

## FINAL REPORT

**Prepared For:**

Association of British Insurers

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# Market impacts of regulating general insurance

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## TABLE OF CONTENTS

EXECUTIVE SUMMARY .....	5
IDENTIFYING SIGNIFICANT CHANGES RESULTING FROM THE INTRODUCTION OF ICOB .....	5
MEASURING MARKET IMPACTS .....	6
IMPLICATIONS FOR ICOB REGULATION .....	8
IMPLICATIONS FOR MEASURING MARKET IMPACTS IN FUTURE CBAs .....	8
1. INTRODUCTION .....	10
1.1. EX POST VERSUS EX ANTE REVIEWS .....	11
1.2. NON-DISCRETIONARY REGULATION .....	12
1.3. COMPLEX CASES .....	13
1.4. STRUCTURE OF THE REPORT .....	13
2. METHODOLOGY .....	14
2.1. BASELINE .....	14
2.2. IDENTIFYING THE SIGNIFICANT CHANGES .....	15
2.3. MEASURING IMPACTS AT THE PRODUCT MARKET .....	15
3. OVERVIEW OF THE MAIN CHANGES IN REGULATION .....	19
3.1. STATUTORY REGULATION .....	19
3.2. INFORMATION PROVISION .....	20
3.3. SUITABILITY .....	21
3.4. RECOURSE .....	21
3.5. THE RELATIONSHIP BETWEEN PROVIDERS AND INTERMEDIARIES .....	22
3.6. SUMMARY OF THE MAIN CHANGES .....	23
4. STATUTORY REGULATION .....	24
4.1. THE IMPACT OF STATUTORY REGULATION ON MARKET PERCEPTION .....	25
4.2. THE VALUE CONSUMERS PLACE ON THESE PRODUCTS BEING REGULATED .....	26
4.3. THE DEGREE TO WHICH THEY ARE WILLING TO PAY FOR THESE BENEFITS .....	27
4.4. WHETHER THE INTRODUCTION OF STATUTORY REGULATION CHANGED PARTICIPATION IN THE MARKET .....	28
4.5. QUANTIFYING THE BENEFITS FROM STATUTORY REGULATION .....	31
5. INFORMATION PROVISION .....	33
5.1. THE VALUE PLACED ON DISCLOSURE .....	34

5.2.	LENGTH OF THE SALES PROCESS.....	37
5.3.	QUANTIFYING THE IMPACT OF A CHANGE IN SHOPPING AROUND.....	43
6.	SUITABILITY.....	46
6.1.	EVIDENCE ON CHECKING FOR SUITABILITY .....	47
6.2.	QUANTIFYING THE BENEFITS FROM SUITABILITY .....	48
7.	RECOURSE.....	52
7.1.	IMPACT OF THE COOLING OFF PERIOD .....	52
7.2.	ACCESS TO THE FINANCIAL OMBUDSMAN .....	55
7.3.	BETTER RECORD KEEPING .....	57
7.4.	USE OF CHANNELS THAT PROVIDE BETTER ACCESS TO COMPENSATION .....	57
8.	SUMMARY OF MARKET IMPACTS.....	60
8.1.	AN AGGREGATE QUANTIFICATION OF MARKET IMPACTS.....	60
8.2.	SCALING TO THE WHOLE GI MARKET .....	61
8.3.	FSA DISCRETIONARY REGULATION .....	63
9.	IMPLICATIONS FOR MEASURING MARKET IMPACTS .....	65
9.1.	THE DIFFICULTY OF ESTIMATING MARKET IMPACTS .....	65
9.2.	IDENTIFICATION OF THE PROBLEM IS VITAL.....	65
9.3.	THE IMPORTANCE OF LOOKING AT 'ECONOMIC' MARKET WHEN ASSESSING MARKET IMPACTS ..	66
9.4.	TOOLS THAT WILL BE USEFUL ACROSS CBAS .....	67

## LIST OF FIGURES

Figure 1: What benefits, if any, do you have from this product or sale being regulated?.....	26
Figure 2: If regulation means that the price of the insurance increases, do you think this is acceptable? Would you say ....	27
Figure 3: If regulation means that the price of the insurance increases, do you think this is acceptable? Would you say ....	28
Figure 4: Do you recall receiving any of the following in writing?.....	34
Figure 5: Did you read the information you received? Would you say .....	35
Figure 6: How useful did you find particular documents?.....	36
Figure 7: Did you shop around? .....	39

Figure 8: Sales length and shopping around.....	40
Figure 9: How many quotes did you obtain this year compared to last year?.....	41
Figure 10: What influenced the number of companies you approached for a quote? .....	42
Figure 11: How many providers did you obtain a quote from? .....	43
Figure 12: Variation in the cost of PPI .....	44
Figure 13: Were you asked about both employment and pre-existing medical conditions? .....	48
Figure 14: How did you find out about this cooling off period? .....	53

## LIST OF TABLES

Table 1: Summary of market impacts by type .....	6
Table 2: Summary of market impacts by product .....	6
Table 3: Summary of overall market impact .....	7
Table 4: Benefit from statutory regulation .....	32
Table 5: Cost of reduced searching for motor insurance policies .....	45
Table 6: Benefit from improved suitability .....	50
Table 7: Benefit from increased searching due to cooling off period.....	54
Table 8: Benefit from reduced complaint resolution .....	56
Table 9: Summary of quantifiable market impacts.....	60
Table 10: Summary of market impacts by product .....	61
Table 11: Similarity of products.....	62
Table 12: Summary of market impacts by product .....	62
Table 13: Impact of FSA extensions to regulation in the three product markets .....	64

## EXECUTIVE SUMMARY

On 14th January 2005, general insurance came under the regulatory remit of the Financial Services Authority. The Association of British Insurers commissioned CRA International to undertake a quantification of the consumer benefits of the impact of this regulation as implemented through the Insurance Conduct of Business rules. As a case-study of the quantification of benefits, the introduction of general insurance regulation is particularly attractive because:

- It brought in a diverse range of regulatory rules including status and product disclosure, training and competence, record keeping, regulation of the sales process and complaints procedure;
- It covered a wide range of companies, including advisers and providers that were previously outside of statutory regulation, as well as companies that were already regulated; and
- It applied to different types of products, sold in different ways and to different types of consumers.

This study does not, however, attempt a full cost-benefit analysis or to quantify the costs imposed on companies as a result of the regulation.

## IDENTIFYING SIGNIFICANT CHANGES RESULTING FROM THE INTRODUCTION OF ICOB

The main changes to the regulatory regime from the introduction of ICOB can be categorised into:

- Statutory regulation: The fixed cost of regulation could result in providers and intermediaries leaving the market. Equally, a statutory regulator may increase confidence in a sector increasing the size of the market;
- Information provision: Providing consumers with more information may help them to determine whether they need a particular product or help them to decide which is the most suitable provider. Alternatively, too much information can result in confusion and stifle competition by increasing the length of the sales process;
- Suitability: Regulating the sales process may lower the number of unsuitable sales, reducing the need for costly complaints; and
- Recourse: Encouraging greater awareness of the cooling off period and greater access to the financial ombudsman may enhance consumer protection, although recourse could be reduced if there is switching to execution-only channels that reduces the benefits from advice.

## MEASURING MARKET IMPACTS

This study considers the impact of regulation on three product markets: motor insurance; critical illness; and payment protection insurance. These markets were chosen as they illustrate the range of products falling under the ICOB rules and as such the results could be extrapolated to similar insurance markets. For example, competition in the motor insurance market is similar to that in the home insurance market and hence results found for motor insurance can be used as the basis of results for home insurance.

Table 1 summarises the overall market impact on consumers for the three products considered according to four categories identified above.

**Table 1: Summary of market impacts by type**

	<b>Costs</b>	<b>Benefits</b>
Statutory regulation for Motor, CI and PPI		£23 million
Information provision reducing searching for Motor due to increased length of sales process	£229 million	
Suitability improving for CI and PPI		£129 million
Recourse improving because of increased searching for Motor due to cooling off period and reduced complaint resolution for all products		£49 million
<b>Totals</b>	<b>£229 million</b>	<b>£202 million</b>
<b>Total overall net impact</b>	<b>£27 million</b>	

Source: CRA International

Overall, for these three products there has been a negative market impact from ICOB regulations. However, when the individual markets are considered, a different picture emerges as can be seen from Table 2.

**Table 2: Summary of market impacts by product**

	<b>Cost</b>	<b>Benefit</b>
PPI		£142 million
CI		£2 million
Motor	£171 million	

Source: CRA International

It is clear that, of the three products examined in this report, the greatest benefit to consumers from general insurance regulation has arisen in the PPI market, with CI having a small benefit from the market impacts (although this reflects the relatively small size of

the CI market). By contrast, consumers of motor insurance have been detrimentally impacted by the regulation.

We have also scaled the market impacts of the three products examined in order to estimate the impact on all significant products affected by ICOB. We find that the overall impact is as described in Table 3 below.

**Table 3: Summary of overall market impact**

	Cost	Benefit
PPI and similar products		£177 million
CI and similar products		£62 million
Motor and similar products	£362 million	
<b>Total</b>	<b>£122 million</b>	

Source: CRA International

We calculate the overall market impacts from general insurance regulation as being a cost of around £122 million per year. This figure can be compared to the compliance costs for ICOB that were estimated at the time of £197 million of one-off costs and £166 million of ongoing costs.<sup>1</sup>

We note that, since this assessment has been conducted within a year of the implementation of regulation, further benefits may yet arise. In particular, we found a relatively low compliance rate in respect of suitability for PPI, CI and similar products; if we include the potential additional improvements in suitability, these would more than double the benefits arising from suitability and make the overall net market impact positive.

Many of the rules brought in by ICOB implemented European directives. However, some of the regulations in ICOB added additional requirements beyond the directives. Of these issues, there are two areas where there has been a quantified market impact:

- The cost of reduced searching due to the increased length of sales process on direct sales resulting from the increased disclosures required; and
- The benefit of increased searching due to the cooling off period for face-to-face sales.

Both of these impacts arise in the context of motor insurance and similar products. Table 3 indicates that the overall impact of general insurance regulation on those products that were similar to motor insurance was a cost of £362 million. Of this, we estimate that £290

<sup>1</sup>

This figure is taken from "Insurance selling and administration & other miscellaneous amendments", CP187, FSA, June 2003; and the supporting study "Estimated Compliance Costs of Conduct of Business Regulation for General Insurance, A report for the FSA", NERA, 27<sup>th</sup> June 2003 it has not been re-examined by CRA International.



million was due to IMD and DMD whereas £72 million was due to the additional requirements imposed by the FSA.

### IMPLICATIONS FOR ICOB REGULATION

There are three main implications from the analysis for the ICOB regulation.

First, the overall market impacts from ICOB are calculated as a cost of £122 million per year and the compliance costs were previously estimated as £166 million per year with £197 million of one-off costs. The scale of the market impacts demonstrates the importance of quantifying the full range of costs and benefits.

Second, there is a very different impact depending on the product that is considered, with ICOB having a positive impact on the PPI and CI markets, but a negative impact on the motor insurance market. This provides strong support for a more targeted approach to regulation. In particular, the danger of applying industry-wide regulation is that it imposes costs on markets that are working well, in addition to potentially bringing benefits to markets that are not working so well. However, before undertaking a more targeted regime (differentiating between products where the market already works well and where it appears to work less well), it is necessary to assess whether this would impose a substantial increase in compliance costs.

Third, the additional requirements that went beyond the European directives were found to have had a negative impact. This suggests that when future directives are being implemented, the market impacts (as well as the compliance costs) of going beyond these requirements should be assessed separately. This interacts with the need to assess market impacts for different product types since the areas where additional requirements were imposed interacted with the products found to face the greatest costs.

### IMPLICATIONS FOR MEASURING MARKET IMPACTS IN FUTURE CBAs

Looking beyond the ICOB rules, we can generalise some of our findings to look at what we have learnt regarding the measurement of market impacts in ex ante and ex post CBAs, such that these principles can be applied when designing and assessing regulation in the future. We can group our findings in terms of:

- Useful tools for measuring market impacts: Although every CBA will have its own challenges, the diversity of the ICOB rules means that we have looked at a wide variety of different market impacts driven by the statutory nature of regulation, information disclosure, status and product disclosure, training and competence, complaints and cooling off. This analysis of market impacts will represent a useful starting point when quantifying benefits in the future.
- The difficulty of estimating market impacts ex ante and ex post: Estimating benefits is not straightforward but involves similar techniques to those required to estimate the cost resulting from market impacts. Therefore, where possible, benefits should be estimated although it is reasonable to assume these will have larger error margins than direct or compliance costs. Furthermore, the simple process of attempting to estimate market impacts before regulation is brought in will have

significant advantages for undertaking ex post reviews i.e. the estimates made in advance of regulation can be used as a baseline for assessing regulation afterwards.

- Identifying the problem that regulation is seeking to address is vital: Examining the impact of regulation at the level of an economic market and taking into account the nature of the market, rather than at the level of the industry, adds a degree of rigour that is useful. Had this been done in the case of ICOB it would have shown that the motor market is largely competitive and that there were likely to be relatively few areas where regulation would bring benefit. This is particularly useful for looking at unintended consequences.

## 1. INTRODUCTION

On 14th January 2005, general insurance came under the regulatory remit of the Financial Services Authority. The FSA then developed the Insurance Conduct of Business (ICOB) rules, which in turn were primarily aimed at implementing the Insurance Mediation Directive (IMD) and the Distance Marketing Directive (DMD) from the European Commission.

The Association of British Insurers commissioned CRA International to undertake a quantification of the consumer benefits of the impact of the regulation of general insurance as implemented through the ICOB rules. As a case study of the quantification of benefits, the introduction of general insurance regulation is particularly attractive because:

- The introduction of the ICOB rules brought in a diverse range of regulatory rules including status and product disclosure, training and competence, record keeping, regulation of the sales process and complaints procedure;
- It covered a wide range of companies, including advisers and providers that were previously outside of statutory regulation, as well as companies that were already regulated; and
- It applied to different types of products, sold in different ways and to different types of consumers.

Before implementing ICOB, the FSA undertook a cost benefit analysis (CBA).<sup>2</sup> In this CBA, in keeping with their own obligations, the costs of implementing the regulation were, where possible, estimated and quantified, whereas the benefits were assessed in a qualitative fashion.<sup>3</sup> The compliance costs of ICOB were estimated as £197 million of one-off costs and £166 million of ongoing costs. The aim of our research was not to revisit the FSA's own CBA, which focused on the costs of implementing the regulation, but rather to focus specifically on the market impacts for consumers. In that sense, this report should not be seen as undertaking a full CBA.

Since conducting the CBA, the FSA has commissioned research into its CBA process that has led to recommendations regarding best practice in terms of undertaking CBAs.<sup>4</sup> This project seeks to build on this analysis. One of the primary aims is to contribute to the debate regarding the methodology for quantifying market impacts when undertaking CBAs and to set out how these could be usefully applied in future CBAs performed by the FSA and others.

A number of particular issues are relevant for this appraisal:

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<sup>2</sup> This is set out in FSA consultation papers, "Insurance selling and administration: the FSA's high-level approach to regulation", CP160, FSA, December 2002; "Insurance selling and administration & other miscellaneous amendments", CP187, FSA, June 2003; and the supporting study "Estimated Compliance Costs of Conduct of Business Regulation for General Insurance, A report for the FSA", NERA, 27<sup>th</sup> June 2003.

<sup>3</sup> Section 155 (10) of the Financial Services and Markets Act 2000 states, "Cost benefit analysis" means an estimate of the costs together with an analysis of the benefits...

<sup>4</sup> "The FSA's Methodology for Cost Benefit Analysis", NERA, 26<sup>th</sup> November 2004.

- Our study has been conducted ex post rather than ex ante so we need to keep in mind that it is easier to measure cost and benefits after regulations have been introduced because data on the actual impact of regulation may be available. However, we believe that the methodologies that we have used are equally applicable to the assessment of benefits before implementation of regulation. Indeed, using these approaches ex ante will prove to be extremely valuable when ex post reviews are undertaken because the estimates made in advance of regulation can be used as a baseline for assessing the results of regulation afterwards.
- The introduction of general insurance regulation primarily resulted from European regulation in the form of the DMD and IMD, although some additional requirements were imposed by the FSA.
- This was a complex set of rule changes that took place at the same time as other significant changes in the market. In particular, intermediaries were also affected by the introduction of mortgage regulation.

We have therefore aimed to design the methodologies such that they can be generalised as far as possible, while taking into account the specifics of the ICOB rules.

### 1.1. EX POST VERSUS EX ANTE REVIEWS

The two-fold aim of this study is to estimate the market impacts of the introduction of the ICOB rules and also to demonstrate more general principles for estimating consumer benefits of changing regulation. Despite the fact that our study has had the advantage of measuring the benefits after the introduction of the regulations, it is also the case that the impact of ICOB is still to have its full effect. The FSA has been extremely active over the last year:

- Focusing its initial efforts on “monitoring the perimeter” i.e. ensuring that those who need authorisation to undertake general insurance have it. Over time the FSA’s efforts have moved, and will continue to move, towards enforcing compliance with the other parts of the ICOB rules;
- Developing proposals and consulting on how the ICOB rules could be modified: in particular, whether a demand and needs statement is needed for consumers purchasing through execution-only channels; and
- Undertaking mystery shopping on PPI sales<sup>5</sup> and reminding firms of their obligations for particular products e.g. through the “Dear CEO” letter regarding the sale of Payment Protection Insurance.<sup>6</sup>

Ideally any review of regulation should occur after a sufficient period of time for the regulation to have been able to settle down and hence it has been recommended that such assessments occur two years after regulation has been brought in. However, the main research in our study occurred in November and December 2005 – less than one

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5 “The sale of payment protection insurance – mystery shopping results”, FSA Consumer Research 45, prepared for the FSA by GfK NOP, November 2005.

6 “Sale of payment protection insurance”, Dear CEO letter, 4<sup>th</sup> November 2005.

year after the advent of ICOB. The shortened timetable is because our study is partly aimed at contributing to the debate on how CBAs should be approached. Hence, although we believe the results of this study give a strong indication of the likely benefits from ICOB, further changes will need to be monitored.

From a methodological perspective, one of the most important differences between ex ante and ex post reviews is the consideration given to sunk costs. In ex ante reviews, significant weight is given to distinguishing between one-off costs and ongoing costs. In ex post reviews, to assess the quality of the previous analysis it may be useful to look at one-off costs, but it is primarily the ongoing costs that are important (although there may be transition costs in reversing regulation). Thus it is possible that regulation with a significantly negative CBA at the time of implementation could have a positive CBA in an ex post review since the one-off costs have already been incurred. It is therefore not surprising that often the industry will be found to resist changes to a particular regulation (because of the cost of implementation), but after regulation has occurred, it may prefer the regulation to stay as it is (because the one-off costs are sunk and the industry only faces the ongoing costs).

There is a similar issue of symmetry regarding the value of consumer benefits. Changes in regulation may add to consumer benefits each year on an incremental basis e.g. through a reduction in mis-selling. However, regulation can be market changing, resulting in a permanent change in the marketplace. That is, even if the regulation is subsequently taken away, the benefits may remain.

An example of this could arise with information provision. If the provision of information leads to the education of consumers regarding what they need to know about when purchasing financial services products, then once consumers are used to this information being provided and see the value from it, the regulation to require information to be provided could be removed. Then, despite there being no regulation, providers would still give information to consumers because consumers would demand such information. However, consumers would only demand the information that they truly found to be useful in making their decisions. Hence any surplus information that had been required through regulation would no longer be provided. Therefore, unless the regulation managed to specify precisely the correct information that each consumer required, removing regulation could reduce costs without removing the benefits that information provision had brought about.

Distinguishing between these “sunk benefits” and ongoing benefits requiring ongoing regulation is important if ex post reviews are to help assess the true value of regulation.

## **1.2. NON-DISCRETIONARY REGULATION**

As noted above, many of the rules brought in through ICOB were required because of the IMD and the DMD. Hence, in assessing the ICOB rules at the time of implementation, focus was placed on the distinction between the non-discretionary regulation and where the FSA was introducing super-equivalent regulation.

Since our project is about developing and demonstrating methodologies used to measure benefits, we have focused on regulation driven by the FSA and that directly emanating from IMD or DMD in an even-handed fashion and have therefore assessed all of the

impacts of ICOB, irrespective of whether they are driven by European or FSA decisions. We have, however, estimated the impact of the additional requirements imposed by the FSA beyond those of the directives.

### 1.3. COMPLEX CASES

Finally, ICOB introduced many different rules to the general insurance market. This makes CBA analysis difficult, and in particular, makes the estimates of the compliance costs resulting from particular parts of the ICOB package difficult to estimate.<sup>7</sup>

However, it is important when looking at the market impacts to review this by looking at different regulatory interventions in isolation from one another. An important aspect of this project has been to isolate the different changes and to identify the effects of each of these.

### 1.4. STRUCTURE OF THE REPORT

The rest of this report is structured as follows:

- Chapter 2 sets out the methodology that we have used to assess the impact of ICOB;
- Chapter 3 focuses on the major changes introduced by the introduction of ICOB which we judged could have had significant market impacts;
- Chapters 4 – 7 review the market impacts resulting from the ICOB rules and the degree to which these market impacts can be quantified;
- Chapter 8 summarises our findings on the quantifiable market impacts of ICOB as well as scaling this for the general insurance market more widely; and
- Chapter 9 then sets out the implications for measuring market impacts in future studies.

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7

“The FSA’s Methodology for Cost Benefit Analysis”, NERA, 26<sup>th</sup> November 2004.

## 2. METHODOLOGY

It is widely recognised that the most difficult and challenging part of undertaking cost-benefit analysis is the assessment of market impacts. Those undertaking CBAs face the temptation to focus on what can be easily quantified rather than the areas where the impact of any change in regulation is most significant but where quantification may be most difficult. In developing the methodology for this report we have sought to build on the analysis of good practice when undertaking CBAs developed for the FSA.<sup>8</sup> This had a number of implications for our research:

- It is important to establish an appropriate baseline to assess the impact of regulatory changes;
- Analysis should focus on the major impacts - the first question in any CBA process is what significant changes will regulation bring about (considering both those that the regulation desired to change and any unintended consequences); and
- There is a need to focus on the process by which the market is impacted rather than to focus solely on outcomes of the quantity, quality and variety of products sold. Hence it is important to examine this at the level of economic fundamentals of demand and supply which leads to the need for assessment on a product basis.

The objective of this project is not to set out a comprehensive methodology regarding how benefits should be quantified. It is well known that benefits are often difficult to estimate and it will not be possible in all cases to estimate them with any degree of accuracy. However, this project does set out “rules of thumb” or “ready reckoner approaches” that could be usefully applied in a wider set of CBAs.

### 2.1. BASELINE

One of the aims of the project is to use the introduction of the ICOB rules as a case study for examining how market impacts can be assessed ex ante and ex post. Therefore we have focused on the pre ICOB regulatory system. This has two main implications for our methodology:

- It was important to understand how the voluntary regulatory system worked prior to ICOB. To do this it was important to distinguish between the rules of the General Insurance Standards Council (GISC), which was the voluntary regulator of general insurance, and the degree to which these were actually followed in the marketplace. We also needed to allow for those who chose to follow the voluntary regulation and those that did not.
- We needed to take into account the interaction between the ICOB regime and other changes; in particular, the introduction of MCOB and ongoing trends in the market in order to understand what would have happened in the absence of regulation.

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8

“The FSA’s Methodology for Cost Benefit Analysis”, NERA, 26<sup>th</sup> November 2004.

## **2.2. IDENTIFYING THE SIGNIFICANT CHANGES**

The first task of the project was to identify the significant changes brought about by the ICOB regime. In doing this we also sought to differentiate between the requirements of GISC, the European Commission and the FSA. To determine this, we:

- Held discussions with representative trade bodies, including ABI, BIBA, the Retail Motor Insurance Federation and the Finance and Leasing Association;
- Undertook discussions with those who used to be at GISC and are still working in the industry, since they are likely to have a clear understanding of where FSA and EC regulation went further than GISC requirements; and
- Held discussions with the FSA regarding differences between GISC and FSA regulation and the areas where they anticipated impacts being observed.

This led to the identification of a small number of significant changes which are described in detail in chapter 3.

## **2.3. MEASURING IMPACTS AT THE PRODUCT MARKET**

There are two aspects to developing the methodology to measure the market impact of ICOB:

- The need to focus on individual products; and
- The type of market research required to collect information on consumer benefits.

We examine these in turn.

### **2.3.1. Choice of products**

Based on early discussions regarding the impact of ICOB, it is clear that there was considerable difference in the effect ICOB was thought to have had on different products. In particular, there was significant variation in the likely market impacts depending on:

- Size of market: suggesting that we should focus on the largest markets with the three biggest being motor insurance, home insurance and payment protection insurance;
- Perceived extent of problems: with little concern regarding products such as motor and home insurance but considerable concern regarding PPI and CI; and
- Nature of the market: with product markets varying depending on whether products are bought or sold, whether they are distributed with advice or on an execution only basis, and whether they were sold alongside another product or sold in isolation.



This process led us to choose to focus on: motor insurance; payment protection insurance; and critical illness cover.<sup>9</sup> While there are many more general insurance products, we believe that these three markets have certain characteristics that mean that they can be used as proxies for other general insurance products.

### *Motor insurance*

Motor insurance is, by far, the largest product market of all general insurance products with gross premiums of around £12 billion. In contrast to many financial services products, motor insurance is an annually renewable and reviewable product. In addition, consumers are believed to actively search the market and price is a key determinant of choice.

### *Payment protection insurance*

Gross premium income for payment protection insurance is around £4.5 billion per year and there are over 18 million policies.<sup>10</sup> PPI is taken out on a particular loan or credit agreement. This underlying agreement may vary and could include financing to buy a car or other consumer durable such as furniture or washing machines, or it may be an unspecific secured or unsecured loan, or it could represent borrowing on a credit card. Due to the link with a specific credit agreement, there are two main characteristics that follow from this:

- First, PPI is sold alongside a financing agreement i.e. the consumer takes out a loan through a particular provider or intermediary and takes out the insurance through the same channel. Typically, competition is often found to be less fierce where products are sold at the same time than where products are sold separately. In this particular case, competition may be further weakened because the loan itself may be sold alongside another product such as a car.
- Second, PPI may be sold through secondary intermediaries i.e. through intermediaries whose primary line of business is not insurance. In the absence of regulation, there is a risk that these intermediaries may be less able to sell PPI to a high standard compared to intermediaries whose business is purely about insurance and therefore have greater experience of both selling it and of the product terms.

### *Critical illness cover*

Finally, we focus on critical illness cover (CI). This is a considerably smaller market than either motor insurance or PPI, with gross premiums of only £33 million. The majority of CI is sold through intermediaries, with around half sold alongside a mortgage.

<sup>9</sup> Although home insurance, at £6 billion gross premiums, represents a much larger market than critical illness, it was considered to be very similar to motor insurance in terms of characteristics and thus any methodological issues would be likely to be the same across these two markets. In practice, the degree to which consumers actively search and buy products is thought to be happening to a lesser degree in home insurance than in motor insurance, due to the greater variety in the cover available for home insurance. Nonetheless, most market participants believed that the characteristics of motor and home insurance were sufficiently similar to use the implications from the impact of ICOB on motor insurance as a proxy for the impact on home insurance; indicating that it would not be necessary to examine both of these markets.

<sup>10</sup> Based on ABI figures and excludes mortgage payment protection insurance.

The nature of critical illness cover is that it is:

- Purchased irregularly, often with the aim of matching the term of a mortgage; and
- It may not only be sold alongside a mortgage, but also alongside life insurance cover.

This has been a market that has been undergoing significant changes both with respect to falling volumes to reflect lower mortgage sales but also with less standalone CI being sold.

### 2.3.2. Market research

To quantify the consumer benefits arising from the ICOB rules, there are a number of possible approaches that can be used, including:

- Gathering information from providers regarding the degree to which consumers valued changes in ICOB;
- Undertaking mystery shopping regarding the actions of intermediaries and providers in providing advice and going through the sales process; and
- Conducting a consumer survey testing the degree to which consumer's directly changed their behaviour, recognised changes in the market and valued any changes.

We chose to use qualitative interviews with providers to understand the impact of the ICOB on the information provided, the sales process and complaints procedure.

Although, we recognise that mystery shopping is one of the best methods for assessing the sales process, since it can control for the types of consumer going through sales process, it does not allow for an assessment of issues such as the reasons for making particular choices or for assessing the value of information.<sup>11</sup>

This was complemented by a consumer survey on the recent purchasers of PPI, CI and motor insurance products. This allowed us to test a broad number of issues:

- Whether increases in information resulted in consumers being better able to assess product characteristics or simply increased the length of the sales process;
- Whether individual consumers had changed their behaviour this year for products that are sold on an annual basis;
- The value of different components of information provision; and

11

Indeed, the use of quantitative mystery shopping in measuring the potential detriment to consumers from a particular sales process was pioneered by CRA in work for the FSA and subsequently used in additional research for the ABI. See for example: "Polarisation: Research into the effect of commission based remuneration on financial advice" for the Financial Services Authority, CRA, December 2001. "Study of intermediary remuneration" for the Association of British Insurers, CRA, February 2005.

- The willingness of consumers to pay for an increase in regulation.

The survey was undertaken in December 2005 by Continental Research. They identified consumers who had purchased motor insurance, critical illness or payment protection insurance during the last six months. The interviews were undertaken over the telephone and resulted in 200 recent consumers of motor insurance and PPI and 100 recent consumers of critical illness.<sup>12</sup>

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The smaller sample for CI was due to the difficulty in finding consumers who had recently purchased CI which in turn was a reflection of the much smaller market size compared to the other products. It should also be noted that the sample size used for some of the figures quoted may differ to these figures because of the routing of the questionnaire in which not all of the sample are asked a particular question.

### 3. OVERVIEW OF THE MAIN CHANGES IN REGULATION

Before attempting to quantify the impact of regulation, it is necessary to identify the most significant regulatory changes in order to focus the collection of data and subsequent analysis. By comparing the rules set out for members of GISC, the voluntary guidelines set out by the ABI and the rules set out in ICOB, we were able to identify changes that could have impacted the market.

Based on this list, we undertook a series of preliminary interviews with the FSA, Financial Ombudsman Service, ex-employees from GISC, the ABI and trade associations whose members were affected by the introduction of ICOB. This allowed us to identify:

- The degree to which GISC rules were complied with, thus identifying areas where the rules are similar but ICOB may still have had significant impact; and
- Areas that were regulated prior to FSMA and the market continued to act as if they were regulated even prior to ICOB.

Hence this chapter summarises the main changes that occurred when ICOB was brought in and compares these to the position of the market before ICOB. In particular we note whether the rules were similar to those enforced by GISC.

#### 3.1. STATUTORY REGULATION

The first set of changes arising from ICOB reflects that all insurers and intermediaries providing and distributing general insurance products have come under FSA regulation. All of those operating in general insurance must be authorised by the FSA and comply with the FSA's regulation of the sector.

This needs to be compared to the situation prior to ICOB. It is estimated that GISC had around one-third of general insurance intermediaries among its members and thus did not cover the whole market. For insurers, the coverage was much greater, with the vast majority of insurers counted among its members.

The introduction of statutory regulation could have significant impacts because of the fixed cost of gaining authorisation and the ongoing cost of compliance, possibly resulting in some intermediaries leaving the market. Equally, because of the fixed cost of compliance for a particular product, there may be a withdrawal of products from the market.

On the other hand, statutory regulation may directly increase consumer confidence. Coming under statutory regulation brings with it the fact that enforcement and the need to comply are likely to be greater than under voluntary regulation where the firm can always choose to stop being subject to the voluntary regulator. Under statutory regulation they have no such choice.

In addition, ICOB imposed a distinction between retail and commercial customers. Our report focuses only on the impact on retail customers.

### 3.2. INFORMATION PROVISION

The second major element of ICOB was to bring in various requirements regarding information provision. Pre-sale, intermediaries must disclose whether they are fair (could advise on products from a wide range of insurers), tied (could advise on products from only one adviser) or limited-number advisers. Various other aspects such as disclosure of a 10% or more ownership share between insurer and intermediary and how registration of an adviser could be checked were also required.

In comparison, GISC rules required that intermediaries could only use the term “insurance broker” if they were independent (or fair) advisers. These requirements would be expected to improve consumer understanding regarding the intermediary.

Consumers must also be told about their duty to disclose relevant information during the sales process which would be expected to lead to more disclosure of such information and hence a reduction in problems when seeking recourse on the product.

In terms of documents, ICOB required both an increase in the amount that must be disclosed to the customer before the sale (or in some circumstances these can be provided immediately after the sale) and the way it was presented, including:

- Statement of demand and needs – explaining whether advice has been given and how the product meets the needs of the consumer;
- Policy summary – with the main terms and conditions of the policy;
- Statement of price – explaining the total premium or the basis on which the premium will be calculated; and
- Consumers need to be told about the complaints procedure.

Information provision appears to be one of the more significant changes. In particular, this could be expected to change consumers’ understanding of how the policy meets their needs, impact on consumers’ understanding of the key terms, conditions and exclusions of the policies, alter the degree to which consumers could assess the value for money of the products that they are purchasing, and help them to know what to do in the event of needing to make a complaint.

After the sale, consumers should also receive the policy document containing the full terms and conditions of the policy. This also gives consumers full details on exclusions, helping them to assess the overall product. This was common practice prior to ICOB and does not appear to be a significant change.

In addition to the impact of the various individual documents, it is also important to consider the impact on the total volume of documents that consumers are being given. While each individual document on its own may bring benefits and clarify consumer understanding, it is possible that having so many documents disclosed together may leave consumers overwhelmed by the number of documents that they have to examine, such that they do not look at any of them.

In some areas ICOB also reduced the amount of information that must be disclosed. Under ICOB there is no requirement to disclose commission to retail consumers. GISC previously had the requirement that commission must be disclosed if retail consumers ask for it and hence not having this requirement may have reduced the information available to consumers. However, it is believed that very few consumers asked for this information and thus this would have a very limited impact.

Finally, in addition to the pieces of information that must be given to the consumer during the course of the sales process, ICOB also brought requirements about financial promotions. These included that financial promotions must be clear, fair and not misleading. Further, those promotions that include a comparison of contracts now need to compare contracts that meet the same needs or which are intended for the same purpose; and where prices are compared this must be done objectively. GISC also had various requirements about ensuring that advertising is clear, fair and not-misleading and that it met various standards required by various advertising codes. Therefore any impact arising from this was due to the statutory nature of regulation rather than a rule change.

### **3.3. SUITABILITY**

ICOB brought requirements to ensure that sales made to consumers would be suitable i.e. that consumers would not end up with insurance products for which they would not be able to make a claim because their characteristics at the point of sale were such that they were already excluded from the terms of the policy. Thus, there are know-your-customer requirements such that intermediaries must gather information about the customer to ensure that the product meets their needs and that a suitable sale is being made when the customer is being advised. In the past, GISC members would have needed to attempt to match a product to the requirements of the customer, but in the absence of a regulated concept of advice, it is difficult to interpret the implication of this requirement.

Various rules were put in place regarding professional requirements for those dealing with consumers. For example, they had to meet various knowledge and competence requirements. GISC already had rules in place that members had to ensure employees were appropriately trained, that they had to be assessed at least once per year and that members had to provide for the continued professional development of staff.

In addition, intermediaries have to have professional indemnity insurance, although this was already the case under GISC. Although there was significant concern regarding this during the consultation process for the ICOB rules, in reality this appears to have resulted in little change.

### **3.4. RECOURSE**

ICOB has also brought new constraints regarding the recourse that consumers have after purchasing products, including:

- Complaints process: consumers must be told about this before sale. In the past, GISC required only that this information was disclosed in the policy or service documents.

- Cooling-off period: consumers have a 14-day cooling-off period after purchasing the product and a 30 day period for pure protection products. In the past, GISC members were only required to offer a 14-day cooling-off period where full documentation was not provided at the point of sale. The lengthening of the cooling-off period for pure protection and the widening of the applicability of it for other products would be expected to give consumers greater ability to change their mind about the product if they discover it is not appropriate for them, or there is an alternative product that can better meet their needs.
- Cancellation or withdrawal rights: consumers are now able to cancel products, with providers only able to charge for the proportion of the service already provided and not able to impose an additional penalty. In addition, they are now able to both claim on their policy and cancel it. In reality, this change is not thought to be significant enough to change behaviour.
- Access to the Financial Ombudsman Service: consumers are now able to bring complaints against intermediaries to the FOS although they could already bring complaints against insurance companies to the FOS before ICOB (and it is argued that in some cases, complaints that were actually against intermediaries were dealt with via the insurance company in the past anyway). We would expect this additional access to lead to an increased chance of redress for the consumer. Under GISC, members had to be a part of an approved dispute resolution facility, although this did not always result in a decision that had to be followed by the member of GISC, unlike with the FOS.

As well as these various issues, firms also have a number of record-keeping requirements that they have to meet. For example, they must retain claims information for the duration of the claim and for three years afterwards regarding: the details of the claim; the date the claim was settled or rejected; and information relevant to the basis of the decision. Furthermore, records must be kept for six years for pure protection policies. Consumers also have the right to request this information. These various record keeping requirements are likely to be of benefit in ensuring that complaints and claims are dealt with on the basis of the facts which should help consumers where they have a justifiable claim against the insurer, and would help the insurer where they face vexatious complaints from consumers.

### 3.5. THE RELATIONSHIP BETWEEN PROVIDERS AND INTERMEDIARIES

In addition to the changes explained above, there were a number of other changes that occurred through ICOB, including:

- Insurers now have to take reasonable steps to make sure that intermediaries are providing the relevant information to consumers. This may lead to insurers imposing greater constraints on intermediaries with the effect of improving the level and quality of information for consumers;
- Rules on inducements have been imposed. This may change the relationships between insurers and intermediaries which may protect consumers' interests.

Although ICOB appears to have initiated a review by many insurers regarding the relationship with their intermediaries, this appears to reflect the impact of statutory regulation as well as internal strategy concerns rather than rules on responsibility or inducement. These issues were not believed to lead to significant impacts on the market and thus are not taken any further in this report.

### **3.6. SUMMARY OF THE MAIN CHANGES**

The main changes to the regulatory regime from the introduction of ICOB can be categorised into:

1. Statutory regulation: the fixed cost of regulation could result in providers and intermediaries leaving the market. Equally, a statutory regulator may raise confidence in a sector, thereby increasing participation.
2. Information provision: providing consumers with more information may help them to determine whether they need particular products, or the best product or provider. Alternatively, too much information can result in confusion and stifle competition. In addition, the provision of information may lead to an increase in the length of the sales process, meaning consumers are less willing to shop around.
3. Suitability: the increased responsibility for ensuring suitable sales could mean consumers are not sold inappropriate products, therefore reducing the need for costly complaints.
4. Recourse: enhanced consumer protection through greater awareness of the cooling off period, greater access to the financial ombudsman but potentially reduced consumer protection through encouragement of execution-only channels.



#### 4. STATUTORY REGULATION<sup>13</sup>

Since 14<sup>th</sup> January 2005, general insurance products and providers have been brought under the statutory regulation of the FSA for the first time. Before this, sales of all three of the products we have investigated would have fallen outside of FSA regulation:

- Motor insurance and payment protection insurance were previously non-regulated products, although there were codes of practice supervised by the ABI. Providers and distributors may have been members of GISC though this was entirely voluntary;<sup>14</sup> and
- Critical illness cover was previously regulated under the PIA regime. However, it fell outside the FSA regime unless it was sold as an integrated product with an investment based life insurance product. As with motor insurance and PPI, there was an ABI code applying to CI; this included definitions of various critical illnesses and the product terms necessary for a product to qualify as being a CI product.

Even without imposing any changes to the products and providers coming under regulation, bringing a product under statutory regulation may have a number of impacts:

- Since regulation is compulsory rather than voluntary, all providers and distributors will face regulation and are not able to walk away from the regulator in contrast to the option that they have of ending any relationship with a voluntary regulator;
- As there is compulsory regulation, the cost from the failure to comply with regulation is seen to be bigger. This occurs, firstly, because the resources of the statutory regulator are likely to be greater than the resources of a voluntary regulator and hence non-compliance is likely to be identified. Secondly, a statutory regulator can require firms to comply or leave the activity whereas the enforcement of a voluntary regulator could be effectively be ignored by ceasing to be a member. This is therefore likely to increase compliance with any regulatory rules; and
- Because all providers and distributors are regulated, this reduces the risk to consumers from unknowingly choosing an unregulated provider or distributor which may have occurred with voluntary regulation that did not cover the whole market.

Knowing that products are regulated may improve consumer confidence in purchasing products. To the extent that consumers who valued the product but were put off by the risks of purchasing an unregulated product, regulation may in itself raise consumer welfare. To the extent that consumers were overly risk averse, due perhaps to problems in the market in the past, regulation may increase consumer welfare, without any corresponding change in quality due to correcting a problem of perception.

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<sup>13</sup> The decision to bring general insurance under the FSA's remit was made by HM Treasury, HMT press release, 12<sup>th</sup> December 2001.

<sup>14</sup> It is interesting to note that motor insurance products themselves would have needed to meet government requirements to ensure that consumers had at least third-party insurance cover.

Indeed, NERA note that the potential to increase quality, and perhaps, more importantly the perception of this, was seen as a significant benefit by a number of providers.<sup>15</sup> To test for a market impact from the introduction of statutory regulation it is useful to look at:

- Whether the introduction changed the perception of the market;<sup>16</sup>
- The value consumers place on these products being regulated; and
- The degree to which they are willing to pay for these benefits.

On the other hand, statutory regulation is seen to be more expensive than voluntary regulation. It is possible that this cost results in different types of product provider or intermediary becoming uneconomic, resulting in a reduction in provision of products that were providing consumer benefits. This effect needs to be offset from any benefits consumers receive from statutory regulation.

#### 4.1. THE IMPACT OF STATUTORY REGULATION ON MARKET PERCEPTION

Based on discussions with market participants, the introduction of statutory regulation is thought likely to have changed the level of compliance. Although GISC had many of the regulations under the ICOB rules, it was seen as a relatively light-touch regime. There are a number of reasons for this:

- Firstly, the level of enforcement activity was seen as small compared to that undertaken by the FSA because of the difference in the level of resources available to each. However, GISC was itself still in development when statutory regulation was announced. Therefore we do not know the degree to which GISC would have been able to raise its profile with consumers and its reputation with participants by fines and reprimands. In the period from June 2002 to January 2005, 30 members were referred to the Enforcement Committee at GISC and fines ranged from £1,000-£120,000. However, GISC could only publicise the results with a members consent (although it did have the power to issue a public reprimand as a penalty in its own right).<sup>17</sup> By contrast, in 2004/5 the FSA imposed fines of £22 million with a range from £1,000-£17million (covering more than just general insurance) and clearly has no such restrictions regarding the publication of penalties.<sup>18</sup>
- Secondly, as a voluntary organisation the threat of suspension was always going to be smaller than for a statutory regulator since firms could always choose to leave GISC.<sup>19</sup>

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<sup>15</sup> "Estimated Compliance Costs of Conduct of Business Regulation for General Insurance, A report for the FSA, Prepared by NERA, 27<sup>th</sup> June 2003".

<sup>16</sup> FSA regulation also brought in a number of rules that were completely new but that do not focus on the sales process. These fall outside of this assignment and we have not investigated them in detail.

<sup>17</sup> GISC performance against objectives 2004, GISC, 2004.

<sup>18</sup> FSA Annual Report 2004/05, FSA May 2005.

<sup>19</sup> Indeed, the clause that would have meant that GISC firms could only use other GISC firms was deemed anti-competitive therefore reducing the threat from being excluded from GISC.

- Thirdly, there may have been a change in the focus of enforcement activity from relatively small firms to relatively larger firms. Given that GISC was a voluntary regulator, it depended on the fees paid by those it regulated to exist. Hence, some believe that it would have been difficult to impose large enforcement penalties on large members who could threaten to leave. By contrast, the FSA takes a risk based approach to regulation that partly includes a focus on larger firms because the total detriment caused by a large firm misbehaving is greater than that for a small firm.

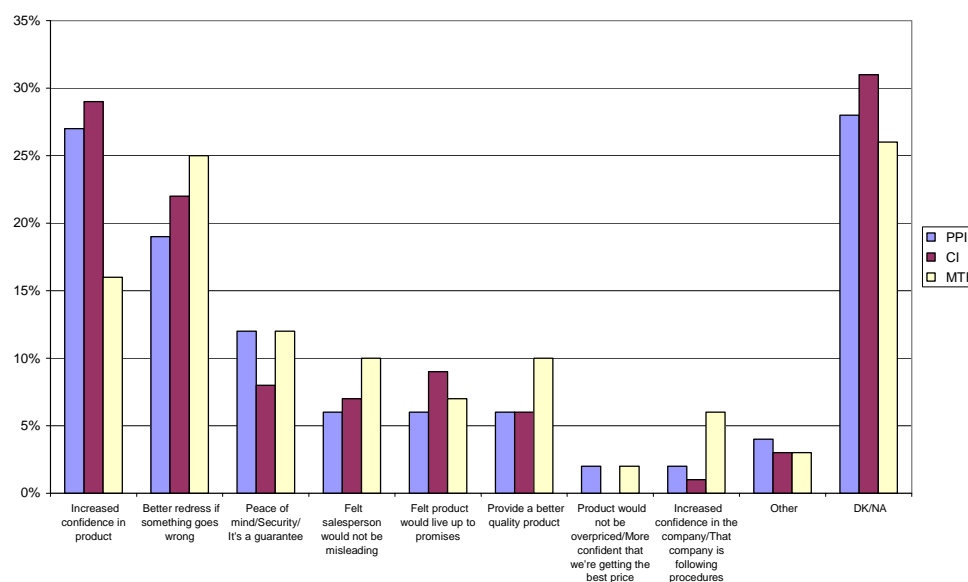
However, there is significantly more evidence that the compliance and enforcement issue is important from the supplier rather than the consumer side. Even almost a year after ICOB rules came in, relatively few consumers know that the FSA is the regulator of these three product markets with only 22%, 30% and 10% of consumer recognising that that PPI, CI and motor insurance were regulated by the FSA. Indeed, 41%, 25% and 33 % respectively believe that PPI, CI and motor remain under voluntary regulation.

However, it is not possible to compare this to the situation pre-ICOB or determine whether this is increasing. Since we are not aware of any data on what consumers understood about regulation before ICOB was brought in, it is possible as many people thought the FSA regulated the general insurance market prior to January 2005.

#### 4.2. THE VALUE CONSUMERS PLACE ON THESE PRODUCTS BEING REGULATED

For those consumers who think that products are regulated, we asked for the examples where consumers believe that regulation is of benefit. The most important benefit identified by consumers of PPI and CI was improving confidence in the quality of the product, which was identified by around 30% of consumers. By contrast, 25% of consumers purchasing motor insurance thought that regulation might provide better redress in the event of something going wrong.

**Figure 1: What benefits, if any, do you have from this product or sale being regulated?**



Source: CRA International based on survey by Continental Research. Note that this question allows consumers to choose multiple answers so the answers do not add up to 100%.

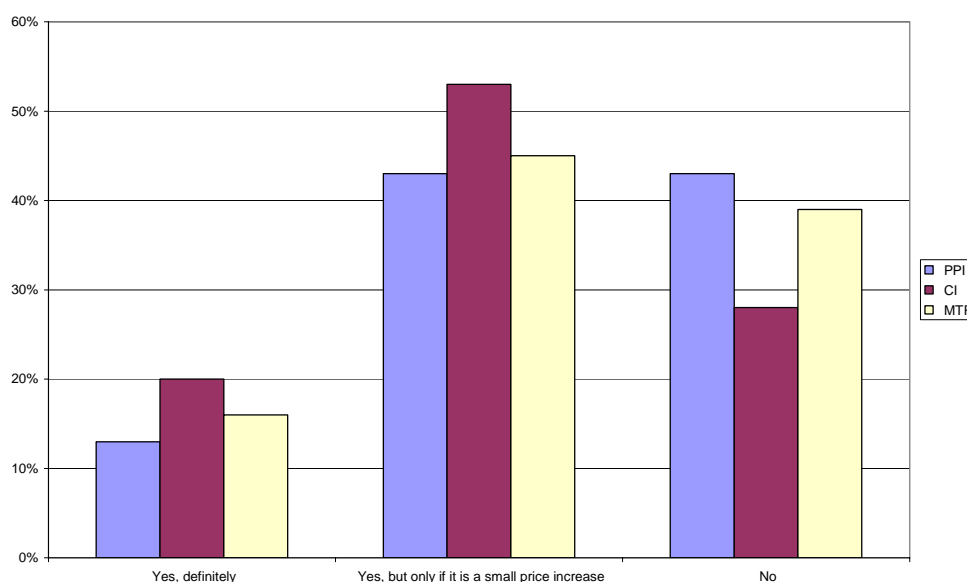
Figure 1 above presents the results for all those thinking that the relevant insurance product was regulated. It is possible however, to look at the difference between consumers who understand that the product is regulated by the FSA and those who believe it continues to be self-regulated by the industry. Comparing these two sets of consumers for the three products under examination we find:

- PPI: substantially higher numbers of consumers (43%) believe that FSA regulation will raise product standards compared to those who believe it is self-regulated (33%);
- CI: Slightly higher proportion of consumers believe that FSA regulation increases product quality and likely redress (33% and 30%) compared to those believing self-regulation (29% and 25%); and
- Motor: a large percentage of consumers believe that FSA regulation increases the possibility of redress in the event of anything going wrong (44% to 21%).

#### 4.3. THE DEGREE TO WHICH THEY ARE WILLING TO PAY FOR THESE BENEFITS

In the end, the introduction of increased regulation is likely to result in consumers paying more for the product they purchase. Therefore a direct way of testing whether welfare improves is to ask consumers directly if they would be willing to pay a higher price for statutory regulatory protection. Based on the consumer survey undertaken for this project, we find that well over 50% are willing to pay more for regulation, with more than 10% being willing to pay a “higher price” and over 40% being willing to pay a little more for regulation. Just under 40% were not willing to pay anymore for regulation.

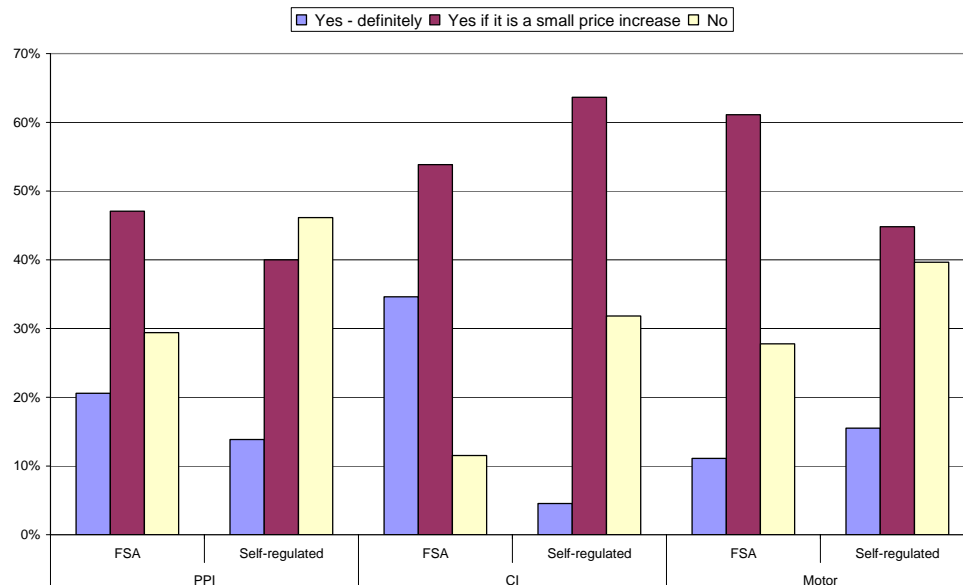
**Figure 2: If regulation means that the price of the insurance increases, do you think this is acceptable? Would you say ....**



Source: CRA International based on survey by Continental Research. Note that this question allows consumers to choose multiple answers so the answers do not add up to 100%.

We can then examine this question for those consumers who understand that the market is regulated by the FSA and compare this to consumers who believe it falls under self-regulation. We find that for every product, a larger proportion is willing to pay for regulation when they know the FSA is the regulator compared to those who believe there is self-regulation.

**Figure 3: If regulation means that the price of the insurance increases, do you think this is acceptable? Would you say ....**



Source: CRA International based on survey by Continental Research

This provides direct evidence that statutory regulation is seen by consumers as resulting in consumer benefits.

#### 4.4. WHETHER THE INTRODUCTION OF STATUTORY REGULATION CHANGED PARTICIPATION IN THE MARKET

To the extent that the increased cost of regulation cannot be passed onto consumers, introducing statutory regulation could result in participants in the market choosing to leave the market. There are two parts to this issue: first, whether regulation changes the number of individuals who are regulated to sell; and second, whether regulation changes the products that are being sold.

First, we examine the number of individuals who are regulated to sell. This is of concern because if the number of individuals who sell certain products declines then consumers may be unable to search across a sufficiently wide number of providers to ensure that they get a good value product, or potentially that they will not be able to get access to a particular type of insurance at all.

For both CI and motor insurance, there was limited concern about a decline in the number of individuals who are regulated to sell, with no-one suggesting that there had been any significant decline in participation in this product.

For PPI, however, there was slightly more concern. In particular, there was a concern raised regarding the number of motor dealers who had previously sold PPI when offering a loan to pay for a car purchase. It is believed that a number of smaller motor dealers decided not to become authorised by the FSA and hence have stopped selling PPI. In addition to those who have not become authorised, those operating in this part of the industry indicated that there was likely to be a further reduction in authorised intermediaries from this sector because of regulatory reporting requirements. That is, some car dealers may have become regulated thinking that this was a one-off requirement without realising that they would need to make regular reports to the FSA regarding the amount of business they had been doing. Since they have now realised this, some may decide to no longer remain authorised in the face of this additional cost.

Similarly, in the retail sector more generally, some market participants believe that there has been a reduction in the number of retail staff selling PPI because some firms have decided not to authorise staff in the retail outlets because of the high cost in training staff for an incidental part of the business and because of the relatively high turnover of staff in the retailing sector. In some companies, it appears as though this may be done on an outlet-by-outlet basis with some outlets training all staff and other outlets training none. The option where one member of staff (or a small number of staff) were trained to sell PPI was believed by some to not be very feasible since consumers do not wish to deal with one sales assistant when choosing and buying the washing machine and then be passed onto another to deal with the financing arrangements.

However, it is important to consider the impact from any withdrawal of the number of individuals selling PPI products. There are two possibilities. Firstly, demand-side substitution, that is the consumer could buy the product elsewhere.

It seems unlikely that consumer would proactively look elsewhere. Based on the survey, less than 10% of PPI customers shopped around for alternatives to the PPI product they bought. To some extent this is not surprising as PPI is often targeted at a particular loan.

Secondly, we might see supply-side substitution. In particular, it has been suggested that if an individual is not regulated to sell PPI, then the actual provider of the finance will contact the consumer direct and sell the PPI instead. Thus although the sale of the PPI may move up the value chain to the finance house, consumers would still be able to access PPI products. The evidence from providers on this is mixed, with some suggesting that PPI will only be sold at the point at which the loan is taken out because the process of selling it is easier at this point. Others, however, suggest that if there is a fall in the number of individuals selling PPI, the finance house would be certain to step into this role as long as the sale of PPI is profitable.

It should also be noted that the market may be changing. Indeed, the proportion of PPI that is being sold alongside the purchase of a particular product (as opposed to being sold on a stand-alone loan or on a credit card) is declining. This is believed to be because consumers are using alternative sources for the underlying finance for the product that they are buying e.g. through taking out a bank loan, through an extension of a mortgage or through the use of a credit card.

More widely, some insurers indicated that they had undertaken a review of the intermediaries with whom they would deal. It was clear that a number of insurers had decided to rationalise the number of intermediaries that they dealt with. In particular, they had reduced the number of small intermediaries since these were typically bringing small volumes of business to them which meant that they may have been uneconomic to deal with. However, in all of these cases, the reduction in the number of intermediaries that they dealt with was said to be driven by business decisions and would have occurred irrespective of ICOB being brought in (although it was noted that decisions and processes may have occurred at the same time since insurers needed to check whether intermediaries would be authorised by the FSA anyway).

Figures from the FSA suggested that there were around 45,000 firms conducting general insurance business before ICOB was brought in.<sup>20</sup> We understand from the FSA that this figure was an estimate made at the time and was believed to be an upper limit on the number of firms involved in general insurance business. On 14<sup>th</sup> January 2005, the FSA indicated that around 40,000 firms had been authorised.<sup>21</sup> Given that the figure before ICOB was an estimate, and given that insurers have been reducing the number of intermediaries with whom they dealt in the absence of regulation, it is difficult to conclude that regulation has significantly impacted the number of intermediaries in the market. However, since the impact of ICOB has not yet been fully felt by the intermediary sector, it will be important to examine this figure in the future to understand whether intermediaries are leaving the sector because of the burden of regulation.

Given all of these factors, therefore, it does not appear as though there has been very significant detriment to consumers caused by a fall in the number of individuals who are selling PPI or the other two insurance products.

Second, we consider whether the number of products being sold has changed. This is important, because if regulation has reduced the number of different types of products being sold this could lead to consumers no longer being able to access products that are valuable to them. In essence, if there is a fixed cost of ensuring that a particular product meets regulatory standards, then this cost will be proportionately greater for products that are sold in smaller volumes.

Some insurers indicated that they had indeed reduced the number of products that they offered. Examples were given where insurers no longer sold specialist motor insurance e.g. insurance covering people who are involved in motor sport. In addition, there was some concern expressed with regards to "mixed use" policies. These policies include cover for both a business and a personal element e.g. where a vehicle is used for business during the week but personal use at the weekend, or where there is a flat above a shop – in this case it was suggested that this would be replaced by two separate policies.

In addition to these examples for the three products under consideration, other examples given of where insurance has been removed included insurance on mobile phones and insurance paying for a locksmith for customers who lose their house keys.

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20 "Insurance selling and administration & other miscellaneous amendments", CP187, FSA, June 2003.  
21 "All systems go as 'GI-day' arrives", FSA press release, 14<sup>th</sup> January 2005.

Overall, however, none of the market participants believed that there had been such a significant decline in the range of products being offered as to be of concern for consumers.

#### 4.5. QUANTIFYING THE BENEFITS FROM STATUTORY REGULATION

The results in this chapter show that a majority of consumers are willing to pay a higher price for their product in order to receive statutory regulation. There is a clear preference for statutory regulation over voluntary regulation but this depends significantly on the product under consideration as evidenced by the willingness to pay for regulation. In particular, more consumers are more willing to pay for FSA regulation of CI than for the other two products.

The benefits that consumers perceive as arising due to regulation also appear to vary by product: with regulation leading to consumers having more confidence in the product for PPI and CI; but improvements in redress being more important for consumer purchasing motor insurance.

Although, basing estimates of benefits on consumer willingness to pay is one of the most difficult ways to estimate benefits, it is the best available approach to value the benefits through increased consumer confidence. Using the survey results, it is possible to infer a value placed by consumers on statutory regulation. If we use the percentage of consumers who understand that the product is regulated by the FSA, and multiply this by the percentage who are willing to pay for increased regulation, we get the percentage of consumers in each market who currently perceive benefits from ICOB. For the purposes of this exercise, we did not ask consumers how much they would be willing to pay. Therefore, we have made an assumption that a small amount would be around £5 per policy. Although arbitrary, the order of magnitude is consistent with the estimate of £2.80 per insurance policy as estimated as the cost of regulating general insurance.<sup>22</sup>

For motor insurance, which is renewed each year, there is no difference between the first year and the steady-state position. For PPI and CI, where policies last for longer than one year, it will take a number of years to reach the steady state position. However, once in steady state, these numbers represent the annual benefit. This approach is applied throughout this report.

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22

"All systems go as 'GI-day' arrives", FSA press release, 14<sup>th</sup> January 2005.



**Table 4: Benefit from statutory regulation**

	PPI	CI	Motor
Percentage understanding that the regulator is the FSA [a]	22%	30%	10%
Number of policies [b]	18.4 million	275,000	24.8 million
Percentage willing to pay more for regulation [c] <sup>23</sup>	68%	88%	72%
Amount willing to pay per policy [d]	£5.00	£5.00	£5.00
Value of benefits = [a]*[b]*[c]*[d]	£13.8 million	£0.4 million	£8.9 million

Source: CRA International

Using this number requires considerable caution. Firstly, what consumers say they are willing to pay for, and what they would actually do given the chance, has been shown to be very different in many empirical studies. Secondly, the value consumers place on statutory regulation includes the benefits through improved information, recourse and suitability. Therefore, care must be taken that we don't double count consumer benefits.

23

Where possible it is useful to test the statistical significance of these results. In this case this is done by comparing the percentage who are willing to pay for regulation for those who understand that the FSA is the regulator compared to those who do not understand that the FSA is the regulator.

## 5. INFORMATION PROVISION

One of the most significant changes due to the introduction of ICOB was to change the documentation that product providers and advisers need to give consumers. This had a number of components:

- Confirmation of whether the consumer received advice;
- A statement setting out whether the product met the demands and needs of a consumer, including whether it was suitable for a particular consumer where advice had been given;
- A summary of the product's terms and conditions; and
- Information regarding the process for complaining in the event of something going wrong.

These components were in addition to the existing product terms and conditions that needed to be provided with the sale of the product.

Increased information can have an impact on the market in a number of ways.

Firstly, the need to provide more written or verbal communication adds costs to providers. These would fall into the compliance costs of the industry and therefore we have not focused on these since details on them are available through the CBA analysis undertaken prior to CP187.

Secondly, increased information may directly enable the consumer to make a better choice by facilitating a comparison of product quality. Conversely, producing too much information can actually make product comparison more difficult, stifling product comparison and reducing competition. Therefore, to assess whether consumers benefited from the provision of information we need to determine whether:

- the changes resulted in consumers being better able to determine whether a product was right for them or not and to be able to choose between providers; and
- whether the information facilitated consumers making choices they would not otherwise have done.

This is considered in section 5.1.

Thirdly, the increase in information can lead to consumers facing a longer sales process and therefore reducing their efforts of shopping around. This is considered in section 5.2.

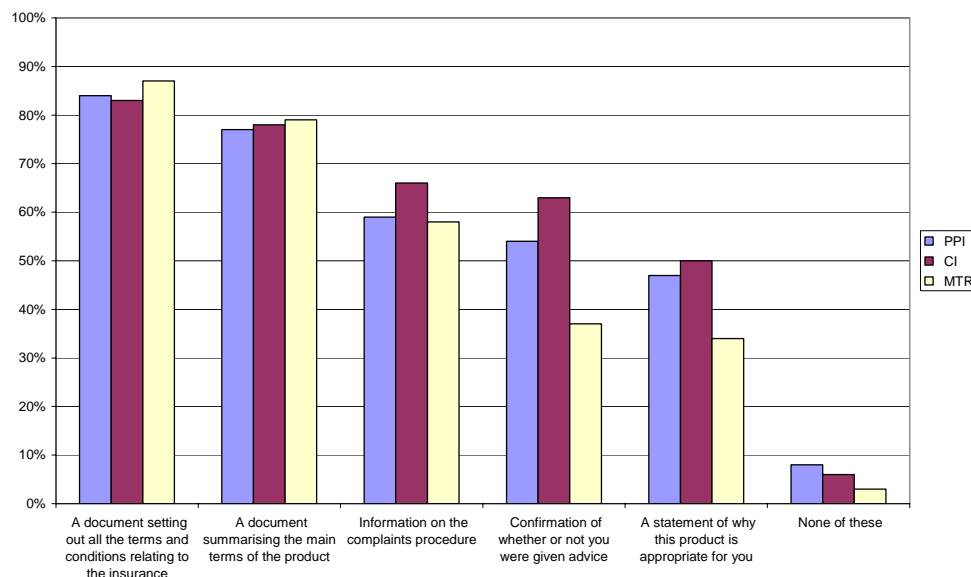
Assessing the value of information is not straightforward. Information can serve a number of purposes: it can be valuable at the point of sale; useful in the period subsequent to the sale (for example during the cooling off period, for reference when the consumer claims on the product or has a complaint regarding the performance of the product); or useful as a benchmark when the consumer comes to choose an additional product or switch provider. Therefore, we should be cautious regarding the value that consumers place on information a short period after the sales process, as this is only one potential value of the

information. In particular, consumers may not value information about the claims process if they have not needed to make a claim.

### 5.1. THE VALUE PLACED ON DISCLOSURE

To look at how consumers use the information provided, we asked them whether they recalled receiving particular parts of the documentation, and the degree to which they found this useful. For information to be useful after the point of sale, the consumer will need to be aware of what it contained. Figure 4 shows the proportion of consumers who remembered receiving these documents for each product. As can be seen, most consumers remembered receiving the product terms and a summary of these. For all products, the degree of recall by consumers gradually fell for information on complaints, confirmation of the provision of advice and the statement setting out the suitability of the product.

**Figure 4: Do you recall receiving any of the following in writing?**



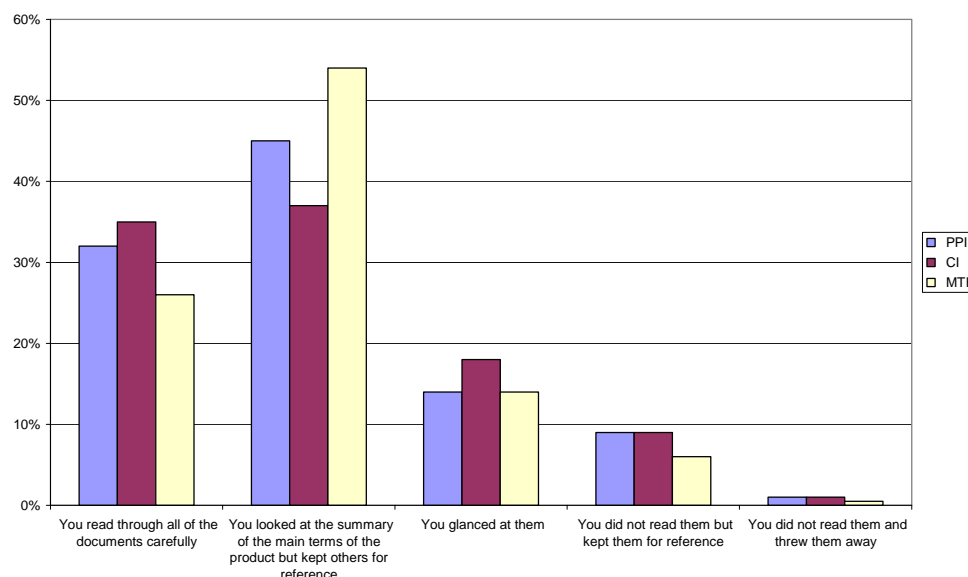
Source: CRA International based on survey by Continental Research

Perhaps, not surprisingly for the product that consumers most frequently purchase and where they actively seek the product - motor insurance - the product terms were more commonly recalled than suitability or documents regarding advice. It is likely that those who know they did not receive advice are less interested in documents providing confirmation of this.

Even if the consumer recalls receiving the document, it will be more beneficial if the consumer reads and understands the document. In Figure 5 we look at what consumers did with this information. This figure suggests that over 70% of consumers either went through the terms and conditions or used the product summary. This supports the value of the summary but interestingly shows this to be more important for motor, where we expect consumers to better understand the product already. Products which are more

often sold, had a slightly higher proportion of consumers who kept the documents but did not go through them in detail during or after the product was purchased.

**Figure 5: Did you read the information you received? Would you say .....**

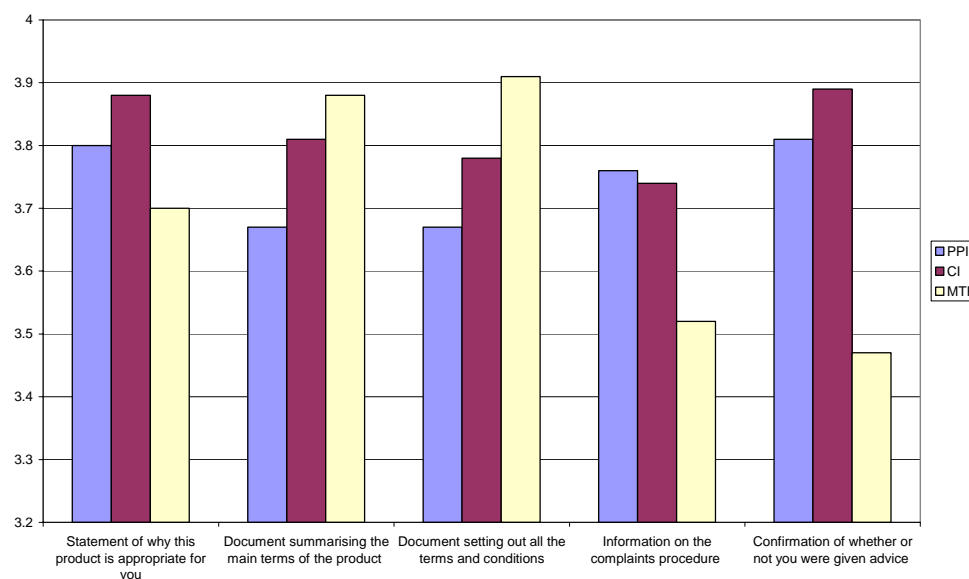


Source: CRA International based on survey by Continental Research. The columns sum to 100% for each product.

### 5.1.1. Components of the product and sales disclosure

To try to understand the value placed on different components of the information brought in through ICOB, we asked consumers to rank each of the pieces of information from 1 to 5, where 1 meant that it was not at all useful, while 5 meant that it was very useful. This shows that:

- On average, all documents were considered to be useful as they all had scores greater than 3;
- Documents focusing on the product terms were more important for motor. This is consistent with the consumer being more active in choosing between products;
- Surprisingly, although consumers of motor insurance thought that redress was the most valuable part of the regulatory regime, a document setting out the complaints process was not found to be as important as for the other products; and
- Unsurprisingly, confirmation of advice and suitability were seen as more important when we are considering products that often have an advised sale. Confirmation of suitability was not seen to be as valuable for consumers of motor insurance.

**Figure 6: How useful did you find particular documents?**

Source: CRA International based on survey by Continental Research. Note that a score of 1 meant that it was not at all useful, while 5 meant that it was very useful.

From the provider interviews, there was considerable scepticism regarding the increased information provision brought about through ICOB. The demand and needs statement, setting out suitability and the provision of advice, was not seen as useful for products that were actively bought by consumers. This is entirely consistent with the consumer research reported above.

The FSA indicated that the policy summary should encourage consumers to take notice of the policy document.<sup>24</sup> They note that before ICOB, only 10% of motor and household policyholders take out a policy on the basis of its terms and conditions. Examination of the same data source (GfK NOP's Financial Research Survey) finds that there is no evidence suggesting that this has risen for motor or household insurance. By contrast, for critical illness the equivalent number has increased from around 8.6% to 10% since ICOB.

Although consumers appear to value the product summaries, providers felt that bigger benefits could have been achieved:

- If there was more guidance on what should be in the product summary. Some in the industry noted that some summaries were almost as long as the terms and conditions in the policy document and hence were not actually acting as a summary. This was thought to be unnecessary since the same product could often be sold through a national broker with a significantly shorter product summary for the same insurer. Providers were concerned that the regulators would take the view that if information was not in the summary then it could not be relied on that the consumers

would have understood it. To avoid potential problems, insurance providers generally provided longer summaries than may be necessary.

- If product summaries had been standardised. There is considerable variation in the information contained and the way that it is presented. This means that although consumers are able to understand the information in the summary, they are not easily able to use them to compare across providers. The practical difficulties of this seem limited given that national brokers are already insisting on presenting similar product summaries for different providers in order to have their products included on the product panel.

### 5.1.2. Information regarding separation of prices

The final change in information provision depends on whether the product was sold alongside another product. Although under the GISC rules before ICOB it was necessary to separate the price of two products sold together, the degree to which this was undertaken in practice and the attention drawn to this by advisers was clearly questioned.

This issue is clearly only applicable to CI which is sold with life cover alongside a mortgage and PPI which is sold with a loan or credit card. The impact of ICOB should have been to increase the awareness that the consumer was purchasing two products with two prices and that it was not obligatory to buy either the CI or the PPI product.

Looking at the consumer purchasing PPI, 93% were told that the product was optional, with only 7% believing that they were told that PPI was compulsory when taking out their loan or credit card.

Comparing PPI to CI, 73% of PPI consumers were given both a price for the loan including and excluding the PPI, whilst 82% of those buying CI were told the cost of life cover with, and without, CI. We also found that consumers thought that this was useful in determining the value of these products, with 78% of CI consumers and 75% of PPI consumers finding the separate price useful for assessing whether it was value for money. These levels are encouraging and may represent significant benefits arising from the ICOB rules. However, without a baseline of the degree to which this was occurring before ICOB, it is impossible to quantify any benefits.

## 5.2. LENGTH OF THE SALES PROCESS

One of the ways in which consumers impose a competitive restraint on the quality and price of products is through the process of shopping around. By undertaking this search, consumers are able to compare the offers made by different providers and assess which best suits their individual needs on the basis of the price and quality offered.

One of the potential unintended consequences of increasing information could be to reduce the amount of shopping around that occurs. For example, if information provision regulation lengthens the sales process, or leads to it becoming more frustrating for consumers to go through, then consumers may undertake less searching. By contrast, if the provision of information leads to consumers gaining greater understanding of the product that they are being offered, this could lead to them seeking other providers in order to establish whether there is an alternative that would better meet their needs.

Therefore, we would ideally want to compare the amount of shopping around that an individual undertook before regulation being brought in with the amount that occurs after regulation has been brought in.

#### **5.2.1. Change in the length of the sales process**

In terms of changes to the length of the sales process because of regulation, there was some difference of opinion in the extent to which this had occurred as well as differences across the products. For instance, with PPI products it was estimated that the length of the sale had increased substantially, with some providers suggesting that the increase was as high as 10 minutes. For CI products, distributors thought that there had been a reasonably small change in the length of sales because they argued that many of the CI sales were going through a broadly similar process before ICOB as afterwards.

However, the concerns about the length of the sales process were greatest regarding motor insurance. Those providers and distributors interviewed had concerns that customers were frustrated by the longer sales process. It was a consistent theme from providers and intermediaries that many customers felt that there was unnecessary information that was being given and that it did not actually help them. Indeed, some major distributors indicated that the more that they listened to the calls with customers, the more that it became clear that customers did not appreciate the information that they were receiving. We have already considered the value of information in section 5.1 above and here we focus on the impact of any changes in the length of the sales process on shopping around.

Estimates of the impact of regulation on the length of the sales process for motor insurance varied. A small number of providers or distributors indicated that the length of the sales process had not changed, although they typically acknowledged that they might have already been providing detail akin to that which has been brought in by regulation. By contrast the majority said that the sales process had increased. Some distributors suggested that the length of sales had increased by 25% both for a process in which the consumer is given a quote and also for the full sales process. More commonly, they said that the length of calls had increased immediately (by around 15%) but that this had been reduced over time as new procedures were refined such that the overall increase was probably around 10%.

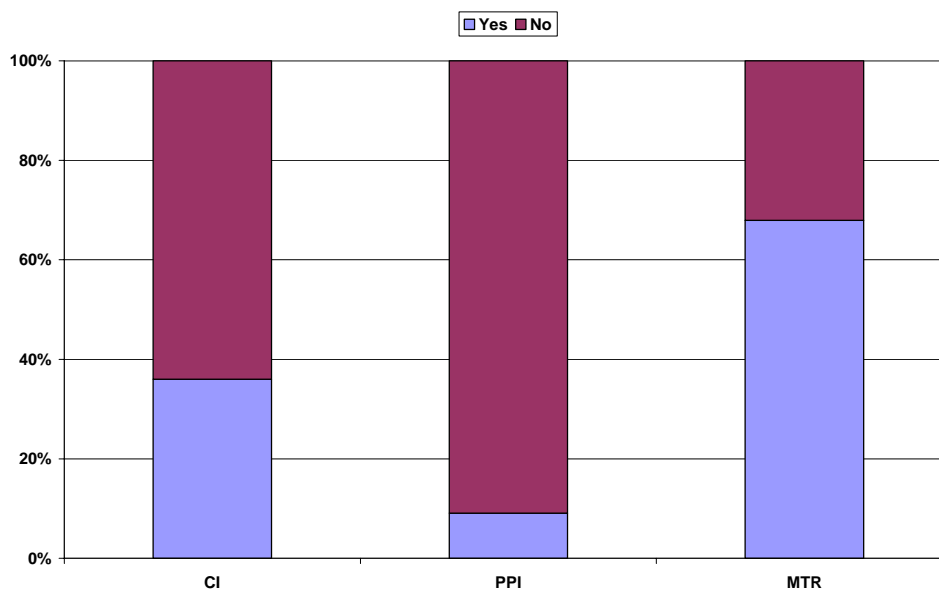
#### **5.2.2. Degree of shopping around**

The degree to which shopping around currently occurs varies substantially across the products under consideration as can be clearly seen from Figure 7 below.<sup>25</sup>

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In addition, because prices have generally been steady or falling, it is thought that this may have led to a reduction in shopping around because the renewal prices sent to consumers have not quoted prices that are very different to existing prices. Hence consumers may believe that they are already been offered a reasonable price and therefore not seek an alternative offer. Nonetheless, the length of the sales process may be putting off additional searching by those who would otherwise want to search and although they may not be facing prices higher than their existing premiums, they may be facing prices higher than they otherwise would.

**Figure 7: Did you shop around?**

Source: CRA International based on survey by Continental Research

In this case, however, we are not aware of any baseline numbers that could be used to compare the figures presented above for either PPI or CI. Furthermore, PPI and CI products are not typically bought regularly by the same individual and thus it is not possible to ask consumers about their previous behaviour under a different regulatory environment.

### 5.2.3. Impact of sales process on shopping around

Given the fact that PPI is linked to a particular loan, in the past it has typically been sold through the same provider of the loan. This is consistent with the much lower figures for shopping around for PPI than those given for CI or motor insurance. Because of the nature of the sale and because the PPI is often taken out at the same time as the loan, it is hard to distinguish the length of the sales process for PPI compared to the sales process for the loan. In the absence of figures for comparison on shopping around, we do not examine this further.

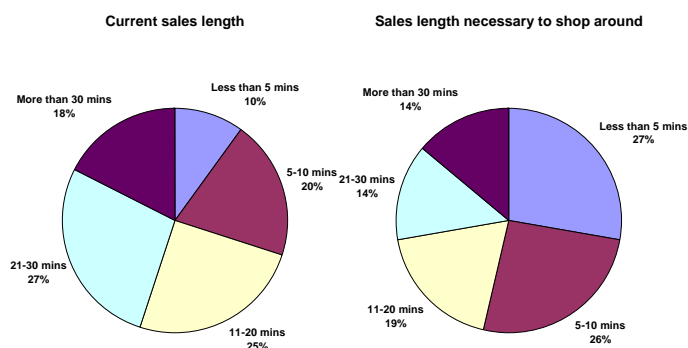
For CI, many providers and distributors of CI noted that CI had been regulated historically and the previous sales process was broadly in place still. In addition, CI was often sold by advisers who would be selling life insurance products and investment products and who would therefore be regulated individuals. Thus, they argued that the sales process for CI would not necessarily have been changed by the impact of general insurance regulation.

However, against these arguments it is noteworthy that a significant proportion of CI is sold alongside mortgages which would not have had a regulated sales process in the past. Furthermore, although providers and distributors indicated that a broadly regulated sales process would have been followed, it was clear that the majority had made changes to some of the sales process in the light of CI coming under the FSA's remit.



CI customers were asked about the length of the sales process which was found to be around 18 minutes on average.<sup>26</sup> They were also asked whether a shorter sales process would increase their searching. However, 52% of consumers said that a shorter sales process would not lead them to shop around. The remaining 48% of consumers were then asked how short the sales process would need to be in order for them to shop around. Customers who would be prepared to switch did have a marginally higher length of sales at 19 minutes. On average, the length of sales would need to fall from 19 minutes to 14 minutes to induce these consumers to search.<sup>27</sup>

**Figure 8: Sales length and shopping around**



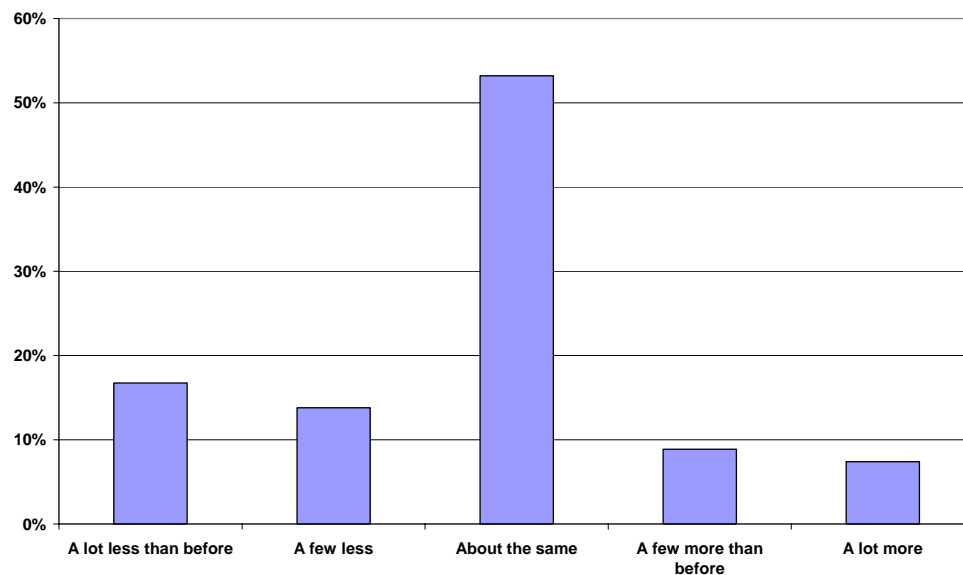
Source: CRA International based on survey by Continental Research. These figures relate only to those consumers who said that they would shop around if the sales process was shorter.

Using these results, it would be possible to make an assumption of symmetry regarding the shopping around process. That is, the reduction in the sales process necessary to increase shopping around could also be used as the basis for a reduction in shopping around due to an increase in the length of the sales process. However, given the evidence that there was a limited change in the length of the sales process, there will be limited impact on shopping around.

By contrast to PPI and CI, because motor insurance is renewed annually, it is possible to directly ask consumers how their behaviour has changed this year. It is also worth noting that motor insurance is the product where there is the greatest amount of shopping around that occurs and therefore if regulation has had a detrimental effect on shopping around, motor insurance would be the product where we might expect to see this most clearly.

<sup>26</sup> Although a substantial proportion of this is sold alongside mortgages which may lead to difficulty in establishing the length of the sales process, there is also a large proportion that is not sold alongside mortgages. Indeed in our survey, only around 38% of consumers had taken out CI at the same time as a mortgage. The length of the sales process for customers who bought alongside a mortgage was found to be 19 minutes compared to 18 minutes for those who bought it separately.

<sup>27</sup> Those consumers who bought the CI alongside a mortgage were less likely to shop around than those who had not bought the products at the same time. However, they would not have required as short a time to induce shopping around (16 minutes) compared to those without a mortgage (13 minutes).

**Figure 9: How many quotes did you obtain this year compared to last year?**

Source: CRA International based on survey by Continental Research

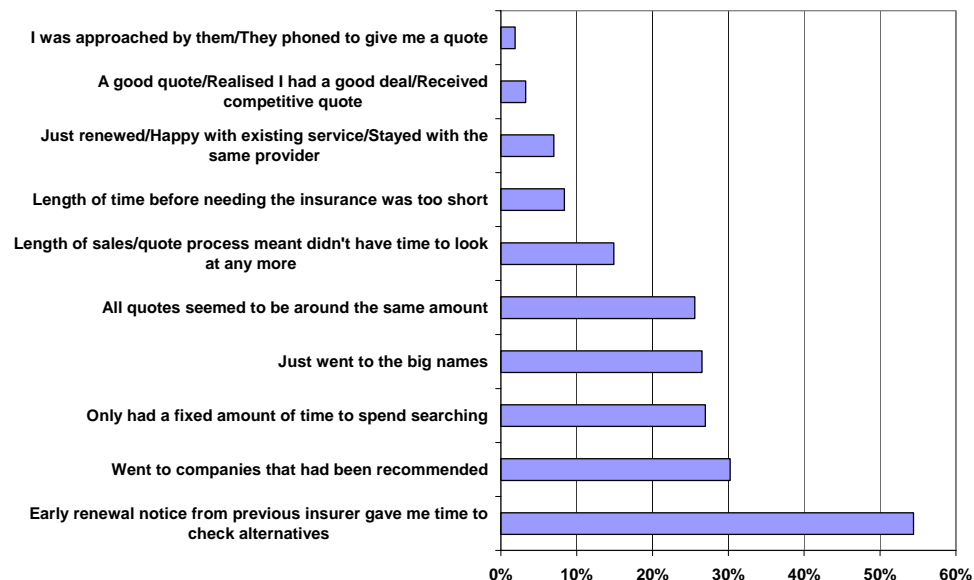
Looking at the same group of people who have purchased motor insurance in the last six months and also purchased motor insurance in the previous year, we are able to test directly whether they changed their shopping around behaviour. As can be seen from Figure 9 above, the majority of consumers undertook the same amount of searching this year compared to last year. However, 31% did less searching this year contrasted with only 16% who did more searching, therefore showing an overall decline in searching of around 15% of people.<sup>28</sup>

This result is consistent with the expected behaviour. That is, we would expect the length of the sales process to directly impact the number of quotes that people seek. For example, if consumers have a fixed amount of time available to search for the best providers, then with a longer sales process per provider, this would translate into consumers being able to search fewer providers in the fixed allowable time. (It is also worth noting that if motor insurance has the shortest sales process this may also help to explain the differences between the amount of shopping around undertaken for motor insurance compared to either PPI or CI.)

In order to examine this issue further, we asked consumers for the factors that influenced the number of quotes they received.

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In results from GfK NOP, there is no significant change in the average number of quotes that people have obtained on renewal of policies. However, they do find that there has been a small reduction in the proportion of people switching their motor insurance provider.

**Figure 10: What influenced the number of companies you approached for a quote?**

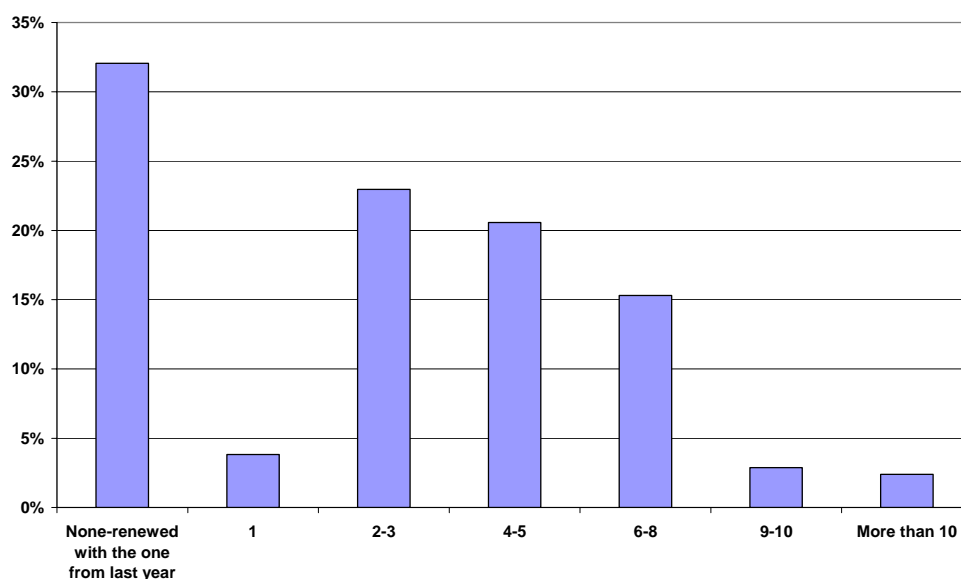
Source: CRA International based on survey by Continental Research. Note that this question allows consumers to choose multiple answers so the answers do not add up to 100%.

Figure 10 provides results backing up both of the theoretical arguments explained above regarding the possible impact of regulation on shopping around. For example, 54% of consumers said that the early renewal notice from their previous provider gave them time to check alternatives. This would suggest that the provision of information required by regulation has had a positive impact on shopping around.

However, 27% of consumers said that one of the factors was that they only had a fixed amount of time in which to search. Furthermore, 15% said that the length of the sales or quote process meant that they did not have time to look at any more companies. These last two factors suggest that the elements of regulation which have lengthened the sales process have had a negative impact on shopping around.

Taking this evidence, together with the earlier results from Figure 9 showing that on average consumers contacted fewer providers, suggests that, on balance, information provision has had a negative impact on shopping around.

In order to assess the impact of this reduction in shopping around, it is important to know how many companies consumers approach when obtaining quotes, how this has changed and the consequences of reducing this number.

**Figure 11: How many providers did you obtain a quote from?**

Source: CRA International based on survey by Continental Research

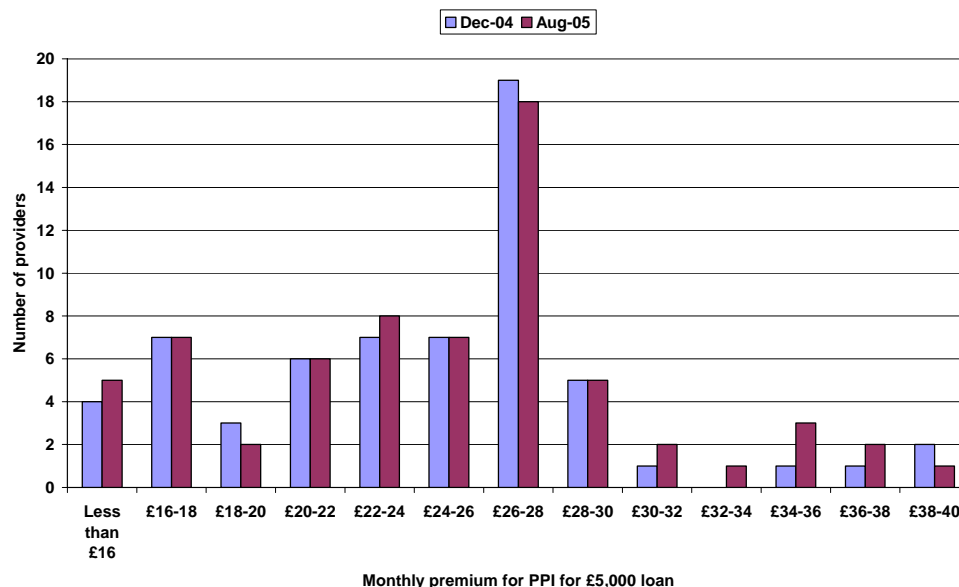
On average, consumers currently approach 4.6 providers. Taking the information from Figure 9 above, we can estimate the decline in the number of providers that are approached for a quote. Assuming that those who search “a lot less” or “a lot more” have changed the number of providers by 3 and that those who search “a few less” or “a few more” changed the number of providers by 1, this would suggest that there was a decline in the number of providers searched by around 0.33.

### 5.3. QUANTIFYING THE IMPACT OF A CHANGE IN SHOPPING AROUND

It is then also important to examine the impact of this reduction in search. We assume that the primary impact of less searching is that consumers will face a higher price than otherwise. The logic of this is as follows. If a consumer rings one provider, the benefit from contacting a second provider is that the second provider may offer a lower price; if it does, the gain to the consumer is the reduction in the price received; if it does not then the consumer would pay the price quoted by the first provider. This argument would also be followed through to assess the impact of additional providers, thus the more providers that are contacted, the lower the price that would be expected to be paid.

This argument is dependent on there being a variation in prices offered to consumers. That is, if all providers offered exactly the same price, then there would be no gain from searching because once they have found one price then they would know the price offered everywhere (and thus there would be no loss to consumers from a reduction in search). Hence it is important to assess whether there is in fact any variation in prices.

For CI, we were not aware of any data that could be easily used to assess whether there is much variation in prices. By contrast, Figure 12 below shows the variation in the cost of PPI.

**Figure 12: Variation in the cost of PPI**

Source: CRA International based on Moneyfacts. The premium for PPI is based on the difference in the monthly repayments for a £5,000 unsecured personal loan with a three-year term.

It is clear from Figure 12 above that there is considerable variation in the cost of PPI between providers of PPI and thus potential gains to be made from shopping around.

For motor insurance, the AA website contains information on the prices of motor insurance for the most recently available month. This lists a wide range of different types of risk and provides the market average price as well as the “shop around” price for each type of risk. The “shop around” price is equal to the average of the three lowest premiums offered when answering their survey. For October 2005, the mean of the market average price is £775 whereas the mean of the shop around price is £458, again showing considerable variation in prices.

We are therefore able to use the information on shopping around and the variation in the prices for motor insurance in order to calculate the impact on prices for consumers. Using the logic from above and assuming that the quality of products is the same, the search process could be seen as being equivalent to making random draws off a distribution of prices. Thus the gain to additional searching is the higher chance of receiving a lower price.

We have used the information available from the AA and assumed that the distribution of prices is uniform.<sup>29</sup> This enables us to calculate that the cost of the reduction in searching is equal to £9.24 per policy. It is estimated that there are around 24.8 million motor insurance policies in the UK.

**Table 5: Cost of reduced searching for motor insurance policies**

	Cost of reduced searching
Cost per policy [a]	£9.24
Number of policies [b]	24.8 million
Total cost = [a]*[b]	£229 million

Source: CRA International based on survey by Continental Research

Scaling the cost per policy by the total number of policies would lead to a total cost of around £229 million for consumers from reduced searching. Given that policies are annually renewable, this would represent the cost of regulation for 2005 only i.e. this cost would be imposed each and every year.

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The use of AA statistics has a number of issues. Firstly, the AA collects data on quoted rates for particular risk types from a wide range of providers. However, some of these providers will quote a very high price because they do not wish to have customers of a particular type and hence they are deliberately pricing themselves out of that part of the market. Thus it is not clear that these rates would actually be made available to consumers in the market. Secondly, to allow comparability they are based on a number of different customer risk profiles, the average of which may not be representative of the market. However as this affects both the average and the shop around value this problem is not thought to be significant. It should be noted that as actual differences in prices reflect different risks, the variation in all prices is much greater, but it would not be appropriate to use this aggregate variation in prices to estimate the cost of a change in searching.

## 6. SUITABILITY<sup>30</sup>

Many financial services products are believed to be complex, with consumers not having a full understanding of the product and how it will meet their needs. Where there is a lack of understanding, it is possible that those selling products could sell them to those for whom they are not appropriate. Similarly, if consumers are concerned that mis-selling is occurring in the industry, then they may decide not to purchase financial services products because they fear that they will be mis-sold the products and hence they may miss out on a good quality products even when they themselves may not have been about to be mis-sold a product. Therefore, one of the aims of regulation is to reduce the amount of mis-selling that occurs.

In the case of general insurance, this has been done in three main ways:

- By ensuring that distributors seek relevant information from consumers;
- By providing information to consumers regarding the product that they are considering purchasing; and
- By regulation itself giving greater confidence to consumers who then purchase financial services products.

We are not aware of any evidence that suggests that consumers are being mis-sold motor insurance. Indeed, it is accepted in the industry that motor insurance is a product that is bought actively by consumers, rather than a product that they need to be persuaded to purchase. In part this will be due to the fact that it is compulsory to have motor insurance.

The focus regarding mis-selling is therefore on critical illness and payment protection insurance. In both of these products, concerns have been raised that during the sales process, information is not always gathered about either the employment status of the individual or about any pre-existing medical conditions that they might have. This is of concern because certain employment and medical conditions may not be covered by the policy.

The impact of this is that:

- Consumers assume that they are covered by the insurance when they are not and hence they miss out on making alternative provision;
- At the point of making a claim (when they have a critical illness or are failing to make payments on a loan), consumers find that they are not eligible for the insurance and hence they do not receive the expected payout; and
- This results in an expensive and time consuming complaints process to determine whether the ineligibility has resulted from the sales person not asking for the information or from the consumer providing incorrect information.

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Although in cost-benefit terms we should consider net social welfare, so discounting pure transfers between consumers and producers, we continue to follow methodology applied in multiple CBAs by focusing on impact

## 6.1. EVIDENCE ON CHECKING FOR SUITABILITY

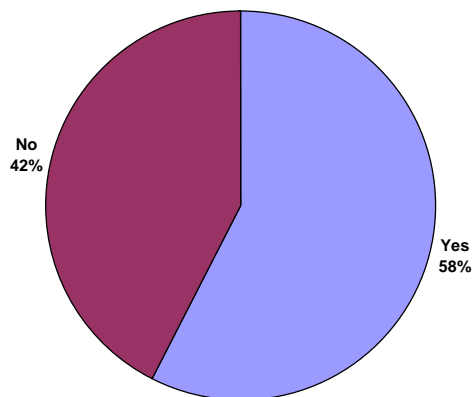
In assessing whether suitability has been improved, it is important to consider the level of suitability that was seen in the market before general insurance was regulated. In 2001, the ABI commissioned NOP to conduct some research on the PPI market. One of the questions asked was whether consumers discussed terms and conditions when purchasing PPI. 58% of those asked said that they did. However, this will be an upper bound on suitability at the time since suitability requires more specific questions to be asked. In particular, it is important to assess the consumers' employment status and whether they have any pre-existing medical conditions.

An alternative baseline is to take the absolute lower bound which is that there were no suitable sales made before general insurance regulation came in – clearly this is highly unlikely to have been the case.

In the absence of alternative options, we have therefore used the mid-point between these two estimates using 29% as the estimate of suitable sales before general insurance was brought under FSA regulation.

In our survey, we have asked consumers whether they had been asked about both their employment details and pre-existing medical conditions. Figure 13 below shows that, for critical illness and PPI, 58% of consumers said that they were asked about both of these issues.



**Figure 13: Were you asked about both employment and pre-existing medical conditions?**

Source: CRA International based on survey by Continental Research – note that the chart combines information for critical illness and payment protection insurance. These had similar proportions of consumers who said that they were asked about both factors.<sup>31</sup>

We use the difference between the results found in 2005 and those estimated before regulation to assess whether regulation has brought any benefits. Assuming that regulation is the reason for the increase in the proportion of consumers who are asked about their employment and medical details, we can use these changes to calculate the benefits from regulation.<sup>32</sup>

## 6.2. QUANTIFYING THE BENEFITS FROM SUITABILITY

Measuring the benefits from improved suitability has a number of interesting methodological issues. Firstly, which consumers are harmed? Secondly, how do we quantify the benefit due to any improvement?

<sup>31</sup> The FSA has also conducted some Mystery Shopping into the sales process for PPI. They found that 33 out of 52 shops checked the employment status of the shopper (e.g. whether they were on temporary contracts) and only 11 asked whether the shopper had a pre-existing medical condition. The FSA research shows a smaller proportion of consumers being asked about these factors than the figures shown in Figure 13 above as at most around 21% of individuals would have been asked about both employment and pre-existing medical conditions (assuming the 11 asked about their pre-existing medical conditions were all among the 33 asked about their employment status). The difference may be because mystery shoppers did not get far enough along the sales process to have been asked about some of these issues. Taken from "The sale of payment protection insurance – mystery shopping results" FSA Consumer Research 45, prepared for the FSA by GfK NOP, November 2005.

<sup>32</sup> At the time of writing, PPI was the subject of a market investigation by the OFT. It is possible that during this investigation additional information could be gathered that would enable a similar methodology to be used to assess the impact of regulation at a later date.

In cases where the consumer makes a claim but is not eligible for a payout because of a faulty sales process, the harm to that consumer is clear.<sup>33</sup> However, it is also the case that consumers who are fortunate not to need to make a claim but who valued the security that insurance offers are not actually receiving these benefits (even though they believe they are). Ex ante we do not know which consumers will be harmed and which will not be harmed. Therefore, although a small percentage of consumers will suffer disproportionately, the appropriate methodology is to count all consumers for whom the product is not delivering the services promised because of a faulty sales process.

To measure the lost benefits, it would be possible to look at the costs that fall onto consumers which would not fall onto them had the sales process been conducted properly, i.e. we would identify the impact of the claims that are not paid because of mis-selling. However, this would understate the lost benefits. Consumers are not only sharing the cost of misfortune but also purchasing certainty. That is, risk-averse consumers value the certainty that insurance offers. To capture these benefits, we need to look at what consumers are willing to pay, i.e. the price of the insurance.

It is important to consider whether the price of a policy represents a good estimate of the benefits of a policy. It is possible to argue that, in a selling environment, consumers are not necessarily focusing on the price of the product. Indeed, where products are mis-sold, it may be that consumers are purposely not made aware of the price of the product. Against this, however, is the evidence from the consumer survey suggesting that even for products such as CI and PPI, which are sold alongside another product, price disclosure was seen as useful for judging the value for money of the product – this was the case for 75% of PPI consumers and 78% of CI consumers. Of course, we do not know if this was the case prior to ICOB but from this result it would seem reasonable to assume that consumers are assessing the value of the product on the basis of price and hence that price is a useful measure of the minimum value they put on it.<sup>34</sup>

In calculating the benefits we make the following assumptions:

- The value of insurance for customers who are not mis-sold insurance is equal to the amount that consumers are willing to pay for it.
- The value of insurance is zero for those customers who are mis-sold the product because we assume that they would not have been eligible to claim on the product. This is a simplification as the policy may be valuable under some circumstances.
- The estimate for the degree of mis-selling is equal to the number of consumers who were not asked about both the employment and medical details and have pre-existing medical conditions or employment statuses that would have made them ineligible for the insurance. As a proxy for this, we use those claims that are rejected

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Note that this assumes that there is no redress available from mis-selling.

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As shown in all standard texts on CBA, the value most consumers place on a product should be higher than the price because there is consumer surplus for all but the marginal consumer. Therefore, this will represent an under-estimate on the value of consumer benefits. However, as is common in most regulatory CBAs we use price as the estimate for all consumers.

for reasons that could have involved mis-selling. Of the 15% of PPI claims that are rejected, we include the following reasons for rejected claims:<sup>35</sup>

- Pre-existing medical condition 27%;
- Temporary/seasonal work 15%;
- Insufficient continuous employment 12%; and
- Voluntary redundancy 11%.<sup>36</sup>

It is important to note that this will represent an upper bound on the number of policies that are mis-sold. That is, many of those who have pre-existing medical conditions or who were in temporary work may have failed to disclose this information even though they were in fact asked about it. Hence using all of those customers whose claims are rejected because of these reasons will over-state the number of policies which were potentially mis-sold.

- The size of the policies for those that are mis-sold is equal to the average premium for all consumers.

In 2004, there were gross premiums of £4.5 billion of creditor insurance and £33 million of critical illness cover. Declined claims for critical illness cover are estimated as being around 20%, but in the absence of separate figures on the reasons for claims being rejected, we use the same figures as for creditor insurance.

**Table 6: Benefit from improved suitability**

	Benefit from suitability
Percentage asked about both employment and medical details pre-regulation [a]	29%
Percentage asked about both employment and medical details post-regulation [b]	58%
Gross premiums [c]	£4.55 billion and £33 million
Proportion of claims rejected [d]	15% and 20%
Proportion of rejected claims due to factors that may link to mis-selling [e]	65%
Value of benefits = [a-b]*[c]*[d]*[e]	£130 million

Source: CRA, FSA

Thus the value of benefits attributed to the reduction in mis-selling is estimated at £130 million.

<sup>35</sup> Proportion of claims rejected based on Protection racket, CAB evidence on the cost and effectiveness of payment protection insurance, September 2005.

<sup>36</sup> ABI figures for 2002 on declined creditor claims.

Since the current estimate is that only 58% of consumers are asked about both employment details and pre-existing medical conditions, it is clear that more improvements can be made in terms of suitability. Furthermore, since the full effects of the ICOB regime is still working through the industry, we might expect some more of these benefits to be achieved. Thus we might expect the overall benefit from suitability to increase over time. Indeed, if this reached 100%, the benefits arising from improvements in suitability would be estimated as £318 million. More than double the estimated benefits reported in Table 6 above.

## 7. RECOURSE

In addition to ICOB changing the information that is disclosed pre-sale and imposing constraints on the sales process, it also increased consumer protection after the product sale. This occurred in a number of ways:

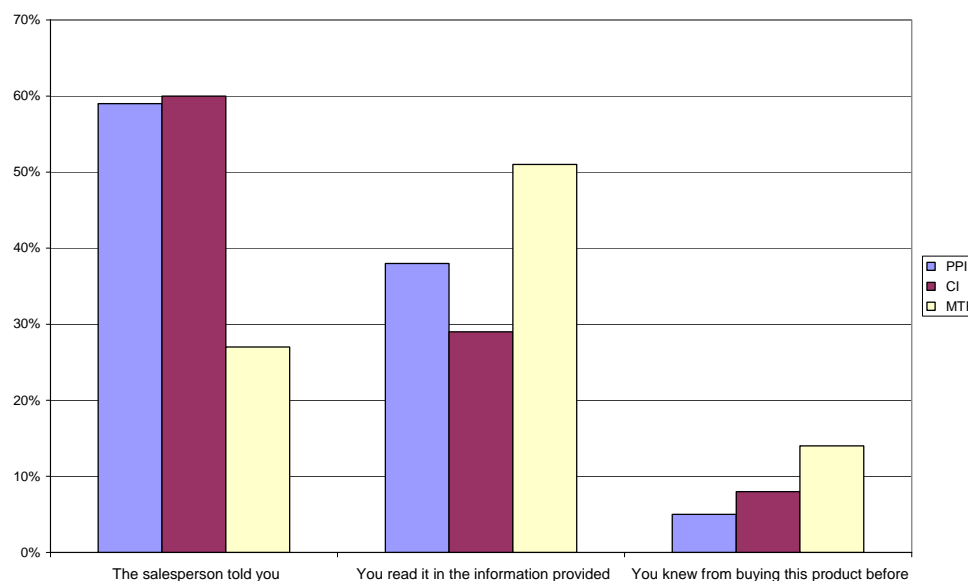
- Increased awareness of, and a longer, cooling off period;
- Increased access to a formal complaints process by increasing access to the financial ombudsman; and
- Better record keeping by advisers and product providers.

In addition, the impact of ICOB may have changed consumer protection indirectly if it influenced the channels by which consumers purchase products and if this changes the protection that these consumers receive.

### 7.1. IMPACT OF THE COOLING OFF PERIOD

The impact of ICOB on cooling off is not entirely straightforward. Prior to ICOB, GISC-regulated companies had to offer a 14-day cooling off period if they did not undertake complete information provision during the sales process e.g. if some of the information was sent by post after the consumer had agreed to purchase the product. ICOB also increased the cooling off period for critical illness and other pure protection products from 14 days to 30 days. Therefore we cannot attribute the availability of the cooling off period, or consumers understanding of it, purely to ICOB since it was already in place for the majority of insurers.

Currently, it is clear that the vast majority of consumers understand the cooling off period, with well over 80% of consumers aware that they had a cooling off period for each product. It is also clear that the way consumers are informed about the cooling off period varies depending on how the product was purchased. For motor insurance, where the product is mostly bought over the telephone or over the internet, then consumers are reading the information. Where a salesman is involved in selling the product, for PPI and CI, this is the most important method by which the consumer finds out about the cooling off period.

**Figure 14: How did you find out about this cooling off period?**

Source: CRA International based on survey by Continental Research. The columns sum to 100% for each product.

Interestingly, the value of the cooling off period appears to vary significantly between PPI and CI and motor. For PPI and CI, over 60% found this a useful option to have whereas for motor insurance over 60% said it made no difference to them. This is entirely consistent with the view that consumers have much greater confidence about the purchase of motor insurance compared to PPI or CI and that this product is bought rather than sold.

Looking at how consumers used the increased cooling off period, only 2% of our sample chose to cancel the product. Although we have no pre ICOB result to compare this to, based on the interviews with providers, to date there has been no increase in cancellation rates since the introduction of ICOB. It is important to note that most of the larger providers and intermediaries would already have been offering a 14-day cooling off period and all interviewees indicated that very few customers exercised the option to change their mind. It therefore seems unlikely that there has been a material benefit to consumers from the cooling off period being used to cancel the policy.

Had there been a change in the use of cancellation rights, this may have been because consumers recognised that the product was not suitable for them. Hence information on this could have been used to estimate the impact on mis-selling. However, since providers indicated that there had been no change in the use of cancellation rights and there is no baseline of the cancellation rates prior to ICOB, there is no quantifiable benefit from this.

The other impact of the cooling off period, is that this time could be used by people to shop around for an alternative provider of the product. Based on the consumer survey, 27% of motor consumers were told about the cooling off period by their salesman. We assume that these would not have taken place prior to ICOB. Further, of these

customers, 23% state that they used the cooling off period to check other products available.

This number is likely to be an overestimate of the number of people who did actually use the cooling off period to shop around (and is likely to represent consumers who know they "should" have shopped around). This is illustrated by 17% of customers who said that they used the cooling off period to check other products available in fact did not shop around at all when they last purchased the product.

Supporting evidence that the rest of these customers benefit from the cooling off period is provided by the fact those customers who state that they used the cooling off period to check other products available on average contacted slightly more companies for quotes this year compared to last year (in contrast to the customers in general).

We can then use a similar methodology to that in the shopping around section to calculate the increased benefit from shopping around due to the use of the cooling off period and can estimate the potential consumer benefits arising from this.

Using the estimates found in section 5.3 regarding the level of search currently undertaken, we assume that those who use the cooling off period to shop around have increased the average number of providers they examine from 3.6 to the current observation of 4.6, i.e. in the absence of the cooling off period, they would only have examined an average of 3.6 providers (so the cooling off period was used to check one more provider).

**Table 7: Benefit from increased searching due to cooling off period**

	Benefit of increased searching
Benefit per policy [a]	£38.35 <sup>37</sup>
Number of policies [b]	24.8 million
Proportion told about cooling off by salesman [c]	27%
Proportion of these using cooling off period to check other products [d]	23%
Proportion of these who do actually shop around [e]	83% (1-17%)
Total benefit = [a]*[b]*[c]*[d]*[e]	£49 million

Source: CRA International based on survey by Continental Research

Increasing the availability of the cooling off period and extending the period of time for which this was available was largely seen as a positive impact of ICOB. However, there was one reservation expressed during our interviews. Some providers and distributors were concerned that the cooling off period could lead to more problems of uninsured drivers because these drivers use temporary cover to get road tax, making them more

37

Note that the benefit of shopping around used here is not equal to three times that used in Table 5. This is because the benefit of moving from a search of 3.6 to 4.6 is not symmetrical to the benefit of moving from 4.9 to 4.6.

difficult to catch, but then cancel the insurance policy. Thus there were some concerns that regulation regarding the cooling off period and cancellation rights more generally could facilitate illegal behaviour. At present, the lack of evidence of an increase in the use of cancellation rights would suggest that this is a fear rather than a reality. However, it may be important to consider whether this would increase in the future.

## 7.2. ACCESS TO THE FINANCIAL OMBUDSMAN

Prior to ICOB, all insurers were members of the insurance ombudsman. After 1<sup>st</sup> December 2001 when the Financial Services and Markets Act took effect, product providers who have been prudentially regulated by the FSA have been subject to the Financial Ombudsman Service (FOS). By contrast, most general insurance intermediaries were not under the FOS's remit unless they voluntarily joined (which a small number did).

However, even this distinction is not straightforward. If a bank was acting as an intermediary on banking business then they may have been subject to the FOS when selling PPI on a loan (because the loan was under the FOS's remit), but the bank could have argued that they should not be subject to the FOS when selling motor insurance. As all of those regulated by the FSA are now subject to the FOS for all general insurance products, the largest impact of ICOB on the FOS was to bring general insurance intermediaries under their remit. It is then important to consider whether bringing intermediaries under the FOS has increased consumer protection.

It is likely that this impact has not been large: first, many intermediaries would have had existing complaints procedures; second, for GISC members, one of the conditions of GISC membership was that they had to belong to an approved dispute resolution facility (although they may not always have had to abide by its decision).

There is only limited information available about complaints before and after ICOB and here we focus on those complaints which have not been resolved between the consumer and the intermediary and where the supervisory body has been brought in.<sup>38</sup> According to GISC, there were approximately 540 conciliated complaints in 2003 and estimated to be 440 complaints in 2004.<sup>39</sup> Given that complaints against the insurer could have been dealt with by the FOS before ICOB, we assume that all of these complaints relate to intermediaries. It was estimated that GISC regulated around one-third of general insurance intermediaries and hence scaling up the complaints would suggest that there may have been around 1,300 complaints from the whole market in 2004 and 1,600 in 2003.<sup>40</sup> If, in fact, complaints were more likely to be resolved by the company in the GISC regulated part of the market, then this would be an underestimate of the number of complaints that would be expected to have required resolution by a different body.

In the period to the end of October 2004, the FOS had received approximately 700 complaints on GI intermediaries since they took over regulation. Scaling this would suggest complaints of around 850 for the whole year. It is noted that this was thought to be at the low end of the FOS's expectations of complaints for the year.

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<sup>38</sup> Hence we do not examine complaints at the firm level and whether or not these have changed.

<sup>39</sup> GISC performance against objectives 2004, GISC, 2004.

<sup>40</sup> Regulatory impact assessment on mortgages and general insurance regulation: transitioning complaints, HM Treasury.



Comparing these numbers suggests that there has been a fall of between some 450 and 750 complaints since the introduction of ICOB.

It is difficult to measure consumer benefits through looking at the number of complaints. For example, if complaints go up this might reflect more consumers getting recourse and deriving satisfactory outcomes from an efficient complaints system. Alternatively, this might reflect lower quality products and sales such that consumers have more to complain about.

However, in this case, complaints have fallen. Since it is now easier to complain than in the past, it can not be the case that complaints have fallen because it is harder to complain. Therefore there has been an unambiguous reduction in the cost of having to have the complaint resolved. The question is, what value do we put on these consumer benefits?

If we assume that consumers who go through the complaints are recompensed for any problems that have occurred, then from a consumer welfare perspective, there is no consumer detriment. However, the reduction in the deadweight cost of going through the complaints process is a pure consumer benefit.

The FOS charges a case fee of £360 for each complaint that comes to them. We can therefore use this as the estimate for the cost of dealing with each case in order to quantify the benefit from the reduced number of cases.

**Table 8: Benefit from reduced complaint resolution**

Benefit from reduced complaints	
Benefit per case [a]	£360
Decline in number of cases [b]	450-750
Total cost = [a]*[b]	£162,000-266,000

Source: CRA International based on survey by Continental Research

Therefore we estimate that there has been a benefit from a reduction in complaints valued at approximately £162,000 – 266,000.

It may be the case that the decline in cases has occurred because complaints are being dealt with by intermediaries in a different way than in the past. That is some of the reduction in the cost of involving the FOS may be incurred by the intermediary instead. Indeed, some have suggested that firms may be trying to actively avoid referrals to the FOS. In part this may be in order to avoid the payment of the case fee. However, more importantly, there is concern that the FSA uses FOS complaints as one of the things that feed into supervision which may cause some firms to be worried about going to the FOS. To date, there is no hard evidence that firms were seeking to avoid the case fee on small claims or that intermediaries were seeking to avoid dealing with FOS.

Alternatively, it is possible that from the firms' perspective using the FOS is cheaper than going to court or that the FOS takes on costs which could remove a burden from the company such as on the time of senior management.

From the consumer's perspective, they would be indifferent between having their complaint dealt with internally in a satisfactory way compared to having a satisfactory resolution from the use of the FOS other than for the convenience and presumed shorter time in which the complaint would be dealt with. We have not attempted to estimate the benefit of this.

### **7.3. BETTER RECORD KEEPING**

The introduction of ICOB resulted in significant changes in the way records of sales were kept within companies. This led to significant compliance costs as firms formalised the process for recording the information collected and given to consumers, as well as stipulating the length of time for which this was held. As found by NERA, past practice appeared to vary substantially between the relatively informal records kept in the PPI market and the best practice seen in the CI market where it was treated "like" a regulated product.<sup>41</sup> The question is whether this record keeping materially benefits consumers.

Based on interviews with providers, the FSA and the financial ombudsman it is questionable whether this resulted in any substantial benefits that are not captured by any reductions in mis-selling or improvements in the clarity of advice. Indeed, without records it is often the firm that is in a difficult position in terms of proving whether it acted fairly with regards to the consumer. Without improving record keeping it would be difficult for a firm to show a sale was compliant or whether they did, or did not, provide advice. Therefore any benefits are likely to apply to the provider and impact only on the split of cases that went in favour of providers compared to consumers. Record keeping is a necessary cost but does not in itself bring benefits to consumers.

### **7.4. USE OF CHANNELS THAT PROVIDE BETTER ACCESS TO COMPENSATION**

One observation that has been made is that regulation is moving people from the telephone and onto the internet. Indeed, some providers and distributors have indicated that there has been a significant increase in the use of the internet this year – some suggesting that the use of the internet for purchasing motor insurance has doubled in the last year. Looking at the results from the consumer survey, we found that 17% bought online, which compares to the majority of consumers (58%) who choose to buy over the phone. In terms of a trend towards the internet, 14% changed the channel they used compared to the previous year with the majority moving from telephone and face-to-face channels.

Although this is supportive of the argument that there is a trend to the use of the internet, it is clearly not evidence that this was caused by changes in regulation. In addition to regulation, there are other factors driving the use of the internet, including the convenience of being able to use the internet at any time and the increase in the prevalence of broadband, leading to faster internet access and greater use of the internet generally. Hence any changes in the use of the internet are unlikely to only be due to regulation.

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41

There is clearly an issue here of how to attribute costs. The introduction of MCOB and ICOB clearly resulted in firms investing in improved systems for monitoring the sales process and keeping records after the sale. It is very difficult to determine whether these would have occurred for ICOB in isolation.

Indeed looking at the main reason for changing channel, the majority did this either to save time through convenience or to save money, with only 20% citing that it was to avoid a lengthy sales conversation.<sup>42</sup> Therefore, based on these observations, we could estimate that the proportion of motor consumers switching channel due to regulation was at most 3% (the 14% who change channel multiplied by 20% who did this to avoid the lengthy sales process). The question then is whether this leads to a change in consumer welfare.

Firstly, the concern expressed by some is that consumers will potentially get less information when buying online. This is because various pieces of information have to be disclosed over the telephone whereas when using the internet, it is fairly frequent for customers to have to “tick a box” to say that they have read certain pieces of information and customers are believed to be “ticking the box” irrespective of whether they have actually read the information.

Those who operate websites for motor insurance have informed us that the time that customers spend examining this information is, in fact, negligible, indicating that customers do not value this information.

In order to investigate this further, we collected data on whether people read the regulatory information provided on the internet when given the option to tick a box. This shows that the vast majority of consumers claim to read the regulatory information, with 36% usually reading it and 36% sometimes reading it. However, a significant minority, 27%, never read this information.

It is difficult to assess whether consumers failing to always read regulatory information has any material effect. For example:

- If consumers mistakenly click over warnings without paying due attention, this could lower consumer awareness of the product risks; and
- Alternatively, standardisation of warnings could mean that consumers would learn little from going through this on multiple occasions and consumers are rationally able to skip over this on subsequent purchases.

To attempt to take this into account, we could assume that those who do not read the regulatory terms are more likely to buy a product that is inappropriate for them. That is, of the 3% of consumers who switched to the internet due to the ICOB rules, 27% of these do so without reading the regulatory information. On the basis of our survey, this would result in only 1% of consumers who were missing out on the regulatory information available. We therefore do not believe this would result in a quantifiable impact on consumer welfare.

Secondly, the channel choice may impact on the consumer protection the consumer receives. In buying through an adviser, consumers are able get compensation for the sales process if the adviser is found to have mis-sold the product. If a product is purchased execution only, the consumer is no longer protected by the advice they have received. When purchasing online, consumers are highly unlikely to be receiving advice

42

Interestingly the average length of the sales process for using the internet was estimated at 7.4 minutes, only slightly shorter than the average sales process for a telephone sale at 8.1 minutes.

(since to-date relatively little regulated advice has been offered over the internet) and thus consumers may be missing out on the additional protection that they receive from an advised sale.

Looking at the data on this, however, suggests that consumers may be more aware of this issue than they are given credit for. In terms of whether consumers understood they were taking on more responsibility to check whether a policy met their needs if they bought online, only 24% did not believe it increased their responsibility.

Therefore, there is reasonably strong ground for assuming that the trend to using the internet seen over the last year has been driven primarily due to convenience and shopping around, with consumers largely aware that buying a product execution only requires them to take more responsibility for the suitability of the product. Thus there are no material impacts that require quantification from this effect.

## 8. SUMMARY OF MARKET IMPACTS

In the four previous chapters we have set out the evidence regarding the significant market impacts arising from ICOB. In this chapter we bring these benefits together and consider the implications of this.

### 8.1. AN AGGREGATE QUANTIFICATION OF MARKET IMPACTS

Table 9 below summarises the overall impact that has been found. Overall, the market impacts from general insurance regulation have been quantified as imposing a cost of £27 million.

**Table 9: Summary of quantifiable market impacts**

	<b>Costs</b>	<b>Benefits</b>
Statutory regulation for PPI		£13.8 million
Statutory regulation for CI		£0.4 million
Statutory regulation for Motor		£8.9 million
Additional information on separation of prices in PPI and CI		Unquantifiable as no baseline
Reduced searching for PPI due to increased length of sales process	Unquantifiable as no baseline on shopping around pre ICOB	
Reduced searching for CI due to increased length of sales process	Zero as limited impact on length of sales process	
Reduced searching for Motor due to increased length of sales process	£229 million	
Improved suitability for PPI		£129 million
Improved suitability for CI		£1.2 million
Increased ability to cancel due to cooling off period		Zero as no change in cancellation
Increased searching for Motor due to cooling off period		£49 million
Reduced complaint resolution		£0.3 million
Change in channel in motor	Zero as negligible number of consumers adversely affected	
<b>Totals</b>	<b>£229 million</b>	<b>£202 million</b>
<b>Total overall net impact</b>	<b>£27 million</b>	

Source: CRA International

Overall, there has been a negative market impact from ICOB. However, when the individual markets are considered, a different picture emerges as can be seen from Table 10.

**Table 10: Summary of market impacts by product<sup>43</sup>**

	Cost	Benefit
PPI		£142 million
CI		£2 million
Motor	£171 million	

Source: CRA International

It is clear from this that, of the three products examined in this report, the greatest benefit from regulation has come to PPI with CI having a small benefit from the market impacts (although this reflects the relatively small size of the CI market). By contrast, motor insurance has been detrimentally impacted by the regulation. This provides strong support for a more targeted approach to regulation. In particular, the danger of applying industry wide regulation is that it imposes costs on markets that are working well in addition to imposing costs in areas where regulation can bring consumer benefits.

However, before undertaking a more targeted regime (differentiating between products where the market already works well and where it appears to work less well), it is necessary to assess whether this would impose a substantial increase in compliance costs.

## 8.2. SCALING TO THE WHOLE GI MARKET

This report has been based on examining the impact of general insurance regulation on three different types of products, namely: motor insurance; critical illness cover; and payment protection insurance. However, these products will also give an indication of the likely impact of general insurance regulation on other general insurance products. Below, we use the results obtained for these three markets to estimate the impact on the significant products areas affected by ICOB.

In order to do this we need to determine whether the other product areas are similar to PPI, critical illness and motor. In discussion with the ABI and others in the industry, this categorisation was primarily based on the characteristics of the products. For example, products that are actively bought on a frequent basis (home, travel and pet) were believed to be similar to motor insurance. Products that are typically long-term products in which disclosing personal characteristics is important and financial advisers are often involved (income protection, private medical insurance) were believed to be similar to critical illness cover. Finally, products that are typically sold alongside other products (extended warranties and mortgage payment protection insurance) were categorised as similar to PPI. Although this does not cover every general insurance product, the largest product

types have been covered and hence this will provide a good estimate of the impact on the market as a whole.

**Table 11: Similarity of products**

	Gross premiums	Number of policies
<b>Similar to motor insurance</b>		
Home insurance	£5.84 billion	16.7 million
Travel insurance	£412 million	8.24 million
Pet insurance	£265 million	2.65 million
<b>Similar to critical illness</b>		
Income protection	£61 million	130,000
Private medical insurance	£1.47 billion	1.78 million
<b>Similar to payment protection insurance</b>		
Extended warranties	£417 million	8.6 million
Mortgage payment protection insurance	£526 million	2.6 million

Source: ABI unless specified. Number of home insurance policies is based on an average premium of £350 for a combined building and contents policy. Number of travel insurance policies based on average premium of £50. Value of Pet insurance market based on Pet insurance 2005 – Mintel. Number of pet insurance policies assumes £100 per year premium for pet insurance. Number of policies for extended warranties based on Competition Commission press release on extended warranties, 18<sup>th</sup> December 2003 scaled according to ABI gross premiums for insured sales.

Based on these values, we can scale the calculation of market impacts of the three products examined in order to estimate the impact on these product areas. The scaling is done using either the value of premiums and the number of policies depending on which of these was used for the calculation of the impact in the original analysis. In addition, since the benefit from reduced complaint resolution was already based on the impact on the whole of the market, this aspect is not scaled up. We find that the overall impact is as described in Table 12 below.

**Table 12: Summary of market impacts by product**

	Cost	Benefit
PPI and similar products		£177 million
CI and similar products		£62 million

43

The estimation for benefits from reduced complaint resolution are only available for the whole market. This has been allocated to each of the three products on the basis of gross premiums. Given that the benefit from this source is small compared to the other figures, this has very limited effect on the results.

Motor and similar products	£362 million
<b>Total</b>	<b>£122 million</b>

Source: CRA International

Therefore we calculate the overall market impacts from general insurance regulation as being a cost of around £122 million. This figure can be compared to the compliance costs that were estimated at the time of £197 million of one-off costs and £166 million of ongoing costs.<sup>44</sup>

We note that since this assessment has been conducted within a year of the implementation of regulation, some of the benefits may be still to arise. In particular, if we include the potential additional improvements in suitability for PPI, CI and similar products, these would more than double the benefits arising from suitability and make the overall net market impact positive.

### 8.3. FSA DISCRETIONARY REGULATION

The majority of the rules brought in by ICOB implemented European directives. However, some of the regulations in ICOB added additional requirements beyond the directives. The main areas where this was the case are as follows:

- Where the IMD applied only to intermediaries, the FSA applied ICOB rules to all insurers (as directed by HM Treasury) and therefore included direct business covering:
  - status disclosure through the initial disclosure document; and
  - the provision of the demands and needs statement including for non-advised sales.
- Extending the DMD requirements such that cancellation rights applied to face-to-face sales as well as distance contracts; and
- Record-making and keeping requirements.

Of these issues, there are two areas where we have quantified market impacts in the rest of the analysis, and where the additional FSA requirements can be examined. Both of which relate to motor insurance:

- Cost of reduced searching due to the increased length of sales process on direct sales due to the increased disclosures required; and
- Benefit of increased searching due to the cooling off period for face-to-face sales.

Of the increased length of the sales process, however, part of this will be due to the status disclosure requirements of the IMD (which the FSA extended for direct sales) and

44

"Estimated Compliance Costs of Conduct of Business Regulation for General Insurance, A report for the FSA", NERA, 27<sup>th</sup> June 2003.



part will be due to DMD requirements (which would be necessary for all but face-to-face sales). Hence it would not be the case that we can assume that the full increase in the length of the sales process for direct sales is due to FSA requirements since some of the increase would have occurred because of DMD requirements. In the absence of information regarding the individual changes in the length of the sales process, we have assumed that 50% of the change is due to the IMD and 50% due to the DMD.

According to ABI statistics, 40% of motor insurance sales are direct sales.<sup>45</sup> According to our survey, 7% of motor insurance is bought face-to-face. We can therefore use these figures to estimate the impact of the additional issues that were required beyond the IMD and DMD.

**Table 13: Impact of FSA extensions to regulation in the three product markets**

	Total impact	FSA	IMD/ DMD
Cost of reduced search due to increased length of sales process for motor insurance	£229 million [a]	£46 million [b]=50%*40%*[a]	£183 million = [a]-[b]
Benefit of increased search due to cooling off period for motor insurance	£49 million [c]	£3 million =7%*[c]	£46 million =93%*[c]
Other benefits to motor (from Table 10)	£9 million	-	£9 million
Overall cost	£171 million	£42 million	£129 million

Source: CRA International

The overall impact of general insurance regulation was to impose a cost of £171 million in the motor insurance market. Of this, we estimate that £129 million was due to IMD and DMD whereas £42 million was due to the additional requirements imposed by the FSA.

In addition to calculating the effect for motor insurance, this can also be scaled up to the overall market by examining those other products that are similar to motor insurance. In the home insurance market, only 26% of sales are direct sales and since we are not aware of figures on the proportion of sales that are direct for other products such as travel insurance and pet insurance, we use this 26% figure rather than the 40% figure found for motor insurance.<sup>46</sup> For the proportion of sales that are made face-to-face, we use the 7% figure from our survey.

In Table 12 above, it was estimated that the overall impact of general insurance regulation on those products that were similar to motor insurance was a cost of £362 million. Of this, we estimate that £290 million was due to IMD and DMD whereas £72 million was due to the additional requirements imposed by the FSA.

<sup>45</sup> ABI general market statistics for 2003.

<sup>46</sup> ABI general market statistics for 2003.

## 9. IMPLICATIONS FOR MEASURING MARKET IMPACTS

The previous chapters have focused on the market impacts of ICOB regulation. It is now useful to generalise from this to look at what we have learnt regarding the measurement of market impacts in ex ante and ex post CBAs, such that these principles can be applied when designing and assessing regulation in the future. We can group our findings in terms of:

- The difficulty of estimating market impacts ex ante and ex post;
- Identification of the problem is vital;
- The value of looking at “economic” markets when assessing market impacts; and
- Useful tools for measuring market impacts.

### 9.1. THE DIFFICULTY OF ESTIMATING MARKET IMPACTS

Although benefits have rarely been estimated when assessing the likely impact of regulation, even small changes in consumer benefits can dwarf compliance costs under most regulatory rules.

Measuring benefits often involves the same type of assumptions and methodological issues as measuring the impact of costs driven by market impacts. Measuring market impacts does, however, often require more imagination and the reliance on reasonable assumptions than measuring compliance costs, where estimates from firms are typically straightforward to discern.

In our view, benefits should, where possible, be estimated. However, it is reasonable to assume that they are estimated with significantly larger error margins than direct costs and compliance costs.

In addition to enabling a quantification of the likely benefits of regulation, the advantage of estimating the benefits from regulatory changes is that a valuable baseline will exist when the FSA comes to conduct an ex post review. For example, it was not possible to estimate the impact of shopping around for PPI products since there was no baseline provided before general insurance was regulated. Conversely, the impact of regulation on searching in the motor insurance market could only be measured because consumers were able to compare their behaviour this year to their behaviour before regulation came in.

### 9.2. IDENTIFICATION OF THE PROBLEM IS VITAL

It is also clear from this analysis that the benefits from regulation depend on the size of the problem before regulation. Hence it is important to understand the characteristics of markets before regulation is imposed on them. To take one extreme example, if competition is working perfectly in one market, then imposing regulation on the market would almost certainly lead to inefficiencies being imposed on a market and consumers losing out. Conversely, if market structure and behaviour (from firms or consumers) is such that consumer detriment in the current market is very significant, it may be the case

that imposing even very costly regulation can bring quite substantial overall benefits. Nonetheless, it will be the case that if a market approach on the basis of competition can bring about the desired outcome, then this is to be preferred to a regulatory approach which always brings the risks of inefficiency.<sup>47</sup>

Furthermore, if the size of the problem is not assessed before regulation, it is impossible to test the impact of regulation afterwards since there is no base line for comparison. Hence, in addition to helping to assess whether or not regulation should be imposed, estimating the size of the problem also helps to assess whether or not the regulation has been successful. This therefore supports the established practice of the FSA of undertaking a market failure analysis before imposing regulation, but suggests greater quantitative evidence should be used.

### 9.3. THE IMPORTANCE OF LOOKING AT 'ECONOMIC' MARKET WHEN ASSESSING MARKET IMPACTS

A further finding of our report is that, although the FSA is not an "economic" regulator, examining the impact of regulation at the level of an economic market and taking into account the nature of the market rather than at the level of the general insurance industry, adds a degree of rigour that is useful.

It is clearly important to structure the analysis around economic markets rather than an industry. Indeed, this is a well established approach in other areas. For example, all competition investigations will start by identifying the "relevant market" - broadly that market in which products compete with each other.

This approach was implicitly seen in the FSA's thinking when designing the ICOB rules. For example, the FSA consulted on whether it was necessary to categorise some products as "high-risk" products and require additional regulation for those selling these products.

Nonetheless, the impact of the ICOB rules was entirely considered at the industry rather than market level. The consequence of this was that there was no identification of whether there were particular products where consumer detriment was in fact occurring and the characteristics of the market meant that regulation was required; or whether there were other products where competition was thriving and there was a risk that imposing regulation could stifle this.

From the demand side, it seems reasonable to assume that other products do not substitute for motor insurance, especially given that having motor insurance is a legal requirement.<sup>48</sup> For payment protection insurance and critical illness cover, it is less clear whether they would represent individual economic markets or whether other forms of insurance represent reasonable substitutes to them.

This general approach is important for a number of reasons:

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<sup>47</sup> Indeed, this is recognised by the FSA. See for example, Competition and Regulation: A seamless web? A speech by Callum McCarthy, Chairman of the FSA, at the Competition Commission on 10<sup>th</sup> November 2005.

<sup>48</sup> Although we recognise that there are different levels of cover within motor insurance, we have not examined whether this would lead to economic markets being narrower than motor insurance, but rather have taken motor insurance as a whole.

- It helps to identify where the market will react to a change in regulation in an unexpected fashion, i.e. where unintended consequences may result. For example, if distributing a product face-to-face is in the same economic market as distributing it over the phone, then a reduction in the number of intermediaries distributing through one of these channels may not have an undesirable impact on competition if there are still sufficient options through the other channel;
- It helps to recognise whether industry concern regarding a level playing field is actually an issue that is likely to have economic consequences; and
- It established whether regulation at an industry level may have differential impacts on products.

By looking at the market impacts at the level of the economic market, it is possible to identify those characteristics of the market that are likely to be improved by regulation. This approach should have significant implications for how the regulation is introduced and whether the balance of regulation is appropriate. For example, the question of whether ICOB should have taken into account different risk products can only really be answered by analysis of this kind.

#### 9.4. TOOLS THAT WILL BE USEFUL ACROSS CBAs

Although every CBA will have its own challenges, the diversity of the ICOB rules means that we have looked at a wide variety of different market impacts driven by the statutory nature of regulation, information disclosure, status and product disclosure, training and competence, complaints and cooling off. In doing this we have:

- Used the difference between stated preference data from consumers with different understanding of the market place to estimate the willingness of consumers to pay for statutory regulation;
- Used stated preference data to look at the relationship between the length of the sales process and the amount of shopping around;
- Used measures of price dispersion to measure the benefits resulting from shopping around;
- Used the cost of the complaints process to estimate the deadweight gain from raising product quality to lower the level of complaints;
- Used behavioural data on the impact of changing consumer behaviour in response to cooling off to measure the impact on mis-selling and shopping around; and
- Used the price of the product as the value consumers place on the product when accounting for mis-selling.

Each of these approaches is likely to be of relevance when considering future CBAs.