ATOL Reform: assessing the impacts of the options for reform – request for further information

CAP 2496

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About this document

This document updates stakeholders on the progress to date of the ATOL reform programme, on amendments to the scope of the programme as requested by the Government via the Trustees of the Air Travel Trust, and on the timetable moving forward. This document also explains the CAA's overall approach to appraising the options for reform set out in the first consultation[1] and seeks stakeholders' views on this and on the options being considered. In addition, the document also requests further information from stakeholders to help finalise the options appraisal process.

Responding to the request for information

1. Responses to this request for information document should be submitted via the Citizen Space page by 24 March 2023. Any material that is regarded as confidential or commercially sensitive should be clearly marked as such and submitted directly to the CAA as a separate annex to atol.consultation@caa.co.uk. Given the need for the close involvement of the Department for Transport (DfT) in the development of the ATOL reform programme[2], the CAA may share with the DfT material submitted in response to this request for information unless clearly marked by the respondent that it should not be shared. The CAA will consider the responses it receives to this request for information as it continues to develop its approach to appraising the options for reform.

2. If you are unable to use the Citizen Space page, or if you have any questions about the document, please send them to atol.consultation@caa.co.uk by 24 March 2023. Alternatively, you can write to:

   Louise Chesterton
   Consumer & Markets Group
   Fifth Floor, 11 Westferry Circus
   London, E14 4HD

3. 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 needs.

[1] https://consultations.caa.co.uk/cmg/atol-reform/.

[2] See paragraphs 2.1, 2.10, and 2.11.

Chapter 1
Why is the CAA issuing this document?

Request for information

1.1 As indicated in its summary of responses and next steps document[3], the CAA is in the process of evaluating the options for reform set out in the first stage of the consultation, taking into account the responses received to date. As part of this ongoing evaluation process the CAA is now seeking further information to ensure that it has identified and understood the range and magnitude of the impacts of each option on different stakeholders. So far as its overall approach is concerned, in addition to identifying the full range of impacts on different stakeholders, the CAA would also like to ensure that the methodology and information used to determine the magnitude of the identified impacts is robust and that, where it is not possible to reliably quantify the impacts, its approach to making a qualitative assessment is reasonable and objectively justifiable.

1.2 Given the far-reaching nature of some of the proposals contained in the first consultation document, their potential to have a significant impact on some stakeholders, and the diversity of views expressed by stakeholders to the different options proposed, the CAA is seeking views from stakeholders on its approach to assessing the impacts of the different options through a number of questions that will help finalise its analysis of the impacts. The CAA will use the responses from stakeholders to this request for information to finalise its approach to appraising the options for reform and in the preparation of an impact assessment, which will form part of its advice to Government, alongside its recommendation on the preferred option for reform.

1.3 Chapter 2 of this document provides an update for stakeholders on the scope of ATOL reform and on the likely timescales moving forward. Chapter 3 builds on the first consultation and the feedback from stakeholders by providing further detail on how the CAA envisages the options for reform could work in practice and the potential interactions between them. Chapter 4 explains the CAA's overall approach to appraising the options for reform. This chapter also explains the analysis and research that the CAA has undertaken to identify and understand the impacts of each option on different stakeholders. Chapter 5 presents the CAA's emerging findings of the options appraisal so far.

1.4 The CAA would like to stress that no decision has been taken on the final proposals for reform. The CAA remains committed to reform to strengthen the

[3] https://consultations.caa.co.uk/cmg/atol-reform/.

financial licensing arrangements for ATOL holders. In presenting these emerging findings, the CAA’s intention is to facilitate stakeholders in engaging with the options appraisal process in a substantive and meaningful way, allowing them to understand, at a practical level, the likely impacts on ATOL holders of the various options for reform. As set out above, feedback from stakeholders to this request for further information will help finalise the impact assessment.

Chapter 2

Update on reform and progress to date

The financial sustainability of the ATTF and the rate of APC

2.1 Although the CAA is currently leading on the ATOL reform programme, ATOL is a statutory licensing scheme that also provides financial protection to consumers of licensable air travel and the Government has a key role in reviewing its effectiveness. In particular, in the context of the role of the Secretary of State for Transport in establishing the Air Travel Trust Fund (ATTF), which funds the costs of administering the financial protection, it is the responsibility of the Secretary of State to set the rate of the ATOL Protection Contribution (APC).

2.2 The Government has, in the past, given commitments to financially stand behind the ATTF when asked to do so by the Trustees of the Air Travel Trust (ATT). If any government loan were to be provided when such commitments were in place, then taxpayers' money would be used to support the loan. It has always been the intention of Government that the ATOL scheme should present a minimal risk to the general taxpayer.

2.3 In this context the Government has requested that Trustees consider a number of scenarios based on different capital requirements for the ATTF and the implications of this for the future rate of APC, and on the basis that the ATTF no longer requires government support. The Trustees have requested that the CAA undertake this analysis on their behalf and incorporate it into the ongoing development of ATOL reform. This analysis is currently underway and the CAA will report on its findings in due course in the context of the ATOL reform programme.

The financial markets option

2.4 In the first consultation document the CAA put forward a potential option (Option D, also referred to as the financial markets option) whereby ATOL holders would be required to obtain full, ATOL equivalent consumer financial protection from third party insurance providers as a condition of taking bookings.

2.5 In the CAA's summary of responses and next steps document, the CAA noted the concerns of many respondents about the availability and coverage of financial products such as insurance for the entirety of the travel industry, the likelihood that such products will pay out in the event of insolvency, the capacity and the cost (and volatility) of premiums. The CAA's view at that time was that the financial markets option would be unlikely to be a viable option to cover the entire market risk[4].

2.6 Since the publication of its summary of responses and next steps document the CAA has been in discussions with insurers and other financial product providers to understand their appetite for re-entering or, if they are already present, expanding their presence in the travel market. These discussions have revealed that, although there is a greater industry appetite for providing financial products to the sector than was the case a year ago, this is generally in the context of such products being complementary to other mechanisms (e.g. segregation) to cover the cost of insolvency protection for individual businesses.

2.7 The CAA acknowledges that some ATOL holders have stated that they can obtain "full insurance coverage", but the evidence received to date indicates that the financial markets option is not currently a viable option in isolation for covering the entire market risk / all ATOL holders. Instead, the CAA is minded to focus its further work in this area on the use of financial products as a complementary measure sitting alongside other mechanisms, for example under a tailored or hybrid approach. The CAA's thinking in this area is expanded further in Chapter 5.

? Questions – The financial markets option

1. Do you agree or disagree that the CAA should focus its further work on the use of financial products as a complementary measure sitting alongside other mechanisms, for example under a tailored or hybrid approach for individual businesses, rather than as a measure to cover the entire market risk?

Pipeline monies

2.8 In the first consultation the CAA identified that customer monies are exposed to insolvency risk when they are held by an Agent on behalf of the principal ATOL

[4] This preliminary view was supported by the shift in approach that underpinned consumer financial protection within the German package travel market. The German scheme was supported by insurance via a capped limit, which in the case of Thomas Cook was not large enough to cover the claims. Subsequently, the scheme has moved to introduce a fund (similar to the ATTF) to cover large tour operators while smaller tour operators have the choice (if capacity is available) between contributing to a fund (and providing security) or utilising a surety-bond-based approach. The available capacity and appetite are very dependent on the insurer's risk rating of the company.

holder (referred to as “pipeline monies”). The CAA asked for feedback as to whether this was something that should be considered when evaluating the proposed options for reform. As outlined in the summary of responses document, stakeholders’ views on this issue were mixed. Having considered these responses, the CAA’s view is that it would be prudent to first focus its efforts at this time on the options for reform as they apply to ATOL holders and direct sales.

2.9 The CAA recognises the importance of consistency across the travel ecosystem and will give further consideration to the pipeline monies issue once a preferred option for reform is identified. To this end, the issue of pipeline monies is revisited at the end of Chapter 5, with stakeholders invited to provide further feedback on the issue having had the opportunity to consider the CAA’s evolving thinking on ATOL reform, including the emerging findings of the options appraisal so far.

Next steps

2.10 The CAA has been working closely with the DfT on the ATOL reform programme, including on timetable planning, and in particular on aspects that may require legislative change, for example changes to the structure of the APC. If legislation is required to deliver the CAA’s preferred outcome, the CAA will make a recommendation to the Government with its view on how to best deliver ATOL reform. The next stage of consultation would therefore likely to be a joint DfT/CAA consultation.

2.11 In the event legislation is required, the usual Governmental and Parliamentary Processes would be followed, including the Government being the ultimate decision maker on the final proposals, and Parliament having the opportunity to scrutinise the proposals and draft legislation.

2.12 If legislation is not required to deliver the option, the CAA will continue to lead the consultation process and decision-making exercise to a conclusion, although the CAA will continue to work closely with the Government in recognition of the Government’s role in relation to the scheme.

2.13 The CAA is also mindful of the need to have an appropriate transition period from the current arrangements to any new ones. As set out in the CAA’s summary of responses and next steps document, there was a range of feedback from stakeholders on the question of the transition period for the industry to move to a new set of arrangements. For example, respondents that have already adopted one of the proposed options (i.e. they already segregate monies or have a bond in place) typically selected a shorter transition period of around one to two years. Whereas other respondents considered that a longer period, for example three to five years, or even as long as ten years, would be more appropriate given the lasting impact of the COVID-19 pandemic on ATOL holder balance sheets.

2.14 In response to this feedback the CAA would like to reiterate that it is committed to ensuring that an appropriate transition period is given for stakeholders to move from the current arrangements to any new ones. The date of the start of the transition period, and its duration, will clearly depend on the option(s) that is ultimately chosen for reform. The CAA will therefore keep this under review as the ATOL reform programme develops. That said, the CAA will look to start to introduce any new arrangements as soon as possible, potentially from April 2024.

2.15 While the CAA concludes the ATOL reform process and during any transition period, the CAA will continue to apply its existing licensing framework and, where relevant, will continue to require ATOL holders to meet certain conditions in order to strengthen their financial position and, as far as possible, to ensure the continued financial robustness of ATOL holders including where necessary putting in place additional financial security measures.

Chapter 3

Further detail on certain practical aspects of the CAA's proposed options for reform

3.1 Building on the feedback from the first consultation and the CAA's ongoing engagement with industry, this chapter provides further detail on how certain options proposed in the CAA's first consultation could work in practice.

3.2 The chapter focuses predominantly on segregation of monies and the APC since feedback from stakeholders revealed that there was a lack of clarity around the segregation options, unlike the bonding option which was well understood.

Segregation

3.3 The CAA's summary of responses document noted that there had been a relatively widespread industry assumption that trust accounts as a method of segregation would require all customer monies to remain in trust until the consumer had returned from holiday (referred to here as 'total trust segregation'). The first consultation presented total trust segregation as one of the options for segregation alongside other segregation options. In the context of segregation of customer monies, the CAA's proposals were, and remain, broader than total trust segregation.

3.4 The CAA continues to consider that a segregated approach could operate in different forms. Broadly speaking, the CAA considers that segregation could operate in the following forms (in this context trust accounts or escrow accounts are considered to achieve the same objective):

(1) Total trust segregation protecting and holding all customer monies in trust until delivery of the holiday is completed;

(2) Trust segregation that allows for release of funds for certain types of supplier payments or up to a certain value or percentage of advance payments to suppliers.

To support the financial protection of the early release of monies this could be underpinned by other mechanisms such as bonding and/or insurance. This is similar to the tailored approach set out in the first consultation;

(3) Trust segregation whereby monies can be released to cover the value of all holiday supplier payments; or

(4) Client account segregation whereby a designated company director takes responsibility of the client account[5] that could operate under any of the approaches set out in (1)-(3) above, or indeed under an approach that also allows payments out of the account to cover other expenses (such as general prepayments made by an ATOL holder to secure commitment volume). The operation of the client account would be validated on a certain frequency by an independent auditor (ATOL Reporting Accountant).

3.5 The previous paragraph does not provide every permutation for segregation (furthermore the type of segregation could be determined on a risk-based basis) but serves to make clear that the CAA is considering different approaches by which segregation could operate. Further, under a tailored or hybrid approach, there is scope to enhance these options by requiring any funds subject to release from the account prior to completion of the consumer's holiday to be protected by a bond or other financial product (this is discussed in more detail in Chapter 5).

3.6 In considering the advantages and disadvantages of each of these different approaches as part of the ATOL reform programme, the CAA is aware of several key factors that need to be considered. These factors, which are factors the CAA currently takes account of in its risk-based licensing framework, are: the size of the ATOL holder; the nature of the ATOL holder's business (in the context of its supplier relationships and supplier payments); and whether the ATOL holder is part of an integrated airline group. In developing its thinking on segregation these factors are also being considered, as explained further the following paragraphs.

? Questions – Segregation methods

2. In considering the possible methods for segregation set out in paragraph 3.4, what are your views on the different approaches put forward by the CAA and are there other aspects that it should consider?

The size of the ATOL holder

3.7 The first consultation asked for respondents' views on whether ATOL holders should be treated differently based on size. In response, the vast majority of ATOL holders considered that it would be appropriate to adopt different approaches depending on the size of the ATOL holder, although views on this

[5] Which, in this context, could be as simple as a separate bank account into which customer monies flow initially. This approach is different from a traditional trust account model which involves independent trustees ensuring that appropriate funds are always maintained in the account and controlling payments out of the trust account in line with the terms of a specific trust deed.

point differed considerably based on whether the respondent was a small ATOL holder or a large one (or an integrated operator).

3.8 In the context of the segregation of customer monies, the CAA acknowledges that smaller ATOL holders could be disproportionately impacted due to the fixed costs associated with setting up and operating a trust account. In response, the CAA notes that existing Accredited Body and Franchise arrangements[6] offer routes for smaller businesses[7] and in the case of Franchises, smaller ATOL holders, to comply with regulatory requirements, and these are underpinned by the protection arrangements of the Accredited Body or Franchise. If ATOL reform was to result in a greater requirement for trust accounts it is possible that, over time, new third parties may come forward to offer products and services tailored to meet the needs of different ATOL holders alongside the existing Accredited Bodies and Franchises.

The nature of the ATOL holder's business and supplier payments

3.9 Direct industry feedback has highlighted concerns from some respondents that trust accounts do not suit operators required to prepay suppliers in advance of departure. Comments focussed predominantly on airline payments, but also accommodation and other major supplier payments, as well as payments made to secure volume commitments for which the product has not yet been sold to a consumer.

3.10 The CAA acknowledges that certain ATOL holders, notably small and medium sized firms, operating in certain markets, for example selling high-value tailor-made holidays, are required to pre-pay a larger proportion of customer receipts in advance to secure particular accommodation and/or other ground and travel services.

3.11 The CAA remains of the view that the pre-payments set out in 3.9 and 3.10 can present different risk factors to the operator and ultimately to the end consumer.

3.12 It is worth noting that the existing trust account arrangements accepted by the CAA currently permit, subject to certain more detailed requirements and conditions to be met in advance, amounts covering the value of airfare payments made to third party airlines to be withdrawn from the trust account when a confirmed ticket has been issued to the consumer. Further, as indicated in paragraph 3.4, the CAA is considering a range of different approaches to segregation, including client account segregation arrangements, which in

[6] Not all franchise arrangements operate a trust account model. All Accredited Bodies are required to operate a trust account as required by the Schedule of Accredited Body Standard Terms.

[7] Businesses can operate as a member of an accredited body without the need for their own ATOL.

principle can allow for a broader range of payments to be made from the account.

Integrated operators

3.13 Discussions with, and feedback from, the industry has highlighted another key factor, which is airlines within the same corporate group or ownership structure as the ATOL holder (referred to here as 'integrated groups' or 'integrated operators'). A number of respondents to the first consultation argued that this was a more important factor than size, noting that the failures of Thomas Cook and Monarch had a significant impact on the reserves of the ATTF due to the nature of their businesses and the need for large scale repatriations.

3.14 Further, although the segregation options proposed by the CAA can be implemented to provide a level of failure liability cover by protecting some or all of the customer monies taken by the business, these options do not cover repatriation costs as, other than in the case of total trust account segregation, only a certain portion of the client monies are protected. In the case of a failure of an integrated group, it would be unlikely that total trust account segregation would be sufficient to meet the costs of operating a repatriation operation given the cost of securing aircraft capacity in a time sensitive situation when aircraft capacity could be constrained. Hence there remains potentially significant exposure for the ATTF.

3.15 In addition, in terms of the impact of failures on the ATTF, the CAA would like to note that alongside the additional risk posed by integrated operators there is a broader risk related to airline supplier concentration – i.e. the extent to which the airline within the ATOL holder group is used by other ATOL holders.

? Questions – Key factors to consider in the context of the different segregation options

3. Are there additional key factors other than the size of the ATOL holder, the nature of the ATOL holder's business and supplier payments, and whether the ATOL holder is part of an integrated airline group, that the CAA should take into account when considering the advantages and disadvantages of the different methods of segregation?

4. On the issue of the size of the ATOL holder, should smaller ATOL holders (up to a certain size limit) be entitled to operate segregation in a way which is proportionate to their size and the risk they pose to the ATTF (for example a client account with appropriate level of third-party oversight)? Please explain your views along with what, if any, size limit should be set, and what other corresponding requirements such as bonding or APC might be required.

5. As set out in paragraph 3.8, Accredited Bodies and Franchise Arrangements provide options for smaller businesses and smaller ATOL holders to operate within

a framework overseen by a third party. Do you consider that it is a viable option now (or in the future) for all smaller businesses / ATOL holders to be required to be a member of an Accredited Body or Franchise?

6. Should the CAA consider general prepayments made by an ATOL holder to secure commitment volume (whether air, accommodation or other travel services) in the same way as specific prepayments required to secure an airline seat, accommodation or other travel service component for an individual booking? Please explain your views.

7. Do you agree or disagree that, where there is a degree of concentration risk with a particular supplier(s), payments made to these suppliers should be considered differently? Please explain your view, including quantifying a threshold that would represent a concentration risk.

8. Do you agree or disagree that payments made by ATOL holders to airlines within the same group structure (integrated groups) should be treated differently to payments made to third party suppliers? Please explain your view.

9. Do you agree or disagree that payments made to other suppliers (e.g. hotels, destination management companies, cruise operators, etc) that are part of the same group structure should be treated in the same way as payments made by an ATOL holder to an airline in the same corporate group (integrated airline groups).

APC

3.16 Responses to the first consultation indicated that a variable APC would be more preferable to the current flat rate APC. As set out in the summary of responses and next steps document, some respondents considered that this would lead to a fairer system in which financially sound ATOL holders are not in effect subsidising riskier financial practices by others. These respondents considered that a variable rate APC should be used to reflect the residual risk not covered by other financial protection measures. An APC model with a mix of value and risk criteria received the most support from ATOL holder respondents, though no model was favoured by an overall majority of respondents.

3.17 Chapter 4 sets out the APC analysis completed on behalf of the CAA to date and the factors that could underpin a future variable rate calculation. Ongoing stakeholder dialogue with the CAA has focused on the interaction between APC and the method of direct protection of customer money (whether that be through segregation, bonding or other financial products, or a combination).

3.18 As set out in the first consultation, the CAA is considering arrangements for APC that appropriately recognise the direct protection of customer money by the ATOL holder – e.g. through a 'banding' or reduction to the calculated APC. The principle being that a discount to the rate of APC should apply where the ATOL holder provides a greater level of direct protection/security than is required by the terms of their licence. For example, those voluntarily operating total trust segregation might be required to pay only a de-minimis APC in recognition that all monies are held on trust until the consumer returns and that amount would cover cost of claims administration or risk that the company-specific trust protection arrangements had failed.

? Questions – Interaction between APC and the method of direct protection of consumer monies

10. Do you think a reduction should be applied to the rate of APC based on the degree to which each ATOL holder provides for their own risk of failure? Please provide an explanation for your answer and, if you do agree that such a discount should be applied, please explain on what basis the discount should be applied and the amount of the discount.

11. Do you think that integrated airline groups should pay a different rate of APC to reflect the potential cost of a repatriation?

Scope for additional risk-based requirements

3.19 Ongoing stakeholder feedback has articulated that the CAA should continue to maintain a risk-based focus in its licensing of ATOL holders. In this context any of the different segregation options discussed in paragraph 3.4 above could be implemented depending on the CAA's risk assessment of each individual ATOL holder.

3.20 Alternatively, a method of segregation could be chosen to apply to all ATOL holders, for example simple client account segregation (see option 4 in paragraph 3.4), and then the CAA could set additional requirements based on the risk assessment of that particular ATOL holder, for example in terms of allowing only certain supplier payments to leave the client account and / or requiring the ATOL holder to provide security to protect these payments against supplier failure (e.g. via a bond or other financial product). This model could fit within a tailored or hybrid approach, which is discussed in more detail in Chapter 5.

? Questions – Additional risk-based requirements

12. Do you agree or disagree that the CAA should retain a risk-based licensing approach? Please explain your view.

13. If you agree, in the context of the different segregation options discussed in paragraph 3.4, do you think that the CAA’s risk-based approach should extend to it requiring different methods of segregation for each ATOL holder depending on its risk assessment? Alternatively, do you consider that a method of segregation should be chosen to apply to all ATOL holders, and then the CAA could set additional requirements based on the risk assessment of that particular ATOL holder?

14. If the CAA continues to operate a risk-based focus in its licensing of ATOL holders and if ATOL holders posing an increased risk are required to provide increased segregation or bonding, should the APC (banding or adjustment) be the same as another ATOL holder that voluntarily provides the same direct protection of consumer monies?

Chapter 4

The CAA's approach to appraising the options for reform

4.1 In its first consultation the CAA set out its rationale for proposing changes to the ATOL framework. The CAA identified two principal concerns with the current framework:

- that 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
- that the APC they incur may not be reflective of the risk that individual ATOL holders or the value of their bookings pose.

4.2 In light of this, the expressed aim of the ATOL reform programme is to: (a) strengthen the financial framework for ATOL to better ensure that ATOL holders meet their obligations towards consumers and, in doing so, mitigate the risk they pose to the customer monies they hold; and (b) to ensure that pricing (i.e. the APC) better reflects the risk that individual ATOL holders or the value of their bookings pose. The CAA is seeking to achieve these aims while still facilitating a competitive market that provides choice and value to consumers and protects them appropriately. On this basis the consultation proposed several options relating to rebalancing how the use of customer monies should be considered within the regulatory regime, how financial protection under ATOL is funded, and how the rate of the APC should be calculated.

4.3 Since the first consultation closed the CAA has been undertaking the background model development to allow it to evaluate the proposed potential options for reform and to assess the impact of these options on different stakeholders. As part of this evaluation process the CAA is seeking to identify and understand the range and magnitude of the impacts of each option on different stakeholders. This chapter sets out the CAA's thinking on how the proposed options impact on different stakeholders, its views on the range and magnitude of these impacts, and summarises the research and analysis commissioned by the CAA to date to inform its thinking in these areas.

Identifying the mechanisms by which the proposed options impact stakeholders

4.4 As set out above, the first consultation put forward several options relating to how the use of customer monies should be considered within the regulatory regime, rebalancing how financial protection under ATOL is funded, and how the rate of the APC should be calculated. In this next section the CAA has sought to set out its thinking on how the potential options can be expected to translate through to impacts on stakeholders.

Improved industry resilience

4.5 Reducing the reliance of many travel businesses on customer money as a source of funding working capital and improving the capitalisation of these businesses in their own right should, other things being equal, lead to an improvement in the financial resilience of these travel businesses. This should lead to travel businesses being less likely to become insolvent than would otherwise be the case. Consumers will benefit from this improved industry resilience through a greater probability that they will be able to take the holiday that they have booked.

Changes to the costs incurred by businesses and consumers

4.6 The first consultation put forward several potential options for how the financial resilience of the industry could be enhanced, as well as options for a variable rate for APC. These options may lead to increased costs, and any associated increase in cost will be met first by industry and then potentially passed on to consumers through increased prices. Any overall increase in cost and, by extension, the price paid by consumers for their holidays, needs to be weighed against the consumer benefit identified above in relation to improved industry resilience.

4.7 In addition to the overall change in cost associated with the option under consideration, there could also be distributional effects between different ATOL holders – i.e. some ATOL holders will incur greater costs than others (in relative and/or absolute terms). The impact on competition will need to be considered in this context. This will depend on the option being assessed, the nature of the ATOL holder's business, and the current state of its financial resilience. In certain cases, some ATOL holders might experience a net benefit if they pose little or no risk to the customer monies they hold.

Resilience of the Air Travel Trust and the potential impact on the public accounts

4.8 As set out in paragraphs 2.1 to 2.3, the Government has requested that Trustees consider a number of scenarios based on different capital requirements for the ATTF and the implications of this for the future rate of APC. Increasing the rate of APC would, other things being equal[8], put the ATTF on a stronger financial footing over time and correspondingly reduce the risk that the Trustees of the ATT would have to ask the Government whether it would step in and financially

[8] The level of security provided by ATOL holders and held for the benefit of the ATT also affects the financial impact on the ATTF of failures.

stand behind the ATTF. This reduction in the potential financial exposure of taxpayers to ATOL holder failures would need to be considered in the context of the costs to industry, and ultimately consumers.

Consumer choice and competition

4.9 Any overall change in cost, as well as the distribution of these changes in cost amongst ATOL holders, could have an impact on consumer choice and competition. This is explained further below.

Market exit

4.10 Currently there is a broad and diverse range of ATOL holders (around 1,600 ATOL holders currently) specialising in many different segments of the travel market. Although the CAA acknowledges that the majority of UK consumers are carried by the largest ATOL holders, the market includes specialised smaller and medium sized holders.

4.11 Following on from any changes as a result of ATOL reform, ATOL holders might decide to exit the market altogether rather than continue to participate in it on the basis of the chosen option for reform. This will clearly impact on those businesses that choose to exit the market in that they will forego the future revenues associated with selling flight inclusive package holidays (although, as pointed out below, these businesses might instead choose to 'de-package').

4.12 From the perspective of the consumer, market exit on a large scale could impact negatively on them through a lessening of choice and value. That said, the number of firms participating in a market is not, on its own, necessarily a proxy for healthy competition, particularly in a market that is already very competitive. Further, as explained above in the context of potential increases to costs and prices, the risk of market exit needs to be weighed against the consumer benefit identified above of improved industry resilience (in particular if the businesses that choose to exit the market are those that rely most heavily on using customer monies to fund working capital and pose an increased risk to consumer interests).

'De-packaging'

4.13 For ATOL holders, an alternative to exiting the market is to stop offering flight inclusive package holidays and instead sell holiday components separately (so as not to create a package). Firms might benefit from this switch due to lower regulatory costs[9]. It should be noted, however, that this opportunity for firms already exists, but many firms continue to offer only package holidays, and

[9] Note that, depending on the reaction to such a move by consumers and the finance sector, for example a greater reliance by consumers on Section 75 of the Consumer Credit Act 1974, the cost of operating in a de-packaged environment might not change substantially even with the removal of costs associated with ATOL.

others offer both package holidays and separate components. This is because, from a consumer perspective, self-assembled holidays are not necessarily fully substitutable for package holidays, not least because of the various protections (for example the provisions under Package Travel Regulations[10] such as repatriation, replacement or refund in certain circumstances and other legal obligations placed on the package organiser) offered as part of a package holiday. Although the risk of de-packaging is real, the willingness of an ATOL holder to de-package will depend on many factors.

4.14 Although consumers are free to choose whether to buy a package holiday or to assemble the components of their holiday themselves, consumers benefit from the protections associated with a package holiday, including ATOL protection, if a flight forms part of the package. Consumers choosing to assemble the components of their holiday themselves do not benefit from the legal obligations of the Package Travel Regulations. Should such consumers wish to continue to be financially protected, they would need to consciously choose to cover the insolvency risk via other means, for example travel insurance or by booking by credit card (and relying on Section 75 of the Consumer Credit Act 1974) or debit card (and relying on the relevant chargeback rules of each scheme). The potential additional complexity and cost for consumers in obtaining their own insolvency protection, in contrast to the relative simplicity of ATOL protection, might be an important factor[11] in persuading some consumers to continue to book package holidays over self-assembled holidays.

Changes in business model

4.15 An alternative to exiting the market or de-packaging might be for an ATOL holder to change its business model to mitigate the impact of any change in costs. Depending on the scale and nature of such changes this could impact on competition (for example if ATOL holders became more or less active in certain segments of the market) and consumer choice (for instance if it led to a narrowing of the range of holidays being offered in the market). As with the risk of de-packaging, the willingness of ATOL holders to change their business models on a sufficient scale to impact on competition and consumer choice will depend on business-to-business specific factors.

Wider impacts

4.16 Each of the financial security options put forward by the CAA in its first consultation require the involvement of an external third-party provided service.

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[10] https://www.legislation.gov.uk/uksi/2018/634/contents.

[11] As covered in paragraph 4.30 onwards, the CAA's consumer research found that, although consumers are not always aware of the detail of what ATOL protects, ATOL protection is associated with 'peace of mind' for consumers. The research showed that these positive associations form a key role ATOL plays for consumers when they book holidays.

For some options, for example segregation via a client account, this is a simple bank account and the involvement of the bank is relatively minimal beyond setting up the account. For other options, such as a trust account, the appropriate legal arrangements need to be put in place and, typically, professional trustees will need to be engaged to ensure that appropriate funds are always maintained in the account and to control payments out of the trust account. Different still is bonding (and other financial products such as insurance) where the counterparty takes on a certain amount of the principal's risk in return for a premium and may require some form of security. All other things being equal, the increased reliance upon third parties reduces the control of the ATOL holder in managing its own affairs and, in some cases, subjects it to the risk appetite of these institutions.

4.17 It is worth therefore considering the wider impacts of these options, both in terms of their potential constraints on implementing the options put forward by the CAA, but also any wider benefits that a particular option might bring.

Potential constraints

4.18 In response to the options involving segregation put forward by the CAA in the first consultation, many respondents cited practical constraints to implementation, with these constraints focusing specifically on trust accounts. Although some respondents disagreed that these constraints were borne out in practice, concerns centred around the cost of such arrangements, their potential complexity, their appropriateness for different business models, and the proportionality of such measures for smaller operators. Although not a major focus for respondents, some referred to the availability of high-quality professional independent trustees, in particular if the CAA was to proceed with a trust account or escrow account option covering the whole ATOL sector. Further, some respondents raised questions over how the professional standards of independent trustees would be assured and what the regulatory framework for this would be. In contrast, there was little feedback from stakeholders on the potential constraints of other segregation methods, for example client account segregation.

4.19 In response to the points raised on formal segregation by way of trust or escrow accounts, the CAA acknowledges that ATOL holders will incur a cost in putting in place these forms of segregation, in terms of the administrative cost of setup and ongoing operation. Additionally, and depending upon the manner in which the trust account is operated, there may be additional cost associated with putting in place sufficient funds to meet the requirements of the trust or escrow account. As acknowledged in Chapter 3, the CAA is aware that this cost could vary depending on the requirements of the trust or escrow account and the business model operated by the ATOL holder.

4.20 As indicated in paragraph 3.4, however, the CAA is considering a range of different approaches to segregation, including client account segregation arrangements, which would be cheaper to operate than a trust or escrow account and could be more flexible in principle in terms of the range of payments that can be allowed out of the account. Additional requirements in terms of protecting the monies that leave the account could be dealt with through the ongoing risk-based licensing of ATOL holders. As discussed in more detail in Chapter 5, this model could be taken forward within a tailored or hybrid approach.

4.21 Notwithstanding this, given the importance of the point on costs, the CAA has ensured that its impact analysis financial model takes account of these costs in assessing the impacts on different businesses.

4.22 In respect of the potential funding requirements for segregation, as discussed in Chapter 3 the CAA is considering a range of options for segregation in relation to the payment of suppliers. For example, trust accounts can be set up so that all funds must be held until departure. Alternatively, they can be set up so that a certain proportion of the advance supplier payments are allowed to be prepaid from the trust account. In another variation, the business can operate simple client account segregation (see option 4 in paragraph 3.4) of customer monies which allow a broader range of payments to be made from the account. As discussed in more detail in Chapter 5, the degree to which payments from the segregated account should be covered by another mechanism that would pay in the event of supplier or ATOL holder failure can be considered on an individual ATOL holder basis under a tailored or hybrid approach.

4.23 In response to the options involving bonding put forward by the CAA in the first consultation, many respondents cited practical constraints to implementation. These centred around the perceived lack of competition within the bonding market, which would mean that ATOL holders would likely be financially disadvantaged by higher prices, and the necessity of additional capital to support the need to bond, which was also seen as restrictive and damaging at the current time. Concerns were also raised about the appropriateness of bonding for different types of ATOL holders and its proportionality, especially for ATOL holders with strong finances.

4.24 As with trust accounts (and other forms of segregation), the CAA has ensured that its impact analysis financial model takes account of bonding costs in assessing the impacts on different businesses. On the breadth and depth of the bonding market, the CAA’s understanding is aligned with that of many of the respondents in that, in its current state, it could not accommodate a significant demand for additional bonding from the industry. If the reform of the ATOL arrangements was to result in a greater requirement for bonding it is possible that, over time, the bond market would respond to meet the additional demand.

The CAA is aware that whilst bonding capacity remains limited at present, in certain cases the need for collateral to support the bond has reduced since the first consultation.

4.25 On this last point the CAA notes that, unlike bonding, the services required to underpin segregation (e.g. professional independent trustees in the case of trust accounts) do not require the service provider to bear the financial cost of failure of the business. In the CAA's view therefore, compared to the segregation options, a move to a greater requirement for bonds is likely to present a more challenging prospect overall in terms of ensuring appropriate and sufficient capacity from the financial markets to meet the new demand.

Potential wider benefits

4.26 As noted by a number of respondents to the first consultation, trust accounts (or indeed simple segregation of client monies) can provide other benefits in addition to the protection of customer monies. First, in the CAA's view there are benefits associated with the additional financial discipline required to segregate monies. For example, trust accounts require businesses to understand their individual cashflows from their customers and to their suppliers on a booking-by-booking basis, which in turn allows them to better manage their own risk and understand in detail the risk to their business (and their customers) presented by third parties such as their suppliers and their agents. Furthermore, by separating the client's money from the company operating account it clearly allows the business to determine it holds appropriate liquidity to meet its general operating expenditure.

4.27 Second, in the CAA's view there are benefits that accrue in the event of a failure of the business. The CAA's experience in managing ATOL holder failures is that the quality of the booking and payment data is highly variable and can, on occasion, be very poor. This can create significant practical challenges for the CAA in managing such failures and can lead to delays in paying customers' claims and to additional requirements for the customer to supply evidence or documentation to support their claim. Under a properly operated trust account, for example, these data quality issues should not be present.

? Questions - Identifying the mechanisms by which the proposed options impact stakeholders

15. As described in paragraphs 4.4 to 4.15 above, has the CAA identified the main mechanisms through which the options proposed in the first consultation will impact on stakeholders?

16. What are your views on the likelihood of market exit, de-packaging and / or changes in business model of the different options for reform put forward by the CAA? What factors do you think are most likely to drive this sort of response by ATOL holders?

17. In your view, how might consumers respond if such measures (market exit, de-packaging and / or changes in business model) are taken by ATOL holders?

18. As set out in paragraphs 4.16 to 4.27 above, what are your views on the wider impacts, both constraints and benefits, that the CAA has identified for the different options for reform?

19. In your view, to what degree would it be possible to manage these constraints, for example through a staged implementation over a particular timeframe?

Approach to assessing the magnitude of the impacts

4.28 On the basis of the nature and range of impacts on stakeholders identified in the previous section, the CAA is setting out to identify and, as far as possible, quantify the magnitude of these impacts. In doing so, the CAA is drawing on five primary sources:

- The CAA's knowledge and expertise gained through the financial oversight of the sector and individual ATOL holders.
- Independent consumer research. Amongst other things, this is exploring consumer attitudes towards how travel businesses use the money they pay for their holidays, their expectations in respect of the financial resilience of the companies they book with, and the balance between consumer protection and its associated cost.
- An independent review of APC and how it could be calculated to better distinguish between the individual risk of failure posed by ATOL holders.
- An independent review of the funding requirements of the ATTF.
- A financial model to quantitatively assess the level of consumer protection provided by each option for reform and its impact on ATOL holders.

4.29 Further information on the independent research and analysis commissioned by the CAA to support the options appraisal can be found in the subsections below.

Consumer research

4.30 The CAA commissioned an external market research company to conduct consumer research on its behalf. The objective of the consumer research was to better understand consumers' attitudes towards ATOL protection and their views on potential changes to the scheme. In particular, the research was intended to assist the CAA in understanding how much consumers value insolvency protection when purchasing a holiday and the degree to which this influences how much they would pay for the protection. In addition, the CAA was seeking to understand consumers' expectations on the financial resilience of the travel companies they book with and how this impacts their decision making.

4.31 The methodology used was a mixed methodology / deliberative approach involving a number of consumer focus groups as well as a quantitative online survey. The sample of consumers used was a broad cross-section of the UK public, focussed on consumers that had purchased at least one package holiday (either with or without ATOL protection) between 2019 and 2022, and that were the sole or joint decision maker for holiday purchases. The sample covered a range of consumers in terms of the amount that they spend on their holiday.

4.32 The findings of the research are published[12] in full alongside this document and are summarised in the remainder of this section.

Booking a holiday and consumer perceptions around the risk of insolvency

4.33 Booking and planning holidays is an exciting process for consumers and there is an underlying positive and optimistic mindset at play. Consumers do still have concerns, but these tend to be around the quality of the trip, for example the standard of accommodation or planned activities falling below expectations. Consumers are also concerned about transport issues such as delays or cancellations.

4.34 The risk of a chosen travel company becoming insolvent is not a front-of-mind concern for consumers when booking holidays. The research revealed that this is because consumers expect and trust that their chosen holiday company will deliver their holiday[13]. This was a recurring theme throughout the research and, in the CAA's view, has strong implications for how consumers expect travel companies to behave. While a company becoming insolvent is not a spontaneous or front-of-mind concern, when expressly asked about this possibility, consumers deem it to be concerning.

Consumer perceptions of ATOL

4.35 As set out above, one of the findings of the research was that the offering of ATOL protection by the company also ties into its trustworthiness in consumers' minds. Although consumers are not always aware of the detail of what ATOL protects, ATOL protection is associated with 'peace of mind' for consumers. The research showed that these positive associations form a key role ATOL plays for consumers when they book holidays – ATOL protection reassures.

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[12] www.caa.co.uk/CAP2512

[13] Consumers have implicit goodwill in the travel company they book with and have a positive expectation that the company will deliver their holiday. Consumers' confidence in this regard comes from the company being known to them, used before, recommended, or positively reviewed. ATOL protection is also a positive factor in this context.

Views on ATOL holders' funding arrangements

4.36 As part of the research the CAA was keen to understand consumers' attitudes towards how ATOL holders fund their operations and how they use the money paid by consumers for their holiday. The research found that consumers do not think about ATOL holders' funding arrangements spontaneously. Indeed, there is little indication that most consumers want to think about how travel companies use the money they pay for their holidays. However, when forced to consider the issue the picture is more complex. On the one hand, consumers feel that all businesses have various financial demands and expenses that need to be met and therefore funded in some way, and travel businesses are no different in this regard. On the other hand, consumers see the merits in requiring companies to first pay for the components of their holiday before using the money to pay other expenditure or taking profit. Notwithstanding this, the research found that locking all customer money away until the consumer has returned from holiday can be seen as unrealistic.

4.37 Although, unsurprisingly, the research revealed that there is little indication that most consumers spontaneously think about how travel companies finance their operation, the CAA's view is that this attitude is very strongly underpinned by the belief that their chosen holiday company has the financial resources available to deliver their holiday. Indeed, some of the research participants went further, pointing out that the travel companies should have in place their own financial contingencies and practices to be able to deliver consumers' holidays, without consumers knowing, or needing to know, what these practices are in detail.

4.38 The implicit assumption of consumers that travel companies should financially be able to deliver the holiday is reinforced by their understanding of the CAA's role in the context of ATOL. To this point, consumers are in favour of, and recognise, the role that the CAA plays in 'vetting' and 'policing' travel companies. The research found that the CAA's role should include ensuring that companies display of the ATOL logo which, in the minds of consumers, should signify that a company has been vetted and deemed financially responsible and, therefore, that they will be able to deliver the holiday as expected. Further, consumers expect that this vetting process should ensure that travel companies have safeguards in place in the form of financial contingency measures to enable them to deliver the holidays purchased by consumers.

Views on APC

4.39 Consumers' views about the best structure for APC (i.e. flat vs variable) varied based on how the information was presented to them. Before they had been informed of the structure and current rate of APC, consumers indicated a preference for a differentiated pricing structure, with the most favourable options being those based on a percentage of the cost of the holiday. However, in the qualitative research, when informed about the level of protection they receive and the current flat rate of APC, consumers saw this as a bargain as well as being simple to understand and administer. The idea of charging for ATOL protection based on the 'riskiness' of the holiday company was less popular, although this view appeared to be driven by a concern that consumers would be able to infer the level of riskiness of particular businesses from their APC rate, which would drive consumer behaviour away from booking with such companies which, in turn, could drive these companies out of business.

4.40 When considering further the structure and level of APC, the research found that consumers do not know how much ATOL protection costs, although there was an assumption that it was more than £2.50[14]. When asked, as part of the quantitative survey, how much should be charged for ATOL protection, an APC rate below £10 was considered acceptable by the vast majority of respondents, with a rate below £5 considered to represent great value for money.

? Questions – CAA's consumer research

20. Are you aware of any other research that can provide insights into consumers' attitudes towards insolvency protection? In particular how consumers view and value insolvency protection when purchasing a holiday and their expectations on the financial resilience of the travel companies they book with.

21. Do you agree or disagree with the CAA's view that, although the research revealed that there is little indication that most consumers spontaneously think about how travel companies finance their operation, this attitude is very strongly underpinned by the belief that their chosen holiday company has the financial resources available to deliver their holiday?

22. Do you agree or disagree that it is a reasonable expectation on the part of consumers that travel companies should have in place their own financial contingencies and practices to be able to deliver consumers' holidays, without consumers knowing, or needing to know, what these practices are in detail?

Review of APC

4.41 The CAA commissioned an insurance actuarial consulting company to provide advice on how the rate of APC could be calculated so that it takes better account of the financial risk position of the ATOL holder and the value of their bookings so that, over time, the value of the APC contributions made by each ATOL holder

[14] Indeed, there was some concern amongst consumers that £2.50 would not be sufficient to provide the cover associated with ATOL. However, on further discussion, consumers recognised that, although this is a very small amount, it makes sense in context of the contributions accumulating over time in the ATTF.

comes closer to representing the value of the financial exposure they pose to the ATOL system[15].

4.42 Using data provided by the CAA, and utilising standard insurance pricing modelling techniques, the analysis revealed that there would be merit in calculating a variable rate APC based on a subset of three factors:

- A measure of the size of the firm. Here it was determined that the number of passengers was the most appropriate metric owing to this being the best populated measure in the data provided by the CAA, the simplest to understand, and providing the greatest lead indicator of volume;
- A measure of the value of trips. To be consistent with the measure used for size of firm, and for similar reasons, the average cost of the trip was determined to be the most appropriate measure; and
- An indicator of the financial strength of the firm. Here it was determined that the leverage ratio was the most appropriate metric on the basis that a higher leverage ratio of liabilities to assets was correlated with an increased chance of failure.

4.43 The CAA would like to note that this analysis is subject to limitations, in particular in terms of the availability of historical data (especially in relation to leverage), and in the sensitivity of this type of analysis to assumptions on the likelihood of the biggest failures occurring. Notwithstanding this, using 2021 APC returns and ignoring inflation since 2021, and using the three factors described above, the CAA is able to derive a variable rate APC for each ATOL holder of around 50p to around £15 per person per booking (as compared to a flat rate of £2.50 today). But it should be noted that these figures will be subject to further consideration and analysis.

4.44 The CAA would like to stress that no decision has been taken on the final proposals for reform, including how APC should be calculated[16]. Further, the analysis described above was unable to take account of the potential to vary the rate of APC paid by ATOL holders according to other factors, such as the degree to which the ATOL holder is protecting customer monies (see Chapter 3 for further discussion on this). Neither did the analysis take into account wider considerations, such as the financial sustainability of the ATTF (which is the subject of further analysis as described in paragraphs 2.1 to 2.3). These factors are likely to impact on the calculation of any variable rate APC.

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[15] For the avoidance of doubt, our external advisers' responsibilities and duty of care relating to this work is solely to the CAA.

[16] Indeed, it is the responsibility of the Secretary of State, not the CAA, to set the rate of APC.

4.45 However, for the purpose of facilitating stakeholders in engaging with the options appraisal process in a meaningful way, the CAA considers it to be worthwhile to indicate the potential range of a variable rate APC based on the current state of the development of its work on this issue.

? Questions – Review of APC

23. What practical barriers do you see to the implementation of a variable APC based on the findings of the review?

24. Are there any additional factors that you consider should be used to calculate a variable rate APC? If so, please explain which factors and why.

25. Alternatively, with reference to the three factors identified through the review (the size of ATOL holder, the average cost of trips sold, and its financial leverage), do you think that any of these factors should not be included in the calculation of a variable rate APC? If so, please explain which factors and why.

Impact analysis financial model

4.46 To assist in developing a sufficiently detailed understanding of the impacts on ATOL holders of the proposals for reform, the CAA has developed a financial model. The model has been developed to include a representation of different types of ATOL holder, including a range of different sized businesses, as well as a range of different business models (for example traditional tour operator, online travel agent, integrated operator and flight only operator). By comparing against the 'do nothing'[17] scenario, the model identifies the impacts of each of the proposed options for reform across a twelve-month period and across the range of ATOL holders as represented in the model.

Modelling framework

4.47 A graphical overview of the modelling framework can be found in Annex A. In modelling the impacts of the different options for reform the impact analysis financial model incorporates three main elements. These are:

[17] 'Do nothing' in this context represents overlaying the individual ATOL holder's current licence conditions with no additional requirements or reform of the ATOL framework, i.e. represents the CAA's current licensing approach.

- *ATOL holder cashflows*. The profile of ATOL holders' cash inflows and outflows throughout the year is modelled based on the timing and magnitude of passenger payments (inflows), supplier payments (outflows) and other outflows. Other outflows include the cost and funding requirements for the financial security options, APC payments, operating costs and other cash outflows.
- *ATOL holder cash position*. The cash position of ATOL holders throughout the year is modelled based on the reported cash position at the start and end of the year and the profile of ATOL holders' cash inflows and outflows throughout the year (described in the previous bullet).
- *ATOL holder failure liability*. The failure liability of ATOL holders is calculated in each month throughout the year based on unearned revenue (i.e. cash from passengers for trips that have not yet taken place), combined with the potential repatriation costs based on the number of passengers on trips at the time of failure.

4.48 The underlying data used to drive the model was drawn from a range of sources, but principally from data provided to the CAA by ATOL holders, for example through their APC returns, the data questionnaire in August 2021 and through publicly available sources such as financial statements. Given the impact on air travel of the COVID-19 pandemic during 2020/21, the CAA elected to use data for the year ending 2019 as this is the most recent 'normal' period for air travel. The CAA appreciates that the conditions under which the sector is operating currently are different than those present in 2019. This is something that the CAA will have regard to as it interprets the outputs of the model.

Assessment criteria

4.49 Using the impact analysis financial model, each of the financial security options proposed by the CAA is appraised against a set of four criteria, which together are intended to assess the impact on a range of ATOL holders. The four criteria are:

- *Effectiveness*. This is a quantitative measure which assesses the level of individual protection offered by each proposed option based on how well it covers ATOL holders' maximum failure liability.
- *Liquidity*. This is a quantitative measure which, over an annual period, assesses the liquidity/funding requirement of each option through the amount of reserving[18] required by ATOL holders.

[18] This funding requirement includes the cost of the financial security measures and the funds required to meet the obligations of each option under consideration, including as appropriate fixed charges, segregated accounts, bond collateral and APC.

- *Current ratio*. This is a quantitative measure which, over an annual period, assesses the impact of each option on the working capital ratio of each ATOL holder, recognising the differing impacts that different types of financial security measures have on working capital. This presents an implication of the extent of strengthening of the ATOL holder's financial position via each of the proposed financial licensing arrangements. Restricted cash or amounts held as security by other parties is not included in the current ratio calculation.
- *Efficiency*. This is a quantitative measure which, over an annual period, assesses the 'out-of-pocket' cost impact of each option on ATOL holders.

? Questions – The modelling framework for the CAA's impact analysis financial model

26. As set out in paragraphs 4.46 to 4.49 above, do you think the impact assessment financial model incorporates the main elements and criteria necessary for assessing the impacts on ATOL holders of each option? If not, please explain why, and please provide details of any different or additional elements or criteria you consider the CAA should be using, including how these should be defined.

Financial security options

4.50 The financial security options modelled within the impact analysis financial model are as follows:

- Trust account options, which can be specified to provide different levels of failure liability coverage by segregating all customer monies and allowing the release of monies already paid relating to different categories of supplier payments prior to the consumer's trip taking place.
- Escrow account options, which can be specified to provide different levels of failure liability coverage by segregating a higher or lower proportion of customer monies prior to the consumer's trip taking place.
- Bonding options, which can be specified to provide a greater or smaller level of failure liability protection (and include correspondingly greater or smaller levels of collateral security to be provided).
- Tailored options, where a financial security option (trust, escrow or bonding) is automatically selected for each ATOL holder represented in the model to achieve a given level of failure liability protection at the lowest cost of that financial security option to the ATOL holder.

Chapter 5

Appraising the options for reform

5.1 This chapter sets out the CAA's emerging findings in its appraisal of the different potential options for reform. In appraising these options the CAA has had regard to the original aims of the ATOL reform programme as expressed in the first consultation[19], feedback from stakeholders in response to this first consultation, the range and magnitude of the impacts of each option as identified in the previous chapter, and a range of data, information and analysis, including that derived from the impact analysis financial model.

5.2 The CAA would like to stress that no decision has been taken on the final proposals for reform, although the CAA remains committed to reform to strengthen the financial licensing arrangements for ATOL holders. In presenting its analysis and emerging findings, the CAA's intention is to facilitate stakeholders in engaging with the options appraisal process in a substantive and meaningful way, allowing them to understand, at a practical level, the likely impacts on ATOL holders of the various options for reform. As set out above, feedback from stakeholders to this request for further information will help finalise the impact assessment and the CAA's advice and recommendations to Government on the preferred option for reform.

Emerging findings of the CAA's options appraisal

Mandatory options

5.3 In the first consultation document the CAA put forward a number of potential options (Group A) that would be mandated by the CAA to apply uniformly across all licence holders – namely either the segregation of customer monies (through trust, escrow, or client accounts) or bonds.

5.4 Based on the initial results of the CAA's impact analysis financial model, for each of these options[20] there is a fundamental trade-off between the level of failure liability coverage provided and the impact on ATOL holders' costs and liquidity. A greater level of failure liability coverage provides greater direct protection of customers' money, though often with greater adverse impacts on costs and liquidity. Similarly, lower levels of failure liability coverage provide less direct

[19] And summarised at the start of Chapter 4.

[20] Client accounts were not modelled independently but would provide the same output as trust accounts but with a reduced cost to operate (i.e. no independent trustee costs) and with no protection of the money held in the account.

protection, with smaller adverse impacts on costs and liquidity. This implies an optimal financial security option is likely to balance failure liability protection with the adverse cost/liquidity impact on ATOL holders.

5.5 Although the detail of the impact of each option on each business varies, this fundamental trade-off can be seen across the different market segments (traditional tour operator, online travel agent, integrated operator and flight only operator) and different licence types (Standard, Small Standard[21] and SBA) represented in the model.

5.6 The most prominent distinguishing factor between the segregation options and the bonding option is in respect of the current ratio criteria – i.e. the impact on working capital for each business. Here the segregation options are shown to be generally more favourable than bonding. This is because any additional capitalisation required to finance the timing difference[22] that arises from operating a segregated account provides further liquidity, directly strengthening the current ratio and supporting greater operational resilience. In contrast, funds that are put aside in the form of bond collateral do not improve the current ratio position as they are not available for working capital purposes. Where bonding is obtained without the need for putting aside collateral, this does not negatively affect the current ratio, but it does not introduce additional funding into the business to strengthen the financial position (current ratio) further.

5.7 Although the trade-off between the level of failure liability coverage and the impacts on costs and liquidity is present across all of the options, the negative impact on cost and liquidity of the bonding option is shown to be generally greater than the segregation options for equivalent levels of protection. This is driven by the costs and funding requirements associated with each type of financial security measure.

5.8 When considering the seasonal trading pattern exhibited by many businesses, the segregation option better responds to the customer cash flows and the failure liability coverage. While it is possible to implement a ‘stepped bond’, this only responds to movement in forecasted failure liability coverage rather than the actual liability. In practice, bonding can lead to periods where the bond is either over or under collateralising the failure liability, which is sub-optimal.

5.9 In summary therefore, based on the initial outputs of the financial modelling, the segregation options appear to be more favourable generally than the bonding option for equivalent levels of failure liability coverage.

[21] Licensable revenue less than £20m

[22] Funds from the segregated account would ultimately be released to operating cash, however the timing of the release would be dependent upon the terms of the segregated account and by no later than the customer returning from holiday.

5.10 In the CAA's view this position is further supported when considering the wider factors set out paragraphs 4.4 to 4.27 above. In particular because:

- In the CAA's view the segregation options are more likely to lead to improved industry resilience than the bonding option as they should reduce the reliance of businesses on customer money as a source of working capital funding and should improve the capitalisation of these businesses in their own right. As explained previously, other things being equal, this should lead to an improvement in the financial resilience of these travel businesses. This should lead to travel businesses being less likely to become insolvent than would otherwise be the case.
- Given that the negative impact on cost of the bonding option is shown to be generally greater than the segregation options (trust and escrow accounts) for equivalent levels of protection[23], in the CAA's view the segregation options should present a lower risk of travel businesses de-packaging or exiting the market altogether. This in turn should reduce the risk that the preferred option for ATOL reform negatively impacts on consumer choice and competition overall.
- Although there are practical constraints for implementing the segregation or bonding options on a major scale[24], because the bonding option requires the financial markets to bear the financial cost of failure of the business, a move to a requirement for bonds across the entire ATOL spectrum is likely to present a more challenging prospect overall in ensuring an appropriate response from the relevant service providers to meet the new demand. These constraints may especially apply for larger businesses where a large bond amount is required (the amount may not be available in the market) or a substantial recapitalisation may be required to operate some forms of segregated accounts.
- While not a quantitative modelling factor, bond availability presents an additional variable. Under a bonding approach, at each licence renewal the travel business is subject to the degree to which the bond obligor will provide capacity (that capacity being subject to the financial credit worthiness of the travel business) and at the limits needed to meet the appropriate coverage of the failure liability.

[23] This is clearer for the escrow options than for the trust account options. This is because it is more difficult to identify directly comparable levels of failure liability coverage with the trust account options due these being defined by the different categories of supplier payments that are allowed out of the account (rather than being defined by an aggregate level of coverage).

[24] As explained in paragraphs 4.18 to 4.25.

- As explained in paragraphs 4.26 and 4.27, compared to bonding the segregation options can provide wider benefits, for example those associated with the additional financial discipline required to operate a trust account and the benefits associated with improvements in the quality of booking and payment data in the event of a failure of a business.

Summary

5.11 Based on the CAA's initial analysis and emerging findings set out above, in terms of an option mandated to apply uniformly across all licence holders, bonding appears to be a substantially less favourable option compared to the segregation options. In light of this, the CAA is minded to focus its further work on bonding on how bonds can be used as a complementary measure sitting alongside other mechanisms to cover the cost of insolvency protection. The CAA's thinking in this area is expanded further in the next section.

? Questions – Mandatory options

27. Do you agree or disagree with the outputs of the CAA's impact analysis financial model as set out in paragraphs 5.3 to 5.8? If you disagree, please explain why.

28. With reference to paragraph 5.10, do you agree or disagree with the CAA's assessment of how the wider factors apply when comparing the segregation and bonding options? If you disagree, please explain why.

29. If you consider that the CAA should conduct further work on bonding as a mandatory option to apply uniformly across all ATOL holders, please explain why and please provide details on the research and analysis that you consider the CAA should undertake.

Tailored options

5.12 In the first consultation document the CAA put forward a number of potential options (Group B) that represented an enhanced version of the tailoring that the CAA allows now, in which different solutions could be agreed for different licence holders, but subject to a mandatory minimum requirement. As described by the CAA, the framework could offer a choice between segregation[25] of funds or bonds, allowing ATOL holders the flexibility to choose whichever option best suits their business model.

5.13 Although there was support amongst many stakeholders for this option, as set out above the CAA's view is that there is a stronger case for some form of

[25] See Chapter 3 for a more detailed discussion of the different methods of segregation under consideration.

segregation than for bonding as a mandatory option to apply uniformly across all ATOL holders. Given that, in essence, tailored options are ones that provide a certain level of protection of customer monies through a combination of segregation and bonding. As a general point tailored options that include a sizeable bonding component will typically be less favourable when compared to a segregation only option, albeit not for all ATOL holders.

5.14 That said, in the CAA’s view there remains a rationale for bonding, and other types of insurance that the market may introduce, to be used as additional measures to enhance the protection of customer monies alongside a form of segregation (i.e. complementary to segregation rather than as an alternative to it).

5.15 As explained in Chapter 3, the CAA continues to consider that a segregation approach could operate in different forms. These include total trust segregation, where all customer monies are held on trust until delivery of the holiday is completed, but also include other forms of segregation, such as simple client account segregation, which can allow a broader range of supplier and other payments to be made from the account, and which can be cheaper to operate for the business. Under this latter type of approach, the requirements in relation to the types of payments that are allowed out of the account, as well how, if at all, these payments are protected (e.g. via bonding, financial products, additional segregation, etc), could be approached in a standardised way or, as is currently the case, could be set by the CAA for each ATOL holder based on an individual assessment of risk.

5.16 Furthermore, the CAA considers that a client account approach could be used to underpin an improvement in the reporting and visibility of customer monies collected and, for example, the amounts used to specifically fund the holiday components and amounts used to support general operating costs. This reporting could be subject to third party oversight and assurance.

5.17 Further, and consistent with the CAA’s current risk-based licensing approach, as explained in Chapter 3 this type of approach could be augmented with additional risk-based conditions whereby ATOL holders that the CAA considers represent a greater risk continue to have to provide additional licensing conditions[26].

5.18 Given the above and feedback received from the industry, the CAA is minded to consider another variant of the tailored option, which is underpinned by a client account and improved reporting (as set out in paragraphs 5.15 and 5.16), and which is then augmented either:

[26] Please refer to the questions below paragraph 3.20.

(1) by a continuation of the CAA's risk-based approach whereby additional conditions (and financial security) would be required on a case-by-case basis; or

(2) a mandatory minimum level of financial security (the form of which is determined by the ATOL holder e.g. bonding or escrow / trust account) and where, based on the CAA's risk-based approach that minimum level is insufficient, additional conditions required on a case-by-case basis to enhance the mandatory minimum level of financial security.

5.19 In light of these considerations, and given the emerging findings of the CAA's work on the financial markets option (see paragraphs 2.4 to 2.7), the CAA is minded to focus its further work on tailored options on this type of hybrid approach – i.e. where bonds and other financial products are used as additional measures to enhance the protection of customer monies alongside a form of segregation.

5.20 Building on the responses received to the first consultation relating to the tailored option, and subject to consideration of responses received to the questions in Chapter 3, the CAA is minded to incorporate into its thinking on this type of hybrid approach consideration of whether, and if so how, APC[27] could take account of the security arrangements in place to protect consumer money as well as reflecting the risk posed by the ATOL holder.

[27] Please refer to Question 10.

Questions – Tailored options

30. Do you agree or disagree with the CAA's minded to view to focus its further work on tailored options on developing a hybrid approach – i.e. where bonds and other financial products are to be used as additional measures to enhance the protection of customer monies alongside a form of segregation?

If you disagree with the CAA's minded to view, please explain why and how you consider the tailored option should be developed further.

If you agree with the CAA's minded to view, please explain how you think a hybrid approach should work. In particular, please explain which form of segregation (trust, escrow, or client account) would work best under such an approach.

Pipeline monies

5.21 As explained in paragraph 2.8 and 2.9, the CAA's view is that it is prudent to focus its efforts at this time on the options for reform as they apply to ATOL holders and direct sales, with the treatment of pipeline monies given further consideration once a preferred option for reform is identified. Notwithstanding this view, the CAA would like to seek the views of stakeholders on whether, and if so how, their views on how pipeline monies should be treated have changed since the first consultation and in light of the issues raised in this document.

Questions – Pipeline monies

31. In light of the issues raised in this document and, in particular, the views expressed by the CAA in this chapter on those options for reform where it is minded to focus its work further, what are your views on how pipeline monies should be treated?

32. Do you consider that agents should be subject to the same requirements as ATOL holders in terms of protecting customer monies, or do you think there should be a different set of requirements specifically designed for agents and pipeline monies? Please explain your view.

33. Given that the scope of the CAA's regulatory oversight does not extend to agents directly, in your view how could the implementation of any such requirements be achieved?

Chapter 6
Summary of questions

Responses to this consultation document should be submitted via the Citizen Space page. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex.

If you are unable to use the Citizen Space page, or if you have any questions about the document please send them to: atol.consultation@caa.co.uk by **24 March 2023**.

The Financial Markets Option

1. Do you agree or disagree that the CAA should focus its further work on the use of financial products as a complementary measure sitting alongside other mechanisms, for example under a tailored or hybrid approach for individual businesses, rather than as a measure to cover the entire market risk?

Segregation Methods

2. In considering the possible methods for segregation set out in paragraph 3.4, what are your views on the different approaches put forward by the CAA and are there other aspects that it should consider?

Key factors to consider in the context of the different segregation options

3. Are there additional key factors other than size of the ATOL holder, the nature of the ATOL holder's business and supplier payments, and whether the ATOL holder is part of an integrated airline group, that the CAA should take into account when considering the advantages and disadvantages of the different methods of segregation?

4. On the issue of the size of the ATOL holder, should smaller ATOL holders (up to a certain size limit) be entitled to operate segregation in a way which is proportionate to their size and the risk they pose to the ATTF (for example a client account with appropriate level of third-party oversight)? Please explain your views along with what, if any, size limit should be set, and what other corresponding requirements such as bonding or APC might be required.

5. As set out in paragraph 3.8, Accredited Bodies and Franchise Arrangements provide options for smaller businesses and smaller ATOL holders to operate within a framework overseen by a third party. Do you consider that it is a viable option now (or in the future) for all smaller businesses/ATOL holders to be required to be a member of an Accredited Body or Franchise?

6. Should the CAA consider general prepayments made by an ATOL holder to secure commitment volume (whether air, accommodation or other travel services) in the same way as specific prepayments required to secure an airline seat, accommodation or other travel service component for an individual booking? Please explain your views.

7. Do you agree or disagree that, where there is a degree of concentration risk with a particular supplier(s), payments made to these suppliers should be considered differently? Please explain your view, including quantifying a threshold that would represent a concentration risk.

8. Do you agree or disagree that payments made by ATOL holders to airlines within the same group structure (integrated groups) should be treated differently to payments made to third party suppliers? Please explain your view.

9. Do you agree or disagree that payments made to other suppliers (e.g. hotels, destination management companies, cruise operators, etc) that are part of the same group structure should be treated in the same way as payments made by an ATOL holder to an airline in the same corporate group (integrated airline groups).

Interaction between APC and the method of direct protection of consumer monies

10.Do you think a reduction should be applied to the rate of APC based on the degree to which each ATOL holder provides for their own risk of failure? Please provide an explanation for your answer and, if you do agree that such a discount should be applied, please explain on what basis the discount should be applied and the amount of the discount.

11. Do you think that integrated airline groups should pay a different rate of APC to reflect the potential cost of a repatriation?

Additional risk-based requirements

12. Do you agree or disagree that the CAA should retain a risk-based licensing approach? Please explain your view.

13. If you agree, in the context of the different segregation options discussed in paragraph 3.4, do you think that the CAA's risk-based approach should extend to it being able to implement different methods of segregation for each ATOL holder depending on its risk assessment? Alternatively, do you consider that a method of segregation should be chosen to apply to all ATOL holders, and then the CAA could set additional requirements based on the risk assessment of that particular ATOL holder?

14. If the CAA continues to operate a risk-based focus in its licensing of ATOL holders and if ATOL holders posing an increased risk are required to provide increased segregation or bonding, should the APC (banding or adjustment) be the same as another ATOL holder that voluntarily provides the same direct protection of consumer monies?

Identifying the mechanisms by which the proposed options impact stakeholders

15. As described in paragraphs 4.4 to 4.15 above, has the CAA identified the main mechanisms through which the options proposed in the first consultation will impact on stakeholders?

16. What are your views on the risk of market exit, de-packaging and / or changes in business model of the different options for reform put forward by the CAA? What factors do you think are most likely to drive this sort of response by ATOL holders?

17. In your view, how might consumers respond if such measures (market exit, de-packaging and / or changes in business model) are taken by ATOL holders?

18. As set out in paragraphs 4.16 to 4.27 above, what are your views on the wider impacts, both constraints and benefits, that the CAA has identified for the different options for reform?

19. In your view, to what degree would it be possible to manage these constraints, for example through a staged implementation over a particular timeframe?

CAA's consumer research

20. Are you aware of any other research that can provide insights into consumers' attitudes towards insolvency protection? In particular how consumers view and value insolvency protection when purchasing a holiday and their expectations on the financial resilience of the travel companies they book with.

21. Do you agree or disagree with the CAA's view that, although the research revealed that there is little indication that most consumers spontaneously think about how travel companies finance their operation, this attitude is very strongly underpinned by the belief that their chosen holiday company has the financial resources available to deliver their holiday?

22. Do you agree or disagree that it is a reasonable expectation on the part of consumers that travel companies should have in place their own financial contingencies and practices to be able to deliver consumers' holidays, without consumers knowing, or needing to know, what these practices are in detail?

Review of APC

23. What practical barriers do you see to the implementation of a variable APC based on the findings of the review?

24. Are there any additional factors that you consider should be used to calculate a variable rate APC? If so, please explain which factors and why.

25. Alternatively, with reference to the three factors identified through the review (the size of ATOL holder, the average cost of trips sold, and its financial leverage), do you think that

any of these factors should not be included in the calculation of a variable rate APC? If so, please explain which factors and why.

The modelling framework for the CAA's impact analysis financial model

26. As set out in paragraphs 4.46 to 4.49 above, do you think the impact assessment financial model incorporates the main elements and criteria necessary for assessing the impacts on ATOL holders of each option? If not, please explain why, and please provide details of any different or additional elements or criteria you consider the CAA should be using, including how these should be defined.

Mandatory options

27. Do you agree or disagree with the outputs of the CAA's impact analysis financial model as set out in paragraphs 5.3 to 5.8? If you disagree, please explain why.

28. With reference to paragraph 5.10, do you agree or disagree with the CAA's assessment of how the wider factors apply when comparing the segregation and bonding options? If you disagree, please explain why.

29. If you consider that the CAA should conduct further work on bonding as a mandatory option to apply uniformly across all ATOL holders, please explain why and please provide details on the research and analysis that you consider the CAA should undertake.

Tailored options

30. Do you agree or disagree with the CAA's minded to view to focus its further work on tailored options on developing a hybrid approach – i.e. where bonds and other financial products are be used as additional measures to enhance the protection of customer monies alongside a form of segregation?

If you disagree with the CAA's minded to view, please explain why and how you consider the tailored option should be developed further.

If you agree with the CAA's minded to view, please explain how you think a hybrid approach should work. In particular, please explain which form of segregation (trust, escrow, or client account) would work best under such an approach.

Pipeline monies

31. In light of the issues raised in this document and, in particular, the views expressed by the CAA in this chapter on those options for reform where it is minded to focus its work further, what are your views on how pipeline monies should be treated?

32. Do you consider that agents should be subject to the same requirements as ATOL holders in terms of protecting customer monies, or do you think there should be a different set of requirements specifically designed for agents and pipeline monies? Please explain your view.

33. Given that the scope of the CAA's regulatory oversight does not extend to agents directly, in your view how could the implementation of any such requirements be achieved?

Chapter 7

Glossary

Phrase	Definition
Accredited Bodies	An ATOL-holding organisation that allows its members to lawfully make ATOL protected sales under their licence without the member holding an ATOL. Accredited Bodies have specific conditions attached to their licence including the requirement to protect the monies of the Accredited Body's members in a trust account for sales made under the Accredited Body's ATOL.
APC	ATOL Protection Contribution
ATOL	Air Travel Organiser's Licence
ATT	Air Travel Trust
ATTF	Air Travel Trust Fund
Balance sheet	A statement of assets, liabilities, and shareholders' equity at a particular point in time.
Bond	A type of irrevocable financial security arrangement whereby an insurer/bank/specialist obligor agrees to pay the ATT a pre-determined sum in the event of the ATOL holder's failure.
Capital	The money available to meet day-to-day operations and fund growth. The primary sources of capital are working capital, debt and equity.
Customer money/customer monies	The money paid in advance by consumers to the ATOL holder for the licensable booking.
Failure	When an ATOL holder ceases trading and becomes insolvent.
Flat rate	All ATOL holders pay the same fee.
Franchise ATOL holder	A business that holds its own ATOL on the basis of its membership of an ATOL franchisee. An

	ATOL franchisee is a business that has reached agreement with the ATT under which it will provide the financial protection in respect of its franchise members.
Licensable booking	A booking which falls within the scope of ATOL and requires APC to be paid
Liquidity	Refers to the level of cash (or other liquid assets that can be quickly converted to cash) to allow a business to pay its financial obligations as they fall due.
Operational cash	The cash required by an ATOL holder to fund their day-to-day overheads and other administrative costs not including the bookings paid for by their customers.
Pipeline monies	These are the customer monies paid to and held by an agent on behalf the ATOL holder responsible for the booking.
Principal ATOL holder	The ATOL holder who is responsible for the booking i.e. the organisation named on the ATOL certificate as providing ATOL protection.
Supplier payments	Payments due to the suppliers of a customer’s holiday, e.g. airline, accommodation provider, transfers etc.
Trust deed	The document which governs the relationship between the ATT, the ATOL holder and the trustee. In particular setting out the responsibilities the trustee has over the assets held in trust.
Trustee	A person under a legal duty to administer assets held in trust, for specified purposes, on behalf of a third party.
Working capital	The amount of available capital that a company has readily available to meet its day-to-day operations. It represents the difference between a business’s current assets and current liabilities.

Annex A – Modelling framework overview