does this mean?

CP56 proposes that the range of uses to which the internal model is put should be comprehensive but that there should be no mandatory list of uses. The rationale here is clear in that the aim

should be for the insurer to have some 'skin in the game' by relying on the internal model for the uses that they have identified. These uses could include strategic planning, limit setting, strategic asset allocation, pricing, product design, determining risk appetite, capital management, reinsurance programme design, hedging, and mergers and acquisitions.

In summarising the above principles it should be clear that an internal model is unlikely to be used if it is not understood, if it is not aligned to the existing business model or if it fails to cover a sufficiently wide range of risks. All identified material risks should be assessed by the internal model and should be discussed in internal management reports. The internal model also needs to produce outputs on the relevant accounting basis, be capable of supporting decision-making and allow management to assess the capital implications of potential decisions. The results and output from the internal model should be used to inform internal debates across the insurers' management structure. In addition, there should be a feedback loop between the internal model and the risk management system where results from one should lead to improvements in the other.

How should insurers approach the challenge of embedding?

Insurers need to develop a road map to plan their progress towards successfully demonstrating an embedded risk process. This can build on the Solvency II gap analysis and form part of the implementation plan.

The corner stone of the process is to identify the extent to which existing risk management processes and procedures are already embedded in the fabric of the

Example internal model uses

Adequate pricing	Assessing customer benefits
Asset/liability management	Business planning/strategy
Capital management	Development and monitoring or risk appetite
Development of risk strategies	Efficient use of capital
Management of exposures and limit setting	External risk reporting
Market valuation for IFRS	Provision of management information
Measurement of material risk	Supporting the ORSA
Reinsurance purchasing decisions	Performance reporting
Product development/pricing	Reconciling economic capital to regulatory capital

organisation. This will require a wholesale review of existing processes from a different perspective to identify risk management practices and procedures already in existence but known by another name, such as standard operating procedures, risk limits, delegated authorities, underwriting guidelines and investment management policies. While this will require a thorough review of existing controls and operational framework, our experience suggests that the results will be surprisingly positive.

However, the fact that many processes may already be in place does not alter the fact that embedding will require a substantial amount of work to be undertaken. Successfully embedding risk management and demonstrating the use test is more about behavioural change than risk and capital management.

In reviewing the existing control framework insurers may find it useful to categorise their existing policies,

procedures and guidelines in accordance with the industry standard three lines of defence model, i.e. day to day management of the business, functional oversight, and independent verification of the adequacy and effectiveness of the internal risk control management system.

As a minimum, the responsibility to make informed and measured decisions to take risk must be defined in the roles, responsibilities and accountabilities of the various levels of management of the insurer. This must be reflected in job descriptions, form part of the annual appraisal process and be reflected in the reward structure (including incentives and bonuses) of the insurer.

It can be seen that embedding and the use test are closely intertwined and one can not be addressed without due consideration of the other. Two things are clear:

1. the uses to which the internal model is put need to be comprehensive

2. the regulator will not be prescribing those uses.

The ability and willingness of senior management to use the outputs of the internal model will therefore require their close involvement in defining the purposes for which they will rely on its use.

The final point to make is that waiting to begin embedding until the internal model is built is a recipe for disaster. If the various levels of management have had no input into the design of the internal model or its parameterisation and if it is presented to them as a black box, how can they have any confidence in the results it produces? And if they have no confidence in the results, they are certainly not going to rely on them when making important decisions. And if they do not do that, you are going to fail the use test.

For this reason, it is imperative that management are involved from an early stage of model design and that their input is sought into functionality, assumptions and parameters so that they can begin to 'buy in' to the model. Then, they will feel a sense of ownership of the results and are likely to place far more reliance on them.

Put another way, the process of embedding needs to begin right at the start of the preparations for Solvency II.

Conclusion

As mentioned at the beginning of this article, embedding and the use test are amongst the biggest challenges facing insurers as they prepare for Solvency II. However, they are also amongst the biggest opportunities and those insurers who grasp the opportunities will give themselves a competitive advantage over those who do not.

Grant Thornton's Actuarial and Risk team have developed a ten point action plan to assist insurance companies in addressing the use test requirements and demonstrating an embedded risk management process.

The ten steps are shown below:

1. Assess the extent to which good risk management practices already exist.
2. Define the criteria for both internal model and Own Risk and Solvency Assessment (ORSA) reruns.
3. Incorporate management of risk into job descriptions, annual appraisals and remuneration policy.
4. Determine how to communicate evidence of embedding internally and externally.
5. Where needed, develop policies and procedures and incorporate into business as usual processes.
6. Identify areas of the business where using the internal model adds value.
7. Assign policies, procedures, controls, guidelines, roles and responsibilities, accountabilities and ownership across the three lines of defence model.
8. Consider how the internal model will support the ORSA process.
9. Define the core management information that the business needs.
10. Incorporate input from business units and apply reasonableness tests.



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How is tax shaping insurance group structures?

Overview of issues facing insurance groups

Insurers are facing unprecedented pressure from all quarters. Shareholders are seeking enhanced returns on their investments and policyholders are demanding enhanced value, whilst at the same time groups are having to cope with increasing regulation, competition and tax complexity. Compounding this, insurance groups will often have complex and outdated structures which have developed over time and which may not represent the most capital, tax or operationally efficient structure for the business going forward. These factors are driving insurance groups to question whether they should be reconsidering how their international structures are organised.

Location of Head Office

A number of trends are emerging. In the Lloyd's and London markets new entrants and established players are opting to put their Head Office and primary capital base in locations such as Bermuda, Ireland and Switzerland with insurance operations in the major markets around the globe. There are a number of reasons cited by groups for this migration of business from more traditional territories – a 'lighter touch' regulatory environment, access to alternative capital providers, access to new markets and, of course, lower tax rates – all of which make good commercial sense and the case for migrating the Head Office compelling.

A company is a separate legal personality from its shareholders.

This distinction means that any restructuring plan needs careful consideration from both a corporate and shareholder tax perspective. The tax benefits can be illustrated simply by way of an example. For an insurance group headquartered in the UK, it will typically be difficult to maintain the group's tax rate below the main UK corporation tax rate of 28% in the long term. By contrast profits arising in, for example, an offshore territory such as Bermuda may not suffer any local tax. The tax position of the shareholders is more complex and will depend not only on where they are resident but also on the tax status of the investor – individual, corporate or a tax exempt body such as a pension fund. Even where a shareholder group is potentially disadvantaged,



the issue might be managed by the promise of enhanced dividends or it may be possible to preserve the existing UK tax treatment in relation to future dividends by putting in place a dividend access arrangement to ensure the continued availability of tax credits for certain UK shareholders (subject to sufficient UK profits).

Significant one-off tax costs could potentially arise in restructuring the Head Office location which would require careful consideration both from a shareholder and corporate perspective. Many countries levy an exit charge which seeks to tax the increase in value of assets owned in that country when a company is migrated or restructured offshore. In fact, the US introduced targeted anti-inversion rules following the departure of a number of high profile groups. For shareholders, the key issue will be the ability to roll-over gains on existing shareholdings into shares in a new Head Office company.

Ongoing issues

The new structure would require careful management to ensure that the potential tax benefits are ultimately realised. Some of the key UK tax issues which would need to be considered are discussed below.

Tax residence

Under UK domestic law, a company is UK tax resident if it is either incorporated in the UK or has its 'central management and control' in the UK. A company incorporated overseas could therefore be considered UK tax resident (i.e. liable to UK corporation

tax on its worldwide profits) if it were centrally managed and controlled in the UK.

Central management and control generally means the highest level of control of the business of a company, i.e. key strategic decision-making. It is largely determined by the facts, focusing particularly on the individuals who exercise management and control and where they exercise that management and control. It would be necessary to ensure that the operation and composition of the overseas company's Board were carefully managed.

The principal, but not conclusive, test applied by the courts when considering a company's residence is to look to the place where the board of directors meet. However, the place of central management and control is a question of fact in each case and HM Revenue and Customs' (HMRC's) practice is to consider first who exercises control and then consider where this control is exercised. In particular, HMRC takes the view that the place of directors' meetings is only significant insofar as those meetings do actually constitute the medium through which the central

management and control is exercised. The risk cannot be simply managed by maintaining a 'brass plate' office overseas and flying executives to an offshore location for board meetings.

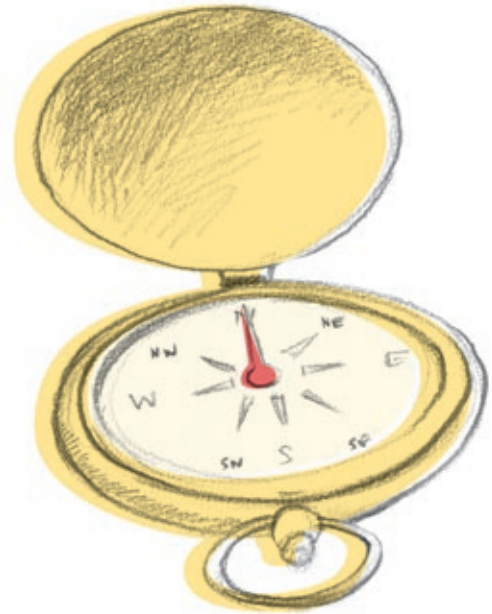
Permanent establishment

Companies not resident in the UK may, under certain circumstances, still be within the charge to UK corporation tax if they carry on a trade through a UK permanent establishment.

Such a permanent establishment could arise either via a fixed place of business in the UK through which the non-resident company carries on its business, or via an agent exercising authority to do business in the UK on the non-resident company's behalf (a dependent agent).

It is therefore important that the new overseas companies do not have a UK permanent establishment in respect of its their activities such that HMRC would seek to tax the profits in the UK. A permanent establishment may be deemed to exist if the business is or the key entrepreneurial risk taking functions are routinely carried on in the UK.

A key risk for such a structure will concern the group's reinsurance



activities. The principal factor in determining whether the reinsurance activities take place through a permanent establishment in the UK will be who evaluates and signs the intra-group quota share agreement and where the signing takes place. It would be necessary to put in place strict operating protocols to ensure a permanent establishment is not created which could impede flexibility within the business.

Transfer pricing

There is tax legislation in the UK which requires that transactions between related parties need to be (and must be shown to be) priced on an arm's length basis. If transactions are not at arm's length, the UK tax position will be adjusted to remove any advantage gained by a UK taxpayer as a result of the non arm's length price. There is a requirement for appropriate documentation to be maintained to evidence the arm's length position and penalties may be imposed where an adjustment is made and inadequate transfer pricing documentation is maintained.

It would be necessary, therefore, to establish a price for the intra-group transactions arising as a result of a restructuring which could stand up to HMRC scrutiny. The key transaction which would require consideration would be the group's reinsurance arrangements. As well as transacting on arm's length terms, a UK cedant would also be required to maintain a good documentary trail which explains and analyses the functions being performed respectively by cedant and insurer;

and explains how the pricing was arrived at and why that satisfies both the OECD and HMRC's transfer pricing requirements.

It is clear from the risks highlighted above that a restructuring of the Head Office location should not be considered lightly. It is necessary to carefully weigh-up the tax and other benefits with the costs of maintaining the structure, both in terms of the actual monetary costs and the impact on operational flexibility.

Re-domestication

Head Office location is only part of the picture. Traditionally, multinational insurance groups have a structure based around locally incorporated subsidiaries with each holding individual regulatory capital. With the Solvency II capital adequacy requirements on the horizon and the focus on capital which this will bring, this is providing the impetus for groups to review the location and structure of insurance operations including run-off business. Increasingly the trend is for groups to move towards a single European Union (EU) carrier model, establishing a single underwriting company in an EU member state and operating in other member states on a freedom of establishment (branches) and/or freedom of services basis. Streamlining in this way allows groups to operate from a larger platform and can bring regulatory benefits including the opportunity to optimise regulatory capital and potentially a single European supervisor. In addition, there may be potential tax savings to be made

from operating from a low tax EU member state such as Ireland.

Branch taxation

In determining the most appropriate structure a group will need to consider whether it prefers to operate through a branch network or subsidiary companies. The commercial considerations such as administrative costs and the attitude of the local market to transacting with a branch rather than a company would need to be taken into account. Also, different countries take different approaches to the taxation of foreign business profits, which can cause difficulties when trying to undertake a comparison, although most developed countries accept that double taxation should be avoided. There are two principal approaches to achieving this aim.

One approach for example taken by the UK and the US, involves the taxation of an entity's worldwide branch profits and providing double taxation relief for foreign taxes suffered so that they may be offset against the tax due, within limits. In essence the overall tax is topped up to the home country rate. The second approach is to allow an exemption for foreign branch profits from local tax. This approach is taken in countries such as the Netherlands and France and can sometimes give a benefit where profits arise in lower taxed branches as there is no top up of the overall tax rate.

Furthermore, there can be inconsistencies between the method of double taxation relief for branches and

subsidiaries within a country. For example, in the UK, whilst a credit mechanism operates for profits from overseas branches, as described above, an exemption regime operates for many dividends received on or after 1 July 2009.

Most countries would claim that the measure of profits of a subsidiary and a permanent establishment should be approximately the same. This would seem reasonable given that the typical double taxation agreement attributes to a permanent establishment the profits it might be expected to make if it were a distinct or separate enterprise, engaged in the same activities, under the same conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. However, a risk of double taxation remains as each fiscal authority seeks its “fair share” or “correct” measure of tax. The position is complicated by the trend for business models involving the division of capital, distribution and skills and it is necessary to undertake detailed and rigorous functional analyses in order to support the arrangements in place.

A bespoke solution

Tax competition has created an uneven playing field that can have a significant impact on returns on capital. As a result, differences in corporate income tax rates and the diversity within the global fiscal environment are leading to considerable opportunities for insurers to improve the tax efficiency of their structure. It is no coincidence that territories with low tax rates (such as Bermuda and Ireland) or

with tax exemptions for foreign permanent establishments in a treaty country (such as Luxembourg) have already attracted interest.

However, the choice of corporate structure is a complex issue requiring a bespoke solution which balances the business drivers such as developing new products and markets and achieving operational efficiencies, whilst also achieving regulatory, capital and tax efficiencies. The existing regulatory framework will change significantly under Solvency II and will have a major impact on how insurance groups utilise their capital.

Insurers need to consider these issues as they analyse their group and capital structures and plan for future development of the business.

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Bribery and corruption

What next for London market insurance brokers?

Against a backdrop of an impaired UK and global economy, the likelihood for financial crime in the form of bribery and corruption has continued to increase.

The FSA has responded to this and the results of the Financial Action Task Force's (FATF's) evaluation of the UK, by undertaking specific thematic review work in relation to firms' financial crime systems and controls. This has included thematic visits to 20 London market insurance brokers.

Background to third party payments

The subject of financial crime as it applies to London market insurance brokers is not a new topic given that the FSA first gave notice of its expectations of firms in a 'Dear CEO' letter back in November 2007. This letter set out that the FSA was aware of instances of illicit payments or inducements being paid and that this practice was not tolerated.

The FSA's letter tasked firms to review their business practices to ensure that they were not, wittingly or otherwise, involved in illicit payments. Unusually, the FSA did not require brokers to respond formally, setting out the results of any internal review, nor were any formal timescales set.

Financial penalties for the unwary

The FSA's expectation, nonetheless, is that firms should have ensured that robust anti-bribery systems and controls were in place and working effectively. The FSA's largest financial crime fine to date was published in January 2009, when Aon was fined £5.25m for failings in its anti-bribery controls, even though no actual cases of bribery were alleged.

The case involved business won abroad with revenues being remitted back to the UK and the FSA made it clear that it was not acceptable for companies to conduct business abroad without robust anti-bribery and corruption systems and controls in place. Since then, the scrutiny and challenge faced by the market has further increased.

FSA's ongoing thematic work

Earlier this year, the FSA commenced thematic visits to 20 London market insurance brokers to ascertain the level and sophistication of controls, specifically looking at a number of areas: governance; policies and procedures; risk assessments; third parties; due diligence;

compliance monitoring; accounts payable; training; and, depending on the size and complexity of the firm, the role of internal audit. In some cases testing took the form of sample payment 'walkthroughs' to evidence the processes and procedures articulated by senior management.

Once the thematic programme has been completed the FSA will formally report its findings back to the market. However, the FSA issued interim feedback in mid-September following the identification of a number of significant weaknesses in the visits conducted to date that appeared common across the commercial insurance broker industry.



This indicated that in the FSA's view:

- due diligence and monitoring of third party relationships are generally 'very weak'
- most firms carry out very basic checks on third parties and rely heavily on an informal 'market view' as to the integrity of the third party
- most firms carry out no formal check as to whether third parties are connected to the assured or the client
- some firms, on the instruction of third parties, had made payments to persons other than the third party without a clear understanding of why
- few firms operate a risk based approach, e.g. by focusing on high risk jurisdictions or third parties that are individuals
- most firms accept third party bank details through informal channels, usually email, with no requirement to verify their authenticity
- vetting of staff in broker firms is generally weak compared to other financial services sectors
- there is very little or no specific bribery and corruption training provided to staff.

In publishing its interim findings, the FSA stated it hoped that it will help firms assess their own systems and controls and take action to strengthen them where necessary.

For those firms that received visits, the message is not to be complacent and to follow through on any undertakings to the FSA. The inferred message to those firms that have not, and do not, receive a visit is to consider the FSA's

interim feedback and act upon it accordingly. The FSA's thematic visit programme signals neither an end, nor the beginning of the end, of the FSA's attention to this subject.

Rather, the likelihood is that the FSA may seek to use some of its other tools, such as the power to issue a 'section 166 order' under the Financial Services and Markets Act (FSMA), which requires the regulated entity to appoint an independent third party (the 'Skilled Person') to investigate and report on the steps taken by the regulated firm to manage the risk of bribery and corruption occurring.

The use of the FSA's Skilled Person's tool in relation to third party payments is likely to be appropriate where the FSA suspects or has evidence that:

- illicit payments are being made (wittingly or unwittingly)
- a lack of procedures or controls (or untested controls) leads to a higher risk that illicit payments will be made
- procedures exist, but are not sufficiently robust and/or are not routinely followed, again increasing the risk that illicit payments will be made.

There are some suggestions within the market that brokers should be proactive and commission work in an effort to mitigate the risk of potential intervention and scrutiny by the FSA, potentially via a s.166. This commissioning, however, may not be necessary and while firms may wish to seek external assurance where they feel that they have a genuine need for guidance as to what policies,

procedures and controls should look like around third party payments, those that have undertaken work internally and satisfied themselves they are acting in a compliant manner or are working towards a robust plan to make them compliant, should have the courage of their convictions.

Ultimately, firms need to weigh up how comfortable they are with the work that they have already done in relation to third party payments. And, for those firms that haven't already received a visit or don't receive a visit later in 2009, then the intervening time between now and any future ARROW visit should be used wisely to develop and adopt a robust, yet pragmatic approach to managing the risk of bribery and corruption.

Furthermore, these measures should be tested to ensure that they work in practice to the satisfaction of senior management and can be demonstrated as such to the FSA at any future point in time. The FSA's expectation will be that regulated firms have listened and acted upon, the messages and communications put to the broking community.

What do good systems and controls look like?

Controls should include, but not be limited to:

- robust due diligence (and follow-up monitoring) of third parties, rather than relying on the sometimes informal market view, including political exposure and anti-money laundering (AML) checks
- central listings and management of third parties

- formal checks on whether third parties are connected to the assured or the client
- retrospective review of third party relationships acquired as part of a business acquisition
- ongoing maintenance of accounts and the ability to pay third parties where the contractual relationship has ceased
- checks to ensure that the percentage split of commission paid to third parties is, in fact, commensurate with the service provided by the third party, and the evidential requirements relating to bank accounts to which payments should be made
- independent reviews of third party payments
- risk based approach to different jurisdictions, with commensurate checks and controls
- risk based vetting of staff in broker firms
- detailed anti-corruption training to deliver the appropriate governance and culture.

Any review of a firm's anti-corruption controls should focus on due diligence measures, ongoing monitoring of third parties, the process by which commission payments are authorised and paid, the recruitment and vetting of staff, and the provision of ongoing training.

Draft Bribery Bill

Against the backdrop of greater regulatory focus on third party payments, the Draft Bribery Bill was published by the Government in March this year. The Bill is intended to



reform the criminal law in an area that, historically, has been fragmented and overly complex. The Government elected not to limit the reform of the law to the consolidation of the existing bribery offences, instead choosing to create new offences specific to the threat that bribery and corruption poses to the UK economy and emerging economies abroad.

The bill is intended to provide a new and comprehensive scheme of bribery offences that will enable courts and prosecutors to respond more effectively to bribery. The primary purposes of the bill are to:

- provide a legal framework that is effective in combating bribery in both the public and private sectors
- replace the offences that exist under common law and the Prevention of Corruption Acts 1889-1916
- simplify legislation covering two general offences:
 - offering, promising or giving of an advantage
 - requesting, agreeing to receive or accepting an advantage.
- provide clearer compliance with international obligations

- create a specific offence of bribery of a foreign public official
- create an offence of negligent failure by commercial organisations to prevent bribery.

The most dramatic proposal contained in the bill concerns the new corporate criminal offence of negligent failure to prevent bribery. The offence applies to 'commercial organisations', defined as corporate bodies incorporated in England and Wales or Northern Ireland, or partnerships registered in the same jurisdictions which carry on business either there or abroad.

The proposed offence is committed where a person performing services for the commercial organisation bribes another person, the bribe is in connection with the commercial organisation's business, and another person connected with the organisation who has responsibility for preventing bribery, negligently fails to prevent the bribe. In practical terms, it is likely that firms will need to have robust anti-bribery systems and controls in place and be able to evidence that these are effective through appropriate levels of monitoring.

The bill is of particular relevance to firms conducting business in developing countries where ethical standards and practices may not be as high as in other parts of the world. Pointedly, the bill includes bribes offered overseas within the list of offences, so when designing systems and controls to mitigate the risk of bribery occurring firms must be mindful to assess the risk posed by any international business they conduct.

The timeframe for the passage of the bill through Parliament is unclear, and a general election is pending within the next year, yet it is safe to assume that the legislative landscape with regard to bribery will change significantly and in the near future.

Management of fraud and corruption risk becomes increasingly challenging as headcount, technology and internal audit spend are reduced. In the light of the draft bill, a defence to the new corporate offence of failing to prevent bribery will be to prove that adequate systems and controls were in place to mitigate corruption risk. However, the UK Government has yet to offer any guidance and clarity in this regard.

The long arm of the (US) law

Many of the drivers for anti-corruption enforcement activity globally originate in the USA. In 2008, 33 enforcement actions were announced by the US Department of Justice (DOJ), which deals with the criminal aspect of a case, and the Securities and Exchange Commission (SEC) on the civil side, under the Foreign Corrupt Practices Act 1977 (FCPA).

In the case of Siemens, total fines and penalties were nearly €1 billion. We also understand that there are some 120 cases under active investigation. A review of the number of prosecutions in the first half of 2009 reveals no signs of the agencies easing off, with the number of prosecutions in the first half of 2009 exceeding that of a similar period in prior years.

A key point to be aware of, is that the enforcement agencies do not believe that corporations have the desire to self-regulate themselves when it comes to

mitigating corruption risk. They make no bones about the fact that they are using prosecutions to shape corporate behaviour and are using a unique approach of achieving policy objectives through law enforcement.

The 'long arm' reach of the FCPA has become legendary although we still find companies that do not appreciate how they can be caught out by this legislation. As an example, cases involving Aon are understood to be under active consideration by the DOJ.



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