Potential deregulation and a pragmatic approach to commercial insurance – welcome news from the FCA

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The FCA has published a 'Discussion Paper' (DP24/1) seeking feedback on its rules on commercial insurance including in respect of the types of commercial customers in-scope of such rules, co-manufacturing of products and bespoke insurance products.

We do a lot of work in the commercial insurance space with clients and we see this review as a welcome change of pace from the FCA. This update will be of particular interest to those in the insurance market undergoing regulatory change projects in respect of consumer duty, product governance and product information/documentation for commercial insurance.

In this blog we are looking only at the potential changes to the classification of commercial insureds and scope of regulation which should apply to them, and we will follow up on the other points covered in DP24/1.

Classification of commercial insureds – potentially moving away from a 35 year old definition!

Insurance regulation has grown significantly over the last decade and there has been an increasing focus on commercial insurance (insurance for non-consumer insureds, so persons acting outside the course of their main, profession or trade).

FCA insurance regulations are designed to protect the customers that are at the greatest risk of potential harm (due to their lower level of expertise, advice and bargaining power). In many ways, the growing regulatory trend was that consumers and SME size commercial customers should be treated much the same and afforded the same level of protection.

This was despite the sense that some aspects of the commercial insurance market are clearly not suited to being treated in the same bracket as consumer insurance and therefore subject to heavy prescriptive regulation. Therefore, it is promising and encouraging that the FCA is reviewing this position; hopefully in particular, so that firms can focus their attention / resources on protecting those most in need (including vulnerable customers).

FCA rules currently distinguish commercial insureds as a) those outside of the scope of most of regulations due to the insurance in question being a 'large risk' and b) everyone else who is in scope. The intention being that the smaller SMEs would be afforded greater protection than the larger SMEs which do not need it.

The issue with this approach is that, firstly the definition of large risk (see below) is outdated. It was adopted into UK law based on EU legislation from 2009 but the definition has its roots in EU rules from 1988.

What constitutes a 'large risk' is currently defined by a high threshold and, in overview only, is risks where:

- the company taking out the insurance fulfils two of the following criteria: a balance sheet of EUR 6.2m, a turnover of EUR 12.9m or more than 250 staff; or
- the risk in question is of a type which is automatically categorised as a large risk (such as aviation or shipping risks, amongst others).

The second issue with the large risk definition (aside from reference to an overseas currency) is that it is inconsistent with other definitions of SMEs which are used by the regulator where it is seeking to afford greater protection to such SMEs. The FCA's paper DP24/1 acknowledges this and refers to four other conflicting forms of definitions used.

To seek to remedy this position, the FCA has proposed three options to change the current classification:

- Option 1: Align the classification so that only commercial insureds which are "*eligible complainants*" (persons eligible to complain to the Financial Ombudsman Service) are within scope of the regulations affording similar protections to consumers.
- Option 2: Remove the automatic classification / product-specific part of the large risk definition so that only commercial insureds which fail to meet the financial and employee number thresholds are within scope of regulations. By way of example, this would mean that commercial insureds within this threshold taking out aviation/marine risks would be within scope.
- Option 3: Develop a new definition entirely, although this would not improve consistency.

Option 1 seems to be the most sensible, and most likely welcome, choice as it achieves the FCA's objective of consistency and also updates the older criteria used for the financial and employee thresholds.

The FCA also presents a further supplementary option of treating all SMEs with only 0-1 employees as consumers. It believes this will offer a benefit of ensuring that these types of SMEs can automatically be classified as within scope of regulation, but in our view this may just be muddying the clear and consistent waters proposed by option 1 above.

Finally, the FCA also seeks feedback on insurance policies with several or unnamed policyholders so that it may better understand the potential challenge.

As noted above, those in the insurance market may wish to factor this update into any ongoing or planned projects in respect of commercial insurance. In particular, a change to the FCA rules could mean that some lines of business and target markets for larger SMEs, which previously needed to be dealt with under prescriptive and more onerous regulation (such as consumer duty and product governance), would be more likely to be outside of scope.

If you'd like to discuss these changes, please do get in touch.

We will also be covering the other two updates relating to co-manufacturing and bespoke products in a further blog.

Notes:

- Responses are requested by 16 September 2024 and can be submitted here.
- The Discussion Paper is available to read here.