

Title: Updating insurance contract law: post-contract duties and other issues Lead department or agency: Law Commission	Impact Assessment (IA)
	IA No: LAWCOM0014
	Date: December 2011
	Stage: Consultation
	Source of intervention: Domestic
	Type of measure: Primary legislation
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Summary: Intervention and Options

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

Insurance contract law is out-of-date in five areas:

- The late payment rules provide insufficient incentive for insurers to pay valid claims within a reasonable time.
- Although fraud is a major problem, estimated at £1.9 billion, the law fails to set clear deterrents against it.
- The rules on insurable interest may prevent people from taking out some legitimate forms of life insurance.
- The requirement for a formal marine policy is no longer needed.
- Marine brokers' liability for premiums may impose unexpected risks in the event of a broker's insolvency.

What are the policy objectives and the intended effects?

Much of insurance contract law is based on out-dated statutes. The requirement for insurable interest in life insurance is governed by the Life Assurance Act 1774, while the law of good faith was codified by the Marine Insurance Act 1906.

The proposals would update these statutes, to provide clearer legal rules to govern relations between insurer and insured. The aim is to encourage prompt payment, to restore businesses to health; to deter fraud; and to remove unnecessary restrictions on business (by, for example permitting a wider range of life insurance and repealing the requirement for a formal marine policy).

What policy options have been considered? Please justify preferred option (further details in Evidence Base)

Option 0: Do nothing.

Option 1: Update insurance contract law to reflect contemporary practice. This will reduce insurers' legal costs and increase confidence in the industry.

When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?

The Law Commission does not implement legislation. Review is a matter for the implementing Department.

SELECT SIGNATORY Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.



Signed by David Hertzell, Commissioner:

Date: 12/12/2011

Summary: Analysis and Evidence

Policy Option 1

Description: Updating insurance law.

Price Base Year 2010	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: £10.313	High: £45.404	Best Estimate: £15.133

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	£1.0	£0.580	£5.820
High	£1.5	£1.159	£11.141
Best Estimate	£1.5	£0.690	£7.238

Description and scale of key monetised costs by 'main affected groups'

Transitional costs: Costs of familiarisation to insurance companies - £1.0 million to £1.5 million

On-going:

Insurance companies: Additional damages claims £690,000 per year (best estimate)

Other key non-monetised costs by 'main affected groups'

Consumer advice agencies would need to incur the costs of familiarisation with the new law and training.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	£0	£2.580	£21.454
High	£0	£6.159	£51.224
Best Estimate	£0	£2.690	£22.372

Description and scale of key monetised benefits by 'main affected groups'

On-going benefits:

Insureds receive £690,000 per year (best estimate) in damages claims

Insurance companies: £2.0 million annual savings in reduced fraud (best estimate)

Other key non-monetised benefits by 'main affected groups'

Insurers would benefit from clearer law and increased market opportunities for life insurance.

Businesses would be less likely to fail as a result of delays in insurance pay-outs.

Economy-wide benefit of small firms continued survival. If the average turnover of a small firm is £2.84 million there is a potential benefit to economic activity by this amount.

Key assumptions/sensitivities/risks

Discount rate (%)

3.5

Assumptions: A normal business year prevails over the ten year period without any catastrophic events

Sensitivities: The number of additional insurance claims in proposal 2 range from 84 (low estimate) to 168 (high estimate)

Risks: There is a medium risk of a catastrophic event over the 10 year period – e.g flooding. This will considerably increase the risk of business failures if the trend in insurance delays continues.

Direct impact on business (Equivalent Annual) (£m):			In scope of OIOO?	Measure qualifies as
Costs:	Benefits:	Net:		
			No	N/A

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?		Great Britain			
From what date will the policy be implemented?		To be decided			
Which organisation(s) will enforce the policy?		Insurers and the courts			
What is the annual change in enforcement cost (£m)?		No direct effect			
Does enforcement comply with Hampton principles?		Yes			
Does implementation go beyond minimum EU requirements?		No EU requirements			
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)		Traded: no effect		Non-traded: no effect	
Does the proposal have an impact on competition?		No			
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?		Costs:		Benefits:	
Annual cost (£m) per organisation (excl. Transition) (Constant Price)	Micro	< 20	Small	Medium	Large
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
<p align="center">Statutory equality duties</p> <p align="center">Statutory Equality Duties Impact Test guidance</p>	Yes	19
<p align="center">Economic impacts</p> <p align="center">Competition Competition Assessment Impact Test guidance</p> <p align="center">Small firms Small Firms Impact Test guidance</p>	No	
	Yes	20
<p align="center">Environmental impacts</p> <p align="center">Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance</p> <p align="center">Wider environmental issues Wider Environmental Issues Impact Test guidance</p>	No	
	No	
<p align="center">Social impacts</p> <p align="center">Health and well-being Health and Well-being Impact Test guidance</p> <p align="center">Human rights Human Rights Impact Test guidance</p> <p align="center">Justice system Justice Impact Test guidance</p> <p align="center">Rural proofing Rural Proofing Impact Test guidance</p>	No	
	No	
	Yes	20
	No	
<p align="center">Sustainable development</p> <p align="center">Sustainable Development Impact Test guidance</p>	No	

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment) and those of the matching IN or OUTs measures.

No.	Legislation or publication
1	Insurance Contract Law: Joint Scoping Paper http://www.justice.gov.uk/lawcommission/docs/ICL_Scoping_Paper.pdf
2	Issues Paper 4: Insurable Interest http://www.justice.gov.uk/lawcommission/docs/ICL4_Insurable_Interest.pdf
3	Issues Paper 6: Damages for Late Payment http://www.justice.gov.uk/lawcommission/docs/ICL6_Damages_for_Late_Payment.pdf
4	Issues Paper 7: The Insured's Post-contract Duty of Good Faith http://www.justice.gov.uk/lawcommission/docs/ICL7_Insureds_Duty_of_Good_Faith.pdf
5	Issues Paper 8: The Broker's Liability for Premiums (Section 53) http://www.justice.gov.uk/lawcommission/docs/ICL8_Brokers_Liability_for_Premiums.pdf
6	Issues Paper 9: The Requirements for a Formal Marine Policy (Section 22) http://www.justice.gov.uk/lawcommission/docs/ICL9_Requirement_for_Formal_Marine_Policy.pdf

EVIDENCE BASE

INTRODUCTION

- 1.1 The UK insurance industry is the third largest in the world. In 2010 it received £46.4 billion in premiums and paid £30.8 billion in claims. Yet the law of insurance contracts is out-of-date. Some statutes are archaic, such as the Life Assurance Act 1774. The common law was codified in the Marine Insurance Act 1906, which has been held to apply to all forms of insurance.
- 1.2 This has made it difficult for judges to develop the law to keep pace with modern developments. In some areas, there is a mismatch between case law and statutory requirements, leading to confusion and unnecessary litigation. It also reduces the esteem in which insurance law in the UK is held. There is a need for Parliament to repeal unnecessary Acts and update statutory provisions.

THE PROBLEMS

- 1.3 This consultation paper is part of a larger review of insurance law. The review started in 2006 with a “scoping study”, asking about problem areas. A wide range of industry stakeholders identified five areas as requiring review:
 - (1) The late payment rules provide insufficient incentive for insurers to pay valid claims within a reasonable time.
 - (2) The law on insurers’ remedies for fraud fails to set clear deterrents against fraud.
 - (3) The rules on insurable interest are confused and may prevent people from taking out some legitimate forms of life insurance.
 - (4) The requirement for a formal marine policy is no longer needed.
 - (5) Marine brokers’ liability for premiums may impose unexpected risks in the event of a broker’s insolvency.

OBJECTIVES

- 1.4 Our objectives are to provide clear legal rules to govern relations between insurer and insured. In particular, we seek to:
 - (1) Encourage prompt payment, so as to help viable businesses recover from disasters such as fire and flood within a reasonable time;
 - (2) Deter fraud, by establishing clear sanctions against wrongdoers;
 - (3) Remove unnecessary restrictions on the types of life insurance which can be written;
 - (4) Remove archaic statutory requirements, such as the requirement for a formal marine policy.
 - (5) Remove unexpected risks on a marine broker’s insolvency.

RATIONALE FOR GOVERNMENT INTERVENTION

- 1.5 Government intervention in the form of a legal solution is required because of the market failure, which adversely impacts on the capacity of the insurance market to operate efficiently. In particular there is a high incidence of insurance fraud as a result of imperfect information that insurance companies have on the insured. This ultimately has adverse implications for the cost of insurance premiums levied on all customers.
- 1.6 There is concern that the full potential of economic activity is constrained because of uncertainty surrounding the legality of selling some insurance products. Widening the category of permissible life insurance removes this uncertainty and potentially enables a greater range of sellers and a more competitive environment.
- 1.7 Overall this package of reform measures will widen the market and remove unnecessary statutory requirements. It brings the English law of damages for late payment in line with general contract principles, and in line with other jurisdictions, including Scotland.

PROPOSAL 1: DAMAGES FOR LATE PAYMENT

Background

- 1.8 Under normal contract principles, where one party breaks a contract promise and the other party suffers loss as a result, the contract-breaker is liable to pay for the loss, provided the loss is foreseeable and the victim does all they can to mitigate it.
- 1.9 English insurance law is an exception to this normal contract principle. If an insurer promises to pay valid claims and fails to do so within a reasonable time, the courts have held that the insurer is not liable to pay damages for any loss the insured may suffer. Instead the insured may only recover the amount of the claim plus interest. This is the case, even if it is foreseeable that the insured would not be able to repair their business premises and would suffer further loss as a result, for example following a fire or a flood. This result arises because of a legal fiction that the insurer is in breach of contract for failing to prevent the loss accruing and English law does not award damages on damages.
- 1.10 This exception appears to be unique to the English courts. It is not followed in Scotland, where the courts provide damages on normal contract principles. Nor is it followed by the Financial Ombudsman Service (FOS). In consumer insurance, the FOS frequently awards damages to consumers who have suffered loss. The FOS also has jurisdiction to hear complaints from “micro-enterprises”, defined as those with less than 10 staff and an annual turnover of under 2 million euros (equivalent to £1.74 million).¹ Again, for micro-businesses, the FOS is prepared to award damages to those able to prove actual loss.
- 1.11 The problems arise in England and Wales. They are particularly acute for small and medium businesses (employing between 10 and 250 staff), who are often especially vulnerable following a catastrophic event, such as a fire, flood or riot.

¹ The definition is found in the FSA Handbook, DISP 2.7.3. This is in line with the EU Payment Services Directive 2007/64/EC.

- 1.12 Airmic, which represents insurance buyers and risk managers for around three-quarters of FTSE 100 companies, commented that even large businesses may sometimes be vulnerable to unreasonable delay following a catastrophe:

Effective indemnity depends as much on the timing of payments as the adequacy of the final settlement if a business is to survive the post loss recovery period. In the event of unreasonable delays in the settlement process, there is currently inadequate opportunity for legal redress. This fact does nothing to encourage reasonable behaviour on the part of the insurer.

- 1.13 We were told that the issue of timely payments has become more acute as firms find it more difficult to obtain bridging loans from banks in the current economic climate. The Department for Business Innovation & Skills (BIS) Small Business Survey 2010 found that 21% of all SMEs seeking finance did not obtain any of the finance they sought, a significant increase from previous studies. This was the case even though the amounts sought tended to be small. Of those seeking finance, 18% had asked for less than £10,000 and 37% had asked for between £10,000 and £49,000.²

The proposed reforms

- 1.14 The proposals are designed to provide incentives for insurers to assess and pay claims quickly. They extend the protections currently available via the FOS to consumers and micro-businesses to all businesses. Businesses who have suffered loss caused by an insurer's unreasonable delay would be entitled to claim compensation from the insurer, in line with general contract law principles. On the other hand, the proposals are measured and include several safeguards against abuse.
- 1.15 There may be good commercial reasons to limit damages for late payment to enable insurers to reserve claims and put the necessary reinsurance provisions in place. Thus for business insurance, the proposals would allow the parties to exclude or limit liability for late payment through a contract term. Where insurers had included such a term, they would not be normally liable to pay for the consequences of delay.
- 1.16 This would not, however, protect insurers who acted in bad faith. Where an insurer seeks to rely on an exclusion clause, it would be required to explain the reasons for its actions. The court would then evaluate whether the insurer's decision was one which a reasonable insurer, acting in good faith, could have taken given the circumstances and the information available to it at the time.
- 1.17 To found a claim for damages for late payment, the insured business must show that:
- (1) It has a valid claim.
 - (2) *The insurer is responsible for unreasonable delay.* The time will not start to run until the insured has submitted a "clean claim", providing all the necessary information. The insurer would then have sufficient time to carry out a full investigation, including time to seek information from third parties.
 - (3) *It has suffered actual loss.* This would never be presumed and must be proved in each case.
 - (4) The loss was caused by the unreasonable delay.

² BIS Small Business Survey 2010 (April 2011).

- (5) *The loss was foreseeable*, in that it was within the “reasonable contemplation” of both parties at the time the contract was made. This is the measure of damages used in contract law. It is more limited than the tort/delict measure, which looks at what is reasonably foreseeable at the time of the loss.
- (6) It took all reasonable steps to mitigate its loss, borrowing money for repairs where necessary.
- (7) Where damages are excluded or limited by contract, *the decision was not one which a reasonable insurer acting in good faith could have taken*. This would protect insurers who had good reasons for thinking that they were not liable to pay even if their decision later turned out to be wrong.

1.18 This seven stage process means that the number of successful claims is likely to be low. The intended effect of the proposal is to encourage insurers to give due emphasis to prompt payment, rather than to encourage compensation claims after the event.

The importance of prompt payment: the example of flood damage

1.19 The importance of prompt payment can be illustrated by looking at the difficulties faced by small businesses following a major flood.

1.20 In 2005, David Crichton summarised research on this issue, looking in particular at the problems following the floods in 2000.³ He cited a 2002 survey by the Federation of Small Businesses of small businesses in the South East which had survived the 2000 floods. It found that losses had been significant: 42% had suffered losses of £50,000 or more taking into account business interruption costs. These firms were the lucky ones: a survey by AXA in 2003 found that the majority of small businesses affected by flooding either never re-open or cease trading within 18 months. Many had under-estimated the business interruption costs of a flood. The ABI reported a general loss of business as people avoided the disaster area and some communities “may be blighted permanently”.⁴

1.21 Crichton commented that loss adjusters had dealt with claims in an inconsistent way: “this lack of standardisation slows down claims handling enormously.”⁵ Although a system had been developed to speed up the process, “claims managers could not see any direct benefits to them and the system was shelved”.⁶

1.22 By contrast, following the floods in 2007, insurers co-ordinated a quick response, putting emphasis on prompt interim payments. The FOS reported low levels of complaints; consumer satisfaction and the long-term effects appeared to be less severe.⁷ Insurers who deal with claims fairly and promptly can make a significant difference to restoring economic activity following a flood.

The scale of the problem

1.23 In order to gauge the current scale of the problem, we sought a snapshot of brokers’ views. We worked with an independent research panel,⁸ which sends a regular omnibus questionnaire to a representative sample of 250 UK commercial insurance brokers. The September questionnaire included five questions on this issue. Out of the 250 brokers, 178 brokers (71%) had been involved in claims over the last two years. We asked all

³ *Flood Risk and Insurance in England and Wales: Are there any lessons to be learned from Scotland?* Benfield Hazard Research Centre (March 2005).

⁴ Above, p 36.

⁵ Above, p 62.

⁶ Above, p 63.

⁷ ABI, *The Summer Floods 2007: one year on and beyond* (2008).

⁸ *Broking Now!* in association with BIBA by FWD Research, *Research on Damages for Late Payment* (September 2011).

brokers who were involved in claims how often they believed that the insurer had unreasonably delayed payment or settlement.

- 1.24 Most brokers had experience of cases where, in the broker's opinion, the insurer had been responsible for unreasonable delays. In all, 60% of brokers said they had experience of unreasonable delay.⁹ However, such cases were infrequent: two thirds of all brokers who had experienced delays stated that they occurred in less than 10% of cases, and almost half (47%) stated that they occurred in less than 5% of cases.
- 1.25 When delays did occur, they generally caused only minor losses. We asked brokers to estimate the average financial loss as a result of the insurer's unreasonable delay, excluding the amount of the claim. In all 65 brokers provided a figure. In 90% of cases brokers gave a figure of no more than £5,000, and in 71% of cases the figure was no more than £2,000. Substantial losses are extremely rare, but they do sometimes occur. Three brokers mentioned cases with losses of more than £10,000. One broker reported a loss of over £100,000.
- 1.26 This suggests that unreasonable delay is considered a problem within the industry, but only in a small minority of cases. Where delay does occur, it usually results in only minor losses. Substantial losses are rare, but may on occasion lead to serious problems.

Costs and benefits

How many additional claims will the proposals generate?

- 1.27 The reforms will not affect consumers and small businesses, where the FOS already has jurisdiction to provide compensation. Nor will it have any effect on liability insurance claims, where late payment is rarely an issue for the insured. The problem is largely confined to property and contents insurance, where a business is unable to resume production until equipment and buildings have been repaired. If the insured is unable to afford to carry out the repairs until the insurance claim has been paid, then delays in payment will lead to delays in production, possibly leading to the firm going out of business.
- 1.28 ABI statistics show that in 2010, UK insurers paid £1.68 billion to businesses in respect of business insurance claims. The average amount per claim differs considerably, from a small claim for a few thousand pounds to cover water damage, to major claims of many millions following major disasters.
- 1.29 No figures are available for the total number of claims. For the purposes of this discussion, we are only concerned with larger claims, where a firm would not be able to cover the damage from its own resources or from reasonable borrowing. We have therefore sought to estimate the number of sizeable property claims, which may affect a firm's production.
- 1.30 We have sought to estimate the number of significant business property claims where a firm would need to replace buildings or capital equipment before resuming trade. Taking the figure of £1.68 billion paid each year, we can calculate that if the average claim were £100,000 there would be 16,800 claims a year. If the average claim were £50,000 there would be 33,600 claims. This demonstrates that there cannot be more than 33,600 significant claims of more than £50,000, and there are probably far fewer – less than 20,000 a year, though this could rise significantly following a major flood.
- 1.31 Using an estimate of around 20,000 significant business claims in a "normal" year, we have attempted to predict the likely number of damages payments, following unreasonable delay. Out of the 20,000 claims, the insurer will have unreasonably delayed payment in only a small proportion. In the survey of brokers, 40% of brokers reported no evidence of

⁹ By contrast, 36% said they had no experience of unreasonable delay or settlement, and 4% did not know.

delay in any cases; out of the remaining 60%, almost half of brokers reported delay in less than 5% of cases. If unreasonable delay were to occur in 2% of cases, this would suggest a total pool of around 400 cases each year.

- 1.32 The main purpose of our proposal is to prevent problems. Under the scheme, the level of unreasonable delay is expected to fall. And given the many safeguards within our scheme to ensure that payments are only made for proven losses, we think that the number of cases meeting the criteria for payments will be small – possibly no more than 100. And in only a small proportion would the unreasonable delay lead to significant loss. As the survey of brokers showed, most cases involve small losses of around £2,000. Only a small proportion (around 5%) is likely to involve substantial losses, averaging £100,000. On this basis, the estimate suggests 5 cases averaging £100,000 = £500,000; and 95 cases averaging £2,000 = £190,000. The total would be £690,000.
- 1.33 Table 1 below sets out how we arrived at this estimate for a range of different numbers of property claims.

Table 1: Post reform property insurance claims

Property insurance Claims	Number and value (low estimate)	Number and value (best estimate)	Number and value (high estimate)
A. Annual property insurance claims	16,800	20,000	33,600
B. Number with unreasonable delays = A x 2%	336	400	672
C. Post reform claims = B x 25%	84	100	168
D. Value of C: 5% x £100,000 95% x £2,000 Total	£420,000 <u>£159,600</u> <u>£579,600</u>	£500,000 <u>£190,000</u> <u>£690,000</u>	£840,000 <u>£319,200</u> <u>£1,159,200</u>
E. Present value over 10 years (@ 3.5% discount rate)	£4,820,304	£5,738,458	£9,640,609

- 1.34 Experience in Scotland also suggests that payments are likely to be low. Although damages for late payment are available in Scotland, insurers told us that this has no effect on pricing business insurance sold in Scotland. We welcome views on these estimates.
- 1.35 **How many claims for damages for late payment are likely to be paid each year? And what would be the average size of each claim?**
- 1.36 **We invite comments on the view that total payments for damages for late payment may be in the region of £500,000 to £1.2 million.**
- 1.37 In terms of overall costs and benefits, any compensation payments would be neutral. The cost to the insurer would be offset by the benefit to the business.

The benefit of preventing business failure

- 1.38 The benefit of the proposal is that it reminds the industry of the importance of prompt, fair claims payment. It would therefore uphold the importance of Financial Service Authority (FSA) rules on Treating Customers Fairly. Prompt payment would enable more businesses to survive the effects of catastrophic events such as fires and floods, resuming production and avoiding business failure.
- 1.39 Business failure not only affects owners and shareholders, but also causes loss to employees, creditors, tax authorities, the community and the general economy.
- 1.40 It is impossible to say how many businesses would be able to continue as a result of our proposals which would otherwise have failed. However, even if a few businesses were able to continue, the results could be significant. Business failure is regrettably common. The ONS Statistical Bulletin on business demography for 2009¹⁰ shows that 279,000 businesses ceased trading, a 26% increase from the previous year. This compared with only 236,000 business births. The BIS Small Business Survey 2010 showed that the average turnover for a small business with between 10 and 49 staff was £2.84 million. This means that if two small businesses were saved by prompt payment it would **preserve more than £5 million in economic activity which would otherwise be lost.**

Costs: would the proposals generate additional court cases?

- 1.41 Where claims are not dealt with by FOS, the main cost of the proposal would lie in the additional court cases generated by claims for compensation. We have not been able to estimate the costs. Claims for compensation are rarely brought on their own, but are usually added to litigation to obtain the insurance payment itself. This means that it is difficult to separate the costs of compensation claims from the cost of the main litigation.
- 1.42 That said, we think these additional costs are likely to be low. Businesses making claims against insurers must pay for their own legal costs, and risk paying the insurer's legal costs should they lose. The "loser pays" rule acts as a strong disincentive to speculative or ill-advised claims.
- 1.43 **What are the likely benefits if prompt payment prevents businesses from ceasing to trade? We invite comments on the view that such benefits may exceed £5 million.**
- 1.44 **What, if any, additional legal costs would be generated by the proposals?**

PROPOSAL 2: THE INSURER'S REMEDIES FOR FRAUDULENT CLAIMS

Background

- 1.45 It is important that the law sets out clear sanctions to deter policyholders from acting fraudulently. Unfortunately, the law in this area is convoluted and confused. There is a tension between the common law rule that a fraudster forfeits the claim, and the statutory rule in section 17 of the Marine Insurance Act 1906 that the policy is avoided. It is not clear whether, following a fraud, the insurer must pay a subsequent claim. Furthermore, it is unlikely that an insurer can claim damages for the costs of investigating fraud.

Our proposals

- 1.46 We propose clear, practical remedies, to deter fraud.
- (1) Fraud should not avoid the contract from the start.
 - (2) Instead, the fraudster should forfeit the whole claim, and all subsequent claims.

¹⁰ Published in December 2010.

- (3) In some circumstances the insurer should be entitled to claim damages from a fraudulent insured for the costs of investigating the fraud.

The scale of the problem

- 1.47 Fraud is a serious and expensive problem. Research by the ABI showed that in 2010, insurers detected 133,000 fraudulent general insurance claims (or 1.5% of all claims). This represented a 9% increase from 2009.¹¹ The value of these claims amounted to 4.8% of the value of all claims paid. In addition, insurers detected 1,076 fraudulent long term insurance claims.
- 1.48 The value of undetected fraud is much greater. In 2009, the ABI estimated that undetected general insurance claims totalled £1.9 billion a year.
- 1.49 Given the scale of the problem, it is important that the law provides a clear, straightforward remedy to insurers, which fully compensates them for their losses, and which provides an effective deterrent to wrongdoing.

Benefits

- 1.50 The benefits of our proposals are improved deterrence, together with a reduction in legal costs.
- 1.51 ABI research in August 2010 looked in detail at ways in which general insurance fraud could be deterred.¹² Surveys have found that the British public shows some moral ambivalence towards insurance fraud. Although only a tiny minority of people say that it is morally acceptable to fabricate an entire claim, around two-fifths say that it is either acceptable or “borderline” to exaggerate the price of an item. Fraudsters often seek to justify their actions in terms of “fairness”, suggesting that it is unfair for insurers to charge high premiums without fully covering the loss by, for example, imposing an excess.
- 1.52 Thus a strategy to combat fraud involves several elements: publicity, sanctions and fairness. There needs to be publicity for the sanctions that will be imposed, together with persuasion that fraud is wrong, and that insurers do not behave unfairly or attempt to “get out” of payment.
- 1.53 Our proposals are designed to be part of that anti-fraud strategy. They provide clear, practical and fair sanctions to the problem. Legal rules do not in themselves ensure that people behave well. When combined with the right publicity, however, they can have a part to play. The proposals clarify that those who exaggerate claims stand to lose the whole claim and all subsequent claims. Furthermore, those who fabricate claims may be required to pay the insurer’s investigation costs.
- 1.54 The estimated volume of insurance fraud is so great that even a very small change in behaviour can result in significant benefits. If the proposals were to reduce the cost of fraud by only 0.1% (one thousandth) the savings would amount to £1.9 million. Thus a very small fall in fraud would produce significant savings, possibly in the order of £2 million to £5 million. This benefit to the insurance industry would ultimately be a benefit to all honest policyholders, including consumers and businesses.
- 1.55 We also think that clearer rules would lead to some reduction in legal costs. Insurance fraud is an issue which generates legal argument. A search of Westlaw showed that in the past two years, there have been three insurance fraud cases reported in the County Court and seven insurance fraud cases were reported in the High Court. Of these, three were taken to the Court of Appeal.

¹¹ ABI, Data Bulletin: Detected Fraud in General and Long-Term Insurance (June 2011).

¹² ABI, Research Brief: Deterring Opportunistic General Insurance Fraud (August 2010).

- 1.56 These cases were not necessarily about the remedies: many other issues are involved. That said, given the propensity for insurance fraud to give rise to litigation, it is clearly important to ensure that the rules are as clear and straightforward as possible.
- 1.57 **Do consultees agree that the proposed reforms to insurer’s remedies for fraudulent claims will provide benefits in terms of improved deterrence and reduced legal costs?**
- 1.58 **We invite comments on the view that the reforms (when combined with effective publicity) would reduce fraud, leading to savings of around £2 million to £5 million a year.**

Costs

- 1.59 The main costs are the one-off costs of familiarisation (see below).
- 1.60 Under the current law, there is some uncertainty over whether insurers can avoid a contract from the start, thus attempting to recoup any valid claims which have already been paid under the contract. We have been told that avoidance is sometimes used as a threat by insurers, though it is rarely practical to recoup money which has already been paid, and we have not found any cases in which the courts have upheld such a claim.
- 1.61 We have considered whether the threat of avoidance might have a deterrent effect, which would be removed by our reforms. Our conclusion, however, is that the threat of avoidance is counter-productive. It gives the impression that insurers act unfairly, by trying to deny valid claims. It may also lead to a view that insurers’ threats over fraud cannot be substantiated, giving the impression that the law will not uphold insurers’ sanctions. We do not think that there would be any ongoing costs to removing legal uncertainty in this area.

PROPOSAL 3: INSURABLE INTEREST

Background

- 1.62 Insurance differs from any other risk-transfer contract, such as gambling, because it is used to compensate for loss. For insurance to be valid, the insured must possess an “insurable interest”. The requirement may be imposed by a mix of contract, statute and the common law, but for some types of insurance it is unclear how the requirement is imposed.
- 1.63 For insurance on goods or land, the policyholder must stand to gain a benefit from the preservation of the subject matter of the insurance or to suffer a disadvantage should it be lost. Although the basic principle is sound, the law is unduly complex. The issue is governed by confusing and archaic statutes:
- (1) The Marine Insurance Act 1788 adds unnecessary formalities by requiring the name of interested persons to be inserted into written documents.
 - (2) The Marine Insurance (Gambling Policies) Act 1909 creates an unnecessary criminal offence, punishable by a fine or imprisonment of up to six months.
- 1.64 For life insurance, which includes critical illness and personal injury cover, the law is unduly restrictive. A person may insure his or her own life, or that of a spouse or civil partner, without evidence of loss and for any amount – but may not insure the life of a cohabitant, parent or child.¹³

¹³ Though, for exceptions, particularly in Scots law, see Chapter 3, Part 11, paragraphs 11.75 – 11.77 of the second joint Consultation Paper.

- 1.65 It is permissible to insure the life of another where the policyholder would suffer financial loss on the other's death. This, however, requires "a pecuniary interest recognised by law", rather than just a reasonable expectation of loss. Furthermore, the loss must be quantified at the time the contract is taken out. The requirement has been interpreted strictly with harsh results. The courts have held that a father's expectation that his son would care for him or maintain him was not sufficient to constitute an insurable interest in the son's life.¹⁴

Our proposals

- 1.66 Our proposals are in two parts:
- (1) To clarify and restate the law on insurable interest for general insurance (on land or goods). We propose to repeal unnecessary statutes, including the Marine Insurance Act 1788 and Marine Insurance (Gambling Policies) Act 1909.
 - (2) To broaden the categories of those who may insure the life of another. We propose to permit insurance on the life of another where the policyholder has a real probability of incurring economic loss on the other's death. This would, for example, allow an elderly person to insure the life of their carer, and would make it easier for firms to insure the lives of key employees for commercially reasonable amounts.

The effect of our proposed repeals

- 1.67 Both the Marine Insurance Act 1788 and the Marine Insurance (Gambling Policies) Act 1909 appear moribund, and we do not think that their repeal would have any direct effect. In particular, we have not found evidence that any prosecutions have been brought under the 1909 Act.
- 1.68 Nevertheless we think there is an advantage in repealing unnecessary statutory requirements. As the Government's red tape challenge has made clear, the default position should be that regulations should be repealed, unless they can be shown to be beneficial. This is especially true of statutes which create criminal offences. The existence of trivial, unused, and unnecessary criminal offences brings the law into disrepute, devaluing the moral authority of criminal sanctions.

The effect of widening the categories of permissible life insurance

- 1.69 As we discuss in the consultation paper, it is common for life insurance policies to be written which go beyond those which are technically permitted under the current case law. Insurers frequently write "key employee" insurance for sums which exceed the notice period. Furthermore, travel insurance often includes a fixed sum on the death or injury of a child. As noted in a leading textbook, this is a time when "insurance practice is becoming increasingly impatient" with the restrictions imposed by the "rigidity and historical emphasis in the English law rules of insurable interest".¹⁵
- 1.70 There are two reasons for changing the law. First, it is wrong to retain unnecessarily restrictive rules where these are widely ignored. Secondly, the rules may act as a disincentive to insurers to write insurance business which is potentially beneficial and for which there is market demand.¹⁶

¹⁴ *Halford v Kymer* (1830) 10 B&C 724.

¹⁵ *MacGillivray on Insurance Law*, (11th ed 2008), at para 1-049.

¹⁶ For a critical analysis of the shortcomings of the current law see *An Analytical Perspective on the Requirements of Insurable Interest in Life Insurance Contracts*, Chapter 4, Dr Oluwadamilola Olujemisi Awoye, University of Manchester, School of Law, (2011).

1.71 One possible use of life insurance would be to allow relatives to insure the lives of those on whom they depend for financial and practical help. For example, under our proposals elderly people would be entitled to insure the life of a son, daughter or other person, on whom they depend for their care whether that is provided in person or financially.

1.72 The Dilnot Commission on the Funding of Care and Support has drawn attention to the major problems society faces in providing and paying for adult social care.¹⁷ The Commission describes the current system of state funded care as “broken”, yet people are unable to take out private protection:

This is the only major area in which everyone faces significant financial risk, but no one is able to protect themselves against it¹⁸.

1.73 We need to develop new and innovative ways of dealing with the costs of social care in old age. Enabling people to insure the lives of those who care for them would be one small way of providing possible new options in this market.

1.74 More generally, there is an urgent need to encourage people to make greater provision for old age, bereavement and illness. Each year, Swiss Re calculate the “Protection Gaps”, to describe the difference in the amount of insurance cover people hold and the level they should ideally have in place to cover their needs on bereavement or disability. The research shows substantial short-falls, when cover is measured in terms of total sums assured. For example, in 2010 Swiss Re looked at the difference in the insurance held and insurance needed in terms of total sums assured and estimated the “Life Assurance Protection Gap” at £2.4 trillion.

Costs and benefits

1.75 Overall this is a moderate deregulatory measure. We do not think that there are any costs associated with it. The benefit is that it removes unnecessary restrictions and may provide possible new business opportunities. It will provide a proper legal basis for products which are already available in the market and which people want.

1.76 The provision of a sole statutory source for the requirement for insurable interest will remove confusion about how and when it is imposed, and it will establish a marker by which insurance products can be clearly differentiated from any other risk transfer transaction, such as gambling or the trade in derivatives. Finally, it will support the existing tax and regulatory regimes that govern insurance by establishing where insurance is based.

1.77 **We welcome comments on the costs and benefits of our proposals on insurable interest.**

PROPOSAL 4: THE REQUIREMENT FOR A FORMAL MARINE POLICY

Background

1.78 Section 22 of the Marine Insurance Act 1906 requires a contract of marine insurance to be “embodied in a marine policy”. This dates from 1795, when stamp duty was imposed on marine insurance. Although stamp duty on marine policies was abolished in 1970, the requirement for a marine policy remains. Section 22 is widely ignored, and no longer appears to have any practical effect.

¹⁷ See www.dilnotcommission.dh.gov.uk.

¹⁸ The Report of the Commission on Funding of Care and Support, July 2011, p13.

Our proposal

- 1.79 We propose to repeal section 22, along with related provisions. In all, we propose to repeal or amend nine sections of the Marine Insurance Act 1906.

The effect of our proposed repeals

- 1.80 We received nine responses to an issues paper on this subject. No consultee indicated that repealing section 22 would have any practical effect, beyond aligning law with current practice. As the International Underwriting Association (IUA) put it:

The practical effect would be negligible given that the market has essentially moved away from the formal requirement to produce a policy and generally does not rely upon section 22 in contract disputes.

- 1.81 Nevertheless, we think it would be beneficial to remove unnecessary complexities in the law. The UK is one of the world's leading insurance law jurisdictions, and outdated and unused provisions undermine the respect in which the law of the UK is held.

PROPOSAL 5: BROKERS' LIABILITY FOR PREMIUMS

Background

- 1.82 Section 53(1) of the Marine Insurance Act 1906 makes a marine broker liable to pay premiums to the insurer. It is a complex and uncertain provision. It appears to reflect the common law position, in which the insured was *not* liable to pay premiums to the insurer. Instead, the policyholder was required to pay the broker, and the broker was required to pay the insurer. The effect of the section is that the broker is responsible to pay premiums to the insurer even if the policyholder becomes insolvent and cannot repay the broker.
- 1.83 Section 53(1) could have surprising consequences if a marine broker were to become insolvent. The section appears to embody a common law rule that the policyholder pays the broker as principal rather than as agent. If so, it has the potential to undermine FSA protections on client money.

Our proposals

- 1.84 We propose to clarify the law in this area, to state that marine policyholders are liable to pay premiums to insurers, and pay brokers as agents. This would ensure that FSA client money rules applied.
- 1.85 On the question of whether the insurer should also have a claim against the broker, we think the law should provide default rules which reflect current market practice. It should, however, be easy to change the default rule through a contract term.
- 1.86 In the marine market, we propose a default rule that the broker is jointly responsible with the policyholder to pay the premium to the insurer. Brokers and insurers may contract out of this provision if they wish, simply by including a term to this effect in their Terms of Business Agreements.

The practical significance of section 53

- 1.87 In response to our issues paper, we were told that the primary means by which insurers enforce premium collection is by inserting payment default clauses in the insurance contract. The Lloyd's Market Association (LMA) explained that credit control departments of managing agents "issue notices of cancellation on a regular basis (usually resulting not in cancellation but in actual payment)".

1.88 Insurers' representatives told us that marine insurers occasionally invoke section 53(1) against brokers, when payment cannot be secured by other means. As the IUA put it, while other methods of securing payment would be relied on in the first instance, section 53(1) provided insurers with a "useful additional protection". Brokers confirmed that "insurers do sometimes rely on section 53(1)". On the other hand, we do not know how often brokers pay premiums to insurers which they are unable to recoup from policyholders, and we have not been able to estimate the amounts involved.

The effect of our proposal

1.89 Our proposal would have two effects:

- (1) It would reduce the risks to insurers should a marine broker become insolvent.
- (2) It would be easier for brokers and insurers to agree rules on liability for premiums, to reflect the position which best suited their needs.

1.90 We look at each in turn.

Reducing risks following the insolvency of a marine broker

1.91 At present, the insolvency of a marine broker is likely to generate difficult and uncertain litigation. The following risks may arise:

- (1) Premiums held by the broker may become the property of the general creditors, rather than being held on trust for the policyholder or insurer¹⁹.
- (2) Where the policyholder has not paid, the broker's liquidators may be entitled to sue the policyholder for the premium. If so, the premium would be paid to the broker's general creditors rather than to the insurer.
- (3) It is uncertain whether the insurer who has not been paid in these circumstances would be held to the insurance contract.

1.92 Our reforms are designed to reduce the risk of such litigation. The uncertainties arising from unexpected insolvency consequences also have a cost. As the broker market consolidates, the effects of a major insolvency could be large and destabilising. For example, the turnover of some of the world's largest broking firms now exceeds £5 billion.²⁰ An insolvency on this scale could lead to losses which some insurers would find difficult to absorb, leading to systemic risks within the market. Although we cannot quantify the costs of this uncertainty, we think that the risks are sufficiently significant to justify their removal.

Default rules which the parties may change

1.93 The growing literature on behavioural economics stresses the importance of "nudging" behaviour rather than prescribing behaviour. This can be done by providing suitable default rules.²¹ Wherever possible, the law should permit commercial parties to reach their own arrangements. Reaching agreement, however, has a transaction cost. Effective law should provide default rules which provide the most effective outcome if no agreement is reached.

¹⁹ For the relevant Scots law, see footnote 26 to para 18.49 of the second joint Consultation Paper.

²⁰ For example Marsh is a member of Marsh & McLennan Companies and its global revenue exceeds \$10 billion: see www.uk.marsh.com/aboutus, Aon's website (www.aon.com) states that "Aon Corporation's total revenue for 2010 was \$8.5 billion". Lockton Inc is smaller but is the world's largest privately owned, independent insurance brokerage firm, and its global revenue exceeds \$800 million: see www.lockton.com/aboutus. Jardine Lloyd Thompson Group plc's total revenue was £746.3 million in 2010: see www.jltgroup.com.

²¹ R. Thaler and C. Sunstein, *Nudge: Improving Decisions about Health, Wealth and Happiness* (2009).

- 1.94 We have proposed a default rule which most closely reflects current practice: namely that where a policyholder fails to pay the insurer may seek payment from the broker. This rule could, however, be excluded easily.
- 1.95 One problem with section 53 as currently drafted is that it is too difficult to contract out of it. To exclude it fully, contracts between three parties would be needed: insurer, broker and policyholder. By contrast, under the proposals, the provision could be excluded by a simple agreement between broker and insurer.
- 1.96 We do not think that there is any cost to this change. The benefit is that it allows more freedom for brokers and insurers to reach their own solutions.
- 1.97 **We welcome comments on the costs and benefits of our proposals on policies and premiums in marine insurance.**

OVERALL COSTS AND BENEFITS: CONCLUSION

Transitional costs

- 1.98 The main costs will be transitional. Any new Bill will, inevitably, require a one-off process of familiarisation and training. Insurers provide regular training for claims staff in any event, and we think the effect of the new measures could be absorbed into the firms' normal training activities. Therefore we do not anticipate that these will be large.
- 1.99 The transitional costs of the recent Consumer Insurance (Disclosure and Representations) Bill were estimated at between £1 million and £1.5 million. We think that the transitional costs for these proposals may be of a similar order of magnitude and we welcome views on this.
- 1.100 **What are the likely transitional costs of these proposals, in terms of training and familiarisation? We invite comments on the view that such costs may be between £1 million and £1.5 million.**

Ongoing costs and benefits

- 1.101 Impact assessments place a strong emphasis on valuing costs and benefits in monetary terms (including estimating the value of goods and services that are not traded). When calculating the net present value (NPV) for the impact assessment we have used a time frame of ten years, with the current year (2011) being year 0. We have assumed that the transitional costs occur in year 0, and on-going costs and benefits accrue in year 1 to 10. We have used a discount rate of 3.5%, in accordance with HM Treasury guidance. See Table 2:

Table 2: Summary of NPVs for all 5 Proposals (best estimates only)

	Proposal 1	Proposal 2	Proposal 3	Proposal 4	Proposal 5
Transitional costs	£1.5 million familiarisation costs spread equally across proposals 1-3 only				
On-going costs (annual)	£690,000	£0	£0	£0	£0
Present value of costs	£5,738,458	£0	£0	£0	£0
Transitional benefits	£0	£0	£0	£0	£0
On-going benefits (annual)	£690,000	£2,000,000	£0	£0	£0
Present value of benefits	£5,738,458	£16,633,211	£0	£0	£0
Net present value	-£500,000	£16,133,211	-£500,000	£0	£0

1.102 In addition to the identified monetised benefits there are other benefits which cannot be sensibly monetised as follows:

- (1) Clearer law should reduce legal and compliance costs.
- (2) Prompt payment following a fire, flood or riot would prevent businesses from failing. Even if only two businesses were able to continue, the effect could be significant, preserving more than £5 million in economic activity which would otherwise be lost.
- (3) Widening the categories of those permitted to insure the life of another may open new markets for life insurance and encourage more people to provide for the effects of bereavement.
- (4) The proposed changes to section 53 of the Marine Insurance Act 1906 would reduce legal risk were a marine broker to become insolvent.
- (5) Repealing out-dated statutes would encourage respect for the law of the UK.

SPECIFIC IMPACT TESTS

Statutory equalities

1.103 We have considered the screening questions that are prerequisite to a full equality impact assessment and do not think that our proposals will have any adverse equality impact on any social group as defined by their race, religion or belief, sexual orientation, gender, age, or disability.

1.104 In considering our proposals on insurable interest, we have considered the compatibility of the current law in the UK with Islamic (Shari'a) law. Under UK law, some forms of insurance are compulsory, such as the requirement to insure motor vehicles or against employers' liability.²² This might cause problems for those whose morality does not allow them to gamble, if the distinction between gambling and insurance is not strictly maintained. Generally, under Shari'a law, insurance is acceptable and operates through the takaful system, although some schools of thought demand certainty that the arrangement is free from any element of gambling, which is strictly prohibited.²³ We propose a clear statutory restatement that the insured must have an insurable interest in the subject matter of the insurance. This is designed to underline a clear separation between insurance and gambling.

1.105 Our proposals will allow a greater range of people to insure the lives of others. In particular, older people or those with disabilities who are or may become dependent on others to care for them (either practically or financially) would be able to insure the lives of their carers. We think this could provide some additional possibilities for a vulnerable group.

Small firms

1.106 The FOS provides some protection to micro-businesses. It has jurisdiction to hear complaints from businesses with less than 10 staff and an annual turnover of under 2 million euros. Where insurers unreasonably delay paying claims, the FOS will provide compensation for the business' proven losses.

1.107 The same protections do not apply to small firms above these limits – such as those with 11 or more employees. Yet small and medium enterprises may be particularly vulnerable following a fire or flood, if the insurance payment is delayed or refused and they are unable to gain access to finance to carry out the necessary repairs. Our reforms are designed to provide greater protection to businesses in these circumstances.

Justice system

1.108 The impact on the justice system is considered in the body of the impact assessment. Overall, we think that the impact on the justice system is likely to be neutral. Although the proposal to permit damages for late payment may result in a limited number of new claims, the proposals on fraud and marine brokers' liability for premiums will reduce litigation.

Other impacts

1.109 We do not consider that the proposals have any impact on competition, greenhouse gas emissions; wider environmental impact; health and well-being; human rights; rural proofing or sustainable development.

²² See Road Traffic Act 1988 and the Employers' Liability (Compulsory Insurance) Act 1969.

²³ However, there is a divergence of views on whether insurance is permitted and some Shari'a scholars consider any insurance (Haram) as a form of gambling because it is uncertain whether the policy will ever pay out and this ambiguity is not permitted (Gharar). Others consider that where insurance is required by law and the subject matter is legitimate, as in car insurance, then the law must be followed and the insured is excused. We are indebted to Dr Ludwig Stiftl, Center for Compliance for Retakaful, Munich Re for his assistance with background materials.