

Direct line: 020 7066 1522  
Local fax: 020 7066 1523  
Email: julian.adams@fsa.gov.uk

20 July 2005

Our Ref: Client Money

Your Ref:

Dear Chief Executive

## **CLIENT MONEY**

I am writing to the Chief Executives of all general insurance intermediaries supervised within our Wholesale Business Unit with an update on the results of a recent review of a sample of firms' handling of client money. I am asking you to confirm that you have taken action to ensure that your firm is able to demonstrate compliance with our rules on this subject and that you have documented the steps taken to ensure that compliance.

A copy of this letter will be published on our website on 26<sup>th</sup> July 2005.

The FSA recognises that the client money rules represented a significant change for general insurance intermediaries and were subject to extensive consultation with the industry. In the light of this, the FSA determined that a review of how intermediaries were complying with the new requirements should be an early priority for the Wholesale Business Unit. To that end, in Q2 of this year we visited as part of a thematic review of client money 15 intermediaries in addition to raising this issue as part of the 16 risk assessments which we have undertaken to date. All the findings in this letter have been drawn from this sample.

Notwithstanding that the client money rules have represented a significant change for intermediaries, we were disappointed to find a large number of failures in the systems and controls in this area. I have summarised the main conclusions from our visits in the attached Appendix 1. These findings lead us to believe that it would be timely to ask all firms to revisit the systems and controls which they have in place to monitor compliance with our client money rules with particular reference to the areas of weakness identified. In view of this, I should be grateful if you would take steps to ensure that:

- your firm's client money accounts are not in deficit;
- your firm's client money accounts have the correct trust status;
- client money resource calculations are performed on a regular and timely basis at least every 25 business days and your firm's client money account balances are reconciled

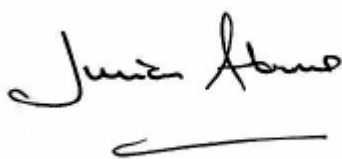
with the balances set out on the statements issued by the bank(s) within 10 business days of performing the client money calculation;

- any shortfall or excess is either paid into or out of the client money accounts by close of business on the day of the client money calculation;
- your firm's balances recorded on your broking and general ledger systems and used in the client money calculation are in agreement;
- if your firm operates a non statutory client money trust account, you have received your clients' informed consent to their money being held in such an account;
- the status of your firm's client money accounts agrees with the Terms of Business Agreements with the insurers, clients and other brokers;
- your firm's client money calculation includes balances paid on to third parties for which the broker has duties as trustee and the calculation is adjusted for un-cleared cheques or debit and credit card cancellation periods;
- client money from appointed representatives is correctly accounted for; and
- where an insurer has given risk transfer and permission to co-mingle, it has consented in writing to its interests in the client money account being subordinated to all other clients' interests.

You may be required in any subsequent visit to produce documentary evidence that you have complied with these requirements. I should be grateful if you would write to your usual supervisory contact confirming that you have completed this exercise by no later than 31 August and would remind firms of their obligations under Principle 11 of the FSA's Principles for Businesses to deal with the FSA in an open and cooperative manner.

Some firms may find the recently updated guide for Small Mortgage and Insurance Intermediaries: Part III - Insurance Intermediaries a useful reference document (<http://fsahandbook.info/FSA/handbook.jsp?doc=/handbook/GIGI>).

Yours faithfully

A handwritten signature in black ink, appearing to read 'Julian Adams', with a horizontal line underneath it.

Julian Adams  
Head of Department  
Wholesale Insurance

## Appendix 1

### SUMMARY OF FINDINGS FROM VISITS

In the most extreme instance, we discovered that a firm had a deficit in its client money account of which it had not previously notified us and which could not be rectified. This prompted direct regulatory intervention as a result. Whilst this was an isolated instance, we uncovered a number of issues at other firms which can be summarised as follows:

- Among the firms visited, a general failure to ensure that the bank's acknowledgement of the trust status of the client money bank accounts conformed to the requirements of CASS 5.5.49R. This is due to the wording of the restrictions on the bank rights to combine, set-off or counterclaim referring to the firm rather than the bank. In addition, some bank accounts were not clearly designated, for example, by failing to include the words client or client money. There was also a failure to ensure that overnight and term deposits were designated as client money. All money belonging to clients needs to be held under a trust arrangement.
- Although many firms performed a client money calculation every 25 business days, most failed to complete a client money calculation within 24 hours of the client money resource calculation (CASS 5.5.63R). Firms tended to perform calculations based on the fully reconciled month end general ledgers but did not do so within 24 hours. The timeframe for the reconciliation process varied from firm to firm although in general firms were performing the calculation on average two weeks after the month-end, using the month-end client money data items, and hence two weeks later than allowed under the rules. CASS 5.5.65R clearly states that the client money resource (used to perform the client money calculation) is the aggregate of the balances on the firm's client money bank accounts, as at the close of business on the previous business day. Firms may choose to perform the client money calculation at any time at least once every 25 business days but should use both up-to-date client money resource and client money requirement calculations and, within 10 business days of the calculation, reconcile their client bank account statements to the firm's books and records.
- There was a failure by some firms to ensure that any shortfall or excess recognised when performing the client money calculation was either paid into or taken out of the client money accounts by the close of business on the day of the calculation (CASS 5.5.63(1) (b) (i) or (ii)). The risk from not withdrawing the excess from the client money account involves the potential pollution of the trust fund that might result in a liquidator attempting to challenge the trust status of the accounts.
- There was a failure by some firms to ensure that balances on their broking system agreed to the accounting systems and therefore to the figures used in the client money calculation.
- There was a failure by some firms to adequately explain, obtain informed consent from clients, to their money being held in a non statutory client money trust account (CASS 5.4.4R(5)).

- Among the firms visited, a widespread failure to ensure that the status of the client money account was consistent with the various Terms of Business Agreements ('TOBAs') in place with customers, insurers and other brokers. Often these problems appear to be a result of the client money allocation and calculation being performed in the Finance function whereas responsibility for TOBAs and contacts with insurers/other brokers often reside elsewhere in firms. Examples of inconsistencies have included a firm operating a statutory trust when a non-statutory trust had been specified in an insurer's TOBA, TOBAs referring to holding money in a designated account for the insurer only and brokers taking commission without regard to an insurer's terms of business.
- Many firms failed to identify third party balances (CASS 5.5.65R(1)). As part of the client money calculation, brokers are required to identify funds that have been received and passed on to a third party who in turn will pay the funds to an insurer. The reason for this requirement is to recognise that the broker is still legally responsible as trustee for the funds until the transaction is complete, through payment to the insurer. In addition there was a widespread failure by firms to instigate a process for acknowledging that funds had been passed to the insurer so enabling the firm to reduce the amount recorded as being with third parties.
- Many firms instantly recognised un-cleared funds on cheques or debit and credit card payments. Firms were treating the funds as cleared as soon as a cheque was paid into the bank account or as soon as a debit or credit card transaction occurred. This resulted in firms taking commission before it was due and payable in accordance with CASS 5.5.16R(1) and 5.4.1G(2).
- Where relevant, some firms failed to account for client money held by appointed representatives within the client money calculation or to do it properly. Some firms had established client money accounts in the name of the appointed representative contrary to CASS 5.5.18R and CASS 5.5.49R.
- Where an insurer has given risk transfer the transitional period for not obtaining the insurers agreement to subordinate their interests to clients' interests has now expired. We are aware that not all agreements are in place. Where this is the case, you should notify the FSA – please see Appendix 2.
- There was a failure to establish and maintain adequate records of bank trust letters established under CASS 5.5.49R and SYSC 3.2.20R. The trust letters were held by a number of individuals therefore firms were not able to demonstrate in a reasonable time frame that the accounts had been established as trust accounts.
- There was a failure to observe the conditions of operating a non-statutory trust in particular the requirement in CASS 5.5.4R(3) to appoint a client money manager. This raised questions regarding accountability for the systems and controls surrounding the operation of such accounts and the management of the associated credit risk.

- A practice among firms of making a declaration in their Terms of Business that they would retain interest generated from a retail customer's account but a failure to obtain the client's informed consent to this retention (CASS 5.5.30R).
- A number of firms that operated a non statutory client money trust account were not aware of the requirement in CASS 5.4.4R(2) to obtain written confirmation from their auditors that the firm has in place systems and controls that enable it to monitor and manage its client money transactions and any credit risk arising from the operation of a non statutory client money trust. The lack of knowledge of the existence of this requirement did not in itself result in any rule breaches due to the fact that this requirement applies in respect of a period of not more than 53 weeks post authorisation and thereafter on an annual basis.

## Appendix 2

### **NOTIFICATION REQUIREMENTS WITH REGARD TO EXPIRY OF TRANSITIONAL RULE ON SUBORDINATION (SEE APPENDIX 1)**

Firms should notify us in accordance with SUP 15.3R and Principle 11 if they do not have agreements in place with insurers which have given risk transfer and whose risk transfer monies are commingled with client monies under which the insurer agrees to subordinate their interests in the client money account to those of other clients.

Some firms will already be aware of the information required in the notification because of FSA's interaction with the LMBC and the resulting letter that was issued by the LMBC. Where you are not an LMBC member please ensure that the notification is forwarded to your normal supervisory contact.

The notification should contain the following information:

1. Total number of agreements to be secured to show that the insurer consents to its interests under the trusts being subordinated to the interests of the firm's other clients.
2. Contact details of individual(s) at firm with responsibility for agreements.
3. Detailed analysis of number of agreements outstanding by counterparty. To include the following non-exhaustive list:
  - Name of counterparty.
  - Date of despatch to counterparty.
  - Follow-up action taken/to be taken by named individual.
  - Timetable for completion.
4. Estimate of magnitude of outstanding agreements relative to overall business – for example, % of client money balances for which agreements will be outstanding.
5. Formal action plan for following up outstanding agreements including prioritisation. To include details of action in interim to mitigate the position.
6. Details of regular management information to the Board on outstanding agreements.