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Pollyanna Deane's insurance column: May 2021

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In her column for May 2021, Pollyanna considers recent messages from the FCA on appointed representatives, the business interruption (BI) test case, and FCA transformation.

Interesting times at the Treasury Select Committee (TSC).

Prompted to look at a recent TSC session where Nikhil Rathi and Charles Randell of the FCA were in the hot seat(s), I note that there are a number of issues which impact the insurance industry and might be of interest to others. These are the committee's views on appointed representatives (ARs), the discussion, albeit brief, on mutuals, and finally the "new broom" approach being taken by Nikhil Rathi and Charles Randell, which has been exposed by recent (well, April) forays into the public arena.

Appointed representatives

Let's start with the issue of ARs and the clear suggestion that their role needs to be reviewed in the light of the Greensill collapse. Having recently done some training for an insurance distribution firm on ARs and introducer appointed representatives (IARs), we had been asked to clarify the difference between "introducers" and ARs. Showing my age, initially I considered the pre-Insurance Mediation Directive role of "introducer", but the question was really about the differences between activities that might be conducted by a firm relying on the exclusions in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (*SI 2001/544*) (RAO), namely article 33B and article 72C of the RAO and a firm appointing an introducer appointed representative. Briefly, whether it is acting as an IAR or relying on the exclusions under article 33B of the RAO (or article 72C of the RAO), the firm in question must work within a restricted approach to introductions. However, an IAR benefits from the key advantage of being permitted to promote the regulated firm by way of non-real time promotion (newsletters, websites, apps). In my view, I advised that the regulator will be more amenable to appointing IARs rather than allowing third parties to rely on article 33B or article 72C, especially for those third parties who routinely make introductions to the firm, and thus it might be a good commercial decision to take a more regulated route, than relying on exclusions.

Looking at the TSC, it is clear that the regulator is considering that the AR appointment is ripe for re-consideration, not least because it has morphed from a system to deal with appropriate supervision of door-to-door insurance salesmen to being used to provide more complex products in the investment sector with minimal supervision. Nikhil Rathi, being quizzed about the regulator's response to Greensill, commented on:

> "...some work that is already under way on appointed representatives, to understand whether this regime, which dates from the 1980s in UK legislation and is now used very widely, is appropriate for the scale of capital markets activity that was being undertaken in contexts such as these, and whether the regulatory hosting model, where there are principals who do nothing else but rent out their licence, is appropriate."

A week or so before the TSC meeting, the FCA had sent a letter to the TSC discussing the issues arising from Greensill and its status as an AR of Mirabella (see Legal update, FCA and BoE responses to Treasury Committee Greensill Capital inquiry). The FCA is keen to show that it is taking account of the problems with the AR regime and unprompted by Greensill (but probably galvanised by it) have commenced a review.

I've extracted from the letter below:

> "The FCA has undertaken analysis in relation to the AR regime and we highlighted risks in in the most recent perimeter report... Since the regime started the number of principals and ARs has grown sharply, and with it the potential for harm. There are currently c.3,600 principal firms that support the activities of c.40,000 ARs.

It was in part a response to this growth that we conducted reviews into principals' understanding of their responsibility to oversee the activities of their ARs. Following weaknesses identified in our 2019 review of principals in the investment management sector, we intervened with a number of firms. This included agreeing the imposition of requirements on their regulatory permissions to either remove or to stop on-boarding ARs, asking principal firms to de-register their ARs and commissioning two FSMA section 166 skilled persons reports.

Although most ARs continue to be involved in the retail distribution of mainstream products and services, for example the distribution of general insurance products or retail investments, ARs are now used in a more diverse range of business models and sectors, including asset management and wholesale firms."

Having consulted particularly on the poor outcomes for consumers using ARs in the investment arena, the FCA concluded:

"Our work programme will include:

Greater engagement with, and scrutiny of, firms as they appoint ARs. This will apply both to new applicants and already authorised firms. Our aim will be to understand even more fully how the AR fits into the firm's business model, and we will assess whether the firm has appropriate systems and controls to oversee the AR.

Using a data-led approach, we will undertake proactive supervision of principal firms that may pose a higher-risk of harm. We will use our full range of supervision and enforcement tools to reduce the risks we identify.

Carrying out a range of targeted supervision activity in sectors, or portfolios, where we consider that the AR regime is a particular driver of harm.

Undertaking analysis, informed by the work above, to determine whether policy interventions are required, including using the full extent of our rule making powers to help reduce the harm posed by the AR regime. This could also include making recommendations to the Treasury for changes in the legislative regime. GCSL is not the trigger for our focus on the AR Regime: we have been considering it as part of our Consumer Investments and Sustainable Credit business priorities. However, the issues raised by recent events highlight some of the potential harm and challenges associated with the AR model."

It is high time that the AR regime was reviewed and it is excellent to know that the FCA is looking into it.

Just as we were putting this column together, the FCA published a first supervisory notice (dated 16 February 2021) issued to Marshall Sterling Investment Management Ltd, imposing a number of requirements relating to appointed representatives. Marshall Sterling was found wanting in terms of appropriate resources and suitability, in appointing and supervising its three appointed representatives. Lacking adequate systems and controls, Marshall Sterling must terminate its existing appointments and can make no others without the FCA's prior written consent.

Business interruption test case

But ARs were not the only areas that the TSC considered. Alison Thewliss, an SNP MP, brought a number of insurance issues to the fore, focussing on business interruption (BI) insurance issues and cladding. Timing was a key consideration for her constituents, with Nikhil Rathi providing figures on cases that have already settled. However, a less welcome intervention from her seemingly ignored the nature of insurance as providing an indemnity for losses, when she questioned why insurers might take account of grants, furlough, rates relief, etc. Mr Rathi rather hid behind the Supreme Court verdict (see Practice note, COVID-19: FCA business interruption insurance test case) and asked the rhetorical question as to how you might define loss:

"To an extent, it is going to depend on the precise contractual terms in each policy. The court did not give completely clear guidance on that point—it can be interpreted either way depending on the policy. We are also in touch with the Treasury on that topic, to see what further guidance can be provided…The question is what some policies will define as loss suffered by the business—that is what was insured. Therefore, if the money for furlough was there to compensate in part for the losses that would have been incurred, the question is whether the insurer should pay out if they get their money from the Government and from the insurance. I think that will depend on the precise wording of each policy. The Supreme Court did not give us the holy grail of a completely clear answer."

Most importantly, Alison Thewliss asked whether there had been any impact on the financial sustainability of insurers as a result of the pandemic pay-outs. Nikhil Rathi answered by noting that this was for the PRA to consider and that they worked together with the PRA throughout the work on BI. Further, they were considering the question of how a pandemic will be insured in future, with Angela Thewliss exploring whether or not the government will instigate a Pandemic Re type of arrangement, as it has for flooding with Flood Re for example. Clearly, there is concern at the FCA about an increased prevalence of insurers that are adding exclusions in contracts for this type of event, because of the scale of the loss that can occur and as a result, it might decide to take some action.

Mutuals, FinTech and FCA transformation

While Steve Baker MP raised questions in rather a hurry in favour of mutuals, little except reassuring noises was heard from the FCA on this subject, while their current conduct suggests a slightly ambivalent approach to mutuals. This one is obviously for another day. However, what I note is that recent speeches from Charles Randell and Nikhil Rathi suggest a change in approach from the FCA, in particular with reference to the financial services landscape post-Brexit. Nikhil Rathi has recently spoken at FinTech week, focussing on the innovation-supporting measures that the FCA has adopted (see Legal update, FCA speech on financial innovation). There is some doubt that the sandbox and the FCA's approach has been as helpful as they think, but it's certainly an eye-catching idea and one that other regulators have adopted. Whether it has promoted quite the avalanche of FinTech solutions that the FCA would like or even considers has happened is open to debate. I was more interested by the second part of his speech, the one that suggested that the FCA would be changing...

> "I also want the FCA to be a more efficient and effective regulator.
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> Our work during the pandemic – whether on lending or on business interruption insurance – has shown what we can achieve where we move quickly to address risk of consumer harm. What's more, our focus over many years on firms' operational resilience was vindicated by their ability to adapt to Covid restrictions...to meet our objectives over the long term requires us ...to improve our structure, technology and data analytics capabilities."

Sadly, I was a little disillusioned, as the speech goes on to cover online platforms and the financial promotions regime, the regulator sees things it can do as increasing regulation, when surely it should now be looking at removing it? Innovation offers a chance to enhance the regulatory regime, which is surely to the good, rather than constantly gold-plating it.

> "Critical support for innovation is written into the legislative DNA of the FCA. It is there in how we balance our objectives and in the remit set for us by government.
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> As a result, we must constantly seek to level the playing field; to help new entrants test innovative ideas and gain regulatory approval. This can do so much for consumers looking for easier, more intuitive access to services and new ways of transacting and investing, as well as supporting the future of the UK economy.
>
> But to achieve truly fair, competitive markets in service of consumers we must be rigorous. Trust in our financial services can only be built by also levelling the playing field so those firms who play by the rules, who genuinely work in their customers' interests, are not disadvantaged by those who can't or won't.
>
> And we must continue to embrace innovation - in our structure, in our capabilities and in the use of our powers - if we are to deliver on our objectives for the long term."

Given his audience, Nikhil Rathi's conclusion is a bit of a rallying call although prefaced with caution – no Wild West here!