



Financial Services Authority

# The sale of critical illness cover: results of thematic work

May 2006



# Contents

<b>1</b>	<b>Overview</b>	<b>3</b>
	Background	3
	Our approach	4
	Our findings	4
	Next steps	8
<b>2</b>	<b>Overall findings and treating customers fairly (TCF)</b>	<b>9</b>
<b>3</b>	<b>Product design and literature</b>	<b>11</b>
	Industry guidance	11
	Product literature	11
	Product design	13
	Reviewable v guaranteed premiums	13
<b>4</b>	<b>Selling practices</b>	<b>14</b>
	Assessing suitability	14
	Explaining the product	17
	Personal circumstances and the underwriting process	20
	Statement of demands and needs (SODAN)	24
<b>5</b>	<b>Training and competence</b>	<b>26</b>
<b>6</b>	<b>Systems and controls</b>	<b>28</b>
	Compliance and monitoring	28
	Senior management and management information (MI)	29
	Pressure selling and remuneration	30
	<b>Appendix – Other relevant publications</b>	



# 1 Overview

## Background

1.1 One of our key priorities is to help retail consumers achieve a fair deal. Our Business Plan identified four key features of an effective and efficient market:

- capable and confident consumers
- clear, simple and understandable information
- responsible firms that treat their customers fairly; and
- risk-based regulation

We aim to deliver this using a number of tools, including thematic work.

1.2 This review of the sales of critical illness cover (CIC) is one of several thematic projects looking at the advice and information being given to retail customers when they buy financial products. We decided to carry out this review because of concerns we identified following a review of CIC documentation and financial promotions. Details of other relevant work are set out in the Appendix. We are focusing on products that, through their complexity or other features, may pose particular risks to consumers.

1.3 We are also doing other work related to protection products. This includes a further review of sales practices of payment protection insurance (PPI), an investigation into the use of unfair contracts in single premium PPI, and later in the year a further review of GI disclosure documents (including CIC). We will publish the findings of that work in the coming months.

1.4 This report sets out our findings on the extent to which firms selling CIC are:

- complying with our detailed rules; and
- more generally, treating their customers fairly during the sales process.

It also identifies potential areas of consumer detriment.

- 1.5 CIC usually pays out a lump sum if the policyholder is diagnosed with certain specified conditions. Most sales of CIC are made to customers taking out a mortgage. While CIC can be bought as a stand-alone product, typically it is taken as part of a term assurance policy. Unlike some other protection policies, many sales of CIC are made on an advised basis following an assessment of the individual customer's financial needs. Overall, CIC sales have been in decline – falling by around 30% between 2002 and 2004.
- 1.6 CIC can be sold under either the COB<sup>1</sup> or ICOB<sup>2</sup> sourcebooks, depending upon length of term and age of the policyholder at the expiry date. In practice, the relevant parts of both regimes are broadly equivalent<sup>3</sup>. In this report we refer to ICOB rules – this should be taken to also mean the equivalent COB rules.

## **Our approach**

- 1.7 Our findings are based on supervision visits to 42 firms. These were mainly mortgage and financial advisers, but also included banks, building societies and insurers. Before each visit we reviewed a variety of documents and information from the firms, particularly the material provided to customers. During the visits we interviewed senior management, compliance and sales staff. We also reviewed a selection of customer files (sales, complaints and refused claims). Our aim was to assess the potential for detriment to customers buying CIC, whether on an advised or non-advised basis.
- 1.8 We also commissioned a market research company, Research International, to carry out 80 mystery shops across a total of 51 firms to look at what happens in practice. Shoppers either asked for a mortgage, a full financial review, or a CIC quotation, depending on the type of firm. In the first two scenarios shoppers were instructed not to proactively enquire about CIC, so that we could gauge the extent to which firms were actively trying to sell CIC. But if CIC was not mentioned, shoppers asked questions to encourage firms to discuss it. In 51 cases, shoppers were told to say, if asked, that they had a previous or current condition or a family history that might affect the cost or availability of CIC. All other relevant customer details, such as financial commitments and occupation were the shopper's own.

## **Our findings**

- 1.9 The purpose of this report is to feed back our detailed findings, so firms and others understand the problems we found and can consider how to address them.

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1 Conduct of Business sourcebook

2 Insurance: Conduct of Business sourcebook

3 The most significant difference is that ICOB requires a firm to recommend a suitable product, while COB requires them to recommend the most suitable product.

4 The sale of critical illness cover (May 2006)

Our findings include specific examples of good and poor practice, and also reflect results of the mystery shopping. The examples of good practice are provided as examples only and may not be relevant to or suitable for other firms.

- 1.10 Some of our findings, such as the way CIC is considered in the context of a review of the customer's financial protection needs, are positive. In that sense, there were similarities to the way PPI is sold alongside a prime mortgage. We also recognise that the industry itself has identified problems with CIC as a product and has launched initiatives to improve things for example to clarify what CIC covers and application forms. These seem to be having a positive effect.
- 1.11 However, our work confirmed some of the compliance concerns we already identified last year in the context of work on the financial promotion of CIC and the general insurance documentation review. We found a number of aspects of the sales process where we consider that firms are not doing as much as they could to treat their customers fairly. As CIC is often a secondary or tertiary purchase (after a mortgage and term assurance) and it has some complex features, firms have trouble getting customers to take enough interest in understanding what they are buying. Of the high level of claims that are rejected (over 25% in some cases) about half are because customers fail to fully disclose their personal circumstances. So it is important for firms to overcome this problem.
- 1.12 Positive findings from the visits to firms were:
  - **Most intermediaries undertook a detailed assessment of the protection needs of the customer before making a recommendation to buy CIC.** We found that advisers would generally find out the customer's priorities for protection – such as repaying the mortgage if they were unable to work – and identified products, including CIC where relevant, that would meet the customer's objectives. On the other hand, where the firm offered more than one CIC product, price was often the only factor used to decide which one to recommend. Others, such as the conditions covered, did not usually influence their advice.
  - **Most firms also had reasonable controls to manage the risk of mis-selling.** Controls were reasonably strong among most of the firms we visited. For example, they had good training programmes, remuneration policies that did not unduly incentivise sales and risk based compliance monitoring. But there were three firms where controls were weak.
  - **While we previously found promotional material that used scaremongering tactics, we did not find any evidence of advisers and sales staff trying to scare consumers into buying CIC.**

### 1.13 But we also found:

- **Firms often assumed that the product was simple and gave their advice accordingly.** Many firms thought the basic concept of the product was simple because they used common definitions of illnesses set by industry guidance. They did not seem to appreciate that customers do not understand the subtlety of those definitions, which in turn determine when the policy will pay out. We also found that sales staff did not always have a clear understanding of the CIC product they were selling.
- **Documentation could be clearer.** For example, key features documents often did not clearly set out the benefits and key limitations and exclusions under the policy.
- **Justification of CIC sales were poor.** Firms used standard wordings in demands and needs statements, which in some cases did not say much more than the policy would pay a lump sum if the customer developed a critical illness. Internal records were no more enlightening about why they had recommended CIC or the level of sum insured.
- **Insurance regulation had not been a priority for some firms.** Some mortgage advisers, new to regulation, had tended to focus their efforts on getting the mortgage side of their business in shape, as insurances sales were only secondary. They recognised they needed to give greater priority to this, although we did not find evidence that they had been mis-selling so far.
- **Firms did not do enough to make sure that customers disclosed relevant medical information.** Intermediaries were sometimes unclear about the medical information they are expected to collect, and so could leave information off the application form sent to the insurer, affecting the validity of any existing cover.
- **The relationship between providers and intermediaries did not always work well.** Industry figures suggest that between 10% and 20% of applications including CIC are “rated”, either with the premium increased or additional exclusions imposed. Insurance companies often do not tell the adviser the outcome of the underwriting process, so the adviser is not in a position to discuss the significance of special terms or changes in premium with the customer.

1.14 The mystery shopping results support the substance of our visit findings on the quality of the sales process and any advice given. They also show some more general issues about the sales of insurance products. These findings are not limited to whether firms comply with our detailed rules, but may indicate whether overall they are treating their customers fairly.

1.15 These shops were only taken so far, and in some cases, the adviser or sales person said they would need a further appointment that was not followed up.

Some of the quotes given were clearly only intended to be indicative following a preliminary discussion of a shopper's circumstances. It is likely that further information would have been provided, and more questions asked, in a further stage of the sales process. The mystery shopping results need to be read with this in mind.

1.16 Encouraging findings from the mystery shopping exercise are:

- **The discussion of protection needs was often part of a wider review of the customer's circumstances:** As CIC is often a secondary or tertiary product, many of the shopper's personal circumstances were discussed during the factfind for the primary product. In advised sales, the shopper's income, financial commitments, planned changes to future lifestyle and existing insurance cover were all assessed to varying degrees and were all used to inform the advice given on protection needs.
- **Other products were considered:** Even during the early discussions, there was evidence that advisers considered whether there were other protection products that might meet the customer's needs.
- **Little evidence of pressure selling.** In only three of the 64 mystery shops where a quote was given, did the shopper feel they were put under any pressure to take out CIC.

1.17 But it also identified some areas of concern:

- **Lack of clarity about the status of the sale.** In 21 out of 69 shops where CIC was discussed, the salesperson did not confirm whether the sale was advised or non-advised (either verbally during the appointment or by providing the initial disclosure document (IDD)). Only 37 out of 69 firms provided shoppers with IDDs either during the visit or afterwards in the post.
- **The quality of explanation of CIC was poor.** A high proportion of shoppers said they thought they had been given a clear explanation of the product, but when we tested further, we found that they had often not understood some of the features. For example, in 19 out of 64 cases where CIC was quoted, shoppers thought it would provide an income. Few firms explained the shopper's cancellation rights or exclusions and limitations. Approximately half (30) of the 64 firms did not tell the shopper that the quote could change on consultation with the underwriter. So many customers were unclear what they were buying.
- **Many firms did not justify their advice.** Few shoppers reported that the firm had explained why CIC was a suitable product to meet the shopper's needs.
- **The importance of full disclosure was given relatively little attention during the evaluations.** The quotes given were provisional, but this was only explained in 29 cases. Firms would have asked for medical information

during the application process, had the customers gone ahead, and the need for full disclosure ought to have been highlighted then.

- 1.18 The report by Research International is available on our website<sup>4</sup>.

## **Next steps**

- 1.19 On the basis of these findings, we have no current plans to undertake a further thematic review of CIC sales, specifically, in the near future. We are giving feedback to firms that we visited. Supervisors will have follow-up discussions with their firms, for example, in the context of ARROW<sup>5</sup> assessments or thematic discussions on TCF. We will also continue to follow market developments to see if the changes we have referred to are starting to benefit consumers, and review whether more thematic work on CIC is desirable.
- 1.20 Some of the findings of this work provide a helpful insight to the effectiveness of the new regulatory regime for general insurance and pure protection products. We will take account of these findings in our effectiveness review.
- 1.21 We have highlighted that many of the problems in this market arise because of lack of consumer understanding. Firms that treat their customers fairly have a role to play in ensuring customers understand their rights and responsibilities. However, we will also review the material we provide to consumers, for example through the consumer section of our website, on critical illness and other protection products.
- 1.22 We will consider whether there are wider issues relating to GI and protection products (including CIC) and the way they are sold in the light of other thematic work.

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4 [www.fsa.gov.uk/Pages/Library/other\\_publications/consumer/index.shtml](http://www.fsa.gov.uk/Pages/Library/other_publications/consumer/index.shtml)

5 Advanced Risk-Responsive Operating Framework – our risk-based approach for supervising firms.

# 2 Overall findings and treating customers fairly (TCF)

- 2.1 Normally, in a report on a piece of thematic work, we would aim to report very strictly on the extent that firms complied with our detailed rules. Our experience in this case is that, although we found some problems, firms are generally attempting to comply with the detail of our rules. However, there is clear evidence of problems with the sales of CIC – the high level of claims rejected, sometimes leading to the kind of significant hardship for the individuals concerned that we hear about in the media. That is not good for consumers or firms.
- 2.2 So we have decided to use this report to:
- highlight areas where firms could do more to help their customers; and
  - share examples of the ways some firms are already trying to tackle the causes of consumer detriment.
- 2.3 In many senses, we provide here a practical case study of how complying with the strict letter of the conduct of business rules alone may not always be enough to make sure that firms are treating their customers fairly.
- 2.4 In some cases, we have given examples of poor outcomes, even though the sale was done on a non-advised basis. In other cases, we have used examples of cases where firms have decided to go further than our rules require to achieve a better outcome for customers, perhaps by aiming to recommend the most suitable product. In others, it is because firms have tried to comply with the rules in a different way or at a different time, as they think this helps them to treat their customers fairly.
- 2.5 As we have noted in the report, sales processes have been developing over recent years. Regulation has been one driver of change, with firms now having to comply with our rules when selling CIC. But the industry has, itself, been trying to improve the situation. The Association of British Insurers (ABI) has introduced guidance to bring greater consistency in the scope of policies and to improve the clarity of documents and application forms. The Association of

Independent Financial Advisers (AIFA) has also issued guidance to its members to improve the advice they give when selling CIC. These changes are welcome and hopefully, they will translate into lower rates of rejected claims over time – inevitably there is a time lag between improved sales practices and improved claims because of the long-term nature of the product.

2.6 We selected a broad sample of firms of different sizes across a range of sectors and they included firms selling on both an advised and non-advised basis. So there are a range of issues for firms to consider. However, three broad areas are worth highlighting:

- **Product disclosure:** Consumers find these products difficult to understand because the precise nature of what is covered is so technical. The fact that policy terms vary adds to the potential confusion. Against that, industry has tended to view these products as simple because they follow industry guidance. This means that the firms selling CIC products may not always recognise the challenge to them in explaining the product in a way that customers find easy to understand. This challenge is all the greater because, of course, CIC is rarely sold as a primary product, and instead is incidental to a life policy and, often, a mortgage. In the meantime, many claims continue to be rejected because the illness is not covered by the policy.
- **Medical disclosure:** The other main reason why claims are rejected is that customers do not fully disclose information about their medical history. We know that there are cases where customers deliberately mislead the insurer, but in most cases, consumers simply do not understand what is required of them. The fact that dishonest consumers think they can hide information and still make a claim shows how little they understand their obligations and the consequences of not disclosing. This, in turn, is a telling indicator of how effectively firms explain about the need to disclose relevant information.
- **Changes to underwriting terms:** One of the consequences of the underwriting process is that the terms of the policy can change compared to how the sales person or adviser originally described them to the customer. Typically, this happens in 10% to 20% of applications. The changes could result in the cost increasing or additional exclusions. There are potentially two concerns here. First, how well these changes are communicated – our file reviews suggested that changes to the price are clear, but changes to the terms and exclusions could be explained better. Second, how effectively – in advised sales – do firms review their initial recommendation and consider whether the outcome of the underwriting process has changed the desirability of the product and its effectiveness for meeting the customer's needs. We have identified that statements of demands and needs for CIC are often of poor quality and issued early in the process, so do not help consumers review whether the product still meets their needs when they receive a formal proposal. Better coordination and support between intermediaries and insurers could improve things.

# 3 Product design and literature

## Industry guidance

- 3.1 In April 1999 the ABI first issued a statement of best practice for CIC, providing standard (model) definitions for the illnesses covered and most common exclusions. The guidance allows insurers to decide which illnesses to include. They can offer cover on additional illnesses, but it recommends they use the model definition if one exists. The model definitions are on the basis of an appropriate minimum standard and firms may increase the level of cover. This has meant that product descriptions are largely consistent, and consumers should be able to compare different providers more easily. The latest revised version of the guidance was issued in April 2006, and this is due to be adopted by firms by 2007.

## Product literature

- 3.2 We reviewed documents prepared by the sample of insurers we visited, and those received by the mystery shoppers. This included looking at policy summaries, key features documents (KFDs), application forms and policy documents. Insurers were using the generic terminology to describe critical illnesses and exclusions. However, consumers would often be no clearer about the nature of cover as they did not understand the significance of the terms used and so were dependent on sales staff being able to clarify or explain the cover. To help address this, some insurance firms have produced plain English guides to the conditions covered. Firms may hand these out to customers for their information, but they could be used more actively as a tool to help explain the cover available. In some cases, advisers could also use them more effectively to help improve their product knowledge.
- 3.3 Also, as CIC is one of several optional covers sold with (usually) a term assurance, there tends to be a single policy document. This makes the policy document long and complex – and not user-friendly – so it is less likely that

most consumers will read it properly. Finding a better, simpler way to structure policy documents could help insurers treat their customers more fairly – some firms have started using techniques like thumbnail indexing, to make it easier to navigate to the relevant sections.

- 3.4 The ABI's April 2006 revised statement of best practice has tried to adopt a description of the conditions covered that will provide consumers with a clearer view about what is, and is not, covered, while keeping it in simple language. Implementing this new guidance gives firms an opportunity to review and improve their literature.
- 3.5 Our findings on reviewing the current documents were consistent with those of the General Insurance Disclosure Documentation review in 2005. We set these out in a Dear CEO letter dated 2 December 2005. As our visits took place only shortly after that feedback, it was not surprising that new literature was not available. Of the half dozen product providers in our sample, a couple told us they had already started, at the time of our visits, to review their literature to take account of our findings from that work.
- 3.6 So our findings confirmed that there was scope for improving documents such as KFDs, particularly as they are often the only sales aid used. While firms had followed ABI guidance, the KFDs were often not as clearly set out as they could be. We found that important information about exclusions was often at the back of the document or scattered throughout it. This makes it difficult for the consumer to get a clear overall picture of the cover. Also, important information about pre-existing conditions or non-disclosure was not mentioned. The KFD was often contained within promotional material. This meant the information about key features was not always clear for customers. We found evidence of insurers not cross-referencing the KFD to the policy document to help consumers and as required by our rules.
- 3.7 Following ABI guidance, firms seem to be recognising that there are problems with how application forms are designed and we did find some evidence of firms redesigning forms to help make things clearer – for example, by colour coding the different sections where there are a number of options.
- 3.8 A few intermediary firms said that they found documents provided by insurers were of a poor standard, though others said they thought they had improved recently.

## Product design

- 3.9 There were signs that firms were improving their product design:
- allocating additional resource to marketing and product design, so they could carry out market research and analysis and better understand customers' needs;
  - an insurer deciding not to reinsure its risks on CIC policies because the reinsurers would only give cover if the CIC policies included terms the insurer thought too restrictive.
  - stand-alone policies were often targeted at a specific, niche market and the insurers had tailored the product to the needs of that market.

## Reviewable v guaranteed premiums

- 3.10 We found that many insurers are moving away from guaranteed premiums to reviewable premiums. Insurers told us this was because it was difficult to obtain reinsurance cover to be able to continue to offer guaranteed premiums. But it is still possible to find guaranteed premium policies, and one firm said it had recently gone back to selling a guaranteed premium product, after it found the difference in the cost of its reinsurance had narrowed.
- 3.11 The product providers we spoke to said they had not exercised their right to review premium rates but they could not rule this out in future. This was covered in our statement of good practice in 2005<sup>6</sup>. Firms said they recognised that they had limited scope for increasing rates, for example to reflect actual claims experience and take account of the costs of underlying improvements in healthcare. We understand the ABI has plans to issue guidance on the practical application of the UTCCRs to reviewable premium clauses.

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6 [http://www.fsa.gov.uk/pubs/other/good\\_practice.pdf](http://www.fsa.gov.uk/pubs/other/good_practice.pdf)

# 4 Selling practices

## **Assessing suitability**

- 4.1 Our rules (see ICOB 4.3.1R) require an insurance intermediary to take reasonable steps to ensure that, when they make a personal recommendation to a customer to buy a particular insurance, that product is suitable for the customer's demands and needs.

## **Identifying the protection need**

- 4.2 We found that mortgage or financial advisers generally undertook a detailed fact find, inevitably with a focus on the primary sale – usually a mortgage. So they collected a range of personal and financial information, such as about income and financial commitments. This information provided the adviser with a good insight into the personal circumstances of the individual when it came to recommending protection products, including CIC.
- 4.3 We also found that firms obtained details of existing protection cover (including employment benefits) and took these into account in assessing need. The senior management and sales advisers that we interviewed, recognised that it would often not be in the customer's interest to replace existing cover. This would particularly be true if the customer had developed an illness since taking out the first policy, which could be excluded on a replacement policy. The customer would therefore lose valuable protection they might have under their original policy.
- 4.4 We found that advisers made their recommendation on the basis of a review of the financial protection needs of the customer. This review included an assessment of the priority the client attached to different objectives, such as repaying a mortgage or to provide an income for their family if they died or were unable to work. CIC would be recommended where the adviser felt this would contribute to those priorities. Where the firm offered more than one CIC product, price was often the only factor used to decide which one to recommend.

- 4.5 The judgement about the suitability of CIC can be different to that for some other protection products such as PPI or a term assurance. This is because we all risk becoming critically ill and would have to face up to the financial consequences of that, such as needing to fund treatment or modifications to our homes or even repaying the mortgage when we are unable to work. This contrasts with some other types of insurance where a policy is of no use to the consumer – whether because their circumstances mean they would never be able to claim or because they do not need the benefits under the policy. The important question of whether a CIC policy is value for money or the best way to meet the customer’s objectives, particularly when additional exclusions apply, is a slightly different issue that we consider later.
- 4.6 When we asked firms whether they thought mis-selling was likely to be an issue, they told us that their main concern was getting people to face up to the need for protection as many were unwilling to pay for protection insurance. They said even where people did take out protection policies, they often let them lapse when money was short as insurance was a low priority for them. This view is in line with market data that has shown the falling sales of CIC and other protection products.

### **CIC sold instead of income protection**

- 4.7 Several firms told us that they recommended CIC, even though the customer’s needs would have been better served by another product – particularly income protection. In particular, a customer unwilling to buy income protection cover might pay for CIC often with lower levels of cover and at a lower cost. Advisers felt this would at least provide some protection even if CIC was not the best product to meet the customer’s objectives and the nature of cover is more restrictive.
- 4.8 But we also found some evidence of firms selling CIC on the basis it would produce a lump sum that could be used to replace lost income, for example by investing the lump sum in a life annuity:
- A direct sales force of an insurer identified that a client had an income protection shortfall of £15,000 per year, yet it offered life and CIC protection of £465,000. Its explanation to the customer was, ‘After meeting any immediate costs (including lifestyle changes, if relevant), the balance may be invested to provide an income’, and they explained to us that the sum assured reflected the number of years until retirement times the annual income that would be lost if the policyholder was unable to work.
- 4.9 This was not an isolated example – we found an almost identical case in our mystery shopping involving the direct sales channel of another major insurer. There could have been other factors leading to these recommendations that are not apparent from the companies’ records and so the products could have been

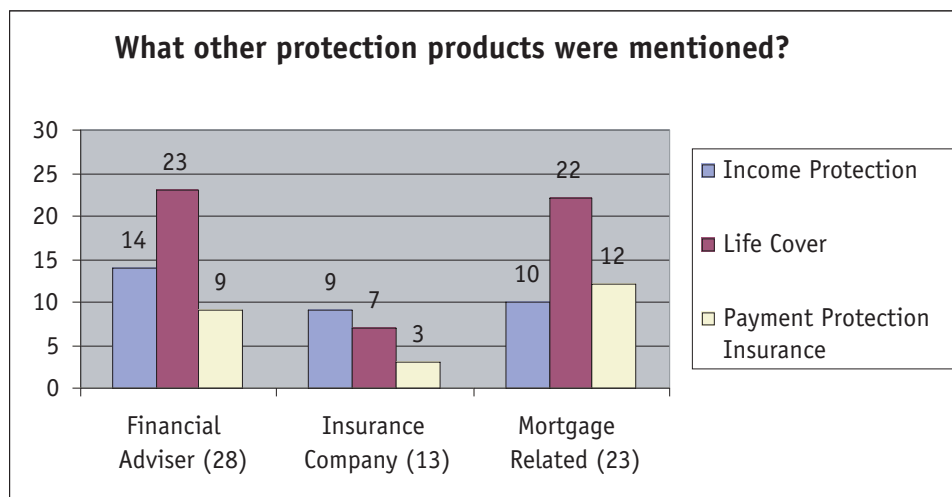
suitable in those specific cases. But this was potentially a high-risk approach to meeting the protection need, and was not necessarily a cost-effective solution for the client, compared to income or payment protection. It was also not clear that the risks were properly explained to the customer.

## Mystery Shopping

4.10 Firms told us that the particular needs of the consumer are usually discussed during the sales process. The mystery shopping provided some evidence of this, but the quality of the discussion varied by sales channel. In assessing protection needs, firms asked the shoppers about:

- income (in three out of four of the shops involving financial and mortgage advisers); and
- in about half the shops (across the board):
  - changes in future lifestyle;
  - other financial commitments; and
  - other protection cover.

4.11 Evaluators commented that, in giving the advice, the sales person had also discussed other options including income protection, life cover and payment protection insurance in a fair number of cases.



4.12 We also asked the evaluators if the member of staff explained why CIC was the most suitable product to meet their needs:

<b>Firm and shop type (sample)</b>	<b>Yes</b>	<b>No</b>
All (64)	22	42
Small financial advisers (15)	8	7
Face to face (30)	16	14
Telephone (34)	6	28

## **Explaining the product**

- 4.13 Our rules (in ICOB 5.3.1R) require an insurance intermediary (for non-distance contracts) to provide a retail customer with a policy summary, or a key features document, and to draw the attention of the retail customer orally to the importance of reading the policy summary, and in particular the section of the policy summary on significant and unusual exclusions or limitations before conclusion of the contract. Principle 7 requires communications with clients to be clear, fair and not misleading.

## **Product disclosure**

- 4.14 During interviews with sales staff, many told us that they relied heavily on the policy summary or KFD as the mechanism for explaining important policy benefits and exclusions to their customers. While we found that these documents gave an overview of the benefits and limitations of the cover, they were not strong when it came to highlighting some of the more complex, but nonetheless key, features. Some sales staff told us that they read out the product description from the policy summary and others said they handed the document to customers to take away and read. In one case, we were told that the policy provided the detail and the customer could cancel within the cooling-off period if they decided cover was inadequate. In a similar instance, a sales person (direct sales force) told us they referred customers to the policy document if they asked questions. We asked if he would take the customer through the relevant sections of the policy. He said he did not have a copy – and had actually never seen one – but thought a copy could be sent to the customer if they asked for it.
- 4.15 We tested sales staff on their level of product knowledge and ability to discuss the product features. The picture was mixed, but some did not know any more than was covered in the literature.
- 4.16 But there were also some examples of good practice:
- advisers discussing the policy summary with the customer, using it to help highlight the important elements of illnesses covered, benefits and exclusions, leaving it with the customer at the end to review in their own time; and

- advisers insisting on a two, or even three, stage interview process, letting the customer take the literature away to read and think more about their protection needs (and other products being considered) before continuing the sale.

4.17 Several firms told us that communicating information about CIC to consumers was a major problem because they do not read the documents. We were also told that consumers rarely ask any questions about the cover or product literature, unless they have had some personal or family experience. In addition, as most CIC sales are secondary to a mortgage, and even then only as part of a life assurance, the customer (and the sales person) is more focused on the mortgage than the detail of the CIC. This makes it a real challenge, in practice, for firms to engage customers in a meaningful way on CIC.

### **Reviewable v guaranteed premiums**

4.18 There was evidence from both the interviews and statements of demands and needs that firms explained the difference between reviewable and guaranteed premiums to customers during the sales process, and that advisers took this into account when giving their advice.

### **Mystery shopping**

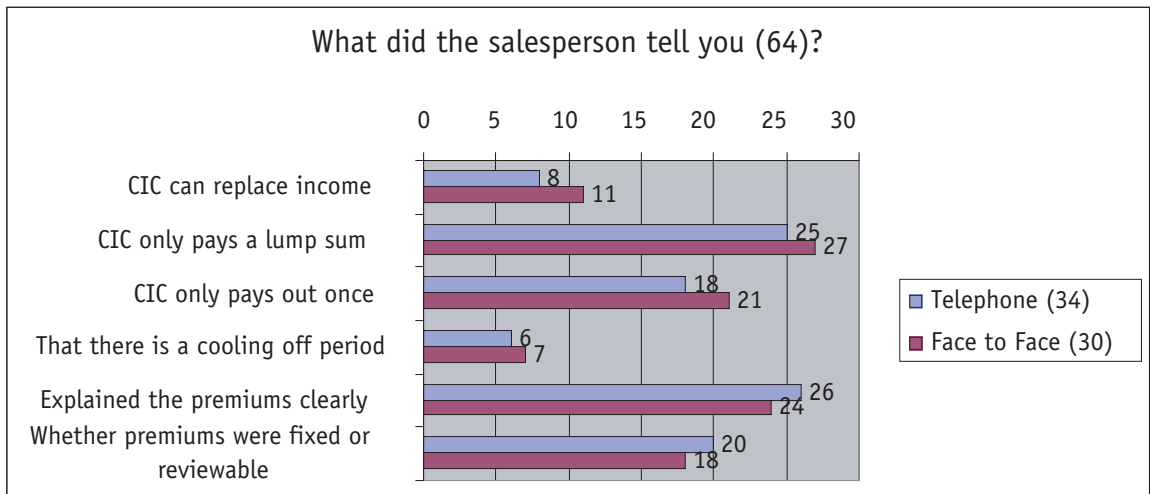
4.19 Some of the mystery shopping results on product disclosure did not fit well with our view of the literature and sales processes. Evaluators reported a high level of understanding of the documents and product:

	Explanation of the documents (28 face-to-face shops where documents were received)	Understanding of the product overall (64 shops)
I fully understood	15	26
I mostly understood	4	12
I basically understood	8	19
There were several aspects I did not understand	1	7

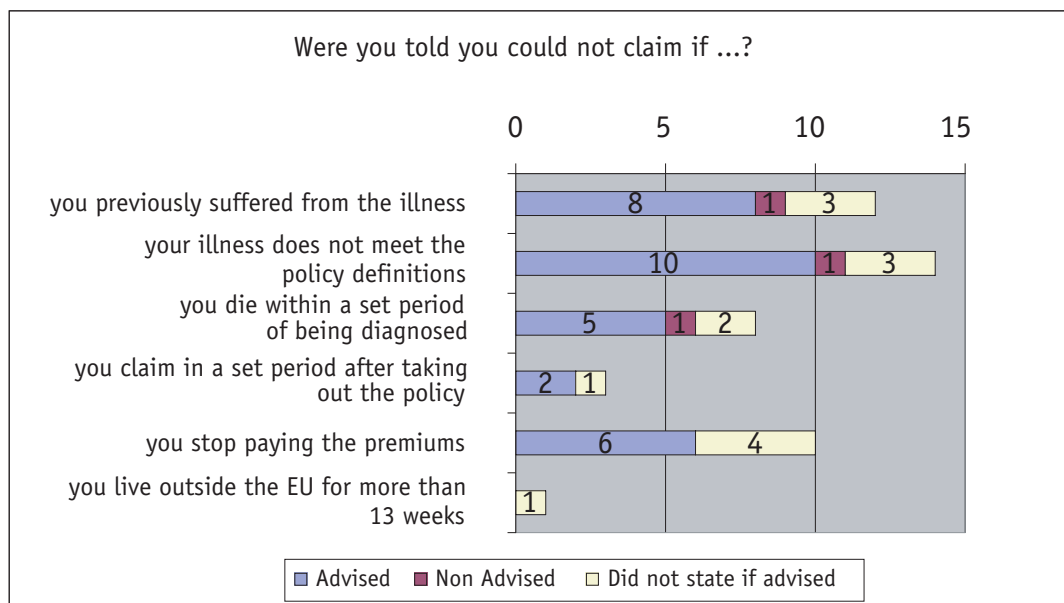
4.20 But those results are not easy to reconcile with the high levels of claims on CIC policies that are rejected on non-disclosure grounds or because the illness was not covered by the policy. Experience shows that CIC is not simple to understand and consumers often only understand the limitations of the product when they submit a claim and it is refused.

4.21 Research International asked evaluators other questions to test their understanding of the product features. The answers suggest there is actually considerable confusion. For example out of 64 shops:

- 19 thought that CIC provided a replacement income;
- 46 were not told about exclusions or limitations, or that the policy would not pay out if they did not disclose all relevant information; and
- only 38 were told whether the premiums were fixed or reviewable.



4.22 The mystery shopping exercise also showed that there was only limited understanding of the key limitations of a CIC policy and the circumstances when policyholders can claim.



## **Personal circumstances and the underwriting process**

- 4.23 ICOB 4.3.3G suggests insurance intermediaries should make clear to customers what they need to disclose.

### **Disclosure of medical information**

- 4.24 Even where the adviser has established that the client has an underlying protection need, there may be other issues that affect how well CIC would meet that need in individual cases. Some significant exclusions and limitations will be standard policy terms which should be covered by the KFD and brought to the customer's attention before the sale is completed.
- 4.25 Normally, when a quote is given, the terms and price are only provisional or indicative and depend on an assessment by the insurer of the customer's medical history. At that stage, the insurer may decide to impose further conditions or increase the premium. The provisional nature of the quote may not be clear to the customer. In the mystery shopping, out of 40 cases where CIC was discussed and the shopper had a medical condition, 16 evaluators said this was not explained to them.
- 4.26 Sales staff and advisers that we spoke to all reassured us that they tell customers they must disclose all material information. But they also said that they rarely went as far as saying that the policy could well be useless if they withheld relevant information. Nor were they able to give examples of how they explained what was material.
- 4.27 We recognise that sales staff are not health experts and so may not be equipped to make judgements about the significance of medical information. But advisers and insurers have an important role to play in making sure consumers disclose the right information. Possible ways that disclosure could be improved include:
- insurers making it clearer in their literature and particularly application forms what they consider to be material – too many application forms are a memory test;
  - insurers and intermediaries looking at ways to support advisers and consumers where there are doubts about the materiality of a condition;
  - greater consistency across insurers over what information is material; and
  - insurers seeking information from GPs more often at the application phase (rather than when claims are made).
- 4.28 The ABI's recent work on the design of health application forms provides useful guidance to insurers and an opportunity for them to review their current application forms. Even before that guidance, we found evidence of

firms doing more to treat their customers fairly. Examples of some positive ways that insurers are already trying to address these issues:

- one insurer had reviewed the medical and smoker questions in its application forms and made them clearer;
- another had included prominent warnings about disclosure on each page of the application form;
- more than one allowed customers to reply confidentially to lifestyle questions (about sexual health and use of recreational drugs) by sending the information directly to the chief medical officer or at least made provision for customers to send the medical questionnaire directly to them rather than via the intermediary; and
- one had set up a tele-underwriting centre so customers could provide their personal information privately by telephone.

4.29 We also found that some intermediary firms had recognised the challenges and were coming up with a range of solutions:

- passing the application to a third party with medical training to deal with medical disclosure;
- giving the customer an explanation of the application process, medical underwriting and the possible outcomes (exclusions and increase in premiums or the application declined);
- giving the customer the chance to complete the health questionnaire independently of the sales person and send it directly to the insurer;
- allowing the person to provide the information in a private environment rather than at a desk in an open plan branch of a bank; and
- having access to the product provider helpdesk and encouraging advisers to call underwriters with queries.

### **Record keeping**

4.30 Another cause of problems with disclosure is poor standards of record keeping. The Financial Ombudsman Service (FOS) told us of cases where consumers claim they did tell the sales person or adviser about their health condition but that information was not passed to the underwriters. This is why it is helpful for firms to keep an accurate record of information disclosed at the application stage.

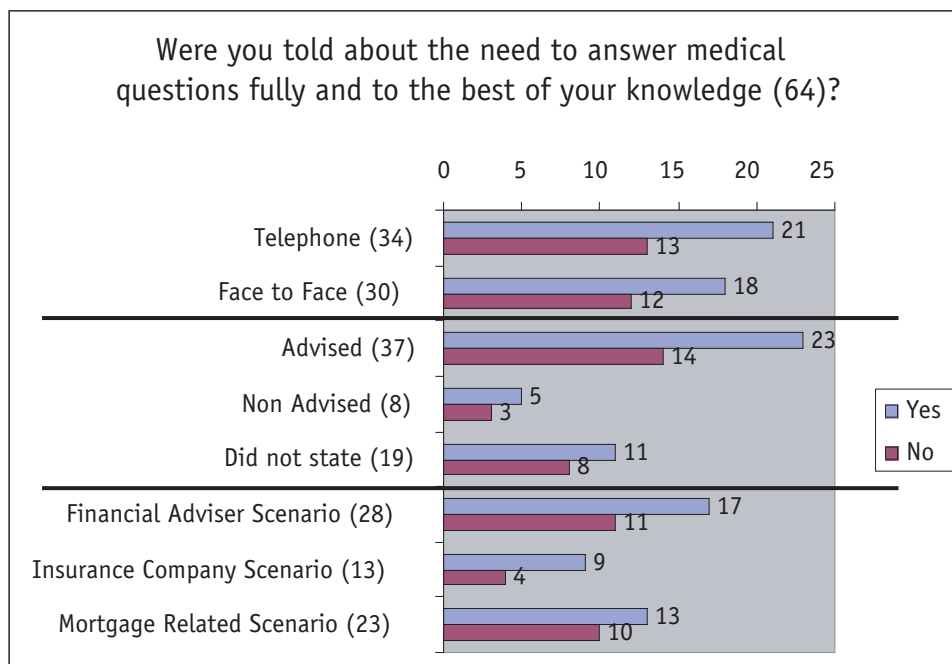
4.31 Technology can help with the process, as information can be entered online in the presence of the customer and transferred electronically to the insurer. But this can also present its own problems: we were also told, anecdotally, that many advisers just take notes during the interview and then input the

information at the end of the day when they are back in the office – when they might leave information out. It also means that consumers can feel less of a sense of ownership for the information if they are not filling in the application forms themselves. To address these problems, one firm making online applications always gives the customer a printed copy of the information provided to check and sign as an accurate record.

### Mystery shopping results

4.32 Shoppers only took the sales to quotation stage: it is therefore likely that more information would be requested on making an application. Nonetheless, the mystery shopping confirmed that there was little discussion of medical issues, at least in the early stages of the sales process:

- Of 37 advised shops:
  - 18 shoppers were asked about previous, current or family medical conditions; and
  - the sales person explained what kind of disclosure could be relevant in only 13 cases;
  - 23 shoppers said the sales person explained their duty to disclose material information; and
  - nine said the consequences of non-disclosure were fully explained.



## **Conditions imposed during underwriting**

- 4.33 A key objective for us as regulator is to ensure that consumers are not sold policies they are ineligible to claim under and that they are fully aware of any limitations. Even where firms were good at discussing the needs of the customer and the policy at the initial advice phase, they were less good at reviewing the advice they had given if new conditions were being imposed by the insurer. We recognise that the advice about the protection need would not change just because it was difficult to find an insurer that would cover all risks. However, where the premiums increase or the exclusions or limitations of cover are significant, this may raise important issues about affordability and value for money for the consumer. Ultimately the question of value for money is a decision for the consumer, but we are concerned that in some cases, the consumer may not understand how the original recommendation has changed.
- 4.34 That does of course assume that the policy that was originally proposed continues to be suitable, in light of increased premiums or restricted cover. We found evidence of only a few advisers reviewing the advice they had given, where conditions were imposed during underwriting, to assess whether alternative cover might be available from another provider, or in fact if an alternative product might now serve the customer's needs.
- 4.35 There is a tension here. If firms are successful in improving levels of disclosure by consumers, this will lead to more applications being "rated" or cover being declined. That is positive because it will lead, over time, to a fall in the number of claims rejected. But it will also lead to an increase in the number of customers who might need additional support with their application. We plan to work with the relevant trade bodies to find ways to ensure customers have access to the advice they need.

## **Non-advised sales**

- 4.36 Even in the case of non-advised sales, we consider that firms should take reasonable steps not to sell a policy the customer will be ineligible to claim under. And before completing the sale, the firm must inform the customer of any significant limitations or exclusions so the customer can make an informed decision about whether the policy meets their needs.
- 4.37 Some firms told us they were concerned that consumers using non-advised sales channels, including telephone and internet, are buying unsuitable products or, at best are unclear about what exactly they are buying. No doubt these views were partly a reflection of the competition from the non-advised channels. But, nonetheless, some were consistent with concerns we had identified about suitability, medical disclosure and the explanation of benefits, exclusions and limitations.

4.38 Specific concerns from our firm visits were:

- cold calling, often targeting of the less financially capable;
- inadequate status and product disclosure; and
- telesales operators straying into advice or giving the impression they were making personal recommendations.

### **Statement of demands and needs (SODAN)**

4.39 ICOB 4.4.1R requires firms to provide a statement to the customer before conclusion of the contract that sets out (a) the customer's demands and needs (b) whether the intermediary has personally recommended that contract and if so (c) explains the reasons for that recommendation.

### **Timing and review of the SODAN**

4.40 The firms we visited all issued a SODAN at the time they made a recommendation, on the basis of the initial advice given because of the customer's protection needs. Where the level of premiums, or extent of cover, changed after the underwriting process, it was normal for the insurance firm to write direct to the customer to tell them. Some insurance firms give the option of reducing the sum assured to fit within the customer's budget.

4.41 We did not find evidence of insurers proceeding without informing the customer and requiring their acceptance of the terms. But, equally, we found few cases where the adviser went back to the customer to discuss the implications of any changes, even though potentially they could impact on the recommendation and the content of the SODAN issued at the time of the initial advice. Many advisers attributed this to the fact that the insurers do not notify them when the final offer is sent to the client.

4.42 It was rare for a firm to issue a revised SODAN to take account of any changes to the terms after the application had been underwritten. And we did not find a single example of a firm that waited until after the underwriting review before issuing the SODAN, even though our rules only require firms to provide it 'before the conclusion of the contract'.

4.43 Nonetheless, there were some examples of good practice. One intermediary firm told us that if there were a material change to the terms or premium, the adviser would contact the customer to review whether the product still met their needs. In another case, the adviser contacted the customer to make sure they understood the revised terms the insurer had offered.

## Content of the SODAN

- 4.44 In any event, we found that the quality of SODANs was often poor. Typically, we saw SODANs with limited customer specific information. They usually did not much more than record that the policy had been recommended because it would pay out a certain amount if the policyholder developed a critical illness in the future. They did not explain in any detail why that benefit was appropriate to the individual's circumstances or why they had recommended a particular level of cover (for example, because of an outstanding balance on a mortgage). Firms used a generic template with standardised wordings available from a pick list, which as one firm told us, 'makes the advisers lazy'.
- 4.45 If firms produced fuller SODANs that provided a better record of the demands and needs of the customer and the reasons for recommending it, this might go some way to addressing the problems we have identified when terms are changed. This would require many advisers to have a better understanding of CIC than they do now, but it would also mean that customers were given more useful information on which to make their decisions. Even relatively simple statements, if they are specific, can provide a helpful explanation. Examples we saw included:
- You would prefer a lower initial premium (reviewable) but understand that your premiums may increase in future years
  - Should you suffer one of the specified critical illnesses you would want to be able to pay-off the outstanding mortgage
  - A decreasing term policy is suitable because it is designed to decrease in line with the mortgage (or, in another case) a level benefit to cover the non-reducing capital debt on interest only element of the mortgage.

# 5 Training and competence

- 5.1 TC<sup>7</sup> 1.2.1G suggests firms should ensure that (1) its employees are competent; (2) they remain competent for the work they do; (3) they are appropriately supervised; (4) their competence is regularly reviewed; and (5) the level of competence is appropriate to the nature of the business.
- 5.2 Overall, we found that most firms had in place a reasonable training and competency framework, but the level of training specifically on CIC was often superficial. That was fairly true across firms of all types and sizes and is consistent with the mystery shopping results of assessment of suitability and explanation of cover. One mortgage intermediary admitted that it had concentrated on making sure its advisers understood their obligations under the mortgage regime, and so they had not paid as much attention as they should have to insurance sales. They did not think there had been any consumer detriment, but it was something they were now seeking to improve on as a matter of priority.
- 5.3 We set out some examples of good practice and areas for improvement below but some specific areas where staff might benefit from further training are
- product knowledge;
  - assessing suitability; and
  - production of better quality SODANs.

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7 TC – Training and Competence sourcebook

Good practice	Areas for improvement
<ul style="list-style-type: none"> <li>• Insurers provide input to training and underwriting guides for intermediaries</li> <li>• Firm has introduced comprehensive training for new recruits with a test on product knowledge, and close monitoring in the field</li> <li>• Business quality checks are carried out by compliance and results are fed into training review</li> <li>• Appointed representatives tested on their knowledge of MCOB, ICOB and the products they sell</li> <li>• The network automatically rejects advisers who fail product knowledge tests three times</li> <li>• Mortgage advisers are required to pass the FPC 2<sup>8</sup> exam which includes protection insurance product knowledge</li> </ul>	<ul style="list-style-type: none"> <li>• Training does not cover suitability disclosure, critical illness definitions and exclusions.</li> <li>• Generic training on protection products – no recognition of complexity of CIC</li> <li>• Many of the advisers are strong on mortgage products but less so on insurance products</li> <li>• Senior management hold the view that CIC is a low risk product</li> </ul>

# 6 Systems and controls

- 6.1 SYSC<sup>9</sup> requires firms to have appropriate systems and controls in place for their business. In particular, SYSC 3.2.6R requires firms to take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system.

## **Compliance and monitoring**

- 6.2 We found firms had different approaches to the role of compliance, reflecting the spread of firms we visited. Some saw the compliance function as being responsible for monitoring the business, while others saw compliance as an advisory function – with the business undertaking its own monitoring. In that case, we are satisfied that the compliance team still carry out their functions, although, in principle, that structure can carry a greater risk of consumer detriment because of the lack of separation of responsibilities.
- 6.3 In all but three firms (from different sectors), we found that the compliance function was well integrated into the business, had a good product knowledge (including CIC) and was either represented on the board or had good access to it. The firms involved the compliance team in the design of products, literature, sales processes and training. Even where compliance was not actively involved in monitoring of sales, they were involved in setting the standards for reviews and received high level reports from operational managers.

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9 SYSC – Senior Management Arrangements, Systems and Controls sourcebook

Good Practice
<ul style="list-style-type: none"> <li>• Monthly file checks by compliance – routinely 10% checked, but could increase to 100% for advisers with poor track record</li> <li>• Compliance observe sales discussions on a regular basis.</li> <li>• Weekly sales data used as triggers for further investigation</li> <li>• Compliance signs off sales process, documentation and training – there was an example where sales materials had been rejected because they appeared to be scaremongering</li> <li>• Reasons for cancellations investigated</li> <li>• All rebrokered business is checked</li> </ul>

6.4 In the three firms where we had concerns:

- senior compliance staff did not acknowledge any market problems with the sale of CIC;
- the firms had weak compliance controls over the sales process; and
- monitoring of sales focused on whether sales targets were met rather than whether they complied with our rules.

## **Senior management and management information (MI)**

6.5 We interviewed senior management responsible for sales, marketing, product development and compliance. Across all sizes and types of firms, we were disappointed by the extent to which management information focused on the quality of CIC product development, sales and claims. Nonetheless, we found some good examples:

- insurers using feedback from customer complaints to identify training needs and make sales process improvements;
- intermediaries using MI on cancelled policies to identify staff training, improvements required in the sales process or compliance issues;
- firms using follow up calls to customers to measure the quality of sales, and to find out why they are cancelling or not taking up policies that have been recommended.

6.6 There were also some examples of firms starting to make better use of claims MI:

- firms were producing regional data on claims paid to inform their sales advisers;
- reviewing claims data every six months to identify trends;

- a TCF committee reviewed the declined CIC claims to enable them to understand the issues and the Financial Ombudsman Service's opinions.
- a firm passed details of the number of claims declined due to non-disclosure through the sales force so they can highlight to new customers the dangers of non-disclosure;
- one firm improved its sales, training and claims processes, leading to a fall in declined claims from 20% to 4% while claims rejected on the basis of definitions fell from 16% to 7%; and
- a firm reviewed application forms, following feedback from the claims department, to identify questions that caused customers problems so they could be expressed more clearly.

## **Pressure selling and remuneration**

- 6.7 By contrast with the findings of our review of CIC marketing materials by our financial promotions team, on the basis of our limited review, we found little evidence of pressure selling or scaremongering in the firms visited and mystery shopped, during the sales process.
- 6.8 We found that firms were not doing as much as they might to monitor sales from that perspective, and so their remuneration strategies might carry a degree of risk. Against that, firms that had considered this more actively said they did not reward the sale of CIC differently from other protection products so there was no direct incentive on staff to sell CIC over another product.
- 6.9 Firms described their commission payments in various ways and it is therefore difficult to make direct comparisons. While there was not necessarily bias between products, the overall levels of commission are high and can create incentives for staff to sell if not properly mitigated:
- a building society said it received 150% of the first year's premium as commission;
  - the commission payable to a the direct sales force of an insurer was six times the monthly premium;
  - one bank paid 17% of annual premium for level term but 12% for decreasing term policies; and
  - several intermediaries said the commission payable to it sales staff was 20% of the first year's premium.
- 6.10 We found evidence that firms had thought about how to reduce the risk of mis-selling:

- commission clawbacks (typically two to four years) had reduced cancellation and lapse rates;
- similar commissions across providers and protection product range;
- using MI to inform risk-based monitoring, with higher performing advisers (in sales volume) attracting attention of compliance;
- quality measures contributing to commission earnings;
- sales targets set for teams rather than for individuals; and
- the amount of sales-related bonus limited for telephone sales staff.

### **Mystery shopping**

6.11 The mystery shopping identified three cases where the evaluator felt they were put under pressure to buy. Most evaluators said they were not put under any pressure to buy.

### **Claims handling**

6.12 While we were looking at how CIC policies were sold, we also reviewed some insurers' claims files to help us consider whether there were aspects of the sales process that may not be effective. We have already flagged the problems that arise because of poor information about the policy and customers failing to make full disclosure of their circumstances. We also found some positive steps that firms were taking to ensure that claims were handled fairly:

- senior management had to approve any rejected claims;
- where the firm would have accepted a policyholder, but at a higher premium, if they had disclosed relevant information, the firm would pay claims at a level proportionate to the actual premium paid;
- where information that had not been disclosed was not relevant a claim, the insurer pays the claim in full, even if they would not have accepted the proposal if full disclosure had been made;
- premiums are refunded where claims are rejected on grounds of non-disclosure and the policy is cancelled;
- firms may contact the customer's doctor more than once to make sure they have all relevant facts before rejecting a claim;
- some insurers set out the reasons for rejecting claims so customers can come back with new information if they are unhappy about the outcome.



# Other relevant publications

## Relevant FSA publications:

- November 2005: PPI Report and Dear CEO letter
- December 2005: GI Disclosure Documentation Review and Dear CEO letter
- May 2005: Statement of Good Practice – Fairness of terms in consumer contracts
- August 2005: Financial Promotions bulletin, which reported the findings from a review of CIC financial promotions

## Relevant ABI publications:

- August 2004: ABI Statement of Best Practice Critical Illness Cover
- February 2006: Application Form Design for Life and Health Protection Insurances
- April 2006: updated ABI Statement of Best Practice Critical Illness Cover providing:
  - a new standard description of Critical Illness;
  - better descriptions of the illnesses covered; and
  - improvements to definitions of each critical illness covered.

## Relevant AIFA publications:

- Avoiding non-disclosure – AIFA information sheet

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