FCA's Firm Systematic Framework

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A new supervisory approach – 3 pillars

- Pillar 1: Firm systematic framework ("FSF")
- Pillar 2: Event-driven supervision
- Pillar 3: Issues and products supervision
FCA’s approach to supervision

- Forward looking and more interventionist;
- Focused on judgment, not process;
- Consumer-centric;
- Focused on the big issues and causes of problems;
- Interfaces with executive management/Boards;
- Robust when things go wrong;
- Focused on business model and culture as well as product supervision;
- Viewing poor behaviour in all markets through the lens of the impact on consumers;
- Orientated towards firms doing the right thing; and
- Externally focused, engaged and listening to all sources of information.
The FCA will continue the FSA’s credible deterrence strategy, meaning:

- More enforcement cases where needed
- Tougher penalties
- Holding senior management to account
- Criminal sanctions; and
- Greater compensation for consumers, where applicable
The FCA firm systematic framework

- **Firm systemic framework**
  - **Business model and strategy analysis** – to identify areas of potential conduct risk
  - **Sales processes** – to assess firms’ systems and controls
  - **Governance and culture** – to assess how effectively a firm identifies, manages and reduces conduct risks
  - **Product design** – to determine whether a firm’s products or services meet customer needs and are targeted accordingly
  - **Post-sales/services and transaction handling** – to assess how effectively a firm ensures its customers are treated fairly after the point of sale, service or transaction, including complaints handling

- **Are the interests of customers and market integrity at the heart of how the firm is run?**
How is it different from ARROW?

- Continuous assessment
- Of key drivers of conduct risk
- RMP focuses on key areas to be addressed
- Follow up work done by firm with greater use of S166 powers
- An example of how it might work
Conduct risk – FCA Risk Outlook April 2013
Key issues for now are likely to be…

- Strategy (achievable, sustainable and TCF?)
- Governance processes and culture to manage conduct risk
- Product design and product governance
- Sales processes
- After sales servicing
- Client money
- Conflicts of interest
- Putting the customer at the heart of everything you do
- Application to wholesale firms
Tips for the process

- Understand
  - FCA’s overarching concerns
  - Industry-specific concerns
  - Firm-specific concerns
- Manage the process
  - Present documents in most favourable light
  - Prepare for the interview - practice
  - Ask for agenda
  - Note-taker at all times
  - Daily de-briefings
  - Befriend & enquire
Tips for the interview

– Be accompanied.
– Read the papers & do your homework.
– Only answer from your personal knowledge.
– If the question is unclear, say so.
– Give clear, brief answers.
– Think as long as you like before answering.
– Don’t accept FCA assertions unless right.
– Do not be drawn into controversy.
Six key messages to convey

1. I know my role
2. I challenge I do not rely
3. I know the strategy
4. I know the risks
5. I understand our governance
6. I understand the new regulatory world
Solvency II – Outsourcing compliance

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What is Solvency II?

− Provides the framework for a new EU solvency and supervisory regime for the insurance sector
− Applies to almost all EU insurers and reinsurers
− Following implementation of Solvency II, Lloyds managing agents will be subject to the same SOLPRU (and SYSC) rules as insurers
− Solvency II Directive 25th November 2009
  • Consolidates existing insurance and reinsurance Directives
  • Omnibus II Directive January 2011 – amends Solvency II regime
− Currently on course for implementation on 1 January 2016
What is Outsourcing under Solvency II?

“An arrangement of any kind between a firm and a service provider by which that service provider performs a process, a service or an activity that would otherwise be performed by the firm”

- “Otherwise performed by itself” test is ambiguous
- Currently limited guidance on what falls within the definition
- PRA: firms should use the time prior to final implementation to assess their current outsourcing arrangements and reliance on outsourcing and document their overall approach to outsourcing – including contingency plans against service provider failure
- Majority of Solvency II rules apply to critical or important outsourcings
- Is the function or activity essential to the operation of the insurer – would it be unable to deliver its services to policyholders without the function or activity?
What is “critical” or “important”?  

- Country specific requirements need to be taken into account
- EIOPA guidance in Level 3:
  
<table>
<thead>
<tr>
<th>Design / pricing of insurance products</th>
<th>Data storage</th>
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<tbody>
<tr>
<td>Regular / consistent compliance, internal audit, accounting, risk management or actuarial support</td>
<td>Investment of assets or portfolio management claims handling</td>
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<tr>
<td>Day to day systems maintenance or support</td>
<td>Own risk solvency assessment (ORSA) process</td>
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- Hiring a specialist consultant to advise, purchase of standardised services (e.g. market information / price feeds), cleaning, catering, HR or, payroll generally not critical or important outsourcings
Rights of regulators

− Service provider must co-operate with regulatory authorities
− The insurer, its auditors and regulatory authorities must have effective access to data related to outsourced functions or activities
− Regulatory authorities must have effective access to business premises of service provider and must be able to exercise those rights of access
− Notification required for entering into contract and “any subsequent material developments”
Governance requirements

- Emphasis on senior management responsibility
- Undertakings to remain fully responsible for discharging all of their obligations when they outsource functions or activities
- Written policies required in relation to (at least): risk management, internal control, internal audit and, where relevant, outsourcing
- Policies should be subject to the prior approval of your governing body
- Ensure the policies are implemented
- Review the policies at least annually
- Adapt the policies reflect of any significant change in the system or area concerned
- Process for monitoring and reviewing quality of service provided
- Monitor compliance with agreement
- Board should receive and review reports on performance
# Outsourcing policy requirements

<table>
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<tr>
<th>Processes and Strategies</th>
<th>Due Diligence</th>
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<tbody>
<tr>
<td>The criteria for determining whether a function or activity is critical or important</td>
<td>Financial and technical ability</td>
</tr>
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<td>How a service provider of suitable quality is selected and how often their performance and results are assessed</td>
<td>Capacity to perform</td>
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<tr>
<td>Details to be included in the written agreement with the service provider</td>
<td>Control framework and any conflicts of interest</td>
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<tr>
<td>Business contingency plans including exit strategies for outsourced critical or important functions or activities</td>
<td>Address the conditions under which sub-outsourcing by the service provider is possible</td>
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What does this mean for contracts?

- Outsourcing of critical or important functions
  - Directly to an external provider
  - Indirectly – e.g. where services are procured from an external provider by one member of the group for the benefit of other members of the group
  - Directly to another member of the group
- Implications for shared services models. Each individual regulated service recipient must be able to demonstrate to its regulators that it has met its regulatory responsibilities – it is not enough that one member in the group can demonstrate this
Shared services

- Need to demonstrate supervision and control – and the contractual right to enforce it
- Options for shared services environment include:
  • Direct enforceability. Need to carefully attribute key rights to each service recipient
  • Separate intra-group arrangement between procuring entity and service recipients
  • Strong governance controls
  • Need to provide “regulatory get outs” and rights to direct action / inaction
- Implications for cost / liability / impact on other service recipients need to be dealt with - is a mere SLA sufficient?
Risk management: compliance

- Provision of services in compliance with applicable laws / regulations and other internal policies and procedures
- Data protection, privacy and confidentiality
- Security – compliance with applicable industry standards, regulatory requirements and internal policies
- CSR, bribery and corruption, money laundering and inside information
Control: step-in / rights of direction

- Extent of customer's right of step-in, or right to direct supplier acts or omissions, where required to meet regulatory obligations or to demonstrate adequacy of controls, processes and procedures
- May be acceptable for service recipient to have right to direct procuring affiliate to exercise rights under supplier contract
Supervision / information / control: records, monitoring and audit

- Parties to maintain accurate / complete records relating to transactions and management of the arrangement (including for a minimum period following termination)
- Monitoring and reporting of performance, including service level failures, security breaches and other issues
- Development and maintenance of underlying operational manuals
- Right of audit for customer (and representatives) and Regulatory Authorities – includes effective access to all information, systems, premises etc.
- Right of Regulatory Authority to directly address questions to the service provider
Supervision / information / control:
reporting and governance

- Parties required to meet regulatory requirements and any applicable professional guidelines
- List of reports and MI to be provided by supplier (and frequency)
- Detailed governance / escalation framework
- Dispute resolution (NB: challenges for resolution intra-group)
Risk management: performance incentives

- Clear description of services (need to be designed so as to enable service recipient to meet its regulatory obligations)
- Service Levels and performance incentives (e.g. Service Credits)
- Continuous improvement mechanism – Service Levels increased periodically
- Milestones and delay deductions (transformational / implementation programmes) - Liquidated Damages for delays or Incentive Payments if earlier milestones are met
Risk management: exit assistance

- Provision of exit or termination services for a sufficient time after termination or expiry of the agreement, including:
  - Assisting in the transfer of services to incoming suppliers or to the customer
  - Knowledge transfer and provision of information
  - Return of customer materials, confidential information and data
Miscellaneous

- Business continuity (and disaster recovery)
- Software escrow
- Data access
- Alternative premises / systems / manual processes
- Alternative suppliers / in-sourcing
- Controls on sub-contracting; flow-downs
- Ownership of IP rights (including on expiry or termination)
- Further information / guidance:
  - https://eiopa.europa.eu/ (EIOPA - CEIOPS)
In Focus Asset Management-v-Clark

The Court of Appeal decision explained

CMS FS INSURANCE UPDATE BREAKFAST SEMINAR
Lloyd’s Library – 26 March 2014

Alexander Denslow
Partner
In Focus-v-Clark: its effect?

- C cannot:
  - i) accept a maximum FOS Award (£150,000)
  - ii) then claim in Court (based on same facts), either for
  - iii) “balance of loss“ (>£150,000); or
  - iv) other losses from the same facts that FOS didn’t award.

- Relevance? Complainants, financial companies (and their insurers).
- Anyone involved with other Ombudsman Schemes (Pension Ombudsman / Legal Ombudsman).
In Focus-v-Clark - the background

- Complaint to FOS. Negligent investment advice given by In Focus.
- FOS made Award + recommendation that balance be paid.
- C accepted Award and expressly “reserved right to pursue claim in Civil Court”.
- C cashed cheque. Commenced court proceedings.
- Circuit Judge struck it out. The High Court then allowed it.
- Award can be used as “fighting fund” for Civil claim…..
- C’s cause of action had “merged” into the FOS Award, extinguishing rights and precluding court proceedings.
- High Court here said “merger” didn’t apply to FOS determinations
- So, conflicting High Court authorities. Clarity required.
In Focus-v-Clark - the issue on appeal

- Partial compromise.
- Only “live” issue: is Andrews correct? Does “merger” apply to FOS?
- s 228 FSMA – states that C can either accept or reject FOS Award.
- Accepted = final and binding. Rejected = free to claim in Court.
- Is there a third way? Accept £150k and sue for balance in court?
- Court of Appeal distilled to 2 issues:
  a) Does principle of ‘res judicata’ apply to FOS Award, once accepted?
  b) Does FSMA oust the operation of “res judicata”?
In Focus-v-Clark – the decision

- Court of Appeal found for In Focus on both issues.
- To apply, “Res judicata” needs a cause of action
- Complaint to FOS may well consist of facts that constitute a cause of action.
- Features of FOS (‘fair and reasonable’, not legal principles and issuing non-binding “recommendations”) did not preclude “res judicata” principle.
- FOS was a judicial body, not administrative.
- FSMA does not oust “res judicata”.
- Part of the common law - FSMA was enacted by Parliament against that backdrop.
- No evidence Parliament intended to put FOS complainants in a special position.
- Had Parliament intended C could recover in excess of the limit, why impose limit in the first place?
In Focus-v-Clark - comment

- Left unchallenged, firms subject to FOS and insurers faced significant financial exposure.
- Closed FOS claims resurrected in Court – issues of liability and quantum back on the table.
- Strong public policy:
  i) finality - D shouldn’t have to face the same claim twice.
  ii) FOS cannot be used as a risk free way of obtaining a “fighting fund”
  iii) Avoid claims industry that might increase cost of financial advice.
- C has a single choice - accept smaller Award (swift, informal, cheap, non-legal) or reject and pursue larger sum in Court but with risks.
- Caution - not a blanket ban on accepting Award and starting civil claim.
- Q – is it based on same facts as accepted Award? Case by case.
- Up to D to prove “res judicata” / abuse of process. C could and should have brought whole claim before FOS (same facts but different type of loss?).