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Adding up the add-ons: the FCA's first market investigation

The UK's Financial Conduct Authority (FCA) has published provisional findings from its first market study, focusing on add-ons in general (i.e. non-life) insurance. The study draws heavily on insights from behavioural economics and provides new empirical evidence on consumer behaviour and market outcomes for a range of insurance products. The analysis raises some questions about the benefits (or not) of add-ons, and the under- or overprovision of insurance

The FCA's first market study since it was formed in April 2013 focuses on general insurance add-ons. Analysing several specific insurance products, it tests whether add-ons have a general effect on consumer behaviour that has common characteristics across the markets studied. The FCA has provisionally concluded that 'the add-on mechanism is associated with weaker engagement with purchase decisions and therefore weaker pressure on sellers to offer good value and high quality products.'[1] More generally, the market study presents new empirical evidence on consumer behaviour, and analyses the difficulty that consumers may have in engaging with, understanding and selecting financial services products.

This article explores the evidence presented by the FCA in order to understand whether add-ons do indeed limit competition and subsequently result in poor value for money for consumers.

The FCA is the only regulator of a major financial centre that has an explicit competition objective—i.e. to 'promote effective competition in the interests of consumers' (in addition to the usual consumer protection and market integrity objectives).[2]

What is the point of add-ons?

The reason for selling certain products as add-ons is straightforward: it may be more convenient for some consumers to purchase complementary products alongside their primary product of interest. Rather than having to go to different providers, a consumer can buy a number of products at the same time and at the same location (or on the same website). Furthermore, add-ons allow sellers to create products that are more appropriate for a heterogeneous population of consumers, and allow for more consumer choice: consumers can select anything from a 'basic' product with no add-ons to one that includes various add-ons. For different consumers, different bundles of the primary product and add-ons will be preferable, and an add-on sales channel allows consumers to select only the cover they need.

From a seller's perspective, it may be profitable to sell certain products only when the distribution costs can be spread over a number of items. It may simply be much cheaper for firms to distribute products in this way—a cost saving that can then be passed on to customers.

The interest of regulators in add-on products is not new: inquiries by the UK Competition Commission (CC) (now the Competition and Markets Authority, CMA) into extended warranties[3] and, later, payment protection insurance (PPI)[4] both focused on add-on products. Remedies specifying better disclosure were found to be sufficient to avoid detriment to consumers of extended warranties;[5] however, the CC found that more interventionist remedies were required in the case of PPI (in the form of a ban on credit arrangers selling PPI at the time of arranging credit).[6] Both of these products are often sold as add-ons, but different conclusions were drawn about the extent of the remedies required to mitigate the consumer detriment in their respective markets, suggesting differences in the existence and effects of add-ons on consumers across different markets.

The FCA study considers five add-on insurance products: home emergency insurance; guaranteed asset protection (GAP) insurance; personal accident insurance; travel insurance; and gadget insurance. Add-on sales in these markets are compared with stand-alone sales of the same product, and evidence is considered from qualitative discussions, a quantitative study of insurance customers,

and an online experiment testing different aspects of purchasing insurance policies (as add-ons and stand-alone products).

What does behavioural economics tell us?

Behavioural economics can provide insights into consumer behaviour—for example, by distinguishing how a sales channel or the 'framing' of a product and price may affect consumer decisions.[7] Specifically, research into how economic choices are influenced by psychology, and empirical tests of how consumers actually behave when faced with certain choices, indicate that the presentation of a product and the way that it is sold may influence behaviour due to certain biases to which consumers are subject. In part, the sales process can influence consumer behaviour because of differences in search costs across sales channels—it is often easier for a consumer to choose an add-on than search for a stand-alone product. Behavioural economics explains why differences in consumer behaviour may be observed even once explicit search costs (e.g. the time and effort needed to select a product) are accounted for.

The FCA identifies the following theories of harm in the context of its study:[8]

- the add-on mechanism can inhibit consumers' desire to shop around;
- consumers' concerns may be increased during the sale process, resulting in higher sales than would otherwise be the case;
- consumers may frame the pricing of the add-on in the context of the price of the (often more expensive) primary product, not in the context of products comparable to the add-on.

Key to this market study is the fact that framing influences consumers' willingness to pay for add-on products. This framing is in terms of both information, where the seller can inform the consumer of the risks of not purchasing the add-on (or imply that significant risks exist), and price, where the cost of an add-on may seem insignificant and cheap compared with the cost of the primary product. Even if firms do not actively try to frame the consumer's decision to purchase add-ons, consumer behaviour may be distorted because of endowment effects that may nudge their willingness to pay for insurance to be more than it otherwise would have been. See the box below for an explanation of the terms used in this article.

Behavioural economics language

- **Framing: the placing of information in a particular context that influences how that information is understood and processed. For example, a price can be framed as being 'cheap' if it is posted as a discounted price, alongside a prominent 'recommended price' which has been crossed out.**
- **Endowment effect: a change in a consumer's preferences resulting from a change in their 'endowment', or the items that the own. In some cases, consumers may display very different preferences simply because they have acquired a product, or because they have lost possession of a product.**
- **Optimism bias: the phenomenon of individuals believing that they will not be as affected by adverse events as others will be, and/or that they will be more affected by positive events than others will be. This also refers to individuals' perceptions of themselves and their abilities: optimism bias is reflected in individuals overestimating their performance or ability relative to that of others or their own actual capability.**
- **Present bias: the phenomenon of individuals disproportionately weighting present benefits and disbenefits against future benefits and disbenefits. An individual who is presently biased will forgo a large future benefit if it has small present costs, and will risk a large future disbenefit if it has a small present benefit relative to the future costs.**
- **Loss aversion: the phenomenon of individuals valuing a loss of a certain amount as being 'worse' than a gain of the same amount. One example of a loss-averse preference is if an individual would prefer finding £10 to finding £20 and then losing £10—even though in both cases the individual has become £10 richer.**

What does the empirical evidence tell us?

For each of the five insurance products considered in this study, the FCA compared add-on products with similar stand-alone products on the basis of a number of metrics, such as claims ratios (i.e. the cost of claims pay-outs as a percentage of the total revenue collected from customers), the extent of shopping around, and consumers' understanding of products and pricing.

To assess whether there is a general effect of add-ons on consumer behaviour, or competition for a product that is sold as an add-on, a comparison is made for each product between add-on sales and stand-alone sales. An additional comparison can be made between add-on sales of a certain product, and the same metric for other markets that have been deemed to be functioning well.

One of the key metrics used is the claims ratio. The implication from the FCA's report is that a small claims ratio may be evidence of a product that is of poor value to consumers, and a high claims ratio may indicate a product that delivers a lot of value to consumers.[9] However, this may not always be the case: for example, a low claims ratio may be indicative of high fixed distribution costs for the primary product and the add-on. For the products studied, there is no consistent relationship between claims ratios on add-on products versus stand-alone products: the claims ratio for travel insurance add-ons (52%) is larger than for stand-alone products (42%); for personal accident add-ons (<9%) it is lower than for stand-alone products (15%); and home emergency insurance has a similar claims ratio regardless of sales channel (25% add-on; 28% stand-alone).[10] As such, there does not seem to be a general effect of add-on sales on claims ratios. Subsequently, any biases that consumers may have when making decisions about add-ons do not seem to be consistent in their effects on consumer outcomes.

The FCA study also compares the price charged by an insurer to the distributor for a product (the 'net price') with the retail price. The analysis indicates that add-on sales result in a lower percentage of the retail price being retained by insurers than in the case of stand-alone products.[11] This result could be interpreted as showing that the distributor retains a greater proportion of revenue with add-on sales than with stand-alone products, implying that add-ons offer proportionally lower value to consumers (similar to the analysis of claims ratios above).

However, distribution costs are typically an amount per sale rather than a percentage of the premium. This means that it is useful to look also at the difference between the net price and the retail price in absolute terms rather than just in percentages. When looking at the difference in levels between the retail insurance price and the net price, with the exception of GAP, the mark-up on stand-alone sales is much greater than on add-on sales. For example, for personal accident stand-alone products, this difference is £41, while for add-ons it is £23; for the two examples of home-emergency insurance studied the stand-alone mark-ups are £43 and £157, while for add-ons they are £42 and £39, respectively.[12] Most net rates for stand-alone products are higher than for add-ons,[13] indicating either more comprehensive coverage or greater underlying risk for stand-alone policies versus add-ons.

This means that, although the mark-up for add-ons expressed in the form of percentages can be higher than the mark-ups for stand-alone products, it can still be lower when measured in absolute terms. In sum, the analysis shows what one would expect—lower distribution costs for the add-ons than for the stand-alone products.

The FCA found that, on average, add-ons perform worse than stand-alone sales in terms of the average shop-around rate—i.e. the proportion of consumers who actively consider other options aside from the one they have purchased. However, shop-around rates are very different across add-on products, from 17% for GAP add-ons to 63% for home emergency add-ons.[14]

Furthermore, when compared with other, well-functioning markets, the shop-around rates for some of the add-on products considered in the FCA study indicate healthy competition and active consumer choice. For example, a 2013 CMA market investigation found that the rate of shopping around in the private motor insurance (PMI) (42%)[15] was sufficiently high to indicate a large degree of competition in the sale of this form of insurance to consumers.[16] As the shopping-around rates for home-emergency and personal accident add-ons (58%) are comparatively high, this can be taken as evidence of robust competition in these markets as well.[17] On the other hand, the particularly low shop-around rate for GAP add-ons indicates that consumer choice is limited in this market; while the shop-around rate for add-on travel insurance (27%) is also lower than for PMI, the claims ratio is higher for travel add-ons than for travel stand-alone products and high compared with claims ratios in other markets, which would suggest that travel insurance provides a lot of value to consumers.

Evidence from the shop-around rate indicates that the degree to which behavioural biases are influenced by an add-on sales channel differs from market to market; for home-emergency or personal accident insurance, consumer choice is not materially influenced, as the shop-around rate still suggests robust competition—while, for GAP, the add-on channel significantly restricts consumer choice.

The metrics about consumers' understanding and recollection also highlight some interesting similarities between add-on customers and stand-alone customers. Nearly as many stand-alone customers (73%) as add-on customers (75%) recalled receiving information about the product at the time of purchase. Of the customers who stated that they remembered receiving information, nearly identical proportions of add-on and stand-alone customers found the information easy to take in (83% add-on; 84% stand-alone), helpful (87% add-on and stand-alone) and comprehensive (95% add-on; 97% stand-alone).[18] On the other hand, a larger percentage of stand-alone customers than add-on customers correctly remembered the cost of their policy (31% add-on; 59% stand-alone), and a larger percentage of add-on customers were unsure of the costs of their insurance policy than stand-alone customers (38% add-on; 15% stand-alone).[19] There is therefore some evidence that the add-on channel may make the price of a product less salient in the minds of consumers, but this may be because consumers who buy an add-on focus more on the price of the bundle of the primary product and add-ons rather than the price of any individual add-ons.

Overall, the empirical evidence suggests that consumer outcomes vary across add-on products, indicating that there is no general restriction on competition that is caused by add-ons, and consequently that add-ons do not necessarily result in consumers receiving poor-value products.

Under- or overprovision?

The FCA considers the possibility that there is a 'waterbed' effect, in which potential excess profits made by distributors in respect of add-ons are competed away in the market for the associated primary product: 'even if we found that the waterbed effect was complete … we would still have concerns about the distortions and cross-subsidies arising in these markets'.[20] The logic here would be that this waterbed effect could result in overprovision of the primary product, and underprovision of the add-on product. Specifically, excess profits from the add-on product(s) would be competed away via a lower price for the primary product if the market for that primary product had a high degree of competition. This could result in an 'underpriced' primary product that is 'subsidised' by sales of the 'overpriced' add-on; in this case, consumers may over-consume the primary product due to its low price, and under-consume the secondary product due to its high price.

The order of magnitude of these distortions is unclear, however. Optimism bias may also nudge consumers towards not purchasing insurance: many consumers believe that bad events are less likely to happen to them than to others, and hence will be less keen than they might be on buying insurance. Similarly, present bias results in consumers avoiding small upfront costs and risking very significant future losses—this is especially relevant in the case of insurance sales.

Given the above biases, add-on sales may have the propensity to increase insurance provision, especially if there are 'pre-ticked' boxes that select an add-on for a consumer. On the other hand, without an add-on channel, or without 'pre-ticked' boxes, underprovision may ensue. Indeed, the FCA's proposed remedy to ban pre-ticked boxes for add-on insurance suggests that the regulator is concerned that an overprovision of insurance causes consumer detriment.

In sum, on the one hand, the FCA's proposed remedy against pre-ticked boxes indicates a concern about avoiding over-insurance; on the other hand, its arguments about any potential waterbed effect indicate an agenda of avoiding underinsurance.

This raises questions about the distribution of insurance and the intended consumer outcomes. It is questionable whether 'micro-regulating' the conduct of firms and consumers can achieve an outcome that results in exactly the right amount of insurance provision (i.e. zero underprovision and zero overprovision). This then raises an important question about what would be worse from a public policy perspective: some degree of underprovision, or some degree of overprovision. The former would result in large detriment to a few consumers—i.e. those who did not purchase a policy but underwent a relevant adverse event—and small benefits to many in the form of savings from not purchasing an insurance policy. Some degree of overprovision results in small detriments to many consumers who pay premiums, even though their risk of being affected by an adverse event is very low, and large benefits to the few consumers who have purchased insurance and are compensated when they undergo a relevant adverse event.

The importance of empirical analysis

Various products sold via add-on sales channels have been subject to market investigations, and the FCA's market study presents some new evidence on consumer behaviour for a range of add-on and stand-alone products. This evidence does not suggest that selling a product as an add-on is necessarily detrimental to consumers. This finding illustrates that, although behavioural economics can be very useful in informing our understanding of the biases to which consumers may be subject in specific circumstances, the presence and effect of these biases are often a matter of degree and do not necessarily result in poor outcomes. This underlines the importance of empirically testing our hypotheses about how consumers behave.

Oxera has advised an insurer on the FCA market study on add-ons.

[1] Financial Conduct Authority (2014), 'General insurance add-ons: Provisional findings of market study and proposed remedies', Market Study, March, p. 23.

[2] The only other financial services regulator that has a competition objective is the Malta Financial Services Authority. See Financial Conduct Authority (2014), 'Our remit', 10 April.

[3] Competition Commission (2003), 'Extended warranties on domestic electrical goods', Final report, December.

[4] Competition Commission (2009), 'Market investigation into payment protection insurance', final report, 29 January.

[5] Competition Commission (2003), 'Extended warranties on domestic electrical goods', Final report, December, Remedies, pp. 7–9.

[6] Competition Commission (2011), 'Payment Protection Insurance Market Investigation Order 2011', 24 March, pp. 2–4. For an analysis of this investigation, see Oxera (2009), 'Competition in secondary products: the case of payment protection insurance', Agenda, June.

[7] See Oxera (2012), 'Behavioural problem, behavioural solution: the case of extended warranties', Agenda, October; (2010), 'Behavioural economics, competition and remedy design', Agenda, November; and (2013), 'Behavioural economics and its impact on competition', prepared for the Netherlands Competition Authority (ACM), May.

[8] Financial Conduct Authority (2013), 'Call for evidence – general insurance add-on market study', July, p. 4.

[9] Financial Conduct Authority (2014), 'General insurance add-ons: Provisional findings of market study and proposed remedies', March, Market Study, pp. 40–1.

[10] The FCA does not calculate a GAP stand-alone claims ratio, although add-on GAP policies have a claims ratio of 10%. Financial Conduct Authority (2014), 'General insurance add-ons: Provisional findings of market study and proposed remedies', Market Study, March, p. 41.

[11] Financial Conduct Authority (2014), 'General insurance add-ons: Provisional findings of market study and proposed remedies', Market Study, March, p. 44.

[12] Financial Conduct Authority (2014), 'General insurance add-ons: Provisional findings of market study and proposed remedies', Market Study, March, p. 44.

[13] This is the case for all comparable products for which the net rate is reported. Financial Conduct Authority (2014), 'General insurance add-ons: Provisional findings of market study and proposed remedies', Market Study, March, p. 44.

[14] Harris Interactive (2014), 'Study into the Sale of Add-on General Insurance Products', Quantitative Consumer Research Report, March, p. 35.

[15] IFF Research (2013), 'Private Motor Insurance Market Inquiry', prepared for Competition Commission, para. 2.20, 12 June.

[16] See Competition Commission (2013), 'Private motor insurance investigation: Theory of harm 4: Obstacles to switching', working paper—in particular, paragraphs 2 and 14. The CMA refers to another survey which finds that 55% of respondents 'generally compare PMI policies every year at renewal'. Of these respondents, 35% (of the 55%) then went on to say they had not compared 'less than a year ago' (question A14a), which explains the difference with the 42% that actually compared 'less than a year ago'. See page 27 of the 'Consumer survey tables' published with the CMA working papers for the PMI investigation.

[17] Harris Interactive (2014), 'Study into the Sale of Add-on General Insurance Products', Quantitative Consumer Research Report, March, p. 35.

[18] Harris Interactive (2014), 'Study into the Sales of Add-on General Insurance Products', Quantitative Consumer Research Report, prepared for Financial Conduct Authority, March, p. 45.

[19] Harris Interactive (2014), 'Study into the Sales of Add-on General Insurance Products', Quantitative Consumer Research Report, prepared for Financial Conduct Authority, March, p. 49.

[20] Financial Conduct Authority (2014), 'General insurance add-ons: Provisional findings of market study and proposed remedies', Market Study, March, p. 50.

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