

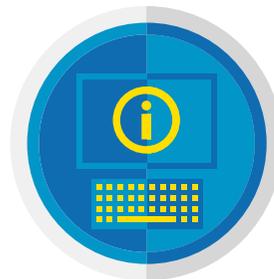
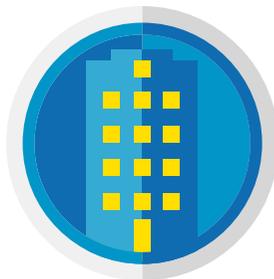
Client Money – A guide

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1. Introduction

This guide is intended to be a summary document setting out:

- the concept of ‘client money’ as held by an ‘insurance intermediary’;
- why insurance intermediaries hold client money in the first place;
- a synopsis of the rules for holding client money;
- a brief overview of common issues firms struggle with; and
- the audit requirements for client money.

It is not intended to be an exhaustive guide to the client money rules and should not be seen as a replacement for the FCA’s detailed guidance in: ‘Client Money: insurance distribution activity’ and being Chapter 5 of the FCA’s Client Asset Sourcebook.

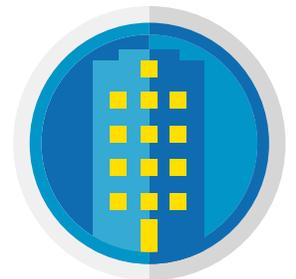
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2. What is client money?

The traditional insurance broking transaction where a client buys an insurance policy will involve the client paying a broker for the insurance premium charged. The broker will in turn then pass on this money to the insurer, or their agent. Depending on the terms of business the broker has with the insurer or agent the amount paid on is normally net of the insurance commission or brokerage retained by the broker.

Insurance monies held by a broker, as part of the insurance broking transaction, can be held in two ways:

- under a risk transfer arrangement; or
- as client money under CASS 5.

(i) Risk transfer

- Risk transfer takes place where an insurer lets a broker hold insurance monies on its behalf and by doing so transfers the 'credit risk' from the broker to the insurer.
- Monies held under this arrangement by the broker are referred to as 'risk transfer money'.
- The broker and insurer must enter into a risk transfer 'terms of business agreement' (TOBA) which is signed by both parties. This is essential to ensure that the TOBA provides for risk transfer without any exception or ambiguity. The TOBA confirms that the broker acts as the insurers agent in respect of the collection of premiums from the client, meaning that in the event of the insolvency or non-payment of the premium by the broker, the insurer is deemed to have already received the premium.
- Generally accepted best practice for holding risk transfer money is to follow the BIBA guidelines and use an 'Insurer Non-Statutory Trust'.
- If a broker is holding risk transfer money together with non-risk transfer money, all monies within the same bank account have to be treated as client money. Where this is the case, the Insurer must consent to the broker comingling their risk transfer money with client money and also confirm that they consent to their interests under the trust being subordinated to the firm's other clients. This must be clearly set out in the relevant TOBA between the broker and the insurer.

(ii) Client Money

- If a broker does not have a risk transfer arrangement in place with an insurer, then the insurance monies must be handled as 'client money'
- The FCA defines client money in its glossary of terms as "Money of any currency which, in the course of carrying on insurance distribution activity, a firm holds on behalf of a client, or which a firm treats as client money in accordance with the client money rules".

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3. What are the rules for holding client money?

A broker is able to hold client money in one of two different types of bank account:

- (i) **A statutory trust client bank account** - in this case, client money is managed in strict accordance with trust law and so a separate trust deed is not required. The main difference between a statutory trust account and a non-statutory trust account is that in respect of a statutory trust account any premium received in respect of a particular client can only be used to discharge the liability to the insurer in respect of that particular insurance policy. The broker has a duty of care for the client money to be operated on a strictly non-funding basis.
- (ii) **A non-statutory trust client bank account (NST)** - this is where the broker executes a formal non-statutory trust deed which permits it to extend credit from the client money account to clients or insurers. This means that the broker can use the funds in the NST account to discharge the liability to an insurer in respect of an insurance policy for which the broker has not yet received payment of the premium. The broker is not permitted to extend any credit to itself.

The detailed client money rules are set out in Chapter 5 of the CASS (Client Asset Sourcebook) of the FCA handbook (see <https://www.handbook.fca.org.uk/handbook/cass5>). We have set out below a general overview of some of the more important concepts of CASS 5:

- Statutory and non-statutory trust accounts in which client money is held are subject to UK trust law, with the broker firm acting as trustee and having a fiduciary duty to act in the best interests of its clients, putting its clients' interest ahead of its own.
- Once established, the protection of the 'trust status' is of critical importance. The CASS rules contain many regulations to ensure that it has been properly implemented in the first place and that the trust status is not 'polluted' in any way through non-client money forming part of the trust funds.
- The protection of the 'trust status' is essential to ensure that client funds are properly ring-fenced and protected so that in the event of the insolvency of the broker firm, a liquidator cannot get their hands on the client monies to discharge liabilities owing by the firm to non-client creditors.
- A broker can only extract its commission income from its client money bank account after preparing a client money calculation (CMC). There are detailed rules in CASS 5 around the format of the client money reconciliation, segregation and timing requirements for a CMC. These basically state the following:
 - A CMC must be carried out in intervals of no more than 25 business days.
 - The balances used in the CMC must be those at the close of play of the previous business day.

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3. What are the rules for holding client money?

- There is a requirement for the bank balances to be reconciled within 10 business days of the date of the CMC.
- The surplus/deficit arising from the CMC must be transferred to/from the office account by close of play on the same day of the CMC.
- The CMC must be completed using balances which have been validated and are in full agreement with the insurance ledgers.
- Allowance must be made for any unrealised brokerage, together with a provision for bad and doubtful debts.
- The CMC can be carried out using either the 'accruals' or the 'account balance' methods:
 - the 'accruals' method includes insurance debtors and creditors as part of the client money resource and requirement, while;
 - the 'account balance' method includes only the client bank balances as part of the client money resource as against the requirement.
- Where firms use the 'accruals' method, there is a requirement to additionally carry out a 'client by client' reconciliation at least once a year. In this reconciliation, the cash is broken down on an individual client basis meaning that if the broker became insolvent, the firm would easily be able to distribute this back to clients. This reconciliation is vital to be able to demonstrate that the firm has adequate systems to hold client money. When completing this reconciliation, you should aim for a degree of accuracy of at least 95%.
- Where a firm holds client money, the FCA capital requirements are increased so as to reflect the increased risk that the firm poses by holding client money. This involves the capital requirement, as reported in RMAR-D, increasing from 2.5% to 5% of regulated business revenue.
- Where a broker operates using a non-statutory trust, this gives them the ability to extend credit to a client or an insurer from the NST bank account, which effectively operates as a 'client money pot'. In this case, and where the broker deals with retail clients, there is a de minimis capital requirement of £50,000. Additionally, operating a non-statutory trust comes with additional controls, these include:
 - the need to obtain a separate auditor's sign off on NST systems and controls; and
 - the need to formally appoint a client money manager who will be responsible for all client money matters of the firm.
- Compliance with the client money rules is absolute and there is no concept of materiality or judgement in ascertaining whether a CASS rule has been breached or not. The client money manager, and those responsible for client money in a firm, must ensure that they have a strong operational understanding of the client money rules. The FCA encourages every firm to maintain a 'Breaches Register' setting out all detected breaches of the client money rules, together with a description of the course of action taken to remedy in future.



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4. Common issues regarding the holding of client money

The FCA's client money rules have been in operation since 2005. Rightly so, the FCA expects all intermediaries to be fully compliant with, and knowledgeable of, the CASS 5 rules without exception.

The reality is that there are times when brokers may not be fully aware of the CASS 5 rules when using client money accounts. More often than not, this arises because the finance team has not had sufficient up-to-date training or does not have the requisite resources in place to enable it to fully comply with the CASS rules.

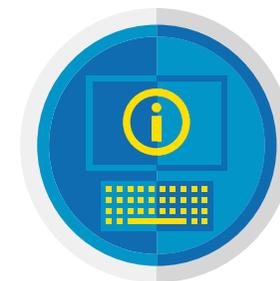
Common errors or misunderstandings around CASS 5 include:

- (i) Not using an appropriate CMC template. The FCA has issued client money calculation templates which will ensure that every element required to be captured is included in the CMC.
- (ii) Use of 'live' balances rather than 'close of the previous business day' balances in populating the CMC.
- (iii) Commission surpluses not being transferred out of the client money bank account on the same day as the CMC.
- (iv) Firms rely on using standard data obtained from their broking software, without proper validation of the data and ensuring that it is sense-checked and in agreement with management information. This can result in balances being missed from the CMC in error.
- (v) Lack of understanding and sense-checking of the 'unearned' commission figure used in the CMC.
- (vi) Firms withdraw commission, often on a mid-month basis and driven by cashflow requirements, without carrying out a CMC. The CMC is the only permitted basis for drawing out commission.
- (vii) Poor TOBA management. Firms sometimes lack signed TOBAs with insurers, or TOBAs do not contain the required terms that reflect how the firm is holding client money or extracting commission.
- (viii) Continued confusion as to whether monies are held under risk transfer or as client money. Firms often suffer from the misconception that if risk transfer has been given, the CASS 5 rules do not apply. However, risk transfer money becomes client money the moment it is paid into the client money trust account and becomes subject to the CASS 5 rules.
- (ix) Incorrect designation of bank accounts and bank letter acknowledgements, or failure to obtain the letters in the first place.
- (x) Client money errors occur primarily because those individuals charged with responsibility over client money are not familiar with the detail of the rules or the implications for the client money trust of non-compliance with the CASS rules. Please see appendix for useful sources of material for client money training.

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5. The client money audit process

All firms who hold client money under a non-statutory trust account or a statutory trust account (where the balance has exceeded £30,000 at any point in the year) are required by the FCA to have a client money audit.

The client money auditor is required to provide an opinion on whether the firm has adequate systems and controls to comply with CASS 5, both at the period end and during the year.

The audit opinion can either be:

- clean;
- qualified (ie. in compliance but with breaches to the rules which are annotated in an accompanying breaches schedule); or
- adverse.

The CASS audit report is addressed to the FCA but is not sent to the FCA unless it is an 'adverse report' which effectively states that the firm has pervasive or systemic issues in their compliance with CASS 5.

In the majority of cases, the opinion given will be a 'qualified' opinion. Although this report does not need to be sent to the FCA, except in case of the FCA reviewing the CASS report through routine inspection etc, they would expect CASS breaches to be rectified and not re-occur in future years.

A 'clean' audit opinion is one where there are no breaches at all, no matter how insignificant. Clean reports are possible, but rare. The FCA will often look at a 'clean' report cynically and it tends to raise more questions than answers.

The firm is responsible for selecting the CASS auditor and ensuring that the auditor has the requisite skills and experience to be able to carry out a CASS audit. If the audit firm is not up-to-date with the CASS 5 rules, they may form an inaccurate opinion of the firm's compliance with the CASS 5 rules, resulting in a false comfort being drawn from the audit.

The CASS audit must relate to a period no later than 53 weeks from the date of the previous CASS audit period, although most firms complete this on an annual basis. The CASS audit report must be signed off within four months from the CASS period end date.

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6. Conclusion

Client money rules exist to protect consumers. This, however, can only be achieved if those responsible for client money in firms are knowledgeable about the CASS rules in the first place.

The FCA has been progressively taking a greater interest in the protection of client monies and this is now a key priority to the FCA. The FCA have much intelligence to ensure that brokers are complying with the CASS rules through monitoring of client money information, as set out in RMAR-C, reviewing CASS audit reports obtained on request and conducting telephone interviews to assess broker compliance with the rules.

Firms need to ensure that they have an adequate understanding of the CASS rules and, if not, that proper action is taken to obtain the requisite knowledge.

In the event of a firm's failure, firms need to ensure that all proper procedures are in place to protect client money.

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Financial Conduct Authority

Name	Summary	Link (Click for more info)
CASS 5	Client money: insurance distribution activity.	https://www.handbook.fca.org.uk/handbook/CASS/5/?view=chapter
RMAR C Form	Client money and assets.	https://www.handbook.fca.org.uk/form/sup/SUP_16_ann_18A_20181001.pdf#page=3
Guide to Client Money for General Insurance Intermediaries	Guide for authorised firms on how to hold client money in accordance with CASS 5.	https://www.fca.org.uk/publication/archive/fsa-client-money-guide_0.pdf
Client Money Health Check	Guide to help firms assess their understanding of client money and how it should be protected.	https://www.fca.org.uk/publication/archive/fsa-client-money-healthcheck.pdf
RMA-C Client money and assets	FAQs.	https://www.fca.org.uk/firms/Gabriel/rma-c-client-money-and-assets-faqs

Financial Reporting Council

Name	Summary	Link (Click for more info)
Providing Assurance on Client Assets to the Financial Conduct Authority*	Client asset assurance standard.	https://www.frc.org.uk/getattachment/3bf164e1-5158-4b2a-ade2-3070cf123e32/Standard-Providing-Assurance-on-Client-Assets-to-the-FCA-Nov-2015.pdf

* Note that the FRC issued a consultation proposing revisions to this standard on 1 August 2019. Any revision is expected to take effect for client money periods beginning on or after 1 January 2020.

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Name	Summary	Link (Click for more info)
Client money templates and resources	Various templates and resources to help comply with the CASS 5 rules.	https://www.pkf-littlejohn.com/sectors-insurance-sectors-intermediaries