To: Filtering Group

Date: 21 July 2005

From: [redacted]
Retail Intelligence & Regulatory Themes

cc: [redacted]
Stuart King

Subject: **F0057 – Buildings insurance – levels of premiums charged to leaseholders**

Introduction

1. In January 2005, Filtering Group considered a referral about concerns that insurance broking firms and property managing agents were over inflating charges relating to building insurance for leasehold blocks of flats.

2. Filtering Group agreed that a small piece of work should be undertaken to assess the scale of the issue, but that this work should be delayed until FSA insurance regulation had been in place for some months. This delay would allow for the possibility of identifying breaches after regulation had commenced.

3. It was agreed that initially a fleet of foot market research exercise would be undertaken to assess how pervasive the problem is. A further piece of work was also undertaken which involved a targeted investigation of firms on which the FSA had received intelligence indicating they may have conducted this activity in the past. This paper will address these points, but will begin by describing the leasehold market structure and how FSA rules might apply in this market.

4. Filtering Group should be aware that Clive Briault has received several letters from individuals and at least two letters from MPs asking him what the FSA is doing in relation to this issue. [redacted]

Why over inflating premiums may occur

5. With leasehold flats, the freeholder or his appointed property managing agent, usually decides which building insurance contract to purchase. Property law then allows the freeholder to claim reimbursement for the cost of the building insurance from the leaseholders.

6. Property law creates a market structure that provides a freeholder with a monopoly position over leaseholders in relation to service charges, including building insurance. As the freeholder does not have to pay for the cost of building insurance, he or she does not have a financial incentive to ensure that the cost of insurance is minimised.

7. Insurance intermediaries, including both general insurance brokers and property managing agents, can financially benefit from this market structure in several ways. An insurance intermediary may increase its charges in relation to the contract when it sells the contract to the freeholder because the intermediary knows that the structure of the leasehold property market means that the freeholder is unlikely to be very price sensitive when it comes to choosing a particular buildings insurance contract.

8. In the above scenario, instead of just one insurance intermediary benefiting from a freeholders lack of price sensitivity, a chain of intermediaries could each benefit. For example, there could be five intermediaries each inflating the cost of the policy by ten percent. Ten percent per intermediary may not seem excessive, but the cumulative effect over five intermediaries leads to a total inflated policy cost of over sixty percent. If free market forces were fully operative a freeholder might choose to buy a policy from a shorter chain of intermediaries to save on costs, but in this market the freeholder has little incentive to shop around for the best price.

9. Insurance intermediaries may have delegated authority from a product provider which allows the intermediary to issue insurance contracts without the provider having first seen that contract. An intermediary with delegated authority could fraudulently increase the amount of the policy premium on an insurance contract and pass on this extra cost to freeholders (and therefore indirectly to leaseholders) and take the difference as profit. This activity would mean the intermediary could avoid paying tax on this profit and it could also avoid paying the appropriate level of Insurance Premium Tax (IPT)). This situation should not be able to occur on a systematic basis as product providers should have systems and controls in place to ensure that any delegated authority it allows is not misused.

10. Freeholders may own all of or part of an insurance intermediary firm. A freeholder can legally employ their own firm to provide services for their leasehold blocks of flats. In this situation, a freeholder would be able to directly profit from charging leaseholders inflated insurance premiums.

11. It is possible in some cases for leaseholders to form a 'right to manage' company that allows the leaseholders, via that company, to select their own property managing agents without the need for the freeholder's consent. This situation is not covered in this paper as in this scenario the leaseholders would be in a position to choose their own building insurance contract.

How FSA rules and principles may apply

12. Since 14 January 2005, the FSA has regulated general insurance activities, including the sale of buildings insurance for leasehold flats. ICOB rules define what information the customer of an insurance contract is entitled to receive. The information all retail customers are entitled to includes a policy summary, a statement of price and details of fees. Commercial customers are entitled sufficient information about the contract, details of premium and fees, and in addition details of commissions must be disclosed upon request. ICOB rules also state that insurance intermediaries must ensure that its charges to a retail customer are not excessive, but does not define excessive.

13. The application of FSA rules is dependent upon whether the leaseholders or the freeholder are determined to be the customer under ICOB in relation to the buildings insurance contract. It is not always clear from reading an insurance contract, who the customer of that contract is for ICOB purposes.

14. If a freeholder is the only policyholder on a building insurance contract, the freeholder will be the customer of the contract for ICOB purposes. In this situation, leaseholders would not have rights under ICOB.

15. If both the freeholder and the leaseholders are policyholders under the contract (i.e a group policy), under ICOB, the legal holder of the policy will be the customer owed the obligations under ICOB. For each insurance contract, legal opinion might be needed to determine who the legal holder is. If the legal holder is found to be the freeholder, then leaseholders may not be owed direct obligations under ICOB. If a particular leaseholder is determined to be the legal holder, then that individual would have rights under ICOB, but other leaseholders may not.

16. It is not known what proportion of buildings insurance contracts for leasehold flats only provide for the freeholder to be the sole policyholder under the contract. If it is found that most contracts only provide for the freeholders to be policyholders, the extent to which ICOB rules could help protect leaseholders would be very limited.

17. If leaseholders are policyholders but not the legal holder of the policy, FSA principles may still offer them some protection. In particular, regulated insurance intermediaries must abide by all FSA principles including Principles 6 (treating customers fairly), 7 (clear, fair and not misleading communications) and 8 (managing conflicts of interest). The exact nature of the action the FSA could take in this regard is outside the scope of this paper. If leaseholders are not policyholders Principle 1 (a firm must conduct its business with integrity) would apply and FSA could take action against the authorised intermediary if it was acting fraudulently by inflating the premium or giving misleading information on it. We could also take action against the insurer if the insurer knew the intermediary was acting fraudulently but continued to use it.

18. If firms were found to be mis-using delegated authority, the FSA could use its powers to censure, fine or deregulate intermediaries and product providers involved in this activity.

19. Some freeholders may be authorised persons if they act as an insurance intermediary (i.e. carry on regulated insurance mediation activities). This situation may occur for example if the freeholder is responsible for arranging insurance contracts by way of business. If a freeholder is an authorised person, the FSA could censure, fine or de-authorise this person if it found that person to be acting against FSA rules and principles.

20. If the FSA found that a firm was fraudulently producing insurance policy documents, we could take action against the firm.

21. If a freeholder purchased a policy that was over inflated because there were a lot of intermediaries involved each adding a fee to the over all cost of the policy, the extent to which FSA rules and principles could be used to protect leaseholders would be limited unless the fees were excessive and the customer was a retail customer. Also if

the freeholder owned significant shares in each of those intermediaries the Principles of Integrity and Customers' Interests might apply. If the intermediaries each receive commission, then this would not affect the premium, as commission comes out of the premium which is agreed with the insurer. Fees and other amounts in additional to the premium must be disclosed to both retail and commercial customers as fees.

Research activity findings

22. Filtering Group asked that leaseholder groups, including the Leasehold Advisory Service (LEASE), be contacted to establish how many complaints are being made in relation to the over inflating of insurance premiums.

23. Our discussions with trade bodies revealed that although LEASE and the Leaseholder Valuation Tribunal were aware of the problem, they could not provide us with any specific statistics and they could not provide us with any evidence that this practice has occurred since the FSA became responsible for the regulation of the general insurance market. We also contacted the Federation of Private Residents Associations and the Association of Residential Managing Agents (ARMA) who claimed to be unaware of this practice. Citizens Advice have no details on this area and Trading Standards have been asked to provide us with information in this regard, but have not yet responded to our request.

Targeted firm investigation findings

24. Filtering Group had received specific information relating to three property managing agents who may have been involved in over inflating the cost of building insurance contracts, possibly by the mis-use of delegated authority. These firms were [redacted] We investigated each of these allegations and our findings are outlined below.

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Additional conflicts of interest

35. During the course of our research into the business of managing leasehold flats, an additional area of conflict of interest came to our attention, although more conflicts of interest may be prevalent in the market than the one described below.

36. A conflict of interest arises when a property managing agent belongs to a group of companies that include a surveying firm. The potential for mis-conduct arises when a property managing agent pays above market rates to its associated surveying firm when it surveys leasehold properties. As by law freeholders can claim reimbursement for the cost of a building survey from leaseholders, the freeholder does not have a direct incentive to ensure that costs of building surveys are kept to a minimum.

37. One extension of this possible conflict of interest arises when property managing agents authorise unnecessary surveys of leasehold blocks of flats and these charges are then passed on to leaseholders.

38. These activities in themselves are not regulated by the FSA, but the firms engaging in these activities may be authorised firms. When these companies are regulated by the FSA, individuals and consumer protection bodies might expect the FSA to take action to protect them against this sort of activity.

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40. The extent to which the FSA in general can or would want to be involved in protecting customers in this regard would need to be considered further and is outside the scope of this paper.

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Why the issue might be bigger than it first seems

42. As stated at the start of this paper, in the case of leasehold flats, the freeholder, or his appointed property managing agent, usually decides which building insurance

contract to purchase. Property law then allows the freeholder to claim reimbursement for the cost of the building insurance from the leaseholders. This market structure may mean that leaseholders do not realise, either independently or as a collective group, that they may have rights under FSA rules and principles to complain about practices of insurance intermediaries.

43. If leaseholders are not considered to be the legal policy holder, their rights to information under ICOB about the level of premium, fees and commission relating to that contract are very limited. This means that leaseholders may not have access to details about how much intermediaries are inflating the cost of their building insurance policies. Without access to policy charges information, leaseholders may not be in a position to know whether they have a valid right to complain.

44. These points indicate that although the practice of artificially inflating buildings insurance premiums may still be prevalent in the market, it may go largely unreported.

Conclusions

45. The FSA has publicly stated that it is investigating the issue of firms over inflating the cost of building insurance contracts. As the FSA regulates firms involved in this activity, it needs to formulate and communicate its position in relation to this issue.

46. Property law is structured so that leaseholders are unable to choose their own building insurance policy. ICOB rules and FSA principles would afford leaseholders some protection if the leaseholders were named as legal policy holders, but only minimal protection could be provided to leaseholders if they are not named on building insurance contracts.

47. Although there is a wide scope for intermediaries to over inflate building insurance premiums due to the structure of the market, our initial findings indicate that incidences of this nature have not been widely reported to the industry bodies we contacted. We currently have no evidence that this practice has occurred since the FSA took over regulation of the general insurance market.

48. Our targeted investigation of firm findings indicates that insurance firms need to ensure that they are effectively managing their network of Appointed Representatives and conflicts of interests and that these firms must also ensure that they are treating customers fairly.

49. Our additional conflicts of interest findings indicate that there is potential for FSA authorised firms and authorised persons to manipulate their monopoly positions in relation to unauthorised business that leaseholders are then legally obliged to pay for, although widespread evidence of this occurring has not been found or sought as part of this piece of work.

Possible options for FSA to pursue

50. The FSA needs to take an active decision about how it is to take forward this piece of work. Several options are briefly outlined below. One of these options or a combination of them could be selected as the next steps of work to be taken in this area.

Take no further action

51. Our research has produced very few examples of property managing agents over inflating premiums. All of the examples we have seen predate FSA regulation. Our contact with leaseholder organisations has produced no evidence that this issue is widespread. Based on this lack of evidence it could be difficult to justify giving further resource to this issue.

52. However, our research has uncovered that there is potential for property managing agents to over inflate premiums. Our work has also highlighted other conflict of interest issues surrounding managing agents. There is the possibility that these practices are widespread, but leaseholders are either unaware that they are happening or do not know how to or do not want to complain about this situation. As this is a new area of regulation for the FSA it could be beneficial to do more work in order to gain a better understanding of how the property managing agent sector works.

53. With MPs writing to Clive, there is a reputational risk to the option of taking no further action because evidence of this type of activity could later be found to be widespread. Whilst our research to date has uncovered very little evidence of this practice, our investigations have not been exhaustive. If the issue is later shown to be significant, the FSA may be asked to justify why its investigations into this issue were not more thorough.

Send questionnaires to a sample of property managing agents

54. Although our initial research has not uncovered any evidence that the issue of property managing agents inflating premiums is widespread, our research has not been exhaustive. We currently regulate approximately 650 property managing agents, but this is a new area of regulation for the FSA. It could therefore be beneficial to send a questionnaire to a sample of these firms to find out more about their practices.

55. Sending questionnaires to a sample of firms could be a resource efficient way of gathering more information on market practices. The questionnaire could for example ask firms to explain how they obtain building insurance, how many firms are usually involved in the process of obtaining building insurance and what fee they usually charge for obtaining building insurance. We could also ask the firms to send in some examples of contracts for building insurance and copies of their service charge invoices.

56. In practice, it may be difficult to obtain all the relevant information we nay need from a questionnaire. Firm visits could be a more productive way of obtaining information from these firms.

Conduct visits to a sample of property managing agents

57. To understand better how property managing agents operate, one option is to undertake a sample of visits to some of these firms. These visits should provide us with a better understanding of the firms' business and give us the opportunity to discuss the area of building insurance in more detail.

58. Although more resource intensive than other options, the quality of information that we could uncover from these visits should be beneficial to our understanding of the processes these firms undertake to obtain building insurance. Following these visits we should be better able to assess the scale of this issue and the potential for consumer detriment.

59. As part of our research we could also visit ARMA to find out more about the standards they would expect from their members. As part of this visit we could discuss the processes their members go through to obtain building insurance for flats and discuss any areas of concerns they feel there may be in this area.

Wait for findings from Regional Brokers Team work

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61. An advantage of waiting until this work has been completed is that it might provide the FSA with more examples of malpractice in this area. These examples might provide evidence that the practice of over inflating premiums is widespread and the outcomes would then provide a basis on which to agree a further stream of work. If the work of the Regional Brokers team did not provide further evidence of malpractice in this area, then the FSA could decide that on a risk based approach no further work in this area would be required.

Ask supervisors to talk to their firms

62. All FSA supervisors of insurance intermediary and property managing agencies could be asked to specifically investigate how their firms are managing conflicts of interest and using delegate authorities. A small project team could be set up to collect and analyse these findings and that team could report back to Filtering with specific details of market practice in this area.

63. Many insurance intermediaries and property managing agents are small firms only supervised via the firm contact centre, so a large proportion of firms' would be excluded from these findings.

Liaise with OFT and government

64. FSA could set up a project team to liaise with the OFT and government (possibly the Office of the Deputy Prime Minster (OPDM)) on this issue. The OFT should be made aware of the potential unfair trading practices that may be occurring in the market that are not regulated business; government should be specifically informed of how the structure of property law may lead to customers being treated unfairly.

65. The FSA could work with these bodies to develop a co-ordinated response to the issues and discuss how FSA rules may be modified to better protect leaseholders in this situation. A fully integrated approach should ensure that all aspects of consumer protection are covered by those that are in a position to initiate change in this area, however the FSA might find that the OFT and government do not wish to participate in this programme of work.

Consider how FSA rules and guidance might be changed to offer leaseholders more protection

66. The FSA could consider initiating further work to investigate how rules and guidance could be amended to afford leaseholders more protection. This may involve investigating to what extent the FSA would want to regulate or issue guidance about unregulated activities (as the relationship between freeholders and leaseholders who are not named on policies is not covered under ICOB). The extent to which principles might allow leaseholders to be considered 'customers' would also need to be considered.

Recommendations

67. Due to the amount of correspondence we have received on this subject, we believe that the FSA should have a public line on this issue. This is because whilst our initial research has uncovered minimal evidence to cause us concern, our research has not been exhaustive; we cannot say with certainty that this practice is not widespread. Clive has received lots of correspondence on this issue, including MPs' letters, and if this practice is later found to be more pervasive than our initial research has shown, the FSA's reputation may be damaged.

68. This message should clarify the areas of this issue that do fall under the FSA's remit. This communication should also confirm that we have completed our initial work and that this suggests the practice is not widespread, but we are still checking our findings with other organisations. This message should reiterate that that where firms are accused of this practice, we will follow up on the accusation. The FSA could also say publicly whether we are carrying out further work in this area, while emphasising that certain areas of this issue may be outside the FSA's remit.

69. If further work is agreed in this area, we believe that we should emphasise to the property management agents the principal of treating customers fairly. We believe that as part of this work, we could liaise with ARMA to help communicate this message to these firms.

70. As not all of the areas in this issue are within the FSA's remit, we believe that we should contact the relevant external bodies (eg OFT and ODPM) to discuss how we could work together on this issue.

71. Filtering Group could initiate further work to investigate how rules and guidance might be amended to afford leaseholders more protection.

Does Filtering Group agree with these recommendations?