

regulation briefing



FSA regulation for insurance products

– new rules for property managing agents and property owners

- Do you need to be regulated?
- What are the regulated options available?
- Key aspects of FSA regulation
- Managing the changes required in your business

PRICEWATERHOUSECOOPERS

PwC is assisting Norwich Union in the provision of this Regulation Briefing

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The information in this Regulation Briefing newsletter represents PwC's understanding at the time of going to press. The information in this paper is generic, and is not intended to be a substitute for a proper analysis of the impacts of the FSA's rules and proposals.

Most property managing agents, and property owners that arrange insurance which gives any rights under the policy to tenants (or other third parties), are likely to need to either:

- 1) seek direct authorisation for their insurance operations from the Financial Services Authority (FSA); or
- 2) seek appointment as a representative of another authorised firm that will act as their 'Principal', meaning they will become an Appointed Representative (AR) of that intermediary/insurer.

The FSA is expected to issue a guidance paper, possibly this month, for market participants to help to clarify the effect of the new regime on the property sector.

Much of the commentary in this Briefing derives from an earlier draft of an FSA guidance note; rather than wait any longer for the formal issuance of the paper, we have decided to publish this Briefing. On this basis, firms need to review the FSA's guidance once it is issued and consider the implications of any changes to the information set out in this Briefing.

Key messages

- The FSA will regulate the insurance market from 14 January 2005
- Firms wishing to arrange or advise on insurance contracts after this date will need to be authorised by the FSA or become an AR of another directly authorised firm; otherwise they will be committing a criminal offence
- In the first instance, property managing agents and property owners will need to assess whether they are caught by the new insurance regulatory regime. Then they will need to determine how they need to respond to the regime and its requirements
- Firms that decide to seek direct authorisation will need to submit an Application to the FSA by 13 July 2004
- Whilst 14 January 2005 may sound a long way off, given the extent of changes to make and, for those firms seeking direct authorisation the need to submit an application to the FSA by 13 July 2004, early attention is necessary.



Introduction

Most property managing agents, and property owners that arrange insurance giving rights under the policy to tenants, are likely to need to seek direct authorisation from the FSA or to seek appointment as an Appointed Representative by an intermediary / insurer.

The Treasury announced its intention to regulate the general insurance market through the Financial Services Authority (FSA) back in 2001. In this way, the Government could implement the requirements of the EU Insurance Mediation Directive (IMD).

Since then both the Treasury and the FSA have issued various consultation papers on the scope of the new regime and the proposed rules which will apply to it. The detailed rule requirements are now substantially established.

The new general insurance regime becomes effective from 14 January 2005.

Substantially all firms planning to trade (where such business constitutes a regulated activity to be undertaken by way of business) in the general insurance market after 14 January 2005 will need to be authorised either directly by the FSA, or be exempt.

To obtain exempt status, an organisation will need to be appointed as an Appointed Representative / Introducer Appointed Representative of a company authorised by the FSA (a Principal firm) or act as a passive introducer. Further explanations of these terms are given below.

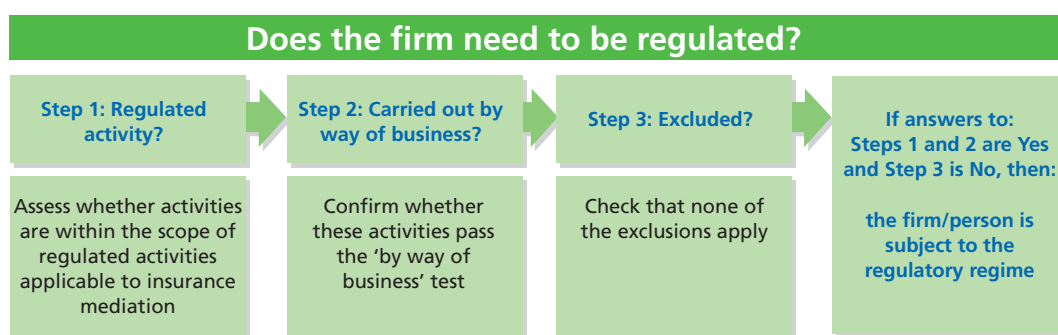
Some firms may decide to cease insurance related operations before 14 January 2005.

Scope of the new regime

Activities

Firms should refer to Annex E (Amendments to the Authorisation Manual) of the 'Insurance Mediation and Mortgage Mediation, Lending and Administration (Prudential Provisions) Instrument 2004 (ref FSA 2004/01) for the FSA's Guidance on Insurance Mediation Activities; this FSA Guidance includes a 'Do you need authorisation?' flow chart.

In summary, a firm needs to determine the extent to which its activities are caught by the regime:



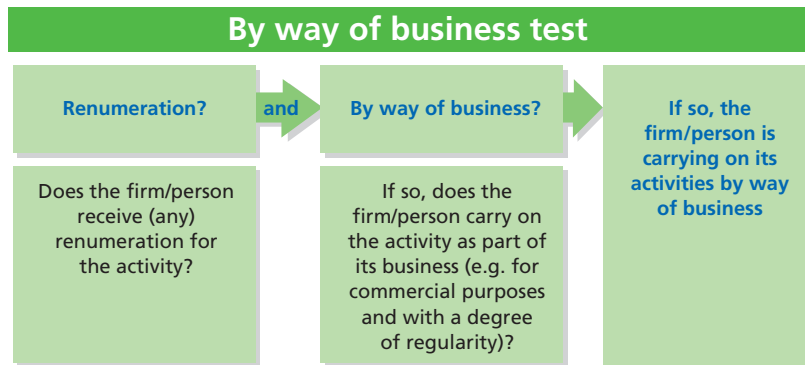
Regulated activities

The new general insurance regime captures a number of specific activities. Broadly, regulated insurance mediation activities will include:

Regulated activities				
Arranging	Making arrangements with a view	Advising	Dealing as agent	Assisting
Arranging or bringing about a contract of insurance	A wider activity that if carried out might bring about an insurance transaction E.g. Introducing (but not passive introductions)	Advice (not just information) given on the merits of buying (or not buying) a particular contract of insurance	Dealing in contracts of insurance as an agent of an insurer or a customer E.g. authority to bind an insurer	Assisting a policyholder in the administration and performance of a contract of insurance (after conclusion of the insurance contract) E.g. Notification of a claim to an insurer (assisting in performance) and negotiating its settlement (assisting in administration)

The “By way of business” test

The new regime only applies to those firms/persons that carry on a regulated activity by way of business, under which there are two test criteria:



Firms need to be aware that the “by way of business” test is not necessarily straight-forward. Any firm that believes its activity fails the “by way of business” test, carving it out of the regulatory regime, needs to assess very carefully the full text of AUTH section 5.4.

Regulated activities exclusions

Limited exclusions also exist which may mean that certain firms/persons are excluded from the regulatory regime. Again the exclusions are not straight-forward and firms seeking to rely on an exclusion may need to seek advice to confirm that the exclusion is appropriate in their particular circumstances.



An important exclusion, which may exclude certain types of introducers from the regime, relates to the activity of providing information to prospective customers:

<p>Provision of information to the customer on an ‘incidental’ basis</p> <ul style="list-style-type: none">• This excludes from the activities of ‘arranging’ or ‘making arrangements with a view’ and ‘assisting in the administration and performance of a contract of insurance’ activities which are limited to:<ul style="list-style-type: none">i) the provision of information to the policyholder or potential policyholder (only);ii) by a firm or organisation whose profession or business does not consist of carrying on regulated activities; andiii) provided the provision of information can be regarded as incidental to that business (where incidental means that the activity is complementary to the main business and is not a business in its own right)• This exclusion may be of particular relevance to certain introducers (where they only provide information to customers about related insurance arrangements)• There is no restriction on remuneration payable to an organisation relying on this exclusion• Organisations aiming to rely on this exclusion should refer Article 72C of FSMA 2000 (Regulated Activities) Order 2001
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The above exclusion (provision of information to the customer on an ‘incidental’ basis) is unlikely to have significant relevance to the property sector. Accordingly, many market participants that engage in activities involving insurance contracts in the property sector will be impacted by the new regime.

Rights under a contract of insurance

The activities of arranging, advising and dealing as agent relate to rights under a contract of insurance. Accordingly, in assessing whether a firm carries out a regulated activity it may also be necessary to determine whether the person to whom mediation services are provided will acquire such rights. Where the rights under the insurance contract include a third party, such that it becomes a policyholder entitled to receive benefits under the policy, then the firm providing the mediation services will be carrying out a regulated activity. This is of particular relevance to policies that are described ‘group policies’ under which a number of parties obtain the benefit of the cover.

Property owners and tenants

A property owner will be caught by the new regulatory regime where the tenant, or another third party, acquires rights under the property owner’s insurance policy (i.e. where the tenant / other third party becomes a ‘policyholder’). Examples of regulated activities carried out by a property owner will include:

1) Where the property owner arranges insurance for itself and its tenants and those tenants have rights under the policy, it will be carrying on the regulated activity of ‘arranging’ insurance
2) Where it commits the tenants to becoming policyholders, it will also be ‘dealing as agent’
3) Where it advises the tenants on the merits of the insurance contract, it will be ‘advising’

As an example, where a property owner’s insurance policy contains terms which give its tenant a right to, say, alternative accommodation in the event of a flood, this could mean that the property owner has carried on the regulated activity of ‘arranging’ (as per item 1 in the table above). This might be contrasted with the scenario whereby the tenant might have rights against the property owner in the context of the tenancy agreement, but not under the terms of the insurance policy itself.

Property Managing Agents acting for property owners

A property managing agent will typically be responsible for, amongst other property related services, organising the insurance arrangements for the property owner both at renewal and potentially during the period of the cover.



In the FSA's draft guidance note, there are examples of activities of property managing agents that may help to determine the regulatory position that will apply to their organisations. In summary, some typical examples include:

Regulated activity	Function/activity of the property managing agent
Arranging	<ul style="list-style-type: none"> Obtains insurance quotes for the property owner Prepares insurance risk details / disclosures for an intermediary (or insurer), resulting in the property owner becoming a policyholder Negotiates the terms of a policy, or its renewal for the property owner, committing the property owner to the policy (may also be 'dealing as agent') Completes the proposal form on behalf of the property owner Arranges insurance(s) for residents associations
Advising	<ul style="list-style-type: none"> Advises the property owner on the suitability of insurance quotes (or renewals)
Dealing as agent	<ul style="list-style-type: none"> Negotiates the terms of a policy (or its renewal) for the property owner, committing the property owner to the policy (may also be 'arranging')
Assisting in the administration and performance of a contract of insurance	<ul style="list-style-type: none"> Assists the property owner to fulfil its obligations under the insurance policy (e.g. provision of updated risk information to fulfil a policy condition) Advises the intermediary (or insurer) of mid-term adjustments such as changes to risk details or notification of changes to interested parties

Claims handling activities undertaken by property managing agents on behalf of insurers are not classified as regulated activities; the insurer would remain responsible for these activities and any requirements for property managing agents would need to be reflected in an outsourcing agreement.

However, certain claims handling activity (e.g. completion of claims forms for the property owner) will fall under the regulated activity of 'assisting in the administration and performance of a contract of insurance'.

Property Managing Agents acting for a Residents Management Company (RMCO)

A property managing agent may be appointed by a RMCO in which case it may provide similar insurance-related services as those provided to a property owner (see above).

In addition, as set out in the FSA's draft guidance note, an employee of the property managing agent may become company secretary of the RMCO to take responsibility for the property management activities (including insurance) for the RMCO. In this case the FSA will deem the person to be acting as the RMCO itself, rather than on behalf of it. Accordingly the RMCO will be a customer, arranging its own insurance, as sole policyholder and, absent its other insurance-related activities, the property managing agent will not need to be authorised (or exempt – acting as an Appointed Representative). However, if the RMCO arranges its insurance through the property managing agent, rather than direct with an insurer or through a third party intermediary, the agent will need to be regulated.

Where the policy provides for rights under the contract (i.e. an entitlement to receive benefits under the policy, which it is assumed is likely to be the case) to be extended to individual residents, then the RMCO is 'arranging/advising' (see group policies above) and would be subject to the general insurance regime.

Options available to firms

Broadly, there are four options available to firms carrying out insurance mediation activities:

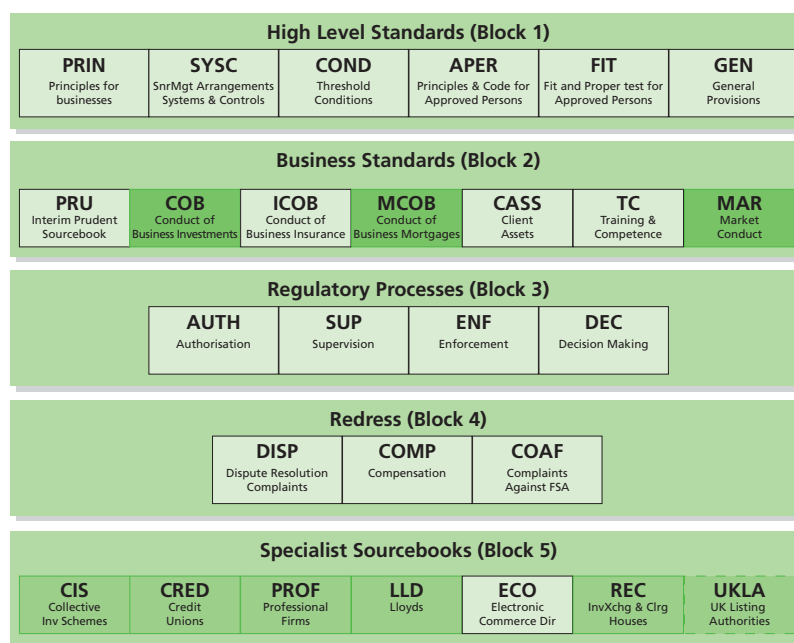
- 1) Obtain direct authorisation
- 2) Seek to become an Appointed Representative (AR) of a principal firm
- 3) Seek to become an Introducer AR of a principal firm
- 4) Carry out passive introductions only (e.g. customer picks up a leaflet; not subject to the FSA regime).

For most property managing agents and property owners (where the policy gives rights to the tenant), it is expected that the only realistic choices revolve around (1) and (2).

Whilst an AR is exempt under the new regime, meaning it does not need to apply for authorisation, it will still need to meet the FSA's rule requirements and, in this context, it will still need to undertake an N(GI) implementation project, aligned to its principal's requirements for systems and processes to be embedded within its business model.

The FSA Handbook at a glance

The FSA's rules requirements are set out in its Handbook. This is made up of various Blocks each of which include various Sourcebooks which may apply to specific firms. Diagrammatically, the Handbook as it applies to firms engaged in insurance mediation activities (applicable Sourcebooks highlighted in light green) is as follows:



An important part of a firm's impact analysis work will be to confirm which parts of which Sourcebooks will apply. A thorough understanding of both the regulatory requirements themselves and the way in which the FSA will act (SUP, ENF and DEC), as regulator, is essential.

Norwich Union has developed a Self Assessment toolkit to help firms prepare for the new regime. This is available electronically from:

http://www.norwichunion.co.uk/ebroking/business_advisor/fsa_self_assessment_toolkits.htm

Key features of the new regulatory regime

Background

The Financial Services and Markets Act 2000 (FSMA) provides the framework for the FSA and equips it with its statutory powers. The act also establishes the framework for the Financial Ombudsman Service and Financial Services Compensation Scheme.

There are 30 parts of the act, including the duties and statutory objectives of the FSA, the establishment of regulated and prohibited activities and Part IV permissions to carry out particular regulated activities; it also establishes the framework for the Approved Person regime.

It is important to understand the FSA's primary objectives as these dictate its approach to regulating its constituency. These are the maintenance of confidence in the financial system, the promotion of public understanding of the financial system, the securing of the appropriate degree of protection for consumers and the reduction of financial crime.

New risks

The FSA's powers (set out in its Enforcement Manual), and its focus on individuals, means that regulatory risk for firms not already regulated by the FSA, and their management teams, will be significantly greater in the new era than in the past.

In addition to the possibility of public statements/public censures and financial penalties, other measures are available to the FSA where it considers it is necessary to take protective or remedial action (rather than disciplinary action), or where a firm's continuing ability to meet the threshold conditions, or where an Approved Person's fitness and propriety to perform the Controlled Functions to which his approval relates, is called into question. These include:

- The variation or cancellation of permission (to carry out regulated activities) and the withdrawal of a firm's authorisation;
- Withdrawal of an individual's status as an Approved Person; and
- The prohibition of an individual from performing a specified function in relation to a regulated activity.

The increased regulatory risk facing firms means that all market participants need to take the challenge of implementation of the regime's requirements very seriously.

Core components of the regime

At the heart of the FSA's regime are three fundamental building blocks:

- Emphasis on a firm's own management (Approved Persons)
- Emphasis on systems and controls, having regard to the organisation's risk profile
- Emphasis on its core Principles for Businesses

Emphasis on a firm's own management (Approved Persons)

The FSA's regime places great emphasis upon a firm's own management. In this context, the firm's senior management are responsible for the establishment and operation of effective governance structures and the effective operation of systems and controls. As senior managers, these Approved Persons will be accountable for their actions.

Approved Persons need to be individually approved by the FSA, having demonstrated their fitness and propriety to the FSA. Approved Persons include the directors of a company and possibly certain senior managers.

The identification of a firm's proposed allocation of senior manager responsibilities, within the Approved Persons regime, and their briefing, is an important early step in a firm's N(GI) preparations.



Emphasis on systems and controls, having regard to the organisation's risk profile

The FSA's regime also seeks to rely upon the robustness of a firm's Senior Management Arrangements, Systems and Controls (the SYSC requirements). These exist to ensure that regulated firms take responsibility for arrangements on matters of interest to the FSA. In particular, the FSA is interested in the way in which a firm designs its systems and controls structure around its risk profile, such that management properly identify the risks to which the organisation is prone, measures those risks and mitigates them.

The documentation of a firm's systems and controls framework, including its risk management framework, is key in preparing for the new regime.

Emphasis on its core Principles for Businesses

In order to communicate its expectations of firms, the FSA has set out eleven key principles, which apply to all regulated entities. These core operating obligations (set out in PRIN) seek to set the framework within which the FSA expects firms to behave within the financial services market. They include:

- Five operating principles (integrity, care & diligence, management control, financial prudence, relationship with the regulator); and
- Six customer principles (market conduct, customers' interests, communications, relationship of trust and client assets).

In preparing for the new regime, firms will need to assess the extent to which any of their existing practices conflict with these fundamental obligations.

Timetable and action required

The timetable for organisations in the property sector to respond to the needs of the new regime are now tight:

Timetable	
31 May 2004	FSA's '1st deadline' (early application fee discount period ended)
Ongoing	<ul style="list-style-type: none">• Applicants can register for application packs• Applications for authorisation can be submitted
13 July 2004	FSA's '2nd deadline' (FSA's guarantee to process complete applications by 14 January 2005 ends; although it will make 'every effort' to process applications after this date in time for 14 January 2005)
9 October 2004	The Distance Marketing of Consumer Financial Services Directive (DMD) becomes effective (requirements will form part of the FSA rules effective from 14 January 2005; firms need to consider implementation requirements from 9 October 2004)
14 January 2005	The new FSA regime becomes effective

Within this overall timetable, key actions for firms involved in the property sector include:

Key actions for property managing agents and property owners
<ul style="list-style-type: none"> • Consider the impact of regulation on existing business models • Assess the regulatory options (e.g. direct authorisation; appointment as an Appointed Representative of an intermediary/insurer and commence dialogue with prospective Principals) • Consider any restructuring options (e.g. to put regulated activities into a distinct legal entity) and the associated cost/benefits) • Determine the operational impact on your business model of the FSA regime's requirements (usually achieved through a 'gap analysis') – including high level standards, business standards and redress/complaints handling requirements • For firms seeking direct authorisation, commence activity to advance your Application for authorisation by registering for an Application form, deciding when to submit your Application and commencing the preparatory work to complete your Application • Identify appropriate resources to manage the implementation project • Establish the project, with appropriate oversight and management

Commentary on various aspects of the regime are set out in Norwich Union's series of Regulation Briefings as follows:

Regime requirements	FSA sourcebook	Regulation Briefing
Principles for businesses	PRIN	1
Senior management arrangements, systems and controls	SYSC	1, 3, 9
Threshold Conditions		4
Approved Persons	APER & FIT	1, 9
Prudential requirements – capital and professional indemnity insurance	PRU	3, 9
Conduct of business	ICOB	6, 9
Client money	CASS	7
Training and competence	TC	
Complaints handling	DISP	8
Authorisation		4
Reporting to the FSA		3, 9

In addition, Regulation Briefing 2 included commentary on some of the strategic issues relevant to the insurance sector and Regulation Briefing 5 included commentary on the FSA's rules implementation work. These Briefings are available electronically from:

http://www.norwichunion.co.uk/ebroking/business_advisor/fsa_regulation_briefings.htm

Client money



The FSA's draft guidance note includes specific reference to client money in the property sector. We understand, however, that it is seeking further clarification around aspects of client money handling and the applicability of its client money rules. Accordingly, readers should be alert to possible changes to the guidance regarding the application of the client money rules.

Regardless of whether a Property Owner or Property Managing Agent is directly authorised with the FSA or acts as an AR of another authorised firm they will need to determine whether:

- (1) Risk transfer applies (i.e. the insurance company takes responsibility for any money that is collected in relation to policies that it is on cover for) or;
- (2) Risk transfer does not apply – in which case the FSA's client money rules will apply.

FSA's Client Money Rules apply

An authorised property managing agent receiving insurance money from lessees (usually within an overall service charge) will normally need to adopt the FSA's client money requirements to ensure that the insurance money is adequately safeguarded. These rules deal with the handling of mixed remittances – the entire amount needs to be paid into a client money bank account with that element that does not relate to the insurance being withdrawn once the funds have cleared.

If the insurance premium is 'funded' (i.e. paid to the intermediary / insurer out of the property managing agent's own funds and subsequently received from the lessees by way of an in-arrears collection), the receipt will not constitute client money as it is then payable to the property managing agent by way of reimbursement of the funded amount.

In addition, where the property managing agent handles insurance money payable by landlords (e.g. vacant property insurance), this will also need to be maintained under the client money requirements.

The FSA's client money requirements are fully explained in Norwich Union's Regulation Briefing No. 7, and you may need to cross refer to that summary. The rules themselves are available at:

http://www.fsa.gov.uk/handbook/legal_instruments/2004/2004_01.pdf

An intermediary that is seeking to appoint a property managing agent as an Appointed Representative will need to determine its approach towards the money collection side of the appointment – see the section entitled 'Appointed Representatives' in Regulation Briefing No. 7.

Insurers Risk Transfer applies

In this instance you will need to engage with the insurance companies with whom you transact insurance business with to determine the specific rules that they will apply in relation to money that you collect on their behalf.

You will need to ensure that you obtain written confirmation from each insurer formally accepting risk transfer.

Any customer money that is collected outside the terms of the risk transfer offered by the insurance company will be need to be covered under the FSA's client money rules.

Managing the challenge of implementing the necessary changes

Moving into FSA regulation need not be seen as a single challenge, rather a series of phases of activity and related challenges leading up to, and following, "Regulation Day":

Migrating to the new regime	
Phase 1	<ul style="list-style-type: none">• Assess implication of new regime and determine appropriate route forward• Confirm strategic response (e.g. direct authorisation or AR status)
Phase 2	<ul style="list-style-type: none">• Mobilise resources and plan activity, including operational impact analysis• Complete Application to FSA (firms seeking direct authorisation) by 13 July 2004
Phase 3	<ul style="list-style-type: none">• Establish implementation framework (resources, timelines, activity, outputs, etc)
Phase 4	<ul style="list-style-type: none">• Roll out implementation work• Carry out pre 14 January 2005 'health-check' to confirm requirements are operational

In managing the challenge, there are five key objectives:

- Planning your route through to FSA regulation effectively, to prevent unnecessary back-tracking and last minute problems
- Ensuring that your Application for Authorisation is complete and robust
- Implementing all the necessary changes to your business in a controlled, cost-effective and timely manner
- Documenting the way in which the organisation meets its regulatory requirements
- Preparing to operate within the FSA's ongoing supervisory and regulatory framework.

Additional commentary on managing the challenge of implementing the necessary changes is set out in Regulation Briefing No. 1.



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