

ATOL Reform: Assessment of funding arrangements and the protection of customer money

CAP 2151

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About this document

1. This document seeks stakeholders' views on the CAA's intention to introduce changes to ATOL. The main changes relate to how ATOL holders fund their operations and how the use of their customers' monies should be considered within the regulatory regime. The document discusses the issues and invites comments on how the regulatory regime might change, but the CAA's expectation is that any proposals for material change would be subject to a further round of consultation.
2. The document also makes specific proposals in respect of i) a changed treatment of mandatory terms to be included in written agreements between ATOL holders and their agents, and ii) changes to the way in which SBA and certain franchisee ATOL holders report and pay their APC returns. The CAA will consider whether to introduce change in these two areas after considering responses to this consultation document only.

Responding to the consultation

3. The CAA is keen to ensure that the above proposals are both effective and appropriate. It is committed to incorporating the views of its stakeholders and the questions in the document provide a structure to enable this.
4. Responses to this consultation document should be submitted via the [Citizen Space page](#). We expect to publish responses we receive on our website as soon as is practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex.
5. If you are unable to use the Citizens space page, or if you have any questions about the document please send them to atol.consultation@caa.co.uk by 30 July 2021. Alternatively, you can write to:

Nina Singh
Consumer & Markets Group,
Fifth Floor, 11 Westferry Circus
London
E14 4HD

Given the on-going Covid-19 pandemic, our preference is for responses and questions about the consultation to be submitted electronically where possible.

6. If you require this document to be provided in a different format, please email atol.consultation@caa.co.uk and we will endeavour to accommodate your need.

Chapter 1

Why is the CAA issuing this consultation?

- 1.1 The ATOL scheme, in line with its terms, protects consumers in certain circumstances in the event that their package organiser ceases trading. For consumers who are yet to travel, it provides financial reimbursement for the cost of their licensable booking. For consumers who are abroad at the time of failure, the CAA will ensure that where possible the holiday can continue, and if required will arrange for passengers to return to the UK at no additional cost. As consumers are required to pay in full prior to receiving the services they have paid for, an effective financial protection scheme is also likely to give consumers confidence to book.
- 1.2 The CAA keeps the ATOL system under constant review to identify where improvements can be made. One of the themes we have considered over the years is ATOL holders' financial resilience, for example in "Rebalancing ATOL" from 2014¹. The changes introduced as result of that consultation sought to reduce consumers' exposure to ATOL holder insolvency and improve financial resilience through introducing a risk based financial assessment of smaller ATOL holders.
- 1.3 Whereas Rebalancing ATOL focused on the financial tests for small ATOL holders, we are now mainly focusing in this consultation on another key element of the system, the means by which ATOL holders fund their operations. The experience of the Covid-19 pandemic has amplified the need for change in this area, in that poor capitalisation and in particular the use of customer monies as a primary source of funding working capital can lead to a rapid deterioration of available cash. This can result in a bad consumer experience when refunds in respect of cancelled holidays have taken a long time to be repaid. Businesses that have clearly separated customer monies from their working capital and retained it until the completion of the customer's holiday have often been more financially resilient in the current crisis and better able to pay refunds for cancelled holidays as required by the law.
- 1.4 This consultation therefore sets out to achieve further strengthening in ATOL holders' financial positions alongside better risk pricing, while still facilitating a competitive market that provides choice and value to consumers, and while protecting them appropriately. A key area of focus is the practice of using customers' money to fund working capital, including making sure that the risks

¹ CAP1190

such an approach can pose to consumers are fully taken into account in the licensing arrangements.

- 1.5 We will be looking at changes to the framework which the CAA is able to make through its own regulatory powers. We continue to engage with Government about the wider ATOL regime, and are mindful of the need to consider the interaction between any changes we make and any other changes Government may make or consider including, in due course, how the Government decides to take forward the Airline Insolvency Review².
- 1.6 This initial consultation document sets out the CAA's objectives in relation to this consultation and is seeking feedback on the options and changes that we think best meet our intentions. As set out in "Next steps", we shall take the responses to this consultation into account before issuing a second consultation that includes specific and detailed proposals for change. We will also be undertaking a business impact assessment which will, in part, consider the effect any changes would have on competition, choice, and pricing.
- 1.7 Further, we are aware that the options set out in this consultation will affect differently the wide variety of business models operated by ATOL holders, including larger and smaller sized businesses. We therefore encourage all ATOL holders to share with us their views on how the different approaches would affect their business.
- 1.8 In addition to the main issues, as set out above, we are taking this opportunity to consult on a number of less far-reaching changes to Agency Agreements and SBA APC returns, where stakeholder input would be useful before taking decisions. These are set out in Chapter 5 and Chapter 6.
- 1.9 Finally, we understand that the Covid-19 pandemic is an unprecedented situation which continues to be financially challenging for both tour operators and consumers. We understand that introducing change industry may require time to adjust for practical reasons. Therefore, as we move to subsequent stages of this work, we will be mindful of the need to consider an appropriate implementation timetable.

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/800219/airline-insolvency-review-report.pdf

Chapter 2

Background to the proposals

- 2.1 The main objective of this consultation is to consider moving to a regulatory framework that improves ATOL holders' financial resilience i.e. having adequate capital and liquidity to reduce the risk individual ATOL holders pose to consumer interests. This includes having a robust financial protection system in place. Further, any change in framework would seek to give consumers confidence that they would also get a better overall experience including the payment of refunds where that proves necessary.
- 2.2 There are two principal problems: many travel businesses are highly reliant on customer money as a source of funding working capital and are not strongly capitalised enough in their own right; and the APC they incur may not be reflective of the risk individual ATOL holders or the value of bookings pose.

High reliance on customer monies as a source of funding

- 2.3 Customer money is the money paid in advance by the consumer to the ATOL holder for the licensable booking. The purpose of the money is for the ATOL holder to meet the costs of providing the holiday, whether paid to third party or in-house suppliers.
- 2.4 Issues arise when this money is used by the ATOL holder to fund other business expenditure rather than the specific booking. Meaning that the customer monies are in effect being utilised as a low-cost source of working capital funding for travel companies to finance their operational activities and growth, as opposed to seeking funding from other sources with the appropriate cost of capital attached. This can mean that the ATOL holder does not have the customer's money available when the supplier payments fall due, which is exacerbated by commingling of the business's own cash reserves with customer monies. Further, this leaves monies paid by consumers in advance of receiving their services more exposed to the ATOL holder's insolvency.
- 2.5 This approach can lead to an over reliance upon advanced customer monies and undercapitalised ATOL holder balance sheets.

ATOL Protection Contribution is not currently reflective of risk

- 2.6 The over-reliance on customer money can persist in part because the regulatory system is not set up to efficiently price the risk that such financial structures pose to the system. For each licensable passenger booking ATOL holders currently pay an APC of £2.50 which is used to fund the Air Travel Trust ("ATT"). This flat

rate means that companies which have an increased chance of failure and therefore pose a greater risk to the consumer pay the same per passenger as those companies who pose a lower risk. Further, it means that lower value holidays pay the same for protection as very high value holidays.

- 2.7 At present the flat rate structure, which was set in 2007 after consultation with the industry, is accompanied by the application of a financial testing regime which aims to bring all ATOL holders up to a common standard. Where the CAA is not content with an ATOL holder's finances, it uses its licensing powers to require improvements, perhaps in the form of an injection of capital or a requirement that customer money is protected.
- 2.8 Although this approach means that the system makes heavier demands on less well capitalised businesses, which has a similar effect to risk pricing, this consultation is predicated on a view that the system may still not sufficiently reflect the risk created by individual ATOL holders, and it may be beneficial to introduce change on a more system-wide basis.

Assessment of the current arrangements

Current ATOL holders

- 2.9 Under the current system, the CAA takes an individualised approach to the assessment of risk. When an ATOL is due to be renewed, all ATOL holders except small franchise ATOLs are subject to a financial assessment as set out in the CAA's [financial criteria](#). We have observed that ATOL holders with a weak financial position often see other financial stakeholders withdrawing financial support or tightening their terms, which in turn can create further financial pressure by reducing the amount of cash available to the ATOL holder. A specific instance of this is seen in ATOL holders' relationships with the credit card industry. The credit card industry is potentially exposed to ATOL holder insolvency by Section 75 of the Consumer Credit Act 1974 and relevant chargeback rules. Therefore, the merchant acquirers that issue card payment facilities to ATOL holders will sometimes require additional security or changes to terms and conditions. This is more likely to occur at a time when the merchant acquirer is concerned about the ATOL holder's insolvency risk and this may impact the business's liquidity and therefore make it harder for them to meet the CAA's financial requirements.
- 2.10 The CAA seeks to use its existing powers to put in place risk mitigation measures in the conditions for granting ATOL licences. Companies that do not meet the financial criteria may have additional licensing conditions imposed on them prior to their licence being renewed, in order to mitigate the additional risk posed by them to the consumer. This can include measures such as a cash injection into the business, or the provision of financial security (such as a bond,

fixed charge accounts or trust accounts) which is in favour of the ATT and is accessed for the benefit of consumers if the ATOL holder becomes insolvent.

- 2.11 If the conditions are met, then the licence is renewed and the ATOL holder can continue to trade for the duration of the licence period within the terms set out during the renewal. These conditions mean that there is an individualised risk adjusted cost mechanism in place, but it is often tailored to each business.
- 2.12 Under the current arrangements, there is no generally applicable requirement for customer monies to be segregated from the business's operational funds with the exception of Accredited Bodies who are required to operate trust accounts. Under their agreement with the ATT, ATOL franchises must have in place an arrangement to provide consumer protection.
- 2.13 Some of the proposed frameworks would affect Accredited Bodies and Franchises differently to regular ATOL holders, because in those frameworks the entire ATOL model would move more closely to that already operated by the Accredited Bodies and Franchises.

New ATOL applicants

- 2.14 New businesses are considered to pose more of a risk to consumers, therefore new ATOL applicants are required to provide a bond of 15% of annual licensable revenue, subject to a minimum of £50,000, during their first year. Where appropriate, this can then be stepped down over the subsequent three years. In addition, new applicants are required to meet the relevant financial criteria to be granted a licence.

The Air Travel Trust

- 2.15 The ATT was created by the Secretary of State for Transport as the principal source of funds for payments to be made to consumers in respect of licensable transactions where the ATOL holder from which they bought their holiday has become insolvent. It is governed by a Trust Deed and the Trustees are four CAA Board Members. Its purpose extends only to making payments in that regard and it plays no role in CAA licensing activities.
- 2.16 As at November 2020, the ATT had cash reserves of £35 million and a borrowing facility of £75 million. In addition, the Secretary of State for Transport recently reaffirmed that the Government will stand behind the ATT. The resources currently available to the ATT (apart from the Secretary of State guarantee) would be sufficient to meet insolvency costs in a typical year, but insufficient to meet very high levels of cost that might arise from a single large failure or a number of failures in quick succession.

Failures

- 2.17 The number of failures over the 5-year period 2014-2019 has remained relatively stable, with an average of 13 per annum. Excluding the two largest ATOL holder failures, the number of consumers affected over this period was approximately 72,000. Including the two largest ATOL holder failures, the number is approximately 980,000. These figures do not account for the number of consumers of other businesses which were also affected by the failures. The cost of an ATOL holder failure comprises repatriating passengers who are abroad at the time of the failure to the UK, as well as securing any other ground arrangements, the payment of claims from consumers who have forward bookings, and the costs of administering the failure. The APC is the ATT's key source of funding. Over time, the ATT seeks to build up sufficient funds held within the Trust to meet the significant amount of failure costs. However, for those ATOL holders most at risk, some will have provided a bond or other type of financial security in favour of the ATT which is used to contribute to the cost of the failure. Where this security is insufficient to meet those costs, the ATT meets the remaining cost directly from its funds.
- 2.18 Every holiday company insolvency leads to stress and disruption for its customers. In some instances it can cause significant financial loss and inconvenience through having to claim a refund and rearrange their holiday plans. The ability for the CAA to issue refunds in a timely manner is also impacted by the quality and availability of the documents and records held by consumers and ATOL holders. Please see chapter 7 below in regard to the CAA's ongoing online ATOL Certificate project. Further, customers who are abroad at the time of failure face additional difficulties in continuing their holidays and during the repatriation process.

Case for change

- 2.19 Many ATOL holders operate a business model which allows customer money to be commingled with operational cash in advance of providing services. Where the business does not have its own cash reserves to meet operating costs, commingling can mean that customer monies are used to fund these costs.
- 2.20 This can cause businesses to face additional risk as it requires a constant inflow of new customer monies to meet the costs of providing the original services sold, where these funds are no longer within the business. In other words, it can create an environment of perpetual refinancing in order to discharge a previously incurred liability, for example using the deposit paid by customer 3 to pay the suppliers for customer 2's holiday.

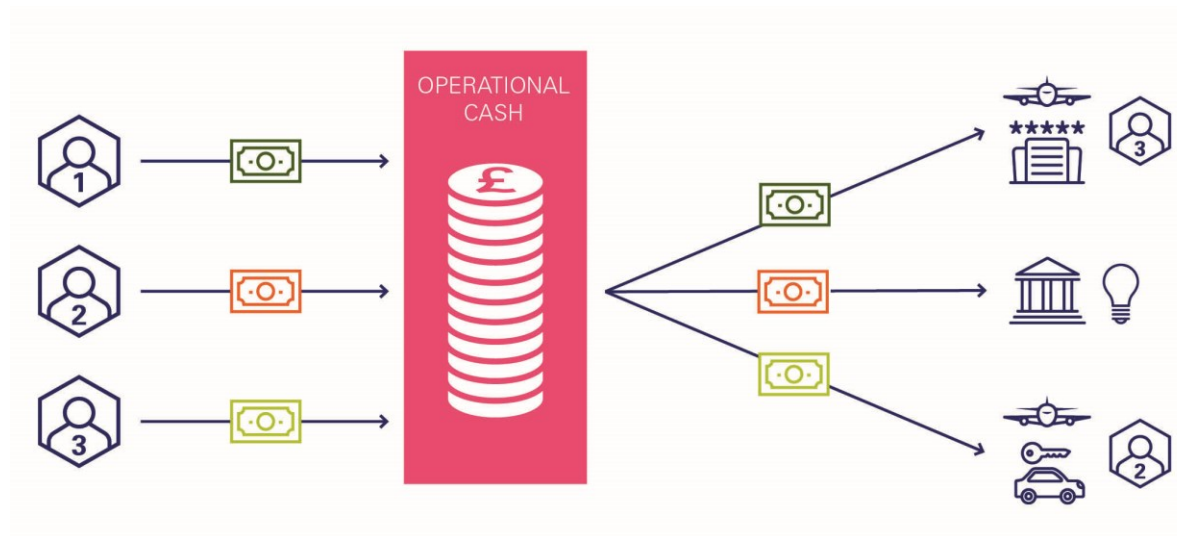


Figure 1: Comingling customer monies

- 2.21 Through its licensing process the CAA has sought to reduce some ATOL holders' reliance upon customer monies by means of various licensing terms and conditions, such as minimum cash requirements or ring-fencing funds. This is achieved as part of the individual financial assessment of ATOL holders when they apply for or renew their licence.
- 2.22 The CAA is now of the view that the current framework has not done enough to restrict the use of customer monies as a source of low-cost financing. Under the individualised approach, the licensing terms and conditions mean that ATOL holders which pose a greater risk to consumers effectively incur higher costs to a hold a licence, e.g. the cost of putting in place a bond etc. However, this has failed to sufficiently incentivise ATOL holders to put in place more robust financing structures and protection of advance customer monies. Further, the use of a non-individualised i.e. a flat rate APC contribution of £2.50, has failed in some cases to sufficiently reflect the risk individual ATOL holders pose to consumers. Where businesses face increased risk of failure, they still pay the same contribution as other businesses which are financially more robust³.
- 2.23 Although this practice itself has not led to large numbers of ATOL holder failures⁴, commingling and the use of customer monies to fund working capital contributed to financing structures which may have factored into the failure of two of the largest ATOL holders. These alone impacted circa one million consumers.

³ This is mitigated to some extent by the use of bonds or other forms of financial security for the benefit of the ATT

⁴ Prior to the Covid-19 pandemic

- 2.24 This view has further been reinforced by the experience of the travel industry during the Covid-19 pandemic and has further been exacerbated by the recent challenges faced with customer refunds.
- 2.25 To rebalance how the ATOL scheme is funded to protect consumers, the CAA is considering moving to a framework that takes a more systematic approach to ATOL holder risk, and that better prices any residual risk an ATOL holder poses to the consumer. The objective would be to encourage and incentivise ATOL holders to reduce their reliance on customers' money as a source of funding working capital thereby requiring them to pursue a more robust funding structure and financial policy. The CAA recognises that requiring ATOL holders to obtain a separate source of funding of working capital rather than using customer monies incurs an additional cost. This consultation is looking at how ATOL holders finance their operations rather than restricting certain types of business models. The CAA is seeking to strike a better balance between a more financially robust set of arrangements with better risk pricing, and still facilitating a competitive market that provides choice and value to consumers, while protecting them appropriately. The CAA is not seeking to completely remove the risk that ATOL holders will fail. However, we are seeking to minimise the impact of failures on all relevant stakeholders where possible.

Other changes

Pipeline monies

- 2.26 The CAA is also seeking feedback on issues surrounding pipeline monies. Pipeline monies are the customer monies paid to and held by an agent on behalf of the ATOL holder responsible for the booking. Currently, there is no requirement under the Agency Terms stating when customer monies held by a travel agent need to be passed on to the ATOL holder. This can mean that significant amount of customer monies can be held by the travel agent prior to departure. During this period the ATOL holder is exposed to the risk of the travel agent failing which can cause additional financial pressure to the ATOL holder. In the event of agency insolvency the ATOL holder is obliged to meet its contractual obligations to the customer irrespective of whether it received the funds from the agent.