

ANNEX E

REGULATORY IMPACT ASSESSMENT

Issue

1. As announced by the Financial Secretary to the Treasury on 12 December 2001, the Government intends to give the Financial Services Authority (FSA) responsibility for regulating insurance business, including arranging insurance, whether carried on by intermediaries or insurers. This represents an extension of the FSA's remit and will also implement the European Union's insurance mediation directive in the United Kingdom.
2. The 12 December decision was taken in the light of the results of consultation and representations from industry. In particular, they questioned why small firms such as mortgage brokers (who might also sell insurances and pensions) had to deal with (and comply with the requirements of) several regulators. In the light of this, the Government has decided to give FSA responsibility for regulating mortgage lending, advice and mediation, as well as general insurance mediation.
3. The Government has separately consulted on mortgage regulation – Regulating Mortgages, HM Treasury, February 2002 – and as a result of comments published final legislation in August that is expected to be taken through Parliament early next year. It is intended that the FSA will take responsibility for regulating mortgages simultaneously with general insurance mediation.
4. This regulatory impact assessment deals specifically with implementing general insurance regulation and accompanies a separate consultation document that explains the proposed policies in more depth.

Objective and overall approach

5. The Objective is to implement the Insurance Mediation Directive that was adopted by the European Parliament and Council on 30 September 2002 in the most cost effective and proportionate way. The main provisions of the Directive are summarised in the appendix.

6. The Government proposes to implement the bulk of the Directive by extending the existing Financial Services and Markets Act 2000 (FSMA) regime which provides the scope of the regulatory powers of the Financial Services Authority (FSA). This approach gives the FSA wide powers to make rules in respect of regulated activities. But these powers are balanced with the need to consult and regulate proportionately, having regard to cost-benefit analyses.
7. The Government has had extensive discussions with a wide range of interests from the current regulators (FSA and the General Insurance Standards Council), trade bodies (Association of British Insurers, Institute of Insurance Brokers, Association of British Travel Agents, British Insurance Brokers Association, British Retail Consortium, Society of Motor Manufacturers and Traders, and others), consumer bodies (Consumers' Association, National Consumers Council) as well as Designated Professional Bodies (such as the Law Society) and a number of individual companies and other government departments. The Government has considered and is grateful for the constructive contribution that everyone has made to the work.
8. The views of these bodies have informed the policy proposals set out in the Consultation Document and this RIA.

Risk assessment

9. The Government supports the single market in financial services and believes that UK firms should be able to take advantage of the EU-wide business of insurance mediation. Implementing the IMD enables UK intermediaries to be registered and take advantage of the opportunities available.
10. Many customers do not actually know that they are dealing with an intermediary. Advertising by large organisations which use panels of insurance companies lead some to believe that they are the insurers themselves.
11. An unregulated sales process can give rise to asymmetric information between the buyer and seller. Where the insured is unaware of this it can lead to problematic claims processes. Where the insured is aware but information is limited, it can reduce consumer confidence.
12. There may be a lack of true competition since the intermediary's range of insurance undertakings will vary from one to another. 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, eg. through a broker.

13. Warranties in relation to auto sales may distort the market. Manufacturers and retailers may hide the price of the warranty within the total price of the car such that the consumer is led to believe that the car ‘comes with a long warranty’, not recognising the warranty as a separable product. Where warranties are sold separately and a regulatory cut-off point exists, a poorer quality product may be provided in order to escape regulation and there is a risk that the complete information regarding cover will not be understood by the consumer.

Options

14. There are three options in relation to regulating insurance mediation:
 - a. *Do nothing* – this option is not available in this case. Were the UK to ‘do nothing’ it would be liable to infraction proceedings and to be fined by the European Commission.
 - b. *Implement the Directive “as is”* – this would certainly benefit UK firms in allowing them to conduct business across the EU. Conversely the ability of EU firms to sell their products in the UK will encourage competitiveness. The disadvantage of Option B is that the opportunities to bring about further possible benefits such as those discussed below are foregone.
 - c. *Go further than the Directive* - the Insurance Mediation Directive is a minimum harmonisation measure and all Member States may also take such other measures that it wishes to facilitate markets and improve competition, and to protect consumers, provided that these measures comply with Community Law.
15. It might be helpful to set out where and why the Government is proposing to go further than the Directive, as well as explaining the background to a decision to consult on travel insurance and to defer a decision on extended warranties:

Direct sales

16. The Directive covers general insurance mediation. This means the activities of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance (or reinsurance), or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim. But many insurance providers sell general insurance products direct. The FSA has the power to regulate direct sales of general insurances and will be consulting separately on this. In consulting, it will, in particular have regard to the need to minimise the adverse effects of competition that may arise from anything done in the discharge of those functions, as well as the desirability of facilitating competition between those who are subject to any form of regulation¹. But the industry and others believe that it is important that direct sales of general insurance be regulated alongside brokers to ensure a level playing field. Moreover, consumers have a right to protection irrespective of who sells them their policy.

Extended Warranties

17. Extended warranties are excluded from regulation under the Directive within certain strict boundaries such as where the annual premium does not exceed €500 (about £300). The Competition Commission (CC) is presently investigating the market for extended warranties on domestic electrical appliances and, as they tend to be for less than £300 there is no requirement that they should be regulated (under the Directive). However, the Government has decided to defer a decision on whether to give FSA responsibility for regulating insurance extended warranties, pending the outcome of the CC review. If, in the light of that decision, regulation is still thought necessary, the Government will consult and carry out a regulatory impact assessment before taking final decisions.
18. There are other warranties that will not be caught by the Directive, for example, for jewellery, carpets and other goods. The Government has little evidence of consumer detriment here, but there may be competition issues similar to that for domestic appliances. The Government proposes, therefore, to defer a decision on this issue also pending the outcome of the CC review.

¹ FSMA 2000 section 2 (3) (f – g)

Motor warranties

19. Some extended warranties will be caught by the Directive i.e. those whose annual premiums are more than €500. The Government is not aware of any warranties for domestic appliances that will be caught, but it is clear that the FSA will have to regulate people who sell warranties for motorcars that cost more than the threshold.
20. The Government believes that the impact of a cut-off point at €500 would be distortionary, and might encourage retailers to alter warranty products to avoid regulation by reducing what they cover and therefore the value of the product. Alternatively, they may seek to ‘hide’ the value of the warranty within a more expensive price for the car. In addition, and according to the Society of Motor Manufacturers and Traders, almost all motor retailers sell creditor protection insurance to protect payments against the finance deals used to purchase the cars, and this will bring them within the scope of the Directive.
21. Finally, poorer consumers tend to buy cheaper cars, and hence cheaper warranties, yet they would be the ones unprotected if the Government was to implement the cut-off point.
22. The industry agreed that it was sensible not to have an artificial cut-off point based on price for motor warranties. Nevertheless, the Government is seeking evidence that these assumptions are correct.

Travel insurance

23. Travel insurance purchased as part of a package is exempted from the Directive. But the Government has been considering the implications of the new regime for these products and has informally consulted widely.
24. In considering the options for regulation there are a number of factors to be taken into account. Issues for consideration include:
 - **level playing field:** the extent to which regulating travel insurance sold as a stand alone product, but not insurance sold with a holiday, could create an unlevel playing field between unregulated travel agents and regulated insurance intermediaries, both in terms of compliance costs and disclosure at the point of sale. However relatively few intermediaries sell only travel insurance, and so most would need to be authorised by the FSA for other business;

- **concerns about ‘bundled goods’:** there are concerns about lack of transparency and choice for consumers in the sale of “bundled” insurance. It is also claimed that insurance sold by travel agents can be poor value for money. Regulation would not necessarily solve these consumer issues, although the FSA could impose disclosure requirements which would enhance transparency and price comparisons;
- **complaints and mis-selling:** there are also reports of travel insurance as a problem area in terms of complaints and mis-selling. For example it is claimed that intermediaries sometimes fail to ask about pre-existing medical conditions that are not covered by the policy being offered.
- **availability of insurance:** there is a risk that, if FSA regulation is introduced, travel agents may cease offering customers insurance when they buy their holiday. This could lead to an increase in those travelling without insurance.

25. The options the government is considering in relation to travel insurance sold as part of a package are:

- **no statutory regulation** of sales of travel insurance sold as part of a package;
- **FSA regulation** to cover these sales in the same way as stand alone sales of travel insurance; and
- **industry specific regulation**, requiring sellers of these products to be authorised by the FSA unless they are subject to an ABTA code which would be certified by the FSA. Sellers who were subject to the ABTA code but who also carried on other FSMA regulated activity, including selling any insurance other than packaged travel insurance, would be subject to FSA authorisation in relation to all of their regulated activities (including the activities to which the ABTA code applied).

Benefits

26. The UK has the largest insurance industry in Europe. In 2000 for example, over £150 billion of general and long term premiums were written. The present market leaves it to consumers to make the right choices for themselves. Many consumers turn to some sort of intermediary. ABI figures show that in 2000, 74% of total general business premiums were written through intermediaries and company agents and only 15%

bought direct (9% of remaining attributable to banks and building societies and 2% to other).

27. Regulation of the sales process would improve competition because consumers will have better information on which to base their decisions. They will also be able to more easily compare one firm's products and proposals with another's. Most problems arise because consumers are not given the information in an easily digestible and understandable form so that they can take an informed decision. Regulation will, therefore, contribute to effective competition since there will be a range of suppliers and consumers will better understand the product.
28. Intermediaries themselves may benefit. At present many firms, including at least 8,000 intermediaries 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 St. broker typically offering personal pensions, general insurance products and mortgages might at present have to comply with the requirements respectively of:
 - The Financial Services Authority (FSA);
 - The General Insurance Standards Council (GISC); and
 - The Mortgage Code Compliance Board (MCCB).
29. Their customers would similarly have to turn to the mechanisms laid down by each of these bodies in order to seek redress or compliance with standards which cover a range of arrangements spanning voluntary codes, industry standard setting bodies as well as statutory regulators. There will in future be one point of call rather than having to deal with the requirements of several regulatory bodies. This will reduce costs for intermediaries, the majority of which are small businesses.
30. Articles 10 and 11 of the Directive set out the requirements in respect of complaints and out-of-court redress.
31. Intermediaries will also be able to benefit from the right to passport to other European countries. Those authorised in the UK will automatically have the right to carry on insurance intermediary activity in any other EU country. Similarly registered insurance intermediaries of other EU states will automatically have the right to operate in the UK. This should lead to more competition.

Costs

32. It is difficult to be precise about the costs of regulation. These are dependant on the exact regime implemented as a result of these measures and the numbers of firms that will be covered. On the number of firms, the Association of British Insurers (ABI) say that there are some 660 insurance companies authorised to carry on general insurance business (about 60 of which are also authorised for long-term business). But it is difficult to have precise figures on the number of brokers and intermediaries who carry on the business of selling or arranging general insurance. There is no central register and they will be statutorily regulated for the first time.
33. The General Insurance Standards Council (GISC), a voluntary industry regulator, has over 6,000 businesses in membership. The British Insurance Brokers' Association has 1,800 members (some may also be members of GISC), representing 35% of all the people employed in the UK insurance industry, ranging from the world's largest broker, to Lloyds Brokers, to small local companies, and national and regional networks. However, credit brokers licensed by the Office of Fair Trading who sell creditor protection insurance, and motor dealers who introduce or arrange car insurance will all need to be authorised or exempted from the FSA regime. There may also be other high street brokers who are not members of these or other relevant organisations.
34. As to costs, these are likely to come in the form of one-off costs in changing procedures to achieve compliance; recurring costs that are not dependent on the level of regulated activity; and recurring costs that vary with the level of the regulated activity. Costs may also differ for those firms already registered with GISC.
35. In 1999, the FSA carried out an analysis of the costs of regulating mortgages². There were certain similarities then to the current general insurance situation. There was/is a voluntary self-regulatory body that has set standards for example in respect of dealing with customers and training and competence requirements. There is also a redress system for customer complaints. (The FSA is currently consulting on its high level cost-benefit analysis of mortgage regulation in order to update the 1999 figures – CP 146.)
36. In the general insurance field, GISC requires that members meet certain standards, for example in the fair treatment of customers, and in financial requirements. They also need to have procedures for the handling of complaints and the availability of redress,

² A cost benefit analysis of statutory regulation of mortgage advice – FSA October 1999.

as well as effective training and competence of staff requirements. Also, like mortgages, most general insurance products are sold by intermediaries and brokers.

37. There are some 150 mortgage lenders and about 13,000 mortgage intermediary firms. In 1999, FSA estimated that the additional costs of statutory regulation (that is over and above MCCB requirements) were some £13.7 million one-off, and £7.7 million recurring costs for lenders, and £22.4 million one-off and £18.3 million recurring for intermediaries.
38. Assuming there are about four times the number of insurance companies as mortgage lenders, and half the number of general insurance intermediaries, this equates to £54.8 million one-off and £30.8 million in recurring costs for insurance companies, and £11.2 million one-off and £9.15 million in recurring costs for general insurance intermediaries. The insurance intermediaries figures do not, of course, take account of the unknown numbers of credit brokers who sell creditor protection insurance, or motor dealers who arrange car insurance, or any other high street brokers who are not members of any trade or regulatory organisation. This is compared with an industry where, in 2000, £150 billion in insurance premiums were written. The Government would welcome views on the cost assumptions made here.
39. The FSA is obliged by FSMA to include in its consultations a cost benefit analysis of its proposed rules, and they will do so.

Small businesses – litmus test

40. The Treasury has already consulted a number of small business representatives and the proposals set out above in part reflect their views. But the Government will be interested in small businesses' views on the assumptions made in this assessment, the results of which will be included in a revised RIA in due course.

Summary and recommendations

41. The Objective is to implement the Insurance Mediation Directive adopted by the European Parliament and Council on 30 September 2002 in the most cost effective and proportionate way. Following an extensive informal consultation on the implications of the Insurance Mediation Directive, the Government is seeking views on a number of issues. But the Government considers that the proposals outlined

above and in the consultation document meet the objective of a proportionate response taking issues such as competition, consumer protection and the effects on industry into account. The Government would welcome views and comments on the assumptions made in this regulatory impact assessment.

Enforcement, sanctions, monitoring and review

42. It will be for the FSA to enforce and monitor compliance by insurance intermediaries. The FSA will have a number of sanctions available if 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 decisions of the FSA.

Consultation

43. The Government has already consulted informally and widely, but is now formally seeking views through a 12 week public consultation on the general approach to regulating insurance mediation. The FSA will also be formally consulting on the content of its new rules to regulate under the new regime and those rules will be subject to a cost/benefit analysis.

The Government would welcome views on the assumptions made in the Regulatory Impact Assessment. It would be helpful to receive views on both the costs and benefits to businesses and consumers of the proposed regulation. We would particularly like to receive views on the likely impact on the small firms that will be covered by FSA regulation of general insurance mediation.

Appendix

The Insurance Mediation Directive

1. The Directive lays down rules for the taking-up and pursuit of the activities of insurance and reinsurance mediation by natural and legal persons which are established in a Member State or which wish to become established there.

Exclusions

2. The Directive shall not apply to persons providing mediation services for insurance contracts if all the following conditions are met:
 - the insurance contract only requires knowledge of the insurance cover that is provided;
 - the insurance contract is not a life assurance contract;
 - the insurance contract does not cover any liability risks;
 - the principal professional activity of the person is other than insurance mediation;
 - the insurance is complementary to the product or service supplied by any provider, where such insurance covers:
 - i. the risk of breakdown, loss of or damage to goods supplied by that provider; or
 - ii. damage to or loss of baggage and other risks linked to the travel booked with that provider, even if the insurance covers life assurance or liability risks, provided that the cover is ancillary to the main cover for the risks linked to that travel.
 - the amount of the annual premium does not exceed €500 and the total duration of the insurance contract, including any renewals, does not exceed five years.
3. The Directive shall not apply to insurance and reinsurance mediation services provided in relation to risks and commitments located outside the Community.