Society of Insurance Broking

Standards. Professionalism. Trust.

Good Practice Guide

June 2019

Internal Audit for Brokers

This paper is in response to members' requests to provide a summary of good practice within one source document and is based upon the Society of Insurance Broking's understanding of the regulator's rules and current stance. Whilst a summary, it is not intended to be exhaustive and should not be relied upon at the exclusion of other sources of information.

In association with PKF

Foreword

Jessica Wills

Partner, PKF Littlejohn LLP

In our experience from carrying out risk and control assurance work across the insurance sector we are seeing a growing recognition among broking firms of the importance of effective governance, risk management and internal control. There are a number of reasons for this but foremost, effective governance, risk management and internal controls helps firms to run their business better. The extension of the Senior Managers and Certification Regime (SM&CR) to broking firms later this year also demonstrates the FCA's desire for firms to 'raise the bar' in these areas.

We see a wide variation in the extent to which firms have established and implemented effective frameworks or functions for managing risk and for providing assurance on the effectiveness of internal controls (ie internal audit). This Good Practice Guide summarises what these functions should look like within a three lines of defence model with some examples of good practice. Whilst it highlights good practice, doing something is better than nothing, so firms should carefully consider how they can implement good practice in a way that is appropriate and proportionate. We hope this provides some useful guidance and demonstrates the benefits that risk management and internal audit can bring to your firm.

Introduction

Effective governance, risk management and internal controls are fundamental to the success of every organisation. An internal audit provides assurance on whether an organisation is well governed and managed, and on the adequacy of its internal controls.

Within the insurance sector, it is a regulatory requirement under Solvency II regulations for insurers to establish and maintain effective risk management and internal audit functions. Whilst insurance intermediaries are not subject to the same regulations, there is an increasing need and demand for greater assurance, with many firms now looking to establish an internal audit function. This is due to:

- Recent and upcoming changes in regulation (eg GDPR, IDD and SM&CR);
- More focus from the Financial Conduct Authority (FCA) on the sector, as seen through recent thematic reviews; and
- Increase in merger and acquisition (M&A) activity within the sector meaning that, as firms grow in size and complexity, there is greater need for assurance by investors and senior management.

What is risk/control governance: the three lines of defence model?

Ideally, firms should operate a three lines of defence model to ensure the effective management of risks and controls within the organisation. The functions and responsibilities of each line can be summarised as follows:

- **First line:** Functions that own and manage risks/controls (risk or control owners)
- **Second line:** Functions that monitor/oversee risks/controls (risk and compliance functions)
- **Third line:** Functions that provide independent assurance over risks/controls (internal audit function)

Some firms do not have clear or robust second or third line functions. For example, some firms rely too heavily on their external auditors or compliance consultants as a source of independent assurance. However, the scope and work of external auditors is predominantly focused on financial controls and the accuracy of financial information/reporting. Other firms rely on their broking file/peer reviews, however these are in fact first line controls.

What does an effective second line look like: the risk function?

Firms should have a clearly defined risk appetite that articulates the level and type of risks that the organisation is willing to accept, in order to achieve its objectives. The risk function is responsible for monitoring the actual risk profile relative to the risk appetite and implementing appropriate risk management techniques.

As part of this, a regular process for identifying and assessing risks and controls should be established with the involvement of key risk/control owners from across the firm. The results of this process (ie the risk profile) should be reflected in a risk register, which should be maintained and used by the firm as a 'living' document.

Once the risk profile has been determined, risk functions may undertake their own monitoring activities, eg to ensure that controls are operating in line with expectations.

The risk function should also be forward thinking, identifying any emerging risks which are new and/or developing risks, characterised by a high level of uncertainty. For example, Lloyd's defines emerging risk as "an issue that is perceived to be potentially significant but which may not be fully understood or allowed for in insurance terms and conditions, pricing, reserving or capital setting".

Finally, to ensure effective governance and oversight of risk, the risk function will produce and present risk information to a Risk/Compliance Committee (or Board if no seperate committee).

What does an effective third line look like: the internal audit function?

The third line of defence should be independent from the first and second lines of defence.

Whilst an external audit provides assurance over the financial controls and the accuracy of financial information/ reporting, internal audit examines the wider business as a whole. The scope of work should cover all key risk areas and organisational objectives: strategic, ethical, operational, reporting and compliance.

Typical audit areas for brokers might include:

- **Acquisition and integration process**
- **Governance**
- **Business continuity planning and disaster recovery**
- **Human resources and payroll**
- **Capital adequacy and cash flow management**
- **Insurer selection and management**
- **CASS 5 compliance**
- **IT general controls**
- **Complaints handling**
- **IT governance and strategy**
- **Conduct risk and product governance**
- **IT security**
- **Conflicts of interest**
- **IT strategy**
- **Credit control and aged debt**
- **Outsourcing and third-party providers**
- **Data quality and management information reporting**
- **Project management**
- **Data protection**
- **Compliance**
- **Delegated authority**
- **Risk management**
- **Finance**
- **Tax (corporate tax, IPT, VAT, payroll tax)**
- **Financial crime, sanctions and AML**

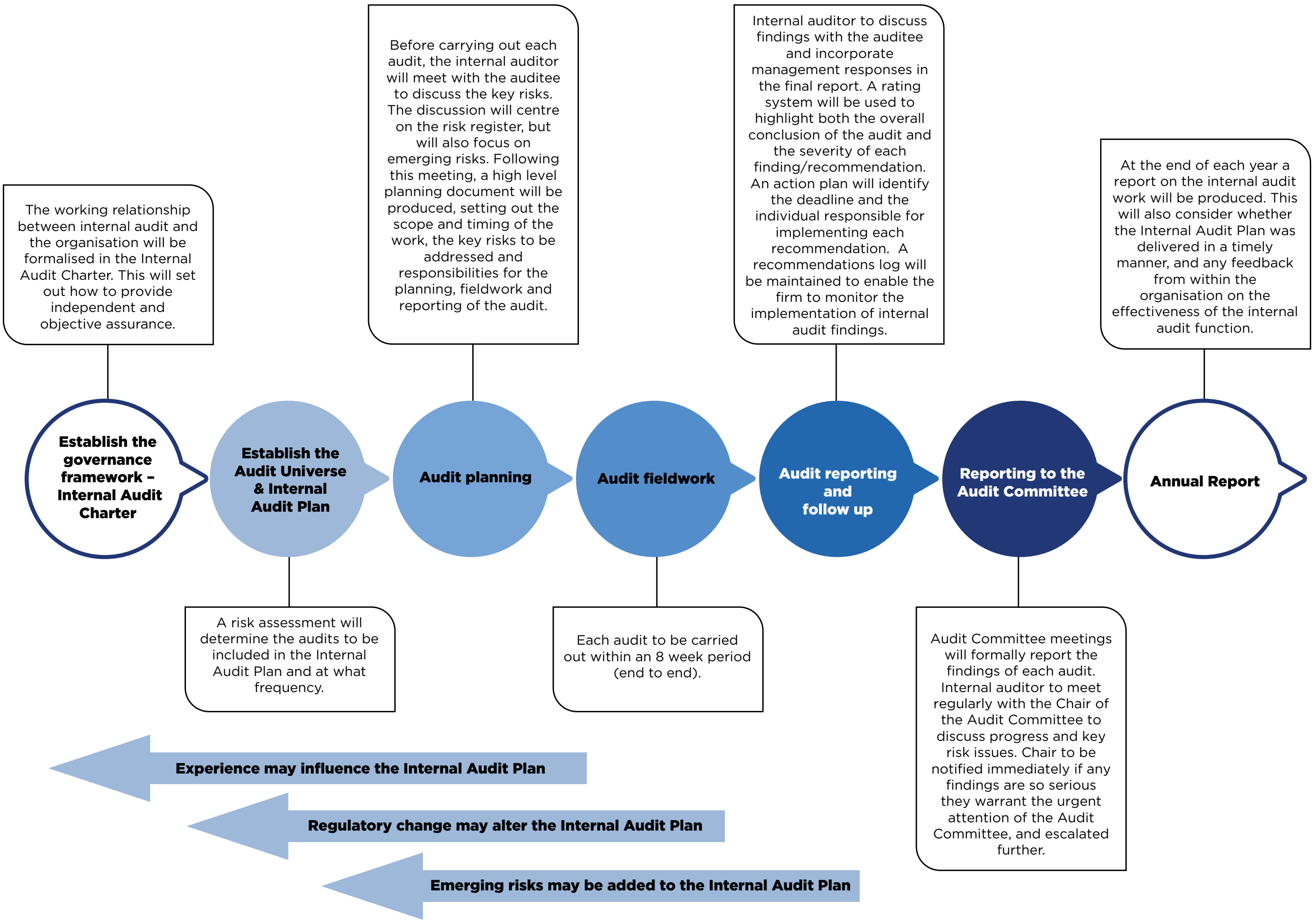
Risk areas should be assessed on a cyclical basis (eg three years), with higher risk areas being reviewed more frequently than lower risk areas. This could be done by providing details of expected key risk areas to cover across a three year plan.

By looking at the how effectively a firm assesses and manages its risks, including the effectiveness of its first and second lines of defence, all elements of an organisations risk management framework should be covered and the results of all internal audit activity reported to an Audit Committee.

An internal audit function can be resourced internally or on a co-sourced or outsourced basis.

What does the structure of an internal audit look like?

At a high-level the structure of an internal audit is set out below:



There are four key issues for directors to note when monitoring an internal audit's effectiveness. These are detailed by the Chartered Institute of Internal Auditors as follows[1]:

1. Internal audit should have a functional reporting line to the board or one of its committees, making it independent of the executive, able to make objective judgements, and giving it the authority to conduct its work across the whole organisation without constraint. To work effectively it also needs a close relationship with the Chief Executive and should have access to management information going to the executive committee and board.
2. Internal audit must be properly resourced, including ensuring a consistently high level of professionalism and quality based on the International Standards, plus appropriate knowledge, skills and experience.
3. Internal audit should use a risk-based approach in developing and executing the internal audit plan in order to focus on the greatest threats to the organisation.
4. Internal audit's scope should be unrestricted, including all areas of risk – such as key corporate events, culture and ethics, reputation, new products and the outcomes of processes.

1. https://www.iia.org.uk/resources/audit-committees/governance-of-risk-three-lines-of-defence/

What are the benefits of internal audit?

There are a number of reasons why brokers are recognising the benefits of internal audit.

In light of M&A activity, buyers are looking for target firms that are well run. Effective governance, risk management and internal controls are key to this. An effective internal audit provides assurance to shareholders, Board of directors or senior management that things are under control. This is particularly important where firms are expanding in size or increasing in complexity.

PKF Littlejohn have identified that there is an “unprecedented level of consolidation taking place in the industry meaning that there are considerable commercial benefits to undertaking internal audit work”. Buyers are looking for target firms that are well-run while shareholders want to know their investment is being well spent. This is not just from a financial perspective but also taking into account good governance, risk management and internal controls. Internal audit provides assurance on all these areas.

The FCA is paying closer attention to effective governance and accountability of senior managers through the implementation of SM&CR. By implementing an internal audit function, firms can demonstrate to the regulator that they take these things seriously which may result in a lower level of supervision. Meanwhile, under SM&CR, senior managers will benefit from receiving assurance from internal audit on the areas of the organisation that they are accountable for.

Good Practice

1. Maintain good compliance with the SM&CR.

As part of your SM&CR preparations, where you will be assessing your governance arrangements, take a good look at your risk governance to assess whether you have outlined senior roles and responsibilities clearly. This includes the decision whether to have an internal audit function and how it is provided. By clearly defining responsibilities, accountability will be more transparent, both within the firm and from the perspective of the regulator.

2. Have a clear and robust three lines of defence model.

Make sure that that your reporting lines are clear and appropriate, ensuring there is independence between the three different lines. While each line should function separately, all three lines need to work effectively with each other and with the Audit Committee in order to create the right conditions.

3. Establish a strong third line.

As the third line of defence assesses how effectively a firm is operating, make sure that you consider the following:

- Identify the key risks within the firm (eg by reference to the risk register) and focus the efforts of the third line accordingly to gain maximum value;
- Consider what sources of risk/control assurance already exist internally/externally – is it effective and suitably independent?;
- Consider the resourcing options and find a solution that works for you, eg in-house, co-source or outsource internal audit function; and
- If you choose to co-source or outsource, choose a provider who has a strong understanding of the insurance broking sector and the risks your firm faces.

4. Understand the concerns of your key stakeholders.

Find out what the concerns are of your key stakeholders including shareholders and non-executives – what keeps them awake at night? These are the areas where internal audit can bring the most value by providing assurance to those stakeholders on whether things are under control. For example, in recent times, issues such as cyber security and data protection have been key areas of concern to stakeholders.

5. Regularly review

It is important that you review regularly the adequacy of your governance arrangements and the effectiveness of your second and third line functions. This will ensure that these remain fit for purpose, particularly during times of organisational change, eg due to M&A activity or the development of new products/services.

Conclusion

With lots of recent regulatory changes, now is the perfect opportunity for insurance brokers to take stock of their internal audit arrangements. Whether the risk areas of concern are how complaints are handled or the acquisition of another company, an internal audit will identify what needs to be improved.

Clear and structured internal control frameworks need to be maintained as well as easily identifying senior management's roles and responsibilities. Combining these with an effective three line defence model mean that insurance brokers and firms are not only complying with regulation but are also operating an efficient risk management strategy.

Appendix - Primary Source Material

Chartered Institute of Internal Auditors

Date	Name	Summary	Link
April 2015	What every director should know	How to get the most from your internal audit.	https://www.iia.org.uk/media/1252483/What-every-director-should-know-refresh-PRINT-FINAL.pdf
September 2017	Guidance on effective internal audit in the financial services sector: second edition	Recommendations enhancing the overall effectiveness of Internal Audit, and its impact, within the firms operating in the financial services sector in the UK.	https://www.iia.org.uk/media/1689286/iia-revised-fs-code-final.pdf
22 November 2018	Audit committees	Providing assurance to the board in the pursuit of the company's objectives.	https://www.iia.org.uk/resources/audit-committees/
22 November 2018	What is internal audit?	The role of internal audit.	https://www.iia.org.uk/about-us/what-is-internal-audit/

Financial Conduct Authority

Date	Name	Summary	Link
3 January 2018	SYSC 3.2	FCA Handbook: Internal audit.	https://www.handbook.fca.org.uk/handbook/SYSC/6/2.html

PKF Littlejohn

Date	Name	Summary	Link
7 July 2014	A Guide to Internal Audit: Solvency II	Steps to building an effective Internal Audit function.	https://www.pkf-littlejohn.com/news/a-guide-to-internal-audit-solvency-ii
2015	Effective Internal Audit in the London Market	PKF Littlejohn's survey of London Market insurers and Lloyd's syndicates.	https://www.pkf-littlejohn.com/effective-internal-audit-in-the-the-london-market-2015