

CLIENT ADVISER

THE FUTURE OF COMMISSION RETENTION BY LANDLORDS

It is accepted property industry practice that the landlord should retain the right to insure its asset, and this is a feature of typical UK leases. Furthermore, it is accepted, though perhaps sometimes begrudgingly by certain parties, that the landlord should recover the costs reasonably incurred in arranging and administering said insurance.

The practice of landlords and property managers (when the management contract allows) retaining a share of the commission generated by insurance premium recovered from tenants has been in place for many years.

What is not accepted is that the tenant should be disadvantaged by these arrangements. While tenants are actively challenging landlords concerning insurance costs, they generally find themselves in a weak position, due to the fact that:

- There is limited case law.
- Codes of practice are often regarded only as guidelines and can be difficult to enforce.
- Small and private tenants don't always know how to challenge, or even that they should challenge, their landlords.
- There is little information to help determine a test of what constitutes fair, reasonable, or equitable income from insurance.

In this paper, we consider current developments, which should mark the beginning of a shift to best practice by all landlords. Current focus is predominantly on the residential sector; nevertheless, we recommend that commercial property landlords also consider the potential impact of these changes.

PROPERTY FACTORS (SCOTLAND) ACT 2011

PROPERTY FACTOR CODE OF CONDUCT

Property and land managers operating in Scotland (Factors) are legally required to ensure compliance with the Code, which states that:

5.3 If your agreement with homeowners includes arranging any type of insurance, you must disclose to homeowners, in writing, any commission, administration fee, rebate or other payment or benefit you receive from the company providing insurance cover and any financial, or other interest, that you have with the insurance provider. You must also disclose any other charge you make for providing the insurance.

THE FINANCIAL CONDUCT AUTHORITY (FCA)

COMMERCIAL INSURANCE INTERMEDIARIES – CONFLICTS OF INTEREST AND INTERMEDIARY REMUNERATION, (THEMATIC REVIEW TR14/9) MAY 2014

In this report, the FCA summarised the findings of its thematic review, which looked into whether insurance intermediaries serving small to medium-sized enterprises (SMEs) are able to effectively identify and mitigate conflicts of interest arising from their remuneration structures.

The report referenced real estate sector practices, as follows:

Extract from Section 2 of the Report – Our Findings

High levels of commissions noted where the end cost is borne by other parties

Certain lines of insurance (notably commercial property, residential property owners and landlords) consistently attracted very high rates of commission (generally over 35% and sometimes over 50%) given the relative lack of complexity in broking such products (which were frequently placed with a single provider or small panel).

Some of the intermediaries and insurers we spoke to expressed concerns that these commission rates exist because the customer buying the insurance product was not the business or individual ultimately bearing the cost of the product. This appears to result in some intermediaries and property owners sharing in high commission levels with the inflated costs (and any potential detriment) being borne by the underlying tenant or lessor. There is currently a Competition and Markets Authority case under way considering residential property management services, which may partially consider this issue as it affects residential properties.

THE COMPETITION AND MARKETS AUTHORITY (CMA)

RESIDENTIAL PROPERTY MANAGEMENT SERVICES – A MARKET STUDY, DECEMBER 2014

The study looked at the supply of residential property management services in England and Wales by property management companies, where there were multiple leasehold flats and some shared facilities or common parts of the building. There were concerns that some property managers may be overcharging customers, providing poor-quality services, and/or spending money on unnecessary works and, in addition, whether property managers were dealing effectively with complaints.

The key insurance-related recommendations of the study emphasise that commentators and regulators want the interests of the consumer put first, (in this case the tenant), especially with regards to increasingly higher levels of transparency:

Extract from section 7 of the report – Recommendations – 7.40 Disclosure of fees, charges, and commissions

We recommend disclosure of (iii) commissions (including commissions earned by the property manager for arranging the buildings insurance).

We recommend that property managers must, for each property they manage (because charges may vary depending upon the contract and administration charges set by the landlord) fully disclose details of:

(iii) Any commission earned by the property manager (including fees/commissions in relation to buildings insurance).

How it addresses the concern or detriment identified

7.44 Some of the submissions to our study have alleged that insurance can be very expensive and that substantial fees/commission payments are made for arranging the buildings insurance. If this is the case, this could mean that leaseholders are overpaying for insurance.

7.45 We recommend that this information is disclosed, together with a summary of what is covered by the insurance. If any fee/commission relates to discounts from taking out insurance for a number of buildings, this information should also be disclosed. This recommendation applies to property managers placing the insurance, and any of their related companies (such as brokers and insurance administrators) where there is a corporate relationship, but does not apply to landlords.

Remedy design issues

7.47 The leaseholder also needs to know where information on charges can be accessed. This should be included in any descriptive document explaining the property manager's activities, within any welcome packs and on the property manager's website.

7.48 We recognise that in some cases administration/supplementary charges may be applied by the landlord, rather than by the property manager. In this situation, we recommend that the property manager states which charges it applies and collects payment for as well as identifying areas it is not responsible for. As the freeholder relationship is excluded from the scope of this study, we are unable to make a direct recommendation to cover them, but note that it would be good practice if landlords also fully disclose any administration/supplementary charges that are made. Where charges are not clear, we would encourage leaseholders to request this disclosure.

In addition, the report includes adverse comment concerning the vertical integration of landlords and property managers, which gives them incentives to act in ways that are not in the best interests of leaseholders.

SO SHOULD I TAKE ANY COMMISSION?

None of the reports have stated or proposed that commission may not be earned by the landlord or property manager.

However, there is no single correct answer to the question: "What is a reasonable rate of commission?"

Commission is only questioned in the context of the percentage level of some arrangements being too high:

- The FCA report refers to "very high rates of commission (generally over 35% and sometimes over 50%)".
- The CMA report states that "Property managers told us that ... commission levels ... of up to 20% could be considered 'reasonable' where the property managers were performing insurance-related tasks".

Our advice is to assess the costs that are incurred in insurance procurement and administration, and to structure compensation to reflect that amount.

DO I HAVE TO DO ANYTHING?

We have seen here that three very significant and influential public bodies – The Scottish Government, the FCA, and the CMA – are all reviewing the practice of landlords and property managers retaining commission from the premium paid by tenants.

So, while it is only Scottish Factors who absolutely have to act, Marsh is raising awareness that change is in the air. It is the spirit of the output of these reports that is of greatest importance to the real estate sector, the opportunity to embrace continuing self-regulation by adopting best practice consistently and voluntarily.

It would be complacent to think that the absence of any further regulation or law emanating directly from these reports is a sufficient reason to not change behaviour.

“The Federation has supported proactive disclosure of insurance commissions by landlords, and those who act for them, for many years now and this was something we pressed to be included in the 2007 Lease Code. This was driven by a desire to achieve what is best for both tenants and landlords, as it provides transparency for tenants and reduced reputational risk for landlords (and their agents) from taking undisclosed commissions. As this excellent summary sets out, such matters are under constant scrutiny by various public bodies and what applied in 2007 remains as pertinent and important today.”

Ian Fletcher at the British Property Federation.

RECOMMENDATIONS

The following five steps will help landlords fulfil their obligations to tenants:

1. Get the premium right

Conduct a regular and professionally negotiated review of your premium while preserving the quality of the insurance company and breadth of policy cover. Undertake the review in a structured manner that can be transparent to your tenants.

2. Fair premium apportionment

Ensure that the apportionment of premium between properties and tenants is justifiable and not weighted to favour property for which premium cannot be recovered. Transparency again: approach apportionment assuming that it could be scrutinised by tenants.

3. Commission should be justifiable

Ensure the level of commission you retain represents equitable compensation for the insurance-related tasks that you undertake. Think compensation, not profit.

4. Transparency and disclosure

Do not be complacent because codes of practice and market review recommendations are disjointed and non-statutory. Inform tenants of commission and any other earnings from insurance premium. Transparency is the recurring theme of the reports discussed here, as it is in two other relevant codes:

- British Property Federation: The Code for Leasing Business Premises in England and Wales 2007. Landlords must always disclose any commission they are receiving and provide full insurance details on request.
- Royal Institute of Chartered Surveyors: Designated Professional Body (DPB) Rules. While these rules apply to surveyors, they provide useful guidance on transparency. A key requirement of the DPB scheme is that the firm must account to its clients for all commission and other benefits obtained through general insurance mediation activity. The client must be informed in writing about the commission, which must be remitted to the client, unless the client has specifically given their informed consent, in writing, that the firm may retain the commission.

Transparency should extend to disclosure of any conflicts of interest arising from the joint ownership between the landlord, the property manager, and/or the entity arranging the insurance.

5. Reputation

Remember, if it's too good to be true, then it probably is. The final but most robust step is to simply ask yourself how you and your organisation will be impacted if your commission retention strategy is made public.

Failing to treat customers fairly has caused reputational damage to a wide range of companies across many sectors over the last year; real estate firms should therefore seek to learn the lessons from these events to ensure that they do not suffer similar reputational damage.

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