Financial Services Authority

FINAL NOTICE

To: **Mitsui Sumitomo Insurance Company (Europe) Ltd**

Address: **25 Fenchurch Avenue, London, EC3M 5AD**

Date **8 May 2012**

ACTION

1. For the reasons listed below, the FSA imposes on MSIEu a financial penalty of £3,345,000 in respect of breaches of Principle 3 of the FSA's Principles for Businesses which occurred between 1 October 2009 and 31 March 2011.

2. MSIEu agreed to settle at an early stage of the FSA's investigation, and therefore qualified for a 30% (Stage 1) discount under the FSA's executive settlement procedures. Were it not for this discount, the FSA would have imposed a penalty of £4,780,000.

SUMMARY OF REASONS

3. This case concerns a serious failure in MSIEu's corporate governance and control arrangements which resulted in it being poorly organised and managed across its business as a whole following a decision to expand and diversify into a new business area, by writing business for European clients through three branches across Europe.

4. The failings occurred despite the FSA clearly indicating that the change in business strategy would require careful and focussed oversight from the Board. Following an ARROW visit, the FSA Supervision Team wrote to MSIEu setting out that oversight of the new and expanded business would be reliant on good systems and controls, adequate pricing and reserving. A key

factor in achieving this was identified as the implementation of a new underwriting and general ledger system. It also highlighted the importance of the Board being supplied with management information of good quality and quantity to enable effective apportionment and oversight.

5. However, the corporate governance at MSIEu and the mix of skills and experience of the Directors and senior management failed to change sufficiently quickly to reflect the expansion of the business into a new area. In addition, personnel operated in senior positions with limited experience of the new business area and UK regulatory obligations. As a result, Board effectiveness was weak and it failed to operate at the level appropriate for the size and complexity of MSIEu's developing operations.

6. The control and oversight of the new business area was inadequate and insufficient resources were given to developing this area. MSIEu was concerned to achieve increased profitability through expansion of the business. Prompt and effective action was not taken to ensure that appropriate corporate governance and systems and controls were put in place to comply with UK regulatory requirements. From December 2010 to the end of the Relevant Period, MSIEu failed to hold sufficient capital to meet its ICG. MSIEu accepted that by March 2011 its corporate governance was clearly deficient and not fit for purpose.

7. MSIEu breached Principle 3 by failing to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. In particular MSIEu failed to take reasonable care to:

   a. ensure that its corporate governance arrangements were operating effectively;

   b. maintain adequate control and oversight over its branch office business, despite the FSA indicating in 2009 that its plan to expand into the non-JIA market required effective oversight;

   c. ensure that key posts were filled with staff with the necessary time, knowledge, skills and experience;

   d. ensure appropriate segregation of duties and responsibilities, especially relating to the Three Lines of Defence;

   e. implement in a timely manner effective IT systems and generate adequate management information to enable it to control business written in its branches; and

   f. ensure that it had sufficient capital to meet its ICG.

8. The FSA regards these failings as serious. The weaknesses at MSIEu posed risks to policy holders and as such had the potential to impact market confidence. Significant actions have been required and undertaken by MSIEu to remediate the position and to mitigate the risks to policy holders and FSA

objectives, although in this case the risk was significantly reduced by MSIEu's relationship with its parent company. Additionally, the breaches arose despite specific communications from the FSA that identified the need for careful and focused oversight from the Board following a decision to expand into new business areas, and various internal reports from staff of issues regarding corporate governance.

9. The FSA also recognises that:

a. the Holding Company commissioned the Review by an independent third party into failings at the Firm and MSIEu voluntarily ceased writing all new non-JIA business until the issues identified by the Review could be appropriately remediated;

b. MSIEu made every effort to co-operate with the FSA investigation;

c. MSIEu is taking substantial steps, including the appointment of a significantly changed Board and Executive Management team, to address the issues identified by the Review so as to improve the control environment including appointment of a new CEO, two independent non executive directors, a General Counsel and Head Actuary; and,

d. the capital shortfall against ICG was addressed by a substantial (£94 million) injection of capital from the Parent Company.

DEFINITIONS

10. The definitions below are used in this Final Notice:

"ARROW" means the framework the FSA uses to make risk-based regulation operational. ARROW stands for the Advanced, Risk-Responsive Operating FrameWork.

"the Act" means the Financial Services and Markets Act 2000

"the Board" means the Board of Directors of MSIEu

"CUO" means Chief Underwriting Officer

"EDM" means the weekly Executive Directors Meeting of MSIEu

"the FSA" means the Financial Services Authority

"the Group" means the MS&AD Insurance Group

"GENPRU" means the part of the FSA's Handbook entitled "General Prudential sourcebook"

"Head Office" means MSIEu's principal place of business in London, where its central management and control functions are based "the Holding Company" means MSIG Holdings (Europe) Ltd, a company incorporated in the UK

"ICA" means Individual Capital Assessment, which is an ongoing assessment by a firm of its capital resources undertaken as part of an assessment of the adequacy of the firm's overall financial resources

"ICG" means Individual Capital Guidance, which defines the amount and quality of capital that the FSA thinks that a firm should hold at all times based on an evaluation of the firm's ICA. ICG may be substantially greater than the firm's minimum regulatory capital requirement.

"Independent NED" means Independent Non-Executive Director

"JIA" means Japanese Interest Abroad

"Mr Kumagai" means Yohichi Kumagai, who held controlled functions CF1 (Director) and CF3 (Chief Executive) at MSIEu throughout the Relevant Period

"MSIEu" means Mitsui Sumitomo Insurance Company (Europe) Ltd, a company incorporated in the UK

"the Parent Company" means Mitsui Sumitomo Insurance Company Ltd (Japan)

"PAS" means MSIEu's Pan-European Policy Administration System, an underwriting and claims IT system

"the Relevant Period" means 1 October 2009 to 31 March 2011 (inclusive)

"the Review" means the review by an independent third party commissioned by the Holding Company into MSIEu's corporate governance referred to in paragraph 22 of this Notice

"RMP" means Risk Mitigation Programme

"Three Lines of Defence" means MSIEu's internal control framework involving operational processes (the first line), compliance and risk management (the second line), and internal audit (the third line)

"the Tribunal" means the Upper Tribunal (Tax and Chancery Chamber)

FACTS AND MATTERS

11. MSIEu is an insurance company regulated by the FSA, carrying out predominately wholesale insurance business including commercial property and liability insurance. Based on its nature, scale and complexity, MSIEu is categorised and supervised by the FSA as a Medium Low (ML) impact firm.

12. MSIEu is 100% owned by the Holding Company which is in turn owned by the Parent Company. The Parent Company first established a representative office in London in 1924. It is now part of the Japanese MS&AD Group which is one of the world's largest non-life insurance groups.

13. Historically, the focus of MSIEu was to service the business needs of the Group's Japanese domiciled clients in Europe and the Middle East. This was known as JIA business.

14. Up until 2007 MSIEu did not write any non-JIA business, i.e. any business for non-Japanese clients. In 2007, a decision was taken to expand into non-JIA business, focussing heavily on the market in Germany and France. MSIEu enjoyed rapid growth in this area, which led to MSIEu's gross written premiums almost doubling by 2010. By year end 2010, approximately half of MSIEu's gross written premium was in non-JIA business. MSIEu's head office was in London but it had a number of branch offices in Europe.

15. In April 2009, Mr Kumagai was appointed as executive Chairman of MSIEu. A number of other new directors were appointed at the same time to replace previous post-holders. These appointments occurred as part of a rotational staffing strategy employed by the Parent Company which involved employees of the Parent Company being seconded to MSIEu for a period of time (typically three years). Employees were appointed from elsewhere within the Parent Company, and typically had little or no non-JIA experience prior to their appointment. Mr Kumagai joined at a critical stage, as MSIEu expanded its non-JIA business. He chaired the Board and also sat on the EDM, a weekly meeting between all executive directors to consider management issues.

16. On 1 June 2009 the FSA Supervision team provided the Board with a Risk Assessment/ Capital Adequacy Review Letter and RMP, resulting from an earlier ARROW visit to MSIEu. This stated that:

"*We also are aware of your intention to grow the business by expansion into the local [i.e. non-JIA] market due to the saturation of the Japanese market. This change in strategy will require careful and focused oversight from the Board to maintain its success...*

…the oversight of the new and expanded European and Middle East operations is reliant on good systems and controls, adequate pricing and reserving. A key factor is the new underwriting and general ledger system (PAS) being implemented during 2008/2009. It is important that the Board is supplied with management information on the new business venture that is of the quality and quantity to enable it to discharge its apportionment and oversight role effectively…"

17. The letter also commented upon MSIEu's governance and culture particularly in relation to a need to appoint an Independent NED with experience within the European market, stating that:

"Whilst historically the governance and regulatory culture of the firm is good, we were concerned that currently on your firm's Board there are no independent non-executive directors to give a robust challenge……Also as the firm diversifies into an increased local portfolio without the independent expertise in this area of the business, there may not be effective oversight of the risks involved…"

18. On 26 June 2009, in response to this letter, MSIEu wrote to the FSA responding to a number of items on the FSA's RMP and provided the findings of an internal audit report as was required by the RMP. The letter identified various steps that MSIEu would take to address issues including:

   a. an update on implementation of PAS which stated that its installation was imminent; and,

   b. recruiting high calibre independent non-executive representation onto the Board.

19. In late 2009, to address the FSA's concern regarding the experience of the Board described in paragraph 16 above, MSIEu appointed an Independent NED with relevant and appropriate experience.

20. The internal audit report recommendations included:

   a. a review of the effectiveness of the Board and executive committees, with the results to be incorporated into the future running of the Board and executive committees; and,

   b. ensuring that the role of MSIEu's Operations Department was clearly communicated and that branch offices developed procedures to operate autonomously.

21. During September 2010, after a further visit raised concerns, the FSA requested details of how MSIEu intended to strengthen its reserves, an overview of the controls and oversight of the European branches, and to arrange a visit to the German branch.

22. In March and April 2011, two meetings were held between FSA Supervision and MSIEu in which MSIEu reported that it held insufficient capital to meet its ICG.

23. In April 2011, after the second meeting between MSIEu and the FSA, the Holding Company commissioned an independent third party to carry out a review of MSIEu's corporate governance. The Review was split into two phases, Phase One (completed 3 May 2011) and Phase Two (19 July 2011).

24. Phase One included a high level review of the oversight and governance and systems and controls within the UK operation and the German branch. It also considered the facts around the capital shortfall against ICG.

25. Phase Two included an in-depth review of the corporate governance arrangements and systems and controls at MSIEu including for the two largest branches in Germany and France.

The Review – Phase One

26. The Phase One report was received on 5 May 2011. Its key findings were that the corporate governance structure, and the make-up of the senior management team of MSIEu had not changed to reflect the developments in its business, and that the board was weak and did not have the appropriate resources to effectively oversee and control non-JIA business. It also found that MSIEu had failed to meet its ICG.

The Review – Phase Two

27. On 19 July 2011, the FSA received Phase Two of the Review. This raised significant concerns about fundamental aspects of MSIEu's corporate governance, oversight of its branch operations, and systems and controls. It identified:

    a. issues with the corporate structure, corporate governance, resourcing and the Three Lines of Defence model used by MSIEu;

    b. significant weaknesses in MSIEu's information systems, reserving and aggregate exposure management; and,

    c. insufficient effective control, support and oversight of the European branch offices, in particular the German branch.

28. These issues, and MSIEu's failure to hold adequate capital to meet its ICG are considered in turn below.

Corporate structure, corporate governance, resourcing and the Three Lines of Defence

29. The Review identified concerns as to MSIEu's corporate structure, with numerous European branches and high central costs. It highlighted governance concerns relating to a lack of Board effectiveness, due to a lack of appropriate skill and experience, a lack of corporate behaviour on the Board, and difficult decisions being deferred several times. The Review also identified that inadequate staff resources and staff changes created gaps in MSIEu's First and Second Lines of Defence.

30. The high central costs led to a concern during the Relevant Period to cut these costs so as to improve profitability. This was a factor in the decision in early 2010 to merge MSIEu's back office functions with those of another Group company within the UK.

31. The relevant skills and experience of the Board were also affected by the Group's rotational staffing policy, described above. As a result of this policy a number of individuals with limited recent experience of non-JIA business were placed into senior positions within MSIEu. They had restricted experience and were unfamiliar with the business and the UK regulatory environment. MSIEu's senior management was aware of the need to ensure that incoming staff were suitably skilled and experienced to perform their new roles, and during the Relevant Period began to operate an interview procedure to assess the suitability of such staff prior to allocating them their new roles. Some training was provided to new staff on arrival. However, this did not adequately address the issue and there remained a lack of relevant skills and experience amongst key post holders.

32. The corporate governance issues are apparent from a review of the minutes of Board meetings and EDMs:

a. In September 2009, Compliance reported to the EDM on a review of Board and committee performance which identified that the various executive committees through which MSIEu was controlled were not operating effectively. During the Relevant Period no effective action was taken by senior management in response to the findings of this review: the chairmen of the respective committees were asked to address the shortcomings identified but no checks were put in place to ensure that this happened and was effective.

b. In late 2009, MSIEu appointed an Independent NED with relevant and appropriate experience in non-JIA business. In March 2010, the Independent NED identified to Mr Kumagai a number of weaknesses in MSIEu including its understanding of European markets, leadership and corporate governance. He suggested a corporate governance model for MSIEu to adopt, but no action was taken in response to his analysis and suggestions.

c. The need for changes to MSIEu's corporate governance was also raised at EDMs from March 2010, by MSIEu's Internal Audit and others, but no action was taken until late 2010. As part of its response to the FSA's request referred to in paragraph 20 above, MSIEu confirmed by letter of 8 October 2010 that it would "*undertake a review of its corporate governance and report to the Board with observations and recommendations.*" This review was repeatedly discussed at the EDM during October and November 2010, but no agreement was reached as to how or by whom it should be conducted.

d. At a Board Meeting on 25 November 2010, the Independent NED observed that almost nothing had been achieved in relation to the corporate governance review and asked what the plan was for the following year. The drafting of new Corporate Rules was also identified as long overdue, having been deferred since the Board Meeting in May 2010. The Independent NED further observed that the Board "*did not have a CEO, CFO or an individual in charge of* *operations. It was not clear who was running the company and who was in charge".*

e. On 27 January 2011, the Board approved as a concept a proposed organisational restructuring of MSIEu. This included the proposed appointment of the Independent NED as Chairman, Mr Kumagai's job title being changed to Chief Executive Officer and a single Director being given direct responsibility for the European branches.

33. Mr Kumagai had begun discussing this revised corporate structure with the Holding Company and MSIEu's Corporate Planning Department in December 2010. Only very limited input was obtained from those in MSIEu with relevant expertise and experience in managing non-JIA business. On 24 March 2011, the Board approved the revised corporate structure, subject to a full legal review being undertaken. On 1 April 2011, the new corporate structure was announced to the staff.

34. At the next Board meeting, on 20 April 2011, it was agreed that no further steps should be taken to implement the new corporate structure until the ongoing corporate governance review, the legal review, and a visit by the FSA in MSIEu's Cologne branch had been completed. In fact, the planned restructure was not implemented, being superseded by a remediation programme which has resulted in significant change to MSIEu's structure, management and governance.

35. MSIEu had a lack of resources in key functions including that:

a. It did not have a CUO. At an EDM on 5 May 2009 the appointment of a CUO was discussed as being intended to "*give the expertise to oversee and support the non-JIA business and that this would enable the firm to demonstrate that it can control its overseas business which had been a concern of the FSA*". An individual identified as a suitable candidate to act as CUO was vetoed by the German branch. This individual was not appointed and no further steps were taken to identify and appoint a suitable CUO during the Relevant Period;

b. On 25 March 2010, a meeting of the Board confirmed the appointment of a senior executive officer to oversee the branch operations. The individual appointed was selected as part of the rotational management strategy and had only limited experience of non-JIA business. Consequently this did not make up for the absence of an appropriately experienced CUO;

c. Key appointments were made on an interim basis from March 2010 onwards and no steps taken to recruit permanent post-holders during the remainder of the Relevant Period;

d. From April 2010, MSIEu made appointments to key posts without considering whether the post-holder's span of responsibility was too wide for him to perform his responsibilities adequately; and

e. Key functions in the Second Line of Defence were under resourced and therefore unable to fulfil their functions. Thus, MSIEu sought to achieve oversight of the German branch's underwriting through reviews by third-party reviewers including reinsurers performing reviews for the reinsurers' own purposes, rather than any reviews and testing by MSIEu's Second Line of Defence.

36. The Three Lines of Defence system was compromised in that responsibility for functions within different Lines of Defence was not always allocated to different individuals.

Information systems, reserving and aggregate exposure management

37. During the Relevant Period MSIEu sought to implement PAS, an underwriting and claims IT system, to standardise business processes across all branches and hence to enhance the control environment. As referred to above, implementation of this system was identified by the FSA in June 2009 as being a key factor in providing management with adequate data to oversee and control the growing branch business. Without such a system MSIEu was unable efficiently to generate financial data that was required to control the business.

38. Although MSIEu reported to the FSA in June 2009 that implementation was imminent, this had not been completed across all of the branches by the end of the Relevant Period. There were fundamental difficulties with implementation of the system, and, as a result, significant weaknesses arising from the lack of an effective system by which the business could be monitored by management.

39. These difficulties were apparent to senior management, as reflected in the minutes of Board and EDMs:

a. At a Board Meeting on 30 July 2009, timing of the PAS implementation was discussed and pressures on the budget noted. Mr Kumagai expressed a *"strong expectation that all directors, managers and staff would implement PAS in accordance with the timescales";*

b. At an EDM on 24 August 2009 it was reported that good progress appeared to have been made with the implementation of PAS in London and the system was about ready to be launched for a live run in Germany;

c. At an EDM on 26 November 2009, it was noted that the German branch was finding the implementation of PAS to be very cumbersome;

d. On 21 December 2009 PAS was described as being used successfully in the UK branch and "*expected to go live in the German Branch in January [2010] and the issues raised by German colleagues should not prevent this";*

e. At an EDM on 5 July 2010 it was noted that PAS had still not been fully implemented at this stage;

f. A visit by the CFO to the German branch on 27 July 2010 identified a number of issues with PAS in the branch, in particular a reticence by members of staff regarding its implementation, inefficient cash matching and slow response times;

g. On 29 July 2010, the Board was informed that PAS was now expected to be completed in "*at least mid to late 2011*";

h. At a Board Meeting on 24 September 2010 a number of complaints were raised about PAS and, in particular, its implementation in the German branch. The Independent NED queried who was taking ownership of this issue which had been repeatedly reported to the Board but he did not see any progress and needed an answer as to how the system was working; and,

i. At the Board Meeting on 27 January 2011, it was observed by the Independent NED that the implementation of PAS was a major issue and he was concerned that "*no matter how many times the issues were mentioned at a Board meeting, nothing appeared to happen. It needed to be solved*". Details were provided to the Independent NED about the steps being taken to address the issue including that there was oversight at the EDM which understood exactly what was going on and that the mistakes had been identified and processes developed to overcome them. It was, however, recognised that the same issues came to the Board every meeting and that a plan to deal with them should be communicated to the Board and employees.

40. Despite these difficulties insufficient steps were taken to ensure that adequate resources, including individuals with sufficient time and adequate IT skills and experience, were devoted to implementation of the PAS system, either at the outset or as difficulties with the system increased.

41. The difficulties with PAS implementation led to numerous manual work-arounds being put in place within the branches to input data into the various information systems. This created concerns as to the quality of data being provided to MSIEu's senior management, Finance Department and auditors.

42. There were significant deficiencies in the reserving process, by which MSIEu calculated the amount of reserves that it should hold so as to be able to meet all future claims arising from policies currently in force and written in the past. This process was run within the central Finance Department with limited senior management involvement. There was no Reserving Committee, integrated reserving methodology or sufficient resources to operate an adequate level of control. These difficulties were exacerbated by MSIEu's difficulties in obtaining data of sufficient quality to support the process.

43. There was also a lack of an aggregate exposure management process, by which MSIEu could assess the total risks written onto its books. Although an external party performed an annual aggregate exposure analysis on some risk areas, weaknesses in the data quality of the non-JIA business resulted in low reliability of the exposure reports. This created a risk that MSIEu was unable to assess the risks on its books at any one time.

Management and oversight of the branch operations

44. The Review identified concerns with MSIEu's control and oversight of its branch operations. The lack of a CUO and the corporate governance and systems issues described above, which persisted throughout the Relevant Period, significantly undermined senior management's ability to monitor and control its branch operations.

45. MSIEu identified non-JIA business as representing better potential for growth due to the relative saturation of the JIA market. However, it failed to adequately resource oversight and control of the expansion of the non-JIA business.

46. On 27 July 2010, the CFO visited the German branch to carry out a review of financial reporting and controls. This reported significant concerns about financial record keeping and control in the German branch, which were exacerbated by a number of other issues including difficulties with the implementation of PAS.

47. Capital requirement management by MSIEu gave no capital assignment to the branches. As a result, the German branch gave little regard to the capital implications from development in its business. Further, the German branch was consistently allowed to exceed planned gross written premiums for the branch, as it expanded as a greater rate than anticipated. This meant that MSIEu was not able to monitor and plan its capital requirement but rather had to manage its capital on a retrospective basis.

Capital Shortfall against ICG

48. From December 2010 to the end of the Relevant Period (three months), MSIEu failed to hold sufficient capital to meet its ICG.

49. The FSA expects firms to meet ICG at all times and interprets ICG as its view, at a point in time, of the adequate amount of capital that a firm must hold, based on that firm's risk profile. Should a firm's capital fall below its ICG, the FSA would take a view as to whether that constituted a breach of the threshold condition of maintaining adequate financial resources or of GENPRU 1.2.26R.

50. Concerns over the adequacy of MSIEu's capital position were raised with senior management throughout the Relevant Period, but inadequate steps were taken to address them.

51. Senior management had numerous discussions in relation to this issue, including the following:

a. On 1 September 2009, the EDM was informed that MSIEu's regulatory capital of £43.1m had fallen below its risk appetite buffer of 10% above ICG (being £43.8m) although it was still above the ICG of £39.8m.

b. On 19 October 2009, the EDM noted that the ICG was *"up to £41.8m which is only £1.3m below our regulatory capital position"*.

c. At an EDM on 8 February 2010, it was agreed that MSIEu would not have the necessary regulatory capital in the next two years due to the expansion of the non-JIA business. There were discussions about the target of providing a Return on Equity to the Holding Company of 10.5%. The majority of the members of the EDM were reluctant to seek a capital injection from the Parent Company without first having generated additional profits from the business.

d. At the Board Meeting on 25 March 2010, the Board again observed that additional regulatory capital would be needed in the future as the business expanded. The intended way to deal with the position was to *"maximise profitability and strengthen the infrastructure to gain efficiencies"*.

e. By 25 October 2010, the EDM was aware that the projected shortfall against ICG was nearly £2m. Some members of the EDM remained reluctant to inform the FSA of the position at that stage. Instead, it was decided to discuss the position with the Holding Company before informing the FSA.

f. An Extraordinary Board Meeting was held on 8 November 2010 to discuss the shortfall against ICG. The Board recognised that the shortfall could increase to £5m by 31 December 2010. It was confirmed that the Holding Company was willing to provide additional funds but that this was dependent upon first being provided with a sustainable business plan.

g. By letter of 12 November 2010, MSIEu informed the FSA that it projected a capital shortfall of approximately £2 million against its ICG as at 31 December 2010.

h. By 31 December 2010 MSIEu had fallen short of its ICG by approximately £1.8 million. In addition, a further shortfall was projected for 2011 based on the 2011 business plan.

i. At an EDM on 31 January 2011, it was noted that discussions with the Holding Company about the capital injection had not started and were to be put back to March 2011. However, it was submitted that this did not fit with the need to submit the ICA to the FSA by the end of February 2011 and that a timeline for the provision of capital from the

Holding Company needed to be agreed before then. The Holding Company "*wanted a business plan to ensure that there was a plan in place to make profit otherwise the risk that MSIEu wrote might need to be reduced.*" At this stage, this required business plan had not been provided to the Holding Company.

j. An Extraordinary Meeting of the Directors was held on 17 February 2011 to discuss the ICA which, as a result of the increase in non-JIA business, had increased from the £37.6m reported in November 2010 to £48.6m. It was agreed that MSIEu would inform the FSA of the position at a meeting on 30 March 2011 that had already been arranged to discuss Solvency II.

k. On 30 March 2011, MSIEu informed its FSA Supervision team that it had fallen short of its ICG and projected that the shortfall would reach approximately £7.7 million.

l. MSIEu submitted a plan to recapitalise to the FSA on 15 April 2011.

m. On 28 April 2011 MSIEu received a capital injection of £14m from the Parent Company to address the capital shortfall against ICG.

Response to the Review

52. On 11 May 2011 after a discussion with the FSA, MSIEu ceased writing new non-JIA business from the German branch. Subsequently, the FSA requested that MSIEu cease writing any new non-JIA business in all of its EU branches. MSIEu agreed to do this voluntarily on 3 June 2011.

53. After the receipt of the Phase One report, Mr Kumagai resigned from his position as CEO of MSIEu on 1 June 2011. A further six members of the board of MSIEu also resigned at this time.

54. On 29 July 2011, MSIEu submitted a risk treatment plan to the FSA for all issues identified.

55. On 19 August 2011, MSIEu wrote to the FSA, stating that it accepted all of the findings of the Review and that its "*corporate governance system…was clearly deficient and not fit for purpose*". . As a result, the firm has entered into extensive remediation plans to resolve all of the issues raised in the two reports.

56. On 7 July 2011, in part as a result of matters outlined above, the FSA gave MSIEu a new ICG which included a loading for management issues known up to that date. The new ICG immediately caused a capital shortfall against ICG of £17.6m which MSIEu addressed by way of a substantial capital injection from the Holding Company of £80m on 10 August 2011. This was in addition to the capital injection made in April 2011

FAILINGS

57. The regulatory provisions relevant to this Final Notice are referred to in Annex A.

58. The FSA agrees with the findings of the Review. By reason of the facts and matters set out above, MSIEu breached Principle 3.

59. In addition, MSIEu breached Principle 3 by failing to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. In particular:

    a. MSIEu failed to take reasonable care to ensure that its corporate governance arrangements were operating effectively, despite warnings from within the organisation from the beginning of the Relevant Period as to issues with corporate governance.

    b. MSIEu failed to take reasonable care to maintain adequate control and oversight over its branch business despite being told by the FSA in early 2009 that its plan to expand into the non-JIA market required effective oversight. The control and oversight of the new business area was inadequate and insufficient resources were given to developing this area. MSIEu was concerned to achieve increased profitability through expansion of the business. Prompt and effective action was not taken to ensure that appropriate corporate governance and systems and controls were put in place to comply with UK regulatory requirements. It did not have in place a CUO to oversee the branch business nor appropriately plan, assign and monitor the capital requirement arising from the growth of the branches.

    c. MSIEu failed to take reasonable care to ensure that key posts on the Board and across the organisation were appropriately filled with staff with the necessary time, knowledge, skills and experience. The Board did not have sufficient knowledge and experience to effectively oversee and control the expanding non-JIA business which was exacerbated by the Group's rotational staff policy. Throughout the Relevant Period there was no CUO. In early 2010 key directors moved to other posts within the Parent Company, in line with the Parent Company's rotation policy. This led to a loss of corporate memory and a lack of relevant skills and experience amongst key post holders which was not adequately addressed. In addition, MSIEu did not take reasonable care to ensure that those responsible for PAS implementation had sufficient time or adequate IT skills and experience, and allowed key functions in the Second Line of Defence to remain under-resourced.

    d. MSIEu failed to ensure that duties and responsibilities were appropriately divided between senior members of staff, and did not take adequate steps to ensure that individuals were not given too wide a span of responsibility. From April 2010, there was insufficient segregation between the First and Second Lines of Defence.

e. MSIEu failed to take reasonable care to ensure that PAS, a system essential for providing management with adequate data to oversee and control its branch business, was implemented effectively and in a timely manner. Full implementation of PAS across all branches was repeatedly delayed throughout the Relevant Period. It was hampered by a lack of resources and suitable skilled and experienced personnel to effect the implementation. In addition, MSIEu failed to take reasonable care to ensure that there were adequate systems and controls surrounding reserving and aggregate exposure management.

f. MSIEu failed to take reasonable care to ensure that it held sufficient capital resources to meet its ICG. Management were aware throughout the Relevant Period that business growth might lead MSIEu to fall below its ICG for the year, but whilst it informed the FSA, it took no timely action to address this situation. As a result of this delay, MSIEu failed to hold sufficient capital resources to meet its ICG from December 2010. The shortfall amounted to over £7m by the end of March 2011.

SANCTION

60. The FSA's policy on the imposition of financial penalties and public censures is set out in the FSA's Decision Procedure & Penalties Manual (DEPP) and the Enforcement Guide. In determining the appropriate outcome in this case, the FSA has had regard to this guidance. The FSA considers that the seriousness of this matter merits the imposition of a financial penalty.

61. DEPP 6.1.2G provides that the principal purpose of a financial penalty is to promote high standards of regulatory conduct. It seeks to do this 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.

62. The FSA introduced a new policy for imposing a financial penalty in March 2010, which requires the FSA to apply a five-step framework to determine the appropriate level of the financial penalty. This policy is set out in Chapter 6 of DEPP. In this case, as the Relevant Period is 1 October 2009 to 31 March 2011, the breach straddles both the old and new FSA penalty policies. However, as the gravamen of the breach occurred from March 2010 onwards, the FSA has applied the new policy to calculate the appropriate penalty for MSIEu's breach.

63. DEPP 6.5A sets out the details of the five-step framework that applies in respect of financial penalties imposed on firms.

Step 1: disgorgement

64. Pursuant to DEPP 6.5A.1G, at Step 1 the FSA seeks to deprive a firm of the financial benefit derived directly from the breach where it is practicable to quantify this.

65. The FSA has not identified any financial benefit that MSIEu derived directly from its breach. The Step 1 figure is therefore nil.

Step 2: the seriousness of the breach

66. Pursuant to DEPP 6.5A.2G, at Step 2 the FSA determines a figure that reflects the seriousness of the breach. Where the amount of revenue generated by a firm from a particular product line or business area is indicative of the harm or potential harm that its breach may cause, that figure will be based on a percentage of the firm's revenue from the relevant products or business area.

67. The FSA considers that the revenue generated by MSIEu from the growth of its non-JIA business is indicative of the potential harm caused by its breach and so should be considered MSIEu's relevant revenue for the purposes of calculating the Step 2 figure. The FSA considers MSIEu's relevant revenue over the Relevant Period to be £35,400,000.

68. In deciding the percentage of the relevant income that forms the basis of the Step 2 figure, the FSA considers the seriousness of the breach and chooses a percentage between 0% and 20%. This range is divided into five fixed levels which represent, on a sliding scale, the seriousness of the breach; the more serious the breach, the higher the level. For penalties imposed on firms there are the following five levels:

Level 1 – 0%

Level 2 - 5%

Level 3 – 10%

Level 4 – 15%

Level 5 – 20%

69. In assessing the seriousness level, the FSA takes into account various factors which reflect the impact and nature of the breach and whether it was committed deliberately or recklessly.

70. DEPP 6.5A.2G(9) lists factors that tend to show the breach was reckless, including whether the firm's senior management, or a responsible individual, appreciated there was a risk that their actions or inaction could result in a breach and failed adequately to mitigate that risk. The FSA considers that MSIEu's senior management was aware that there were weaknesses within the business and took inadequate steps to address those weaknesses, and was negligent in that in some cases its senior management failed to appreciate that there was a risk that their actions or inaction could result in a breach.

71. DEPP 6.5A.2G(11) lists factors likely to be considered ‘level 4 factors’ or ‘level 5 factors’. Of these, the FSA considers the following to be relevant:

    a. the breach revealed serious weaknesses in the firm’s management systems and internal controls; and

    b. MSIEu’s senior management was aware there was a risk that the weaknesses in the business could result in a breach but took inadequate steps to address those weaknesses.

72. DEPP 6.5A.2G(12) lists factors likely to be considered ‘level 1, 2 or 3 factors’. Of these, the FSA considers the following to be relevant:

    a. MSIEu did not make any profit or avoid any loss directly as a result of the breach. It is not clear whether the firm’s failure to introduce appropriate controls indirectly increased its profit;

    b. there was no loss to MSIEu’s customers, either individually or in general, and the risks to customers were significantly reduced by MSIEU’s relationship with the Parent Company; and,

    c. MSIEu’s conduct included negligent conduct.

73. DEPP 6.5A.2G(6) lists factors relating to the impact of the breach and DEPP 6.5A.2G(7) lists factors relating to the nature of the breach. These include the factors referred to at paragraphs 68(a) and 69(a) and (b) above and the following additional factors which the FSA considers to be relevant:

    a. MSIEu’s senior management was aware that there were weaknesses within the business; and,

    b. MSIEu took some steps to address the weaknesses of which it was aware, albeit that these steps were mostly late and ineffective.

74. The FSA considers that the breaches, which involved significant failings in corporate governance and which continued for a period of eighteen months, represent a persistent failure by MSIEu and its senior management to address risks which were brought to its attention by the FSA and by internal reports prepared during the Relevant Period. Allowing its non-JIA business to grow without implementing the appropriate controls could have put policy holders at risk, albeit that in this case the risk was significantly reduced by the relationship with the Parent Company. The FSA considers that the failure to address doubts about MSIEu’s capital adequacy promptly shows a lack of understanding of the importance of compliance with regulatory requirements, even if MSIEu’s senior management was confident that additional capital could be required at short notice from its Parent Company. The FSA considers that in some instances some members of MSIEu’s senior management failed to appreciate the seriousness of the concerns being raised and the need to take effective action to address them.

75. Taking all these factors into account, the FSA considers that this is a level 4 breach in terms of seriousness and that the appropriate Step 2 figure to reflect this is £5,310,000.

Step 3: mitigating and aggravating factors

76. Pursuant to DEPP 6.5A.3G, at Step 3 the FSA may increase or decrease the amount of the financial penalty arrived at after Step 2, but not including any amount to be disgorged as set out in Step 1, to take into account factors which aggravate or mitigate the breach.

77. The FSA considers that there are the following aggravating factors:

a. MSIEu received direct communications from the FSA in 2009 identifying the need for careful and focussed oversight over its growing business through good systems and controls;

b. These issues were also highlighted throughout the Relevant Period by internal reports senior management received from staff; and

c. In 2010, the FSA published a policy statement (PS 10/15) emphasising that the quality of governance is a major focus for the FSA.

78. The FSA considers that the following factors mitigate the breach:

e. The Holding Company commissioned the in-depth Review by an independent third party into failings at the Firm and MSIEu voluntarily ceased writing all new non-JIA business until the issues identified by the Review could be appropriately remediated;

f. MSIEu made every effort to co-operate with the FSA investigation;

g. MSIEu is taking substantial steps, including the appointment of a significantly changed Board and Executive Management team, to address the issues identified by the Review so as to improve the control environment including appointment of a new CEO, 2 independent non executive directors, a General Counsel and Head Actuary; and,

h. The capital shortfall against ICG was addressed by a substantial (£94 million) injection of capital from the Parent Company.

79. The FSA also notes that MSIEu has no previous disciplinary findings recorded against it.

80. The FSA regards these aggravating factors to be serious but considers that the mitigating factors set out above are also significant. Having taken all these factors into account, the FSA considers that the Step 2 figure should be reduced by 10% at Step 3. The Step 3 figure is therefore £4,780,000.

Step 4: adjustment for deterrence

81. Pursuant to DEPP 6.5A.4G, if the FSA considers the figure arrived at after Step 3 is insufficient to deter the firm who committed the breach, or others, from committing further or similar breaches, then the FSA may increase the penalty.

82. The FSA considers that the Step 3 figure of £4,780,000 represents a sufficient deterrent to MSIEu and others, and so has not increased the penalty at Step 4. The Step 4 figure is therefore £4,780,000.

Step 5: settlement discount

83. Pursuant to DEPP 6.5A.5G, if the FSA and the firm on whom a penalty is to be imposed agree the amount of the financial penalty and other terms, DEPP 6.7 provides that the amount of the financial penalty which might otherwise have been payable will be reduced to reflect the stage at which the FSA and the firm reached agreement. The settlement discount does not apply to the disgorgement of any benefit calculated at Step 1.

84. The FSA and MSIEu reached agreement at Stage 1 and so a 30% discount applies to the Step 4 figure. The Step 5 figure is therefore £3,345,000.

Penalty

85. The FSA has therefore imposed a total financial penalty of £3,345,000 on MSIEu for breaching Principle 3 of the FSA's Principles for Businesses.

PROCEDURAL MATTERS

Decision maker

86. The decision which gave rise to the obligation to give this Notice was made by the Settlement Decision Makers.

87. This Final Notice is given under section 390 of the Act.

Manner and time for Payment

88. The financial penalty must be paid in full by MSIEu to the FSA by no later than Tuesday 22 May 2012, 14 days from the date of the Final Notice.

If the financial penalty is not paid

89. If all or any of the financial penalty is outstanding on Wednesday 23 May 2012, the FSA may recover the outstanding amount as a debt owed by MSIEu and due to the FSA.

Publicity

90. 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 the consumers.

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

FSA contacts

92. For more information concerning this matter generally, contact Clare McMullen (direct line: 0207 066052) or Stephen Smith (direct line: 0207 0662142) at the FSA.

Matthew Nunan

Acting Head of Wholesale

FSA Enforcement and Financial Crime Division

ANNEX 1

RELEVANT STATUTORY AND REGULATORY PROVISIONS

STATUTORY PROVISIONS

1. The FSA's statutory objectives, set out in section 2(2) of the Act, are market confidence, financial stability, consumer protection and the reduction of financial crime.

2. Section 206 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*."

3. The procedures to be followed in relation to the imposition of a financial penalty are set out in sections 207 and 208 of the Act.

4. MSIEu is an authorised person for the purposes of section 206 of the Act.

5. The requirements imposed on authorised persons include those set out in the FSA's Principles and Rules made under section 138 of the Act. Section 138 provides that the FSA may make such rules applying to authorised persons as appear to be necessary or expedient for the purposes of protecting the interests of consumers.

REGULATORY PROVISIONS

Principles for Businesses (PRIN)

6. The Principles are a general statement of the fundamental obligations of firms under the regulatory system and are set out in the FSA Handbook. They derive their authority from the FSA's rule-making powers as set out in the Act and reflect the FSA's regulatory objectives. The Principles relevant to this case are as follows:

7. Principle 3 (management and control) provides:

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

General Prudential Sourcebook (GENPRU)

8. The General Prudential Sourcebook contains rules and guidance in relation to the adequacy of a firm's financial resources.

9. GENPRU 1.2.26R provides:

   "A firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due."