CLIENT UPDATE

FSA REVIEW OF THE CLIENT MONEY RULES FOR INSURANCE INTERMEDIARIES

LONDON
Jeremy G. Hill
jhill@debevoise.com

Benjamin J. Lyon
blyon@debevoise.com

Edite Ligere
eligere@debevoise.com

On 28 August 2012, the United Kingdom's Financial Services Authority (the "FSA"), which is an independent non-governmental body that regulates the financial services industry in the United Kingdom, including insurers and insurance intermediaries ("insurance firms"), published a consultation paper (the "Consultation Paper") which includes proposals to amend the rules on how insurance firms deal with client money.

The Client Assets Sourcebook ("CASS") is used by the FSA to regulate how financial institutions with operations that are subject to the FSA's jurisdiction deal with client assets. The Consultation Paper focuses on Chapter 5 of CASS ("CASS 5"), which governs how insurance firms receive or hold client money in the course of their insurance business. The scope of CASS 5 applies to insurance firms whose insurance activities are regulated by the FSA.

The FSA undertook the consultation as a result of the perceived poor understanding of and compliance with the rules by insurance firms to which CASS 5 apply, including the inappropriate controls around the use of the non-statutory trust funds, ineffective risk transfer documentation, and client money held by third parties.

FSA PROPOSALS

The overarching proposal which the Consultation Paper introduces is to improve user understanding of CASS 5 by producing a rulebook in order to clarify the client money regime for insurance firms and other stakeholders. There are nine chapters in the Consultation Paper; however, two particular aspects of the Consultation Paper should be of interest to our insurance clients with insurance business regulated by the FSA.

RISK TRANSFER

The FSA sets out a number of proposals in the Consultation Paper, which include revising certain provisions to ensure a more effective risk transfer regime applies to insurance firms. To receive money from clients under risk transfer, a written agency agreement must be entered into between the insurance intermediary and the insurer. These agreements to appoint the intermediary as an agent are currently conditional on certain events, which may result in confusion and uncertainty to underlying insurance clients.

The FSA proposes the prohibition of conditional risk transfer so that the applicable rules are clear and unequivocal.

The FSA also considered issues relating to when insurance intermediaries hold risk transfer monies as client money, which has certain regulatory consequences. When insurance intermediaries agree to hold risk transfer money in their client bank account in accordance with CASS, they are holding client money and must have the appropriate authorisation from the FSA and comply with the CASS rules. This is the case even if all the client money they hold is held on behalf of such firms under risk transfer. If insurance firms do not have a risk transfer agreement in writing, then CASS' requirements are not satisfied, which results in all monies received being treated as client money.

It is up to insurance intermediaries and insurers to agree how the risk transfer money is held by the insurance intermediary. These arrangements could, for example, mandate that the insurance intermediary is to hold risk transfer money in an insurer trust account. So long as the insurance intermediary does not agree to co-mingle the money and hold it in accordance with CASS, the insurance intermediary and insurer can agree to appropriate commercial arrangements without reference to CASS.

It is important to note that under the current incarnation of CASS, firms are permitted to hold client money on trust in the form of a statutory or non-statutory trust. Holding the money in this way allows the firm to have legal ownership of the money while the beneficial interest remains with the assured, therefore protecting, to an extent, the assured's interest in the funds. The key difference between these two forms of trust is that under a non-statutory trust, the firm can make credit advances to the insurer prior to the client's obligation to pay the premium being met.

SECTION 53 OF THE MARINE INSURANCE ACT 1906

Section 53 of the Marine Insurance Act 1906 was recently examined by the Law Commission (the United Kingdom's law reform body, which reviews and recommends reform of law). The Law Commission considered the meaning of Section 53 to be in conflict with the historical principle of agency law because under Section 53, the broker is directly responsible to the insurer for payment of the premium, even if the broker has not received the premium from the assured (e.g., because the assured does not pay the requisite premium), leaving the broker bearing the financial risk.

If the statute operates as described by the Law Commission, it establishes a debt obligation between the broker and the insurer. The FSA considers that there may be potential inconsistencies between Section 53 and CASS 5. Amendments will be made if necessary depending on the outcome of the Law Commission's consultation with interested parties.

CONCLUSION

The FSA invites comments on the Consultation Paper by 30 November 2012. A policy statement is planned to be published by the FSA containing the final rules in the second quarter of 2013. The FSA may delay commencement of the revised rules for 12 months following the publication of the final rules, with the exception of the proposals it made to unclaimed client money.

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Please do not hesitate to contact us with any questions.

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