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Agenda

Advancing economics in business

Insuring the insurers: are caravan dealers riskier than insurance brokers?

A recent consultation by the UK Financial Services Authority (now the Financial Conduct Authority) on the Financial Services Compensation Scheme asked whether levies imposed on financial services firms could be made more reflective of the risks that the different types of firm pose to consumers. Can the type of business or distribution model of such a firm indicate the likelihood that the Scheme will be required to compensate its customers?

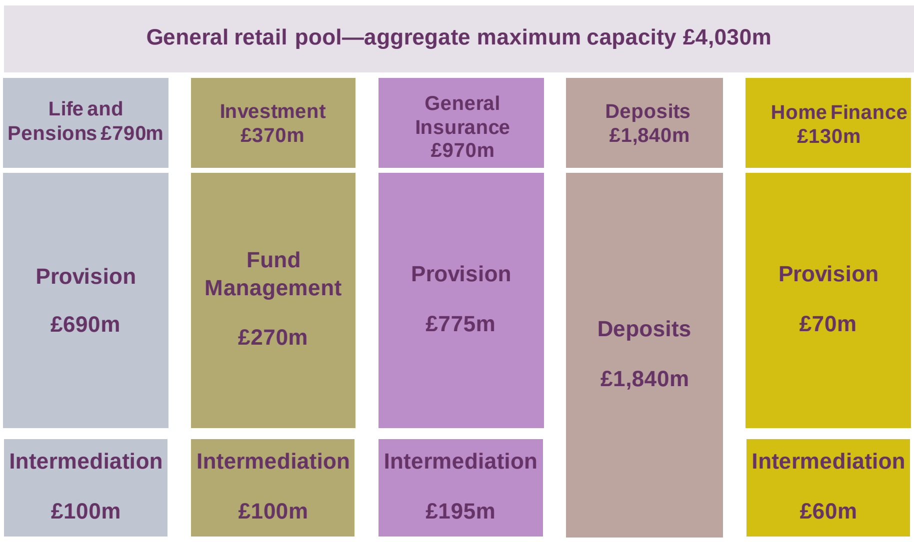
While the focus of this recent consultation[1] was on the design of the Financial Services Compensation Scheme (FSCS), the questions it raised may have wider relevance, particularly in the context of the emphasis by the newly established Financial Conduct Authority (FCA) on managing conduct risks and assessing the risks of different business and distribution models. This article explores these questions in relation to the mis-selling of payment protection insurance (PPI).[2]

The Financial Services Compensation Scheme

The FSCS is the UK's fund of last resort for customers of financial services firms. The Scheme can pay compensation to consumers if a financial services firm is unable, or likely to be unable, to pay claims against it—for example if the firm has gone bankrupt. A common cause of claims in the financial services sector is mis-selling, which arises if a financial services firm (or its salespeople) misrepresent or mislead a customer about the characteristics of a product, resulting in the customer being sold a product that is not suitable for them.[3]

The current FSCS framework splits financial services firms into five broad classes, which are then subdivided to form nine sub-classes, including a General Insurance Intermediation group (see Figure 1). Levies are collected from each sub-class, forming the 'pool' of money from which compensation is paid when

Figure 1 The FSCS funding model



Note: The 'Home Finance' class does not contribute to the general retail pool.
Source: Financial Services Authority (2012), 'FSCS Funding Model Review', Consultation Paper 12/16, July.

This article is based on work by Oxera for the British Insurance Brokers' Association (BIBA). See Oxera (2012), 'Review of the Financial Services Compensation Scheme Model', prepared for British Insurance Brokers' Association, October 26th, available at www.oxera.com.

necessary. In most years, each sub-class funds (through its levy) all of the compensation paid due to claims within that sub-class, but a maximum yearly levy has been set for each sub-class to ensure that the levies are 'affordable'. A three-tiered funding model operates during the compensation process, as follows:[4]

- level 1: in the case of a default, the sub-class in which the default occurs bears the cost of all defaults up to the point of its sub-class threshold;
- level 2: the other sub-class in the same broad class as the triggering sub-class then pays for any further compensation costs up to its own threshold;
- level 3: if the broad class threshold has been reached but liabilities to eligible claimants remain, the general retail pool will provide any excess funding for compensation payments.

Levels 2 and 3 provide the explicit cross-subsidy, with other classes contributing to compensation payments if a class reaches its threshold. For example, if the default of a general insurance intermediary firm generates claims exceeding £195m, the general insurance providers contribute up to an additional £775m (see Figure 1). If the claims exceed £970m (ie, the sum of £195m and £775m), level 3 of the funding model is triggered and the customers are paid out of the 'general retail pool'.

The sub-classes within any broad class are designed to have a higher level of mutual financial interest than the financial interest between broad classes. For example, general insurance intermediaries and general insurance providers are sub-classes within the broad class of general insurance. If the insurance intermediaries sell more insurance policies, it is likely that the insurance providers (who develop and underwrite these policies) would benefit.

The recent increase in FSCS claims

Started in 2005, General Insurance Intermediation is the largest sub-class within the FSCS model (in terms of number of participants), comprising 13,528 firms across a wide variety of sectors, including insurance brokers, doctors, dentists, caravan park operators, motor dealers and credit brokers. The total levy received has grown from less than £1m in 2008/09 to £8m in 2009/10 and to £57m in 2010/11.[5]

The rapid increase in levies has been driven by the increase in claims from this sub-class over the past few years, particularly in relation to PPI. Certain firms mis-sold PPI and then defaulted, so the FSCS has had to cover the cost of these PPI compensation claims.

The total number of all claims increased by 220% between 2009/10 and 2010/11, of which PPI claims formed more than 95%.[6]

A large portion of the PPI claims in 2009/10 came from one company, Picture Financial Services plc, which specialised in mortgages, while Welcome Financial Services Limited, a credit broker, was responsible for a large portion of the claims in 2011/12.[7] The levies and compensation payments have increased in line with the amount of compensation paid out, meaning that all firms in the General Insurance Intermediation class (including those that do not sell PPI) have been subject to a higher levy. The levies have remained below the threshold, however, so other financial services firms have not contributed to the claims cost.

Approximately 80% of the companies triggering PPI-related FSCS claims have been brokers that sell insurance in addition to another (non-insurance) product, such as credit brokers, motor dealers and mortgage brokers.[8]

A new sub-class for pure insurance brokers?

While the FSCS does not attempt to achieve risk-based levies, the Scheme's funding principles recognise that an industry-funded scheme should have sub-classes of firms that share affinity with one another (eg, mutual financial interest is an important element of this, as are structural similarities). Moreover, funding of the FSCS should be fair and proportionate.[9]

The rapid increase in FSCS levies due to PPI-related claims arising from a specific subset of firms suggests that there may be a case for re-classifying firms so that the FSCS sub-classes share greater affinity. BIBA asked Oxera to assess specifically whether it would be possible to separate the general insurance intermediaries for which selling insurance is a secondary (or, in some cases, tertiary) activity (such as credit brokers, motor dealers and banks) from those intermediaries that are focused primarily on the sale of insurance (referred to as 'pure insurance brokers').[10] This distinction arises because the firms that mis-sold PPI did so mainly on the back of another financial product—usually loans, mortgages, or some other form of credit. The interaction between these firms and their customers centred around the credit product, with the PPI sold as a secondary product. In contrast, pure insurance brokers, which typically did not sell PPI, interact with their customers primarily on the basis of selling insurance products.

Do structural differences exist between pure insurance brokers and 'non-pure insurance intermediaries'?

Demand side: the customer experience

In the FSA and Competition Commission investigations, the mis-selling of PPI was linked to the fact that it was typically sold as a secondary product at the point of sale of the primary product, which resulted in limitations in consumers' ability to judge whether the product was suitable or the price reasonable.

Secondary products are quite common. Examples include travel insurance (possibly purchased from a travel agency when booking a flight); certain accessories (eg, a tie to match a suit or shirt purchased in the same clothes shop); and satellite navigation systems (chosen as a feature when buying a new car).[11] Pure insurance brokers also sell some add-on insurance products. At first sight, there may not appear to be a difference between non-pure and pure insurance brokers, but a closer examination of the reasons for the serious consumer protection issues with PPI reveals important differences from the consumer's perspective. These include:

- the consumer's focus on insurance products;
- the 'loss aversion' factor;
- the extent to which prices can be compared.

When a customer makes a purchase with a pure insurance broker, their mind is framed in terms of assessing the need for insurance. They need to think about the risks they are exposed to, how much coverage they need, what excess they can afford, and so on. This means that they are well placed to consider the need for any *additional* insurance products that they may be offered. The add-on may simply be a policy enhancement, such as legal expenses cover in conjunction with motor insurance. In other cases, add-on insurance products may also be sold as separate products in their own right, such as home or lost key insurance.[12]

In contrast, a customer of a credit broker is most likely to be focused on obtaining a loan, just as the main focus of a customer of a caravan dealer is likely to be obtaining a caravan. Once the customer has decided on the loan they want to take out, the credit broker may offer an insurance policy (such as PPI or identity theft insurance). With the credit broker, therefore, the customer has to change their focus from loans to insurance products. This difference is relevant to the FSCS because, in the case of PPI, the lack of focus on the secondary product has been shown to be a key determinant of the risk of mis-selling, which in turn is a key determinant of FSCS claims.

Behavioural economics[13] and experiments have indicated that, once committed to the purchase of a primary product, people may not fully process add-on information about the price and suitability of a secondary product if that product is perceived to provide 'protection' for the first product they have agreed to buy, a behavioural trait known as 'loss aversion'. For example, PPI protects the ability to service the loan that the consumer will have just agreed with the credit broker (and the case for this perceived protection would be further strengthened if there were a suggestion that PPI was required in order for the loan to be offered in the first place). Another example is extended-warranty agreements, which have also been subject to a Competition Commission investigation.[14]

Products sold by pure insurance brokers, on the other hand, can be expected to create less risk of loss aversion, as they would not typically be perceived by the customer to provide protection for the primary product. Consequently, this would suggest that the reasons for poor decision-making on the purchase of PPI as a secondary product would not apply (at least not to the same extent) for pure insurance brokers.

Also relevant are the Competition Commission's findings on the focus of consumers on the price of credit rather than on the price of PPI (or the total price).[15] In contrast, a customer of a pure insurance broker is focused on insurance as a product and is in a better position to compare the prices of the package of insurance being sold, including add-on products. The price of additional products sold by pure insurance brokers, such as legal expenses cover, can be added to the premiums for the primary product, allowing for easy price comparison. This is in contrast to the findings of the Competition Commission investigation into PPI, where most consumers struggled to compare the cost with the cost of the credit because the comparison was made with a figure that included the repayment of the capital of the loan in addition to the interest payments.

More generally, consumers' preferences are reference-dependent (dependent on the circumstances of the sale) and can be exploited during the decision-making process. For example:

- consumers may be more prepared to pay for an add-on secondary product at the point of sale of a primary product, as they already regard themselves as owning the primary product, and are then prepared to pay to avoid 'losing' it;

- consumers may not actually take account of, or be able to calculate, the full combined cost of the two products at the checkout stage. For example, the price of a loan is expressed in terms of an interest rate, whereas the price of PPI is expressed in terms of a premium for a certain amount of coverage. It is then far from straightforward to work out the total price;

- for similar reasons, consumers may be more prepared to incur add-on fees (eg, ‘drip pricing’ of credit card surcharges on non-financial services products such as holidays, and add-on fees in mortgages) later in the decision-making process than when the add-on fees are either clearly set out up front or included in the product price to begin with.[16]

In summary, secondary purchases of insurance from other insurance intermediaries that focus on selling a different primary product (such as credit) can lead to reduced quality of consumer decision-making relative to pure insurance brokers. This is for three main reasons:

- the customer is likely to be focused on the primary product, which means that for other insurance intermediaries the customer is not likely to be focused on insurance, and hence is at risk of not fully processing add-on information about the secondary product;

- the customer may suffer from loss aversion in the case of buying insurance as a secondary product related to a different (non-insurance) primary product, as they feel they have achieved a deal on the primary product and do not wish to lose that because of the secondary product;

- customers’ ability to compare price levels can be hindered in the case of buying insurance from non-pure insurance brokers, as shown by the evidence on PPI.

The PPI mis-selling experience supports the expectation that the sale of insurance as a secondary product attached to some unrelated product is more likely to result in mis-selling than when insurance is sold by itself. This suggests that there is likely to be less mis-selling of insurance policies in the case of pure insurance brokers than in the case of other insurance intermediaries that are focused on selling other products (such as the caravan dealers in the example above). This points to there being a structural difference that suggests that pure insurance brokers are likely to have a different (lower) level of FSCS claims in the future than other insurance intermediaries.

Supply side: firm behaviour

It may also be the case that structural differences between brokers reflecting different customer experiences are bolstered by differences in the way that firms behave. Possible supply-side structural differences may include the following:

- pure insurance brokers may have different incentives, as they are focused primarily on insurance products, unlike secondary brokers, which sell insurance as an add-on product. This could potentially affect the risk of mis-selling—for example, a motor dealer or a credit broker may focus on their reputation for selling cars or credit, and be less concerned about the quality of their insurance products because this is not their core business;

- pure insurance brokers may maintain longer-term relationships with their clients than other insurance intermediaries, with regard to the provision of insurance contracts, also potentially reducing the risk of mis-selling owing to the desire of the broker to maintain the relationship for future sales. This could arise due to many insurance products being repeat purchases that are due for renewal every year, whereas credit and motor transactions, for example, are less likely to be repeated over short time horizons.

Not all pure insurance brokers maintain long-term client relationships, and not all will be more knowledgeable about their products than other insurance intermediaries. However, both the demand- and supply-side arguments reinforce the point that different consumer experiences and different company focus suggest a lack of affinity, whether in terms of sharing mutual financial interests or sharing similar structures.

Are there any general lessons?

It is useful for regulators, insurance providers and intermediaries to understand the pros and cons of different types of business and distribution models, not only from the perspective of profitability but also in terms of managing conduct risk. Which models are likely to minimise conduct risk and therefore be more sustainable in the longer term?

To monitor conduct risk, regulators must know the companies they regulate, just as firms must know their customers. It is relevant to know whether an intermediary that sells insurance specialises in insurance or whether it is actually primarily a credit broker or a caravan dealer. Although the FCA does enquire about primary activities at the point of authorisation, it does not currently monitor this over time by, for example, collecting data on the value of financial and non-financial products sold. Arguably, the FCA could benefit from collecting information about a firm’s product sales activities in order to gain a better understanding of the focus of the firm.

[1] Financial Services Authority (2013), 'FSCS Funding Model Review – Feedback on CP12/16 and Further Consultation', CP13/1, March; Financial Services Authority (2012), 'FSCS Funding Model Review', CP12/16, July. The Financial Services Authority (FSA) became the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) on April 1st 2013.
[2] This type of insurance covers buyers if they are unable to pay back their loan or pay their debt repayments because of problems such as redundancy or illness. In the event of a claim, the insurance underwriter is liable to pay out.
[3] The FSA's advice on the concept of mis-selling can be found in Financial Services Authority (2003), 'FSA Advises Industry on Definition of "Mis-selling"', FSA/PN/052/2003, April 17th.
[4] Financial Services Authority (2007), 'Financial Services Compensation Scheme – Funding Review: Including Feedback on DP06/1', Consultation Paper 07/5, March, p. 22. The Level 4 mentioned in this Consultation Paper was subsequently dropped and hence no longer operates. See Financial Services Authority (2007), 'Financial Services Authority FSCS Funding Review: Feedback on CP07/5 and Made Text', Policy Statement 07/19, November, p. 32.
[5] FSCS Annual Reports 2010/11, 2009/10 and 2008/09. The 2008/09 figures are net of any credit notes that were issued.
[6] FSCS Annual Reports 2009/10 and 2010/11; and 'FSCS Levies Raised', available at: http://www.fscs.org.uk/uploaded_files/Industry/fscs-levies-raised-2012-07.pdf.
[7] FSCS Annual Reports 2009/10, 2010/11 and 2011/12; and 'FSCS Levies Raised', available at: http://www.fscs.org.uk/uploaded_files/Industry/fscs-levies-raised-2012-07.pdf.
[8] This proportion is calculated using data received from the British Insurance Brokers' Association. Of a total of 73 firms that were considered to have defaulted as a result of PPI, 58 (80% of the total) were conducting lines of business in addition to insurance broking, while the remaining 15 were brokers selling insurance as their primary product.
[9] See Financial Services Authority (2006), 'FSCS funding review', Discussion Paper 06/1, March, p. 33.
[10] See Oxera (2012), 'Review of the Financial Services Compensation Scheme Model', prepared for British Insurance Brokers' Association, October 26th, available at www.oxera.com.
[11] See also Oxera (2009), 'Secondary Products: the Case of Payment Protection Insurance', *Agenda*, June.
[12] There are limits to the amount of information that consumers are likely to be able to interpret usefully in a sales situation. This suggests that being presented with an array of add-on products might impair the quality of the consumer's decision-making.
[13] Behavioural economics is the study of the effects of social, cognitive and emotional factors on the economic decisions of individuals and organisations. For further details, see Oxera (2010), 'Behavioural Economics, Competition and Remedy Design', *Agenda*, November; and Oxera (forthcoming), 'Behavioural Economics and its Impact on Competition Policy – A Practical Assessment with Illustrative Examples from Financial Services', prepared for the Netherlands Authority for Consumers and Markets.
[14] Competition Commission (2003), 'Extended Warranties on Domestic Electrical Goods: A Report on the Supply of Extended Warranties on Domestic Electrical Goods within the UK'.
[15] Competition Commission (2009), 'Market Investigation into Payment Protection Insurance', January, para 5.38.
[16] With drip pricing, consumers face a headline price up front, and as they engage in the buying process, additional charges are 'dripped through' by the seller.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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