

**Jon Pain**  
**Managing Director**  
**Supervision**

23 February 2010

Dear Managing Director/Proprietor,

**Adequate financial resources for insurance intermediaries**

We are writing to insurance intermediaries because we are concerned that many still cannot demonstrate to themselves (or the FSA) that they have adequate financial resources.

*Why we are doing this*

Our supervisory work with insurance intermediaries regularly shows that they are not paying sufficient attention to threats to the financial viability of their firms. Consequently the firms are not taking steps to guard against such threats or to develop management plans for the materialisation of those threats.

This failure to consider financial resources properly has led to a number of firms underestimating future demands on them.

Examples we have seen include:

- One firm failed to make adequate provision for its obligations to fund additional pension contributions. This caused the firm to have a negative net asset position which it had to remedy by way of a capital injection from its parent.
- Another firm was relying on intercompany debts to demonstrate compliance with FSA rules under [MIPRU](#). These could not be repaid. Consequently the firm was found to be in breach of MIPRU as well as Threshold Condition 4 (TC4) and was required to remedy the situation immediately by way of additional funding.

We are particularly concerned about this issue in view of the continuing challenging business environment. This concern is impacted by the frequency of weaknesses that we are also finding in insurance intermediaries' client money handling procedures. These weaknesses raise the risk of an intermediary's client money trust status being compromised and, subsequently, the funds becoming vulnerable to other creditors in the event of the firm's insolvency. In this context, the adequacy of a firm's financial resources is crucial to its ability to sustain its operations.

#### *How this fits in with our rules*

The FSA's prudential sourcebook for mortgage and insurance intermediaries (MIPRU) prescribes a general solvency requirement and a capital resources requirement. Whilst firms appear to be meeting their MIPRU regulatory capital resources requirement, this provision is a minimum and provides only basic protection against financial failure. There is also a wider requirement, applicable to *all* regulated firms, that they should have adequate resources, at all times, including financial resources. This is set out under [Threshold Condition 4 \(TC4\)](#), a high-level standard in the FSA Handbook. It is this more general requirement that we believe is continuing to receive insufficient attention from firms.

*What we require of you*

We require insurance intermediaries to satisfy themselves that they have adequate financial resources and, if necessary, make good any deficit. If your firm has not recently done so, you should undertake a Threshold Condition 4 assessment, paying full regard to the Handbook requirement, so that you are satisfied your firm has adequate resources, as expected by the FSA. In this communication, we are focussing on the adequacy of firms' financial resources but we also expect firms to be able to demonstrate that they have adequate non-financial resources.

Where an insurance intermediary is part of a group (even if this is simply as the subsidiary of a holding company), the assessment should take into consideration any effects on the regulated firm of the liabilities (including contingent liabilities) or commitments of all other group companies.

Appendix A explains in more detail the points boards you consider in reaching your view. Appendix B gives more detail on the distinction between the MIPRU and TC4 requirements.

We will be continuing to engage with firms on this issue and expect to see any firm's current TC4 assessment when asked. You should ensure that your assessment is kept up to date and be prepared to make it available to the FSA upon request.

Please confirm your receipt of this letter to [TC4Queries@fsa.gov.uk](mailto:TC4Queries@fsa.gov.uk).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jon Pain', written in a cursive style.

**Jon Pain**

**Managing Director, Supervision**

## **Appendix A: Points to Consider in Meeting Threshold Condition 4 (Financial)**

Threshold Condition 4 (TC4) is one of the key conditions that all firms must be able to demonstrate to the FSA that they satisfy *at all times*, in order to retain their permission to conduct regulated business.

Even where firms do undertake a formal assessment of compliance with TC4, this is often carried out on too narrow a basis. The following are common examples of where firms are paying insufficient attention:

- insufficient analysis of a firm's cash generation capabilities and retention needs
- changes to funding requirements that may be needed in order to manage:
  - liquidity
  - banking covenants
  - crystallisation of group obligations
  - liabilities owed to third parties
- weaknesses in controls over client money and other client asset arrangements
- weaknesses in a firm's risk assessments of the size and probability of potential causes of significant stress to its business models, including the effect of multiple events
- the quality of other relevant systems and controls, such as risk transfer arrangements, including terms of business agreements.
- the quality and adequacy of a firm's professional indemnity insurance in relation to its exposures
- the implications of a firm's business model and operational structure, notably the implications of any cash sweep arrangements in groups
- various aspects of a firm's financial statements, in particular the quality of assets, working capital requirements and the robustness of cash flow forecasts

- where a firm is part of a group, the recoverability of intercompany balances or, where several firms are under common control, amounts due from connected persons
- the types of liabilities to which firms are exposed, including;
  - pensions obligations
  - contingent liabilities, such as unlimited deeds of cross-guarantee
  - mortgage debentures which create a fixed and floating charge over all the assets of a regulated firm

This list should not be considered exhaustive. We expect each regulated firm to consider the quality, quantity and availability of its assets in the context of its individual circumstances within the prevailing and potential market and economic conditions.

**Where we consider that a firm is unable to demonstrate compliance with Threshold Condition 4, we will first look for it to take immediate steps to strengthen its financial position and may seek to restrict all or part of its regulated activities until such time as the position is addressed to our satisfaction. In severe cases we will also consider Enforcement action.**

## **Appendix B: The difference between MIPRU and Threshold Condition 4**

A firm's compliance with the general solvency and capital resources requirement (MIPRU 4.2.11R) does not necessarily mean that the firm has adequate financial resources as required under Threshold Condition 4.

The outputs from the calculations required under MIPRU 4.2.11R do not recognise aspects such as the quality of assets, any adjustments to their value, contingent liabilities or group issues. Furthermore, the calculation required to be performed under MIPRU 4.2.11R is essentially a regulatory *minimum*, driven by formulae based on the previous year's turnover arising from the firm's regulated activities, with thresholds that are dependent on whether or not the firm holds client money.

By way of comparison, Threshold Condition 4 deals with the actual *and prospective* adequacy of a firm's resources, having regard to the regulated activities it undertakes or intends to undertake.

**As a minimum, we expect all UK regulated insurance intermediaries to be able to demonstrate to us that:**

- **they meet MIPRU requirements**
- and**
- **they have sufficient resources within their direct control to deliver their business plan in a compliant manner.**

Accordingly, in order to satisfy the FSA that they are meeting Threshold Condition 4, we expect all regulated insurance intermediaries to ensure that they retain assets of sufficient quality, quantity and availability (COND 2.4.2G(2)) to meet their commitments arising from their regulated activities in full as they fall due.