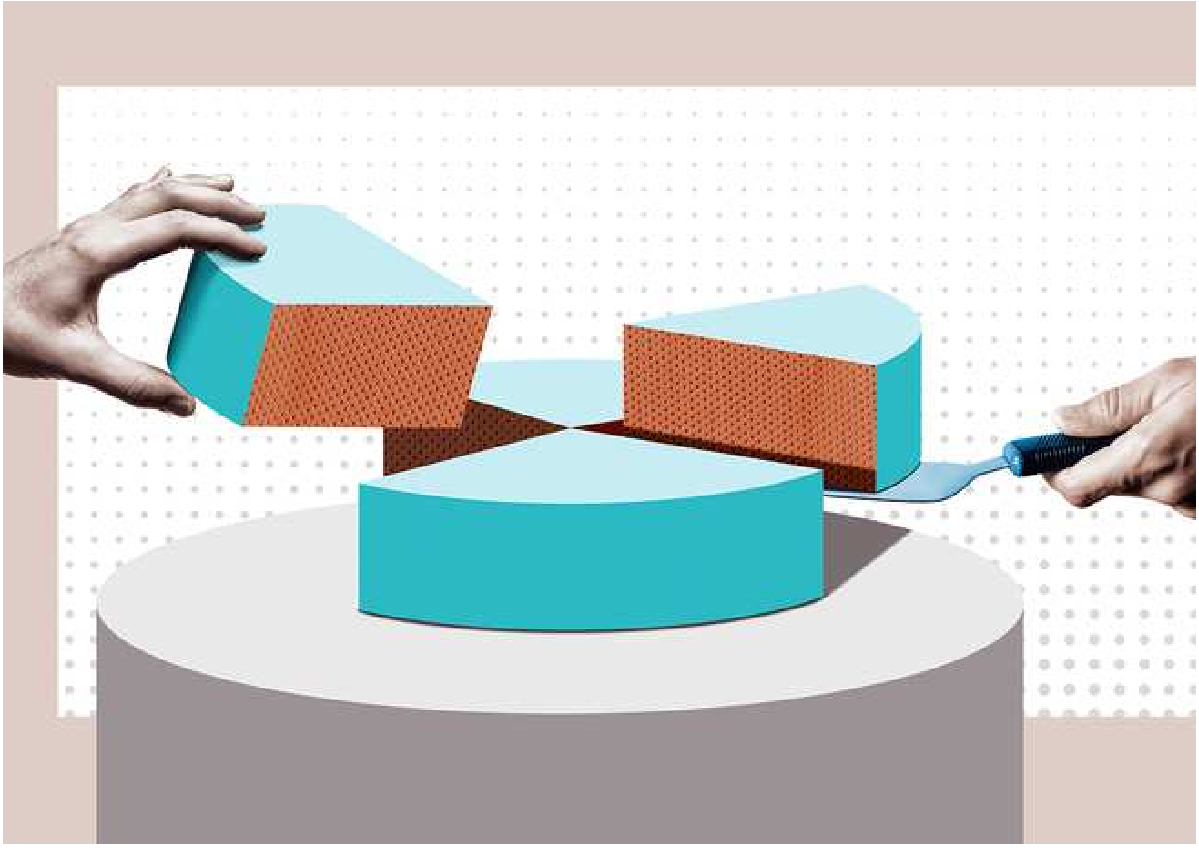
Thin end of the wedge – Could an FCA property commissions crackdown extend to all SME products?



Saxon East

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Indicative reading time: **8 minutes**

Could the government's plan to ban insurance commissions being taken by landlords, managing agents and freeholders on buildings insurance be extended to other lines? Saxon East looks at what might happen if this proves to be the start of something more far-reaching for the broking sector.

Tory big hitter Michael Gove has the insurance industry in his crosshairs. The Secretary of State for Levelling Up, Housing and Communities has vowed to ban insurance commissions being taken by landlords, managing agents and freeholders on buildings insurance.

The Conservative politician wants to help leaseholders with cladding who are faced with unaffordable premiums following the Grenfell Tower fire disaster in June 2017.

He sees insurance firms as a major part of the problem and has instructed the Financial Conduct Authority CEO Nikhil Rathi to get a grip on it. The regulator has been ordered to publish a review in March and then update him with an action plan by the summer.

Brokers are watching events closely. Any intervention on property commissions would be a big blow for brokers.

FCA executive director **Sheldon Mills admits a commission level ban** has been contemplated in its review of the property sector. The bigger fear is it could mark a thin end of the wedge scenario.

Once considered a distant possibility, the nightmare scenario of the FCA intervening on commissions throughout commercial insurance is now being talked about.

Advice at risk

Brokering CEO Stuart Randall still feels angry about what the FCA's predecessor, the Financial Services Authority, did on commissions for pension advice.

In 2010, the FSA announced its intention to ban financial advisers from taking commission on investments products such as individual savings accounts, life insurance and pensions.

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>
> **Stuart Randall**

The ban came into force in 2012 following the Retail Distribution Review, which concluded financial advisers were gripped by conflicts of interest, recommending products that offered them the juiciest commissions rather ones which served their customers best.

According to Randall, this has had a devastating impact on investment advice, driving people online where they are exposed to all the complexities of financial products without anyone to hold their hand.

Randall said he felt 'so angry' with the FSA's reforms to commissions that had impacted financial advisers.

“That goes against everything they’ve tried to do. It is the law of unintended consequences. It destroyed the [financial adviser] industry. It had to rise from the ashes in a slightly different form.”

Financial advisers pulled away from giving advice following the restrictions, leaving a gaping hole in service for financial products, Randall believes.

“The massive amount of administrative burden that they put on advisers, financially, it was not worth their while to give advice. The amount of work they had to do, which equated to half a tree [in paper work] to comply with the FCA, and combined with the reduction in commissions, meant it just wasn’t worth it.”

Clear Insurance non-executive director Ashwin Mistry echoes these concerns about commission caps.

“I think the larger insurance customers are commercially in tune with what needs to be done compared to your retail and domestic customer who is perhaps not so well-equipped. So I think that is the danger of starting to get involved in this area,” he commented.

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Ashwin Mistry

“It would just dissuade larger brokers to get involved in smaller end clients, and then you leave a massive vacuum. If you follow what has happened in financial services, those who need financial advice can’t even go to the bank because they are no longer providing that shop counter front advice.

“They have to make financial appointments, you have to go through professional advice, and that’s just dissuading people to take their finances seriously, and seek advice, because of the cost.”

Poor value SME products

To date, the FCA’s focus on poor value products is centred on personal lines.

There are signs though of a growing interest in commercial insurance. The regulator has already flagged its concern about certain micro-SME products, waving a big red flag around tradesman.

In 2019, the FCA reported brokers charging between 25% and 45% commission in this space. The FCA was particularly concerned about brokers layering the commission with administration charges, meaning in some cases they walked away with more than 50% of the premium.

Even worse, distributors throughout the insurance chain, such as wholesale brokers and MGAs, would also take away their own commissions and administration charges.

Those concerns on commercial insurance have only deepened with the regulator **now under immense pressure from Westminster** on property commissions and transparency.

In September last year, Simon Clarke, then the Secretary of State for Levelling Up, Housing & Communities, took aim at broker commission in a letter to British Insurance Brokers' Association CEO Steve White.

Clarke noted that an FCA probe on buildings had "brought to light disturbing evidence on remuneration practices".

30%

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He cited that broker commissions accounted for 30% of the premium and the average absolute value of commissions has more than tripled for brokers between 2016 and 2021.

The 261% rise took the mean to £4,690 per building, he stated: "In most cases the broker shares their commission with the managing agent/freeholder: in more than half of cases, these parties receive 50% or more of the commission given to the broker."

And declared: "It is unclear how these practices can be of any benefit to leaseholders."

With the FCA discovering such high commissions in property, they might probe all SME products to find commissions levels. However, there are reasons why the FCA might steer clear from intervention into commissions in property and other SME products.

Managing General Agents' Association CEO Mike Keating believes the regulator would need to unpick a lot of complexity, something which would be a time consuming and costly process.

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Mike Keating

Using the example of property insurance, he said: "If it is framed as commission, you need an absolute definition of commission.

"Let's say, and we'll make up a figure here, they cap it at 30 points, is that all remuneration including arrangement fee, mid-term adjustment?

"It is lifting a real rock in terms of what can come out underneath it interpretation wise. What are they going to do, spot checks and ask for returns from brokers who place property owners or associated products to attest to their revenues?"

Fair value agenda

This is where the FCA's whole onus on fair value comes into play. Brokers hope the FCA will address the issue of commissions in its fair value push, rather than opening up a separate Pandora's Box with commission caps and bans.

Fair value products for customers are at the centre of the Consumer Duty implementation. Insurance firms have filled in forms on all SME product lines to show they offer fair value.

Claims data has been published on a range of personal lines products, which brokers are expected to use as benchmarking to understand the suitability of placements.

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Partners & chairman Stuart Reid said: "Bearing in mind we have fair value and all the changes are coming in July, I think the FCA has more than enough in its toolkit to address unfair value."

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Compliance consultant Kenneth Underhill agreed: “The big picture is that the FCA are unlikely to want to mandate conditions or to ban them completely.

“The FCA had the biggest opportunity ever in 2004 with the Spitzer inquiry and it decided not to.

“I think that if they wanted to do that, then they wouldn’t have gone through the whole process of setting out fair value down the distribution chain. Because that was another opportunity.

“They’ve made it very clear to brokers and to insurers that the approach should be about fair value for customers. They are effectively happy with what is worked out and the payment between brokers and insurers, but they don’t want the customer getting a poor deal.”

A more likely outcome to emerge from all the current regulatory and political storm is greater transparency on commission payments.

Commission disclosure

At the heart of the battle on property commissions is leaseholders fighting to get full information on what remuneration is paid to intermediaries and those taking insurance payments in the property sector such as property managing agents, landlords and freeholders.

In March 2022, a property tribunal ordered Reich Insurance Group to hand over a spreadsheet with details on fees and commissions on a property estate managed by companies owned by Monaco-based billionaire property magnate Yiannakis ‘John’ Christodoulou.

Around the same time, the FCA expressed concerns in a ‘Dear CEO’ letter about hidden remuneration, stressing fairness to leaseholders should be taken into account. At present, across the SME sector, brokers only declare full commission and remuneration if requested by the client.

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Kenneth Underhill

It is possible that, once finished with the property commissions, the FCA demands much greater transparency on broking remuneration up front and without request from the client.

Clear's Mistry believes that might not be such a bad thing: "I'm just coming towards the end of the tax year for my company, and my auditor has specified the charges they propose to make.

"Before the work starts, I agree to the fees, and the timing of when they are going to do the audit. I have transparency at the start of the relationship, which is an annual relationship.

"Similarly, I get a note from my lawyer if I'm undertaking a particular property project. I get fees specified in advance and unless we agree mid-term to increase that because of work, or unfair work, that is my prerogative to negotiate. If we want to be seen as a profession, what is the harm in following that template?"

Underhill stated: "Disclosure is a halfway house to mandating, isn't it? Maybe they do roll that into the fair value requirements."

Underhill continued: "Perhaps you end up with something similar to what happened in 2004. The really big risks, such as airlines and oil rigs, went for fees. There was a move away from commissions to fee income for brokers on large risks. SME and micro-SME were left somewhere in between."

Would greater commission disclosure drive brokers to charge fees instead of commissions on SME?

Underhill said: "I can see that happening in the SME space. I'm not sure that that's going to drive anything in micro-SME where you have your mums and dads with their newspaper shop."

The clock is ticking

Pulling everything together, Reid concludes that the importance of getting Consumer Duty and fair value right is vital in maintaining the status quo.

The FCA is ramping up warnings on Consumer Duty, urging insurance firms to get their house in order before the July deadline. In February, FCA leader Matt Brewis wrote to general insurance businesses reminding them to embed the interests of customers into their firms' culture and purpose.

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Stuart Reid

The director of insurance supervision, policy and competition – consumers and competition, set out in a 'Dear CEO' letter issued on 3 February: "We expect the Consumer Duty to be a top priority for you personally."

The duty comes into force on 31 July for new and existing products or services that are open to sale or renewal. It applies to offerings to retail customers, and to all firms who determine or have a material influence over customer outcomes – not just those with a direct customer relationship.

Reid concluded: "Consumer protection is our last chance. If we cannot do what the FCA is asking of us come July, I think that is the next stage. We as brokers, and this is my opinion, have a last chance to avoid commission disclosure, or limits, by getting consumer protection right. I think the FCA looks at it that way as well, frankly."
