

## **Financial Intermediaries – Risk Assessment**

**Talk by Geoffrey Clarkson at the fifth Conference arranged on behalf of the Professional Indemnity Forum 27-29<sup>th</sup> March 2001, Queens College Cambridge**

### **1 Introduction**

As a solicitor and partner in a major law firm I was accustomed to the assessment of risk in the transactions for which my firm was responsible. From experience and the statistics provided by the Solicitor's Indemnity Fund we were aware that risk fell into two clearly defined categories. The first related to the quality of legal advice given and the second related to the adherence to time tables and administrative requirements. Evidence showed that the bulk of claims by volume came within the latter sector with a relatively small number both by volume and value falling within the first. We found it, as many solicitors do, difficult to manage and control the first level of risk in relation to legal advice. However, we were able to install good control procedures for administrative responsibilities relating to court time-tables and corporate transactions. In relation to advisory risk we sought to limit our liability through capping it by reference to the size and value of a

particular transaction. As a consequence we were able to run two parallel systems of risk management but with emphasis on the areas of risk we knew to be the most prevalent and the most easily controlled.

In the world of financial intermediaries the two risks remain the same. They are, however, seen from different perspectives, the first being legal liability and the second regulatory liability. A financial intermediary is responsible in law to his or her client for the quality of advice and guidance given. Should there be a breach of contractual responsibility or negligence then the law can make that intermediary responsible to the client for any financial loss. The situation is, therefore, similar to that of a law firm. However, the financial intermediary has to be alert to regulatory liability in a way which has to be seen as quite distinct from that applicable to other advisory organisations. The Financial Services Act of 1986 introduced a regime which has until now concentrated on documentation and procedures rather than the quality of advice given. Whilst ignoring the quality of advice it has created a procedural liability which has proven to be extensive and costly to all concerned. The best example of this is the Pensions Review instituted by the Securities and Investment Board which had, at its core, the premise that if an advisory transaction had not been properly documented it was, ipso facto, a transaction which created liability on the part of the intermediary. This led, as I am sure many of you are aware, to the payment of compensation to

investors in a manner, and at an amount, which would not have been the case had legal liability been the sole test.

Accordingly my talk this afternoon is going to look at those risks particular to the financial intermediary market and to highlight those areas where risk differs from other areas of activity which could, however, be seen as similar.

Risk based monitoring has become the watchword of the new regulatory regime created by the Financial Services and Markets Act 2000. Helpfully the regulators have identified their view of risk but one which touches more upon the integrity of the businesses they monitor as opposed to the service actually delivered to the investor. This curious distinction needs to be understood in assessing the risk associated with insuring a financial intermediary.

It is my intention that by the end of this talk the range of areas you should look at in deciding whether or not to insure a financial intermediary and, if so, at what premium and on what terms will have been explored in a helpful way. Risk was once explained to me in the context of driving a car. The risk, I was told, was not associated with my identifying the destination of the car in front of me and which direction it would take at a junction. My concern, as the driver behind, was whether or not that vehicle would undertake an unforeseen manoeuvre which endangered me. The same can be said of

financial intermediaries. You need not be troubled with the general direction of their business but only with those areas of uncertainty which can create a liability.

## **2 Scope of Talk**

The Financial Services Act 1986 and, more importantly, the Financial Services and Markets Act 2000 cover a very broad range of activity in the financial services sector. The new Act extends from the largest bank to the smallest financial intermediary and covers all types of financial institution in between. Whilst much of what I have to say could be applied to some of those institutions I am going to concentrate on a specific type. These are financial intermediaries currently regulated by the Personal Investment Authority but soon to come within the mandate of the Financial Services Authority. They comprise:

- Independent financial advisers operating as sole traders, partnerships or limited companies.
- IFA Networks responsible for appointed representatives.
- Large IFA firms with employed or self-employed representatives and possibly with franchisees.
- Lawyers and accountants who will soon be joining the FSA regime.

If I had been talking several years ago the range of activities undertaken by these firms would have been diverse. However, regulation has limited what these firms actually do in practice.

The areas where many firms have decided to limit their activities because of regulatory requirements cover primarily pensions related business, the management of broker bonds and discretionary fund management. These categories have become highly regulated and uneconomic for smaller firms to be involved in. Similarly the regulation of mortgages and now general insurance products is starting to result in a further segregation of the market. Only the larger ones are able to have a structure which can cope with the diverse range of responsibilities.

Lawyers and accountants will also have to face a decision consequent upon the change in regulatory requirements. Those firms which conduct little investment business will have to remain limited in their activities and regulated by their professional body. The remaining firms will have to make the decision to continue with the more extensive provision of financial advice and move to the Financial Services Authority.

The consequence of this regulatory change is a limitation on the scope of activities of many financial intermediaries which should make the job of the insurer that much easier.

Essentially an IFA advises on what are known as designated investments. A designated investment is primarily a packaged product provided by an insurance company or investment company. As indicated above, however, the range of activities can extend to advising on:

- Securities
- Derivatives
- Pension transfers
- Broker funds

Such firms can also handle client money but this is increasingly rare owing to the relatively high capital adequacy requirements relating to such activity. Solicitors and accountants will be placed at some advantage in this respect because the client money requirements of their professional bodies will be accepted as adequate by the Financial Services Authority.

I am sure you are all familiar with the extent of the activities of intermediaries but in assessing the risk of the activities they undertake it is important to remember just how much is changing.

This change means that a failure to comply can create liabilities which would not otherwise exist. For example, until recently an IFA firm could advise on

pensions transfers. This is no longer the case until one of the designated individuals has a qualification known as G60 is registered with the PIA as a transfer specialist and is prepared to sign off advice given by his colleagues. In your assessment of risk of such intermediaries it is, therefore, important not only to know if the firm undertakes pensions transfer work but who is the authorised person. Procedures also need to be in place to ensure that if that person leaves the firm such business is immediately terminated in the absence of a suitably qualified replacement being found. All this creates the need for more extensive and more effective means of understanding what the firms you insure are actually doing.

This can be put into greater context by looking at the changes which are currently occurring.

### **3 What is Changing**

For the last two years the Financial Services Authority has been issuing consultative documents relating to the changes it would wish to introduce consequent upon the introduction of the Financial Services and Markets Act. In relation to financial intermediaries the main areas of change relate to the following:

- Conduct of business
- Training and competence
- Financial resources
- Authorisation
- Market abuse
- Complaints handling

All these changes will require by, or shortly after N2 (the date when the Financial Services Authority takes over legal responsibility), the amendment of procedures by regulated firms and the introduction of new compliance procedures. The FSA is debating how much time it will give to such firms to amend their procedures but requirements so to do will apply as from N2. This date was foreseen as being some time in the year 2000 but is now likely to be later in this year or, possibly, right at the beginning of 2002.

So by N2 all regulated firms will have had to complete the following tasks:

- Understand the changes and modify their business practices to meet them.
- Re-write their compliance and related procedures.
- Ensure all staff are adequately trained to undertake the jobs which they do.
- Produce and introduce verification procedures.



- Review their insurance requirements and ensure that they can comply with them.

Accordingly, we are facing a period of further change and uncertainty. This must obviously be of concern to you as insurers in order that you do not find yourself exposed to risks which you had not foreseen.

Fortunately in all this the law seems to remain the same. Intermediaries have no greater liability in law than they previously had and the main risk, therefore, comes from a regulatory failure which generates a liability which might not otherwise have been the case. This can arise from the Ombudsman applying different standards or the regulator requiring a regulated firm to undertake remedial action which would not be the case from the legal perspective.

#### **4 The Regulator's view of Risk**

The Financial Services Authority is headed by Howard Davies who was previously with the Bank of England. Many of his key colleagues also come from either a banking or large institutional background. Unlike the PIA and its predecessor, FIMBRA, there are few people of influence familiar with the smaller intermediary market. It appears, therefore, that the principles

applicable to larger organisations are being translated to smaller firms with sometimes worrying and other times re-assuring consequences.

The prudential management of banks has led to the establishment of some clear principles which I thought it would be helpful explore. The fall-out from the Equitable Life failure is likely to strengthen the regulator in its determination to impose adequate risk management controls. Let us now look at four features of the current regulatory regime.

But first it might be helpful to look at the four statutory objectives set out in the Financial Services and Markets Act. These are:

- Maintain market confidence
- Promote public awareness
- Protect consumers
- Reduce financial crime

I will now look at the way in which the regulator operates

Firstly, regulators have accepted that they need to be more focused and systematic in their assessment of the risk characteristics of an individual firm. Over the last three years, beginning in the Bank of England and continuing at the FSA, the regulators have instituted a new risk assessment process which

they claim delivers a calibrated risk profile of each institution in their care. There is an assessment of business risks and control risks undertaken separately. The analysis of risks generated is then compared between each institution so each regulated firm understands how it rates against its peers. The database thus provided allows the regulator to identify those particular firms or categories of firms which create the greatest risk. This analysis has been clearly applied to the financial intermediary sector in that the FSA views small firms as low risk and larger firms with more diverse ranges of activity as higher risk. However, this system does appear to break down in relation to networks which are, essentially, a legal vehicle for the authorisation of many small firms. Such institutions are seen as higher risk by the FSA even though the individual firms for which they are responsible would otherwise fall into low risk categories. Perhaps this is an area we could debate during the question and answer session. In addition to the general risk assessment of a firm the regulator has also stated that it pays continuous attention to the economic and market environments in which the firms operate in order to identify whether or not new areas of risk have arisen.

Secondly, the regulator has said that it believes it is important to look at institutional risks in the round and to look at the impact of different markets across different types of institution. This has been particularly relevant as banks have diversified and entered into areas of activity with which they would not normally be associated. This is less relevant to the intermediary

sector where, as I have said earlier, there is tending to be more limitation of activity than extension of them.

Thirdly, the regulator has acknowledged that it needs to enhance the skill base of its front line staff. The use of knowledgeable staff for monitoring is vital and I have to say that I have met many of the front line regulatory staff who have, quite frankly, not the knowledge or experience to understand the intermediary market. You, as insurers, must look closely at the reports which the FSA produces on firms which you insure. They should not be taken at face value but, equally, you might be concerned as to whether or not you accept the response of management at face value also. It is for this reason that many intermediaries, both small and large, are outsourcing compliance verification so that there is bench marking of their procedures and reassurance given to their insurers as to the quality of their procedures and the integrity of the operation. With regulatory change gathering apace I see the use of compliance outsourcing as likely to grow in order to ensure there is a proper understanding of regulatory change and its implications.

Fourthly, the regulator has made it clear that it is vital to look at risk management in the context of its position within the firm as a whole and to look at the management structures and procedures which surround it. This has been translated into obligations placed upon senior management within

regulated firms in a way which has not hitherto been the case. These I will look at shortly.

The above high level statements by the regulator have been translated into the way they look at financial intermediary firms. The risks they have identified and upon which they focus are as follows:

- Does the firm handle client money?
- What are its selling practices and is there a culture of high standards and compliance within the firm?
- Are there adequate compliance controls?
- How has the firm been rated in the past?

These areas of risk identification are not dissimilar from those applied to larger institutions and can be used as a base model for an analysis of risk within an intermediary firm.

The risk grading mechanism used by the FSA in this context are:

- Impact on the industry of the collapse of the firm
- Impact of the firm's collapse on public perception
- The number and type of customers and their exposure to the firm
- Availability of compensation

The firm's specific risk is then multiplied by the probability that a problem will arise so that the FSA has a formula which is probability x impact.

## **5 What are these risks in an IFA firm?**

From your point of view it is understanding the culture and nature of the firm which you insure. Culture has, in my opinion, a major role to play. Most firms will say that they have a high level of compliance culture. However, one has to look as to whether or not this intention is translated into reality. An area to look at here is how, say, the approach to risk management relates to incentive structures for staff involved. It is all very well for an intermediary firm to stress its emphasis on good advice and high levels of client servicing but it has to have a reward structure which reflects these values. If all the advisory staff were self-employed and paid on sales rather than anything else one has to wonder whether the cultural standard is really matched by its reward structures.

### **Risk based compliance**

As I have said earlier the FSA is seeking to move away from the assessment of documentation in an intermediary's office to risk based compliance which uses better the resources of the regulator. To a certain extent this has already

been achieved by the FSA visiting smaller firms very infrequently (every three years or more) and its visiting of network firms very frequently (once or twice a year). Similarly it has visited firms which handle client money or undertake discretionary fund management more than it has those firms which do not.

In terms of risk based compliance the framework which is being constructed through the FSA's new Rule Books and policy announcements supports regulation not by many visits but by risk monitoring. The emphasis is on a strong system of controls, monitored carefully and frequently with the priority on key risks and controls which should receive greater attention. Here it is helpful to look at the senior management arrangements, systems and controls ("SYSC") rules. These are to be found in the High Level Standards in the FSA's Handbook.

In Rule 2.1.3R it is stated that:

"A firm must appropriately allocate to one or more individuals ..... the functions of:

- (1) Dealing with the apportionment of responsibilities .....; and
- (2) Overseeing the establishment and maintenance of systems and controls ....."

In addition the SYSC Rules (3.2.6) require a firm to:

“ ..... take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards  
.....”

In Rule 3.2.10 the FSA even goes as far as saying that it may be appropriate for a larger firm to have a separate risk assessment function responsible for assessing the risks that a firm faces.

From your perspective it is essential to ensure that the different firms which you insure match these objectives. If one translates the statements of the FSA into reality then the process of implementing risk based compliance methodologies require the following:

- Alignment of compliance and business objectives
- Recognition and incorporation of FSA's requirements
- Identification and analysis of key compliance risks
- Identification, assessment and enhancement of compliance controls and,
- Development of sustainable reporting methodologies used to monitor business operations, including key performance indicators.



The owner or chief executive together with the compliance officer have an obligation to provide information to the FSA and it is this information, I believe which is relevant to you as insurers. Shortly I will come on to this subject but before I do it might be helpful if I comment on the value of outsourcing elements of compliance, particularly for the smaller firm, in order to attain the high levels which are being set by the regulator. Save for a few large financial practices the industry is still divided into a large number of small firms. Whether or not they form part of a network or are directly regulated they are tending to conduct the same class of business. It has to be accepted that a degree of specialisation is arriving as a result of regulatory change but, nevertheless, one can readily categorise these firms. For those with up to ten financial advisers the cost and expertise involved in implementing the standards to which I have referred is daunting. Even for the larger firm the recruitment and retention of appropriately qualified staff is difficult. Indeed this is an area which has been recognised by the FSA itself in its own recruitment programme.

Outsourcing is therefore an attractive option which enables a firm to acquire expertise which it could not otherwise afford and provides compliance auditing staff without the firm itself being involved in their employment.

From your perspective such external review of firms which are rarely visited by the FSA gives you the reassurance you need that the firms are meeting the

standards now being set. More importantly you can be satisfied that the changes being introduced are being recognised by the insured firms and being correctly adhered to.

### **3 Key Points for the Insurer.**

Many of you have got long standing experience of the financial intermediary market. Somewhat to your cost, however, you have made aware of changes to that market which have generated liabilities which did not previously exist.

External audits of firms you insure can at least alert you to the business risks they might generate of which you would otherwise be unaware. Compliance officers and key staff can come and go – the reputable firm reviewing the activities on a regular basis has a certainty and continuity which might not otherwise exist.

### **4 What you should be looking for**

I believe that one of the problems for the insurance market dealing with financial intermediaries is lack of knowledge about the individual firms which they are insuring. For networks and larger IFAs this is not quite so worrying because the premiums payable warrant the investment of time in

understanding the nature of the businesses being insured. Even so, with a network, it is difficult to understand the activities of the diverse range of firms which constitute its membership. The only easy firm to risk assess is a centralised national IFA and there are very few of these.

Accordingly, for IFA firms whether small or large the areas you ought to be concentrating on are as follows:

- How is the firm owned and structured?
- Who is responsible for compliance and what are his or her qualifications?
- How relevant and robust are compliance manuals and procedures?
- Who is responsible for monitoring compliance and do they have enough time; what are their qualifications?
- Does the firm handle client money?
- What are the authorisations of the firm and are they in riskier areas such as pension transfers?
- How does the firm find clients, where are they seen and what sort of business is transacted?
- Who are the financial advisers, what are their qualifications and what are their key performance indicators?
- What is the compliance record of the firm viewed from the perspective of the FSA and externally by, for example, outsourced compliance specialists?

- Does the reward structure of key staff reflect a sound compliance culture?
- Are the administrative staff qualified and if so to what extent?
- Does the firm have procedures in place to prevent the giving of unauthorised advice (eg by administrative staff on stakeholder decision trees)?
- How does the firm compare with its peers?
- Does your proposal form enable you to gather the information you require?
- Would you be reassured by an external review of the intermediary and the provision of regular objective information on its performance.

The information provided by an application of the above list goes well beyond that available from any proposal form. It is therefore, vital, from my point of view that you all review the information that you are obtaining on firms which you insure and that you introduce procedures which reassure you that the risk profile of the firm does not change during an insurance year. Only by doing this and matching closely the profile of your insurance risk with the changing regulatory environment will you be able to ensure that your own risk is itself managed.

We do not wish to see further problems between intermediary firms and their insurers as we have seen as consequence of the pensions review. However, unless there is a clear understanding by insurers of the risks run by the

financial intermediary market coupled with an ability to assess and monitor that risk then I can only see further difficulties arising. These will be related to both the willingness of insurers to insure, the premiums which they charge and the liability they accept for claims. Many intermediary firms offer low risk. Regrettably their low risk cannot be adequately assessed and they seem to suffer from the problems generated by the higher risk firms. Were insurers able to introduce better risk ratings themselves then the market could be more clearly identified as to its component parts and those firms which do not meet the necessary standards would have a strong financial incentive to improve their performance. This would work to the advantage of all concerned.

I hope this afternoon I have been able to give you some insight into the financial intermediary world and the changes which are occurring. By so doing I hope that there will be a better understanding of the roles the insurers and the insured which will lead to a more stable market and one which is more attractive to insurers than has perhaps been the case over the last several years of change.