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Cross selling practices in insurance products and the IMD2 Proposal¹

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Abstract

The paper deals with insurance cross-selling together with the banking or investment services regulated by the Draft Directive on insurance mediation 2002/92. Author particularly points out that the package products offered to consumers differ from the risks of their components. On consumer request, therefore, insurance intermediary or insurance company has the duty to provide adequate description of different package parts and the ways how their mutual relationship changes related risks towards consumer. Author concludes that combined product sale can be in the interest of the consumer under condition that the selling practices are in line with the Directive on unfair commercial practice. Such practice must not be aggressive, unfair or misleading.

Key words: tying products, bundled products, gateway product, Proposal for the revision of the EU Insurance Mediation Directive 2002/92

1. INTRODUCTION

The Proposal for the revision of the EU Insurance Mediation Directive 2002/92 (IMD2)¹ takes a position with regard to the controversial issue of cross selling practices in financial products, which regards the provision of insurance services together with banking or investment services.

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¹ On 26 February 2014 the European Parliament plenary voted the final text of the Proposal for the revision of the IMD2, subject to trialogue negotiation between the European Commission, Council and Parliament; see <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2014-0155#BKMD-29>.

The IMD2 defines „*tying practices*” as meaning „*the offering or the selling of an insurance product in a package with other distinct ancillary products or services, where the insurance product is not made available to the consumer separately*”(IMD2, 2002, Art. 2.1 (19)).

By contrast, a „*bundling practice*” is defined as the case where the insurance product is also made available to the consumer separately but not necessarily on the same terms and conditions as when offered in a bundle with the ancillary services (IMD2, 2002, Art. 2.1 (20)).

The two kinds of marketing practices are not treated alike. The Proposal distinguishes the selling of tied from that of bundled products (IMD2, Article 21a para): when insurance is offered together with another service or an ancillary product, either as part of a package, then the insurance intermediary or the insurance undertaking, as the case may be, shall inform and offer the customer the possibility to buy the different components jointly or separately; it will further provide a separate evidence of the premium or prices of each component.²

In other words, to comply with the IMD2 requirements, the compounded services should be unbundled and the specific parts of the bundle should be available to the customer individually and separately from each other. Tying practices, where the various components are not available to buy on a standalone basis, are not allowed.

² It is not clear from the text of the proposed directive, whether the information requirement is covered under the KID, i.e. the Key Information Document on Packaged Retail Investment and Insurance-based Investment Products provided under the Proposal for a Regulation (COM(2012)352 fin) on Key Information Documents for Investment Products. A provisional agreement on the KID PRIIPS has been achieved between the Parliament and the Council, on the final act. The KID will be a pan-European 3-page-document with clear, comparable and complete pre-contract information on product investment, risks and potential rewards, as well as the costs associated to the product in question.

2. GATEWAY PRODUCT AND BUNDLED PRODUCTS

There are a number of products which reach the consumer by way of cross-selling. The basic product, which is usually called the „gateway product”, may be a current account, a mortgage, an investment scheme, or insurance. Common examples include:

- A current bank account bundled with various kinds of insurances, such as travel insurance, mobile phone insurance, roadside recovery, concierge services;
- A mortgage loan with fire insurance and life / incapacitation insurance;
- A health insurance bundled with life insurance linked to investment;
- Municipalities and regional authorities buying complex structured investment products in combination with deposits;
- Loyalty or volume preferential contract conditions.

3. CROSS SELLING: RISKS TO CONSUMERS

What is the risk for the consumers, which is connected with such practices? The IMD2 is interested in the cases (IMD2, 2002, Art. 21a para. 2), where the risks resulting from such an agreement or package offered to a customer are likely to be different from the risks associated with the components taken separately. In this case and only if requested by the customer, the insurance intermediary or the insurance undertaking, as the case may be, is called to provide an adequate description of the different components of the package and the way in which their interaction alters the connected risks to the customer. In order to be comprehensible and prone to be perused by the customer, the information should be consistent and not overly complex. It should include details on the cover, the price, and on how the customer can claim the benefits under each cover.³

In taking this position, the IMD2 has recognised that cross-selling practices are a common and appropriate strategy for retail financial service providers throughout the Union (IMD2, 2002, Recital

³ This reflects the recent cases of payment protection insurance (PPI) sales in the UK, where bank borrowers would purchase PPI insurance to cover the risk of non-payment. A number of abusive practices were noticed in the marketing of these covers. For example, in a large number of cases the policyholders would not even qualify to claim under the policy when the risk occurred, as they did not fulfill the policy requirements in the first place, and they had not received advice on that by the intermediary or the insurance undertaking at the time they had purchased the cover.

41). However, in intending to protect consumers⁴, when purchasing insurance products bundled with other financial products, it directly refers to the consumer protection Unfair Commercial Practices Directive: „When insurance is offered together with another service or product as part of a package or as a condition for the same agreement or package, it is subject to Directive 2005/29/EC on Unfair Commercial Practices” (IMD2, 2002, Recital 41a).

4. FROM CROSS-SELLING TO MIS-SELLING

Directive 2005/29/EC on Unfair Commercial Practices applies a basic unfairness test, which combines objective and subjective elements (Directive 2005/29/EC, 2005, Art. 5.2): a practice is unfair if, cumulatively, it is contrary to the requirements of professional diligence, and it materially distorts or is likely to distort, with regard to the product, the economic behaviour of the average consumer whom it reaches or to whom it is addressed.

The criterion of professional diligence is defined as the standard of special skill and care, which a trader may reasonably be expected to exercise towards consumers. It must be commensurate with honest market practice and/or the general principle of good faith in the trader's field of activity (Directive 2005/29/EC, 2005, Art. 2(h)). The criterion is obviously difficult to benchmark, particularly in the financial services; all the more so, if the unfair practice is widely followed by competing service providers in a consolidated market. The IMD2 sets its own standard of professional diligence, by requiring insurance intermediaries to always act honestly, fairly, trustworthily, honourably and professionally in accordance with the best interests of their customers (IMD2, 2002, Art. 15(1)).

The unfairness tests applied by the Unfair Commercial Practices Directive help to understand the benchmarks. Thus, misleading practices are clearly unfair (Directive 2005/29/EC, 2005, Art. 6 and 7), and may consist of providing false and untruthful information, or omitting material information to the customer, which will mislead them as to the benefits, the risks, the composition, the results, the price calculation, and the advantages of the product.

Aggressive practices are similarly unfair (Directive 2005/29/EC, 2005, Art. 8), as they significantly impair (or are likely to) the average consumer's freedom of choice or conduct with regard to the product. They may

⁴ The directive is an important step towards increased level of consumer protection and internal market integration (IMD2, 2002, Recital 21).

take various forms, such as the exercise of pressure as well as certain more sophisticated practices. Inertia selling is the practice where sellers send products or services to people who have not asked for them, and then demand payment. Churning is the excessive trading by a broker in a client's account, largely intending to generate commissions. By steering, the seller directs customers to avoid specific providers in favour of others (for example, when a bank offers mandatorily the policies of its bancassurance partner to cover the mortgage risk from its lending activities); or stresses the credit risk to steer the customer to a higher cost solution.

There are a number of examples of unfair practices which regulators or courts scrutinise and penalise. Unclear contract terms on cover and price, and the sale of services which the consumer does not need are at the forefront (*Financial Times*, 2012). A recent example in the UK is that of the sales of insurance against home emergencies, breakdowns and flooding, when that is already covered by home fire insurance, and/or by the water supply companies. The insurer in question is facing a fine which may extend to GBP 3.4 million (*The Guardian*, 2014). In another reported example involving thirteen UK banks and an insurer where credit card insurance was sold along with credit cards without the customers being adequately informed, the sellers were obliged by the FCA to pay €1.5 billion to 7 m customers. A number of UK banks have been obliged to pay compensation so far amounting to €11.7 bn in restitution of damages to consumers for mis-selling PPI insurance along with credit. In the United States, a NYSE listed insurance company may end up paying \$4.5 m for fines and a consumer restitution refunds pool in settlement with the insurance commissioners of the States of Mississippi, Missouri and Wisconsin for forced bundling of life insurance on group health policies purchased by employers.

As a common denominator deriving from the above, mis-selling is the failure to deliver fair outcomes for consumers, and this occurs when customers are not treated fairly by providers; when customers don't understand the key features of the service and the seller does not appropriately and sufficiently explain so that customers can take an informed decision; when customers do not understand whether they are given only information, or advice (i.e. personalised recommendation for products suitable to their individual needs) (FSA, 2013).

The features of financial products promoting mis-selling touch upon factual and psychological factors. A basic parameter is the information asymmetry between sellers and customers. For example, banks selling

bancassurance products avail of the strong element of trust and path-dependency embedded in „relationship banking”, i.e. in the relation they have built with the customer over a long course of frequent cooperation. Furthermore, customers are not interested or prone or experienced enough to research the market for best deals of the sort. Finally, there are various cognitive biases putting emotional pressure on consumers, including personal financial and family circumstances, choice and information overload, overconfidence to the seller, difficulty in handling uncertainty and risk, and in evaluating future benefits and costs.

Unfair practices make the consumer take a transactional decision he would not have taken otherwise, and once this decision is not to the consumer's interest, this would be contrary to the seller's target: an insurance intermediary's first target as endorsed in the IMD2 is the best interest of the customer. Notably the Unfair Practices Directive is a full harmonisation directive, with the exception of financial services. Hence Member States are free to elect to pass more stringent rules with regard to unfair practices with respect to the provision of financial services.

In addressing these marketing practices the IMD2 does not focus on the implications on the level of prices of each standalone component product, which may be higher if it is offered on its own. Taking the cost / pricing factor into account in non-concentrated markets, where many insurers compete, bundling practices are not necessarily harmful to consumers. Unless churning, steering and other aggressive and misleading practices are applied, bundling may prove to the benefit of the customer more than that of the provider (CEPS, 2009, 404).

To monitor market behaviour, the IMD2 proposal (IMD2, 2002, Art. 21a paras. 4 and 5) requires EIOPA, EBA and ESMA to develop and periodically update guidelines for the assessment and supervision of cross-selling practices, indicating, in particular, situations in which such practices do not comply with Article 15(1) of the IMD2.

5. SUMMARY

Under the IMD2 Proposal, when insurance is part of a packaged product, the insurance intermediary or undertaking shall make each product separately available and provide the customer with a separate price for each product. Upon the customer's request, it shall explain how the risk may vary from the separate to the packaged product and describe each product component. If advice, i.e. personalised recommendation

is provided, the overall package of insurance products shall have to meet customer's needs and demands.

Bundling may prove to the benefit of the consumer, provided sales practices are in conformity with the Unfair Commercial Practices Directive. Such practices shall not be aggressive, unfair, or misleading.

Key words: tying products, bundled products, gateway product, Proposal for the revision of the EU Insurance Mediation Directive 2002/92

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