



Europe Economics Executive Brief

Why vets, musical instrument shops, pet shops, jewellers, dentists, car dealers and many others will be affected by the move to FSA regulation of insurance intermediation

From 14 January 2005 general insurance intermediation will be subject to statutory regulation. This is a result of a new EC directive, to be implemented in the UK by the FSA. This change has potentially important implications for many businesses, not just firms traditionally considered in the financial services sector.

The new regulations cover anyone who arranges or advises on insurance contracts, deals as an agent to conclude contracts, or manages insurance contracts. The FSA estimates up to 150,000 firms whose primary business is not insurance may be affected, including “vets selling pet insurance or mobile phone retailers selling insurance”.¹

There are currently only two sets of firms selling general insurance that will be exempt from FSA regulations:

- Firms that sell travel insurance as part of a holiday package; and
- Firms selling extended warranties on electrical goods (but firms that sell extended warranties for motor vehicles are currently subject to the proposals).

All other firms that advise on or arrange general insurance will be subject to FSA regulations from January 2005.

When the new regulations come into force, firms that continue offering insurance intermediation services will have to:

- obtain FSA authorisation,
- satisfy prudential requirements; and
- follow conduct of business rules.

This note provides more guidance on what this might mean in practice.

The costs of FSA regulation

The cost implications are potentially significant, if the experience of firms already subject to similar regulation is any guide. As part of its monitoring of compliance costs, the FSA recently published a report by Europe Economics that collected evidence from firms across the financial services industry.²

For the year ending financial year 2002, the report found that the costs of complying with FSA regulations accounted for 1.6 per cent of the median firm’s operating expenditures. For retail firms (ones that deal with private individuals), the share of operating costs was rather higher at 2.6 per cent.

The study also found that the costs of compliance as a percentage of total costs were significantly higher for small firms. There appear to be economies of scale.

¹ FSA (2003) *Consultation Paper 174: Prudential and other requirements for mortgage firms and insurance firm*, www.fsa.gov.uk/pubs

² Europe Economics (2003) *Costs of Compliance* www.fsa.gov.uk/pubs/



This suggests that firms would be wrong to conclude that their compliance costs will be insignificant because they conduct little insurance intermediation.

Focussing specifically on the proposed regulations for insurance intermediaries, the FSA's cost-benefit analysis suggests that the conduct of business rules alone will amount on average to £2.80 per annual premium on each insurance policy written.³

Authorisation

The FSA will release details on how to apply for authorisation in the last quarter of 2003.

To be eligible, firms will have to demonstrate that they satisfy the FSA's threshold conditions. This will include satisfying the FSA that the firm can effectively be supervised, that the firm is "fit and proper", and that it has adequate resources — both financial and in terms of quantity and quality of management and staff.

An approved persons regime will apply for individuals holding a position of significant influence in an authorised firm or dealing with customers. Approved persons will need to satisfy a fit and proper test.

Prudential requirements

The FSA's proposals also include a number of financial safeguards firms must implement.

- Intermediaries will need to have professional indemnity insurance to cover for claims arising from professional negligence or mis-selling.

- Firms will have to hold a minimum level of capital no less than the greater of £5,000 or 5 per cent of annual income.
- Firms that hold client money, e.g. premiums that they subsequently transfer to the insurer, will have to set up strictly segregated client accounts (or agree a contract of agency with the insurer).

Conduct of business rules

From January 2005, firms offering general insurance intermediation services will also be subject to various conduct of business rules. We shall consider the rules when dealing with a private individual, for whom intermediaries may not make "excessive charges".

All intermediaries will have to provide customers with a status disclosure using a durable medium (e.g. paper, floppy disk). This disclosure should detail:

- The name and address of the firm
- Whether the firm is FSA authorised
- How to check the firm on the FSA register
- The range of insurance undertakings on whose projects the firm has provided advice or information in relation to the contract provided
- Any fees the firm received for advising or arranging the contract
- Information on the financial relationship between the intermediary and the insurer (i.e. do they have stakes in each other?)

³ See FSA (2003) *Consultation Paper 187: Insurance Selling and Administration & Other Miscellaneous Amendments*, www.fsa.gov.uk/pubs



- How customers can complain, including the fact that complaints can be referred to the Financial Ombudsman Service (current plans will require all intermediaries to sign up to Compulsory Jurisdiction of the Financial Ombudsman Service, paying a yet-to-be-determined fee)
- What compensation arrangements apply, including the extent and level of any cover, relating to the insurance intermediation service.

Intermediaries that give advice will have to provide “adequate” advice, giving due regard to various factors, such as:

- value for money;
- the credit-worthiness of the insurer;
- the insurer’s claims-handling record; and
- the probability of winning in no-win no-fee insurance.

Firms will have to indicate where the advised product fails to meet customer’s demands and needs (including consideration of the existing coverage the customer is known to have).

Firms will have to provide a “demands and needs statement”, indicating whether advice has been given, and if so, why the contract has been recommended.

Firms will be responsible for ensuring their staff are competent to advise. Inducements to staff that conflict with a firm’s duty to its customers are prohibited.

Intermediaries that sell insurance will be responsible for delivering product disclosure information to the customer. Price

information should include the premium and any related fees.

For contracts that last more than one month, the customer must be advised 21 days prior to contract expiry whether or not the firm is inviting them to renew.

Customers will have cancellation rights for all insurance contracts with duration more than one month, except for pure protection contracts that last less than six months.

Intermediaries selling payment-protection insurance will have to:

- ◆ Provide a summary sheet of the policy and orally alert customers to any exclusions that apply (such as an ineligibility to claim)
- ◆ Disclose the price of the insurance separately
- ◆ State whether insurance is provided with the product and whether the insurance is a compulsory or voluntary part of the offer

Finally, the conduct of business rules will impose a record-keeping requirement. Intermediaries will need to keep records for at least three years on information provided in the product disclosure, the advice given and reasons why.

Implications for firms

It is unclear what impact these new regulations will have on industries where firms offer insurance intermediation as an “extra” service. The effects are likely to vary by industry.

Analysing the potential implications will be prudent for all affected businesses. Firms need to forecast how other firms in their industry are likely to react, and what



strategic responses they should therefore adopt to be best positioned in January 2005.

In some markets, the value to firms of any insurance sold may be so small that the prudent action is to cease offering insurance intermediation services. The FSA's own central projection is that only 25,000 affected firms will seek authorisation. Other firms might, for example, limit themselves to having leaflets on insurance available — making sure not to recommend (advise) customers to purchase the contracts described in the leaflets.

In other industries, advising and arranging insurance may represent a more important part of the overall service firms provide customers. Firms in these industries will have to decide how best to remain competitive.

Should they incur the regulatory costs associated with getting authorised and adapting their processes to comply with the conduct of business rules? Or will they be able to continue to compete effectively even if they no longer sell insurance?

Another alternative might be to become an appointed representative of an insurer. The firm would still be subject to the conduct of business rules, but would no longer need to seek FSA authorisation. Instead a principal (or principals) would assume responsibility for ensuring that the intermediary complies with the conduct of business rules. Under these circumstances, the firm would have to indicate when disclosing its status what principal it is representing. Whether insurers

will be willing to take on appointed representatives remains to be seen.

FSA consultation

The FSA is required to implement the EC's Insurance Mediation Directive and satisfy its statutory objective to ensure consumers receive adequate protection. Nevertheless, it still has some flexibility in how it regulates insurance intermediaries and is currently engaged in a consultation process.

For example, the FSA has just published the (over 300-page!) consultation paper describing its proposed conduct of business rules.

Comments from “secondary intermediaries” — firms whose primary business is not insurance — are likely to be particularly welcome. The FSA estimates that currently the majority of intermediaries are secondary intermediaries. Yet for the cost-benefit analyses it conducts, the FSA has thus far received relatively little input from firms outside the financial services sector.

This is an important and material change in regulation affecting up to 150,000 firms, which secondary intermediaries and their trade bodies would be well-advised not to ignore. The FSA has invited responses to its conduct of business consultation paper by 30 September 2003.

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For further information, please contact Peter Edmonds, Andrew Lilico or John Spicer.

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