



Consumer Protection Insurance

Rodney Lester

PRIMER SERIES ON INSURANCE
ISSUE 7, AUGUST 2009

NON-BANK FINANCIAL
INSTITUTIONS GROUP

GLOBAL CAPITAL MARKETS
DEVELOPMENT DEPARTMENT

FINANCIAL AND PRIVATE SECTOR
DEVELOPMENT VICE PRESIDENCY



THE WORLD BANK

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THIS ISSUE

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The *Primer Series* on Insurance provides a summary overview of how the insurance industry works, the main challenges of supervision, and key product areas. The series is intended for policymakers, governmental officials, and financial sector generalists who are involved with the insurance sector. The monthly primer series, launched in February 2009 by the World Bank's Insurance Program, is written in a straightforward, non-technical style to share concepts and lessons about insurance with a broad community of non-specialists.

The Non-Bank Financial Institutions Group in the Global Capital Markets Development Department aims to promote the healthy development of insurance, housing finance, and pension markets, and to expand access to a broad spectrum of financial services among the poor. These markets provide opportunities for household investment and long-term savings, and can buffer the poor against the risks of sickness, loss of breadwinner, catastrophic events, and other misfortunes.

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Consumer Protection Insurance

Rodney Lester

Financial markets and the need for consumer protection

Each year the global economy adds an estimated 150 million new consumers of financial services. Most are in developing countries, where consumer protection and financial literacy are still in their infancy. Protecting the interests of consumers has become an important component of sound and competitive financial markets, particularly in those countries that have moved from state planning to market economies. The public in many emerging markets lacks a history of using sophisticated financial products. Even in well-developed markets, weak consumer protection and a lack of financial literacy can render households vulnerable to unfair and abusive practices by financial institutions—as well as financial frauds and scams operated by intermediaries.

At its heart, the need for consumer protection arises from *an imbalance of power, information and resources* between consumers and their financial service providers, most often placing consumers at a disadvantage (although information asymmetries can run in the opposite direction as well). Consumer protection aims to address this market failure. Financial institutions know their products well but individual retail consumers may find it difficult or costly to obtain sufficient information on their financial purchases. In addition, complex financial products can be difficult to assess, even when all relevant information is disclosed. Imbalances are most likely in cases where:

- *Transactions are infrequent* (for example, when taking a mortgage on a personal residence),

- *Entry or exit costs are low* (such as for financial intermediaries), thus allowing disreputable firms to emerge, or
- *The cost or payoff to the consumer is postponed or very high.* For many long-term investment products such as life insurance and pension savings, performance cannot be evaluated until many years have elapsed.

A well-designed consumer protection framework can help reduce the imbalances of power and information between consumers and financial institutions.

A financial sector should provide consumers with:

- **Transparency** by providing full, plain, adequate and comparable information about the prices, terms and conditions (and inherent risks) of financial products and services;
- **Choice** by ensuring fair, non-coercive and reasonable practices in the selling of financial products and services and collection of payments;
- **Redress** by providing inexpensive and speedy mechanisms to address complaints and resolve disputes; and
- **Privacy** by ensuring control over access to personal financial information.

Consumer protection and financial literacy also promote the efficiency and transparency of retail financial markets. Consumers who are empowered with information and basic rights—and who are aware of their responsibilities—provide an important source of market discipline to the financial sector, encouraging financial institutions to compete by offering better products and services rather than by taking advantage of poorly informed or captive consumers.

In addition, consumer protection helps financial firms in facing the specific risks that arise in dealing with retail customers. In its April 2008 report, the Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commission and the International Association of Insurance Supervisors identified three key risks related to possible “mis-selling” of financial products to retail customers. They are: (1) legal risk, if successful lawsuits from collective action by customers or enforcement actions by supervisory agencies result in obligations to pay financial compensation or fines; (2) short-term liquidity risk and long-term solvency risk, if retail customers are treated unfairly and thus shun the financial institution and withdraw their business; and (3) contagion risk, if the problems of one financial institution (or type of financial product) spread across

the financial sector. Effective consumer protection can help ensure that the actions of financial firms do not make them subject to criticisms of misselling.

Consumer protection also protects the financial sector from the risk of political over-reaction to financial crises. The political response to collapses of parts of the financial sector may be to over-compensate with heavy regulation. The impact of too little consumer protection became evident, for example, during the insurance and superannuation scandals in the United Kingdom and Australia¹. The results were a series of costly studies and far reaching recommendations for regulatory reform.

Issues specific to retail (B to C) insurance markets

Consumer products can be broken into three categories: *search goods* (can be assessed in advance of purchase—e.g. a piece of art), *experience goods* (can be assessed relatively quickly with use—e.g. soap powder), *credence good* (attributes only discovered after a long delay or upon occurrence of contingent event or never—e.g. a mutual fund).

Insurance clearly fits into the credence good category and the sector thus relies heavily on the public's trust that it will deliver what it promises. Widely publicized failure in this regard can dampen the sector's development for many years. Given that insurance is a social good with large potential positive externalities, failures are to be avoided—subject to the cost benefits of any market modifiers being properly assessed.

Insurance markets in many emerging and developing countries now have rapidly growing consumer components, driven by the introduction of compulsory motor and health insurance, links with credit provision and the growth of micro-insurance technology. There are a number of common undesirable industry practices that emerge in parallel and these can be largely mitigated through a strengthening of consumer rights. Poor practices include unrealistic benefit illustrations, non disclosure of the real costs of products, misleading advertisements, unfair claims settlement practices, selling tied to other products or services (e.g. credit insurance and white goods consumer credit), and not selling to identified needs. Insurance is an industry where agency incentives can be the main driver of what product is sold and how much. Further, multi level sales through family and friends, tying and bundling (especially if adhesion principles apply under the law), can

¹ See for example <http://www.smh.com.au/news/business/thousands-more-snared-in-superannuation-scandal/2007/02/15/1171405369454.html>. The relevant industry body has now recommended the phasing out of intermediary commissions on retirement products.

limit a consumers' choice and mobility. Table 1 illustrates some of the differences between insurance and other retail financial products.

Under an earlier mode, the US introduced price controls on insurance after a spate of failures during and after the great depression but there is a growing consensus in that country that these are not necessarily consistent with consumer welfare. Instead a new approach, based on competition and information theories, has been rapidly evolving in English speaking common law jurisdictions over the last two decades. This largely reflects the impacts of activist media, a number of high profile cases such as Equitable in the UK, which have involved consumer friendly judicial interpretation, and a history of major failures (Confederation Life in Canada, Independent in the UK and HIH in Australia). The EU has more recently become engaged with the passage of the Mediation Directive and an ongoing dialogue on how to harmonize the broader consumer protection agenda.

In developing and emerging markets consumer protection tends to be secondary to sectoral development and prudential oversight, and reflects the usual late development of the retail component of insurance markets. In many developing countries the middle class protect themselves by dealing with reputable international insurers or JVs with international partners. However the rapid development of microinsurance is forcing an earlier consideration of relevant regulation.

The insurance sector, because of a history of weak regulation and misuse for taxation and capital transfer purposes, or even direct fraud, has sometimes attracted less than desirable proprietors. This combined with the almost universal requirement as countries develop that certain classes of insurance be mandatory inevitably means the eventual introduction of specific consumer protection laws and systems (although this sometimes follows rather than precedes politically sensitive scandals). The following template was developed for transition and developed markets but the sections on contracts, the role of the courts, disclosure and sales practices have universal application.

Table 1: Comparison of retail financial services characteristics

Comparison of common products

	<i>Insurance</i>	<i>Mortgages</i>	<i>Hardware</i>	<i>Automobiles</i>
Wholesale Cost	Unknown at time of sale.	Variable over the period of the loan.	Known to manufacturer.	Known to manufacturer.
Retail Price	Specific price quotes available. Difficult for the public to comparison shop.	Loan rates published and specific quotes available.	Publicly advertised.	Publicly advertised.
Limitations	Some people might only be eligible for limited forms of coverage.	Some people might only be eligible for higher interest rate loans.	No limitations.	No limitations.
Access	Available to all that meet underwriting standards.	Available to all that meet underwriting standards.	Available to all who can afford cash or credit.	Available to all who can afford cash or credit.
Transparency	Underwriting standards generally unavailable to the public.	Underwriting standards available to the public on request.	Prices clearly marked on items.	Prices marked, but often willing to negotiate.
Suitability	Consumer generally can only determine suitability after a claim occurs.	Consumer has limited time period to reconsider decision.	Can return to retailer if unsuitable some warranties apply.	Warranty provided for a specified time period.
Finality of the Transaction	An agent can arrange coverage but an underwriter might decide that the person is ineligible and cancel the policy on a prospective basis.	The underwriting decision is made before a mortgage is granted.	The hardware item belongs to the consumer once it is purchased, unless it is defective and returned at the consumer's option.	The automobile belongs to the consumer once it is purchased, unless a lemon law applies and returned at the consumer's option.
Compulsion to Buy	Some personal lines insurance products are mandated. Auto because governments require. Homeowners because lenders require.	Have option to rent or pay cash for a dwelling.	Optional.	Essential unless public transit is available. Not compulsory.

Source: NAIC. Personal Lines Regulatory Framework, September, 2006

Insurance Consumer Protection Assessment Template

Consumer Protection Institutions

CONSUMER PROTECTION REGIME

The law should provide for clear rules on consumer protection in the area of insurance, and there must be adequate institutional arrangements for implementation and enforcement of consumer protection rules.

- **There should be specific provisions in the law, which create an effective regime for the protection of retail consumers of insurance.**
- **The rules should prioritize a role for the private sector, including voluntary consumer protection organizations and self-regulatory organizations.**

Good practices demand that insurers offering retail products and services are under supervision for consumer protection purposes because of the essentially opaque nature of insurance contracts (they offer a contingent intangible service delivered sometimes well after the contract is entered into), the enforced use of standard contracts (sometimes subject to adhesion rules), and the complexity of the relevant law (whether civil code or common law based). The IAIS Core Principles and Methodology (ICP 25) expresses this as follows:

Consumer Protection:

The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through the point at which all obligations under a contract have been satisfied.

CONTRACTS

There should be a specialized insurance contracts section in the general insurance or contracts law, or ideally a separate Insurance Contracts Act. This should specify the information exchange and disclosure requirements specific to the insurance sector, the basic

rights of insurer and retail policyholder and allow for any asymmetries of negotiating power or access to information.

Due to its highly specialized nature and very long history insurance remains largely subject to a separate specialized body of law. In Civil Code countries insurance contracts are almost inevitably covered by a separate section of the Civil Code, which will often refer to relevant sections elsewhere in that code. The Civil Code may be supplemented by more specific sections in the insurance law dealing with supervisory and prudential matters. Some common law countries have separate insurance contracts laws, and these may supplement a Civil Code in mixed law jurisdictions (e.g the Czech Republic).

Because commercial and industrial insurance usually precedes the development of consumer (retail) insurance markets, the corpus of the insurance law in most developing and many transition markets does not adequately cover B2C situations and such countries often eventually draw on industrial country models. Aside from specifying the minimal contents of an insurance contract (ideally differentiated by the fundamental nature of the coverage—long term, liability, property, etc.) good B2C contract regulations should differentiate between material and non material non disclosure, specify clearly when the contract goes into force (including cover note situations), when underinsurance justifies the application of average, notification requirements when an insurer wishes to cancel or alter a contract, how contracts will be interpreted in the event of dispute, minimum requirements regarding use of plain words, typeface etc and what clauses may not be included (e.g warranty clauses, compulsory arbitration on the insurer's terms etc). The following table summarizes possible approaches:

- Eastern European Countries with separate contracts law—
Germany, Czech Republic, Austria, Latvia
- Major other countries with separate insurance contracts law—
UK, Australia
- Major countries with Insurance Contracts section in Insurance
Law—China, India, US, Brazil, Russia, Canada
- Civil Code/ Law of Obligations only—Italy, Turkey

CODES OF CONDUCT

- **There should be a principles-based Code of Conduct for insurers that is devised in consultation with the industries and**

- consumer protection associations involved, and is monitored and enforced in the last resort by a statutory agency.**
- **The statutory Code should be limited to good business conduct principles. It should be augmented by voluntary codes on matters specific to the product or channel concerned.**
 - **The operation of voluntary codes should be monitored by a statutory agency, and the Annual Report of that agency should comment on the operation of those codes.**

In European legislation, there is no specific demand for establishing Codes of Conduct in the insurance sector, nor are there provisions that demand the cooperation of the industry and consumer protection associations. Codes are acknowledged by supervisors and statutory consumer bodies in some other jurisdictions, such as Australia and Malaysia.

Table 2: Some codes of conduct

<i>Country</i>	<i>Original Title</i>
Australia	General Insurance Brokers' Code of Practice, General Insurance Code of Practice, Financial Planners' Code of Ethics and Rules of Professional Conduct
India	Code of Best Practice for Indian Life insurers— Life Insurance Council of India
Malaysia	Life Insurance Association of Malaysia Code of Ethics and Conduct (approved by Bank Nagara)
Russia	Russian Association of Motor Insurers—various codes including developing a register of insurance agents and insurance brokers against whom complaints have been made; rules of professional conduct entitled 'Improving the level of service in the MTPL market'; rules covering the review of claims made by victims and the payment of compensation.
South Africa	Life Offices Association Code—24 chapters covering a range of products and activities
UK	ABI Codes including—Statement of Long-term insurance practice, Mortgage endowment Policy reviews; Statement of Best Practice for Critical insurance Cover, with Profit Bonds etc

The exact institutional arrangement depends on legislation (for instance whether there is provision for the legal institution of a statutory code). In some European legislation, it is remarked that the existence of codes alone is not sufficient for full compliance (Council of Europe Convention).

OTHER INSTITUTIONAL ARRANGEMENTS

- **There should be a balance between prudential supervision and consumer protection.**
- **The judicial system must provide credibility to the enforcement of the rules on financial consumer protection.**
- **The media and consumer associations ought to play an active role in promoting financial consumer protection.**
- **Insurers should be legally responsible for all statements made in marketing and sales materials related to their products.**

Where insurers fall under the supervision of a body with both market conduct and prudential responsibilities, a balance needs to be found. For instance, in the UK, the Financial Services Authority is responsible for capital requirements and consumer matters. Similar duties are held by the NAIC certified state insurance departments in the US. On site inspectors are required to examine both prudential and market conduct aspects of their charges. Both the FSA and many state supervisors in the US provide web based support to insurance consumers (see for example New Jersey Department of Banking and Insurance, Division of Insurance—Consumer Protection Services—<http://www.nj.gov/dobi/enfcon.htm>). Theoretically it is better to separate these roles (see for example the Wallis Inquiry—Australia) but institutional reality in many countries means that the prudential supervisor becomes the default recourse for consumers until financial markets have relatively deep penetration into the household sector and formal ombudsmen or equivalents are established (e.g. the UK and Australia—see Australian Financial Ombudsman Service: http://www.fos.org.au/centric/home_page.jsp).

Media and consumer associations often play a very active role in promoting consumer financial protection in most industrial countries. In all European countries, there are consumer associations that also deal with financial services, and an overview is provided by the European Commission.² If, as under Article 7 of decision No 20/2004/EC, specific criteria are fulfilled, organization might be even supported financially by the Community (this holds for two organizations as of August 2008, ANEC and BEUC).³

Further, the Commission has created several consultative bodies, such as the Financial Services Consumer Group, a sub-group of already

² See website: http://ec.europa.eu/consumers/cons_org/associations/index_en.htm

³ Bureau Européen des Unions des Consommateurs (BEUC); European Association for the Co-ordination of Consumer Representation in Standardisation (ANEC).

existing European Consumer Consultative Group.⁴ These are permanent committees that encompass representatives of consumer organizations from each of the Member States. They are particularly asked to ensure that consumer interests are properly taken into account in EU financial services policy. Worldwide addresses of consumer association can be found on the Consumer International website.⁵

Several directives in Europe, hold financial institutions responsible for the content of their public announcements. These are the *Directive on the Distance Marketing of Financial Services, 2002/65/EC* and the *Directive on Comparative Advertising, 1997/55/EEC*.

The treatment of wordings in insurance sales material and contracts is most developed in common law countries where case law has supported the introduction of such concepts as plain meaning interpretations (consensus as idem), good faith and fair dealing (*mala gestio*) and bans on warranty clauses that can enable insurers to avoid legitimate claims.

BUNDLING AND TYING CLAUSES

Whenever an insurer contracts with a merchant or credit grantor (including banks and leasing companies) as distribution channel for its contracts, no bundling (including enforcing adhesion to what is legally a single contract), tying or other exclusionary dealings should take place without the consumer being advised and being able to opt out.

Consumer protection can be used to avoid market power abuse by the dominant players.⁶ Vertical restraints between companies of different industries include anti-competitive tying and bundling. Cross-selling that constitutes bundling or tying can have positive demand and supply-side effects, but may also hamper competition and customer mobility. Bundling is the sale of two goods together in a bundle. Firms bundle for several reasons (economies of scope, price discrimination, demand management or leverage of market power into other market segments). Bundling of faux insurance products has also been used to disguise the real price of associated credit or goods, particularly in Civil Code countries where the doctrine of adhesion applies.

⁴ The website of the sub-group can be found here: http://ec.europa.eu/internal_market/finservices-retail/fscg/index_en.htm

⁵ Web: <http://www.consumersinternational.org/Templates/Internal.asp?NodeID=97533>

⁶ Bakker, M. R. and A. Gros (2004). Development of Non-bank Financial Institutions and Capital Markets in European Union Accession Countries, World Bank Working Paper No. 28.

Bundling is not *per se anti-competitive*, but can reduce competition and limit consumer choice, especially if there is the condition to purchase good B together with a good A (for instance, a mortgage contract together with payment insurance).

Positive effects on the demand side exist, when the price of bundled/tied services is lower for consumers than for unbundled goods and if convenience is increased. Supply-side effects may result from reduced costs of providing bundled services. Bundling, however, can increase pricing complexity and reduce market transparency—thus competitive strategies of firms do have implications for consumer protection.

Bundling further has the potential to render price comparisons impossible. Two criteria are important: (i.) the limitation of consumer choice, (ii.) whether other competitors are hindered. In the European Union, bundling and tying practices in competition policy refer to Art. 81 and Art. 82 of the EC Treaty.

Bundling and tying that limits consumer choice is widespread in markets with weak competition enforcement and should therefore be one of the components to be evaluated when conducting diagnostics of consumer protection.

Disclosure and Sales Practices

FORMAL DISCLOSURE

- **Insurers should ensure their advertising and sales materials and procedures do not mislead customers. Regulatory limits should be placed on investment returns used in life insurance value projections.**
- **Insurers should be legally responsible for all statements made in marketing and sales materials they produce related to their products.**
- **All marketing and sales materials should be easily readable and understandable by the general public.**
- **A key-facts document should be attached to all sales and contractual documents, disclosing the key factors of the insurance product or services in large print.**

Common Law countries again have more scope to deal with the enormous range of potential transaction types that can arise under property, liability (tort) and credit related insurance arrangements.

Civil code countries tend to rely on specific sections of their Civil Codes or separate Contracts Law (Law of Obligations) and sometimes on strict regulatory/ supervisory oversight of transaction and sales material. Thus courts in common law countries are able to bring all relevant material, including sales documents, to bear in arriving at a judgment. This in turn eventually affects the regulatory environment, while supporting an innovative and competitive market.

The key facts (and features if intermediary and product are differentiated) requirements are most developed in the UK and reflect the political response to a number of very public scandals, including Equitable (see <http://www.moneymadeclear.fsa.gov.uk/home.html>). Key facts documents are also known as initial disclosure documents or IDD's. In other countries (e.g. Australia) standardized B2C insurance contracts are established by law, with the right of derogation provided that this is fully disclosed. Some states in the US specifically ban certain wordings (such as warranty clauses) that would enable an insurer to avoid an otherwise legitimate claim. Some US states also lead the way in applying fair dealing concepts.

SALES PRACTICES

- **All insurance intermediaries should be licensed and proof of licensing should be readily available to the general public, including through the internet.**
- **Sales personnel and intermediaries selling and advising on insurance contracts should have sufficient qualifications, depending on the complexities of the products they sell.**
- **Educational requirements for intermediaries selling long term savings and investment insurance products should be specified, or at least approved, by the Regulator or Supervisor.**
- **The sales intermediary or officer should be required to obtain sufficient information about the consumer to ensure an appropriate product is offered. Formal 'fact finds' should be specified for long term savings and investment products and they should be retained and be available for inspection for at least 7 years.**
- **Insurers should be held responsible for product related information provided to consumers by their agents (i.e. those intermediaries acting for the insurer).**
- **The consumer should be made aware of whether the intermediary selling them an insurance contract (known as a policy) is acting for them or for the insurer (i.e. in the latter case they have an agency agreement with the insurer).**

- **If the intermediary is a broker (i.e. acting on behalf of the consumer) then the consumer should be advised at the time of initial contact with the intermediary if commission will be paid by the underwriting insurer. The consumer should have the right to require disclosure of commission paid to an intermediary for long term savings contracts. The consumer should always be advised of the amount of commission paid on single premium investment contracts.**
- **An intermediary should not be allowed to identically fill broking and agency roles for a given general class of insurance (i.e. life and disability, health, general insurance, credit insurance).**
- **There must be a reasonable cooling-off period associated with any traditional investment or long term life savings contract, after the policy information is delivered, to deal with possible high pressure selling and mis-selling.**
- **Sanctions, including meaningful fines and, in the case of intermediaries, loss of license, should apply for breach of any of the above provisions.**

The main sources of guidance on insurance sales practices in the EU are the consolidated life insurance directive (Ch 4 and Annex III), the numerous directives covering non life insurance and motor insurance and the Mediation Directive. Annex III of the Life Directive in particular requires that life insurance consumers are advised of recourse mechanisms at the time of sale. Some EU members such as the UK have disclosure and sales practices that are substantially stronger than those of the Life and mediation Directives, including requiring that full records (sometimes including recordings) of sales transactions are maintained.

There also exist the *Directive on the Distance Marketing of Financial Services, 2002/65/EC* and the *Directive on Comparative Advertising, 1997/55/EE* and the *Directive 2005/29/EC on Unfair Commercial Practices*, which set out misleading practices (Art. 6, 7) with 23 examples in the Annex and aggressive practices (Art. 8, 9) with 8 examples. In Art. 10 it is explicitly stated that unfair commercial practices may be controlled through codes of conduct. Further, there can be recourse to out-of-court settlement, but the latter shall not be seen as equivalent to judicial or administrative recourse.

Outside the EU and its affiliates the main sources of regulation are again the common law industrial countries, and the US, and Australia particular, although there appear to be issues in the US for 'force placed insurance' (i.e. where a lending institution is the policyholder and beneficiary and passes on the cost to its customer). Canada has relied

to a greater extent on widely publicized and accessible industry codes of ethics and a long established consumer inquiries center (see <http://www.insurance-canada.ca/index.php>).

Cooling off periods (also known as free look periods) are seen primarily as a consumer protection mechanism but it has been argued that they are also economically efficient⁷.

The right of withdrawal is enshrined in the Art 6 of the Distance Marketing of Financial Services Directive. According to the provisions, the consumer has the right to withdraw from a contract without penalty and without giving any reasons. The periods vary with product and are longer for insurance contracts and pension products. The period of withdrawal typically begins with the conclusion of the contract and typically is in the range of *two weeks* (14 calendar days as stated in the aforementioned directive). The EU Life Insurance Consolidated Directive specifies a cooling off period of between 14 and 30 days after the 'contract has been concluded'.

Cooling off periods are not uncommon for long term insurance products (i.e. life insurance) in other industrial countries and some emerging markets such as Singapore and cover a relatively wide range of insurance products in others such as Australia: (see <http://www.asic.gov.au/fido/fido.nsf/byheadline/Cooling+off+rights?openDocument>). Typically they are longer than for securities (including investment linked life contracts) because of the onerous early termination penalties that apply to many traditional life insurance savings contracts. In other countries for instance Japan certain products such as variable annuities have cooling off periods incorporated into their products design.

The UK FSA has pioneered know your customer KYC concepts in the insurance sector (see for example http://www.fsa.gov.uk/pubs/cp/cp06_19.pdf Ch14). It defines KYC (in the consumer protection as opposed to the money laundering sense) as follows:

Know your customer. When advising customers, KYC is also known as 'factfinding'. It refers to obtaining sufficient information about a customer's personal and financial situation before giving the advice.

KYC standards in the money laundering sense must be implemented by the national supervisory authorities, whereby financial institutions have different degrees of freedom to design their own customer acceptance policies. The key elements of the policy as it relates to the insurance sector can be found in IAIS ICP No. 28—Anti Money Laundering, Combating the Financing of Terrorism, which specifically

⁷ Rekaiti, P. and Van den Bergh, R. 'Cooling-Off Periods in the Consumer Laws of the EC Member States. A Comparative Law and Economics Approach', *Journal of Consumer Policy*, Nov. 2004

acknowledges the role of FATF. In practice, and despite the huge international financial flows the insurance sector generates (part of which is known to involve funds transfer), this sector has been relatively untouched by the AML/ CFT community.

ROLES OF THIRD PARTIES

- **The regulator or supervisor ought to publish annual public reports on the development, health, strength and penetration of the insurance sector either as a special report or as part of the disclosure and accountability requirements under the law governing it.**
- **Insurers should be required to provide their financial information to enable the general public to form an opinion as to the financial viability of the institution.**
- **If credible claims paying ability ratings are not available the Regulator or Supervisor should periodically publish sufficient information on each insurer for an informed commentator or intermediary to form a view of the insurer's relative financial strength.**

IAIS Core Principle No. 26 (Information, Disclosure and Transparency towards the Market) covers disclosure and is summarized as follows:

The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.

Virtually every country requires insurers to publish their annual accounts (or more often summaries thereof) in the print media at least annually. In most industrial and emerging markets the leading insurers already have web sites that include their product offerings and periodic public accounts, including annual reports. Unfortunately, accounting and actuarial standards are still not at international levels in the majority of emerging and developing countries. In industrial countries the relevant IFRS remains mired in controversy, particularly in accounting for the fair value of liabilities. Regardless of context a high degree of sophistication is required to interpret the financial information provided. As a fall back some countries (e.g. Pakistan) require that claims paying ability is rated for all insurers although the relevant rules do not always specify that international rating agencies should be employed.

More detailed technical data is available in some industrial countries, most notably the US, although in other countries (e.g. Australia)

certain information such as claims run off triangles have been withdrawn under industry pressure.

Privacy and Data Protection

CONFIDENTIALITY AND SECURITY OF CUSTOMERS' INFORMATION

Financial institutions' customers have a right to expect that their financial transactions are kept confidential. The law ought to require financial institutions to ensure that they protect the confidentiality and security of personal data, against any anticipated threats or hazards to the security or integrity of such information, and against unauthorized access.

The confidentiality of personally identifiable information, that is any information about an identified or identifiable individual, is protected under several international statutes, such as the *Guidelines governing the protection of privacy and trans-border flows of personal data* (Art. 2 'Scope of Guidelines'); the *UN Guidelines concerning computerized personal data files adopted by the General Assembly on 14 December 1990* (Sect. A, minimum guarantees that should be provided in national legislations);

Further, important statutes are the *Directive on the Protection of Individuals with regard to the Processing of Personal Data, 1995/46/EC* (Chapter 1, Art. 1-3) as well as the Convention for the protection of individuals with regard to automatic processing of personal data (ETS No.108, the 28 January 1981, Chapter. 1 'General Provisions') and in the APEC Privacy Framework (Part ii, 'Scope').

Technical security is also demanded under the above guidelines and directives, a more detailed guideline on such security has been provided by the *OECD Guidelines for the Security of Information Systems and Networks: Towards a Culture of Security*.

In the U.S., the Federal Trade Commission established guidelines in form of a document entitled '*Safeguarding Customers' Personal Information: A Requirement for Financial Institutions Financial Information Safeguards Rule*' (2002) which obligates financial institutions to hold customer information secure and confidential.⁸

The use of medical and genetic (biometric) information for the acceptance/ decline and rating of life related risks is now a major area of debate, but is not within the scope of this best practice note.

⁸ The document can be downloaded from the FTC's website: <http://www.ftc.gov/opa/2002/05/bussafeguards.pdf>

Dispute Resolution Mechanisms

INTERNAL DISPUTE SETTLEMENT

- **Insurers must provide an internal avenue for claim and dispute resolution to policyholders.**
- **Insurers should designate employees to handle retail policyholder complaints.**
- **The insurer must inform its customers of the internal procedures on dispute resolution.**
- **The regulator or supervisor must provide oversight on whether insurers comply with their internal procedures on consumer protection rules.**

Insurers ought to have written policies in place for dispute settlement. A written policy should hold the insurer liable for the announced policy. This policy should offer contact points for the consumer that are accessible during business hours without undue waiting times, state in plain language the main steps of customer dispute resolution, provide firm, reasonable time lines, guarantee the fairness in handling the customer dispute, states the coordination with any ombudsman and/or supervisory authority, explain in plain language the consumer's rights in the process. Consumer dispute settlement should not lead to unreasonable costs in terms of time and money for the consumer.

The EU Life Directive requires that policyholders are advised of their right of recourse; however specific provisions of this type are uncommon in insurance law. Consumer protection law sometimes does provide for notification of rights, although insurance transactions may be excluded in certain circumstances (e.g. the latest version of the Croatian Consumer Protection Law).

FORMAL DISPUTE SETTLEMENT MECHANISMS

- **A system should be in place that allows consumers to seek affordable and efficient third-party recourse in the event they cannot resolve an issue with the non-bank credit institution, which could be an ombudsman or tribunal.**
- **The role of an ombudsman or equivalent institution vis-à-vis consumer complaints must be in place and made known to the public.**
- **Ombudsman's impartiality and independence from the appointing authority and industry must also be assured.**

- **The enforcement mechanism of the decisions of the ombudsman or equivalent institution and binding nature of the decision on banks must be in place and publicized.**

Few customers have the knowledge to realize that their rights have been infringed and even if they become aware of this, they typically have few avenues to pursue their claims. Thus insurers should be mandated to have an internal dispute resolution or complaint handling mechanism, which provides a first level dispute resolution mechanism. Unless there are voluntary consumer protection associations that have the resources and skills to assist customers with their complaints or legal actions against insurers, consumers do not have many venues to seek redress. The absence of small claims court, as is the case in many countries, prevents an affordable means for the average customer to bring action against sellers, service providers and corporations. Thus, it is not surprising that a specialist insurance Ombudsman or insurance claims and inquiries service (sometimes as part of an omnibus Ombudsman service as in the UK) is increasingly regarded as a fundamental requirement for sound consumer protection.

It can be difficult for an Ombudsman to effectively mediate and ameliorate the problems faced by policyholders without clear codes of insurance practice and standardized contracts. One of the most advanced integrated systems is now to be found in Australia, where an SRO based insurance inquiries and complaints resolution system has evolved into a fully fledged financial sector ombudsman (http://www.fos.org.au/centric/home_page.jsp).

Consumer Advocacy and Financial Literacy

- **Policymakers, industry and advocates should understand the financial capability of various market segments, particularly those most vulnerable to abuse.**
- **Consumers, especially the most vulnerable, should have access to sufficient resources to enable them to understand financial products and services available to them.**

The role and impact of media cannot be overstated. However, there is often weak coordination and cooperation between the media and regulators and/or industry associations with the relevant information to educate consumers.

Industry associations in more developed markets should provide a centralized inquiries service that is well publicized, knowledgeable and easily accessible.

Insurance account handling

- **The customer should receive periodic statements of the value of their policy in the case of insurance savings and investment contracts. For traditional savings contracts this should be at least yearly, however more frequent statements should be produced for investment linked contracts.**
- **Customers should have a means to dispute the accuracy of the transactions recorded in the statement within a stipulated period.**
- **Insurers should be required to disclose the cash value of a traditional savings or investment contract upon demand and within a reasonable time. In addition a table showing projected cash values should be provided at the time of delivery of the initial contract and at the time of any subsequent adjustments.**
- **Customers should be provided with renewal notices at least 30 days before the renewal date for non life policies. If an insurer does not wish to renew a contract it should provide at least 30 days notice.**
- **Claims should not be deniable or adjustable if non disclosure is discovered at the time of the claim but is immaterial to the proximate cause of the claim. In such cases the claim may be adjusted for any premium shortfall or inability to recover reinsurance.**
- **Insurers should have the right to cancel a policy at any time (other than after a claim has occurred—see above) if material non disclosure can be established.**

Insurance law rarely deals with customer account handling in any detail—partly reflecting the huge variation in insurance arrangements that are possible. The EU Life Directive does require that policyholders are advised of bonus developments, but this does not appear to mean that individual policyholders are regularly advised of the cash value of their contracts. The heavy selling costs associated with traditional life insurance products often means that a contract has no value for some years and there are strong incentives for the life insurance sector to resist cash value disclosure for the first 5 or more years a contract is in force. As markets develop insurers tend to unbundle the pure risk and

savings/ investment components of long term contracts and disclosure standards often improve.

Guarantee Schemes and Insolvency

With the exception of schemes covering mandatory insurances, guarantee schemes are not to be encouraged for insurance because of the opaque nature of the industry and the scope for moral hazard. If such schemes are desired for political economy purposes they must be accomplished by strong governance and supervision regimes.

Nominal defendant arrangements should be in place for mandatory insurances such as motor third party liability insurance.

Assets covering life insurance mathematical reserves and investment contract policy liabilities should be segregated or at the very least earmarked, and long term policyholders should have preferential access to such assets in the event of a winding up.

Non life insurance is typically subjected to normal commercial wind up rules in the event of insurer insolvency, and the subsequent claims settlement process is usually handled by guarantee funds or specialist run off companies. Policyholders normally arrange new coverage with the remaining solvent insurers in the market concerned. However most countries do have claims guarantee arrangements for mandatory consumer classes such as motor third party insurance. These cover claims that cannot be settled due to insurer bankruptcy or because the guilty driver/ vehicle cannot be identified (i.e. the guarantee fund acts as 'nominal defendant').

Life insurance is also often deemed to require supplementary arrangements because it can represent a significant asset for the individual or household and may also serve as loan collateral. In this case the usual protection is primarily afforded through separation of life and non life insurers and strong prudential oversight. However composites (insurers writing both life and non life) have been grandfathered in numerous countries and special additional arrangements are required in this situation. This may range from the relatively weak EU directive (Directive 2001/17/EC Reorganisation and winding-up of insurance undertakings), which requires that the assets covering defined life insurance liabilities are earmarked, to the requirement that completely separate statutory funds are maintained, as in South Africa, Pakistan and Australia. In addition life policyholders normally rank very high in terms of creditor priority. Most countries also either specify investment limits for the assets covering life insurance mathematical reserves or,

where risk based supervision already operates, require that capital allocated reflects the risk characteristics of the asset portfolio.

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Annex 1—Legislative Sources

Table A1: Overview of consumers protection legal infrastructure

<i>Institution</i>	<i>Directive, Implemented Laws, Guidelines, Studies</i>
European Union	<p>EU: Directive 77/92/EEC, Insurance agents and brokers and Directive 2002/92/EC on insurance mediation</p> <p>EU: Directive 2002/83/EC on Life Insurance Ch4 and Annex III</p> <p>EU: Directives on Non Life Insurance and Motor Insurance</p> <p>EU: Directive 2001/17/EC Reorganisation and winding-up of insurance undertakings</p> <p>EC Green Paper on Retail Financial Services in the EU: Com (2007) 226 Final</p> <p>European Commission Recommendation on the principles applicable to the bodies responsible for out of court settlement of consumer disputes (98/257/EC) and on the principles for out of court bodies involved in the consensual resolution of out of court disputes (2001/310/EC).</p> <p>Insurance Contract Law Review papers of the English and Scottish Law Commissions: http://www.scotlawcom.gov.uk/downloads/cp_insurance.pdf</p> <p>The Project Group—Restatement of European Insurance Contract Law submission to the European Commission—Draft Common Frame of Reference (CFR): “Insurance Contract”: http://www.restatement.info/</p> <p>Insurance Contracts Law of Latvia, Sept 1998 as amended</p> <p>The Insurance Contract Act Czech Republic, December 2003 and Act on Insurance Intermediaries and Loss Adjusters Czech Republic, December 2003</p> <p>Directive Concerning Processing Personal Data and Protection of Privacy in the Electronic Communication Sector, 2002/58/EC</p>

	<p>Directive on Protection of Consumers in Respect of Distance Contracts, 1997/7/EEC</p> <p>Directive on the Distance Marketing of Financial Services, 2002/65/EC</p> <p>Directive on Comparative Advertising, 1997/55/EEC</p> <p>European Commission Recommendation on the principles applicable to the bodies responsible for out of court settlement of consumer disputes (98/257/EC) and on the principles for out of court bodies involved in the consensual resolution of out of court disputes (2001/310/EC).</p> <p>Policy statement: Nature and consequences of pyramid activities in life and accident insurance: Commission on Financial Services and Insurance, 30 May 1997</p>
Council of Europe	<p>Convention for the protection of individuals with regard to automatic processing of personal data (ETS No.108, the 28 January 1981, Entry into force: 1.10.1985) and Explanatory Report</p>
International Association of Insurance Supervisors	<p>Insurance Core Principle No. 25—Consumer Protection</p> <p>Guidance Paper No. 4 on Public Disclosure by Insurers, 2002</p>
United Nations	<p>UN Guidelines concerning computerized personal data files adopted by the General Assembly on 14 December 1990</p>
OECD	<p>OECD: Good Practices for Enhanced Risk Awareness and Education in Insurance Issues: 2008</p> <p>OECD Guidelines for Good Practices for Insurance Claims Management: November 2004</p>
APEC	<p>Guidelines governing the protection of privacy and trans-border flows of personal data</p> <p>APEC Privacy Framework</p>
Other leading jurisdictions	<p>Australian Insurance Contracts Act, 1984</p> <p>US National Association of Insurance Commissioners Market Conduct Model State Law</p> <p>Alberta, Canada—Fair Practices Regulation under Insurance Act—128/ 2001</p>



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