

**EXPLANATORY MEMORANDUM TO
THE FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED
ACTIVITIES) (AMENDMENT) (NO. 2) ORDER 2007**

2007 No. 3510

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.
2. **Description**
 - 2.1 This Order amends Article 72B of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 S.I. 2001/544 ("the Regulated Activities Order") to limit the exemption it provides from regulation by the Financial Services Authority (FSA) for certain activities (specified in the Regulated Activities Order) connected with travel insurance. Under the article as amended, the exemption will only apply to those cases where the insurance in question is linked to:
 - (a) travel to an event organised by the travel provider where the person seeking insurance is not an individual acting in a private capacity or a business or group with annual turnover of less than £1,000,000; or
 - (b) the hire of a aircraft, vessel or vehicle that does not provide sleeping accommodation.
 - 2.2 The Order also provides an interim authorisation regime for applicants who have applied for the necessary permission and approval under the Financial Services and Markets Act 2000 by 15 November 2008.
3. **Matters of Special Interest to the Joint Committee on Statutory Instruments**
 - 3.1 None.
4. **Legislative Background**
 - 4.1 Article 72B was inserted into the Regulated Activities Order in 2003 as part of the Government's implementation of directive 2002/92 of the European Parliament and of the Council on insurance mediation (the Insurance Mediation Directive). That directive requires the regulation of insurance mediation activities (such as proposing or selling contracts of insurance), but allows an exception to be made in relation to travel insurance sold alongside a holiday or other related travel.

- 4.2 Following consultation on implementation of the directive, the Government decided at that time that travel insurance sold alongside a holiday or other related travel should not be regulated, but gave a commitment to review the position in 2 years.
- 4.3 This instrument is being made following that review, and in response to the Treasury Select Committee's report of February 2007 "*Are you covered? Travel insurance and its regulation*", which recommended that FSA regulation should be extended to cover the bundled travel insurance market (paragraph 42 of that Report). The instrument amends article 72B of the Regulated Activities Order to achieve this, by limiting the exemption from regulation set out in that article in respect of the activities specified in the Order.

5. Extent

- 5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

- 6.1 The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

In my view the provisions of the Financial Services and Markets Act 2000 (Amendment)(No 2) Order 2007 are compatible with the Convention rights.

7 Policy background

Policy

- 7.1 The Government's review of its original decision to exempt travel insurance sold alongside a holiday or other related travel from regulation by the FSA found evidence of the potential for consumer detriment arising from the selling of such insurance. In view of this, and the relatively more complex nature of travel insurance products compared to other general insurances, the Government has decided to extend FSA regulation to this area.
- 7.2 This will ensure that all those purchasing travel insurance will benefit from a core statutory baseline of consumer protection, irrespective of the channel through which the insurance is sold. It will also ensure that all consumers of travel insurance have access to the Financial Ombudsman Service and the Financial Services Compensation Scheme should things go wrong during the sales process.
- 7.3 The Government believes that the other options under consideration, such as doing nothing or strengthening industry self-regulation, would not offer an appropriate level of consumer protection.

7.4 The car hire and event management sectors also benefit from the current exemption in Article 72B of the Regulated Activities Order. The Government's review has found no evidence of consumer detriment in relation to these two areas and the Government can see no benefit in extending regulation to these two sectors. This instrument maintains the exemption from FSA regulation in these two areas.

Consultation

7.5 Public consultation has been conducted at two stages of the policy development process. A 3-month call for evidence asked for interested parties' views, supported by evidence as far as possible, on a list of options: doing nothing; strengthening industry self-regulation; and, extending FSA regulation to this area.

7.6 77 responses were made to the call for evidence. Of those responses directly expressing a preference for one of the options proposed, 9 supported doing nothing, 4 supported strengthened industry self-regulation and 13 supported FSA regulation. Further detail is provided in a summary of responses document available from the Treasury website.

7.7 The call for evidence was followed by a 3-month consultation on the Government's intended approach, including draft legislation and a partial Regulatory Impact Assessment.

7.8 15 responses were made to the consultation. Of those responses offering an explicit view, 8 were supportive of the Government's intended approach and 2 disagreed. Further detail is provided in a summary of responses document available from the Treasury website.

8. Impact

8.1 A final Impact Assessment has been prepared for this instrument and accompanies the draft Statutory Instrument.

9. Contact

9.1 Jack Middleton at HM Treasury, tel: 020 7270 5468 or e-mail: jack.middleton@hm-treasury.gov.uk can answer any queries relating to this instrument.

FINAL IMPACT ASSESSMENT

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of the regulation of the selling of travel insurance sold alongside a holiday or other related travel	
Stage: Implementation	Version: Final	Date: 13 December 2007
Related Publications: Travel insurance review: summary of consultation responses		

Available to view or download at:

http://www.hm-treasury.gov.uk/consultations_and_legislation/travelinsurance

Contact for enquiries: Jack Middleton

Telephone: 020 7270 5468

What is the problem under consideration? Why is government intervention necessary?

Unlike the selling of most general insurance products, the selling of travel insurance sold alongside a holiday or other related travel is not currently subject to statutory regulation. Concerns have been raised around the level of consumer detriment arising from mis-selling in this area.

The Government has reviewed this area and thinks that statutory regulation of these sales, through the Financial Services Authority (FSA), is necessary. This Impact Assessment provides further details of the costs and benefits of this

What are the policy objectives and the intended effects?

The Government's intention is to raise standards in the selling of travel insurance sold alongside a holiday or related travel with the intended effect of minimising consumer detriment related to mis-selling.

The Government also intends to ensure that consumers have access to appropriate redress measures where they have been mis-sold travel insurance sold alongside a holiday or related travel.

What policy options have been considered? Please justify any preferred option.

Option 1 - do nothing.

Option 2 - some form of strengthened industry self-regulation including access to the Financial Ombudsman Service (FOS).

Option 3 - FSA regulation. Option 3 is the Government's chosen option. The main benefits of FSA regulation are that firms will have to meet the FSA's high-level principles, for instance on treating customers fairly, as well as meeting any rules or guidance issued by the FSA, for instance on clear disclosure information.

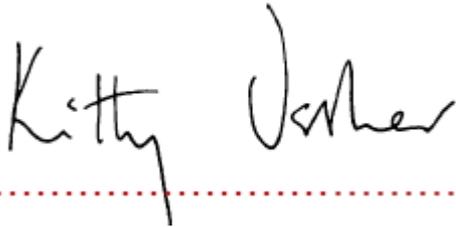
When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government keeps all legislation under review, and in line with good practice would expect to review the policy within three years.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:



A handwritten signature in black ink, reading "Kitty Josher". Below the signature is a horizontal dotted red line.

Date: 13 December 2007

Summary: Analysis & Evidence

Policy Option: Option 2	Description: Strengthened industry self-regulation including access to the Financial Ombudsman Service
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COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' Key monetised costs will fall to the travel industry trade associations responsible for industry self-regulation and to travel firms selling insurance.
	One-off	Yr	
	£ 0.1 - 0.2m	1	
	Average Annual Cost (excluding one-off)		
	£ 0.68 - 1.46 m		
Total Cost (PV)			£ 5.95 - 12.77m
Other key non-monetised costs by 'main affected groups' The cost to firms of implementing improvements, including an annual levy or per case fee (or combination of both) to fund disputes taken to the FOS.			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' Key monetised benefits will fall to consumers of travel insurance sold alongside a holiday or other related travel that purchase the insurance from a member of a trade association.
	One-off	Yr	
	£ None		
	Average Annual Benefit (excluding one-off)		
	£ 15.65 - 16.08m		
Total Benefit (PV)			£ 134.70 - 138.42m
Other key non-monetised benefits by 'main affected groups' Possibility of improvement in selling practices by some travel firms. Some consumers will have access to an independent, impartial and low cost method of redress through the FOS.			

Key Assumptions/Sensitivities/Risks Key assumptions include the level of mis-selling by travel firms and the likelihood of mis-selling leading to a claim being rejected.

Price Base Year 2007	Time Period Years 10	Net Benefit Range (NPV) £ 121.93m - 132.47m	NET BENEFIT (NPV Best estimate) £ 127.2m
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What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	N/A

Which organisation(s) will enforce the policy?		Travel industry		
What is the total annual cost of enforcement for these		£ 0.2 - 0.5m		
Does enforcement comply with Hampton principles?		No		
Will implementation go beyond minimum EU requirements?		Yes		
What is the value of the proposed offsetting measure per		£ N/A		
What is the value of changes in greenhouse gas emissions?		£ N/A		
Will the proposal have a significant impact on competition?		No		
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)					(Increase - Decrease)
Increase	£ N/A	Decreases	£ N/A	Net	£ N/A

Annual costs and benefits: Constant Prices

(Net) Present Value

Summary: Analysis & Evidence

Policy Option:
Option 3

Description: The selling of travel insurance sold alongside a holiday or related travel to be regulated by the FSA

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' Key monetised costs will fall to travel firms selling insurance.
	One-off	Yr	
	£ 7.25m - 8.14m	1	
	Average Annual Cost (excluding one-off)		
	£ 2.48 - 5.14m		Total Cost (PV) £ 28.6m - 52.39m
Other key non-monetised costs by 'main affected groups' These include the cost of entering the jurisdiction of the FOS (both case fees and awards made by the FOS) and the cost of the Financial Services Compensation Scheme levy.			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' Key monetised benefits will fall to consumers purchasing travel insurance from a travel firm.
	One-off	Yrs	
	£ None	N/A	
	Average Annual Benefit (excluding one-off)		
	£ 19.56 - 20.1m		Total Benefit (PV) £ 168.37 - 173.01m
Other key non-monetised benefits by 'main affected groups' These include: (i) an increase in travel firms' insurance selling standards through reference to FSA principles and more specific rules, and (ii) access for the consumer to the FOS where they think they have been mis-sold insurance.			

Key Assumptions/Sensitivities/Risks

Key assumptions include: the average commission level earned by travel firms; the likely reaction of travel firms to the introduction of regulation; the level of mis-selling by travel firms; the likelihood of mis-selling leading to a claim being

Price Base Year 2007	Time Period Years 10	Net Benefit Range (NPV) £ 115.98 - 144.4m	NET BENEFIT (NPV Best estimate) £ 130.19m
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What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	1 January 2009

Which organisation(s) will enforce the policy?		FSA		
What is the total annual cost of enforcement for these		£ Minimal		
Does enforcement comply with Hampton principles?		Yes		
Will implementation go beyond minimum EU requirements?		Yes		
What is the value of the proposed offsetting measure per		£ N/A		
What is the value of changes in greenhouse gas emissions?		£ N/A		
Will the proposal have a significant impact on competition?		No		
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)
Increase	£ N/A	Decreases	£ N/A	Net
				£ N/A

Key: Annual costs and benefits: (Net) Present Value

Evidence Base (for summary sheets)

The costs and benefits of the Government's three proposed options are provided below.

Some 21m travel insurance policies are sold each year¹ in a market worth £670m in 2006². According to Datamonitor, travel insurance sold by travel agents and tour operators accounted for around 44% of all travel insurance sales by Gross Written Premium in 2006³. However, estimates by Mintel put the share of policies sold by travel agents at 24%⁴. The Association of British Travel Agents (ABTA) estimate that the travel industry's share of the travel insurance market is no more than 25%⁵. Only 8% of the members of consumer association *Which?* purchasing travel insurance bought from a travel firm⁶, although this figure is not necessarily indicative of the market as a whole.

ABTA's response to the call for evidence estimated that the number of customers that will make a claim against their policy is approximately 3%. Defaqto estimate the frequency of travel insurance claims to be around 4%⁷. They also estimate the level of claims paid by insurers to be at most 70% of premiums received. ABI statistics show that their members paid around 850,000 claims in 2006 – a claims frequency of 4% (assuming 21m policies sold per annum). The cost of these claims totalled £330m, suggesting an average claim size of around £388.

OPTION 1 – COSTS AND BENEFITS

Option 1 is no change. Sales of travel insurance sold along with a holiday would remain unregulated, although subject to some degree of industry self-regulation, such as the ABTA Code of Conduct and the Association of Independent Tour Operator's (AiTO) Code of Business Practice.

The Unfair Commercial Practices Directive (UCPD) will require that by April 2008 consumers in EU Member States are protected from unfair, misleading and aggressive selling practices. Under Option 1, the selling of travel insurance sold alongside a holiday would be subject to the regulations implementing the Directive. The Department for Business, Enterprise and Regulatory Reform⁸ (BERR) have recently consulted on draft regulations. The Office of Fair Trading (OFT) would be responsible for enforcing these regulations.

Benefits

There are no incremental benefits arising from option 1 as it maintains the status quo.

The attractive features of this option are that:

- no additional costs of regulation are imposed on the travel sector;

¹ Source: Association of British Insurers (ABI). ABI estimate that their members account for 93% of the travel insurance market.

² Source: Mintel, *Travel Insurance, Finance Intelligence, February 2007*

³ Source: Datamonitor *UK Travel Insurance 2007*

⁴ Source: Mintel, *Travel Insurance, Finance Intelligence, February 2007*

⁵ Source: ABTA response to consultation stage of this review

⁶ Source: *Which?* response to consultation stage of this review

⁷ Source: Defaqto, *Travel Insurance in the UK, May 2007*

⁸ See <http://www.dti.gov.uk/consumers/buying-selling/ucp/index.html>

- all travel agents/tour operators would be able to continue selling travel insurance without any additional restrictions;
- some additional protection, against the current baseline, provided through implementation in the UK of the UCPD.

Costs

There are no incremental costs associated with option 1 as it maintains the status quo.

However, the potential remains for consumer detriment, including:

- a lack of statutory requirements on a travel firm to take steps to ensure that the consumer understands the policy, for example through providing disclosure information at the point-of-sale or explaining the features of the cover;
- the relative complexity of travel insurance as a product means that bundling may be likely to lead to mis-selling, since there is little opportunity for customers to check that the policy meets his or her requirements, or to shop around and compare prices;
- consumer difficulty in understanding the distinction between policies sold along with a holiday and those sold as a stand-alone product;
- a lack of access to the Financial Ombudsman Service (FOS) whenever a dispute concerns the mis-selling of the insurance product by a travel firm, and there is no access to the FOS at all where cover is provided through a non-UK insurer. Anecdotal evidence suggests that non-UK insurers underwrite a significant proportion of the insurance policies offered by travel firms in the UK.

OPTION 2 – COSTS AND BENEFITS

Option 2 would involve some form of strengthened industry self-regulation along with access to the FOS. The travel industry would be responsible for ensuring high standards of selling, but consumers would ultimately have recourse through the FOS if things go wrong. Primary legislation would be required to make the jurisdiction of the FOS compulsory. An independent body would also be required to certify that the relevant industry Codes were of an appropriate standard.

Benefits

The benefits of option 2 include:

- a market-led solution to improve consumer protection;
- possibility of improvement in selling practices by some travel agents and tour operators through strengthened requirements on disclosure information;
- consumers have access to an independent, impartial and low cost method of redress through the FOS.

Benefits arising from this measure can be quantified if we assume that, under the status quo, mis-selling can lead to some consumers buying policies that are of reduced value since they

will become void in certain situations. However, under Option 2, this effect will be decreased through raised selling standards. Compliance with industry self-regulation is unlikely to be 100%, but there will be access to the FOS in circumstances where the consumer feels that mis-selling has been responsible for a claim being rejected. This will only be the case where the firm selling the travel insurance is the member of a relevant trade association.

Making the simplifying assumptions that:

- travel firms sell 24% of travel insurance policies out of a total market worth £670m;
- 80% of these sales are made by firms within the membership of a relevant trade association;
- 25% of these policies are mis-sold;
- mis-selling leads to an average reduction in value of the policy of 50%;

the total quantifiable benefits arising from this option are £16.08m per year.

The level of mis-selling is an estimate based on the evidence provided to the review from a number of organisations including ABTA, the British Insurance Brokers' Association and *Which?*. The estimate around the loss of value of a travel insurance policy is a best estimate, given that no firm data is available.

The estimate above is sensitive to the assumptions used. The following gives an idea of how the numbers would be affected by changing some of the assumptions:

- If travel firms' share of the market was 40% the total benefit would be £26.8m per year. If travel firms' share of the market was 10% the total benefit would be £6.72m per year;
- If 50% of policies sold by travel firms are mis-sold the total benefit would be £32.16m. If 10% are mis-sold the total benefit would be £6.72m;
- If mis-selling leads to an average reduction of 75% in the value to the consumer of the policy the total benefit would be £24.12m. If mis-selling leads to an average reduction of 25% in the value to the consumer of the policy the total benefit would be £8.04m.

This estimate uses the total value of travel insurance premiums underwritten by insurers as the starting point for calculating the benefits arising from Option 2. An alternative methodology would be to look at the total value of lost claims arising from mis-selling of travel insurance sold alongside a holiday.

Assuming that:

- 21m travel insurance policies are sold annually;
- 24% of these policies (i.e. 5.04m) are sold by travel firms;
- 80% of these sales are made by firms within the membership of a relevant trade association;

- 4% of these policies are claimed upon;
- 25% of these claims are rejected on the basis of mis-selling;
- the average claim size is £388;

the total quantifiable benefits arising from this option are £15.65m per year, in terms of the value to consumers of the lower likelihood of a claim being rejected due to mis-selling, given the likely improvement in selling standards, and access to the FOS where consumers have been mis-sold a policy.

The estimate above is sensitive to the assumptions used. It is possible to consider the effect if some of the variables move:

- If 2% of policies are claimed upon the total benefit would be £9.78m. If 6% of policies are claimed upon the total benefit would be £29.33m;
- If only 10% of these claims are rejected on the basis of mis-selling the total benefit would be £7.82m. If 50% of these claims are rejected due to mis-selling the total benefit would be £39.12m;
- If the average size of a rejected claim were £200 the total benefit would be £10.08m. If the average size of a rejected claim were £615 the total benefit would be £31.0m.

There are some risks associated with this approach. First, there is a risk that using average claims sizes undervalues the role of insurance as a tool for managing risk. A key role of travel insurance is to provide protection against a heavy financial loss (for instance costs incurred relating to hospital treatment whilst abroad). Using average claims sizes fails to pick up the value of this protection.

Second, it is possible that claims rejected due to mis-selling are likely, on average, to be larger than the total average claims size. This could be the case if mis-selling is more likely to occur in regard of medical conditions, and hence claims rejected are more likely to be for medical expenses. ABI data shows that the average claim for medical expenses is £615 compared to the overall average of £388. Whilst no evidence has been presented directly on this point, the *Which?* and BIBA evidence does highlight specific problems relating to mis-selling regarding the disclosure of pre-existing medical questions.

Costs

The exact nature of the costs associated with Option 2 would depend entirely on the nature of the industry self-regulation. Broadly, these costs can be disaggregated into:

- one-off direct costs – such as the costs to trade associations of introducing new self-regulation or rewriting existing requirements;
- ongoing direct costs – such as the costs to trade associations of monitoring and enforcing the strengthened industry self-regulation. These costs would usually be passed to firms through increased Membership fees (perhaps specifically aimed at those selling insurance). These costs also include the cost of taking disputes to the FOS through an annual levy or per case fee (or combination of both);

- ongoing indirect costs - the incremental cost to firms of compliance with the strengthened requirements, for instance the cost of ensuring the adequate provision of key disclosure information to all consumers.

It is difficult to say with any degree of certainty what these costs will be. However, it is possible to make some best estimates.

The incremental one-off costs might be quite small, given that some form of industry self-regulation is already in place. Strengthening these requirements might cost travel trade associations in the region of £0.1 – 0.2m in terms of rewriting and reprinting Codes of Practice and marketing new features to their Members.

However it seems reasonable that ongoing direct costs, in particular the costs of adequately enforcing and monitoring any credible industry-led scheme, would be significant, **perhaps in the range of £0.2 - 0.5m per year.**

Additionally, it also seems reasonable that the ongoing indirect costs would be significant, given the concerns around the level of selling standards by travel firms. Assuming that:

- travel firms sell 24% of travel insurance policies out of a total of 20m sales per year;
- improved selling standards would impose a cost on firms, in terms of the extra staff time taken to make the sale and the managerial cost of ensuring that firms are complying with the increased requirements (perhaps in the range of 10 – 20p per policy sold);

the ongoing indirect costs associated with this option would be in the range of £0.48 - 0.96m per year.

On this basis, the ongoing costs associated with this option would be in the range of £0.68m - £1.46m per year.

A major limitation associated with this option is that travel firms outside of trade association membership would not be required to comply with any non-statutory requirements. ABTA Member firms are responsible for the sale of around 80% of all package holidays sold in the UK⁹. Additionally, trade associations' ultimate sanction is only to expel the firm from membership of the trade association. It is possible therefore that there might be a regulatory arbitrage effect, where firms decide to relinquish membership of trade associations that have signed up to the strengthened industry self-regulation, leading to a reduction in overall consumer protection.

OPTION 3 – COSTS AND BENEFITS

This option involves giving the FSA responsibility for regulating the selling of travel insurance sold along with a holiday or other related travel. This would mean that all firms would require authorisation to sell travel insurance no matter what the distribution method used. Firms would be responsible for meeting high-level principles set by the FSA as well as any conduct of business rules. Consumers would have full access to the FOS as a method of redress and access to the Financial Services Compensation Scheme (FSCS) in the event of an insurer/travel agent insolvency in

⁹ Source: *ABTA Travel Statistics and Trends 2005*

relation to travel insurance, assuming that the FSA continues to give the FOS jurisdiction in relation to all regulated activities.

This option involves maintaining an exemption from regulation for insurance sales by event management firms – in respect of commercial customers - and car hire firms. The call for evidence and consultation stages provided no evidence of consumer detriment arising from these sales.

Benefits

The benefits of option 3 include:

- FSA regulation would require firms to meet the FSA's high-level principles for conducting business, for instance on treating customers fairly, as well as meeting any rules or guidance issued by the FSA. At present, authorised firms selling insurance are required to comply with the FSA's Insurance: Conduct of Business (ICOB) rules, especially on clear disclosure information. This means that firms need to ensure a high-standard in selling insurance, reducing the potential of consumer detriment through mis-selling;
- subject to FSA proposals, consumers would also get increased consumer protection through:
 - access to the FOS in the event of a dispute concerning the selling of travel insurance, rather than having to rely on: a) an industry trade body dispute resolution scheme (sometimes perceived as being inadequate or against the consumer); or, b) taking the travel agent or tour operator to court;
 - access to the FSCS in respect of the travel insurance policy if a travel agent or tour operator becomes insolvent (although any benefit to the consumer would be limited to the FSCS covering payments resulting from outstanding FOS disputes, in circumstances where travel firms' insurance sales are currently made on a 'risk transfer' basis, i.e. the insurer will cover any risks from the time that the consumer pays the premium to the travel firm);
- more transparent information and moving away from an inertia (bundled) sale could have a positive impact on consumers if it encourages them to shop around and seek the best policy in terms of coverage and price;
- a core baseline of statutory protection for consumers when buying travel insurance, irrespective of the distribution channel. There is evidence of consumer confusion regarding what protections are available when buying essentially the same type of insurance. The results of BIBA's consumer survey indicate that 54% of consumers believe that all sellers of travel insurance are currently covered by the same regulations. However, it should be noted that it will be up to the

FSA to determine how best to regulate the selling of travel insurance through different distribution channels;

- there is likely to be a benefit to regulated travel insurers and insurance intermediaries through some levelling of the cost base across the market.

In this way FSA regulation goes further than the requirements of the UCPD. A major limitation of the protection afforded by implementation of the UCPD is that it does not offer guaranteed access to the FOS, or to the FSCS. Such access could only be achieved through primary legislation. Additionally, the Government does not believe that enforcement of implementing regulations by the OFT would be comparable to enforcement by FSA under option 3, given the relative complexity of travel insurance as a product and financial services in general. The FSA is the single unified regulator for financial services and has the greatest experience in regulating the selling of insurance products, whether by financial services firms or by firms for whom selling insurance is a secondary activity.

The FSA's approach to the implementation of the UCPD in financial services is that it does not see the need for additional rules because its Handbook already sets out principles and rules which have the same effect as the Directive. The FSA has also stated that where feasible, they will seek deregulatory measures made possible as a result of the implementation of UCPD to remove any duplication¹⁰.

Benefits arising from this measure can be quantified if we assume that, under the status quo, mis-selling can lead to some consumers buying policies that are of reduced value since they will not respond in certain situations. Under FSA regulation, this effect is diminished through raised selling standards. As with option 2, compliance with FSA regulation is unlikely to reach 100%. But it is plausible to imagine that compliance will be higher than under option 2, given for instance the enforcement and monitoring capabilities of the FSA compared to trade associations. And access to the FOS will allow consumers to seek redress where they feel that mis-selling has led to a claim being rejected.

Assuming that:

- travel firms sell 24% of travel insurance policies out of a total market worth £670m;
- 25% of these policies are mis-sold;
- mis-selling leads to an average reduction in value of the policy of 50%;

the total quantifiable benefits arising from this option are £20.1m per year, given the likely improvement in selling standards and access to the FOS where consumers have been mis-sold a policy.

As with Option 2, the level of mis-selling is an estimate based on the evidence provided to the review from a number of organisations including ABTA, the British Insurance Brokers' Association and *Which?*. The estimate around the loss of value of a travel insurance policy is a best estimate, given that no firm data is available.

¹⁰ See http://www.fsa.gov.uk/pubs/policy/ps07_06.pdf

The estimate above is sensitive to the assumptions used. The following gives an idea of how the numbers would be affected by changing some of the assumptions:

- If travel firms' share of the market was 40% the total benefit would be £33.5m per year. If travel firms' share of the market was 10% the total benefit would be £8.4m per year;
- If 50% of policies sold by travel firms are mis-sold the total benefit would be £40.2m. If 10% are mis-sold the total benefit would be £8.04m;
- If mis-selling leads to an average reduction of 75% in the value to the consumer of the policy the total benefit would be £30.15m. If mis-selling leads to an average reduction of 25% in the value to the consumer of the policy the total benefit would be £10.05m.

This estimate uses the total value of travel insurance premiums underwritten by insurers as the starting point for calculating the benefits arising from this measure. An alternative methodology would be to look at the total value of lost claims arising from mis-selling of travel insurance sold alongside a holiday.

Assuming that:

- 21m travel insurance policies are sold annually;
- 24% of these policies (i.e. 5.04m) are sold by travel firms;
- 4% of these policies are claimed upon;
- 25% of these claims are rejected on the basis of mis-selling;
- the average claim size is £388;

the total quantifiable benefits arising from this option are £19.56m per year, in terms of the value to consumers of the lower likelihood of a claim being rejected due to mis-selling, given the likely improvement in selling standards, and access to the FOS where consumers have been mis-sold a policy.

The estimate above is sensitive to the assumptions used. It is possible to consider the effect if some of the variables move:

- If 2% of policies are claimed upon the total benefit would be £9.78m. If 6% of policies are claimed upon the total benefit would be £29.33m;
- If only 10% of these claims are rejected on the basis of mis-selling the total benefit would be £7.82m. If 50% of these claims are rejected due to mis-selling the total benefit would be £39.12m;
- If the average size of a rejected claim were £200 the total benefit would be £10.08m. If the average size of a rejected claim were £615 the total benefit would be £31.0m.

There are some risks associated with this approach. First, there is a risk that using average claims sizes undervalues the role of insurance as a tool for managing risk. A key role of travel insurance is to provide protection against a heavy financial loss (for

instance costs incurred relating to hospital treatment whilst abroad). Using average claims sizes fails to pick up the value of this protection.

Second, it is possible that claims rejected due to mis-selling are likely, on average, to be larger than the total average claims size. This could be the case if mis-selling is more likely to occur in regard of medical conditions, and hence claims rejected are more likely to be for medical expenses. ABI data shows that the average claim for medical expenses is £615 compared to the overall average of £388. Whilst no evidence has been presented directly on this point, the *Which?* and BIBA evidence does highlight specific problems relating to mis-selling regarding the disclosure of pre-existing medical questions.

Costs

There are various monetary costs associated with being regulated by the FSA¹¹. These costs are a matter for the FSA to determine, subject to the statutory requirements on the FSA to conduct cost-benefit and market failure analysis and to consult publicly before introducing new rules. In the examples given below, FSA fees for general insurance intermediaries are used as a guide, although the FSA is able to set up a different fee regime specifically for travel firms.

As well as its own fees, the FSA invoices on behalf of the FSCS and the FOS. The FSA charges firms:

- periodic fees (paid yearly), which provide most of the funding needed to carry out its statutory duties;
- application fees, which recover some of the costs of processing certain applications under its rules or FSMA;
- special project fees where activity is undertaken at the request of fee-payers.

The amount a firm pays as an annual fee depends on its potential impact on the FSA's statutory objectives. The FSA uses an appropriate size of business measure in each fee block as a proxy for potential impact. In general this means that the larger the firm is the more it has to pay. Application fees for authorisation are based on the complexity of the application, which is a product of the permission being applied for. More information on fees is available from the FSA's website: www.fsa.gov.uk.

The initial direct cost of FSA regulation

The FSA will charge a flat authorisation fee of £1500 for general insurance intermediaries in the financial year 2007/08¹². Although there are no definitive figures for the number of travel agents, there are around 1600 ABTA Members. It also appears fair to assume that there are at least as many non-ABTA travel firms. Assuming therefore that there are around 3,200 travel agents and tour operators, in the hypothetical case that all of these firms sought authorisation **the maximum initial cost would be around £4.8 million for the industry as a whole.**

¹¹ The latest on FSA fees is set out in the FSA's consultation paper 07/3 *'Regulatory fees and levies 2007/08'*, published in February 2007.

¹² See FEES 3 Annex 1R: *Authorisation fees payable* of the FSA's Handbook.

Ongoing costs

The FSA also charges firms a periodic fee to cover the ongoing costs of its regulation. This is based on: (i) the regulated activities that the firm undertakes; and (ii) the amount of business related to its regulated activities¹³.

The FSA's fee structure for general insurance intermediaries is based on a minimum fee plus a sliding scale of additional fees based on turnover from regulated activities. The minimum fee for general insurance intermediaries with an annual turnover from regulated activities of under £100,000 will be £410 for the financial year 2007/08. For additional fees the sliding scale is:

- for the firm's annual turnover from regulated activities from £100,000 to £1m an additional fee of £3.88 per £1000 income from regulated activities is payable
- from £1m to £5m an additional periodic fee of £3.39 per £1000 income from regulated activities is payable;
- from £5m to £15m a further additional fee of £2.45 per £1000 income from regulated activities is payable;
- from £15m to £100m a further additional fee of £0.98 per £1000 income from regulated activities is payable;
- and above £100m a further additional fee of £0.40 per £1000 income from regulated activities is payable.

ABTA figures show the following for the size and distribution of its members:

- £100m plus: 51 firms with total turnover of £21,556m;
- £50m – £100m: 28 firms with total turnover of £1,957m;
- £15m - £50m: 135 firms with total turnover of £3,621m;
- up to £15m: 1329 firms with total turnover of £3,755m.

So, assuming that:

- travel firms sell 24% of travel insurance policies out of a total market worth £670m;
- travel firms earned, on average, 20% commission on each insurance policy sold;
- all ABTA's member firms become authorised, along with 1600 non-ABTA members;

¹³ For firms carrying out general insurance intermediation, this is the net amount retained by the firm of all brokerages, fees, commissions and other related income (e.g. administration charges, overrides, profit shares) due to the firm in respect of or in relation to insurance mediation activity. See FEES 4 Annex 1R *Activity groups, tariff bases and valuation dates applicable* of the FSA's Handbook.

the total direct cost of ongoing regulation would be £1.37m per year or 27 pence per policy. This estimate is based on an average firm and does not take into account the different sizes of firms within the turnover brackets outlined above.

The numbers above are sensitive to the assumptions used. The following gives an idea of how the numbers would be affected by changing some of the assumptions:

- If the number of non-ABTA firms was instead 3,200, the total ongoing direct cost of FSA regulation would be £1.99m per year or 40 pence per policy sold;
- If the commission travel firms earned on travel insurance was 5% instead of 20% then the total direct cost of ongoing regulation would be £1.31m or 26 pence per policy sold. If commission was 40% then the total direct cost of ongoing regulation would be £1.45m or 29 pence per policy sold;
- If travel firms were responsible for 50% of all travel insurance sales then the total cost of ongoing regulation would be £1.45m or 14 pence per policy sold. If they were responsible for 15% of all travel insurance sales the total cost of ongoing regulation would be £1.34m or 43 pence per policy sold.

Some responses to the consultation suggested that assuming an average commission level of 20% from travel firms' insurance sales was a significant underestimate of the true level. However the sensitivity analysis indicates that the costs estimates are relatively insensitive to changes in the commission level.

The indirect cost of FSA regulation

The indirect cost of FSA regulation is uncertain and would depend on the regulatory regime that was introduced by the FSA and how firms who decided to get authorised adapted to the new regulation. It is likely that the indirect costs would be significantly more than the direct costs and would primarily comprise compliance costs for firms under the FSA regime. Estimates would depend on the regime that the FSA decided to introduce. The FSA are looking, as part of the current review of their Insurance: Conduct of Business (ICOB) rules, to move towards a more principles-based style of regulation for the majority of general insurance products, which will allow firms more freedom in the way they interpret and implement the high-level standards set by the FSA.

On introducing the general insurance regime the FSA undertook a cost-benefit analysis of the impact of its ICOB Rules. This was undertaken by NERA and set out in the publication: "*Estimated compliance costs of conduct of business regulation for general insurance*".

This report estimated costs associated with ICOB of £197.4 million one-off plus £163.9m ongoing (annually). Costs associated with minimum Directive requirements (arising from notably the Distance Marketing Directive (DMD) and the Insurance Mediation Directive (IMD)) were estimated at £179.9m in one-off costs and £143.8m annually. It should be noted that IMD requirements would not necessarily be applicable to firms selling travel insurance along with a holiday since these sales are exempt from the Directive.

The NERA figures are based on a population of 45,220 firms selling insurance.

Uprating for inflation, and assuming the FSA introduces the same ICOB rules as estimated in the NERA report, this means that the initial indirect cost per firm was in the order of £4,750, while ongoing costs would be in the region of around £4,000. There are likely to be other indirect costs associated with being regulated – for example, authorisation costs, training and competence costs, although there is likely to be some overlap in costs. Importantly, the FSA's recent review of the selling of general insurance is proposing removing many of the ICOB rules, which may lead to cost reductions for firms.

Assuming there are 3,200 travel firms, and all of these firms seek FSA authorisation, this would result in indirect one-off costs of £15.2m and ongoing costs of £12.8m (£2.54 per policy sold, assuming travel firms sell around a quarter of all travel policies).

However, academic research¹⁴ suggests that the indirect costs of FSA regulation might be around four times the direct costs. Given the direct costs outlined above, this would suggest a one-off indirect cost to travel firms of around £19.2m and on-going annual indirect costs of £5.48m.

Indirect costs imposed by FSA regulation will not all be additional costs. Travel firms should already be providing staff training and firms that are members of a trade association, such as ABTA, will need to comply with its rules. It is also worth pointing out that, under the requirements of the Distance Marketing Directive¹⁵ (DMD), where travel firms make a 'distance' insurance sale, for example, over the telephone or on the internet, they are already required to provide the consumer with certain information, including a description of the main characteristics of the product.

Costs where not all travel firms seek FSA authorisation

It would of course be for travel firms to decide whether or not to become authorised to continue to sell travel insurance and **in practice it is highly unlikely that all travel firms will seek FSA authorisation following the implementation of this measure.**

Other routes available to travel firms would be to become either an Appointed Representative or an Introducer Appointed Representative (IAR) of an insurer or an insurance intermediary. Travel agents and tour operators could also look to team up with others selling insurance services to ensure insurance is still offered to their customers or simply provide information to consumers. Under this option it is not possible to determine how many travel firms will go down the Appointed Representatives route, although anecdotal evidence suggests that some are actively considering it.

The Appointed Representatives route is generally seen as a lower cost way for firms to ensure regulatory compliance without becoming directly authorised by the FSA. The IAR route is similar in structure to the Appointed Representative route, however Agents (i.e. travel firms) are only allowed to introduce clients to the Principal or to distribute certain forms of financial promotions (such as press or internet advertising)

¹⁴ "The direct and compliance costs of financial regulation" Franks, Schaefer and Staunton, Journal of Banking & Finance, Volume 21, Issues 11-12, December 1997

¹⁵ Implemented in the UK by SI 2004 No. 2095: The Financial Services (Distance Marketing) Regulations 2004.

relating to its Principal's products. Another option would be for the travel firm to undertake an 'introducer' role, whereby the travel firm simply directs the individual to a regulated intermediary or insurer in return for a fee from the regulated firm. **The number of firms actually seeking FSA authorisation may actually turn out to be quite low given these alternative routes available.**

Assuming that: (i) 5% of travel firms seek FSA authorisation; 15% become Appointed Representatives (AR); 40% become IARs; and, 40% either make use of the Article 72C exemption to act as unregulated 'introducers' or curtail their insurance activities altogether; and, (ii) the cost of becoming an AR is 75% of the total direct and ongoing costs under FSA authorisation and the cost of becoming an IAR is 50% of the total ongoing costs under FSA authorisation:

- there will be a total direct one-off cost to travel firms of £1.74m;
- there will be a total direct ongoing cost to travel firms of £0.50m per year;
- there will be total indirect one-off costs to travel firms in a range of £5.51m and £6.96m;
- there will be total indirect ongoing annual costs in a range of £1.99m and £4.64m.

This suggests that the total costs to travel firms following the introduction of FSA regulation amount to one-off costs of between £7.25m and £8.7m and ongoing annual costs of between £2.48m and £5.14m. **These costs are sensitive to the assumptions made and would depend on the nature of the regime the FSA decide to introduce.**

It is not possible at this stage to split the costs associated with this option into policy compliance costs and administrative burdens. This will only be possible when the FSA has indicated the regime that it intends to apply. At this point in time, the Government expects that policy compliance costs (such as the costs of ensuring that the details of insurance policies are disclosed in a fair and transparent way, FSA authorisation fees, FOS case fees) will constitute a higher proportion of total costs than administrative burdens.

Subject to the underlying assumptions, these figures for the costs of regulation are maximum figures as it is likely that the introduction of regulation will cause firms to alter their business models.

Additional costs

Other costs associated with regulation include:

- **Financial Services Compensation Scheme** - the FSCS is funded by levies on firms authorised by the FSA. For levying purposes, FSCS business is split into sub-schemes, including one for insurance mediation (from 14 January 2005). For each sub-scheme there are one or more contribution groups, based on the "fee blocks" used by the FSA for allocating its own fees to regulated firms. Firms are allocated to a contribution group (or groups) according to their regulated permissions, i.e. the type of business they are authorised to

transact¹⁶. There are limits to the amounts FSCS can levy in a financial year. For compensation payments the limit for general insurance intermediaries is currently 0.8% of annual eligible income (from regulated activities). It is estimated that travel firms' income from selling travel insurance policies is around £19.5m, **which would indicate that the maximum contribution from regulated travel firms in any one year to the FSCS would be £156,000** – although this is an upper limit and is only likely to be reached following several firm failures in that specific contribution group. The FSA is currently reviewing the funding of the FSCS and has proposed an increase in the maximum levy payable by insurance intermediaries, to 3.5%¹⁷. If this is adopted, the maximum levy payable would rise to £682,500 across regulated travel firms;

- **Financial Ombudsman Service** - there is an annual fee for access to the FOS. This is currently £50 for general insurance mediation. Each firm is not charged a case fee for the first two disputes in each year for which the FOS are required to reach a decision. For additional cases, charges are levied at £400 per case no matter what the outcome of the complaint. There will be additional costs to travel firms wherever the FOS makes an award to the consumer on the basis of a mis-selling complaint.

Second round effects

It has also been argued that regulation might lead to a loss of claims handling services and advice on the suitability of the product that may currently be provided by travel firms.

Where travel firms decide to become an Appointed Representative of a regulated firm there will also be additional indirect and ongoing costs on the authorised firm. However, authorised firms are only likely to enter into an Appointed Representative agreement where this is in the firms' best interests, for instance where they believe that the increase in premium income brought about by the activities of the Appointed Representative will more than compensate for these costs.

It is possible that these costs may be passed onto the consumer through travel firms charging higher premiums. It is also possible that some travel firms might stop selling insurance altogether, given the increased costs of regulation. This could have a negative impact in terms of its impact on the number of people taking out insurance for trips abroad. The consultation unearthed differing views amongst some stakeholders over the extent to which this measure might impact upon the level of those travelling uninsured. Some responses suggested that the impact would be significant, with one respondent suggesting a rise in percentage terms from a current estimate of 13% to around 20%. However, other respondents felt that any impact would be negligible.

The UK has a very well developed stand-alone travel insurance market across several distribution channels including telephone sales, internet sales and face-to-face sales by insurance brokers. Many travel firms would remain under an obligation under the

¹⁶ Full details of the funding rules for FSCS are available in the FSA's Handbook.

¹⁷ See the FSA's *Consultation Paper 07/5: Financial Services Compensation Scheme Funding Review* at http://www.fsa.gov.uk/pages/library/policy/cp/2007/07_05.shtml. The consultation period closed on 20 June 2007.

Package Travel Directive to provide information on the availability of travel insurance, so even if full FSA authorisation is inappropriate they are likely to consider the alternative options including the Appointed Representatives route, the IAR route, or taking advantage of the exemption in article 72C of the Regulated Activities Order to team up with insurers and/or brokers to provide information on insurance to their customers. **Given these alternative options, and consumers' ability to access the stand-alone travel insurance market, the Government is confident that any impact upon the aggregate level of those travelling uninsured will not be substantial.**

There may be a further cost to travel firms who stop selling insurance through lost profit streams that had been provided through insurance sales. Alternatively there may be a lost profit stream for travel firms who decide to take the IAR or unregulated introducer route, given that any commission earned through these routes is likely to be lower than the commission level where the firm makes the sale independently. It is not possible to quantify this effect. Responses to the call for evidence suggested that many travel firms make only a small margin from sales of insurance alongside a holiday and so it seems reasonable to assume that, if firms do stop selling insurance products as a result of this decision, this will not have a large impact on the profitability of the sector. Some responses to the consultation stage offered the view that, in fact, many travel firms (and especially travel agents, as opposed to tour operators) earn a substantial level of commission from travel insurance sales. There may, however, be an opportunity for travel firms to offset any lost income by advertising or introducing travel insurance.

Research by the Association of British Insurers¹⁸ looking at the overall costs and benefits of general insurance regulation concluded that regulation has had a positive effect for customers who purchase insurance alongside other goods or services.

Impact on small firms

Some responses to the call for evidence stage and the consultation stage argued that smaller travel firms would be less able to meet the additional costs imposed by a requirement for travel firms selling travel insurance to be regulated.

It is likely that smaller firms will be less likely to seek FSA authorisation. Instead it is likely that they will look for alternative methods of providing insurance services, either through becoming an Appointed Representative or an IAR of a regulated firm or by undertaking an unregulated introducer role. Some responses to the consultation stage also noted that smaller travel firms might be less able to make use of the Appointed Representatives route. This is because capacity within the regulated sector to accept agents in an Appointed Representative relationship is constrained due to the increased compliance costs and regulatory risks. Given this constraint it is likely that larger travel firms will be more attractive to regulated firms, given the potential for larger increases in revenue for the regulated firm. However, the Government believes that the benefits afforded by proper consumer protection, coupled with these options for travel firms to continue providing insurance services, justify seeking to have the selling of travel insurance products taking place in a regulated environment.

Impact on competition

It has been argued that a requirement for the selling of travel insurance alongside a holiday to be regulated would lead to fewer firms selling travel insurance, and hence

¹⁸ *The Regulation of General Insurance Sales: One Year On*, March 2006.

lower competition in this area. However it can also be argued that inertia sales inhibit competition as they discourage individuals from shopping around to find the most appropriate product.

The UK's travel insurance market is widely regarded as being competitive and presents an obvious alternative route for consumers to purchase cover, should the number of travel firms selling insurance shrink. These firms would also have the opportunity to introduce customers to brokers and insurers who sell travel insurance. On this basis, the Government does not consider that the introduction of regulation for the selling of travel insurance sold alongside a holiday would adversely affect competition.

Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No