Financial Conduct Authority

Market Study MS14/1

General insurance add-ons: Provisional findings of market study and proposed remedies

March 2014

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Or in writing to:

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Foreword by Christopher Woolard – FCA Director of Policy, Risk and Research

This report sets out the provisional findings of our market study into general insurance add-ons. This is our first market study, which marks an important milestone for us. It is our first opportunity to show what an FCA market study looks like in practice, and what consumers, firms and others can expect from us under our new competition objective.

Competition and consumer protection go hand in hand – in markets where engaged consumers face genuine choice, rivalry between firms drives better deals for consumers. Where competition does not work well, consumer interests are less well served. So in seeking to improve the way competition works in a market, we also advance our objective to protect consumers.

Market studies consider problems through the lens of the market rather than solely through the conduct of firms. They can vary in scope and approach, but at their core they focus on understanding how markets work and whether they are delivering good consumer outcomes.

General insurance has an important role to play in the daily lives of millions of consumers, helping to protect themselves, their families and their property against risks and unexpected events.

Buying this insurance as an add-on – alongside another insurance policy or product – can be a quick and convenient way for consumers to secure the cover they need. However, the many instances of poor outcomes from products sold as add-ons in recent years suggest that these markets do not always work well for consumers.

Our consumer research included an innovative behavioural experiment simulating the add-on sales process, to help us understand how consumers react to the process and how it affects their decisions. We publish the results of this experiment alongside this report, but we will also shortly be issuing an occasional paper on the use of behavioural experiments as a regulatory tool which discusses this experiment more widely.

We also wanted to know whether consumers can genuinely access a range of options, or whether there were restrictions on choice. And we asked whether any market power held by firms translates into high prices or poor cover, and if that means consumers are getting poor value from their purchases.

We found that competition in add-on markets is not effective, and our proposed remedies are focused on tackling this problem.

The general insurance add-ons market study is the first of a programme of market studies that we have launched since we took on our competition mandate. Our approach will evolve over time, and we will continue to learn lessons, but the questions we pose in this study about consumer behaviour, market power and consumer outcomes are the kinds of questions that we will ask in our future market studies.

Contents

Abbreviations used in this document

ABI	Association of British Insurers
CC	Competition Commission
CCR	Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013
COR	Combined Operating Ratio
EEA	European Economic Area
FCA	Financial Conduct Authority
FSA	Financial Services Authority
GAP	Guaranteed Asset Protection
ICOBS	Insurance Conduct of Business Sourcebook
IPT	Insurance Premium Tax
MLEI	Motor Legal Expenses Insurance
OFT	Office of Fair Trading
PCW	Price Comparison Website
PPI	Payment Protection Insurance

TDT	The Development Team
UK	United Kingdom
US	United States

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Executive summary

We (and previously the FSA) have been growing increasingly concerned that consumers are experiencing poor outcomes when buying general insurance alongside other products (or as an 'add-on').

Our concerns arose against the backdrop of a series of actions tackling the mis-selling of products sold as add-ons, including Payment Protection Insurance (PPI), card protection, identity theft protection, personal accident, home emergency and breakdown cover products.

In July 2013 we confirmed that we would make the sale of general insurance add-ons the focus of our first market study under our competition objective. We wanted to assess whether competition in the markets for general insurance add-ons was effective and, if not, why not. We also wanted to understand the impact of this on consumers.

We investigated the impact of the add-on mechanism by looking at five products as case studies. We mainly focused on the mechanism rather than the individual products selected, but we did draw conclusions about specific products where appropriate.

This report sets out our provisional findings. We found that competition in the markets for general insurance add-ons is not effective and that this can lead to poor consumer outcomes. Consumers are significantly overpaying when they buy products as add-ons.

We believe that there is a clear case for us to intervene in respect of the supply of general insurance add-ons, and this report also outlines a number of proposed remedies.

Our approach

The five markets we studied were travel, gadget, Guaranteed Asset Protection (GAP), home emergency and personal accident insurance. We compared add-on sales with sales on a stand-alone basis for these five products.

We analysed a range of information from insurers and intermediaries, including product literature and data relating to sales, pricing, profitability and claims.

We used behavioural economics as a key tool during the study. We carried out both quantitative and qualitative consumer research, and undertook an innovative behavioural experiment in which we tested consumers' reactions to the add-on mechanism in a simulated environment.

Our concerns

When we set out to do this work, we were concerned that:

- the add-on mechanism might affect consumer behaviour and the likelihood of consumers making good purchasing decisions
- the add-on channel would provide the primary product provider with a clear point of sale advantage that could restrict competition and choice for consumers
- the consequence of restricted competition and choice would be high mark ups or lower quality products
- consumers might end up buying inappropriate or unsuitable products, or receive poor value for money or both

Our findings

Our evidence suggests that many of these concerns are borne out in practice.

Consumers face well documented difficulties in engaging with financial services.[1] These are exacerbated when insurance is sold alongside a more engaging product, such as a holiday or a car. Difficulties for consumers are made worse by the timing of the introduction of the add-on, by the lack of transparency about add-on cover and price, and the complexity of comparing packages of products with separate prices.

We found that the add-on mechanism has a clear impact on consumer behaviour and affects the way they make decisions. Add-on buyers are less likely to shop around, less effective when they do shop around, and less sensitive to price. In the consumer survey, 58% of add-on buyers said they did not consider any other policy when purchasing their insurance compared to only 22% per cent of stand-alone buyers. One in four consumers who bought insurance as an add-on were not aware they could buy the product separately elsewhere. Consumers who bought insurance as an add-on were much less likely to be able to correctly recall how much they paid for their insurance – in fact, 69% of add-on buyers could not give an accurate estimate of the price they paid.

Our research also shows that when buying add-ons, consumers are often not engaging with the purchase and are buying products without clear intent, and as a result they are more likely to end up with products they do not need or use. In our survey, 38% of add-on buyers said they had not thought about buying insurance before the day of their purchase, compared with just 15% of stand-alone buyers. This rose to 59% for those buying GAP as an add-on. When surveyed approximately three to four months after the purchase, 19% of add-on buyers – almost 1 in every 5 – were not aware that they owned the product (compared to 9% for stand-alone buyers).

But our research also shows that consumers' understanding of policies and product cover is poor for both add-on and stand-alone products. This highlights that there are challenges associated with the selling of general insurance products that do not relate to the add-on mechanism specifically.

But we are clear that weak consumer engagement increases the point of sale advantage enjoyed by firms selling add-ons, and provides an opportunity and an incentive for them to sell products that might not meet consumers' needs or to charge high mark-ups or both.

A lack of competition for add-ons can lead to consumers receiving poor value for money from many add-on products. We have used the claims ratio (the proportion of the premiums consumers pay that is paid out in claims) as our core measure of value.

1 FCA, April 2013, Applying Behavioural Economics at the Financial Conduct Authority

The claims ratios that we find for add-ons are almost all very substantially lower than for more mainstream general insurance products. In the case of add-on GAP and personal accident insurance the claims ratios are exceptionally low, indicating very poor value for money (10% and less than 9% respectively). However, poor value is not constrained to add-ons, and some stand-alone products represent poor value too.

The picture does vary across different products. For example, our evidence suggests we should be much less concerned about travel insurance (which consumers buy frequently and are broadly familiar with) than the other products in our sample (which are less familiar and often not frequently bought).

We conclude that in many cases competition is not currently delivering value for money add-on products. We estimate that consumers overpay for the add-on products in our study by around £108m to £200m per annum.

We recognise that some of this overpayment might be returned to consumers through lower primary product prices (e.g. cheaper cars). However, we think it is highly unlikely that all the surplus is returned to consumers. In any event, we are concerned by the sizeable distortion to prices suggested by these figures.

So we believe there is a clear case for us to intervene to make competition in the markets for general insurance add-ons more effective for consumers.

Our proposed remedies

This report sets out a number of proposed remedies that we believe will strengthen competition in the markets for add-ons by improving the way decisions are presented to consumers and the way add-ons are sold, and by putting pressure on firms to improve product value across both add-on and stand-alone products.

In particular, we intend to:

- Impose a deferred opt-in on add-on sales of Guaranteed Asset Protection (GAP) – we will break the point of sale advantage enjoyed by those selling add-on GAP by mandating that the sale cannot be concluded at the point of sale of the car or car finance but only at a later point, and that the consumer must be given information about alternatives if the product is offered at the point of sale at all.

- Ban pre-ticked boxes (so-called 'opt-outs') for the sale of add-ons because of the negative impact they have on consumer behaviour and consumer outcomes.

- Require firms to publish claims ratios – to shine a light on low-value products and increase pressure on firms to improve product value.

- Improve the way add-ons are offered through price comparison websites, focusing in particular on what information consumers can access about add-ons and when this is introduced.

Next steps

We invite comments on our provisional findings and proposed remedies by 8 April.

Our remedies will then be further refined and subject to cost-benefit analysis and formal consultation.

We will publish our final findings in due course and will consult on remedies before the end of the year, with our remedies on GAP insurance being introduced on an accelerated timetable.

We look forward to working closely with industry, consumer groups and other interested stakeholders as part of this process.

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What are general insurance add-ons and why are we focusing on them?

We started this work against a backdrop of concerns about markets in which consumers purchase insurance alongside other products.

We define such sales as 'add-ons', as opposed to 'stand-alone' sales where insurance is bought separately and is not dependent on the purchase of another product.

'Primary products' are the products alongside which the 'add-on' is sold. For example, home emergency insurance (add-on) may be sold alongside home insurance (primary product).

'Deferred add-ons' refer to sales of insurance that are connected to but not made on the same day as the sale of a primary product.

Characteristics of add-ons sales include:

- Add-on insurance is sold through a range of channels, including online, over the phone and face to face
- A common feature is that the add-on insurance is often introduced at a fairly late stage in the sale of the primary product
- Customers may be offered several add-ons in relation to a single primary product sale
- The timing of information provided and complexity of options makes it difficult for customers to understand or compare both the cover and price of add-on products

Supply chains for the sale of add-ons vary in length and complexity but can include some or all of the following: insurers, intermediaries, retailers and price comparison websites (PCWs).

Most add-on insurance sales are subject to FCA regulation in the same way as sales of stand-alone insurance, but there are some exemptions from regulation.

In this chapter we explain why we chose general insurance add-ons for our first market study, what we mean by add-ons and how they are sold and regulated.

Why general insurance add-ons?

In December 2012, the FSA launched a study into the sale of general insurance add-on products. This was prompted by increasing concerns that consumers were experiencing poor outcomes when buying such products.

For example, in the 2012 Retail Conduct Risk Outlook, the FSA highlighted add-on sales as an emerging risk of harm to consumers. The FSA noted that 'It is sometimes the case that there is little profit margin in the primary general insurance product, so firms supplement their income through add-on sales with a high profit margin, some of which will historically have been included in a standard policy. Firms might therefore incentivise staff to pressure sell or to automatically include the add-on without explaining the cover properly or that it is optional. When products are bundled in this way it is not easy for consumers to understand the overall cost and value of the product to them'.[2]

There is also a history of FSA actions involving the mis-selling of products sold as add-ons, including payment protection insurance (PPI), personal accident, home emergency, breakdown cover, card protection and identity theft insurance.

The thematic reviews of motor legal expenses insurance (MLEI)[3] and mobile phone insurance[4] that we published in June 2013 highlighted further examples of concerns associated with the sale of insurance products as add-ons. The Office of Fair Trading (OFT) has also carried out reviews of extended warranties[5], which are often insurance contracts, and found similar issues.

These interventions were largely driven by and focused on conduct failings and related to a range of different products. Nevertheless, the fact that the add-on mechanism was a common feature of all of the above interventions prompted us to consider whether there are common features of add-on markets that increase the likelihood of misconduct and drive poor consumer outcomes.

In addition to the past history of poor consumer outcomes in different markets for general insurance add-ons, the current investigation is prompted by the fact that markets for these products are large in aggregate, creating scope for potentially large consumer detriment.

The total net written premiums for the five products we investigated directly as part of this market study was £2.5bn in 2012, of which £500m were sold as add-ons. FCA regulatory returns from underwriters indicate, however, that the sales of all products for which the add-on mechanism is a potential distribution channel were much larger, totalling £4.8bn in 2012 on a net written premium basis. We do not have reliable data on the proportion of add-on sales in each of these markets, but if the proportion of add-on sales for the five products we investigated is on average representative of general insurance add-on markets more broadly, we estimate that annual add-on purchases by UK consumers could be around £1bn in total.

What are general insurance add-ons and how are they sold?

The term 'general insurance add-ons' encompasses a huge variety of products which are sold through a range of channels and offered by a large number of different providers.

2 FSA Retail Conduct Risk Outlook 2012: http://www.fsa.gov.uk/static/pubs/other/rcro12.pdf; page 78

3 TR13/1: Motor legal expenses insurance (MLEI): http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr13-1

4 TR12/2: Mobile phone insurance – ensuring a fair deal for consumers: http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr13-2-mobile-phone-insurance

5 OFT Market review of Domestic Electrical Goods, home page: http://www.oft.gov.uk/OFTwork/markets-work/othermarketswork/electrical-goods/ http://www.oft.gov.uk/shared_oft/marketswork/ OFT1403.pdf

A general insurance add-on is a general insurance product sold alongside – or as an 'add-on' to another product, which is considered to be the 'primary product'.

The primary product alongside which the add-on is sold can be either a financial product such as another insurance product (often home or motor insurance) or a credit card or bank account, or a retail product (such as a holiday, a car, a phone or similar).

Consumers encounter general insurance add-ons in many different ways, which reflects the fact that add-ons are sold through a range of distribution channels. For example, a consumer may be offered an add-on:

- online, either directly from a firm's website or through a price comparison website (PCW) – for example when buying another insurance policy, such as home or motor, or a non-financial good or service
- face to face, for example when buying a car, gadget or booking a holiday
- over the phone, for example when buying insurance, or arranging a boiler service or repair

Consumers may be offered a single add-on or several add-ons at one time. Our own review of add-on sales showed that consumers were frequently offered more than one add-on at a time. The Competition Commission[6] found that for private motor insurance, a consumer could be offered up to seven add-ons at once when shopping for motor insurance cover.

Add-ons can be introduced at different points in the sales process for the primary product. For example, the add-on may be offered upfront alongside the primary product, during the course of the sales process or only once the main purchase is almost complete.

Our research and analysis suggests that introducing the add-on insurance to the customer only towards the end of the process of purchasing the primary product is common.

We also found that consumers are often given little information about the add-on product's cover before they buy and that pricing is not always clear. Sometimes only the monthly cost is provided and no annual total is given, or the cost of the add-on is bundled with the price of the primary product.

Definitions used

As noted above, for the purposes of our study we defined:

- an add-on product as an insurance product that is sold to consumers as an add-on to a primary product purchase
- a stand-alone product as a separate insurance contract, independent of any other purchase of another product, policy or service

While our definitions of add-on and stand-alone produces clear results for many products, we note that there are instances when it can be difficult to categorise a product clearly as either an add-on or stand-alone sale. The definitions are discussed in more detail in Annex B.

6 Competition Commission, Private Motor Insurance Market Investigation, Provisional Findings Report 17 December 2013. http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/provisional_findings_report.pdf

Our work also highlighted a third category – the deferred add-on. These are sales where the insurance product is not sold at the same time as the primary product but is still related to it. For example, a consumer may contact, or is contacted by, their utility provider and sold an insurance product. We found this type of 'deferred add-on' to be common in the sale of home emergency products.

The sales processes commonly used by banks for card protection and identity theft protection cover could also fall under the definition of a deferred add-on, as these products were often offered when a consumer made a phone call to activate a new card.

While the qualitative consumer research found that deferred add-on sales were often more closely aligned with how consumers buy stand-alone products, consumers may still be influenced by factors relating to their main purchase, such as brand recognition, relying on existing relationships and trust in a provider and past experience of service.

Understanding the characteristics of different types of add-on sales and how consumers react to them is relevant to both our analysis of how well markets are working and our approach to remedies.

The add-ons supply chain

Broadly speaking, there are two types of firm involved in selling insurance add-ons: insurers and insurance intermediaries.

An insurer is the person legally responsible for carrying the 'risk' associated with an insurance product and for paying claims. An insurer might choose to sell insurance products directly to customers or via an intermediary or a chain of intermediaries, each of whom might take a different role in the distribution process. In this report we use the term distributer to mean either an insurer or an intermediary that sells an add-on product directly to a consumer.

Supply chains for general insurance add-ons can vary in length and complexity. Consideration of the various supply chains informed the approach and methodology of the study, and is also relevant when assessing possible remedies.

In its simplest form an insurer sells add-ons to their core products (motor and home). The insurer may outsource some activities, but will remain responsible for everything from product design, underwriting, sales and marketing, and claims handling and payment.

Add-ons to core insurance products are also sold by intermediaries. The intermediary may have a role in the design and pricing of the add-on, including placing their own brand on another firms' product. The insurer still remains responsible for underwriting the product and claims handling.

For other add-ons sold alongside a retail product, the supply chain may be more complex. For example, a wholesale intermediary might make the initial arrangements with the underwriter, such as agreeing the policy cover and the wholesale price they pay to the underwriter. It will then distribute the product through one or more suppliers. The supplier at the end of the chain with whom the consumer interacts might be an FCA-authorised intermediary, or an appointed representative of another authorised firm. For example, the supply chain for GAP might involve a finance company, which is part of the same group as the car dealership, which acts as the wholesale distributor to the dealership. The wholesale intermediary may play the lead role in designing and in pricing the product or the pricing may be done by the car dealership.

Alternatively, the intermediary firm may act as a 'managing agent', or similar. In this scenario the insurer is responsible for underwriting and paying claims, but the 'managing agent' takes responsibility for everything from administering the policies to claims handling on behalf of the insurer.

An additional step in the purchasing process for the consumer may be a PCW, where the core product is an insurance product, and we noted above that the information and price detail provided to the consumer by the PCW can vary. The business models of PCWs vary, but where PCWs are paid 'per click-through'[7] they do not receive additional payment for add-ons sold. Instead, they receive a single fee regardless of whether the consumer purchases any add-ons.

How general insurance add-ons are regulated

The vast majority of activity relating to insurance products sold as add-ons falls within the full scope of our regulatory regime in the same way as for products sold stand-alone.

Unless an exemption applies, UK based insurers and intermediaries must be authorised by the FCA.

When an FCA regulated firm sells an insurance product, whether add-on or stand-alone, it must meet our conduct rules, set out in our Insurance Conduct of Business Sourcebook (ICOBS). These rules require that, where a firm sells a product, it must give the customer information about the firm, its services and the product. Specifically, firms must provide appropriate information about the policy so that the customer can make an informed decision.[8] Firms should also take reasonable steps to ensure that a customer only buys a policy under which he is eligible to claim benefits[9] and, where they give advice, a firm must ensure that the advice is suitable.[10]

Not all activity relating to add-ons is regulated under our regime, and therefore some activity is outside the scope of this report. There is an exemption available to intermediaries who sell qualifying insurance policies connected to certain goods (the 'connected contract' exemption). So, for example, intermediaries that sell extended warranties connected to electrical goods or cover for mobile phones and gadgets often fall outside FCA regulation.

In addition, there are products sold as add-ons that some customers might perceive to be insurance but are structured so that they are not insurance contracts and therefore fall outside of our regulatory perimeter entirely. The most common examples of these are some extended warranty products.

7 A PCW is only paid a fee if the customer 'click-through' to the insurer's website and buys the insurance
8 ICOBS 6.1.5R: http://fshandbook.info/FS/html/FCA/ICOBS/6/1
9 ICOBS 5.1.1G: http://fshandbook.info/FS/html/FCA/ICOBS/5/1
10 ICOBS 5.3.1R: http://fshandbook.info/FS/html/FCA/ICOBS/5/3

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Approach and methodology

The study's objective was to assess whether competition in the supply of general insurance add-ons is effective, and if not, to understand why. We also wanted to understand whether poor consumer outcomes from add-on sales could be the result of ineffective competition.

We sought to understand the common impact of the add-on mechanism across several markets, although we also draw a number of conclusions about specific products. We selected five products – travel, gadget, personal accident, Guaranteed Asset Protection (GAP) and home emergency insurance – against a range of criteria to compare across add-on and stand-alone sales.

A key focus of the study was to understand whether poor outcomes in add-on sales could reflect particular consumer behaviour and firms' responses to them. In particular, we were concerned that the specific context of add-on sales might limit how far consumers explore alternatives or base their decisions on relevant measures of price and quality. Our concerns were informed by what we know about consumer behaviour from our own and other work on behavioural economics.

We were interested in outcomes for consumers in terms of value for money, quality of products and consumer understanding of products.

We drew on a wide range of evidence, including data obtained from firms, several types of consumer research, a public call for evidence, and engagement with stakeholders.

This chapter sets out the approach we used for this market study and describes our methodology.

Scope and approach

The study's objective was to assess whether competition in the markets for general insurance add-ons is effective, and if not, to understand why. We wanted to understand whether poor consumer outcomes from add-on sales could be the result of ineffective competition.

We considered that focusing on a small number of products and comparing add-on sales against sales of similar products sold on a stand-alone basis would provide a useful benchmark.

We wanted to understand the impact of the add-on mechanism across several markets, rather than focus solely on individual products – this differentiates this project from a more traditional market study.

We selected five products to compare across add-on and stand-alone sales: travel, personal accident, gadget, Guaranteed Asset Protection (GAP) and home emergency. These were selected against the following criteria:

- they were available both on an add-on and stand-alone basis
- they had not recently been the focus of thematic work
- they covered different types of risks
- they were sold across different distribution channels
- consumers were likely to have different degrees of familiarity with the products
- the markets were at varying levels of maturity

Travel was included in particular because we wanted to understand the impact of the add-on mechanism in relation to a product where we thought the market might be working reasonably well. We chose travel because it is a product that that has a significant range of stand-alone options, and because it is a product which consumers buy frequently and could be expected to be reasonably familiar with, both in terms of the product itself and where and how it can be purchased.

Consumers paid premiums of £2.5bn in 2012 for these five products, of which approximately £500m were add-on sales.[11]

Our aim was to consider these five products to see if there were commonalties across them that would allow us to draw conclusions about the add-on mechanism. We have also considered the relevance of any of these common findings to add-on sales more widely, in other words to products not included in this study but sold as add-ons.

We recognise that general insurance add-on products can be very different. Such products can differ in terms of complexity, customer familiarity and price, and are sold alongside a varied range of primary products. However, as many of our concerns derive from the add-on mechanism itself, and not from the particular nature of any one add-on product, we believe that similar risks of consumer detriment are likely to exist in markets for all general insurance add-on products. This has implications for the application of our proposed remedies as set out in chapter 7.

Our findings therefore generally focus on common findings, but if we found a product to be a significant outlier, this is highlighted. We were mindful of the interaction of add-on sales with primary product markets, but investigating outcomes (e.g. value or profitability) in primary product markets or for the overall package was not within the scope of this study. However, where we consider that the interaction between the sale of primary and add-on products had a particular impact on consumer behaviour and outcomes, we acknowledge this.

Our concerns and what we were testing

For competition to function effectively consumers need to:

- have a range of options to choose from that could meet their needs
- be able to access appropriate information at the right time about the options available

11 As discussed in chapter 2, classification of add-on and stand-alone sales is not always straightforward.

- assess the various options and decide whether to buy and if so which option is best for them, taking into account costs and benefits
- act on this assessment by buying from their preferred supplier

Therefore competition may be weak either because consumers do not have appropriate options available at the right time or are unable to access, assess and act on the relevant information about those options.

We wanted to evaluate whether competition was effective not only by considering whether there were any practical barriers to effective competition in place, but we also wanted to understand consumers' behaviour when confronted with the add-on mechanism to see whether this in turn had an impact on competition.

In the Call for Evidence we published in July 2013 we outlined what we thought the reasons might be for ineffective competition in the markets for add-ons.

We set out that one of the areas we would focus on was the question of whether poor outcomes in add-on sales could reflect particular consumer behaviour and firms' responses to them. In particular, we noted that we were concerned that the specific context of add-on sales might limit how far consumers explore alternatives or base their decisions on relevant measures of price and quality.

Our concerns were also informed by what we know about consumer behaviour from our own and external work on behavioural economics.[12]

For example, there is evidence to suggest that when the consumer is focused on their primary purchase they are less likely to shop around and compare value for money. This might be particularly true if the price of the add-on is relatively low, compared to that of the primary product. In this situation, consumers could be using a false reference point for comparison, considering the price of an add-on product against the price of the primary product rather than against the price of relevant alternatives.

Consumers may also be susceptible to the 'endowment effect' – valuing their new and potentially expensive purchase more once they start the purchasing process and they already imagine the new product as their own. As a result, the potential sense of ownership once the sales process begins can strengthen the desire to protect the new purchase from loss or damage by purchasing insurance cover at the point of sale.

On the supply side, we wanted to assess any potential barriers to entry or other constraints on competition that might make it harder for alternative providers to enter one of the relevant markets, expand in one or more of those markets, or otherwise affect the price and quality of add-on products.

Suppliers might be enjoying a point of sale advantage. If there was little or no competitive pressure, we considered that consumers might be paying inflated prices and therefore not getting good value for money. This might be evidenced by low claims ratios or high mark ups.

We also wanted to compare the quality of the products between different providers and with stand-alone equivalents, and understand whether firms might be responding to weak consumer pressures by selling poorer

12 For overviews of the research about potential behavioural influences on consumer decisions that involve add-ons and insurance more generally, see:
Baker, T., & Siegelman, P. (2013). Protecting Consumers from Add-On Insurance Products: New Lessons for Insurance Regulation from Behavioral Economics. Connecticut Insurance Law Journal, 20, 13-1;
Kunreuther, H. C., Pauly, M.V. and McMorrow. S. (2013). Insurance and Behavioral Economics. 1st ed. Cambridge: Cambridge University Press ;
Huysentruyt, M., & Read, D. (2010). How do people value extended warranties? Evidence from two field surveys. Journal of risk and uncertainty, 40(3), 197-218; or
Erta, K., Iscenko, Z., Hunt, S. and Brambley, W.(2013) Appling behavioural economics at the Financial Conduct Authority, FCA Occasional Paper 1.
For examples of academic research on the potential effects of add-on pricing on competition, see: Ellison, G. (2005). A model of add-on pricing. The Quarterly Journal of Economics, 120(2), 585-637; and Gabaix, X., and Laibson, D. (2006). Shrouded attributes, consumer myopia, and information suppression in competitive markets. The Quarterly Journal of Economics, 121(2), 505-540.

quality products as add-ons. Low claims ratios, frequencies or pay-outs or high consumer complaints might also be evidence that quality was poor and/or consumers' expectations were not being met.

Therefore we considered the following as part of the study:

- How the add-on mechanism affects consumer behaviour and decision-making, for example shopping around, sensitivity to price or likelihood of buying insurance.
- Whether there is a difference in consumers' awareness and understanding of the add-on product when compared to stand-alone purchases.
- The content and presentation of information consumers typically receive as part of the different ways in which add-ons are sold.
- What firms compete on, and whether add-on and stand-alone sales are in direct competition with each other.
- How price and quality of cover compare across similar products offered on an add-on or stand-alone basis.
- Whether there were material differences in claims frequencies and consumer complaints between add-on and stand-alone products.
- Whether products are good value for money, for example when measured by the claims ratio.
- Any barriers to entry or expansion.
- The profits earned by distributors or underwriters of add-ons.

As a market study, this study was not intended to test for mis-selling or deliver a compliance review against our existing requirements. However, we reflect on the interaction between our findings, for example in relation to the information provided to consumers, and our rules in chapter 5.

The evidence we gathered to support our analysis

To better understand the markets in our study and to test our theories of harm, we asked over 80 firms (insurers and distributors) to provide us with information about the five products. We also commissioned consumer and behavioural research to explore our theory about the effect on consumer behaviour of the add-on sales process. All these pieces of work are described in more detail in the relevant annexes to this report, which set out both approach and findings.

Firm data

We selected a representative sample of firms to give us a view across each of the markets, covering a variety of different firm sizes and business models. To ensure that we captured the whole distribution chain we targeted insurers as well as distributors. We designed the questions to assess the value chain for indicators of ineffective competition, such as whether consumers were getting value from the sampled products and whether firms were in a position to earn excessive profits. For each sampled product we looked to capture firms with the highest sales in the markets as well as smaller firms to ensure we had a balance of different firms, both between insurers and distributors as well as between add-on sales and stand-alone sales.

We sent questionnaires to insurers and distributors to request a range of information including:

- product details – product cover

- product governance details for products, as well as product governance processes and procedures
- target markets and distribution channels for the product
- product sales – prices, volumes
- data relating to customer satisfaction – cancellations, complaints
- claims data – number of claims paid and declined, claims payments
- supply chain – the different distribution arrangements in place and key commercial terms
- profitability data – profit and loss information
- product sales processes – sales scripts and screenshots of online transactions
- assessment of competition, such as how firms view the competitive environment
- information about competitors, including what they use as their benchmarks in setting prices

The quality of information that firms provided varied significantly. For example, some distributors selling add-on products were not able to split out their costs between the primary product and the add-on product.

Where there are gaps in data, we acknowledge this throughout our report. However, we were also able to supplement the information directly provided by firms with other data sources, including regulatory returns, Mintel, Datamonitor, Defaqto, academic research and our own regulatory knowledge.

We also supplemented our analysis with desk-based research on a range of topics of interest, for example, historical developments in some of the markets under investigation, additional online mystery shopping to complement the data on sales processes submitted by firms, and other work.

Consumer research

We carried out a programme of consumer research to help us understand consumer behaviour and consumer outcomes in the context of add-on sales. Specifically, we sought to:

- understand whether and how consumers shopped around for their cover, any barriers to shopping around and reasons for purchase
- understand whether they intended to buy the insurance before it was offered and whether they were aware of alternatives
- explore consumers' understanding of the product in terms of its suitability for their needs and their awareness of, or familiarity with, the product before purchase
- gauge consumers' perceptions of the sales techniques used by firms during the sale
- assess recollection/awareness of owning the product
- assess consumers' satisfaction with information provided, their confidence in understanding the cover, their knowledge of product features and awareness of price paid
- understand consumers' intentions regarding purchasing a similar type of product in the future

We commissioned qualitative research (focus groups and in-depth interviews) as well as quantitative research (a large-scale telephone survey). We also carried out an online behavioural experiment simulating various add-on sales environments to help us understand how consumers really react to different aspects of the add-on sales process and what impact this might have on their behaviour and decision making. We believe this experiment gives us unique behavioural insights into the impact of the add-on mechanism on consumers, and complements the more traditional 'self-reporting' quantitative and qualitative research.

The Development Team (TDT) carried out the qualitative research to understand in detail consumer behaviour, perception and their experience with these products. This work also supported how we designed the quantitative research.

Consumers who had recently purchased one of the five products on an add-on or stand-alone basis were interviewed in small groups or on a one-to-one basis. 106 consumers took part in the research. The sample contained a range of consumers in terms of demographic profile, geographical locations and purchase channel used (i.e. phone, face to face or online).

Harris Interactive then conducted the quantitative research by carrying out a 15-minute telephone survey to test whether the findings from the qualitative interviews applied to a much larger, representative sample of consumers who had bought one of the five products from firms in the study in the previous three to four months.[13] 1070 consumers took part in the research, 546 who had purchased their insurance on an add-on basis and 524 who had purchased on a stand-alone basis. The results of the two groups were compared across a variety of measures to enable comparisons between add-on and stand-alone purchases on a general basis as well as within products where possible.

We also worked with London Economics and academics from University College of London to carry out a behavioural experiment that explored how common ways of presenting the add-on products affected the way consumers made their choices and therefore their ability to drive effective competition.

The experiment involved consumers doing a series of online tasks, in which they were shopping around to minimise costs on different primary purchase products and optional add-on insurance. The experiment explored how different factors – such as timing of introducing the add-on during the primary purchase, price format and access to stand-alone alternatives – affected the likelihood of consumers buying insurance and their ability to shop around effectively.

1,513 consumers, recruited from a representative YouGov survey panel took part in this research. The controlled environment of the experiment allowed us to explore how specific features of the add-on transaction affect consumer behaviour. Because some of these influences are subconscious, consumers may not be consciously aware of them and so would not be able to reliably discuss their effects in traditional consumer research. The experiment also helped us to explore whether those effects are general – i.e. there is an add-on 'mechanism' that is likely to be influencing behaviour even for add-on insurance products outside of the scope of the current study. We will shortly be publishing an occasional paper on the use of behavioural experiments as a regulatory tool which discusses this experiment more widely.

Call for evidence

In July 2013 we issued a Call for Evidence asking for information to help us understand whether competition in the markets for GI add-ons was effective or not. We asked:

- Is competition in the sale of GI add-on working well for consumers?
- Where you consider competition is not effective, why do you think that is?[14]

13 See the individual consumer research reports published alongside this report for more detail on our analysis.

14 The full questions are set out in the call for evidence at http://www.fca.org.uk/static/documents/general-insurance-add-on-market-study.pdf

We received 27 responses from consumer groups, individual consumers, trade bodies and industry which informed our analysis. Annex A contains a list of non-confidential respondents.

Stakeholder engagement

We complemented our formal evidence gathering by engagement with industry stakeholders. For example, we met with industry representatives and trade bodies to gain a deeper insight into the markets for the five products in our study. We also held follow-up discussions with some of the sampled firms to discuss in more detail the information they provided to us, and attended roundtable sessions held by the Association of British Insurers (ABI) and its member firms to explore further how each of the markets in our study operates.

Thank you

We thank all firms and consumers who took part in the study and other parties who contributed for their time and contribution.

The five products in our study

We selected five products for the study:

Home emergency

- Products range from basic cover for plumbing and drainage to options including boiler, electrical and gas appliance cover.
- Prices vary from £25 to £240 for add-on and from £45 to £330 for stand-alone, for annual cover.
- 14.75 million consumers bought a home emergency product in 2012 either as an add-on to home insurance or stand-alone.
- Cover is either on a monthly rolling basis or annual.
- Consumers most often buy home emergency cover over the phone or online.
- Estimated total premiums in 2012 £1.3bn, in a growing market.

Guaranteed Asset Protection (GAP)

- GAP provides cover if a consumer's car is written-off or stolen and the motor insurance pay-out is not sufficient to repay outstanding finance, replace the car as new or with one of equivalent value to the original price.
- Prices vary according to the purchase value of the car, in bands. For example prices of a three-year GAP cover policy for a car of up to £25,000 would range from around £140 for stand-alone to £300 as an add-on.
- 1.3 million consumers held a GAP product in 2012, either as an add-on or stand-alone.
- Cover as an add-on is typically between two and five years – for a single premium – but as a stand-alone purchase it is available on a monthly or annual basis.
- Consumers usually buy GAP as an add-on face to face when buying their car. Stand-alone sales are mostly online.

- Estimated total premiums paid in 2012 £160m. Add-on sales dominate with approximately 99% of sales. From 2008 this was a fairly static or declining market but 2012 showed an increase in sales, possibly reflecting the economic climate generally and an increase in car sales.

Personal Accident

- Personal Accident pays out a lump sum for specified injuries, and sometimes a payment for each night spent in hospital as a result of an accident.
- Prices vary depending on the cover. For example, in our study prices for add-ons ranged from £10 – £28 and for stand-alone ranged from £30 to an extreme of £168.
- Around 6m consumers held a personal accident product in 2012. Approximately 1m of these were add-ons to home or motor insurance mostly bought online or over the phone.
- With the exception of add-ons to motor insurance this is generally a declining market. Stand-alone personal accident is now most commonly sold on a group basis, for example through employers or associations.

Travel

- Travel insurance covers medical expenses, baggage loss, holiday cancellation and a range of other risks. There are many different levels of cover available.
- Prices vary depending on many factors. At a basic level a single (two weeks) trip to Europe for a couple in their thirties ranges from £8 – £80, whereas an annual policy with worldwide cover for a 60 year old couple could be £55 – £200.[15]
- Consumers bought 26 million travel insurance policies in 2012, more often as an add-on to their holiday or flight but around nine million bought it stand-alone.
- Travel insurance is also frequently held as part of a packaged bank account.
- Travel insurance is available through multiple channels, including face to face, phone or online.
- Estimated annual premiums in 2012 were £800m. The market for travel insurance as an add-on has remained fairly constant over the last five.

Gadget

- This product covers damage or lose of a gadget – can cover single or multiple gadgets.
- Prices vary from around £10 as an add-on to £100 for some stand-alone products.
- Around 100,000 consumers bought gadget cover in 2012, around double that in 2011. Gadget insurance can often be sold in a way that is outside the regulatory perimeter. Stand-alone purchases are usually online.
- This is a relatively new market with a lot of potential for growth.

15 Based on quotations using www.moneysupermarket.com February 2014

4
Consumer behaviour

We found that the add-on mechanism has a clear impact on consumer behaviour. Add-on buyers are:

- less likely to shop around
- less effective when they do shop around
- less sensitive to price

Difficulties for consumers are made worse by the timing of the introduction of the add-on, by the lack of transparency about add-on quality and price, and the complexity of comparing packages of products with separate prices.

Our research shows that the add-on mechanism is associated with consumers not engaging with the purchase, and as a result often buying products without clear intent and potentially ending up with products they do not need or use. Add-on buyers are:

- more likely to show poor awareness of owning the product and poor price recollection shortly after purchasing insurance
- more likely to state they had not thought about buying the product in question until the day of purchase
- passive buyers, with less than a third enquiring about the product themselves, and
- less likely to consider whether they already had other insurance policies which may provide similar cover

We conclude from this 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.

This increases the point-of-sale advantage enjoyed by those selling general insurance products as an add-on and provides an opportunity and an incentive for firms to sell products that might not meet consumers' needs or charge high price mark-ups that can lead to poor value to consumers. The following chapter will examine how firms respond to this known consumer behaviour, and what outcomes this leads to.

We note that both add-on and stand-alone buyers report being happy with the amount of information provided and are confident that they understand their cover and satisfied with their purchases. And yet research clearly shows that, in fact, understanding of policies is poor for both add-on and stand-alone products.

This demonstrates that there are challenges associated with the sale of general insurance products that go beyond the add-on mechanism, and that there are limits to the level of information we can expect consumers to take on and process when it comes to purchasing insurance products.

Finally, our research also confirms that consumers, whether add-on or stand-alone, primarily buy insurance for peace of mind. Add-on buyers also value the convenience of the add-on mechanism.

These factors will need to inform our thinking on remedy design.

This chapter looks at how the add-on mechanism affects consumer behaviour and understanding. It sets out the findings of the three strands of consumer research we commissioned as part of this market study.

The experience of past competition and regulatory investigations, as well as other research strongly suggests that if there is ineffective competition in add-on markets, many of its roots are likely to lie in consumer behaviours.[16] Our hypotheses were that the add-on mechanism may affect consumers' ability to drive effective competition in several ways, and this chapter sets out our findings and analysis against these hypotheses.

As described in chapter 3, we carried out in-depth qualitative and quantitative research and conducted a behavioural experiment to understand how consumers respond to the add-on mechanism, and the analysis in this chapter is based on these pieces of work.

Before considering the findings in detail, it is worth noting that we did not find that add-on buyers corresponded to a particular demographic profile, for example in terms of age, financial sophistication or income. Rather, the profile of buyers varied more by product than by purchase mechanism. Detailed data on this and indeed all the other findings set out in this chapter are described in the relevant research reports published alongside this study.

Shopping around

As set out in chapter 3, to drive effective competition, consumers need to shop around – compare prices and quality of alternative products, and be able to choose suppliers that offer the best deal on either the insurance product on its own or the combination of the primary product and the insurance add-on. Unless a significant number of consumers consider the add-on offerings when choosing the supplier for their primary purchase there is little incentive for firms to improve add-on price and quality. Similarly, add-on providers will not face a material competitive constraint from firms that sell similar insurance on a stand-alone basis unless consumers are aware they can buy the product separately and consider this when deciding whether to buy the add-on.

Extent of shopping around and awareness of alternatives

We found strong evidence that consumers shop around less for add-ons than when purchasing on a stand-alone basis. In the consumer survey, **58% of add-on buyers said they did not consider any other policy when purchasing their insurance compared to only 22% per cent of stand-alone buyers**.

16 Examples of evidence from past competition investigations include Office of Fair Trading (2012) Extended Warranties on Domestic Electrical Goods An OFT market study and notice of the OFT's intention to accept Undertakings in Lieu of a Market Investigation Reference; and Competition Commission (2009) Market investigation into payment protection insurance. Final Report.
An overview of academic evidence on the ways in which consumer behaviours may contribute to ineffective competition can be found in: Baker, T., & Siegelman, P. (2013). Protecting Consumers from Add-On Insurance Products: New Lessons for Insurance Regulation from Behavioral Economics. Connecticut Insurance Law Journal, 20, 13-1. See footnote 12 for additional references

Our quantitative research suggests that a key reason why consumers do not shop around is that they are not aware of stand-alone alternatives — **25% of those who bought insurance as an add-on were not aware they could buy the product separately elsewhere**. This was particularly common among GAP buyers, where both survey results and focus groups showed a widespread perception that the product is connected to the car dealer and the car purchase. By contrast, travel-add-on buyers showed good awareness of alternatives.

> *'I didn't realise that you could buy GAP insurance outside of the garage. I thought it was connected to the garage' Qualitative research participant*

Introduction and presentation of add-ons

The way in which add-ons are typically presented to consumers in their purchasing journey is also likely to be contributing to lower levels of shopping around.

When reviewing insurers' websites and sales scripts we found that substantive information about the price and cover of the add-on (or even the existence of the optional insurance) is often not made clear to consumers until quite far along in their purchase of the primary product.[17]

Our behavioural research shows that this **practice of revealing add-on prices only at the point of sale of the primary product is a very powerful barrier to consumers looking for alternatives**. In the experiment, when add-on price was available up-front alongside the primary product information and price, only 17% of participants bought the first insurance offer they had seen. **In contrast, delaying giving the add-on price until the point of sale of the primary product led 65% of add-on buyers to buy the offer without looking at any other add-on prices offered by other providers**, even though it was very simple to do so in the experiment.

The tendency to shop around improved considerably if participants were given an easy way of searching for stand-alone alternatives directly at the point of sale. But even small barriers to accessing information about stand-alone alternatives (a single click, equivalent to switching to a new tab in an internet browser) significantly reduced willingness to take advantage of this option.

Overall, buying insurance appears to be a less premeditated choice for add-on buyers, which also helps explain the lower levels of shopping around. In our survey, **38% of add-on buyers said they had not thought about buying insurance before the day of their purchase, compared with just 15% of stand-alone buyers**. There are considerable differences in intention to purchase across products, with the proportion of add-on buyers who reported not having thought about buying the insurance until the day they bought it particularly high for GAP (59%) and low for travel (13%).

For all products, however, add-on buyers are approximately twice as likely as stand-alone to not intend to purchase insurance in advance.

In general, add-on buyers appear to be largely passive in the purchase – only 28% said that they had enquired about the insurance product themselves, with the rest reporting they were offered the product by the seller. In contrast, the vast majority of stand-alone buyers (82%) report actively initiating the purchase.[18]

Notably, the differences in intention to purchase insurance between add-on and stand-alone buyers are not primarily driven by the relatively lower familiarity with the product among add-on buyers. They were only slightly

17 Clearly, insurer websites are not the only way in which consumers might encounter add-ons; for example, actual or indicative prices of some add-ons (including home emergency and personal accident cover) are available in search results for motor and home insurance on price comparison websites. However, only about a half for add-on buyers of home emergency or personal accident insurance in our survey who shopped around reported using price comparison websites to do so.

18 The consumer survey did not allow exploring in detail the different ways in which stand-alone sales were initiated. General information submitted by firms about product distribution strategies suggests, however, that the 18% of stand-alone consumers who did not initiate the transaction themselves were most likely cold-called by the supplier.

more likely than stand-alone buyers to report not having been aware of the product before being offered it by the seller (13% vs 7%), and were no more likely to be buying this type of insurance for the first time.

But it is worth noting that any potentially lower prices from shopping around may not be worth the extra time consumers spend searching and the associated loss of convenience.

The most common reasons for not shopping around – for add-on and stand-alone buyers equally – were related to convenience. Consumers said they were sufficiently satisfied with the current offer and price to not be interested in looking elsewhere and did not want to spend more time on shopping around due to a general lack of interest in insurance.

We recognise that this is an important consumer preference, and one which we consider as part of our response and remedy design. For example it prompts us to focus on additional ways to help consumers make better decisions rather than only seeking to promote shopping around. However, as we discuss in chapters 5 and 7, the one possible exception to this is GAP.

Whether justified or not, **lower levels of shopping around among add-on buyers overall suggest that many consumers do not engage with the decision on whether to buy insurance until the point of sale. This gives primary product providers an advantage over competitors at that point and puts them under little pressure to improve price or quality of add-on offers.**

Effectiveness of shopping around

We also found evidence that the add-on mechanism leads to less effective shopping around. It means **consumers pay less attention to add-on costs and makes it more difficult for them to calculate the total costs of the overall purchase**.

An important finding from experimental research was that even when consumers were only shopping around for a primary product and a single add-on, with prices for both products transparently provided up-front, 17% of participants did not choose the cheapest combination of the add-on and the main product out of those available.[19]

Later introduction of prices increased the likelihood of consumers making mistakes in the behavioural experiment. When add-on prices were not revealed until the point of sale – this is common among the real add-ons we considered – consumers failed to choose the best option 24% of the time, with half of the mistakes driven by selecting the cheapest primary product rather than reducing the cost of the bundle overall. By comparison, just 4% of participants did not choose the cheapest option when they were shopping around just for insurance (i.e. comparing a single price).

These findings suggest that even add-on buyers who shop around face significant difficulty choosing the best deal because of their focus on the primary product, the lack of transparency of add-ons and the complexity of comparing and evaluating bundles of products with separate prices without a clear total.

Consumers are likely to find shopping around effectively even more difficult in the real world, as in the experiment all products were of equal quality, whereas in real-life situations consumers need to compare offers in terms of quality as well as price. To complicate matters further, consumers will often have to keep track of prices of multiple add-ons for each primary product.[20]

19 There were no differences in quality among suppliers in the experiment; hence failure to minimise price among alternatives that had been viewed is always a mistake.

20 Behavioural research from OFT supports the concerns that consumers are even more likely to face difficulties when comparing offers where price is split into more than two parts (e.g. a primary product and more than one add-on). (Office of Fair Trading (2013). Partitioned Pricing Research. A report by London Economics.)

We also found that the way the add-on price is displayed affects the way consumers make decisions. Our review of add-on sales processes suggests that add-on prices are often quoted in monthly terms, which for most products means that they appear to be very cheap (typically under £10 per month). This is particularly the case when compared against the main purchase.

Our experimental research showed that this way of presenting prices meant that participants were even less likely to shop around or identify the cheapest option available. The monthly price format was also associated with a significant proportion of participants initially underestimating the total annual cost of their purchase.

These findings are also supported by the qualitative research, where some consumers who reported buying their add-on products because they seemed cheap when quoted on a monthly basis expressed surprise when focus group coordinators prompted them to think about the total yearly cost.

Our findings suggest that the use of monthly prices appears to make it more difficult to shop around effectively, although we note that consumers may derive benefit from knowing the monthly cost, for example to help with budgeting.

> *'It was only about £6/7 a month (gadget insurance)… the price of a couple of cups of coffee'. Qualitative research participant*

Price awareness and price sensitivity

Our consumer research found that **consumers buying insurance as an add-on generally paid less attention to the price of the add-on product, and indeed had poor awareness of price paid**. Consumers who bought insurance as an add-on were much less likely to be able to correctly recall how much they paid for their insurance around three to four months after purchase – **in fact, 69% of add-on buyers could not give an accurate estimate of the price they paid**. Of these, 38% of add-on buyers said they were not sure how much they had paid in contrast to only 15% of stand-alone buyers. Almost double the number of stand-alone buyers (59%) were able to provide reasonable estimates of their policy cost compared to add-on buyers (31%).[21]

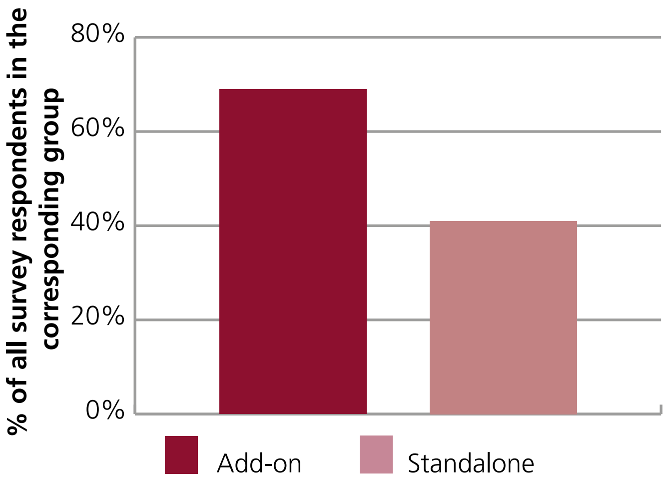
Widespread inability of add-on buyers to recall how much they had paid for their insurance suggests that they were paying less attention to add-on price when they originally chose to purchase the product. Similarly, **in the experimental research participants were much less sensitive to add-on prices in deciding whether to buy insurance than they were for stand-alone alternatives**.

This research found that when add-ons were only revealed at the point of sale, there was a much weaker link between the add-on's price and the likelihood of the consumer purchasing it, than for any other ways of presenting insurance. For example, almost a quarter (23%) of very expensive insurance offers (where price was more than 4.5 times the expected pay-out value) were accepted by consumers in our behavioural experiment when the add-on price was revealed at the point of sale, compared to much lower acceptance rate of this type of insurance in other settings: just 3% for stand-alone offers and 5% for cases where add-on price was shown transparently alongside the primary product.[22]

21 The estimate given by the consumer was accepted as reasonable if the price range they selected was at least partially within the +10%/-10% of the actual price paid.

22 The limited sensitivity of consumers to add-on prices is also reflected in direct evidence of firms' ability to mark up add-on prices, without significant constraint. We received evidence from a firm supplying personal accident insurance, which indicated that the firm had realised that its add-on price was below other personal accident add-on prices providers and had decided to significantly increase its price to move into line with other providers. Analysis of the impact on add-on sales showed a small reduction in sales but the increased margin on the remaining sales meant it was profitable to increase the price of the add-on.

Figure 4.1 Proportion of respondents who were unable to accurately estimate the price they paid for insurance



Product understanding and suitability

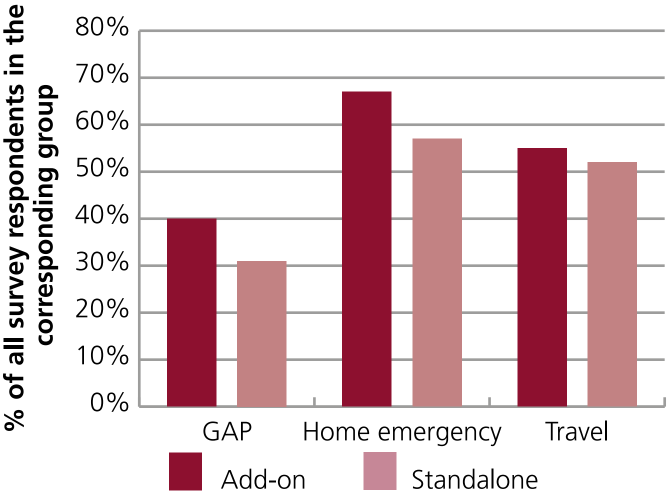
Based on the evidence from behavioural economics about consumers' behaviour, our hypothesis was that consumers would be likely to focus on the purchase of the primary product and pay comparatively little attention to the add-ons on offer. Not focusing on the add-on insurance would in turn increase the likelihood that consumers fail effectively to assess the information provided about the add-on product. This would increase the risk of consumers buying add-ons that they do not need or do not meet their particular requirements.

Our research confirmed that product understanding among add-on buyers was poor. However, it also highlighted that poor understanding was not limited to add-on buyers, with stand-alone buyers performing only very marginally better. Both groups of consumers were also over-confident about how well they understood their products.

When surveyed as part of the quantitative study, consumers' initial self-assessment of their product understanding was very positive across both add-on and stand-alone buyers. The majority of survey respondents claimed to be either confident or very confident that they understood their cover. The survey results also showed broad satisfaction with the information provided at point of sale.

We tested consumers' understanding by asking relatively simple factual questions about specific features of the cover for each of the five products (e.g. whether a product covered certain events or if specific exclusions applied). **This exercise revealed widespread misunderstanding of the basic policy details among both add-on and stand-alone purchasers**. Consumers who had purchased their insurance on an add-on basis got 54% of questions incorrect or stated they were not sure of the answer, as did 52% of stand-alone purchasers. As shown in Figure 4.2, there was a consistent pattern of relatively poor product understanding for all of the products, with add-on being only slightly worse than stand-alone. Note, however, that error rates are not comparable between the three products presented because the questions testing understanding were tailored to each product type, and so the difficultly of the test overall may not have been the same.

***Figure 4.2 Average % of questions about cover which a respondent did not answer correctly*[23]**



Similar patterns emerged in discussions of product understanding in the qualitative research. At the outset many consumers considered themselves to have a good understanding of their cover, but on reviewing their policy documents they found this was often not the case.

> *"I thought I was covered for £750 for my ski equipment but now I've read the policy you only get 90% if it's less than a year old and if it's over 3 year's old you only get 30%! Mine is 18 months old and cost £500 so I'd only get 50% back. I'm surprised". Qualitative Research participant.*

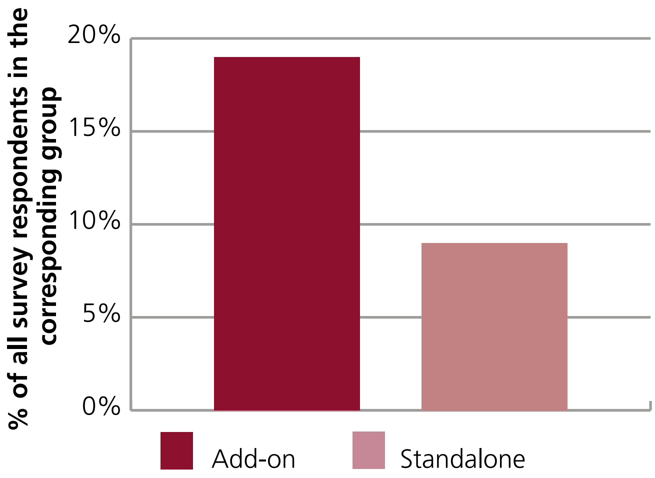
Awareness and suitability

There are three further indications that the add-on channel is associated with a greater risk of consumers purchasing products that are not suitable for their needs, are unnecessary or which they will not use.

First, consumers who had purchased their insurance as an add-on were significantly more likely than those who purchased on a stand-alone basis to be unaware or have forgotten that they owned the product, even when asked only a short time after their purchase. When surveyed approximately three to four months after the initial purchase, 19% of add-on buyers – almost 1 in every 5 – were not aware that they held the product. The figure was 9% for those buying on a stand-alone basis.

23 The survey did not investigate experiences of personal accident stand-alone buyers and gadget add-on buyers because of the difficulties with obtaining sufficient customer data from firms and with reliably matching individual buyers to the add-on or stand-alone purchasing channel for these sub-groups. However, our survey sample covers all other combinations of the five products and add-on or standalone purchase mechanism. See Consumer research report by Harris Interactive for more detail on our analysis.

Figure 4.3 Proportion of respondents who not aware of owning insurance they had previously purchased



Second, at the point of purchase add-on buyers were less likely to consider whether they already had other insurance policies which may provide similar cover. This means they are at a greater risk of double-insuring and paying for cover they do not need and are unlikely to use. **64% of add-on purchasers did not consider whether they could already be covered compared to 49% of stand-alone purchasers.**

Finally, **consumers buying add-ons are vulnerable to opt-out presumptive selling (i.e. the default option of including an add-on with the main purchase)**. We believe this can significantly increase the likelihood of consumers buying insurance regardless of the need for it.

Our concerns with opt-out sales

We did not test for consumers' reactions to opt-outs as part our consumer research because of the wide range of existing evidence available. The FSA had previously stated that the use of pre-ticked boxes in the online sales of travel insurance does not demonstrate fair treatment of customers and interferes with customers' ability to make an informed decision.

Opt-outs are associated with consumers not making informed decisions. Buying insurance should be an active and informed choice which a consumer makes once they have received appropriate information on the main features of the policy including the benefits, significant exclusions and limitations and the price. Our rules require firms to take reasonable steps to ensure they give customers appropriate information about a policy in good time and in a comprehensible form.

There is also evidence that consumers are often very unwilling to deviate from the option that is set for them by default. The information firms provided as part of our review of motor legal expenses insurance (MLEI) showed that, while some consumers do have the confidence to de-select MLEI when it has been pre-selected for them by a firm, it remains likely that some consumers do not have the confidence to override the 'authority' of an insurance company or intermediary that they believe has decided they need MLEI.

Data obtained from a large insurer as part of our MLEI review showed that for one of the firm's brands that sold MLEI on an opt-out basis the penetration rate was 80%, whereas for another brand that sold MLEI on an opt-in basis penetration rate was about 40%. Moreover, similar default inertia has been found to have a powerful effect on shaping consumer behaviour in many other settings ranging from pension savings in the US and the UK to insurance take-up by farmers in developing countries to organ donation rates.

Purchasing a product on an opt-out basis can also have a significant negative impact on the likelihood of consumers claiming on a policy. One large insurer explained that the key variables when designing and pricing a new product include whether the product is to be sold on an opt-out or opt-in or stand-alone basis. The insurer identified that claims frequencies are lowest for opt-out policies, slightly higher for opt-in policies and significantly higher for stand-alone policies.

Overall, evidence suggests that opt-out selling is declining. As a direct result of our MLEI review, a number of insurers and intermediaries decided to move away from opt-out selling, both for MLEI and other add-on products. Some firms involved in this market study also told us they had recently reviewed their approach to opt-out sales and stopped the practice. But pre-ticked boxes are still being used to sell general insurance add-ons online, and we remain concerned that this continues to have a detrimental impact on both consumer decision-making and consumer outcomes.

Satisfaction with sales process and the product

We found little evidence of consumers stating that they were actively pressured into buying add-on insurance at point of sale or are dissatisfied with their purchasing experiences. However, survey responses do suggest that add-on providers may be using softer persuasive techniques to convince consumers to buy insurance more often.

A predominant majority, 92%, of consumers in our research stated that they did not feel pressured into buying their insurance and only 6% said they felt a little pressure to buy it. Add-on purchasers reported feeling some pressure slightly more often than those who bought on a stand-alone basis. There were, however, differences within products: 15% of GAP add-on buyers reporting experiencing a little pressure to buy the product compared to 5% of GAP stand-alone buyers.

The reported reasons for purchase, however, suggest that in the add-on channel consumers' decision to buy may be more likely to be influenced by 'softer' persuasive techniques. For example, add-on buyers were more likely than stand-alone buyers to say they took out the insurance because:

- it was with a company they trusted (83% compared to 72%)
- they felt helped by the salesperson and trusted them that this was an insurance product they should buy (58% compared to 29%)
- there was a free trial period (36% compared with 26%), and
- it was part of a special deal/offer (39% compared with 12%)

> *'My personal accident insurance is part of my car insurance…When they said 'the first three months are free' I thought "why not?" I've just left it rolling on. It's not much per month. I thought I'd cancel it after the three months ... but I don't mind the amount is not large'. Qualitative Research participant*

Although there is nothing to specifically suggest mis-selling (and testing for mis-selling was not the focus of this market study), in general the opportunity to influence consumer willingness to buy the add-on product through the use of persuasive tactics at the point of sale forms a part of the point-of-sale advantage for the primary product provider who, unlike other insurance suppliers, has direct access to the consumer and can build on the existing relationship to make the case for the product.

Face to face sales are of particular interest in this regard. Research carried out by the academics from London School of Economics for the FSA on PPI sales in 2007 suggests that the benefits of opportunity to interact with the consumer at the point of sale for face to face sales can be very large. Through a complex experiment that involved consumers buying insurance from professional salespeople, the study found that the more skilful sellers had very powerful effect on consumers' willingness to pay for insurance. The skill of the salesperson had a greater effect on likelihood of the consumer purchasing insurance than any of the disclosure changes tested in the experiment.[24]

In contrast, stand-alone buyers were more likely to give more general reasons for buying insurance. In particular, they were more likely to report that they bought insurance because of recommendation from family or friends (26% compared to 19% add-on buyers); that the price was low (73% compared to 66%); or that they did not want to regret not having insurance in case something bad happened (92% compared to 84%).

In line with what we know about consumers' motivation for buying general insurance more generally, wanting to avoid regret in the future was the most popular reason for buying insurance among both groups. More than a half of both add-on and stand-alone buyers cited it as their main reason for the purchase (65% for stand-alone and 52% for add-on).

Overall, consumers appear to value their insurance cover, and 86% of both add-on and stand-alone buyers said they would purchase it again in the future. While this apparent widespread consumer satisfaction needs to be considered in the context of relatively poor product understanding and the fact that individuals surveyed had only bought their policies recently and therefore normally had not had an opportunity to experience a claim, this finding is nevertheless relevant for our consideration of remedies.

24 De Meza, D., Irlenbusch, B., and Reyniers, D. (2010). Disclosure, trust and persuasion in insurance markets, IZA Discussion Paper Series, No. 5060.

In summary

We found that, on average, there is less shopping around and lower price sensitivity when consumers buy add-ons. This can be made worse by how and when information on add-ons is presented to the consumer. In addition, buyers of add-ons have a lower awareness of having bought the product and have poor recollection of the price paid.

We conclude from this that the add-on mechanism weakens consumer engagement with the purchase decision and can lead to worse decisions. Sellers of add-on insurance products enjoy a point of sale advantage, which is further enhanced by consumers' behaviour when encountering add-ons. The add-on mechanism provides an opportunity to sell a product to a consumer whose focus is elsewhere, and who is therefore less likely to be thinking clearly about whether they want, need, or understand the product.

Understanding of product cover is poor for both add-on and stand-alone buyers, with no material difference between the two. Consumers also value the convenience of buying through the add-on mechanism, and both add-on and stand-alone buyers buy for peace of mind, and would repeat their purchases. We will take these findings into account as part of the process of designing remedies.

The next chapter considers how firms respond to these features of add-on sales, and what this means for how effective competition in add-on markets is.

5
Are markets for add-on insurance products working well?

Add-on sellers enjoy a clear point of sale advantage, which is further exacerbated by the way the add-on mechanism affects consumer behaviour.

There are two ways in which, in principle, competition could limit the market power arising from the point of sale advantage: competition from other add-ons if consumers can shop for bundles (of primary product and add-on); or competition from stand-alone alternatives.

An important factor in assessing the effectiveness of competition is the availability of information to consumers. We find that consumers' ability to assess options and make choices is hindered by the fact that there is often insufficient information available relating to the quality and prices of add-ons, and that the information that is available is often presented very late.

Based on our findings we consider that, for each of the products that we looked at, consumers cannot easily take into account the price of add-ons in their choice of primary product provider. This limits the effectiveness of competitive pressure on the price and quality of add-on products. Competition for add-ons is not currently effective in terms of consumers shopping for bundles of primary product and add-ons.

With the exception of travel insurance, competition from stand-alone products does not appear to constrain the pricing and quality of add-on insurance. Stand-alone products often differ in the level of coverage from add-on products and therefore consumers may not find a like-for-like alternative from stand-alone product providers. Only in the case of travel insurance we do observe a range of stand-alone options that appears to constrain the supply of add-ons. We note that there appears to be value in consumers shopping around for GAP, given lower stand-alone prices for similar coverage.

Overall, the consequence of lack of competition in the supply of add-ons is that distributors are able to mark up prices significantly above costs and consumers receive poor value for money from many add-on products. We have direct evidence of the ability to earn substantial mark-ups on the insurance cost of add-on products. In some cases less than ten percent of the money paid by the consumer goes directly to cover the risk consumers are trying to protect against.

We have used the claims ratio as our core measure of value for these insurance products and as an indicator of profitability. The claims ratios that we observe are, in all cases except travel insurance, substantially lower than for more mainstream general insurance products, indicating poor value for money. In the case of add-on GAP and personal accident insurance, the claims ratios are exceptionally low.

We conclude that add-on insurance often represents poor value for money, but note that we found instances of poor value for stand-alone products too.

The profitability analysis showed that:

- Insurers did not generate high profits from the underwriting of the sampled products for both add-on and stand-alone sales, with the exception of personal accident.
- Commercial terms between insurers and distributors appeared weighted in favour of distributors.
- Some add-on distributors can generate high profits on the sampled products, and the high profits appear to be driven by a combination of high mark-up from insurance cost to retail price and very low incremental distribution costs. We believe that this in turn is made possible by the weak consumer engagement that is associated with the add-on mechanism.
- Stand-alone distributors did not generally earn high profits on the sampled products.

This chapter considers what the nature of competition for add-ons is and whether it is effective. It also considers measures of product value and firm profitability to understand whether markets are working well for consumers.

The point of sale advantage and competition for add-ons

The add-on mechanism provides the add-on seller with a clear point of sale advantage. For example, the way the sale is structured benefits the add-on seller in a number of ways:

- The add-on seller is already in contact with the consumer through the consumer's interest in the primary product. This gives them an opportunity to sell their add-on product with minimal additional marketing or distribution costs.
- The add-on mechanism means that the consumer's choice is likely to be restricted in terms of the options that are readily available to them at the point of sale of the primary product.
- It is likely that the add-on seller will also have an advantage by being the first seller to offer the product if the consumer has not considered the product before (and indeed we know this is often the case from our consumer research).
- Stand-alone providers can be at a clear disadvantage as they have to incur greater costs to identify relevant consumers to sell their products.
- The cumulative effect of these advantages enjoyed by the add-on seller can limit the number of stand-alone suppliers and the constraint they place on add-on sellers.

As described in chapter 4, **the point of sale advantage is exacerbated by the way consumers behave when they buy add-ons**.

We are concerned that the market power which the point of sale advantage can confer on the add-on seller might enable and incentivise them to raise the price of the add-on significantly above cost yet still make sales of add-ons to consumers. We consider this question below.

There are two ways in which, in principle, competition could limit the market power arising from the point of sale advantage:

- Competition from other add-ons. If consumers can shop around for the package of primary product and add-on before deciding on the primary product provider and can and do take into account the price and quality of the add-on products alongside the price and quality of the primary product in making their choice, then suppliers would compete in terms of the overall package. This could limit the ability to raise price of the add-on.
- Competition from stand-alone alternatives. If there are stand-alone alternatives which consumers are aware of and which they take into account when purchasing add-ons, this can put competitive pressure on add-on suppliers to offer a good deal.

This chapter considers whether the conditions for effective competition from either bundles or stand-alone alternatives exist. We look at what information is available to consumers and when it is introduced, and what this means for effective competition for bundles. We consider the availability and characteristics of stand-alone alternatives, and whether these can exert a constraint on add-on prices for the products in the study. We briefly assess concentration, barriers to entry and expansion, to understand whether there were other factors limiting the number of available suppliers of add-ons.

We go on to consider what the market power derived from the add-on point of sale advantage translates into in terms of outcomes. We consider whether prices are above cost, whether consumers receive poor value, and what profits different firms involved in the sale of add-ons are able to make.

Availability and presentation of information

As set out in chapter 3, an important factor in assessing the effectiveness of competition is the availability of information to consumers. Consumers need to have access to the right information at the right time to be able to assess options and make effective choices.

We therefore considered what information is available to Consumers in terms of product information and price of add-ons, and also when important information is introduced in the sales process.

Consumers most commonly encounter add-ons in one of two ways – as part of a point of sale offer for a primary product (for all add-ons) or when shopping around for primary product on a price comparison website (generally only for add-ons sold alongside home or motor insurance). We did not review firms' conduct or their compliance with existing FCA rule requirements; however, we are able to make some observations on the basis of the sales processes that we have seen.

We found that when add-ons are purchased alongside a primary product (without using a price comparison site) they are often offered toward the end of the sales process. We found a lot of variation in the level and quality of product and price disclosure. In some cases consumers are given detailed explanations of the cover and any exclusions and prices are disclosed separately for each add-on. In others there appears to be little or no information given about the add-on product.

When the primary product (usually motor or household insurance) is purchased via a price comparison website, consumers' search results usually show the most common (although not all available) types of add-ons for the primary product. Prices for add-on products are usually shown, but these prices can often be indicative or in the form of a range. Comparing overall bundles offered by different providers is further complicated by the fact that the search results do not give a total price for the primary product and the listed add-ons. There is also usually no or very little information given about the cover until the customer clicks through to the primary provider's website. Additional add-on products might also be offered to the consumer by the provider later in the sales process.

Whichever distribution channel is used, we found that there is often little or no information about add-ons available before the primary purchase starts. We also found that it is not uncommon for consumers to be offered multiple add-ons, irrespective of distribution channel. We found no examples of consumers being offered information about stand-alone alternatives to add-on products as part of an add-on sale.

Our findings suggest that firms' information disclosure relating to add-ons does not currently facilitate effective competition. In particular, we are concerned that the timing of when the information is provided can contribute to consumers not being able to weigh up options effectively to help them make an informed choice.

As we outlined in chapter 4, our research shows that revealing the price of the add-ons later in the purchase process significantly deters shopping around for insurance and makes consumers less able to choose the cheapest deal of those available to them. Moreover, multiple (and sometimes indicative) add-on prices and poor quality information or no product information at all make it difficult for consumers to assess and compare overall offers from primary providers.

As set out in chapter 2, our rules currently require that firms take reasonable steps to ensure that a consumer is given appropriate information about a policy, so that they can make an informed decision about the arrangements proposed. The rules require that this information be given "in good time", so that this decision can be made. Our guidance states that, in determining what is "in good time", a firm should consider the importance of the information to the consumer's decision making process and the point at which the information would be most useful. Our rules apply to add-on sales in the same way as stand-alone sales.

This market study was not designed to review firms' conduct or their compliance with existing FCA rule requirements. However, our findings suggest that some firms' sales practices might currently not be fully in compliance with our regulatory requirements. We reflect on this further in chapter 7.

Competition from other add-ons/ between bundles

As set out above, the consumer will typically only find out about the existence and characteristics of the add-on product once they have chosen the primary product. This is consistent with the findings of our review of advertising by firms selling add-ons, which showed that suppliers typically focus their advertising on the price and features of the primary product and not the add-on insurance products.

Therefore in most cases the consumer cannot compare the package price before they approach the seller. This raises the costs of search to the consumer, and so reduces the amount of shopping around for add-on products.

In addition, we note that add-on buyers are constrained by limited information about price and quality available to them about the add-on. In addition this information is often presented very late. Our behavioural experiment showed that many consumers struggled to compare bundles of add-on and primary product, in particular when the two prices are not disclosed at the same time.

Based on our findings we consider that, for each of the products that we looked at, consumers cannot easily take into account the price of add-ons in their choice of primary product provider. This limits the effectiveness of competitive pressure on the price and quality of add-on products. Competition for add-ons is not currently effective in terms of consumers shopping for bundles of primary product and add-ons.

Competition from stand-alone alternatives

This section considers the extent to which stand-alone products constrain the add-ons in our study.

Availability of stand-alone alternatives

As noted in chapter 3, all products in the study are available on both an add-on and stand-alone basis, but the availability of stand-alone alternatives varies. For travel and home emergency insurance there are widespread stand-alone alternatives to add-on sales. In fact, stand-alone sales form the majority of sales. Gadget insurance is available on a stand-alone basis from a number of online sellers.

For GAP there is a much more limited stand-alone market. Stand-alone suppliers of GAP insurance exist, primarily selling online, though currently they make up a very small market share.

In the past there have been a range of stand-alone alternatives to personal accident insurance. However, we note that in recent years a number of suppliers have stopped selling new stand-alone personal accident insurance policies, citing the high marketing costs associated with identifying and contacting customers.

Of the products, only travel is available on a stand-alone basis on price comparison websites. The greatest apparent constraint from stand-alone alternatives is in travel insurance.

Comparability of stand-alone alternatives

For stand-alone sales to constitute a genuine alternative to add-ons for consumers, add-on and stand-alone policies need to be directly comparable in terms of price and quality. However, in general we find that this is not the case. **We found that stand-alone alternatives tended to be more expensive (with the exception of GAP), but also tended to offer better or more extensive cover (again, GAP is the exception).**

For example, most add-on home emergency products will only provide cover for emergency situations, such as a boiler breakdown. Similar stand-alone alternatives are available, but often home emergency cover sold stand-alone will be far more extensive and cover, for example, the cost of an annual service for a boiler or heating system in addition to emergencies.

Similarly stand-alone gadget insurance may cover more than one device, while add-on insurance sold by the gadget retailer is typically linked to the specific device the consumer has just bought.

Travel insurance sold as an add-on is typically associated with the particular journey or holiday with which it is being sold. By contrast stand-alone policies can be single trip or multi-trip policies.

For GAP insurance, typically add-on and stand-alone policies offered similar levels of cover so were more directly comparable.

Given the different nature of add-on and stand-alone products, in general we were not able to compare them in a way that allowed us to draw any definite conclusions about the price/cover relationship and to conclude that add-ons were either generally more expensive or cheaper on a like-for-like basis. However, we consider the extent to which add-ons are priced above cost and whether this results in poor value to consumers later in the chapter.

The one exception to this is GAP. **Our analysis of GAP policies for price and quality shows that, in most cases, add-on GAP policies are significantly more expensive than stand-alone products for similar levels of cover.**

Assessment of the constraint offered by stand-alone policies

With the exception of travel insurance, competition from stand-alone products does not appear to constrain the pricing and conditions of add-on insurance. We asked distributors whether they thought that stand-alone prices constrained add-on prices. Out of four GAP distributors that responded (all add-on distributors), none thought stand-alone prices were a constraint. Responses were similar for other products, with the exception of gadget where a sizeable minority of firms considered that stand-alone gadget prices were a constraint on add-on prices. **Overall, the large majority of firms that responded did not consider stand-alone prices as a constraint to add-on prices.**

This raises the question of whether stand-alone products might be a greater constraint on add-on prices if only consumers shopped around more and considered stand-alone alternatives. A change in consumer behaviour might have an impact on the extent to which add-ons are unconstrained by stand-alone products. However, we note that at present, the differentiation between add-ons and stand-alone products in terms of cover or quality means that, in practice, shopping around is likely to be difficult, and consumers would be shopping for different types of products rather than exploring alternatives on a like-for-like basis.

The notable exception to this is GAP insurance. While GAP add-on prices are equally unconstrained by stand-alone offers, our analysis of price and quality shows that GAP is the product where there is likely to be a strong case for promoting shopping around. While the cover is similar, stand-alone products appear to offer the opportunity to save significant sums of money relative to add-ons. The relatively high cost of the product (on average around £300 when sold as an add-on) means that the potential savings are likely to outweigh any additional costs incurred from shopping around.

Barriers to entry and concentration

Competition might be constrained by barriers to entry or expansion, and high levels of concentration might suggest competition is not effective. We therefore considered the ease with which new insurance distributors could enter and provide the selected insurance products. We looked at recent examples of entry and whether firms currently distributing an add-on product felt there were barriers to entry that would prevent them distributing other add-on products.

For each of the chosen products, we were provided with a number of examples of entry by distributors in recent years. At least three examples were given for each product. In our survey we asked distributors how easy it would be for them to start providing each of the five products included in the study that they were not already providing. For each product, at least three firms considered that it would be fairly easy to start providing it. The examples of entry provided related to both stand-alone and add-on products.

Overall we found no evidence of significant barriers to entry into either underwriting or distribution of the add-on products.

If there are few suppliers in a market there can be concerns about lack of competition and choice for consumers. We estimate that, for personal accident, gadget and travel insurance, the largest distributor accounts for at most 35% of total product sales, and in most cases considerably less. British Gas is the largest supplier of home emergency insurance. However, we note that there have been a substantial number of recent entrants distributing home emergency insurance in recent years.

Indicators of competition and value: Claims ratios, mark-ups and profitability

We now look at a number of indicators of whether competition in the supply of the add-on and stand-alone products is effective. We examine the scale of mark-ups that the point of sale advantage allows distributors to charge, the profitability of distributors and insurers, and the claims ratio. These indicators provide insight into the value for money for consumers provided by add-ons, and the extent of competition.

Claims ratios[25]

The claims ratio shows the value of claims paid out as a percentage of the premiums paid[26], and indicates what financial benefit consumers might expect to receive on average for every £1 that they spend on a product.

For example, a claims ratio of 10% on an insurance product would indicate that for every £100 a consumer pays in premiums and Insurance Premium Tax (IPT), the insurer pays out on average £10 in claims. As such, in a single measure the claims ratio combines average frequency of successful claims, the average claim value paid out by the firm, and the price paid by the consumer.

The lower the claims ratio, the worse value for money the product provides; and, other things being equal, the more a distributor is able to increase price above cost.

The claims ratio of a product is a measure commonly used by firms to consider product value, although the basis for calculation can vary. A number of the firms sampled as part of this study use similar claims ratios as part of their ongoing management reporting and product reviews.

Consideration of claims ratios has also been an integral part of other competition studies for similar products, for example the OFT's work on Extended Warranties[27] and the Competition Commission's ongoing consideration of add-ons as part of its investigation of the Private Motor Insurance market.[28]

25 Annex B sets out more detail about how we calculated the claims ratio from the data we received from firms, the analysis we performed and our detailed findings. We were unable to obtain reliable information on claims ratios for gadget insurance, which is why no figures are provided for gadget here.

26 For all calculations of claims ratio in this analysis, retail premiums paid include Insurance Premium Tax (IPT).

27 The OFT found that competition issues in the supply of extended warranties resulted in higher prices and relatively low claims ratios (albeit higher than most of the products in our sample).

28 The Competition Commission found that some of the claims ratios were extremely low, especially for motor legal expenses insurance, personal injury cover, key loss cover and extended foreign use cover which all had unweighted average claims ratios of below 30%.

The claims ratios for the add-on and stand-alone products in the study are:

Table 5.1 Claims Ratios

Product	Weighted average claims ratio % (2008 to 2012)	
	Add-on sales	Stand-alone/ deferred add-on sales
GAP insurance[29]	10%	–
Home emergency[30]	25%	28%
Personal accident[31]	<9%	15%
Travel	52%	42%

Source: Responses to market study data requests

The claims ratio results above show that, with the exception of travel, the sampled products are poor value, especially when compared to core insurance products. For comparison, the average net loss ratio[32] across all personal insurance lines (including motor, household and other categories) for the 2012 regulatory returns was 64% (with 53% for household and 80% for motor).

The claims ratios for add-on sales of GAP and personal accident indicate particularly poor value. For home emergency add-on sales, nine out of the ten firms that provided 2012 claims data or pricing model data had claims ratios below 30%. This is still low compared to the average across core products, or indeed when compared to travel, the better performing product in our study.

We also note, however, that our data shows that low claims ratios are not restricted to add-ons. We equally see, for example, a very low claims ratio for stand-alone personal accident insurance.

In their responses to our firm survey, **several firms across different products indicated that claims/ loss ratios below 30% would be a cause for concern from a consumer value perspective**, and three firms recognised in their internal documents that their home emergency and personal accident products did not offer good value to consumers. One firm reported for its home emergency product with a loss ratio of about 14% that "*in aggregate the return (claim pay-out to the customer) is relatively low compared to the premiums collected.*" A second firm selling home emergency identified internally that one of its home emergency products had a low loss ratio (26%) and was taking steps to offer greater customer value. Another firm selling personal accident as an add-on reported that a claims ratio of between 15% and 20% represented a "*danger of apparent 'profiteering' given estimated PA profitability/ claims ratio*".

While it is a very useful measure, we recognise that there are some limitations associated with the claims ratio. For example:

- The claims ratio can vary from year to year depending on the incidence of claim events. We would not expect significant variation over time in claims for gadget, personal accident or GAP insurance which are largely made up of independent events. However, there may be some variation for travel insurance in response to significant events that affect many travellers, such as the volcanic ash cloud in 2010 and the Asian tsunami in 2004. In addition, home emergency claims ratios could be impacted by extreme weather conditions.

29 For GAP stand-alone sales we did not have the data to calculate the claims ratios.
30 For home emergency, the claims ratios have been calculated using a simple average of the 2012 data or firm pricing model information.
31 For personal accident add-on sales, the claims ratios have been calculated using a simple average of the 2012 data and/or firms' pricing model information.
32 The net loss ratio is broadly similar to the claims ratio calculation in this report, although IPT will not be included in the calculation

- The claims ratio does not capture non-financial benefits, such as the peace of mind a product may provide to a consumer. Insurance does not necessarily have to be claimed upon to have value to a consumer.

- A low claims ratio does not does not always imply high profitability. The claims ratio calculation will not include other costs incurred in the supply of insurance products, such as distribution costs, operating costs and claims handling costs.

We therefore considered additional indicators of competition and value for money, which are described below.

Claims frequency
One factor that influences the claims ratio is the frequency with which consumers claim. We expect claims frequencies to vary according to:

- consumer awareness and understanding of their policy

- the extent of cover provided by the policy

- the likelihood of consumers experiencing claims events

As expected, given the different risk covered, claims frequencies varied significantly between the sampled products. Claims frequencies were typically lower for add-on sales compared to stand-alone sales. Differences in cover (with add-ons generally having lower cover) will account for part of this difference. **But our findings in chapter 4 also show that consumers buying on an add-on basis will be less aware of owning the product, less likely to have actively sought out the product and less likely to have been aware of the product before the day of purchase. We expect that this contributes significantly to lower claims frequencies for add-on products.**

One large insurer identified that even for comparable products sold on an add-on and stand-alone basis the claims frequency would be significantly higher for the stand-alone sales. In addition, there were examples of net rates[33] for comparable products being significantly higher for stand-alone products compared to add-on products, consistent with different expected claims frequencies.

The claims frequencies for GAP and especially personal accident are very low. Claims frequencies for personal accident add-on sales for a majority of firms in the market were around one claim pay-out per 20,000 to 25,000 policies in force per year. The claims frequencies varied significantly between firms for the sampled products.

We note that where claims frequencies are very low there is little opportunity for consumers to learn from their claims experience, and understand how financially valuable a product really is.

33 Net rate is the amount charged by an insurer to the distributor for an insurance product and is discussed further below.

Table 5.2 Claims Frequency

Product	Weighted average annual claims frequencies % (based on claims settled over the period 2008 to 2012)	
	Add-on sales	Stand-alone sales
GAP insurance	0.3%	Insufficient information
Home emergency	5%	58%[34]
Personal accident	0.05%	0.15%
Travel	3%	4%

Mark-ups on net rates

The claims ratio reflects the performance of products and the monetary value they have delivered to consumers. The claims ratio can be affected by unexpectedly high or low levels of claims events. We therefore also considered the net rates of the products in our study and compared these to retail prices.

The net rate is the amount charged by an insurer to the distributor for a product. This rate reflects the insurer's expected claims costs (including settlements and claims handling), operating costs and the insurer's expected profit.

Comparing the net rate with retail prices allows us to examine the expected mark-up from net rate to retail price for an individual product, and tells us something about the ability of distributors to increase price above the core insurance costs they pay. For example if a product with a retail price of £100 has a net rate of £25 then the distributor has been able to increase the price of the product by £75 above the core insurance costs (though they will need to pay for distribution and other costs out of this amount). A very large difference between net rate and retail price can also indicate poor value. For a product retailing at £100 but with a net rate of £25, the maximum expected claims ratio would be 25% and in fact the claims ratio would be expected to be lower than this to allow for the insurer's other costs and profit.[35]

We obtained a range of information on net rates and retail prices for the products in our study.[36] For 20 add-on products (with retail prices less than £100) sold by 12 firms in the sample covering GAP, home emergency and personal accident, the simple average percentage of the retail price retained by insurers was 23%. **This means that, for these products, less than a quarter of the premium paid by retail customers goes towards paying the insurer to cover claims, other costs and the insurer's profit margin. The remainder of the premium is retained by the distributors and other firms in the supply chain where applicable.**

For some products the net rate payable was even lower. We saw examples of add-on personal accident insurance products where the net rate paid to the insurer was £2 for a policy with a retail price of over £25. The maximum expected claims ratio for these products would be less than 8%[37]. The following table sets out some examples of the net rate to retail price differences for a number of the sampled products sold during the period 2008 to 2012:

34 The claims frequency of stand-alone home emergency sales (calculated in the table on a simple average basis) will cover some products with annual boiler service included, which accounts for part of the difference between the add-on and stand-alone frequency.

35 In this example, the net rate of £25 would include all the insurers expected costs and profits/ losses, and if the claims cost accounted for £15 of the £25 going to the insurer the claims ratio would in fact be 15%, being £15 divided by £100.

36 Net rates are only available where the distributor contracts with an insurer/underwriter and not where the insurer is also the distributor.

37 £2 as a proportion of £25 is 8%. The costs of claims handling, other insurer costs and the insurer a profit margin will also have to be covered by the £2, so the expected claims ratio would be lower than 8%.

Table 5.3 Net rates and (actual or estimated) retail prices

Product	Net rate £	Retail price (including IPT) £	% price retained by insurer
GAP insurance – stand-alone			
– Simple average of a range of 3 year GAP products	63	129	49%
– Simple average across range of top selling GAP products	85	152	56%
GAP insurance add-on			
– 3 year GAP products for a variety of insurers	44	>360	<12%
– Average across GAP products for one firm	62	317	20%
Personal accident stand-alone			
– Example 1	9	>£50	<18%
Personal accident add-on			
– Example 1	2	>25	<8%
Home emergency stand-alone			
– Example 1	47	>90	<52%
– Example 2	43	>200	<22%
Home emergency add-on			
– Example 1	17	>65	<26%
– Example 2	16	>55	<29%
Travel – stand-alone			
– Example 1	14	>30	<47%
– Example 2	27	>42	<64%

Table 5.3 shows that for GAP add-on, home emergency add-on and personal accident (for both add-ons and stand-alone), there are a number of examples of products with low net rates relative to retail prices.

Low net rates relative to retail prices therefore suggest poor value to consumers and high mark-ups for distributors, and indicate that competition is not effective.

In assessing whether prices could be lower in a more competitive environment we need to take account of distribution costs, which will need to be met out of the mark-up. If distribution costs were high, relative to the mark-up, the scope for competition to reduce prices would be limited.

However, the evidence we received indicated that the incremental distributional costs of add-ons tend to be very small both in absolute amounts and relative to retail prices, as they represent incrementally very small costs in addition to the costs of distributing the primary product. For example, one distributor identified that for one of its add-on products, they would incur an additional £1 in incremental costs for a product priced between £50 and £60. Distributional costs were more significant for stand-alone providers. This difference in distributional costs is reflected in the results of our analysis of distributor profitability.

Firm profitability[38]

In order to help understand the nature and extent of competition for the five products in our study, we looked at the profitability of firms in the supply chain. High profits may indicate that competition for these products is not effective. While there can be a number of firms that perform a role in the supply chain, we focused on the underwriters and distributors (distributors here includes insurers distributing their own products). We were interested to understand both the level of profits and who made them.

We compared the profits and losses for add-on and stand-alone products for both insurers and distributors. Although we requested data from more than 80 firms, a majority of firms (especially distributors) were not able to allocate costs in a meaningful way across specific product lines, which hindered the assessment of profitability by product.

As well as data submitted by firms, we also examined firms' own internal documents where relevant. These covered product design, product review and strategy papers, management accounts, commercial agreements and other relevant material.

Insurer profitability

Insurers measure profitability by calculating the Combined Operating Ratio (COR), calculated as the insurance cost, including incurred claims and operating expenses, divided by the earned premium. A ratio below 100% indicates an underwriting profit, for example a COR of 91% would indicate an underwriting profit of 9%.

Generally we found that insurers were not earning high profits from the underwriting of the sampled products for both add-on and stand-alone products. The summary results over the period 2008 to 2012 were:

Table 5.4 Combined Operating Ratios

Product	Average weighted COR %[39]	
	Add-on sales	Stand-alone/ deferred add-on sales
GAP insurance	97%	–
Home emergency	92%	92%
Personal accident	Insufficient information	48%
Travel	95%	100%
Gadget	Insufficient information	94%[40]

Source: Responses to market study data requests

With the exception of personal accident, fewer than 10% of insurers were able to consistently generate COR percentages of less than 80%. For personal accident, one firm appeared able to generate consistently high profits from the underwriting of this product line. By way of comparison, the 2012 COR ratios from the regulatory returns for personal household and personal motor were 94% and 104% respectively.

38 Annex B contains more detail about how we assessed insurer and distributor profitability, including detailed examples, methodology, analysis and analysis limitations.

39 For add-on personal accident and gadget and GAP stand-alone we did not obtain sufficient data to enable reliable COR percentages to be calculated.

40 Based on a limited sample of data

Distributor profitability

The number of distributors who were able to provide reliable profitability data on the add-on product sales was limited. Some distributors were not able to separate the add-on costs from the costs of distributing the primary products, and other firms allocated costs by telephone and online sales but not by product. However, there were a number of distributors who were able to allocate costs between product lines and the data from these firms, including internal management information, was used to assess profitability.

The results for the distributor profits for four of the five sampled products over the period 2008 to 2012 were as follows:

Table 5.5 Distributor profitability

Product	Weighted average profit beforre tax %	
	Add-on sales	Stand-alone/ deferred add-on sales
GAP insurance	62%[41]	12%
Home emergency	57%	29%[42]
Personal accident	59	55%
Travel	–[43]	5%

Source: Responses to market study data requests

Overall the distributors of add-on products on which we were able to obtain profitability figures were able to generate high profits on the distribution of the sampled products, compared to stand-alone sales. This finding is consistent with our wider findings. We believe that this high profitability is driven by low demand-side pressures on firms, the primary product point of sale advantage enjoyed by add-on sellers, the high mark-ups from net rates and low incremental distribution costs.

The profits earned by distributors of stand-alone products were significantly lower than for add-on distributors. Stand-alone distributors tended to have significantly higher distribution costs, including higher marketing and advertising costs.

The exception to the above is personal accident, where we observe comparatively high profits for distributors across both add-on and stand-alone. However, we are aware that for stand-alone personal accident over the period 2008 to 2012, firms in our sample tended to have steady or declining books of business which did not have the high marketing and sales costs associated with generating new stand-alone business. We also note that the claims ratio for stand-alone personal accident insurance is low, indicating poor value for money for these consumers.

The findings were supported by a review of internal firm papers, which confirmed the low costs incurred in distributing the add-on products (including minimal marketing and advertising) and higher profits compared to stand-alone distributors. There were additional indicators that the add-on profit before tax figures set out above may be even higher, and above 80% for certain firms. Several firms provided internal governance documents that indicate that they recognise that profits on their add-on products were high and/or the value for consumers was low.

It may be that the profits made by distributors in respect of add-ons are competed away in the market for the associated primary product. Our observations on this so-called 'waterbed effect' are set out in chapter 6.

41 Based on a limited amount of information of pricing and profitability information.

42 For home emergency stand-alone/ deferred add-on the percentage has been based on the simple average rather than the weighted average.

43 The data provided for add-on travel was not sufficient to enable a reliable profit before tax percentage to be calculated.

Profitability summary

The profitability analysis showed that:

- Insurers did not generate high profits from the underwriting of the sampled products for either add-on or stand-alone sales, with the exception of personal accident where underwriting performance varied between firms.
- Commercial terms between insurers and distributors appeared weighted in favour of distributors.
- Some add-on distributors can generate high profits on the sampled products, and the high profits appear to be driven by a combination of high mark-up from insurance cost to retail price and very low incremental distribution costs. We believe that this in turn is made possible by the weak consumer engagement that is associated with the add-on mechanism.
- Stand-alone distributors did not generally earn high profits on the sampled products.

These findings are consistent with previous analyses of competition in such markets. For example, the Competition Commission's analysis of PPI found that insurers typically did not earn high profits but that high profits were earned by distributors, to whom the point of sale advantage accrues. The Competition Commission's provisional findings for the private motor insurance investigation published in December 2013 identified that motor insurers generate lower claims ratios (and hence greater profits) from the sale of add-ons than the sale of the core motor insurance.

In summary

Our overall finding is that add-on distributors possess a point of sale advantage that leads to weak competition for each of the products, with the possible exception of travel insurance. The consequence of weak competition is that prices of add-ons are typically high relative to underlying costs; consumer value for money is poor, exceptionally poor in some cases. However, we also note that consumer value for money can be poor for some of the stand-alone alternatives we looked at, indicating wider issues of how well consumers are able to assess value for money for insurance products.

6
Impacts on consumers and markets

In this chapter we consider the scale of the impacts on consumers. We have estimated the size of the overpayment for add-ons relative to a more competitive benchmark using various assumptions about the value for money that could be achieved in these markets.

Our most conservative estimate of the scale of overpayment is that consumers are overpaying by £108m for the products in the Study, compared to overall add-on sales of £500m. On alternative but still plausible assumptions, that overpayment rises to £216m.

We recognise that some of this overpayment may be competed away in lower prices of the primary products. In other words, where consumers pay too much for the add-on, some of this this may be returned to them (rather than retained by the firm) through a corresponding reduction in the price of the primary product.

However, we consider that it is unlikely that all of the overpayment would be competed away. Even if it were, we would still have concerns about such a substantial distortion in relative prices.

We conclude from this analysis that there is overpayment that is significant enough for us to intervene in respect of general insurance add-on markets

In this chapter we consider the impact of ineffective competition on consumers. We do this by calculating the amount by which consumers may be overpaying when buying the add-ons in our study.

Consequences of weak competition and consumer harm

From the analysis in chapters 4 and 5, we conclude that competition in the market for general insurance add-ons is not effective. The add-on mechanism leads to weak consumer engagement with the add-on purchase and consumers exert little pressure on firms in terms of the pricing and quality of their products. Add-on sellers enjoy a clear point of sale advantage, which is further exaggerated by consumer behaviour, and are able to charge prices significantly above cost for their products. Consumers can get poor value as a result.

There are broadly three ways in which consumers buying general insurance add-ons might be harmed when competition is not working.

Consumers pay too much: The point of sale advantage combined with the relative lack of price sensitivity and shopping around by consumers can be exploited and lead to prices substantially above costs. This can lead to consumers paying too much for their insurance relative to a more competitive situation.

Consumers do not buy at all: Some consumers may be put off by the high prices and do not buy at all. These consumers might have valued the add-on insurance product at a lower competitive price. These people lose out on insurance that they would find valuable in a more competitive world.

Consumers buy the wrong thing: Our consumer surveys have demonstrated that consumers' awareness and understanding of these add-on insurance products is low. This could lead to consumers not buying the product that best suits their needs. This is made worse by the add-on mechanism since consumers are naturally focused on the features of the primary product.

All three measures are important to understand how consumers may be harmed from ineffective competition. However, for the purposes of this study, we have focused on analysing the extent to which consumers may be overpaying for general insurance to give our assessment of consumer detriment. We use the claims ratio as the basis of our calculations. We note that while we have not explicitly sought to calculate the harm to consumers from buying the wrong product, to the extent that poor consumer understanding or buying the wrong product leads to fewer insurance claims, this will be reflected in the claims ratio which underpins our overall detriment calculation.

Consumer overpayment

Although we did consider the profitability of both underwriters and distributors (as described in the previous chapter), the complexities of the supply chain and the well-documented difficulties with identifying 'excess profits' meant we did not consider this the best basis for estimating the extent of any overpayment. Instead we use the claims ratio as the basis for our calculation of potential overpayment. This approach is consistent with previous analysis of similar products such as extended warranties by the Office of Fair Trading (OFT) and Competition Commission (CC).[44]

To assess the extent that consumers may be overpaying for add-on insurance products we have compared what consumers currently pay to what they would pay if the claims ratio were closer to a competitive benchmark. In effect we hold the claims volumes constant and estimate how much premiums would need to fall to reach the benchmark claims ratio. We note that, after the OFT investigated in 2002 and the CC required changes to the sales process for extended warranties in 2005, prices fell significantly and the claims ratio increased from around 20% to 50%.[45]

We used a range of claims ratios from 30% to 50% as the potential competitive benchmark. This is a deliberately conservative approach. Data from the FCA 2012 annual insurance returns show that for general insurance products as a whole the average claims ratio is 64%. For some general insurance products such as motor insurance it is as high as 80%. Therefore when looking at benchmarks of 30 to 50% we believe that we are being conservative in estimating the overpayment.

For some low priced add-on insurance products the underlying insurance cost of the cover may be relatively small, while the minimum cost of distributing the product may be relatively large as a proportion of the price. For such products, it might not be cost effective to continue to distribute those products after a fall in their prices that would be required to improve their claims ratios to our benchmark levels. In our most conservative estimate of overpayment we therefore capped the implied reduction in retail price to 50%.[46]

44 Office of Fair Trading, Extended Warranties on Domestic Electrical Goods: An OFT market study February 2012: http://www.oft.gov.uk/shared_oft/markets-work/OFT1403.pdf;
Competition Commission, Private Motor Insurance Market Investigation, Provisional Findings Report 17 December 2013. http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/provisional_findings_report.pdf

45 Office of Fair Trading, Extended Warranties on Domestic Electrical Goods: An OFT market study February 2012: http://www.oft.gov.uk/shared_oft/markets-work/OFT1403.pdf; page 5

46 Without this restriction the implied comparative price could be more than 90% lower than the current price.

Taking these factors into account, **we conservatively estimate that for the five products in our study, using estimated claims ratios for 2012, consumers are overpaying by between £108m and £216m. The total sales of the five add-on products in the study are £500m. This estimated overpayment is therefore large both in absolute value and relative to the size of the add-on sales. Over a half of this estimated overpayment is accounted for by just one product – GAP insurance**.

Table 6.1 Estimates of overpayment by product

	Estimated market size – Add-on sales only (£m)	Overpayment relative to a more competitive market (£m)		
		Benchmark Claims Ratio		
		50%	30%	30%*
Travel	270	29	–**	–**
Personal Accident	38	36	35	19
Home emergency	39	20	7	7
GAP	152	121	100	76
Gadget	19	11	6	6
Total	518	216	147	108

*The maximum price fall is capped at 50% of the current retail price in this case
**There is no overpayment for travel relative to a 30% benchmark as the current claims ratio exceeds this level
***Given limited information on Gadget insurance claims ratios we have estimated the 2012 claims ratio using information on other products in the study.

Source: Study estimates based on data responses

The existence of a potential waterbed effect

There may of course be a 'waterbed effect' in the sale of add-on insurance products. Any excess profits resulting from high prices for add-on insurance products may be competed away in the markets for primary products alongside which add-ons are sold, and passed on to consumers in the form of lower prices for the primary product.

We have not attempted to analyse the extent of any such waterbed effect in these markets. To do so would have involved the analysis of the sale of many primary products along with all the associated add-on products, which was not within the scope of the study.

Furthermore, **even if we found that the waterbed was complete (that is, all excess profits on add-on insurance products were competed away in the markets for primary products), we would still have concerns about the distortions and cross-subsidies arising in these markets** because:

- Consumers who would purchase the add-on insurance at a competitive price might still not be purchasing it because add-on prices are too high
- Consumers who purchase add-on insurance products might still be subsidising consumers who purchase only the primary product but not an add-on
- The overall deal to consumers would still be opaque, which in itself can weaken competition

Therefore, notwithstanding any waterbed effect, based on our estimates of consumer overpayment there is still scope for substantial consumer harm in the markets for add-on insurance products.

We conclude from this analysis that there is overpayment that is significant enough for us to intervene in respect of general insurance add-on markets, and we discuss our proposed remedies in chapter 7.

7
Remedies

In this chapter we set out a number of remedies that we believe will strengthen competition in add-on markets by improving the way add-ons are sold and putting pressure on firms to improve product value.

In particular, we propose to:

- Impose a deferred opt-in on add-on sales of Guaranteed Asset Protection (GAP) – we will break the point of sale advantage enjoyed by those selling add-on GAP by mandating that the sale cannot be concluded at the point of sale of the car or car finance but only at a later point, and that the consumer must be given information about alternatives if the product is offered at the point of sale at all.

- Ban pre-ticked boxes (so-called 'opt-outs'), for the sale of add-ons-because of the negative impact they have on consumer behaviour and consumer outcomes.

- Require firms to publish claims ratios – we want to shine a light on low-value products and increase pressure on firms to improve product value.

- Improve the way add-ons are offered through price comparison websites, focusing in particular on what information consumers can access about add-ons and when this is introduced.

Our proposed remedies will be subject to our formal consultation and cost benefit analysis processes, so interested parties will have the opportunity to comment on the final measures that we propose.

We will also continue to engage with the Competition Commission on the add-on related parts of their investigation of the private motor insurance market, including the remedies they are considering.

We do not intend to refer this matter to the Office of Fair Trading (OFT) for consideration, but we do intend to use our own extensive powers to address the competition concerns that we find.

In our call for evidence in July 2013, we stated that if it was appropriate, we would set out our proposed solutions for addressing any competition concerns alongside our provisional findings. This chapter describes our approach to identifying remedies and sets out the remedies we intend to take forward.

Summary of our findings

The objective of this market study was to understand whether competition in the markets for general insurance add-ons is effective, and if not, why not. **Our provisional finding is that competition in general insurance add-on markets is not effective, and these markets are broadly not working for consumers.** In particular, we have highlighted that:

- **The add-on mechanism has a real impact on consumer behaviour and affects the way they make decisions.** There is little pressure on firms as add-on buyers are less likely to shop around and are less price sensitive. They have poor awareness of buying products or of the price they paid. Their attention is not on the purchase of the add-on, leading many consumers to buy products they do not need or understand.

- Information about the product is an important component of how a decision is presented and framed for a consumer. **Consumers' ability to assess options and make choices is hindered by the fact that there is insufficient information available relating to the quality and prices of add-ons, and that what information is available is often presented very late.** We have concerns about the impact this has on consumers' ability to make informed decisions.

- **Add-on providers enjoy a clear point of sale advantage, which is further strengthened by the way consumers respond to the add-on mechanism.** Competition between bundles (package of primary product and add-on) is not effective, and stand-alone products do not constitute a constraint for sellers of add-ons. **Our analysis shows that this can translate into poor value and prices significantly above cost for many add-on products.** Competition is clearly not effective in lowering prices or improving the quality of many add-on products.

- Add-on insurance often represents poor value for money, but **we found instances of poor value for stand-alone products too**, and there is currently no easily comparable measure of the value of an insurance product.

- **Ineffective competition translates into consumers paying too much when buying the products in our study as add-ons.** The scale of this overpayment or market distortion is such that we believe there is a clear case for us to take action.

Our approach to selecting remedies

Our objective in considering remedies has been to identify solutions that will promote competition that is more effective and works in the interest of consumers. Our thinking is informed by behavioural economics, and draws on our extensive consumer research into how consumers actually behave and react to the sales environment.

We want our proposed remedies to work towards achieving one or both of our stated goals:

- **First, we want to improve the add-on sales mechanism to help consumers make better decisions when buying add-ons.** We want consumers to be in a better position to decide whether they need a product, and to be better able to assess the options available and then make a choice that gives them a good deal if they do decide to buy. We believe that this will directly benefit consumers, but will also improve competition because of the increased pressure on the supply chain.

- **Second, we want to put pressure on firms to improve the value and/or quality of products, regardless of whether they are sold as add-ons or stand-alone.** Remedies designed to increase transparency and provide a measure of value for an insurance product should have this effect.

In designing our remedies, we have also taken into account that:

- Add-on insurance is not always poor value. Consumers can get a good deal and it can be an efficient way for firms to sell products.
- We must understand consumers and consider what motivates them. Consumers value convenience and how easy the process of buying what they want is. They don't buy just on the basis of product coverage and price, but also for peace of mind.
- Consumers must have access to the right information at the right time, and the way decisions are presented can have a particularly significant impact on consumers' decisions. But we also know that simply providing more information is not the answer, and that disclosure must be smart.
- The issues we identified were not confined to add-ons alone, and where appropriate our remedies should tackle issues in stand-alone markets too.
- Similarly, many of the issues we identified are not unique to the five products in our study, and unless stated otherwise, we therefore consider that our proposed remedies should apply to the wider market.
- Equally, while our research was conducted with consumers, because the findings relate to the effect of the add-on mechanism itself, we believe the findings apply to all customers rather than just those acting in a personal capacity.

Consumer or customer?
This market study focused on five general insurance add-on products that are usually sold to people acting in a personal capacity i.e. a consumer rather than a commercial customer.

However, as the point of sale advantage that we have identified derives from add-on mechanism itself, and not from the particular nature of any one add-on product or customer type, we believe that similar risks of detriment are likely to exist in markets for add-on products sold to commercial customers as well. The level of risk will of course differ depending on the size and sophistication of the commercial customer in question – for example small or medium sized businesses might be more likely to be at risk than large multinationals; however, firms might wish to consider the findings of this report in relation to their business with commercial customers where appropriate.

The Financial Services Act 2012 grants the FCA the power to refer a competition matter to the OFT for consideration, and potential onward referral to the Competition Commission. We do not intend to use this power here, but will instead rely on our own extensive powers to address the competition concerns that we have found.

Our proposed remedies will be subject to our formal consultation and cost benefit analysis processes, so interested parties will have the opportunity to comment on the final measures we propose. Our final remedies may include remedies that we do not set out here. We set out the likely timetable for our consultation in chapter 8.

We will also continue to engage with the Competition Commission on the add-on related aspects of their investigation of the private motor insurance market, including remedies they are considering.

The following sections describe the remedies we intend to take forward.

General insurance add-ons and our rules

As described in chapter 2, sales of add-ons are subject to our rules in the same way as stand-alone products. This market study was not intended to deliver a review of compliance of general insurance add-on sales with our existing rules, and as such, we are not giving a formal assessment of the state of compliance with our requirements. However, our findings suggest that some firms' sales practices are currently not fully in compliance with our regulatory requirements.

We would encourage all firms to note the findings of this market study and firms may wish to review their processes for the design, distribution and sale of all add-on products, and not only those in the sample in our study, to ensure that they comply with existing FCA requirements. This might involve not only a review of compliance with existing FCA rules and guidance on product design, sales and disclosure, but also a wider consideration of whether the firm's business model and processes are achieving the right outcomes for add-on customers. We will be engaging with firms through follow up supervisory work as appropriate.

Our proposed remedies

GAP add-on sales – imposing a deferred opt-in

Our work has raised particular concerns about ineffective competition in the add-on GAP market, and the poor outcomes that consumers experience as a result of this. We therefore want to take action to tackle the problems in this market as a priority.

Why focus on GAP?
GAP insurance stands out relative to the other products in our sample. **The impact of the add-on mechanism on consumer behaviour and decision-making appears to be particularly severe in respect of GAP.** Of the products in our sample, GAP add-on customers were the least likely to shop around (19% said they did). GAP add-on buyers had worse understanding of the product than those who had bought GAP on a stand-alone basis. GAP was generally not a planned purchase and almost two-thirds of add-on GAP buyers (59%) reported not having thought about buying the insurance until the day they bought it. Almost half of customers reported being unaware that they could have bought the GAP insurance elsewhere. This suggests that the point of sale advantage enjoyed by the person selling the car or car finance is particularly strong.

We also note that the particular circumstances of the GAP sale may exacerbate some of the things we know can affect consumer behaviour. For example, GAP is usually sold face to face, and we know that such sales can be particularly persuasive as outlined in chapter 4. In addition, the price of GAP may seem small against a high reference price – that of the car the consumer is about to buy. The consumer is also likely to be more sensitive to risk and receptive to a sale at the point of making what is, for many people, one of the most expensive purchases they will make, and which they will want to protect. Consumers may also be unclear about the actual cost of GAP versus that of the car or the car finance, as GAP may be presented as part of a deal or a way of securing a discount on the primary product.

And yet, shopping around is likely to be particularly worthwhile for GAP. GAP is a comparatively expensive product, relative to other general insurance products in our study, and relative to cost of search. Our evidence also suggests that GAP add-on prices can be significantly higher than stand-alone prices, and could be twice as expensive for broadly equivalent cover.

This is reinforced by the extent of poor value products and consumer overpayment in GAP insurance. Our evidence shows that GAP sold as an add-on is poor value for consumers with around 10% of retail prices paid being paid out in claims – a very low claims ratio. GAP add-on sales made up a significant proportion of our estimate of the yearly overpayment by consumers – £76m out of at least £108m under our most conservative estimate. **The extent of the market distortion strengthens the case for action focused on this product at this stage, rather than relying on our more general remedies proposed.**

GAP is almost exclusively bought as an add-on, and the stand-alone GAP market is at the moment very small. Yet there appears to be significant scope for consumers to save money by shopping around for stand-alone GAP insurance. We believe that a remedy aimed at tackling the point of sale advantage and encouraging consumers to make better decisions about their needs and potentially shop around could lead to a significant stimulus to the stand-alone market and lead to a marked increase in competition for GAP insurance.

We propose to impose a 'deferred opt-in' on the sales of all forms of GAP insurance when sold as an add-on. We have considered an outright point of sale ban but believe that a deferred opt-in is a better option because it is more likely to stimulate competition in the GAP market.

We see a deferred opt-in as a pro-competitive remedy. Our objectives are to:

- restrict the ability of the car salesman to exploit the point of sale advantage
- empower consumers to make a better decision on whether they need GAP and to shop around and find the best value option if they do.

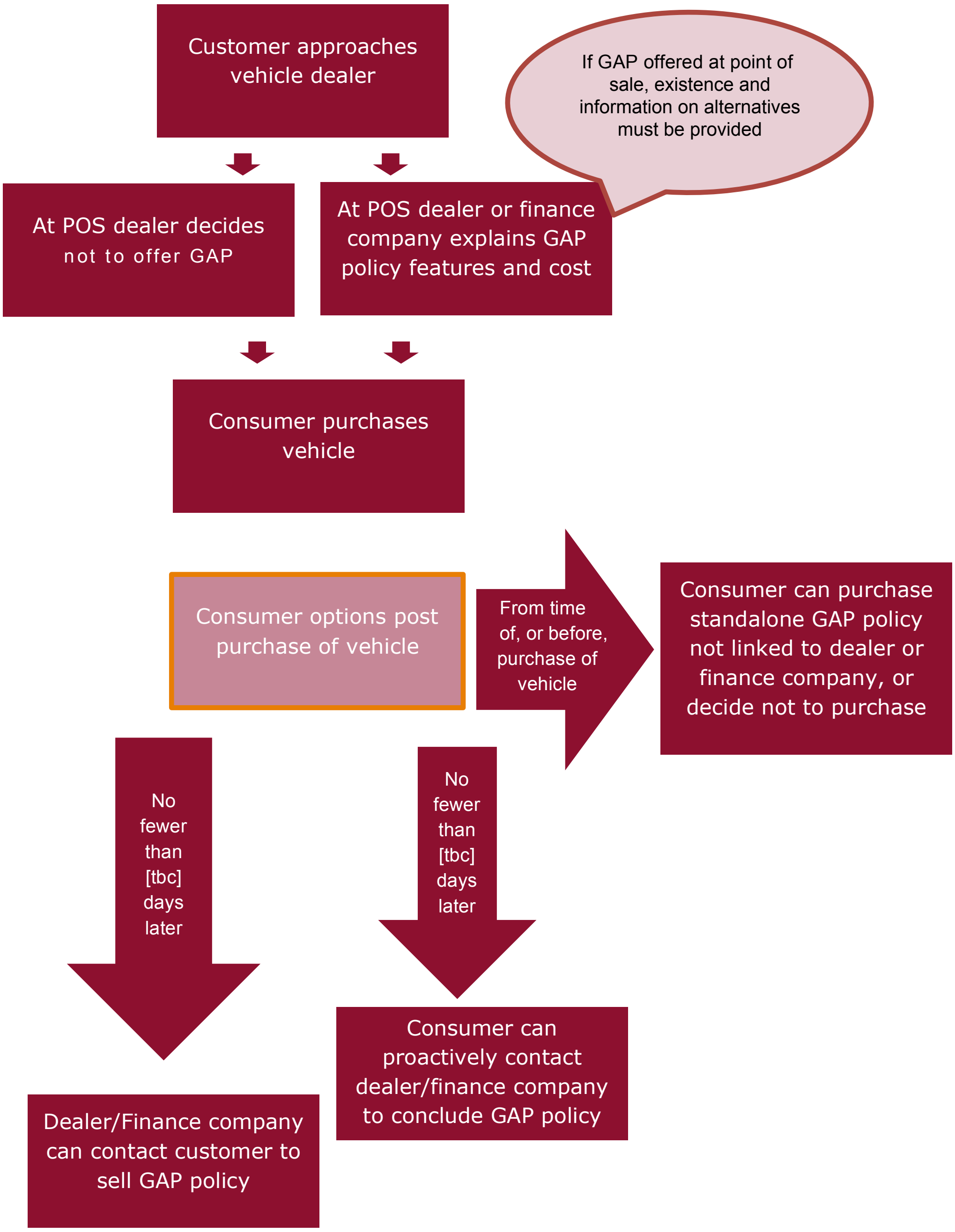
In practice, we envisage that a deferred opt-in would work as follows. GAP could be offered alongside the vehicle/credit, so the sales person could explain what GAP is and offer details of the dealership's policy. However, a GAP sale could not be concluded or take effect at the point of sale of the car/credit agreement. Instead, the consumer would need to confirm proactively that they want the cover after a stipulated period has elapsed. Premiums would only be paid and cover only start after this period.

We would also mandate that if GAP is offered at the point of sale, the customer must be told that they can buy it elsewhere and be given information on how to shop around. This may include a requirement to direct the customer to a useful source of information on how to consider their needs and evaluate the value of a GAP policy in the context of their comprehensive car insurance.

We will also consider how best to improve transparency to help tackle some of the unclear pricing that consumers struggle with when the car and GAP are offered together.

We intend to differentiate between seller-initiated and consumer-initiated contact during the deferred opt-in window. The seller would be banned from contacting the consumer within the stated period to close the deal, but the consumer would be able to proactively contact the seller to close the deal within a shorter period.

Diagram 7.1 shows how we envisage this process working.



We are aware that if the consumer is unable to take out GAP insurance when they buy the car, they may not be covered for the difference between a total loss settlement and the credit debt/invoice price if the car is written off or stolen before the consumer can opt-in to the GAP cover. While we will consider this issue carefully, our assessment at this point is that this risk is minimised by the cover provided by the vast majority of comprehensive motor insurance policies during the first year, particularly for new cars. In addition, the consumer would of course be able to take out stand-alone GAP cover to take effect from the point that they receive the vehicle.

We believe that the deferred opt-in is appropriate given the well-known risks and challenges posed by face to face sales and the particular characteristics of GAP, which is an infrequent purchase, comparatively expensive, not a product that many consumers are naturally familiar with, and where there are genuine savings to be made from shopping around. We will in future consider whether a similar remedy is appropriate for other face to face sales, given the challenges posed by face to face distribution in particular.

Given the clear detriment arising from add-on GAP sales, we intend to introduce this remedy as soon as possible, and we will consult in the near future on our proposed rules (ahead of consultation on the other remedies).

Banning default opt-out sales

An 'opt-out' sale is a sale that requires the consumer to take an active step to opt-out of a purchase. In other words, they need to override a default setting that preselects a purchase for them. Opt-outs commonly take the form of pre-ticked boxes, which the consumer needs to untick. Such opt-outs exploit consumers' well-documented inertia/status quo bias[47], which leads to consumers not taking action.

As we outlined in chapter 4, the available evidence indicates that selling insurance add-ons on an opt-out basis has a detrimental impact on consumer behaviour and outcomes.

For example, as outlined in chapter 4, our Motor Legal Expenses Insurance (MLEI) thematic review showed that the sales rate achieved for one large insurer was 80% for MLEI sold on an opt-out basis, double the 40% rate for MLEI sold on an opt-in basis.

In turn, we also find that opt-out sales can lead to lower claims ratios and frequencies indicating that consumers are less aware of owning a product, or have ended up with a product that they don't need or is not right for them.

The use of opt-outs for the sale of general insurance add-ons undermines effective competition. Opt-outs knowingly exploit consumer biases and can result in consumers not making informed decisions. We therefore propose to ban the use of opt-outs for the sale of general insurance add-ons.

We have previously indicated that the use of pre-ticked boxes and opt-out sales practices does not comply with our requirements that firms treat customers fairly. However, even though it appears that the use of opt-outs is declining, we also have evidence that these practices are still in use, so we propose to make a rule banning the use of opt-outs to put our position beyond doubt.

We note that the Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013 (CCR) come into force in June 2014, and these regulations will ban the use of opt-outs in some but not all circumstances in which general insurance add-ons can be sold. In defining our proposed rules, we will consider the scope and applications of these regulations. We will also be guided by the desire to maximise our ability to take action against firms that do not comply with the ban.

Improvements to how price comparison websites (PCWs) provide add-on options and pricing

Up to 17m[48] motor and home insurance policies are bought every year through PCWs, and many of those will include some sort of add-on product. There is therefore clear benefit in exploring how this distribution channel can be improved from the point of view of the add-on buyer in line with the findings of our consumer and experimental research into consumer buying behaviours.

47 FCA, April 2013, Applying Behavioural Economics at the Financial Conduct Authority

48 GfK Financial Research Survey June 2013

For example, as described in chapter 5, the provision of information about add-ons is very mixed on PCWs. Consumers can often find that they are not given price data at all or are offered a range, meaning that they are only able to assess the full price of everything they want to buy once they have clicked through to the individual insurer's website. These sorts of factors have a harmful effect on the ability of consumers to choose the cheapest price, the most appropriate cover, or indeed the best value package of primary product and add-on.

Improvements to the consumer journey might therefore include consumers being offered optional add-ons early in the journey[49], receive the actual price and/or better product information, or are able to use an improved search function that incorporates add-ons or allows them to search for the whole package. Alternatively or in addition, an alert that add-ons can be bought separately from a different provider may be appropriate.

We intend to complete further work over the coming months to establish what would best meet consumers' needs, while maintaining the key aspects of PCWs that consumers value, such as speed, convenience and ease of use. The consumer research that we have carried out as part of our ongoing thematic work into PCWs[50] will give us valuable insight to inform our remedy development.

We will consider any proposed improvements against our existing rules relating to the provision of information. We will also assess whether proposed improvements might be delivered through market-led solutions, or whether we should make further rules to take forward these measures. We will also consider whether firms should give PCWs product and pricing data for add-ons to facilitate a better customer experience on price comparison websites when it comes to shopping for add-ons.

In refining our remedy proposal, we will also continue to work with the Competition Commission[51] and make sure that we take into account the findings of our thematic review into PCWs.

Publishing claims ratios

Our findings clearly show that there are poor value general insurance products in both add-on and stand-alone markets. We are concerned that there is currently no common or consistent method for measuring the value of insurance products. We want to tackle this general lack of transparency and comparability across the insurance markets and to help increase competitive pressures.

We consider that the claims ratio – which is broadly the amount paid out in claims as a percentage of what is received in retail premiums and insurance premium tax (IPT) – is a useful measure of the value of insurance products. We therefore propose to require firms to publish claims ratios.

We see this as a 'sunlight' remedy, shining light on low value products. We believe that a credible and robust measure of product value would be primarily used by consumer groups, the financial press and by us as the regulator to highlight instances of apparent poor product value.

Our experience from the publication of complaints data is that 'sunlight' remedies can result in substantial benefits – for example, following our intervention, firms have focused more on complaints, compared their performance to peers, and were more transparent about what they were doing to improve complaints handling.

We would therefore expect greater transparency around claims ratios to prompt firms to reconsider product design and features, distribution, sales processes and claims handling processes to understand what is driving poor value

49 Our research showed that add-ons are less actively considered the later they appear in the sales process.

50 http://www.fca.org.uk/news/thematic-reviews/price-comparison-websites

51 Private Motor Insurance Investigation Notice of Possible Remedies 17 December 2013. The CC's report notes that in respect of add-ons to motor insurance, both price and product information were insufficient for consumers to make informed decisions when buying add-ons. It proposed possible remedies to improve the provision of actual prices of add-ons, rather than indicative prices, and clearer descriptions of the product, to help consumers when choosing whether to buy specific add-ons, and a requirement on insurers to provide better data, including pricing information or add-ons, to PCWs.

and make improvements accordingly. As a result we would expect the number of low value products sold to decrease.

There will be a number of practical issues to resolve in making rules requiring the publication of claims ratios. We intend to work closely with industry and consumer groups as well as other interested parties over the coming months to resolve outstanding questions. We will set up a formal working group to help us progress the work.

Other remedies

We will continue to consider what other remedies may be appropriate, or whether any of the above proposals should be extended across other products or distribution channels. We welcome any suggestions on alternative or additional remedy proposals.

We will issue a consultation on our remedies package before the end of the year.

8
Next steps

This report sets out the provisional findings of our general insurance add-ons market study and describes the remedies we intend to take forward to make competition for add-ons more effective.

Before finalising our findings and deciding on a package of remedies we are consulting interested parties. In particular, we would welcome views on the following questions:

i) Do you agree with the conclusions we have drawn from our analysis?

ii) Are there any reasons why our provisional findings should not become final?

iii) Are our proposed remedies likely to be effective in addressing the issues we have found?

iv) Are there any other remedies we should consider?

The participants in this study as well as any other interested parties are invited to provide any views in writing, including relevant supporting evidence, by 8 April 2014.

We will consider all responses when we finalise our conclusions and decide on our final remedies.

Our proposed remedies will be further refined and subject to cost-benefit analysis and formal consultation.

We will publish our final findings in due course and will consult on remedies before the end of the year.

We look forward to working closely with industry, consumer groups and other interested stakeholders while we refine our remedy proposals. We intend to set up a series of working groups relating to individual remedies.

We are asking for comments on this report by 8 April 2014.

You can send comments by using the form on our website at: www.fca.org.uk/your-fca/documents/market-studies/ms14-01-response-form

Or in writing to:

Barbara Buettner
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS
Telephone: 020 7066 6832

Email: FCAGIadd-on@fca.org.uk

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Market Study report from our website: www.fca.org.uk. Or contact our order line for paper copies: 0845 608 2372.

Annex A: Call for evidence – non-confidential responses

Association of British Insurers (ABI)
Aviva Group
British Insurance Brokers Association (BIBA)
C W Choi
Consumer Council (NI)
David Brown
David Vass
Don Naybour
F J M Wakefield
Helen Woodbury
Jackie Randall
Jane Splaine
Jeremy Speller
John Sutcliffe

Jubilee Insurance

Kate Hardy

LV= Group

Mark Halsall

National Federation of Dealers Association (NFDA)

Pauline Phillips

Roslynn Azzam

Victor Markham

Which?

Financial Conduct Authority

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