FSA Lessons for Foreign Firms: Senior Management Expectations Crystal Clear

DENTONS

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On 8 May the FSA **announced** that it had fined the European arm of one of Japan's biggest insurers (Mitsui Sumitomo Insurance Company (Europe) Limited (**Mitsui**)) £3.345 million and given its former executive chairman (Yohichi Kumagai) a lifetime ban as well as a personal fine of £119,303.

Mitsui breached Principle 3 of the FSA's Principles for Businesses by failing to take reasonable care to organise and control its affairs responsibly and effectively. Kumagai breached Statements of Principle for Approved Persons (**APER**) 5 and 7 by failing to take reasonable steps to ensure that the business of the firm for which he was responsible as a significant influence holder was organised so that it could be controlled effectively and comply with the relevant regulatory standards.

Background

Mitsui is a London-based subsidiary of a Japanese insurer whose business was traditionally the supply of wholesale insurance cover solely to Japanese firms operating in Europe and the Middle East. However, from 2007 this model shifted to include non-Japanese business and by 2010 it earned 50 per cent of its premium income from this market.

April 2009 saw Kumagai seconded from Mitsui's Japanese parent company to hold the role of executive chairman as part of a staff rotation programme. Shortly after this the FSA advised that expansion into European markets required careful oversight from an appropriately skilled and experienced board; systems and controls would need improvement both to identify and address the inherent risks in the strategy.

Mitsui did not take effective steps in time and the FSA found Mitsui was poorly organised and managed as a whole, as a result of significant failings of corporate governance and control arrangements. These were serious failings for which Kumagai was also responsible as holder of controlled functions CF1 (director) and CF3 (chief executive).

The FSA considered both Mitsui and Kumagai were more focused on achieving increased profitability through expansion of the business, at the expense of ensuring organisation and control of the firm and adequate risk management systems. Their failure to address issues, in particular concerns about capital adequacy, indicated a lack of appreciation by the firm and its management of the importance of complying with regulatory requirements and taking effective steps to address concerns.

Mitsui: breach of Principle 3

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

- Ensure corporate governance arrangements operate effectively – corporate governance was poorly organised and managed across the business as a whole and warnings from within the firm were not acted on. The firm accepted the governance system was "*clearly deficient and not fit for purpose*".

- Adequately control and oversee European branch business – despite FSA warnings, prompt and effective action was not taken to comply with UK regulatory requirements.
- Staff key posts with individuals with appropriate skills, experience and time – the firm's rotation staff policy meant key positions were often occupied by staff who lacked the necessary skills and experience, making the board less effective and unable to cope with the size and complexity of Mitsui's expanding business. Key functions such as risk and compliance were under-resourced.
- Ensure appropriate division of responsibilities - staff had too broad a span of control and there was not adequate segregation between compliance and operational functions.
- Implement effective IT systems in time – this was repeatedly delayed and, when it was implemented, under-resourced. As a result management lacked the information to control and oversee business written in branches.
- Ensure sufficient capital to meet its individual capital guidance (**ICG**) – management knew that growth might lead the firm to fall below its ICG but delayed in acting to address this.

Mr Kumagai: breaches of APER Principles 5 and 7

Kumagai breached APER Statement of Principle 5 in failing to take reasonable steps to ensure Mitsui's business was organised so as to be controlled effectively. In particular, he failed to:

- Ensure management structure and composition changed quickly enough to reflect Mitsui's changing business – despite clear guidance from the FSA he failed to act promptly to remedy problems with the firm's management structure and composition.
- Take reasonable steps to ensure key functions were properly resourced and duties appropriately segregated – in particular, he failed to hire a chief underwriting officer, which then hindered the firm's ability to control the expansion of the business.

Kumagai was also found to have breached APER Statement of Principle 7 in failing to take reasonable steps to ensure the business he was responsible for in his controlled functions complied with relevant regulatory requirements. Notably, he:

- Failed to ensure Mitsui's corporate governance was effectively reviewed – even though this issue was repeatedly brought to his attention by the FSA and internal reports.
- Permitted the expansion of the European business without implementing controls and oversight necessary to support it – he was aware that control and oversight of the European branch business was inadequate but did not devote enough resource to address this.
- Failed to ensure the IT system was implemented timely and effectively across branches.
- Failed to take reasonable steps to ensure Mitsui managed its capital adequately.

Sanctions

The FSA considered Mitsui's and Kumagai's failings were serious and this was reflected in the penalties imposed on both. The FSA noted in particular that their actions put policyholders, and therefore market confidence, at risk and arose despite warnings from the FSA and internal reports about governance issues.

However, in mitigation, significant remediation has been undertaken by Mitsui. This was helped by its parent company which commissioned an independent review into the failings and provided two capital injections (totalling £94 million) to address Mitsui's ICG shortfall. In addition, Mitsui voluntarily ceased writing new business, co-operated with the FSA and has taken substantial steps including the appointment of new management.

In respect of Kumagai it was noted that he had voluntarily resigned, had no previous disciplinary history and had co-operated with the FSA.

Both parties received a 30 per cent discount for early settlement, without which their fines would have been £4,780,000 and £170,433.

The FSA also made an order under section 56 of the Financial Services and Markets Act 2000 banning Kumagai from performing any significant influence controlled function in future on the basis he lacked competence and capability, and so is not fit and proper, to perform such functions.

Learning points

The key message from **Mitsui's** and **Kumagai's** Final Notices is that the FSA requires all firms to have effective corporate governance and controls. Where business changes or expands governance and control procedures must be adapted or new procedures put in place to reflect changes in risk. It is also a reminder of the risks associated with expanding into new markets without investing enough in compliance with local regulatory requirements.

Additional points which firms and senior management should bear in mind include:

- Assessing whether existing or planned staff rotation policies are appropriate. The FSA noted that Mitsui's policy of rotating senior management from the parent company to Europe led to a loss of corporate memory and lack of relevant skills and experience. Although there is nothing wrong with this type of policy in principle, firms would be wise to consider whether their particular policy ensures staff have sufficient time and training to take over new roles without putting the firm (and individuals) at risk of breaching regulatory expectations.
- Failing to devote sufficient resource to compliance with overseas regulation can be extremely costly. Mitsui's Japanese parent company has had to inject £94 million into the firm to recapitalise it. Mitsui itself has faced costly remedial action, appointment of a substantially new board and been given a new (higher) ICG by the FSA, including additional "loading" for management issues.
- Ignore FSA warnings at your peril. In this case, crucially, the firm failed to act on points identified to it by the FSA and later, even when it specifically agreed to take action, this was repeatedly delayed. Firms should prioritise meeting FSA deadlines and, if this is not possible, be careful to keep the regulator updated.
- Kumagai's substantial individual fine and ban makes it "crystal clear" that senior management responsibility is still high on the regulator's agenda. The FSA emphasised that Kumagai was the key decision maker at Mitsui and ultimately responsible for ensuring the competent and controlled running of its business. This is particularly timely should the recent successful challenge by UBS's John Pottage of his individual fine of £100,000 in the Upper Tribunal have suggested that the FSA might shy away from holding senior management to account.

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