
FINAL NOTICE

To: **GoshawK Syndicate Management Limited**

Of: **52 Jermyn Street
London
SW1**

Date: **10 October 2005**

TAKE NOTICE: The Financial Services Authority (“the FSA”) of 25 The North Colonnade, Canary Wharf, London E14 5HS gives GoshawK Syndicate Management Limited (“the firm”) final notice about a requirement to pay a financial penalty.

1. ACTION

- 1.1. The FSA gave you a Decision Notice dated 7 October 2005 which notified you that pursuant to section 206 of the Financial Services and Markets Act 2000 (“the Act”), the FSA had decided to impose a financial penalty on you in the amount of £220,000.
- 1.2. Pursuant to section 206 of the Act, and having agreed with you the facts and matters relied upon and set out below, the FSA imposes a financial penalty of £220,000 on you in respect of breaches of Principles 2 and 3 of the FSA's Principles for Business and Rule 3.1.1 of the Senior Management Arrangements, Systems and Controls (SYSC) module of the FSA Handbook.
- 1.3. You have confirmed that you do not intend to refer the matter to the Financial Services and Markets Tribunal.

2. REASONS FOR THE ACTION

- 2.1. During September 2002 to October 2003, the firm breached Principles 2 and 3 of the FSA's Principles for Businesses and Rule 3.1.1 of the Senior Management Arrangements, Systems and Controls (SYSC) module of the FSA Handbook. The firm failed to:
- (1) conduct its business with due skill, care and diligence;
 - (2) take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems; and
 - (3) take reasonable care to establish and maintain such systems and controls as were appropriate to its business.
- 2.2. The FSA has decided to take action because of the following serious failings:
- (1) The firm did not take adequate steps to ensure that it had effective controls operating over binding authorities. This was demonstrated by a small number of binding authorities for which it did not carry out adequate due diligence prior to granting or renewing the binding authority and did not undertake adequate monitoring.
 - (2) There was a breakdown in the system of independent review at the firm for the period October 2002 to August 2003. The firm was aware of this breakdown but did not take reasonable steps to rectify the situation.
 - (3) The firm failed to ensure that its underwriters complied with the Board-approved underwriting and reinsurance limits.
- 2.3. The FSA considers that the above failings represent a significant risk to the FSA's regulatory objective of maintaining market confidence. They are particularly serious given that the firm received reports from the Society of Lloyd's ("Lloyd's") in previous years that highlighted weaknesses in respect of controls over binding authorities and the system of independent review. As a result, the firm was required to take further steps to rectify the weaknesses in its controls and improvements were made. However, the revised controls were not implemented in an effective way.
- 2.4. The seriousness of the failures is demonstrated by the losses incurred by its managed syndicate, Syndicate 102, on the binding authorities where the due diligence and monitoring was not adequate. The high risk nature of the business the firm was entering into should have led to senior management taking appropriate steps to mitigate the risks to Syndicate 102 and to Lloyd's Central Fund.

3. RELEVANT STATUTORY PROVISIONS, RULES AND GUIDANCE

- 3.1. Section 2(2) of the Act includes (among the FSA's regulatory objectives) market confidence.
- 3.2. Section 138 of the Act authorises the FSA to make rules applying to authorised persons with respect to the carrying on of their business.
- 3.3. Section 206(1) of the Act provides:

"If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate."

FSA Principles for Businesses

- 3.4. The FSA Principles for Businesses are high level statements of the fundamental obligations of firms under the regulatory system. The principles refer and relate to the FSA's statutory objectives.
- 3.5. FSA Principle 2 provides:

"A firm must conduct its business with due skill, care and diligence."

- 3.6. FSA Principle 3 provides:

"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."

FSA Senior Management Arrangements, Systems and Controls (SYSC) 3.1.1R

- 3.7. The SYSC rules are designed to enable firms to manage the risks to their business adequately. Failure by firms to do so increases the risk that the FSA will not achieve its objectives. SYSC requires the directors and senior managers of firms to take appropriate responsibility for their firm's arrangements on matters relating to confidence in the financial system, the fair treatment and protection of consumers and the use of the financial system in connection with financial crime.
- 3.8. SYSC 3.1.1R provides:

"A firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business."

FSA/Lloyd's "Co-operation Arrangements"

- 3.9. The firm was responsible for managing the affairs of Syndicate 102. Managing agents are subject to the FSA's rules, including the high level principles and the systems and controls requirements.
- 3.10. With effect from 1 December 2001, the FSA and Lloyd's entered into co-operation arrangements for the supervision and enforcement of Lloyd's managing agents. These arrangements have as their objectives, amongst other things, the prevention

of unnecessary duplication in the supervision, investigation and discipline of Lloyd's underwriting agents by the FSA and Lloyd's. Under the terms of these arrangements, Lloyd's performed certain monitoring functions in respect of managing agents on the FSA's behalf.

- 3.11. During the period under investigation, Lloyd's carried out the monitoring of managing agents and it did so through the use of a variety of tools including periodic reviews of the risks run by managing agents and the controls in place to mitigate these.

FSA Investigation

- 3.12. On 23 March 2004, following discussions with Lloyd's, the FSA appointed investigators under section 168(5) and section 167 of the Act to examine the systems and controls at the firm for the period 1 December 2001 to 30 October 2003.
- 3.13. During the course of its investigation, the FSA and Lloyd's co-operated closely and the FSA relied on reports and information provided by Lloyd's for the years 2000 to 2003, the firm's own internal reports and two third party reports commissioned by the firm in July 2003. The criticisms made of the firm by the FSA in this notice derive substantially from the findings made by Lloyd's in its reports.

4. FACTS AND MATTERS RELIED ON

Background

- 4.1. The firm is a Lloyd's managing agent owned by GoshawK Insurance Holdings, a London based holding company. The firm was responsible for managing the business and affairs of Lloyd's Syndicate 102. Syndicate 102 was established in 1982 and wrote marine and non marine classes of business. During the relevant period, Syndicate 102's two corporate members were supported wholly by capital provided by GoshawK Insurance Holdings and had a total capacity of approximately £225 million in its last underwriting year.
- 4.2. The firm was an authorised person under section 31 of the Act.
- 4.3. On 30 October 2003, following discussions with the FSA, Lloyd's prohibited the firm from accepting new risks on behalf of Syndicate 102. This had the effect of placing Syndicate 102 into run-off.

Binding Authorities

- 4.4. The FSA investigation identified significant deficiencies in the operation of the firm's binding authorities.
- 4.5. A Lloyd's binding authority is an agreement between a managing agent and a third party (referred to as the "coverholder") under which the coverholder may, in accordance with the terms of the agreement, accept risks and/or settle claims on behalf of the syndicate managed by the managing agent.

- 4.6. During the relevant period, a managing agent granting binding authorities was required to have regard to the guidance contained in the Lloyd's Code (in relation to managing and controlling binding authority arrangements). In brief, this Code provided guidance to managing agents in establishing effective systems and controls over (a) their vetting of new coverholders and binding authorities; (b) the operation of binding authorities; and (c) the monitoring of binding authorities that had been granted.
- 4.7. Managing agents should monitor binding authorities regularly throughout each year and carry out an annual review of each coverholder prior to renewal. Where a syndicate is leading a binding authority, the managing agent should also ensure that the coverholder is subject to an effective on site review.
- 4.8. Details of the deficiencies in the operation of the firm's binding authorities are set out in paragraphs 4.15 to 4.30.

Independent Review

- 4.9. Widespread failings were also identified in the operation of the system of independent review at the firm.
- 4.10. The requirement for a managing agent to have an effective system of independent review is set out in Lloyd's Managing Underwriting Risk Code. This Code demonstrates that the existence of independent review procedures to assess compliance performance is a feature of a managing agent's control framework.
- 4.11. Each managing agent should implement a system of independent review. The firm should review the system of independent review and monitor any remedial action that is taken to rectify weaknesses in the system. The system of independent review provides a check on the activities of underwriters to ensure that they are complying with all relevant systems and controls. Without such a check, a managing agent is exposed to the risk that an underwriter may, for example, be writing business that does not comply with the syndicate's business plan, be pricing his business below the market or be carrying out inadequate due diligence on his clients.
- 4.12. A system of independent review should ensure regular reviews of a syndicate's most significant binding authorities and ensure that binding authority procedures are being complied with. Without this extra level of review, a managing agent is exposed, for example, to the risk that the granting of a binding authority may have been inadequately researched or may not be being properly monitored.
- 4.13. As a result of recommendations from Lloyd's, the firm introduced a revised system of internal review. This rectified, in principle, the points raised by Lloyd's but the revised system of control was not operated adequately in practice.
- 4.14. Details of the deficiencies in the firm's independent review procedures are set out in paragraphs 4.31 to 4.34.

Reports - Binding Authorities

- 4.15. Lloyd's reviewed the firm's binding authorities and associated procedures during a review that was commenced in July 2003 and completed in September 2003. This review was further to earlier findings by Lloyd's that the firm had failed to meet the guidance contained in the Lloyd's Code on managing and controlling binding authorities. The 2003 review noted:
- (1) that basic documentation for binding authorities was missing, including audited accounts;
 - (2) that detailed procedures for obtaining approval to underwrite binding authority business (that were issued to underwriters in December 2002) were not being followed; and
 - (3) that there was no evidence that the firm had reviewed procedures for the handling of binding authority arrangements and the setting up of a Binding Authority Committee.
- 4.16. A third party review (commissioned by the firm and completed in September 2003) noted similar significant deficiencies in the systems and controls operating over binding authorities. In particular, the review noted that binding authorities were approved to go on risk when insufficient information had been collated and insufficient research performed and that no formal review of how binding authorities were monitored was in place.
- 4.17. The failings identified by Lloyd's in 2003 and the firm's third party independent review demonstrated that the firm had entered into binding authorities on the basis of inadequate information. In so doing, the firm potentially exposed Syndicate 102 to risks it was unaware of or did not properly understand. The firm was not in a position to identify problems in binding authorities at a sufficiently early stage to take effective pre-emptive or remedial action.
- 4.18. The deficiencies and the impact of the failings in the systems and control environment at the firm are demonstrated by the following binding authorities.

Binding Authority A

- 4.19. In relation to this binding authority, the firm did not carry out adequate due diligence before it took over 100% of the risk upon renewal and did not monitor adequately the coverholder to ensure that it was carrying out its duties to the required standard. This binding authority was, on renewal, one of Syndicate 102's largest single contracts by premium income.
- 4.20. The firm commissioned an independent third party review of the coverholder after it had renewed and taken over 100% of the binding authority. This report should have been commissioned, received and assessed prior to renewing the binding authority.
- 4.21. A report was also produced by the firm's Independent Review Committee which made a number of observations. These included the following:

- (1) the binding authority approval process form was signed off with minimal and perfunctory responses to many of the questions asked;
 - (2) the file contained unaudited financial statements and there were no management accounts for the period September 2002 through May 2003;
 - (3) the firm was given no guidance as to the financial position of the coverholder at the time the renewal of the binding authority was reported to it;
 - (4) there was no evidence that due diligence had been conducted by the firm on the third parties responsible for vetting the risks selected by the coverholder;
 - (5) there were no records held on file indicating regular and current monitoring of business written, premiums due and claims paid;
 - (6) in assessing the risks of the venture, there was nothing on file to indicate that proper consideration was given to the impact on the firm's Realistic Disaster Scenarios or aggregates; and
 - (7) it concluded that the setting up and management of the binding authority falls far short of the standards expected.
- 4.22. The firm therefore failed to conduct adequate due diligence before renewing the binding authority in March 2003. This was particularly important given that the firm had assumed 100% of the risk on the binding authority and that the coverholder was in financial difficulty at the time of renewal. The firm should have carried out thorough due diligence and it would be reasonable to expect that this should have included the receipt and analysis of audited financial statements and a full set of management accounts.
- 4.23. The firm should also have carried out due diligence on the third parties responsible for vetting the risks selected by the coverholder. Its failure to keep records on file indicating regular monitoring of business written, premiums due and claims paid meant that the firm was unable to monitor effectively Syndicate 102's solvency and capital requirements. The firm should also have given proper consideration to the impact of Binding Authority A on its Realistic Disaster Scenarios and aggregates. Lloyd's requires all managing agents to consider how a particular risk fits in to the pattern of other risks it has accepted and how this affects its exposure to a particular sector or geographical region.

Binding Authority B

- 4.24. Binding Authority B required, amongst other things, that the coverholder would process claims itself. Particular skills are required for claims handling and the firm was satisfied that the relevant individuals employed by the coverholder had these skills. It was, therefore, important that the coverholder carry out the claims handling itself.
- 4.25. In 2002, the firm renewed Binding Authority B despite not having carried out the 2002 audit and despite not having received up to date financial information for the

coverholder from the broker responsible. The firm relied instead, in taking the decision to renew the binding authority, on its own figures.

- 4.26. The firm received a significant claim two weeks after renewing the coverholder's binding authority. The firm immediately scheduled a visit to the coverholder which revealed that, in breach of the terms of the binding authority, the coverholder had outsourced administration and claims handling to a third company. Although this relationship had operated without significant losses for the previous five years, the firm should have had in place effective procedures that would have identified the losses and the breaches of the binding authority prior to renewal.

Binding Authorities C

- 4.27. The firm did not carry out adequate due diligence on these binding authorities and also did not monitor their operation adequately.
- 4.28. These binding authorities required the firm to monitor carefully the risks the coverholder was entering into. An independent actuarial review commissioned by the firm concluded that the firm had failed to do this.
- 4.29. The firm did not purchase any reinsurance cover for this business, which left it exposed when considerable losses developed. The run-off manager for Syndicate 102 has estimated that Syndicate 102 is liable for significant claims.
- 4.30. The FSA considers that the firm failed to carry out adequate due diligence before entering into these binding authorities. It should have researched the risks associated with this type of business more thoroughly. It also failed to monitor these binding authorities to the required standard.

Independent Review

- 4.31. The Lloyd's review of the firm in 2003 concluded that the firm had failed to implement fully an effective system of independent review. The firm had been told previously by Lloyd's to improve the operation of this control and worked with Lloyd's to make significant improvements to the system, including the establishment of the Independent Review Committee. This resulted in a framework process being introduced which was acceptable to Lloyd's. However, the Lloyd's review in 2003 found that the process was not being implemented adequately for a period of time. It found that:
- (1) formal independent review meetings had not been held with class underwriters in February and March 2003. The review scheduled for December 2002 to look at underwriting figures for certain classes had not taken place;
 - (2) during the period October 2002 to April 2003, the system of independent review failed to produce five monthly written reports to the Board on a timely basis, contrary to its terms of reference; and

- (3) reviews of sample risks for the period January 2003 to August 2003 were not undertaken. These reviews were intended to analyse, amongst other things, data accuracy.
- 4.32. The firm accepted the findings of the Lloyd's 2003 review in full. These findings were confirmed by the firm's third party review commissioned in July 2003.
- 4.33. The system of independent review was inadequate for a period of time (October 2002 – August 2003). This was despite the improvements to the system that had been implemented by the firm and the operation of the Independent Review Committee. The FSA recognises that, during this period of time, the firm's independent review resources were occupied in a number of other key activities including completing the reinsurance to close exercise for the 2000 year of account and finalising the syndicate's 2002 accounts and its Lloyd's return. Nonetheless, the firm's conduct fell short of the standards expected by the FSA of Lloyd's managing agents. The FSA considers that the failings in the system of independent review limited the ability of the firm to make a full assessment of the risks associated with the decision to write 100% of Binding Authority A.
- 4.34. In particular, the FSA considers that the firm's failure to ensure formal independent review meetings took place on a timely basis, meant that there was, on these occasions, an inadequate review of the risks that had been written. This is notwithstanding the work of the Independent Review Committee which met regularly over the period and any meetings that may have been held with class underwriters that were not documented. The formal meetings were a key part of the firm's control framework. The FSA acknowledges that reports were submitted by underwriters to the Board during the period October 2002 to April 2003 but considers that, nonetheless, the absence of independent review reports during this period, limited the firm's ability to monitor the risks that Syndicate 102 was writing.

Exceeding Limits

- 4.35. The underwriters employed at the firm breached both underwriting and reinsurance limits that had been set by the firm. These breaches included failures to follow pre-authorisation procedures for breaches of reinsurance, risk limits and local license requirements.
- 4.36. These matters were significant failures that would not have occurred in a properly controlled environment.

5. FACTORS RELEVANT TO DETERMINING THE SANCTION

Relevant guidance on sanction

- 5.1. The principal purpose of the imposition of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefit of compliant behaviour.

- 5.2. In determining whether a financial penalty is appropriate and its level, the FSA is required to consider all the relevant circumstances of the case. ENF 13.3.3 indicates the factors that may be of particular relevance in determining the level of a financial penalty.

The seriousness of the misconduct or contravention

- 5.3. The FSA has had regard to the seriousness of the firm's contraventions, including but not limited to the nature of the requirements breached, the number and duration of the breaches, the identification of the contraventions by the firm's senior management and the extent to which problems were systemic. The level of financial penalty must be proportionate to the nature and seriousness of the contraventions. Details of the breaches identified in this case are set out above. For the reasons detailed at paragraph 2.3 above, the FSA considers that the breaches identified in this case are of a serious nature.
- 5.4. In deciding on the level of financial penalty, the FSA has taken into account the following:
- (1) on 30 October 2003, Lloyd's prohibited Syndicate 102 from writing new business with the effect of placing Syndicate 102 into run-off and subsequently transferred the management of Syndicate 102 to another firm. Therefore, the firm has limited assets to pay a financial penalty;
 - (2) the failings identified by the FSA and Lloyd's occurred under the previous management team and the current management team have assisted Lloyd's in effecting the run off of Syndicate 102;
 - (3) the firm conducted its own investigation into the failings of its system of independent review and its system of monitoring its binding authorities and gave its findings to Lloyd's/FSA; and
 - (4) the firm has been open and co-operative with the FSA during the FSA's investigation and has entered into settlement negotiations.

Conclusion

- 5.5. Taking into account the seriousness of the contraventions and the losses incurred, but also having regard to the fact that Syndicate 102 has been placed into run-off and the co-operation shown, the FSA has imposed a financial penalty of £220,000.
- 5.6. In the event that the firm had not been placed in to run-off and was still writing new business, the financial penalty imposed would have been significantly higher.
- 5.7. The FSA considers the sanction to be a proportionate exercise of its enforcement powers and consistent with the FSA's publicly stated policies.

6. DECISION MAKER

- 6.1. The decision which gave rise to the obligation to give this notice was made by the Regulatory Decisions Committee.

7. IMPORTANT NOTICES

7.1. This Final Notice is given to you in accordance with section 390 of the Act.

Manner of Payment

7.2. The penalty must be paid to the FSA in full.

Time for Payment

7.3. The penalty must be paid to the FSA no later than 25 October 2005, being not less than 14 days beginning with the date on which this notice is deemed served on you.

If the Penalty is not Paid

7.4. If all or any of the penalty is outstanding on 25 October 2005, the FSA may recover the outstanding amount as a debt owed by you and due to the FSA.

Publicity

7.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

7.6. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

7.7. For more information concerning this matter generally, you should contact William Amos at the FSA (direct line: 020 7066 1324 /fax: 020 7066 1325).

Ian Mason
FSA Enforcement Division