

PFI

The IMD

What's it mean for PFI?



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New rules and regulations relating to insurance mediation are being implemented by the Government and the Financial Services Authority (FSA). They are to implement the "Insurance Mediation Directive" or IMD and they could impact upon PFI projects. The FSA have been recently engaged to try and reconcile PFI market concerns. This engagement focuses around the specifics of a "live" deal that is currently in the closing phases. For the majority of the PFI market that is not engaged in this deal, what does all this mean? We explain below.

Introduction

The FSA will regulate certain pre-contractual sales and post-contractual administration activities relating to contracts of insurance from 14 January 2005 (a date known as N(GI) Day). The rules and regulations are being introduced in order to implement the Insurance Mediation Directive (IMD). If the FSA determines the changes are relevant to PFI "Project Co's" because of the way in which they usually arrange insurance and carry on other insurance related activities, this could mean changing the conventional insurance arrangements for PFI projects or becoming authorised by the FSA. This is because certain activities will be regulated.

Under section 19 of the Financial Services and Markets Act 2000 (FSMA), it is an offence for any person to carry on a "regulated activity" in the UK by way of business unless he is authorised or exempt by becoming an appointed representative (AR) of an authorised firm. Anyone who carries on a regulated activity without FSA authorisation/exemption can be imprisoned, fined or both.

The existing regulated activities have been amended. It's these amendments that will come into force on N(GI) Day. The amendments mean that there will be new regulated activities relating to general insurance and pure protection contracts and changes will be made to the application of various exclusions.

Regulated Activities

This note is concerned only with regulated activities that could possibly be carried on in relation to the "rights under a contract of insurance" – this being a specified investment regulated by the FSA. The regulated activities which Project Co's (and others involved in PFI projects) will be concerned with are:

- ☒ **Article 21: Dealing in investments as agent:** This makes dealing in contracts of insurance as agent a regulated activity. It applies where a person enters into the transaction as agent for another person. This activity could be carried out if:

- a party commits an insurer to provide insurance for a policyholder – for example if Project Co has an agency agreement or binding authority with an insurer or broker; or
- where a party commits the prospective policyholder to the contract – for example, by signing an application or proposal form on another's behalf under a power of attorney.

There may be occasions where Project Co may have authority to bind funders, public bodies and subcontractors, as well as themselves, with regard to physical damage policies (CAR and Material Damage).

🔗 **Article 25(1): arranging (bringing about) deals in investments:** This activity is carried on only if the arrangements bring about, or would bring about, the transaction to which the arrangements relate. A person will bring about a contract of insurance if his involvement in the chain of events leading to the contract of insurance were important enough that without it, there would be no policy. So, for example, Project Co acting on behalf of others involved in the project, obtaining quotes for insurance and paying the premium may be arranging under Article 25(1).

🔗 **Article 25(2): making arrangements with a view to transactions in investments:** Article 25(2) is aimed at cases where it may be said that the transaction is 'brought about' directly by the parties to it but where this happens in a context set up by a third party specifically with a view to the conclusion by others through the use of the third parties facilities. So, for example, if Project Co has an arrangement with an insurance broker or insurer such that he introduces the others involved in the project to the insurance broker/insurer, the activity covered by this article may be carried on. Project Co is instrumental in

obtaining the insurance and will itself be a policyholder. Playing 'devil's advocate' :Project Co is therefore more likely to be conducting a regulated activity under article 25(1) rather than article 25(2) as its involvement is more than merely the effecting of an introduction.

🔗 **Article 39A: assisting in the administration and performance of a contract of insurance:** In broad terms, this covers activities carried on by intermediaries after the conclusion of a contract of insurance, for or on behalf of policyholders, in particular in the event of a claim. To be undertaking this activity the person must be assisting in both administration and performance. Circumstances of Project Co's behaviour are likely to differ on a deal by deal basis. However, if Project Co assists a subcontractor in completing a claim form and submits it and this assistance is material to whether performance takes place to contractually notify claims – this could fall under article 39A.

By way of business test

For an activity to be a regulated activity, it must be conducted "by way of business". For insurance mediation purposes, the two principle elements to the business test are that the person in question receives remuneration for the activities and, if he does, the person pursues the activities on a regular, rather than one off basis and for commercial purposes.

Remuneration is a pre-requisite for regulated activities to be carried on. 'Remuneration' is, however, very broad and covers both monetary and non-monetary rewards, regardless of who makes them and there is no minimum level of remuneration.

Whether activities are being carried on 'by way of business' will depend on individual

circumstances. However, a typical example of where the business test would be likely to be satisfied is where a person recommends a specific insurance policy in the course of carrying on a trade or business and received a fee or commission for the referral.

Whether or not a person has been remunerated has been the cause of much discussion recently. The FSA has recently stated that whilst it accepts that if a person receives reimbursement of variable costs, such as premiums associated with a particular insurance contract, it will not be seen to be receiving remuneration, a person that recovers some of its fixed costs (eg. the overheads associated with the insurance activity) may be "remunerated". This has come under fire from various institutions and trade bodies and so the full extent of what does and does not amount to remuneration remains to be seen. It is equally unclear in a PFI project context.

Group Policies

As stated above, regulated activities concern activities in relation to the specified investment of "rights under a contract of insurance". A person will have rights under a contract of insurance where he or she is a policyholder. The question of whether a person has rights under a contract of insurance may require careful consideration in the case of group policies. The definition of "policyholder" may be summarised as including a person who is entitled to receive benefits under the policy. With group policies, usually a person is the main policyholder and arranges for others to be added to a schedule. If those who are added to the schedule become policyholders then anyone who arranges for them to become, or advises them on the merits of becoming, a policyholder will be carrying on insurance mediation activities. On the other hand, if the policy provides for

benefits to be provided only to the main policyholder but in relation to the circumstances of other persons named in the schedule, then anyone arranging for those names to be added is not carrying on an insurance mediation activity.

Exclusions

The regime provides a number of exclusions that (effectively) take certain activities outside the scope of regulation.

Article 28 of the RAO provides an exclusion from the arranging of regulated activities where the arranger is or is to be a party to the contract, but only where the person making the arrangements either is the only policyholder or, as a result of the transaction, would become the only policyholder. This would not be helpful for group policies where there are a number of policyholders including the project sponsor.

Project sponsors will also be looking at the exclusion contained in Article 72C, which concerns the provision of information on an incidental basis. Broadly, Article 72C excludes from the activities of arranging and assisting in the administration and performance of a contract of insurance:

- ⌚ activities that consist of the provision of information to the policyholder or potential policyholder;
- ⌚ by a person carrying on any profession or business which does not otherwise consist of regulated activities;
- ⌚ if the provision of information may reasonably be regarded as being incidental to that profession or business.

The exclusion will be of assistance to introducers assuming that they provide information only to policyholders or potential policyholders, and not to the intermediary or insurance undertaking to whom they introduce these policyholders or potential policyholders.

In the FSA's view, 'incidental' in this context means that the activity must arise out of, be complementary to or otherwise be sufficiently closely connected with the profession or business. In other words, there must be an inherent link between the activity and the firm's main business. For example, introducing buildings insurance may be incidental to a project company's activities; introducing pet insurance would not be incidental to his activities. In addition, to be considered 'incidental', in the FSA's view, the activity must not amount to the carrying on of a business in its own right. Therefore the main focus of the profession or business should not involve regulated activities and the regulated activities that are carried on arise in a way that is incidental and complementary to the carrying on of the profession or business.

Project Co?

The market has been considering where PFI "project companies" fit in the regulatory context. The consequences of failing to achieve a successful authorisation (if its required) or the implications of being authorised are important issues. The preliminary soundings of the FSA have (reportedly) indicated that the intention is not to capture Project Co's in the PFI market. However, the regulatory framework is far from clear and there is a way to go yet. We have set out some of the implications of the authorisation process below – to give a high level feel for the nature of FSA regulation.

Application for Part IV Permission

Should it be determined that a Project Co conducts regulated activities, then in order to conduct those activities after N(GI) Day, there must be an application for authorisation from the FSA (known as applying for Part IV Permission) or it must become an appointed

representative of an FSA authorised firm (the later being highly unlikely).

The FSA has developed a streamlined process for firms applying for authorisation to conduct general and pure protection insurance business. Companies can now obtain an application to apply for authorisation by registering with the FSA on-line.

The FSA has 6 months to decide on a complete application and 12 months to decide on an incomplete application. Therefore fully completed application forms had to be submitted by 13 July 2004 in order for a firm to ensure that it received its authorisation in time for N(GI) Day. This means most operational SPV's will have missed the boat!

FSA authorisation?

Authorised companies must comply with the detailed requirements of the FSA rules. For example:

- ⌚ The company must pay an application fee, periodic fees and make contributions to the Financial Ombudsman Service (FSA's dispute resolution scheme) and the Financial Services Compensation Scheme.
- ⌚ Most likely being classed as a 'secondary intermediary', one individual within Project Co who has responsibility for the company's insurance mediation activities will need to be individually approved with FSA.
- ⌚ The company would have to maintain minimum levels of capital (the level of which would depend on whether it was entitled to hold client money and its annual income obtained from insurance mediation activities), professional indemnity insurance and hold clients' insurance monies (premium and claims) in accordance with FSA's client money rules. This could clearly cut-across

funding requirements and/or add expense to a deal.

- ⌚ The company must have documented systems and controls which are appropriate to its business, including controls to ensure compliance with FSA rules.
- ⌚ The company would have to comply with Insurance Conduct of Business ("ICOB") Rules - these are largely prescriptive rules which govern the way in which it would provide insurance related services to its clients.
- ⌚ The company's staff involved in insurance activities must be vetted and trained on an ongoing basis to ensure they are competent to perform those activities.

If a company fails to meet the requirements of the FSA rules it can be disciplined by FSA which may result in a fine or withdrawal of your authorisation. Approved persons can also be disciplined. Alternatively a project company could become an appointed representative (AR) of an FSA authorised firm.

An AR can carry on the regulated activities without being FSA authorised. Instead, the authorised firm who appoints the AR accepts responsibility to FSA and to customers for the AR's activities.

There are advantages to becoming an AR because a person does not need its own FSA authorisation and FSA rules will not apply directly to that person. The main consequences of this are:

- ⌚ the person will not have to pay application fees, annual fees etc.
- ⌚ the person will not have to maintain minimum capital or professional indemnity insurance.

However, it should be borne in mind that AR status is not an easy way out of regulation. The firm which appoints the AR will have to ensure compliance with FSA rules and, unless it is an insurer seeking to ensure distribution, will expect a fee for providing its services.

Conclusion

The regulations are unlikely to be changed. They come into force on N(GI) day. They are unclear. Project Co's could be conducting regulated activity and the market is thinking seriously about this. As deals move to close in the near future, a way forward with the FSA is likely to become clear and – as with other regulatory or policy changes – the PFI market will find ways to adapt.

**If you require further information please contact Projects/PFI Partner
Richard Guit on (020 7880 5772 or * richard.guit@addleshawgoddard.com or
David Heffron on (0113 2092390 or * david.heffron@addleshawgoddard.com**

150 Aldersgate Street
London EC1A 4EJ
Tel: +44 (0)20 7606 8855
Fax: +44 (0)20 7606 4390

25 Cannon Street
London EC4M 5TB
Tel: +44 (0)20 7606 8855
Fax: +44 (0)20 7788 5060

Sovereign House
Sovereign Street
Leeds LS1 1HQ
Tel: +44 (0)113 209 2000
Fax: +44 (0)113 209 2060

100 Barbirolli Square
Manchester M2 3AB
Tel: +44 (0)161 934 6000
Fax: +44 (0)161 934 6060