RETHINKING FINANCIAL PROTECTIONS: PRA'S DISCUSSION PAPER ON FSCS LIMITS FOR GENERAL INSURANCE

The PRA has recently published a Discussion Paper (DP2/23) (linked here) which seeks feedback on Financial Services Compensation Scheme (FSCS) limits for General Insurance (GI) products. Currently, the FSCS provides 90% or 100% coverage of valid claims under insurance policies, with the level of protection depending on the type of insurance. The PRA is now exploring the possibility of increasing FSCS coverage for certain GI products to align with its objective of ensuring an appropriate degree of policyholder protection and is seeking feedback on potential changes.

The paper is relevant to UK insurers, including UK branches and those in run-off, EEA insurers in the Supervised Run-off or Contractual Run-off regimes, policyholders, as well as the FSCS as the scheme administrator. It is particularly relevant for EEA insurers with UK branches, most notably those who may be currently close to the £500m FSCS liability limit for subsidiarisation (please see section below).

AN OVERVIEW OF KEY POINTS

- *Potential Gaps in FSCS Protection*: The paper identifies potential gaps in FSCS protection, where policyholders may not receive full compensation in the event of an insurer's failure. This could lead to significant financial hardship for affected individuals and businesses. Historically, FSCS protection was set at 100% cover for liabilities subject to certain compulsory insurance and 90% cover for all other insurance. Following a consultation in 2014, the PRA increased coverage for long-term insurance to 100% coverage.
- *Re-evaluating the Definition of "Small Business"*: The PRA is considering revising the definition of "small business" in the Policyholder Protection Part of the PRA Rulebook.
  - The PRA believes that the current £1 million turnover threshold may not adequately reflect the current business landscape, potentially excluding eligible policyholders from FSCS protection.
  - The PRA considers that it may be appropriate to amend the threshold in the Policyholder Protection Part definition to make it consistent with that set out in s.382 Companies Act 2006 and which is already used in the Policyholder Protection Part to define a large company. The PRA considers that this approach would have the benefit of simplifying FSCS eligibility criteria for policyholders and would be more administratively straightforward for the FSCS to deliver thus potentially reducing the FSCS' operational costs.
  - This change would extend FSCS cover significantly as the threshold would change from the current £ 1 million turnover to one where a company satisfies two of the following three requirements: Turnover - not more than £10.2 million; Balance Sheet total - not more than £5.1 million and Number of employees - not more than 50. This alignment with the definition of a "small company" in section 382 of the Companies Act 2006 suggests a substantial number of companies could be eligible for the revised regime.
- *Specific Areas of Concern*: The paper highlights specific GI product categories where a 10% shortfall in FSCS coverage could lead to an 'inappropriate degree' of policyholder protection. This is deemed to occur where an appreciable portion of policyholders would face a 'material negative impact on their quality of life including their financial and social circumstances' (referred to in the paper as a 'life circumstances impact' ("LCI"):
  - The GI products identified as having an LCI impact include Insurance Backed Guarantees, Private Health, Home, Motor and Travel Insurance.

- *Possible Approaches to Remedy Gaps*: The PRA outlines several potential approaches to address the identified gaps in FSCS protection, including:
  - Moving all GI policy types to 100% coverage: While this could potentially lower costs for individual firms, it could also lead to a higher industry-wide cost of funding due to increased levies arising from higher protection levels. To assess the potential materiality of this disadvantage, the PRA collaborated with the FSCS to review data on GI claims subject to 90% coverage paid over the five years from August 2018 to August 2023. Based on this analysis, the PRA determined that if the FSCS had paid 90% of claims at the higher 100% rate, this would have increased total compensation costs by approximately £39 million over those five years.
  - 100% coverage for only certain targeted GI products with LCI potential: Although a targeted approach has the potential to control costs to the industry, it would still lead to an increase in costs, particularly if most types of GI policy were moved to 100% cover.
  - Rule-based discretion for the FSCS to pay out 100% compensation based on specified criteria: However, defining these criteria in advance poses challenges, and there is a risk that the type of decision-making required would call for significant FSCS resources in processing claims (or risk slowing down the pay-out timeline for all claimants).
  - Introducing an 'FSCS excess'-deducting a specified amount from each claim paid out: While this could limit cost increases and reduce LCI potential from large claims, this could be at the expense of complexity and the appearance that large claims are being treated more favourably than small ones. It would also increase claims processing costs which would ultimately be passed on to firms.
  - Implementing a reverse deductible-providing 100% cover for a specified amount of a claim and 90% cover for the remainder: While this could balance industry costs and reduce LCI risks, it may pose operational challenges and potential delays in payouts.
  - Maintaining protection at the current 90% level: This maintains current costs to the industry but forfeits potential benefits of reducing LCI outcomes.

IMPLICATIONS FOR UK BRANCHES

The PRA's proposed changes could have significant implications for Insurance groups with UK branches. The PRA currently expects third-country branches to have under £500 million of insurance liabilities covered by the FSCS and may consider authorisation as a subsidiary as an alternative where higher than this amount.

The discussion paper raises the possibility of expanding the FSCS both in terms of availability and coverage extent. As a result, the likelihood of surpassing the £500 million threshold increases for some insurance groups, especially those close to the threshold who write GI and SME business. It is also notable that this £500 million threshold was set by the PRA in March 2018 and has not been inflation-adjusted since that date.

Notably, the PRA's consultation paper does not seem to take into account or consider the potential impact of the proposed FSCS changes on the UK branch/subsidiarisation point. It appears to be an unintended consequence, but highly material for some in the market and so we strongly recommend that affected firms' feedback in the consultation on this issue.

One available option is for the PRA to consider raising the £500 million threshold to address this concern (as well as the inflationary point referred to above). If the limit is not changed, it could prompt those groups with branches approaching the limit to consider the alternative of subsidiarisation, which is a costly and time-consuming process.

NEXT STEPS

The PRA encourages stakeholders to provide feedback on the discussion paper by January 24 2024. The PRA will review the feedback received and publish a subsequent consultation paper in 2024 outlining proposed changes to the FSCS limits.

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