Financial Conduct Authority

Consultation Paper CP14/29**

Guaranteed Asset Protection insurance: a competition remedy

December 2014

Contents

We are asking for comments on this Consultation Paper by **13 March 2015**.

You can send them to us using the form on our website at:
www.fca.org.uk/your-fca/documents/consultation-papers/cp14-29-response-form.

Or in writing to: Awhi Fleming
General Insurance Policy
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 1062
Email: cp14-29@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 Consultation Paper from our website: www.fca.org.uk.

Abbreviations used in this document

ABI	Association of British Insurers
FCA	Financial Conduct Authority
GAP	Guaranteed Asset Protection
GI	General Insurance
ICOBS	Insurance Conduct of Business Sourcebook
Market Study	The general insurance add-ons market study
NFDA	National Franchised Dealers Association
PCWs	Price comparison websites
RTI	Return to Invoice

1 Overview

Introduction

1.1 In July 2014, we published our confirmed findings from the General Insurance Add-ons Market Study (the Market Study).[1] The report examined how competition is affected by selling general insurance products as an add-on to a primary product. Our main findings were:

- First, that the add-on mechanism has a clear impact on consumer behaviour. It often affects consumers' decision-making and weakens engagement which in turn strengthens a structural point of sale advantage; and
- Second, there is a lack of transparency and comparability about the value provided by general insurance products leading to consumers getting poor value not just from some add-on products but also from standalone purchases.

1.2 We found that competition is not effective where products are sold as an add-on and that markets for these products are broadly not working for consumers. We proposed four remedies, one of which related specifically to Guaranteed Asset Protection (GAP) insurance. The GAP insurance remedy is the subject of this consultation.

1.3 The GAP insurance market was highlighted in particular because of the pronounced impact the add-on mechanism has in this market. Most of the over one million GAP insurance policies in force were sold as an add-on during the motor vehicle sales process.[2]

1.4 We set out a proposed remedy in the Market Study, composed of a deferred opt-in and greater information disclosure to encourage consumers to shop around.[3] A deferred opt-in requires a pause in the purchasing process and creates time for the customer away from the sales environment to consider their options and make a decision. In this paper we consult on rules to implement the deferred opt-in and requiring enhanced disclosure, subject to refinements we have made to take account of feedback received from stakeholders in response to the Market Study.

1.5 Our detailed proposals are set out in this consultation paper, including our analysis of the costs and benefits. The draft rules that we propose to include in our Insurance Conduct of Business Sourcebook (ICOBS) are also included for your comment.

1 FCA, General Insurance Add-ons: Final report – confirmed findings of the market study, http://www.fca.org.uk/your-fca/documents/market-studies/ms14-01-final-report

2 FCA, General Insurance Add-ons: Provisional findings of market study and proposed remedies, http://www.fca.org.uk/your-fca/documents/market-studies/ms14-01, pgs 21 – 22

3 FCA, General Insurance Add-ons: Provisional findings of market study and proposed remedies, http://www.fca.org.uk/your-fca/documents/market-studies/ms14-01, pg 57

Who does this consultation affect?

1.6 The proposals covered in this consultation affect any firm that distributes add-on GAP insurance in connection with the sale of a motor vehicle. As well as insurance companies that produce GAP insurance products, other intermediaries involved in the distribution of GAP insurance may also be affected.

1.7 This consultation will also be of interest to firms involved in the sale of standalone GAP insurance, motor finance, motor insurance and the sale of motor vehicles more generally.

1.8 Finally, the wider financial services industry may be interested in the proposals as this is the first consultation on proposed rules implementing a competition remedy under our new mandate.

Is this of interest to consumers?

1.9 At the broadest level, our proposals would affect any retail customer or consumer purchasing a motor vehicle and/or GAP insurance. The proposals would influence whether and how GAP insurance is offered to potential customers when purchasing a motor vehicle, as well as impacting the wider GAP insurance market.

1.10 The Market Study focused on five general insurance add-on products that are usually sold to people acting in a personal capacity i.e. as a consumer rather than a commercial customer. As GAP insurance can also be sold to commercial customers for whom the same competition issues arise because of the point-of-sale advantage, our proposals will apply to sales of add-on GAP insurance made to both retail consumers and commercial customers.[4] For simplicity, we refer to both as 'customers' (or potential customers) within this consultation.

1.11 These proposals may also be of interest to consumer groups, as well as organisations that monitor trends and approaches in the insurance, finance or motor markets.

Context

1.12 The Financial Services Authority launched a study on general insurance add-ons in December 2012. Following the establishment of the Financial Conduct Authority (FCA) this was confirmed as the FCA's first Market Study in July 2013. A Market Study is a relatively new tool for the FCA, and is used by competition authorities to assess the dynamics of a market and whether or not competition is effective. This tool relates directly to the FCA's competition objective.

1.13 The objective was to test whether competition in the markets for add-ons was effective or not and, if not, to understand why this might be so. We analysed a range of information from insurers and intermediaries, including product literature and data relating to sales, pricing, profitability and claims.

1.14 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.

4 See ICOBS 2.1 for more information: FCA Handbook ICOBS 2.1

1.15 Provisional findings were published in March 2014. In summary, we found that:

- The add-on distribution model has a real impact on customer behaviour and affects the way people make decisions. Customers' attention is on the purchase of the primary product rather than the add-on, leading many to buy add-on products they do not need or understand. Add-on buyers are less likely to shop around and less price sensitive. They also have poor awareness of whether they have bought products.
- Customers' ability to assess options and make choices is hindered by the fact there is often insufficient information available about the quality and prices of add-ons, and what information is available is often presented very late.
- Add-on providers benefit from a clear point-of-sale advantage in comparison with standalone providers, which is reinforced by the way customers respond to the add-on option. There is little pressure on firms to offer good value and standalone products do not generally constrain sales of add-ons. Our analysis showed that this can lead to poor value and prices significantly above cost for many add-on products.
- Ineffective competition translates into consumers paying too much and receiving poor value when buying the products in our study.

1.16 Since publishing the confirmed findings in July 2014, we have continued to refine the four proposed remedies. They are: requiring firms to publish claims ratios to shine a light on poor value products; improving the way add-ons are offered through price comparison websites (PCWs); banning opt-out selling; and finally, a market-specific remedy for GAP insurance. The latter is the subject of this Consultation Paper and proposals arising from the other elements will be consulted on in early 2015.

Specific findings on GAP insurance

1.17 One of the specific markets considered in the Market Study was that for GAP insurance. GAP insurance provides cover for a financial shortfall that can occur when a customer's vehicle is written off or stolen and the settlement from the comprehensive motor insurance pay-out is not sufficient to repay outstanding finance, replace the vehicle as new or replace it with one of equivalent value to the original price. It is available for new, used, leased, business-owned and privately purchased vehicles.

1.18 There are different types of GAP insurance available, the main types of which are as follows:[5]

- Return to Invoice (RTI) GAP – which pays the difference between the vehicle's market value at time of loss and the amount initially paid.
- Finance GAP – this is for vehicles bought under a finance agreement, and pays the difference between the vehicle's market value at time of loss and the amount outstanding on finance.
- RTI Combined GAP – this combines both RTI and finance GAP insurance – it pays the difference between the vehicle's market value at the time of loss and the amount initially paid for the vehicle (the invoice amount), which could cover any outstanding finance.

5 ABI, Making sense of GAP insurance - How to Mind Your GAP, June 2012: https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Motor/ABI%20guide%20to%20making%20sense%20of%20GAP%20insurance.ashx

- Variations include Return to Value GAP (based on the market value of the vehicle rather than the invoice value); equivalent vehicle/replacement GAP (intended to provide a replacement vehicle); and, lease GAP (to cover the unexpired period of a vehicle leasing agreement).

1.19 GAP insurance tends to last for more than a year, with some policies being up to five years in duration. Furthermore, while monthly premium policies are available, single premium policies are the most prevalent.

1.20 In relation to GAP insurance, our Market Study found that:

- GAP insurance was generally not a planned purchase and almost two-thirds of add-on customers (59%) reported not having thought about buying the insurance until the day they bought it.
- GAP add-on customers had a worse understanding of the product than those who had bought GAP on a stand alone basis.
- Almost half of customers reported being unaware that they could have bought GAP insurance other than at the point of sale and GAP add-on customers were the least likely to shop around relative to purchasers of the other four sampled (add-on) products (19% said they did).

1.21 We also found that:

- Shopping around is likely to be particularly worthwhile. Our evidence suggests that GAP add-on prices can be significantly higher than stand alone GAP prices, and could be twice as expensive for broadly equivalent cover.
- The stand-alone share of the market is very small in comparison with add-on GAP. This further underlines the advantage held by add-on distributors.
- Our evidence suggests that GAP sold as an add-on is poor value for customers, with only about 10% of retail premiums for add-on GAP being paid out in claims – this is a very low claims ratio relative to other products.

Summary of our proposals

1.22 Our proposed rules for GAP insurance seek to implement two main elements:

- A deferred opt-in period for customers when add-on GAP insurance is sold as part of buying a vehicle. This means GAP insurance cannot be introduced and sold on the same day. The deferral period would start when the customer is given certain prescribed pre-sale information and end four days after that information is provided (the four days includes the day the prescribed information is provided). We also propose a variation to enable a confident customer to make the purchase sooner if they wish to do so, at their own initiative.
- Improved information about shopping around – this is part of the information that would trigger the start of the deferral period, and is intended to provide the customer with a better opportunity to determine whether they need GAP insurance and, if so, to shop around for the right product for their needs.

1.23 We believe that the proposals will increase the options available to customers for the purchase of GAP insurance. The customer is encouraged and given the tools (both time and information) to make informed decisions in their purchasing. By doing this, we expect to see better customer outcomes during the purchasing process and improved competition between add-on and stand-alone distribution channels.

Consideration of alternative proposals

1.24 As part of the policy development process we reviewed a range of options, including options put forward by stakeholders. Options considered included:

- Requiring commission disclosure for all customers
- Introducing comparison tables or a comparison website of GAP insurance products
- Extending cancellation rights and a post-sale reminder
- Banning add-on sales for GAP insurance
- Capping the total price for add-on GAP insurance or the total amount retained by add-on distributors
- Requiring add-on distributors to offer a panel of GAP insurance products
- Requiring or encouraging insurers to use other distribution channels
- Stronger product governance requirements on insurers to manage the end value to the customer

1.25 In particular, we considered the merits of extended cancellation rights and a post-sale reminder to customers that they have these rights, as a stand-alone remedy or as part of a package. This option was favoured by many industry participants in their responses to the Market Study, and was a tool adopted by the Competition Commission in respect of Extended Warranties. The ABI Good Practice Guide for GAP Insurance[6] already provides that "policies should offer the customer an entitlement to cancel the policy at any time during the term and obtain a refund."

1.26 Our two main reasons for rejecting this option are that:

- We want customers to make an informed decision at the time of purchasing GAP insurance about whether it is needed and which product. An extended cancellation period and reminder would provide the information post-sale of GAP insurance, and so would not achieve this aim.
- The add-on distributor's point-of-sale advantage would remain intact. Instead, it would be up to customers to take action by cancelling the policy and switching to an alternative. We felt that this was not behaviourally informed as it does not take account of customers' tendency towards post-sale inertia.[7]

6 ABI, Guaranteed Asset Protection Insurance: A Voluntary Good Practice Guide for Providers, Feb 2011, https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/GAP/ABI%20good%20practice%20guide%20-%20GAP%20insurance%20for%20providers.pdf

7 Data received showed a low incidence of customers cancelling their add-on GAP insurance policies post-sale.

1.27 Having reviewed the options we are satisfied that a deferred opt-in to limit the point-of-sale advantage coupled with improved shopping around information form the best remedy. We rejected other options because they did not meet our policy aims by either not directly addressing the issue or being disproportionate.

Equality and diversity considerations

1.28 We have assessed the likely equality and diversity impacts of the proposals and have not identified any material issues. But we would welcome comments.

Other considerations

1.29 Firms should also be aware of a recent Supreme Court judgment (Plevin v Paragon Personal Finance Limited[8]) related to commission disclosure. While it does not affect the proposals in this Consultation Paper directly, we are considering the issues raised by the judgment and firms may wish to take their own advice in relation to it.

Next steps

1.30 We want to know what you think of our proposals. Please send us your comments by 13 March 2015. You can respond by using the online response form on our website or writing to us at the address on page 2.

1.31 We will consider all responses and expect to provide feedback in a Policy Statement by June 2015 together with the finalised rules. We intend for the rules to come into force on 1 September 2015.

Q1: Do you have any comments on the proposed timing of the coming into force date for the finalised rules?

8 Plevin v Paragon Personal Finance Limited [2014] UKSC 61

2
The deferred opt-in

2.1 We found in the Market Study that add-on GAP insurance distributors benefit from both a point-of-sale advantage and from customer inertia, which allows them to charge higher prices for GAP insurance in comparison with broadly equivalent standalone products. We also found that the add-on mechanism resulted in potentially poor purchasing decision-making by the customer, where, for example, most did not research the product before buying it, despite the potential benefits of shopping around. For example, our Market Study found that 83% of buyers of add-on GAP insurance did not consider other policies when purchasing, compared to 9% of standalone GAP insurance buyers.

2.2 In our final report on the Market Study we said that we remained committed to acting in respect of the ineffective competition we identified in the GAP markets and the poor consumer outcomes for add-on sales of GAP. Our proposed remedy contained a number of elements, the key one being the introduction of a deferred opt-in. In response to feedback we said that we would do further work before we consulted on how best to tackle the problems we identified in the GAP market. The proposals here are the result of that further work.

2.3 We found that the main harm to competition in this market arises from the point-of-sale advantage held by distributors of motor vehicles. We are therefore continuing with our proposal for a deferred opt-in, which introduces a pause in the add-on GAP insurance sales process (the 'deferral period'). A distributor can introduce the product to the customer and provide the necessary information, but cannot conclude the sale until after the deferral period has ended. This limits the point-of-sale advantage and the extra time can be used by customers to consider whether they need the product, whether the product presented is the right one for their needs or whether there are others that better meet their needs and offer good value. This puts the customer in a better position to drive competition between different GAP insurance products.

2.4 This chapter sets out how the deferred opt-in period will operate from both the insurance distributor's point of view and that of the customer. It details the key design features of the deferred opt-in and when it will apply.

When the deferred opt-in will apply

2.5 Most GAP insurance is bought during the sale of a motor vehicle. We therefore propose that the rules will apply where a firm sells GAP insurance as part of the motor vehicle sales process. Specifically we propose that the deferred opt-in will apply where:

- a motor dealer is selling a vehicle and intends also to sell GAP insurance. The deferred opt-in would apply at the point of sale, as well as during any follow-up contact with the customer.
- the primary product being sold by a motor dealer to which the insurance is an add-on is not the motor vehicle itself, such as when GAP insurance is sold or is intended to be sold by a motor dealer as an add-on to the motor finance agreement or another product commonly

purchased with a vehicle. The remedy will also apply where GAP insurance is bundled with other products when sold alongside the motor vehicle, and

- the motor dealer is not the GAP distributor, but the motor dealer has introduced or has an appointed representative to carry out the GAP insurance sale.

2.6 For convenience, we refer to all of these circumstances as 'add-on GAP insurance' throughout this Consultation Paper.

2.7 Where GAP insurance is not sold as part of a motor vehicle sale, we propose that these sales should be excluded from the new requirements. For example, if GAP insurance is sold as an add-on to motor insurance (and not sold at the same time as the motor vehicle) then we propose this circumstance should be excluded from the scope of the proposals.

Key design features

2.8 One of the advantages of the deferred opt-in is that it has three components which can be adjusted to achieve the outcome we are seeking in a proportionate way. The three components are:

- when the deferral period starts
- the length of the deferral period – for the distributor (the length of time before the distributor can follow up with the potential customer to conclude the GAP insurance contract), and
- the length of the deferral period – for the customer (allowing customers to initiate contact themselves to conclude the GAP insurance contract at an earlier point)

2.9 The first two bullets define the 'pause' that a distributor must observe before seeking to finalise a sale of add-on GAP insurance. The third allows a customer to break that pause in advance of its full duration where that is appropriate for the customer's circumstances.

Start of the deferral period

2.10 The first key design feature is the trigger for the start of the deferral period. In considering an appropriate trigger for the market, our options include fixing it to a specific point in the vehicle sales process or to a point in the GAP sales process (and indeed the vehicle and GAP sales processes may overlap).

2.11 Our proposal is to start the deferral period once key information about add-on GAP insurance has been provided to the customer. As such, we are fixing it to a point in the add-on GAP sales process when the customer is provided with the prescribed information as set out in the next chapter.

2.12 This approach is designed to trigger the start of the deferral period at the point when the customer has the necessary information to consider the purchase and compare against other products. This allows the distributor to introduce the product and highlight the risks covered by add-on GAP insurance with the customer, thereby raising awareness, while also allowing the customer time to consider their options away from the sales environment.

2.13 Importantly, our proposal allows distributors to start the deferral period at a time of their choosing during the vehicle sale and which suits their internal processes. For example, if they currently provide add-on GAP insurance sales information at the point-of-vehicle order, they can provide the prescribed information then. Or, if they would like the deferral period to start earlier in the vehicle sales process, then they can adjust their sales processes accordingly.

2.14 We considered starting the deferral period at or after the point at which transfer of vehicle ownership has occurred and the customer has possession of the vehicle. This option benefits from a clear separation between vehicle purchase and add-on GAP insurance purchase. However, we have not included this proposal in this Consultation Paper because of the potential burden imposed by the need to create an additional contact point after the conclusion of the vehicle sale. This would be less convenient for customers, as well as increasing the potential for them to be uninsured in respect of GAP insurance.

2.15 Another option that was considered was for the deferral period to start when the vehicle is ordered. The problem with this approach is that the deferral period becomes a rigid point in the vehicle sales process, which does not provide for the different types of vehicle sale processes.

> **Q2: Do you agree with our proposal to start the deferral period once key information (prescribed information) about GAP insurance has been provided? If not, how would you start the deferral period?**

Length of deferral period before the distributor can complete the sale

2.16 The second key feature is to set the length of the deferral period, which is the minimum amount of time that must elapse before the distributor can contact the customer to complete the sale of add-on GAP insurance. The sale of the add-on GAP insurance could take place after this period has elapsed, if the customer agrees. The proposal we set out below is for the deferral period to be at least four days if the sale is concluded at the distributor's initiative.

2.17 Pinpointing the 'right' length of time is difficult, as customers will have different needs and take different approaches to shopping around. Our guiding principle here is to give customers sufficient time to consider the add-on GAP insurance product they have been told about and to shop around. In deciding what is sufficient, we are mindful of:

- the benefits of customers having time away from the sales environment to consider other options
- the benefits of limiting the distributor's point of sale advantage
- any inconvenience caused to customers as a result of a longer sales process for add-on GAP insurance
- the potential for customers to have a period of being uninsured if they take possession of the vehicle but do not have GAP insurance cover in place
- the cost and burden of any changes to distributors' processes, and
- the fit with existing contact points between distributor and customer in the vehicle sales process

2.18 There can be wide variations in the time taken to conclude a vehicle sale. Used vehicle purchases typically take much less time to conclude than new vehicle purchases, which can take several months. We also understand that it is possible, though not usual, to conclude a used vehicle sale from start to finish within a single day (sometimes called 'deal and deliver').[9]

2.19 We considered a range of options. For example, we considered setting a specific length of time or basing the trigger for the end of the deferral period on an event (such as when the formal transfer of vehicle ownership takes place). We discounted options based on such an event because of the variations in length of the vehicle sales process. If a vehicle sale can be concluded within a single day, particularly for a used vehicle sale, then a distributor could in theory comply with the deferred opt-in without the customer in practice having time to consider the insurance purchase and shop around. This concern interacts with the proposal for the start of the deferral period; a firm could provide the prescribed information immediately before whatever trigger event would end the deferral period and thus comply with the rule without in practice enabling the customer to reflect and to shop around if they wish to do so.

2.20 We also considered the scope for customers being left uninsured by the deferred opt-in and potentially suffering financial loss as a result. We acknowledge the peace of mind gained from having the cover in place, even if there is no claim. This issue could arise when the customer has taken possession of the vehicle without having concluded an add-on GAP insurance purchase, despite intending to do so.

2.21 This risk would only arise for customers who take ownership of their vehicle within four days of receiving the prescribed information. This is a smaller risk than, for instance, if the deferral period started when the transfer of ownership took place or if the deferral period was longer than four days. The risk is further mitigated because:

- all customers can seek to be insured immediately by way of taking up stand-alone cover. The deferred opt-in only applies to add-on GAP insurance, and
- we are proposing an option for customers to have a shorter deferred period on their own initiative

2.22 We also note the availability of comprehensive motor insurance that will cover at least some of the costs if a vehicle is written off. While this would not be the full invoice or finance cost, it would not leave the customer completely out of pocket. In our previous report, we also stated that motor insurance policies can include vehicle replacement cover. We acknowledge that this benefit is not included in all policies, and particularly those policies covering used vehicles whose owners are arguably more likely to fall within the group exposed to the uninsured risk because of the shorter transaction time for used vehicle sales.

2.23 We have received some information on the number of claims made during the first seven days after sale, which indicates that the potential for financial loss during this period is very small. Nonetheless, we would welcome further views and evidence on this matter and would particularly like to hear from GAP providers (insurers / distributors) how our remedy reflects the new versus used vehicle markets.

2.24 The option that we are proposing therefore is to specify the minimum number of days that must elapse before the distributor can initiate contact to conclude the GAP insurance sale. This avoids the variability issue described above and can be simply explained to customers.

2.25 According to the National Franchised Dealers Association (NFDA), whose members are the primary channel for GAP insurance sales, the shortest time for a new vehicle transaction from

9 The NFDA estimate, based on their members' sales, that 2% of car sales are same-day sales.

a customer viewing a vehicle to delivery is around four days but the sector average for new vehicles is just over 17 days.[10] We have limited information about the length of time for a used vehicle sale.

2.26 We propose that the full deferral period should be four days. Day one would be the day that the prescribed information is provided, and day four is when the distributor could make contact with the customer to conclude the GAP insurance sale. We believe this allows sufficient time for customers to shop around and consider options, creating that crucial break point.

Q3: Do you agree with the proposal that the deferral period should be four days (including the day on which the prescribed information is provided) before the distributor can contact the customer to conclude the GAP insurance sale? Will there be significant differences in impact between the new and used car markets?

Length of deferral period – customer-initiated completion of the sale

2.27 Finally, we considered whether to allow customers to waive the deferral period or have a shorter period, by initiating contact themselves to conclude the add-on GAP insurance contract. This would be for those customers who make an informed choice to purchase the add-on GAP insurance without the need for a shopping around period.

2.28 We propose that there should be a shorter deferral period in instances where the customer initiates contact themselves. Customers initiating contact themselves to conclude the sale of add-on GAP insurance is a good behavioural indicator that a customer is making an informed and active decision. Specifically we propose that the distributor can conclude an add-on GAP insurance contract on the day after the start date if contact has been initiated by the customer for the purposes of concluding an add-on GAP insurance contract.

2.29 Customers who contact the distributor on the day after they are provided with the prescribed information will be asked by the add-on distributor to give their agreement that they are aware of the longer deferral period but want to proceed at this point.

2.30 It is important if provision is made within the rules for a shorter deferral period, that this is not used to circumvent the primary rule. We do not want customers to be encouraged by distributors to shortcut the deferral period. Similarly, while we acknowledge that contact may need to be made between the distributor and customer during the deferral period on other aspects of the vehicle sales process, our focus is on the GAP insurance sales process specifically and any discussion about GAP insurance during the deferral period should be avoided unless customer initiated.

2.31 We would expect firms to monitor high levels of customer-initiated completion of the sales process. This can be achieved, for example, by recording the agreement that customers must sign when they wish to conclude a GAP insurance sale under the customer-initiated process.

Q4: Do you agree that customers should be able to initiate contact to conclude a GAP insurance sale and end the deferral period early on the day after receiving the prescribed information?

10 NFDA, response to market study consultation, April 2014.

3
Information to encourage shopping around

3.1 The second component of our remedy package is the provision of prescribed information to encourage customers who are presented with add-on GAP insurance to consider whether they need it and, if so, to shop around for the most appropriate product. It is an important aspect of the remedy because, as noted previously, we found in the Market Study that:

- The vehicle purchase channel is the main way that customers become aware of risks covered by GAP insurance. Prior to this, customers are likely to be unfamiliar with GAP insurance.
- Add-on GAP insurance is often not a planned purchase – 59% of surveyed add-on GAP insurance buyers had not thought about GAP insurance until the day of purchase.
- Almost half of customers reported being unaware that they could have bought their GAP insurance elsewhere. Furthermore, most add-on GAP insurance buyers do not shop around – only 19% of those surveyed did.
- Add-on GAP insurance buyers had a worse understanding of the product than those who had bought GAP insurance on a stand-alone basis.

3.2 As set out in chapter 2, we propose to trigger the deferred opt-in with the provision of the prescribed information.

3.3 This chapter sets out what prescribed information must be provided to customers by distributors who want to sell GAP insurance as an add-on, and how this information should be provided.

What information must be provided?

3.4 We want customers to have the information to make decisions about whether or not they need GAP insurance and, if so, to be able to shop around and identify the right product for them.

3.5 Our existing rule in ICOBS 6.1.5 states that:[11]

> "A firm must take reasonable steps to ensure a customer is given appropriate information about a policy in good time and in a comprehensible form so that the customer can make an informed decision about the arrangements proposed."

3.6 Existing guidance also sets out how the rule can be applied, including stating that appropriate information includes the price of the policy.

3.7 We want to go further in the case of add-on GAP insurance to provide clarity to firms about what exactly needs to be provided to the customer to trigger the deferred opt-in. As such,

11 See FCA Handbook: ICOBS 6.1.5 R

we propose to require firms to provide specified information, some of which is in addition to existing regulatory requirements.

3.8 Under our proposals, add-on GAP insurance distributors must provide customers with the following information as a minimum to trigger the deferred opt-in:

a) The premium of the add-on GAP insurance policy, separately from other prices.

b) The main benefits, exclusions and limitations of the add-on GAP insurance policy, including the duration of the policy.

c) That GAP insurance can be purchased from other sources.

d) Whether the GAP insurance policy is optional.

e) How the deferred opt-in works, including the date on which the prescribed information was provided so that it is clear to the customer when the 'clock' has started.

f) Where add-on GAP insurance is being offered alongside vehicle financing, it should be clear that GAP insurance can be purchased elsewhere.

3.9 This information will form part of the general sales information that is normally provided during the process of buying a GAP insurance.

Q5: Is there anything you would add or remove from the proposed list of prescribed information or amend?

How should the information be provided?

3.10 As a general consideration, whatever information is provided to customers should be provided in compliance with rules and guidance. However in this circumstance, in addition to thinking about what information should be provided, it is equally important to think about how the information is communicated. We are aware that the vehicle sales environment relies heavily on oral communication and that the customer can be presented with information about a number of products such as the vehicle, finance and other services. The information must therefore be specifically brought to the attention of the customer when provided.

3.11 For that reason, we think that the prescribed information must be communicated in a clear, accurate and prominent manner in writing. This does not preclude the distributor from also communicating the information orally.

Q6: Do you have any comments on how the prescribed information should be provided?

4
Conclusion and next steps

4.1 Following publication of the final report of the Market Study and the proposed add-on GAP insurance remedy, this consultation paper proposes specific rules to improve competition in the GAP insurance market. These are:

- A deferred opt-in period for customers when add-on GAP insurance is sold as part of buying a vehicle. This means GAP insurance cannot be introduced and sold on the same day. The deferral period would start when the customer is given certain prescribed pre-sale information and end four days after that information is provided. We also propose a variation to enable a confident customer to make the purchase sooner if they wish to do so.

- Improved information about shopping around – this is part of the information that would trigger the start of the deferral period, and is intended to provide the customer with a better opportunity to determine whether they need GAP insurance and, if so, to shop around for the right product for their needs.

4.2 The objectives of these rules are firstly, to reduce the advantage enjoyed by the add-on distributor, so that competition can work more effectively. Secondly, to empower customers to make informed and active decisions on whether to buy GAP insurance and, if so, from where. We consider that our proposed rules and guidance meet these objectives in a way that is proportionate and minimises costs and other burdens on customers and firms.

Next steps

4.3 We welcome feedback on the proposals. We invite comments by 13 March 2015, and the details on how to respond are on page 2. We intend to consider the feedback and publish our final rules in a Policy Statement by June 2015 with a view to the rules coming into force on 1 September 2015.

Annex 1: Cost benefit analysis

1. The Financial Services and Markets Act 2000, as amended by the Financial Services Act (2012), requires us to publish a cost benefit analysis (CBA) of our proposed rules. This annex sets out the market failures associated with the sale of add-on GAP insurance policies at the point-of-sale and the basic facts of the market relevant to the baseline from which to compare the effects of the proposed policies. The relevant costs and benefits arising from the policy are then estimated, with net benefits expected to arise from the policies.

2. We have separately published a technical appendix setting out our detailed calculations and sensitivity analysis.

Market failure analysis

Point-of-sale advantage

3. Our Market Study into general insurance add-ons found that sellers of add-on GAP insurance have a point-of-sale advantage. This occurs because:

- The add-on seller is already in contact with the customer because of the primary product, giving the seller an opportunity to sell their add-on product with minimal additional marketing cost.
- Customers' choices are restricted in terms of the options that are readily available at the point-of-sale.
- Add-on sellers may have an advantage by being the first seller to offer the product if the customer has not considered the product before.
- Stand-alone providers have to incur greater costs to identify relevant customers to sell their products.

4. As the point-of-sale advantage interacts with certain customer behaviour, competition, whether between add-on GAP insurance sellers or between add-on and stand-alone GAP insurance sellers, is diminished. This results in subsequent overpayment by customers.

Behavioural issues

5. Distributors offer GAP insurance as an add-on to their vehicle sales. Distributors have told us that they discuss add-on GAP insurance with customers early on in the vehicle sales process. However, they cannot discuss prices until the customers have settled on the vehicle that they wish to purchase, since the price of add-on GAP insurance also depends on the vehicle and the finance arrangements. We were told that around 70% of add-on GAP insurance sales are paid for through a finance agreement, with payment for add-on GAP insurance rolled into monthly repayments for the vehicle.

6. This point-of-sale advantage is exacerbated by the way customers behave when buying add-ons. Our Market Study found that 83% of buyers of add-on GAP insurance did not consider other policies when purchasing, compared to 9% of stand-alone GAP insurance buyers.

7. Our behavioural research has also shown that the fact that add-on prices are only discovered at the point-of-sale of the primary product is a very powerful barrier to customers looking for alternatives. In our experimental consumer research for the Market Study, giving the add-on price at the point-of-sale of the primary product led 65% of add-on buyers to buy the offer without looking at any other products, compared to 17% when the add-on price was available upfront alongside the primary product information.[12]

8. In addition, add-on GAP insurance buyers are less likely to have thought about the product before they bought it than standalone GAP insurance buyers. 59% of add-on GAP insurance buyers did not think about buying the product until the day they did so, compared to 29% for standalone GAP insurance.

Customer overpayment

9. There is evidence of significant overpayment and poor value for add-on GAP insurance. We note that three year add-on GAP insurance policies generally sell for around £300, compared to £150 for standalone sales. We examined add-on and standalone policies as part of the Market Study and did not find significant differences in coverage.

10. In the Market Study, we showed that add-on GAP insurance has a claims ratio of 10%, whereas conservative estimates of a competitive baseline using other general insurance products are in the region of 30% to 50%. In addition, add-on GAP insurance had a low claims frequency of 0.3%. We estimated total customer overpayment with respect to the 30% and 50% baseline claims ratios, which we took to be a conservative baseline compared to the 2012 average claims ratio for general insurance products of 64%. For add-on GAP insurance, this suggested overpayment is around £76 million for a 30% benchmark to £121 million for a 50% benchmark. Add-on GAP insurance accounted for more than half of the £108 to £216 million overpayment across the five products in the Market Study.

Conclusion on market failure

11. The point-of-sale advantage that motor vehicle distributors have in selling add-on GAP insurance reduces the extent of competition that such distributors face and can lead to market power in the sale of add-on GAP insurance.

12 London Economics and YouGov, "Study into the sales of Add-on General Insurance Products: Experimental consumer research" p23

Cost benefit analysis

12. The table below summarises our assessment of the costs and benefits of the policy.

Table 1: Table of costs and benefits

Benefits	Quantification
Consumer surplus in add-on market.	£30.3 million to £54 million depending on whether there is a price fall.
Consumer surplus in stand-alone market.	£40.5 million.
Increase in stand-alone firms' revenues.	£40.5 million.
Costs	**Quantification**
Loss of convenience due to having to buy stand-alone or defer vehicle collection to be covered.	Minimal but incorporated in sensitivity analysis.
Customers picking up vehicle within four days may be left uninsured.	£90,000 to £493,000.
Increase in firm costs.	Up to £5 million implementation costs. Minimal on-going costs.
Loss in add-on firms' revenues.	£45 to £58.5 million.

Baseline

14. The relevant baseline against which we assess the costs and benefits of the policy is the situation that would occur in the add-on GAP insurance market in the absence of our proposed intervention.

Firms and costs

15. A number of types of firm are involved in the GAP insurance sales process:

- Insurers that underwrite add-on GAP insurance policies.
- Distributors who sell add-on GAP insurance as an end-product.
- Other intermediaries who participate in the distribution chain.

16. We are aware of 16 insurers that currently underwrite GAP insurance, though there may be additional smaller insurers. We do not have information on the number of distributors or intermediaries. Evidence that we examine below suggests that add-on GAP insurance sales are in the region of 600,000 per year. Vehicle distributors told us that their target sales rates for add-on GAP insurance are around of 30% of total vehicle sales, suggesting that add-on GAP insurance was targeted at around 2 million car sales. Data for 2012 suggests that there were 4.1 million used car sales through dealers and 0.97 million new car sales (excluding fleet sales).[13] This suggests that over 3 million car sales took place in which add-on GAP insurance was not offered to buyers.

17. In the baseline situation, distributors will continue to hold a degree of market power over their sales of add-on GAP insurance. This reflects the findings of our Market Study that a very limited

13 BCA Used Car Market Report 2013

number of add-on buyers shop around and that a large number were not aware that they could buy GAP insurance from elsewhere.

18. In the Market Study we found that the price of standalone GAP insurance is around £150, depending on the level of cover. An assessment that the FCA conducted for the Market Study suggested that there was not a significant difference between the coverage provided by add-on GAP insurance and the coverage provided by standalone alternatives. The standalone market appears to be competitive, with prices closer to the level of costs. It is possible that costs for distributors are different, as they incur staff time and other costs associated with face-to-face sales, but we expect that this would be offset by additional costs that standalone providers incur, such as marketing costs.[14] Overall, this is consistent with a level of around £150 for the cost of supplying an add-on GAP insurance policy.

Market size and prices

19. We examined evidence from insurers on the size of the add-on GAP insurance market. This suggests approximately 470,000 add-on GAP insurance sales, which is broadly consistent with evidence on market size from industry bodies and our Market Study estimate. However, there are a number of firms that are not included in these figures, and analysis of data from distributors suggests that in 2012 there were another 150,000 policies sold that are not covered by the above figures. This suggests a market size in excess of 600,000 policies.

20. We looked at prices in the market. Although there is variation across GAP insurance policy types and between firms, this is consistent with a generic add-on GAP insurance price of approximately £300, reflecting the most common type of three-year policy. In our Market Study we found an average price of £311.

Benefits

Benefits to consumers

21. To measure the effect of the policy on customers, we estimate how their consumer surplus would change relative to the baseline that we identified. Consumer surplus is a measure of wellbeing that refers to the difference between the maximum amount that customers would be willing to pay for add-on GAP insurance and how much customers actually pay (£300 for 600,000 in the baseline situation). In the baseline situation, our estimate is that consumer surplus is £40 million. This comprises £220 million total willingness to pay, less £180 million total payment.

22. Our policy is designed to have the following effects:

- Due to increased awareness of alternatives from information provision and the time opportunity given by the deferred opt-in, the number of customers that shop around for GAP insurance would increase.
- Due to the time opportunity given by the deferred opt-in, customers would have more opportunity to consider their GAP insurance purchase.

23. We believe that the policy will drive benefits to customers in the following ways:

14 A motor distributor will incur marketing costs for the vehicle, but the incremental marketing costs for the sale of the GAP will be very low relative to those of the vehicle.

- Some customers will make more considered purchases.
- Some customers will shop around and gain better GAP insurance prices.
- Some customers may not change their behaviour but still benefit if the market as a whole becomes more competitive.

24. The policy would also increase revenues to standalone providers. There could be other benefits, for example if firms improved their policies' levels of cover due to greater competitive pressure, but we do not have sufficient information to estimate these benefits.

More considered purchases

25. As many customers are not aware of GAP insurance before they buy it when they purchase a vehicle, we expect that some customers who would have bought add-on GAP insurance on the day of their vehicle sale, would then not agree to buy GAP insurance after the deferral period with time to consider their purchase. It is likely that these customers buy add-on GAP insurance at a price that is higher than their true willingness to pay.

26. Our survey for the Market Study asked add-on GAP insurance customers how likely they would be to buy the same insurance again in the future, if the need arose. Of these customers, 9% said that they were unlikely to do so and 2% said that they were very unlikely to do so, suggesting that the number of customers that bought add-on GAP insurance and subsequently regretted doing so is 11%.

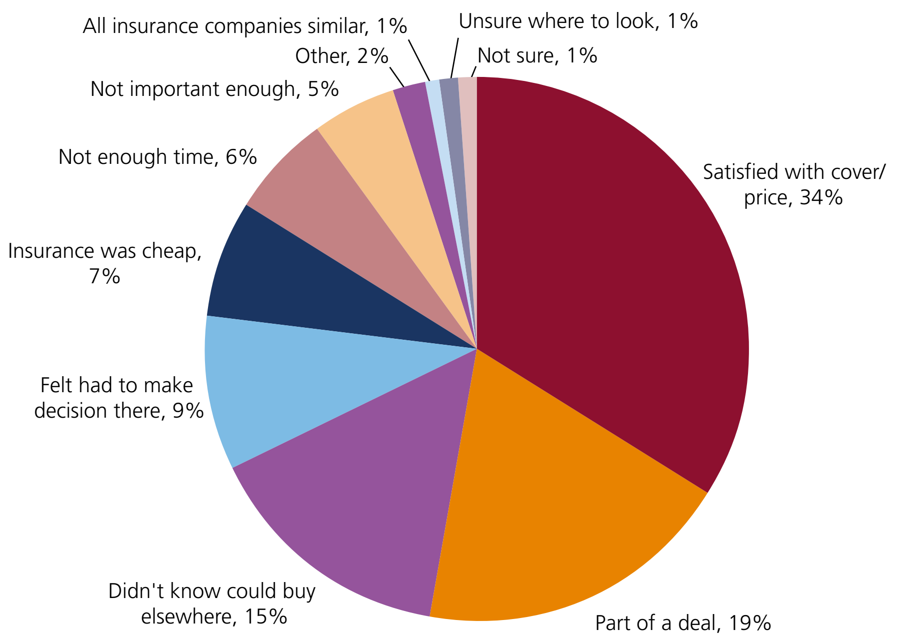
27. Our assessment is therefore that around 10% of customers that would have bought add-on GAP insurance would not do so after the implementation of the policy. This amounts to around 60,000 customers, reducing add-on GAP insurance demand to 540,000 at a price of £300. For such customers the purchase of add-on GAP insurance would not have been net beneficial, in the sense that the price at which they bought add-on GAP insurance exceeded the amount of value that they actually attached to add-on GAP insurance coverage. With 600,000 customers buying GAP insurance at a price of £300, the implied consumer surplus is £45 million. However, with 10% of customers paying more than their maximum willingness to pay, consumer surplus in the baseline situation is in fact £40 million (comprising £220 million total willingness to pay, less £180 million total payment), so the gain to customers who no longer buy GAP insurance is £5 million.

Shopping around in response to information provision

28. Our survey for the Market Study suggested that, of add-on GAP insurance customers, 17% said that they shopped around, whereas 72% said that they did not and 10% said that they did not know that there were multiple policies to consider. This was significantly higher than for add-on sales in general, for which 42% said that they shopped around, with 53% not having done so and 4% unaware that there were multiple policies to consider. We think it likely that the 17% of add-on GAP insurance customers that shopped around would continue to buy GAP insurance post-intervention.

29. Our survey also asked those add-on GAP insurance customers that did not shop around their reasons for this. The reasons that customers cited as their main reason for not shopping around are shown in Figure 1 below. Of those that bought GAP insurance as an add-on, the 15% of customers that gave a lack of awareness of alternatives, the 9% that gave feeling that they had to make a decision there and then, and the 6% that gave a lack of time as their main reasons for not shopping around appear to be the most likely candidates to shop around post-intervention. This suggests that 30% of current add-on GAP insurance customers who did not shop around would shop around post-intervention.

Figure 1: Customers' main reasons for not shopping around, add-on GAP insurance[15]



30. This suggests:

- Around 17% of customers would shop around but continue to buy GAP insurance from the point-of-sale, post-intervention.
- Of the remaining 83%, around 30% would shop around. This suggests around 25% of customers would shop around and could buy standalone GAP insurance.

31. This is consistent with other aspects of the customer survey from the Market Study. In particular, when asked if they believed that it was the right decision not to shop around, 25% of add-on GAP insurance customers said that it was not the right decision, compared to 57% who believed that it was and 18% that were not sure.

32. The survey sample only contains add-on GAP insurance customers who, given the high price of add-on GAP insurance, will be less price sensitive and attach more importance to the convenience of buying at the point-of-sale than the average customer. It is therefore conservative to examine the effects of the policy with 25% of customers shopping around after implementation.

Effect of shopping around and information provision

33. In the benchmark situation, distributors have market power. It is possible that, post-intervention, this could continue with respect to those customers that do not shop around. In this case, add-on customers would continue to behave as in the benchmark and the price in the add-on market would not change in response to the policy intervention. However, it is also possible that the provision of information could make customers in general more price sensitive, so that the price of add-on GAP insurance would have to fall to stop even more customers shopping around.

15 Source: Responses to FCA survey for GI add-ons market study.

34. We do not have sufficient information to estimate what, if any, price fall would occur in response. We therefore consider two scenarios for the add-on market, one in which the add-on GAP insurance price does not change as a result of the intervention, and one in which add-on GAP insurance customers become more sensitive to price and as a result the price of add-on GAP insurance falls to £250. We examine the benefits to customers of a fall to £250, as it represents a significant saving to add-on customers of £50, but maintains a large mark-up for add-on GAP insurance of £100.

35. Our assessment is that 10% of customers would cease to buy add-on GAP insurance given the option to consider their purchase more carefully. This would reduce the add-on GAP insurance demand to 540,000 at the £300 baseline price. Of this 540,000, the 25% that would shop around would discover that they could buy stand alone GAP insurance and save £150. This would reduce demand for add-on GAP insurance by a further 135,000 to 405,000 if the price of GAP insurance remained at £300. The remaining add-on customers' surplus would be £30.4m. However, if the price of GAP insurance fell to £250, the effect of shopping around would be offset and demand for add-on GAP insurance would be 540,000 and customers' surplus would be £54m.

36. With 25% of customers shopping around, 135,000 customers that previously bought add-on GAP insurance would shop around and buy standalone GAP insurance, saving a total of £20.2 million. In addition, our assessment is that 25% of customers who did not buy add-on GAP insurance because of the high price, would shop around and consider buying add-on GAP insurance at a lower price. At a price of £150, a further 135,000 customers would buy standalone GAP insurance. The surplus of these customers would be an additional £20.2 million. Total standalone consumer surplus would therefore be £40.5 million.

Table 2: Comparison of consumer surplus

	Baseline	No change in add-on price	Fall in add-on price
Add-on sales	600,000	405,000	540,000
Add-on price	£300	£300	£250
Add-on consumer surplus	£40 million	£30.4 million	£54 million
Stand alone sales	–	270,000	270,000
Stand alone price	–	£150	£150
Stand alone consumer surplus	–	£40.5 million	£40.5 million
Total surplus	£40 million	£70.9 million	£94.5 million

Our assessment of the benefit of shopping around is that it would increase consumer surplus from around £40 million to between £71 million and £95 million. This increase includes those that would have bought add-on GAP insurance in the baseline situation who save due to shopping around, and those that would not have bought add-on GAP insurance in the baseline situation but who buy it on being made aware of alternatives.

Increase in standalone firms' revenues

38. A further result of the policy would be that standalone firms' revenues would increase. Our estimate is that standalone sales would increase by 270,000. At a price of £150, this would increase their revenue by £40.5 million.

Costs

Costs to customers

Uninsured customers

39. We considered the possibility that some customers could be prevented from purchasing add-on GAP insurance by the time they take delivery of their vehicle and may therefore drive without GAP insurance and potentially suffer an uninsured loss. However, customers would still have the opportunity to buy standalone GAP insurance. Contrary to some responses that we received, differences in policy coverage between add-on and standalone GAP insurance are not material, so there would be no significant divergence in cover from purchasing standalone as opposed to add-on GAP insurance.

40. In addition, we note that for new vehicles, many comprehensive insurance policies include coverage for the full invoice price of the vehicle within the first year, so a significant proportion of those that might not be covered by add-on GAP insurance within the first few days would be insured against this loss in any case by their motor insurance. Although this is not the case for used vehicles, the uninsured risk is lower for these since market value will be closer to vehicle value over the first few days of purchase. Further, there are large numbers of new and used vehicle sales in which add-on GAP insurance does not appear to be offered to customers in any case. Consumers would therefore only be left uninsured if they wished to pick up the vehicle within the deferral period, were not covered by their motor insurance policy and did not purchase standalone insurance.

41. Nevertheless, we examine the potential cost to consumers of being uninsured, on the assumption that they do not change their behaviour in response to the proposed remedy to mitigate this (with the result that our estimates of these costs are upper bounds). To examine the potential losses that would go uninsured, we note that in most years, most firms' average GAP insurance pay-outs are around £3,000. Evidence from a large insurer, adjusting for market size, suggested that the total number of claims within the first seven days of a vehicle being delivered to a customer in the whole market is around 30 claims per year. Taking the number of customers that claimed within seven days of taking delivery of the vehicle at 30, and with an average pay-out of £3,000, this would imply a total loss to customers of approximately £90,000. This represents an upper bound for uninsured losses since our actual deferral period is shorter at four days and starts the point at which information is presented to the customer, not the point of delivery of the vehicle.

42. We acknowledge that there could be an additional cost to these customers comprising lost peace of mind. A four day deferral period would lead customers that wished to purchase GAP insurance as an add-on to be uninsured for a maximum of four days, out of a standard policy length of three years. With an add-on GAP insurance price of £300 and 405,000 add-on sales after the policy has been implemented, this implies a maximum cost to customers of £444,000.[16] In the scenario with an add-on price of £250 and 540,000 sales, this implies a maximum cost to customers of £493,000. Again, these calculations represent an upper bound to costs to consumers.

Loss of convenience from delay

43. We acknowledge that there could be a reduction in convenience for some customers, though we note that for all sales there will be an incentive for vehicle distributors to provide information on add-on GAP insurance early in the sales process in order to maximise their chance of making a sale of add-on GAP insurance before the customer picks up the vehicle.

16 This calculation implies that the benefit to customers of holding GAP-insurance remains constant over time. The insured benefit Finance GAP policies tends to decrease over time, but the insured benefit for RTI GAP tends to increases over time. Therefore a constant benefit appears to be a reasonable simplification.

44. Customers who collect their vehicle on the same day that they were first provided with information about add-on GAP insurance would not be able to conclude the sale of add-on GAP insurance at the point of delivery, nor would they be able to contact the distributor on that day to arrange to buy add-on GAP insurance. However, they would still be able:

- to buy a standalone GAP insurance policy, or
- to defer the delivery of their vehicle by at least one day until they had contacted the distributor to confirm willingness to buy add-on GAP insurance

45. Customers who pick up their vehicle between one and four days of being presented with add-on GAP insurance information would not be able to conclude the sales of add-on GAP insurance at the point of delivery. Instead those customers who wanted to insure themselves from the point of delivery of the vehicle could:

- contact the distributor directly to arrange the sale of add-on GAP insurance, as long as this contract is initiated one day after the provision of information on add-on GAP insurance
- buy a standalone GAP insurance policy, or
- defer the delivery of their vehicle until four days after they were provided with information on add-on GAP insurance

46. The policy would have no adverse effect on those customers that pick up their vehicle after the deferral period ends. As was the case before the imposition of the remedy, such customers would be able to confirm their purchase of add-on GAP insurance at the point-of-sale. There would therefore be no cost imposition either from driving without add-on GAP insurance. They would benefit from having information on add-on GAP insurance provided to them before they concluded the sale, thereby allowing them to shop around and consider their purchase more carefully.

47. We acknowledge that there would remain potential inconvenience to some customers. However, we believe that this inconvenience is modest relative to the benefits of addressing the significant amount of customer harm that we have identified. Further, we note that when the Competition Commission estimated the loss of convenience for its more burdensome PPI remedy, it actually found that, in aggregate, consumers had a stronger preference for a delay than for buying at the point-of-sale.[17] We therefore examine changes in convenience in our sensitivity analysis of the policy.

Waterbed effect

48. In the Market Study we noted the possibility of a 'waterbed' effect, whereby firms' excess profits in the sale of add-on GAP insurance are competed away in the vehicle market. As evidence for this, vehicle distributors have told us that their overall margins are low. This would imply that firms were in fact cross-subsidising their vehicle sales from GAP insurance sales, so a reduction in firms' add-on GAP insurance profits would result in an increase in vehicle prices. In the Market Study we said that we would still be concerned even if all excess profits were competed

17 The Competition Commission found that 60% of personal loan PPI customers preferred to buy at the point-of-sale, compared to 31% who said they preferred to buy it later. The equivalent numbers for mortgage PPI were 50% and 36% respectively. Although more customers preferred buying at the point-of-sale, those that preferred a delay had a stronger preference, meaning that the overall effect of inducing a delay was a net increase in customers' willingness to pay. For consumers that preferred to buy at the point-of-sale, willingness to pay for this ranged from being statistically insignificant for mortgage PPI to a third of the monthly premium for personal loan PPI.

away, because of the resulting distortions to price. We show in our sensitivity analysis that the policy still produces benefits even in the presence of a 100% waterbed effect.

Firm costs

One-off costs

49. As a result of the policy, firms may incur implementation costs. We do not expect these costs to be significant, but they could include revisions to customer literature and changes to systems and processes. We have examined the costs of similar remedies to provide an assessment of these costs. The OFT's consultants assessed the costs and benefits of the Supply of Extended Warranties on Domestic Electrical Goods Order 2005. This remedy is not exactly the same as our proposed remedy, though it has some similarities. It requires information provision at the point-of-sale, while the requirement to provide written quotations with a 30-day duration has some similarities with a deferred opt-in.[18] The OFT's consultants estimated that the implementation costs of the order were around £4.9 million. On-going costs were not thought to be significant, though did include factors such as staff compliance. Since the extended warranties market is larger than the add-on GAP insurance market (£671 million in 2005), we take this evidence as suggesting an upper bound of £5 million for the one-off costs of the policy.

On-going compliance costs

50. We acknowledge that firms may also incur some on-going costs. We believe that firms may incur costs due to the need to train staff, but we do not think such costs would be significant. In our workshop some distributors told us that the most significant impact of a deferred opt-in process on costs could be on arranging payment. We were told that approximately 70% of those buying add-on GAP insurance paid for it as part of their finance repayments, rather than making a one-off payment. Some distributors told us that the impact of a deferred opt-in would be that they would potentially have to run the process by which they agreed a finance agreement with a customer twice – once at the point of order, without the GAP insurance premium, and once at the point of delivery, this time including the GAP insurance premium. We were told that this would result in higher costs for both distributors, who would have an extended sales process, and finance providers, who would have to run their checks on customers twice, once for the lower amount and once for the higher amount. Customers would also be subject to two credit checks, which could affect their credit score.

51. We do not believe that the impact of the policy on costs would be as significant as suggested, for the following reasons:

- Distributors said that, in cases in which customers, having initially declined to buy add-on GAP insurance, subsequently requested it at the point of delivery, they would arrange an add-on GAP insurance purchase. The costs of doing so are therefore not prohibitive.

- We believe that distributors would have the incentive and be able to work with finance companies to minimise the associated costs of a deferred opt-in. We were told that distributors and finance companies are able to manage changes to finance agreements occurring due to GAP insurance cancellations relatively easily. Although we appreciate that a cancellation involves a reduction in the outstanding amount of finance, whereas an opt-in involves an increase, we do not think that these problems are insurmountable.

18 The Order required retailers: to display prominently freely available leaflets containing specified information; to display price and duration information about extended warranties adjacent to the price of the primary product; upon request by a purchasing customer, to provide a written quotation that guarantees that the extended warranty will be available on the same terms for 30 days if the customer chooses not to buy it at that time; to allow customers to cancel an extended warranty with an initial period of more than one year and receive a full refund for 45 days after purchase and a pro rata refund after this.

- Even if finance companies had to run credit checks again, it is likely that a customer who was allowed to borrow thousands or tens of thousands of pounds would be accepted for an additional £300. We believe that, except for those customers for which the decision to grant finance was marginal, the additional costs to finance companies are likely to be low.

52. We acknowledge that the policy could result in some costs to distributors in the form of additional storage if some customers defer the collection of the vehicle. However, this would only affect a limited number of sales due to the period of deferral, which would only bind on a proportion of used vehicle sales. We therefore expect the cost would also be modest. Our overall assessment is therefore that the on-going costs of this policy are limited.

Reduction in revenue

53. The remedy will reduce revenue for add-on GAP insurance sellers, relative to the benchmark where their revenue would be £180 million. In the scenario in which there is no price fall, revenue would be £121.5 million, implying a loss in revenue of £58.5 million. In the scenario in which there is a price fall, revenue would be £135 million, implying a loss in revenue of £45 million.

Conclusion

54. We therefore expect the policy to have the following costs and benefits, assessed against a counterfactual with consumer surplus of £40 million.

Table 3: Table of costs and benefits

Benefits	Quantification
Consumer surplus in add-on market.	£30.3 million to £54 million depending on whether there is a price fall.
Consumer surplus in stand-alone market.	£40.5 million.
Increase in stand-alone firms' revenues.	£40.5 million.
Costs	**Quantification**
Loss of convenience due to having to buy stand alone or defer vehicle collection to be covered.	Minimal but incorporated in sensitivity analysis.
Customers picking up vehicle within four days may be left uninsured.	£90,000 to £493,000.
Increase in firm costs.	Up to £5 million implementation costs. Minimal on-going costs.
Loss in add-on firms' revenues.	£45 to £58.5 million.

55. We compare these against our baseline situation of a consumer surplus of £40 million. **This analysis suggests total benefits to customers relative to the baseline situation of the region of £31 to £54 million per year.** The table below shows how we expect the add-on and stand alone markets to be affected.

Benefits	One-off	On-going
Benefits to customers	–	£31 to £54 million
Increase in revenues for stand alone firms	–	£40.5 million
Losses to uninsured customers	–	£90,000 to £493,000
Compliance costs to firms	Up to £5 million	Not significant
Lost revenue to add-on firms	–	£45 to £58.5 million

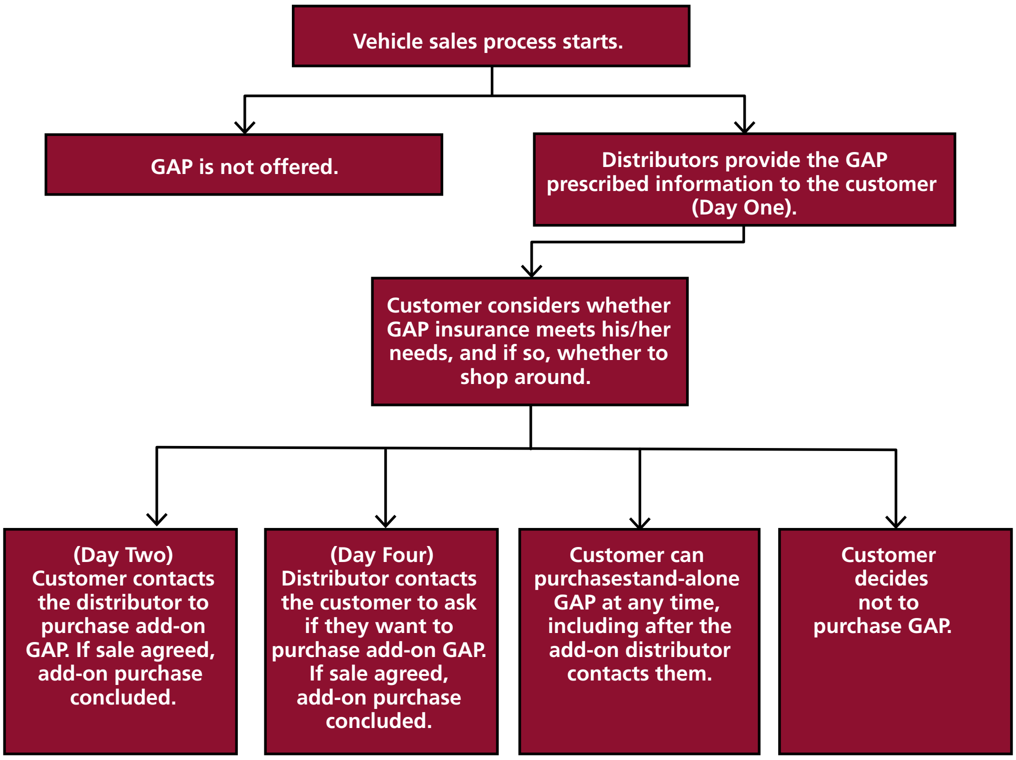
56. We also performed a sensitivity analysis to examine how much these estimates would change if we changed our original parameters. This shows that the policy remains net beneficial over plausible ranges for these parameters.

Q7: Do you have any comments on our market failure analysis and cost benefit analysis for the proposed GAP remedy?

Annex 2:
How the proposed process would work

1. Our view is that the two components of the remedy can be effectively integrated. We show this in the following diagram, with a short explanation below:

Diagram 1: How the proposed GAP remedy is applied



2. As the diagram suggests, the deferral period starts once the customer has been provided with the prescribed information. The customer has time to consider whether they need GAP insurance and, if so, to shop around. The customer can decide not to purchase add-on GAP insurance or to purchase standalone GAP insurance at any stage in the process.

3. Add-on GAP insurance can be sold in one of two ways: either by the customer contacting the add-on distributor to conclude the contract (they can do this at any time after day one); or by the distributor contacting the customer and agreeing to conclude the contract, on or after day four.

Annex 3: Compatibility with the FCA's general duties

Compatibility with our general duties

4. We are required by section 138I(2) of the Financial Services and Markets Act 2000 (FSMA) to also include in our consultation:

- an explanation of the FCA's reasons for believing that making the proposed rules is compatible with its duties under section 1B(1) and (5)(a), and
- any statement prepared under section 138K(2), which sets out whether the proposed rules will have a significantly different impact on mutual societies, as opposed to other authorised persons

5. In fulfilment of section 1B(1) we set out how we are acting compatibly with our strategic objective, and advancing one or more of our operational objectives. In fulfilment of section 1B(5)(a), we set out how we have had regard to the regulatory principles in section 3B and the importance of taking action to minimize the extent to which business is carried out in connection with financial crime.

Compatibility with our strategic objective and operational objective

6. The proposals in this consultation paper are compatible with our strategic objective of ensuring that the relevant markets function well. The proposals emerge from our first Market Study, where we found that competition in the markets for general insurance add-ons is not effective and that this can lead to poor customer outcomes. Our work raised particular concerns about ineffective competition in the GAP insurance market, and the poor outcomes that customers experience as a result. By remedying these competition concerns we are seeking to ensure that the relevant market, for GAP insurance, functions well.

7. Our proposals are intended to help advance our operational objective of promoting effective competition in the interests of consumers. Our remedy package, combining a deferred opt-in and information to encourage shopping around, will promote effective competition in the GAP insurance market by limiting the advantage held by the add-on distribution channel over other distribution channels thereby encouraging firms to improve the value of their products as they compete for customers. We want to further support better competition by requiring firms to provide their customers with the information to shop around, with the expectation that at least some customers will act on this information and decide whether they need GAP insurance and, if so, identify and purchase the cover. Even when all customers do not act on the information, we expect that sufficient customers will and that the benefits of activity on the value proposition for GAP insurance will be shared.

Compatibility with the FCA's regulatory principles

8. We set out below how our proposals demonstrate such regard for each of the regulatory principles.

The need to use our resources in the most efficient and economical way

9. We considered a range of options to address the concerns we found with competition in the market. We believe our proposals best address those concerns. Implementing the proposals will introduce rules which will be supervised and enforced against, however we do not think this will impact on resourcing.

The principle that a burden or restriction should be proportionate to the benefits

10. We believe that our proposals are proportionate to the benefits that we are seeking, and we have calibrated the remedy so that it can be embedded (as far as possible) within existing processes and limiting the burden imposed. Our cost benefit analysis in Annex 1 sets out our assessment that the implementation of our proposals will have net benefits.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

11. Increased competition will encourage sustainable growth. We expect this to happen because the remedy encourages add-on distributors to improve the value proposition of their GAP insurance product, as well as drawing customers' attention to the availability of alternatives to add-on GAP insurance.

The general principle that customers should take responsibility for their decisions

12. Our research shows that customer decision-making is impacted by the add-on mechanism and particularly the characteristics of the way add-on GAP insurance is sold. This can result in poor outcomes. We therefore believe that there is justification for intervening to limit the impact of the add-on mechanism in the GAP insurance market and improve the ability of customers to make informed decisions about GAP insurance. The remedy also prescribes information which must be provided to help customers make these decisions.

The responsibilities of senior management

13. Our proposals place obligations on firms to comply. While we have not specifically identified senior management within the proposals, our expectation is that senior management will be involved in ensuring that the final rules are complied with.

The desirability of exercising our functions in a way that recognises differences in the nature and objectives of businesses carried on by different persons.

14. We recognise that firms may sell add-on GAP insurance in different ways, which can be impacted by the sale process for the primary product (the vehicle). Our remedy design takes account of different business models because the deferred opt-in is sufficiently flexible for firms to decide how to embed it in their processes.

The desirability of publishing information relating to persons

15. Our proposals are compatible with this principle.

The principle that we should exercise our functions as transparently as possible

16. The Market Study stage of the process resulted in the publication of a provisional findings report in March 2014 and a final findings report in July 2014. The provisional findings report identified GAP insurance as an area for specific intervention, and we set out our high-level proposal for a deferred opt-in and shopping around information. We noted in our final findings report a summary of the feedback we had received on the remedy proposals.

17. We have had further opportunity to consider the feedback. We also took the opportunity to discuss further with stakeholders, and specifically those stakeholders who raised concerns with the original remedy proposals so that we could better understand the alternatives they suggested as well as their views on how our proposal could be implemented and the impact. This has informed the design of our proposals.

18. This consultation provides another opportunity for stakeholder input, and we are considering what other discussions or meetings might be useful.

Expected effect on mutual societies

19. We see no reason why our proposed rules would impact a firm differently based on the firm having a mutual society structure.

Annex 4:
List of questions

Q1: Do you have any comments on the proposed timing of the coming into force date for the finalised rules?

Q2: Do you agree with our proposal to start the deferral period once key information (prescribed information) about GAP insurance has been provided? If not, how would you start the deferral period?

Q3: Do you agree with the proposal that the deferral period should be four days (including the day on which the prescribed information is provided) before the distributor can contact the customer to conclude the GAP insurance sale? Will there be significant differences in impact between the new and used car markets?

Q4: Do you agree that customers should be able to initiate contact to conclude a GAP insurance sale and end the deferral period early on the day after receiving the prescribed information?

Q5: Is there anything you would add or remove from the proposed list of prescribed information or amend?

Q6: Do you have any comments on how the prescribed information should be provided?

Q7: Do you have any comments on our market failure analysis and cost benefit analysis for the proposed GAP remedy?

Appendix 1:
Draft Handbook text

INSURANCE: CONDUCT OF BUSINESS SOURCEBOOK (GAP CONTRACTS) INSTRUMENT 2015

Powers exercised by the Financial Conduct Authority

A. The Financial Conduct Authority makes this instrument in the exercise of the powers and related provisions in or under:

(1) the following sections of the Financial Services and Markets Act 2000 ("the Act"):

a) section 137A (The FCA's general rules);
b) section 137D (FCA general rules: product intervention)
c) section 137T (General supplementary powers);
d) section 139A (Power of the FCA to give guidance);

(2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.

B. The rule-making powers listed above are specified for the purpose of section 138G (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the FCA Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Insurance: Conduct of Business Sourcebook is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Insurance: Conduct of Business Sourcebook (GAP contracts) Instrument 2015.

By order of the Board of the Financial Conduct Authority

[*date*]

Annex A

Amendments to the Glossary of definitions

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

GAP contract	a guaranteed asset protection contract which is a *contract of insurance* covering a *policyholder,* in the event of total loss to a *vehicle*, against the difference between: (a) the amount claimed under the *policyholder's vehicle policy* in respect of that loss; and (b) an amount defined in, or calculated in accordance with, the *GAP contract*.

Annex B

Amendments to the Insurance: Conduct of Business sourcebook (ICOBS)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

1 Annex 1 Application (see ICOBS 1.1.2R)

…

Part 4: Guidance

…

4 Non-Life: effect on territorial scope

…

3 Insurance Mediation Directive: effect on territorial scope

3.1 G The *Insurance Mediation Directive's* scope covers most *firms* carrying on most types of *insurance mediation*. The *rules* in this sourcebook within the Directive's scope are those that require the provision of pre-contract information or the provision of advice on the basis of a fair analysis (see *ICOBS 4* (Information about the firm, its services and remuneration), *ICOBS 5.2* (Statement of demands and needs), *ICOBS 5.3.3 R* (Advice on the basis of a fair analysis), ~~and~~ *ICOBS 6* (Product information) and ICOBS 6A.1.4R (Ensuring the customer can make an informed decision)).

…

4 Non-Life Directives: effect on territorial scope

4.2 G The *rules* in this sourcebook within the Directives' scope are those requiring the provision of pre-contract information or information during the term of the contract concerning the *insurer* or the insurance contract (see *ICOBS 2.2* (Communications to clients and financial promotions), *ICOBS 4* (Information about the firm, its services and remuneration), *ICOBS 6* (Product information), ICOBS 6A.1.4R (Ensuring the customer can make an informed decision) and *ICOBS 8* (Claims handling) except *ICOBS 8.2* (Motor vehicle liability insurers)).

…

7 Distance Marketing Directive: effect on territorial scope

7.1 G In broad terms, a *firm* is within the *Distance Marketing Directive's* scope when conducting an activity relating to a *distance contract* with a *consumer*. The *rules* in this sourcebook within the Directive's scope are those requiring the provision of pre-contract information (see *ICOBS 2.2* ((Communications to clients and financial promotions), *ICOBS 4* (Information about the firm, its services and remuneration), ~~and~~ *ICOBS 6* (Product information), and ICOBS 6A.1.4R (Ensuring the customer can make an informed decision)), the cancellation *rules* (see *ICOBS 7*) and the other specific *rules* implementing the Directive (see *ICOBS 3.1*).

…

Insert the following new chapter after ICOBS 6. The text is not underlined.

6A Product Specific Rules

6A.1 GAP contracts

Application

6A.1.1 R This chapter applies to a *firm* which sells a *GAP contract* to a *customer* in connection with the sale of a *vehicle* by:

(1) the *firm*; or

(2) a *person* connected to the *firm.*

6A.1.2 G There would be a sufficient connection between the *GAP contract* and the sale of a *vehicle* if the *GAP contract* is sold in connection with other goods and services, for example a *credit agreement*.

6A.1.3 G A *person* connected with a *firm* would include acting as an *introducer* or *appointed representative* for that *firm* or if, regardless of *authorisation* status, if it has a relevant business relationship with the *firm*.

Ensuring the customer can make an informed decision

6A.1.4 R Before a *GAP contract* is concluded, a *firm* must give a *customer* the following information:

(1) the total *premium* of the *GAP contract*, separately from any other prices;

(2) the significant features and benefits, significant and unusual exclusions or limitations, and cross-references to the relevant policy document provisions;

(3) whether or not sold in connection with *vehicle* finance, that *GAP contracts* are sold by other distributors;

(4) the duration of the *policy*;

(5) whether the *GAP contract* is optional or compulsory;

(6) when the *GAP contract* can be concluded by the *firm*, as described in *ICOBS* 6A.1.8R and *ICOBS* 6A.1.9R; and

(7) the date the information in (1) to (6) is provided to the *customer*.

6A.1.5 R The information must be communicated in a clear and accurate manner and in writing or another *durable medium* available and accessible to the *customer*.

6A.1.6 R The information must be drawn to the *customer's* attention and must be clearly identifiable as key information that the *customer* should read.

6A.1.7 G A *firm* must also comply with the *rules* in *ICOBS* 6 (Product Information).

Deferred opt-in applicable to GAP contracts

6A.1.8 R Except as specified in *ICOBS* 6A.1.9R, a *GAP contract* cannot be concluded by a *firm* until at least 2 clear *days* have elapsed since the *firm* provided the information required by *ICOBS* 6A.1.4R.

6A.1.9 R A *firm* can conclude a *GAP contract* the *day* after providing the information in *ICOBS* 6A.1.4R to a *customer* if:

(1) the *customer* initiates the conclusion of the *GAP contract*; and

(2) the *customer* consents to the *firm* concluding the *GAP contract* earlier than provided for in *ICOBS* 6A.1.8R and confirms that he understands the restriction in *ICOBS* 6A.1.8R.

6A.1.10 G Before concluding a *GAP contract*, a *firm* should have regard to the information needs of its *customers* and consider whether it would be in the *customer's* interest to receive the information in *ICOBS* 6A.1.4R again. For example, if a long time has passed between providing the information and the conclusion of the contract.

Financial Conduct Authority

PUB REF: 004978

25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1062
Website: www.fca.org.uk