

REGULATORY IMPACT ASSESSMENT

Regulating insurance mediation

Issue

In a consultation document¹ in October 2002, the Government set out its proposals for giving the Financial Services Authority (FSA) responsibility for regulating the sale of general insurance products. The measures proposed, together with forthcoming FSA rules, will implement Directive 2002/92/EC of the European Parliament and Council on Insurance Mediation (the Insurance Mediation Directive or IMD). The Government has now revised its proposals in the light of consultation. This RIA deals with the revised proposals taking into account consultation responses.

The market

The UK has the largest insurance industry in Europe. In 2000 over £150 billion of general insurance and long-term insurance premiums were written. Over 800 insurance companies are authorised to carry on insurance business in the UK, and nearly 600 firms carry on general business only. The top three general insurance providers accounted for £9.8 billion of net premium income in 2001. The ABI estimates that some 360,000 people are employed in the UK insurance industry. The FSA has estimated that there are between 70,000 and 150,000 secondary insurance intermediaries² – that is firms for which general insurance is not the main activity such as motor retail outlets and mobile phone companies.

Purpose and intended effect of the measure

i) the objective

The objective is to implement the IMD in the most cost effective and proportionate way, giving adequate weight to consumer interests and competition concerns.

Implementing the IMD is an important part of completing the single market and will enable UK firms to trade in Europe.

Financial service regulation applies to the whole of the UK.

¹ Regulating Insurance Mediation - HM Treasury, October 2002

² Annex 1 to CP 174 – Prudential and other requirements for mortgage firms and insurance intermediaries – available from the FSA website at www.fsa.gov.uk.

ii) the background

The Directive provides an exemption for certain insurances sold as part of a package including extended warranties and travel insurance provided certain conditions are met, including that the annual premium is under €500 (about £300 per annum). The Directive only applies to the selling of insurance by insurance intermediaries and excludes insurance sold directly to consumers by insurers.

In its consultation document (footnote 1) the Government set out its proposals for implementing the IMD. Whilst implementing the IMD in its entirety, the Government proposed to go further than the Directive in two important respects. It proposed to give the FSA responsibility for regulating general insurance policies sold directly by insurers as well as those that are sold through intermediaries to ensure a level playing field for consumers. The Government also proposed giving the FSA responsibility for regulating sales of all motor warranties, irrespective of the annual premium cost.

The Government also conducted an open consultation on the regulation of sales of travel insurance sold as part of a package with a holiday, without taking a view as to whether such products should be brought into regulation.

Following the consultation responses the Government has confirmed its intention to give the FSA responsibility for regulating direct sales of general insurance policies by insurers, and to give the FSA responsibility for regulating sales of all motor warranties, irrespective of the annual premium. The Government does not intend to bring sales of travel insurance sold as part of a package with the holiday into FSA regulation.

iii) overall risk assessment

- The Government supports the completion of the European single market in financial services and believes that UK firms should be able to take advantage of the EU-wide business of insurance mediation. Failure to implement the IMD would mean that UK intermediaries could not take advantage of the opportunities available.
- An unregulated sales process may give rise to asymmetric information between the buyer and seller. For example, failure to disclose all relevant conditions of insurance may result in problems when the insured makes a claim.
- Moreover, there may be a lack of true competition since a customer may not know whether the intermediary uses a large panel or whether it is a tied agent

dealing with a small number of companies. Consumers with limited knowledge may not realise that they can obtain better quotes elsewhere.

- The advice consumers receive would have no statutory rules governing either the competence of the advisor or the suitability of the advice he or she gives. Without regulation covering disclosure and suitability of advice, consumers may pay more than they would have done if there had been adequate, clear advice or buy products that do not cover their needs in the event of a claim.

Options

Option 1 - *Do nothing.*

Option 2 - *Implement the directive as it is.*

Option 3 - *Go further than the directive in terms of regulating direct sales of insurance by insurers and by regulating all motor warranties that are contract of insurance.*

Risks of each option

Option 1 - *Do nothing* – this option is not available, as once passed, EU Directives become law. Were the UK to do nothing it would be liable to be infringed and fined by the European Commission.

Option 2 - *Implement the directive as it is* – the risk of this is that opportunities to bring about further possible benefits in terms of improving consumer protection, ensuring a level competitive playing field, and ensuring there are no adverse impacts on competition are foregone.

Option 3 - *Go further than the directive* - the risk here is that more firms will be subject to regulation and the additional compliance requirements might be oppressive if not implemented in a proportionate way.

Analysing the benefits

Option 1

- doing nothing is not an option that is permitted under European law. Were the UK to do nothing, it would be liable to infraction proceedings and be fined by the European Commission. Also, UK firms would not be able to take advantage of the EU-wide market in insurance mediation services.

Option 2

The benefits of regulation are:

- consumers will be able to benefit from one redress and compensation system, rather than the present arrangements that depend on the distribution channel of the product;
- intermediaries will benefit. At present many firms, including mortgage and general insurance intermediaries and independent financial advisers have to comply with a wide array of requirements if they wish to offer a full range of services to their customers. For example, a High Street broker offering personal pensions, general insurance products and mortgages will, under these proposals, together with the proposals to regulate mortgages, only have one regulator to comply with. This may allow them to streamline their systems and processes; and
- implementing the IMD will mean that intermediaries will be able to passport to other European countries.

Option 3

This would realise all the benefits of option 2 together with the further benefits of regulating direct sales of insurance (as well as the selling of insurance by intermediaries) and all motor warranties. Regulating direct sales of insurance would achieve a level regulatory playing field in the selling of insurance irrespective of the distribution channel. Depending on the regulatory regime that the FSA implements, in practice this could mean:

- one set of training and competences;
- one disclosure regime;
- one dispute resolution scheme; and
- one compensation scheme if things went wrong.

Finally, the IMD excludes insurance extended warranties provided that certain conditions are met, including that the warranty is for less than €500 (about £300) per annum. Those with a value above €500 are not excluded from the Directive. Most extended warranties of most products fall within the exclusion, however, there are significant numbers of extended warranties for motor cars that cost less than €500. If it was decided to retain the exclusion in the motor warranties market, market distortions might occur as some warranties would be regulated and others not. Regulation of all motor warranties will prevent such market distortions.

Calculating the costs

The FSA published a cost benefit analysis of regulating mortgages and insurance mediation as Annex 1 to its consultation paper CP 174³. This summarised the results of the work of ‘Europe Economics’ an independent firm of economic consultants. Europe Economics carried out a survey of mortgage and general insurance firms to produce estimates of the costs and benefits of regulation and to gather information on firms’ likely response. Europe Economics identified a representative sample of the potential regulated population, stratified by firm size and current regulatory status. Written questionnaires and, where possible, face-to-face interviews were held. Four insurers and 12 insurance intermediaries took part in the work, but only one secondary insurance intermediary⁴. The assumptions used in assessing the costs of regulation in this paper are drawn heavily from that work.

It should be noted that the FSA estimates resulting from the CBA in CP 174 do not take account of complying with FSA conduct of business regulation. Rather they relate to the costs that firms will need to incur to become authorised by the FSA – the prudential and other requirements. This includes meeting the FSA high-level standards, its principles for business, and having appropriate management systems and controls in place. For individual firms, it means the costs in management time in completing the application forms together with financial safeguards, for

³ Financial Services Authority prudential and other requirements for mortgage firms and insurance intermediaries. FSA – March 2003.

⁴ Intermediaries for which general insurance is not the main activity. Examples include: car showrooms, mobile ‘phone companies and others selling some form of insurance as a secondary line of business.

example in holding adequate Professional Indemnity Insurance (PII), and arrangements to ensure that client money is handled safely.

We do not think that there would be any compliance costs of option 1 in addition to the compliance costs currently incurred by those firms that have opted to be regulated by one of the self-regulatory bodies such as the General Insurance Standards Council (GISC). A summary calculation of the cost of options 2, and 3, together with some working assumptions are contained in Annexes A and B to this document. In summary, the costs are as follows:

Option 1 - nil.

Option 2 - £55.6m one-off and between £60.8m and £120m recurring costs.

Option 3 - between £58.8m and £62.7m one-off and between £61m and £120.4m recurring costs.

However, these estimates do not include the costs of compliance with the FSA's conduct of business rules. The FSA will be consulting on their rules shortly at which time they will publish a cost benefit analysis. These costs are likely to be significant.

The wide range of estimates of recurring costs relate to the impact of firms taking out professional indemnity insurance (PII). This follows the FSA assumptions in Annex 1 to CP 174⁵. The lower level assumes that there will be no changes to current levels of PII rates – currently an average of 2.4% of turnover for primary insurance intermediaries. The higher figure assumes that PII for general insurance firms will on average be the same as an Independent Financial Advisor at 3.5%.

Whilst there will be additional costs to firms, it is possible to put a figure on some savings. For example, some 6,000 firms are members of the General Insurance Standards Council (GISC), an industry self-regulatory body. GISC running costs amount to some £7 million a year. This funding comes directly from insurance providers and intermediaries. When the FSA takes over regulation of general insurance, this £7 million cost to the industry will be saved since GISC will no longer exist.

The FSA has estimated that their costs for the development and implementation of the new regimes - from policy making to the design and roll-out of the authorisation and post mortgage and general insurance supervision processes - is some £33 million. The FSA is now consulting on how they intend to recoup these

⁵ Prudential and other requirements for mortgage firms and insurance intermediaries – CP 174

costs from the new population of regulated firms⁶. These costs have been allocated as £8 million for mortgages and £25 million for general insurance.

Small firms impact test

The FSA has estimated that there are some 15,000⁷ general insurance primary intermediaries that can be considered to be small firms - firms that have between 1 and 5 advisers. Implementing the IMD will have a significant effect on those firms in terms of compliance requirements.

The FSA has also estimated that there are between 70,000 and 150,000 general insurance secondary intermediaries⁸ – intermediaries for which general insurance is not the main activity such as car showrooms, mobile phone companies and so on, but are involved in offering various types of insurance as an ancillary part of their activities. As a result of implementing the IMD, the FSA has concluded that many of these firms may decide to discontinue this activity, or become appointed representatives of insurers, or limit themselves simply to providing information rather than being regulated by the FSA. Having considered a number of scenarios, the FSA based their cost benefit analysis on a central projection of 25,000 general insurance secondary intermediaries seeking authorisation. Of these, the FSA say that 22,500 would be considered to be small firms. It is clear that implementing the IMD will have a significant impact on small secondary intermediary firms in the way they become involved in the selling of insurance.

Competition assessment

The proposals would impact on the provision of general insurance products by insurers and insurance intermediaries.

In the UK domestic market, insurance products may be sold direct by insurance companies or through intermediaries. Intermediaries may take the form of independent insurance brokers, single or multi-tied agents (these together number 16,000) or be intermediaries who are not insurance specialists but who offer insurance as a subsidiary part of their business or in connection with the sale of another product. For example, motor dealers, and suppliers of products such as computer equipment, household appliances and mobile phones offer various kinds of insurance as an ancillary part of their activities. Such intermediaries will normally have arrangements with particular insurance companies either to introduce the business to them or act as their agent in the sale of the product. In a number of sectors, intermediaries who offer insurance do not merely sell the

⁶ Chapter 5 of CP 180 - Fees for mortgage firms and insurance intermediaries – FSA April 2003

⁷ Excludes those firms who primarily do mortgage business and a small amount of general insurance

⁸ CP 174 – Prudential and other requirements for mortgage firms and insurance intermediaries

insurance policies of insurance companies but devise their own insurance policies that they place with underwriters.

It is therefore likely that there is competition between insurance products sold directly by insurance companies and those sold through intermediaries.

We expect some firms, particularly some secondary insurance intermediaries and some small primary intermediaries to exit the market for selling insurance. This will lead to consolidation, and some reduction of competition. But it is a competitive market. Whilst there is some concentration in the general insurance market with the top three intermediary firms having 37% of the market, even with some consolidation there would still be many thousands of intermediaries selling insurances direct or as appointed representatives of insurance providers. And the proposals will benefit competition by increasing transparency and raising standards, making it easier for consumers to shop around.

Enforcement, sanctions, monitoring and review

It will be for the FSA to enforce and monitor compliance. The FSA will have a number of sanctions available if insurers and intermediaries fail to comply including fines, and ultimately withdrawal of permission to carry on the business. But firms have the safeguard of the right of appeal to an independent tribunal against FSA decisions.

Consultation

The Government received some 400 responses to the consultation. Respondents ranged from the FSA, to trade bodies such as the ABI and ABTA, to intermediary firms, as well as consumer bodies. Most respondents who commented supported the Government's policy of giving responsibility for general insurance mediation to the FSA.

Direct sales

Nobody disagreed with the Government's position that direct sales of general insurance should be regulated by the FSA, alongside sales by insurance intermediaries. Respondents who commented agreed this provides clarity to consumers as well as a level playing field for insurers and intermediaries.

Motor warranties

Virtually all respondents agreed with the Treasury's proposal that all motor warranties that are contracts of insurance should be subject to regulation by the

FSA including those costing less than €500 per annum. All the insurance providers that commented on this point supported the proposal. There was concern that if only those warranties costing more than €500 per annum were regulated by the FSA then companies would transfer the cost of the warranty onto the vehicle price to avoid regulation, and suppliers might price their products just below the threshold for the same reason. Many respondents also considered that those warranties that require the most regulation are those costing the least. This is because they tend to offer poorer levels of cover in comparison with more expensive ones.

Summary

Option 1

The Government must implement the Insurance Mediation Directive to comply with European Law. Therefore the Government considers that it cannot 'do nothing'.

Option 2

This option would ensure that the UK would be compliant with the Insurance Mediation Directive. Implementing this option should also improve the quality of the intermediary market as a result of FSA authorisation and related high-level requirements for firms and individuals. There would also be a reduced likelihood of market disruption or consumer detriment achieved through the introduction of financial safeguards (including firms having to have professional indemnity insurance (PII), and with client account segregation rules and the possibility of the FSA introducing a compensation scheme for sales of general insurance through intermediaries). There would also be savings to the industry of £7 million a year following the closure of GISC. The costs of option 2 are estimated to be £55.6m and between £60.8m and £120m recurring.

Option 3

Option 3 involves going further than the Directive by regulating direct sales of insurance (as well as insurance mediation) and all motor warranties (rather than just those below €500). The benefits of regulating direct sales of insurance (as well as the selling of insurance by intermediaries) would be a level regulatory playing field irrespective of the distribution channel. Similarly, regulating all motor warranties that are contracts of insurance would ensure a level regulatory playing field irrespective of the price of these products. The net costs (including the savings through the closure of GISC) are estimated to be between £58.8m and £62.7m one-off and £61m and £120.4m recurring.

Therefore the additional costs of option 3 are between £3.2m and £7.1m one-off and between £0.2m and £0.4m recurring.

Virtually all respondents supported the Government's proposals to give the FSA responsibility for regulating direct sales alongside general insurance mediation. They also supported the regulation of all motor warranties.

Recommendation

The proposals to regulate direct sales and all motor warranties enjoyed almost universal support and the additional costs are relatively small in comparison with implementing the IMD. The Government therefore recommend that these be regulated by the FSA.

Declaration

I have read the Regulatory Impact Assessment and am satisfied that the benefits justify the costs.

[Signed]

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ANNEX A

Option 2 - Calculating the costs of implementing the Insurance Mediation Directive itself

Estimate of the costs of implementing the IMD excluding the regulation of direct sales of insurances and motor warranties below €500. These estimates relate to the prudential and other costs that firms will need to incur in order to meet the FSA's authorisation requirements. They also take account of savings from the demise of GISC and the costs that the FSA has incurred in setting up the new regulatory system.

Compliance costs	One-off - £m	Recurring - £m
Authorisation - providers	Nil	Nil
Authorisation Pack – primary intermediaries	7.6	Minimal
Authorisation pack – secondary intermediaries	12.1	1.2
Approved persons	5.2	0.2
Approved persons – higher risk products	0.3	0.5 – 1.0
FSA capital requirements	5.0	1.3
Client money – primary intermediaries	Not possible to cost	35.0
PII – primary intermediaries	1.1	19.7 – 73.9
PII – secondary intermediaries	6.3	9.9 – 14.4
Gross total compliance costs	37.6	67.8 – 127.0
GISC	(7.0)	(7.0)
Net total	30.6	60.8 – 120.0
FSA Policy and Development	25.0	-
Grand total	55.6	60.8 – 120.0

Assumptions

1. All compliance cost assumptions are based on the cost benefit analysis published by the FSA as Annex 1 to CP 174.

2. The FSA has estimated that the population of firms affected by these proposals is as follows:

Insurers and friendly societies	557
General insurance primary intermediaries	15,850
General insurance secondary intermediaries	25,000

3. Because direct providers are excluded from the IMD, with this option, none of the 557 insurers and friendly societies would require permission to carry out general insurance business and would not need to meet FSA requirements in respect of authorisation or compliance costs (for general insurance business).

4. General insurance secondary intermediaries are firms for which general insurance is not the main activity – that is firms selling general insurance as a secondary line of business. For example, car showrooms and mobile phone companies. FSA estimate that 25,000 firms are likely to need to be authorised - 22,500 small, 2,250 medium and 250 large.

5. The authorisation pack costs for this option are calculated as follows. The FSA has estimated the total costs of all firms completing the authorisation pack to be £7.8 million. This includes £0.2 million for insurers and friendly societies. However, under this option, they will not need to seek authorisation, so this has been debited from the total cost to make £7.6 million for authorisation pack costs for option 2. The FSA estimates that the average cost for a large firm of completing the authorisation pack is £622, for a medium firm £564 and a small firm £476. Therefore, the total cost is £12.1 million (£10.71 million for small firms, £1.27 million for medium firms and £0.16 million for large). The FSA assumed that there would be a 10% turnover for these firms as well, which means a recurring cost of £1.2 million.

6. The biggest costs however are in PII requirements. For primary intermediaries they could be £1.1m one-off and between £19.7m and £73.9m recurring costs. For secondary insurance intermediaries the estimate is £6.3m one-off and between £9.9m and £14.4m recurring. The wide variation in recurring costs follows the FSA assumptions in Annex 1 to CP 174⁹. The lower level assumes that there will be no changes to current levels of PII rates – currently an average of 2.4% of turnover for primary insurance intermediaries. The higher figure assumes that PII for general insurance firms will on average be the same as an Independent Financial Advisor at 3.5%.

⁹ Prudential and other requirements for mortgage firms and insurance intermediaries – CP 174

ANNEX B

Option 3 - Calculating the costs of regulation

Summary of the costs of the full proposals contained in the Treasury consultation document 'Regulating General Insurance Mediation'. This includes regulating direct sales of insurance and all insurance motor warranties. It also takes account of the savings from the demise of GISC and the costs incurred by the FSA in setting up the new regulatory system.

Compliance costs	One-off	Recurring
Authorisation – providers	0.2	Not possible to cost
Authorisation Pack – primary intermediaries	7.6	Minimal
Authorisation pack – secondary intermediaries	12.1	1.2
Approved persons	5.2	0.2
Approved persons – higher risk products	3.3 – 7.2	0.7 – 1.4
FSA capital requirements	5.0	1.3
Client money – primary intermediaries	Not possible to cost	35.0
PII – primary intermediaries	1.1	19.7 – 73.9
PII – secondary intermediaries	6.3	9.9 – 14.4
Total compliance costs	40.8 – 44.7	68.0 – 127.4
GISC	(7.0)	(7.0)
Net total	33.8 – 37.7	61.0 – 120.4
FSA Policy and Development	25.0	-
Grand total	58.8 – 62.7	61.0 – 120.4

Assumptions

1. All compliance costs assumptions are based on the cost benefit analysis published by the FSA as Annex 1 to CP 174.
2. The FSA has estimated that the population of firms affected by these proposals is as follows:

Insurers and friendly societies	557
General insurance primary intermediaries	15,850
General insurance secondary intermediaries	25,000

3. The costs for direct insurers and primary intermediaries of completing the authorisation pack are some £7.8 million one-off. This calculation includes the costs (£0.2m) of direct providers - the 557 insurers and friendly societies who would require permission to carry out general insurance business under this option. The FSA has said that it is not possible to cost, or there would be only minimal ongoing costs.

4. General insurance secondary intermediaries are firms for which general insurance is not the main activity – that is firms selling general insurance as a secondary line of business. For example, car showrooms and mobile phone companies. FSA estimate that 25,000 firms are likely to need to be authorised - 22,500 small, 2,250 medium and 250 large.

5. The FSA estimate that the costs of approved person status for general insurance primary intermediaries would be £2.88 million. For general insurance secondary intermediaries, the FSA assumed the costs would be £2.3 million. A total of £5.18 million (rounded to £5.2m). The FSA has assumed that staff turnover is minimal and a figure of £0.2 million has been included.

6. The FSA estimate that the costs of approved person status for firms that deal with higher risk products ranges between £3.3m and £7.2m one-off and £0.7m and £1.4m recurring.

7. FSA estimate that the total cost for firms to meet its capital requirements are £5 million one-off and £1.33 million ongoing.

8. The biggest costs however are in PII requirements. FSA has assumed that there will be no additional PII costs for providers. But for primary intermediaries they could range from £1.1 one-off and between £19.7 million and £73.9 million recurring. For secondary insurance intermediaries the estimate is £6.3 million one-off and between £9.9 million and £14.4 million recurring. The wide variation in recurring costs follows the FSA assumptions in Annex 1 to CP 174¹⁰. The lower level assumes that there will be no changes to current levels of PII rates – currently an average of 2.4% of turnover for primary insurance intermediaries. The higher figure assumes that PII for general insurance firms will on average be the same as an Independent Financial Advisor at 3.5% (of turnover).

¹⁰ Prudential and other requirements for mortgage firms and insurance intermediaries – CP 174