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Policy Statement | PS21/20

Extending policyholder protection for building guarantee policies

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Extending policyholder protection for holders of building guarantee policies

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) contains a rule change to increase protection for eligible policyholders of building guarantee policies (BGP). It makes amendments to the Policyholder Protection Part of the PRA Rulebook (Appendix).

1.2 This PS is relevant to:

- the Financial Services Compensation Scheme (FSCS) as the scheme administrator of the policyholder protection rules;
- UK insurers (including those that establish a branch or operate on a freedom of services basis in the European Economic Area (EEA), EEA insurers that establish a UK branch or operate in the United Kingdom on a freedom of services basis, and Channel Islands insurers and Isle of Man insurers with UK, Channel Island or Isle of Man risk or commitments);
- firms that have assumed responsibility for liabilities from PRA-authorised insurers (successors); and
- policyholders.

Background

1.3 The PRA is responsible for making the rules that govern the operation of the FSCS in relation to deposit takers and insurers. Rules in relation to insurers are contained in the Policyholder Protection Part of the PRA Rulebook.[1]

1.4 Policyholder Protection 17.2(1)(a) sets out that protected policyholders are covered for 100% of any benefit under their contract of general insurance (GI) where the claim:

- is in respect of a liability subject to compulsory insurance; or
- is in respect of a liability subject to professional indemnity insurance; or
- is in respect of and arises from the death or incapacity of the policyholder due to injury, sickness, or infirmity.

1.5 In all other cases, protected policyholders should receive at least 90% of any benefit under their contract of GI, as set out in Policyholder Protection 17.2(1)(b).

1.6 The PRA considers that 90% coverage for protected policyholders of a BGP no longer amounts to an appropriate degree of protection, as discussed in paragraphs 1.8 to 1.13. The PRA defines BGP as a contract of general insurance providing building guarantee, construction warranty and/or structural defects cover in relation to newly built, converted or renovated residential property, including but not limited to the risk of physical damage and/or defect arising from non-compliance with relevant building or fire regulations or standards. The PRA also notes that in the case of BGP the ultimate beneficiaries of BGP policies have little choice in the selection of their insurer as the policy is usually provided to property owners by the builder and the policy is transferred to policyholders in onward sales.

1 http://www.prarulebook.co.uk/rulebook/Content/Part/213382.

1.7 Under rule changes set out in this PS protection will be extended, from 8 October 2020, to 100% for protected policyholders of BGPs.

Extension of full policyholder protection to BGP policies

1.8 In its last consultation on FSCS protection for GI policies (CP21/14, confirmed in PS5/15[2]) the PRA explained that the two-tier approach to GI compensation limits reflected differences in the significance to policyholders of the risk insured, and the potential for significant adverse consequences for GI policyholders of cover being disrupted or obligations not paid.

1.9 The 90% cover for most GI policies was retained on the basis that these GI policies were short-term, they did not feature any contractual lock-in, and there were no significant costs of exiting and switching cover to another provider.

1.10 The PRA noted that this would leave the policyholder to bear some residual financial cost in the event of failure, but on balance rejected the alternative option of increasing cover to 100% for other insurance policies on the basis that it made no allowance for the different types of risk that disruption to cover could cause, as well as the higher costs for some FSCS levy payers.

1.11 The wider context of BGP has evolved significantly since the PRA set out its policy rationale for policyholder protection in 2014, particularly in light of the Grenfell tragedy, subsequent changes to building regulations and high profile court cases. The PRA considers that some features of BGP are similar to the policies for which 100% cover is available. For example:

- 100% protection is provided for claims arising from death or incapacity. This reflects the policyholder's likely lessened ability to seek alternative cover and mitigate risk in other ways. BGP has similar features because, even if alternative cover is available, it may be prohibitively expensive.

- 100% protection is also provided for liabilities subject to compulsory insurance (i.e. where that insurance is required by legislation). Notwithstanding that BGP is not required by legislation, it is likely to be a necessary requirement for any lender when advancing a mortgage in respect of a new build property or when re-mortgaging an existing property, and therefore it has some features analogous to compulsory insurance.

1.12 Further, once known defects exist in a property covered by a BGP, the loss of BGP protection in the event of the subsequent failure of the insurer may have significant potential adverse financial and social consequences for policyholders, meaning that 100% FSCS coverage for protected policyholders represents a more appropriate degree of protection. These potential adverse consequences include:

- current owners may be unable to re-mortgage without comprehensive BGP, and it may not be possible to get a new BGP providing replacement cover without rectification of any defects which arose under the original BGP. An inability to re-mortgage may result in policyholders reverting to more expensive standard variable rate terms at the end of any initial discounted or fixed rate mortgage period, potentially creating ‘mortgage prisoners’;

2 April 2015: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/policyholder-protection-ps.

- for similar reasons, current owners may be unable to sell their property;
- in a BGP context, the 10% residual amount that policyholders will have to contribute beyond the 90% FSCS compensation is, in reality, likely to amount to a significant amount of money which many BGP policyholders may struggle to find. This could mean they face the prospect of staying in a building that may be considered unsafe, and one they cannot afford to repair. The issue is exacerbated by the fact that, in buildings with multiple occupants, building repairs may be a collective issue; and
- as an ancillary risk, the wider market consequences of BGPs not being covered at 100% appear potentially to be significant and difficulties in selling such properties will be exacerbated. These may have an impact on parts of the housing market. This in turn may have knock on impacts on the rate at which BGPs are available to current and potential policyholders, making these policies unaffordable for a potentially significant segment of the market.

1.13 In implementing a rule change to extend coverage for protected BGP policyholders to 100%, the PRA is preserving the original policy intent of having a two-tier system, but recognising that BGPs have similar features, and similarly severe adverse consequences, to those the PRA originally identified as warranting 100% cover.

1.14 Given the issues raised in this PS, the PRA also plans to review whether there are other types of insurance policy for which additional FSCS coverage could be warranted on policyholder protection grounds, with a view to consulting, if necessary, in the future.

Urgency

1.15 When making rules in relation to the FSCS, the PRA ordinarily consults the public, conducts a cost benefit analysis and, where relevant, complies with additional statutory requirements relating to mutuals.

1.16 The PRA is aware that a firm with a book of BGP business has filed for administration. In order that protected BGP policyholders of this firm may benefit from 100% cover, the rule change set out in this PS must take effect before the FSCS declares the firm to be in default. In this context, the PRA considers that the delay involved in consulting the public, conducting a cost benefit analysis and following the additional requirements relating to mutuals would be prejudicial to securing the appropriate degree of protection for policyholders.

1.17 The PRA has reached this view having considered the interests of policyholders of that firm and of other insurance policyholders, PRA-authorised insurers and successors. The PRA recognises that there will potentially be a cost to firms as a result of the rule change in the form of higher levies in the future, but considers that the benefits to policyholder protection outweigh these costs.

1.18 The costs to the FSCS (and ultimately the general insurance industry through any FSCS levies) of the change from 90% to 100% for BGP will depend on the future incidence of firm failure and the protected liabilities of these firms at the point of failure. FSCS costs from general insurance policies are spread across general insurance levy-payers in proportion to the business undertaken, and any future additional FSCS levy costs would likely be spread across a number of years as claims against any failed firms arise. Based on the PRA's current understanding of liabilities within the BGP market, the PRA does not consider the costs of this change for the general insurance sector are likely to be material.

1.19 Therefore, under section 138L(2) of the Financial Services and Markets Act 2000, the requirements to consult the public, conduct a cost-benefit analysis and the additional requirements relating to mutuals do not apply.

Implementation

1.20 The rule change came into effect on Thursday 8 October 2020.

1.21 The policy set out in this PS has been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.22 The PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'[3] for further details.

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3 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

Appendix

1 **PRA RULEBOOK: SOLVENCY II FIRMS: NON SOLVENCY II FIRMS: NON AUTHORISED PERSONS: FSCS LIMIT FOR BUILDINGS GUARANTEE INSURANCE INSTRUMENT 2020, available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2020/ps2120app.pdf.**