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Limitations of German Insurance Disclosures to Improve Consumer Understanding, With Lessons for U.S. Insurance Practices

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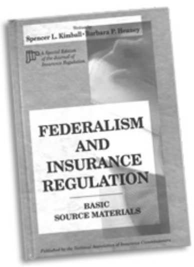

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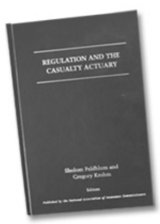

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Limitations of German Insurance Disclosures to Improve Consumer Understanding, With Lessons for U.S. Insurance Practices

Christoph Schwarzbach*
Harold Weston**

Abstract

Germany changed its insurance regulations to require intermediaries to provide disclosures at the time of application to improve consumer knowledge and protection. The German experience is that the disclosures were incorporated well into the business process but were largely ineffective to improve consumer knowledge. This outcome is consistent with numerous studies on the limitations of disclosures, due to cognitive limitations (bounded rationality) and financial literacy. We review the German practices for effectiveness, compare German and U.S. experiences with insurance disclosures, and conclude that disclosures show little impact on consumer decisions. We recommend that disclosures could provide

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benefit if conveyed in better formats in line with existing research on financial services disclosures. Regulators and consumer advocates should, therefore, be restrained about general proscriptions for disclosures. Greater benefit to consumers may come from improving default coverages and raising the advisory standard for intermediaries.

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Introduction

Information disclosure about insurance has long been recognized as especially complex in insurance markets because of the complexity of the products and the range of risks to be addressed, and because insurance "is a mixture between an experience and a post-experience good" (Kukoc, 1998:227 and 231). The policyholder must know exactly what risks are covered and what risks are excluded under the contract, which requires details about the contract, coverage and exclusions (Kukoc, 1998:233). Disclosures have been the usual proposed solution to inform consumers about their insurance choices, both specifically for insurance and in general for financial services. Germany took another step in this direction by implementation of a Directive of the European Parliament and of the Council of the European Union to improve insurance consumer knowledge and protection through policy disclosures and stronger insurance agent representation requirements. The disclosures include important information about coverage and price, among other items, and new requirements on the agent to advise the client. The idea is that agents (intermediaries) can reduce informational asymmetries between the insurer and the client—with informational advantages to both sides—and, therefore, facilitate the closing of a contract (Cummins and Doherty, 2006; Beenken, 2010; Eckardt and Raethke-Doeppner, 2010; Hoeckmayr, 2012; and others discussed later). These studies show that while disclosures have improved and the burden (transaction costs) on the intermediaries was slight, consumers' understanding of the insurance products was little changed. These results are in line with numerous other studies in Europe and the U.S. on consumers' cognitive limitations and the limited effectiveness of disclosures for financial services. Thus, this experience adds evidence to the limitations of disclosure efforts from the quite opaque German market and lessons for the U.S. insurance market on the limited effectiveness of disclosures.

We begin with a review of studies on consumer understanding and limitations to understand financial services. We next review the German implementation of the European Union (EU) Directive. We then compare the practices for insurance transactions with consumers in the U.S., where intermediaries can have different responsibilities to the consumers depending on the intermediaries' classification as agent/salesperson, broker/order-taker or adviser/fiduciary, and where disclosures also are favored and sometimes required. We conclude that more disclosures are unlikely to accomplish the desired goals of a better-informed consumer making better insurance choices unless disclosures are drafted based on more recent studies as to how to improve readability and understanding. We, therefore, suggest consumers will be better served by rules that mandate default options to increase insurance coverages, as required now in some lines of insurance, and that insurance intermediaries be required to provide a higher level of advice: from salespeople and order-takers to a fiduciary duty. This fiduciary standard exists in the U.S. for insurance when there is a "special relationship" and in financial services under a new U.S. Department of Labor (DOL) rule for rollovers of

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employee money. For the U.S. market to accomplish a higher level of advice, the regulators will have to reconcile the diverse roles and legal responsibilities of insurance intermediaries to align the intermediaries' interest with the consumers' interests. As a comparison, the U.S. Securities and Exchange Commission (SEC) continues to study the issue of the financial services intermediary's duty to advise on investment securities (whether to raise that from a suitability standard to a fiduciary standard), and the U.S. federal government is using behavioral economics to create better outcomes and default actions for consumers and citizens. Additionally, European regulators are studying the effects of behavioral economics on the market. (See, for example, Decision Technology Ltd., 2010.)

Expected and Actual Benefits from Mandated Disclosures—a Literature Review

The use of more disclosures to improve consumer knowledge in various financial transactions has been largely ineffective. Cude (2006) found most consumers had limited understanding of disclosures, and many participants said they were unlikely to read disclosures. Ben-Shahar and Schneider (2011) surveyed various studies of the effectiveness of consumer disclosures and found little impact. Isaccharoff (2011:59–60) noted that the "soft paternalism" of disclosure had little effect to improve poor decision-making, especially in light of behavioral insight in how consumers make decisions. Fun, Graham and Weil (2011:31-34) noted the imperfections of the real world, which is that people in general have difficulties in comprehending, interpreting and applying information given to them, especially when made available in disclosures. This phenomenon is usually called "bounded rationality." These studies suggest a priori skepticism that more disclosures will improve consumer knowledge. Issacharoff writes, "A population that is bombarded with disclosure forms and information is not necessarily better off if the recipients are unable to understand what is being presented to them." (Issacharoff, 2011:60; See also Sovern, 2010; Matthew, 2005). Inderst (2011:6–7) is skeptical that consumers who make only infrequent decisions with limited feedback are able to make better decisions with more information, due to cognitive biases. As he says, "If poor financial capability is … a matter of psychology rather than one of information, then information-based approaches to educating households are likely to, at best, improve outcomes only modestly."[1] (See also

1. Related studies in the sociology of risk are informative here: that lay people evaluate risk differently than experts (Wiedemann, 2003) and how risk communication studies at the macro level might be applied to the individual level with disclosures. Löfstedt (2008) notes the fragmentation of studies in risk communication and perception across multiple disciplines such as environmental, technological, public health, etc. Kievik, ter Huurne and Gutteling (2012: 131–132) discuss the role of information-seeking behavior as "mediator between risk communication and subsequent risk-related knowledge and behavior," and because risk messages that work in

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Fernandes, Lynch and Netemeyer, 2014). Hart (2011:67–76) contends that disclosures are a remedy that masks, and encourages, the problem of the bargaining inequalities.

Omri Ben-Shahar (2009:3–6) argues that the opportunity to read contracts is an unnecessary presumption based on myths of assent based in contract law, and not worth the time and effort for the product. This is probably correct where contracts accompany products, but the idea is problematic for insurance where the product *is* the contract. The difference is sometimes referred to as a "relational contract," where the parties begin their duties and liabilities when they enter into the contract, against a "transactional contract," where the contract brings about or culminates in some product or service (Schwartz, 2008:108; Feinman, 2009; Feinman, 2000).

Studies show financial literacy is low in developed countries. "[F]inancial illiteracy is widespread even when financial markets are well developed, as in Germany, the Netherlands, Sweden, Italy, Japan, and New Zealand, or when they are changing rapidly, as in Russia. Thus, observed low levels of financial literacy in the USA are prevalent elsewhere, rather than specific to any given country or stage of economic development" (Lusardi and Mitchell, 2011:503). "In all countries, higher educational attainment is strongly correlated with financial knowledge, but even at the highest level of schooling, financial literacy tends to be low. Among other items, education is not a good proxy for financial literacy" (Lusardi and Mitchell, 2011:504). Lusardi and Mitchell (2014:13) provide details of the types of errors in investment and financial literacy among U.S. consumers: "[F]ew people across countries can correctly answer three basic financial literacy questions. In the U.S., only 30 percent can do so, with similar low percentages in countries having well-developed financial markets (Germany, the Netherlands, Japan, Australia and others), as well as in nations where financial markets are changing rapidly (Russia and Romania)."[2] A study on financial literacy and retirement planning in the Netherlands found most households have weak financial knowledge, which results in poor retirement planning (van Rooj, Lusardi and Allessi, 2011, who note that "thinking about retirement" shows a positive correlation with actually planning for retirement). A World Bank meta-study on financial literacy across many countries at different income levels concluded that studies examining financial education and retirement savings showed improvements in savings and financial record keeping in higher income groups, whereas other measures of financial education and decision-making did not change significantly with higher income levels (Miller, Reichelstein, Salas and Zia, 2014:26).

Other studies and articles note the almost complete absence of reading of any type of standard contract (White and Mansfield, 2002; Ben-Shahar, 2009; Becher

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the lab do not work well in the real world where "risk information has to compete with myriad other issues and messages that call for the individual's attention."

2. They also note a persistent gender gap, with women having lower financial literacy than men (Lusardi and Mitchell, 2014:17), a point not important to our argument.

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and Unger-Aviram, 2010; Eigen, 2012). Various explanations are given for this, usually in the behavioral economic terminology—for example, Edwards (2005), information overload and cognitive behavioral limitations; Marotta-Wurgler (2010), click-through licenses led to readership between 0.1% and 1.0%; Prentice (2011), bounded rationality, rational ignorance, irrational optimism; Ahn, Park and Haley (2014), optimism bias reduces attention to risk disclosure; Korobkin (2003), bounded rationality and the costliness of shopping for better terms; and Cheremukhin, Popova and Tutino (2011), inattention theory.

Fung, Graham and Weil (2008:90) write, "Simply providing more information to consumers, investors, employees, and community residents will not assure that risks are diminished or that schools, banks and other institutions improve their practices. Without careful design and implementation, transparency policies can do more harm than good." Eigen (2012:138–139) finds that the more information is provided in a form contract, the less consumers read it, but the more they do read, the more likely they are to perform as obligated.

Prentice (2011:1065–1066 and 1097–1153) addresses disclosures in investment products offered by stockbrokers and concludes that disclosures do not lead to better decisions. That is because people are not the perfect rational actors using all available information to make the utility-maximizing decisions that theory suggests. (Similarly, Ben-Shahar, 2009; White, 2009.) Worse, according to Prentice (2011: 1096, 1101–1102), persons who believed they acted morally at one point may grant themselves "moral license" to play fast and loose with the rules afterwards, and that "disclosure distortion" may result in even more biased advice, as if there is some "moral equilibrium effect." Further, consumers who receive disclosures may be more reluctant to question the stockbroker's recommendations and actually trust the advisor more, or be more reluctant to discount the advice (Cain, Lowenstein and Moore, 2010, and discussed in Prentice).

Doing More to Improve Consumer Knowledge—The German Implementation of the Directive 2002/92/EC to Advise and Disclose

German insurance is mostly sold through intermediaries. German law requires even single-company representatives to do their best for the consumer and enquire of the insured's needs, if there is a reason to prompt the inquiry, as the law describes it (§ 61 (1) VVG).

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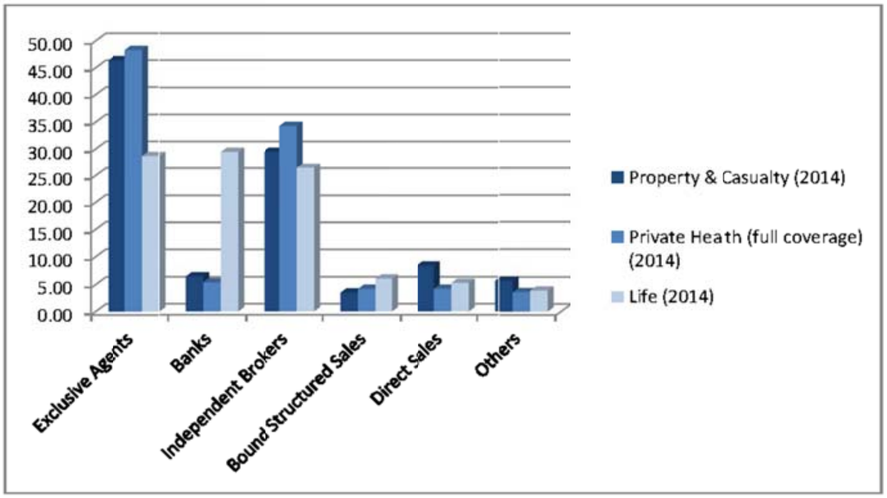
Figure 1:
Market Share in Germany 2014



Towers Watson, 2015; Towers Watson, 2016

The dominant forms of insurance intermediaries for private insurance lines in Germany are exclusive agents (legally independent but bound to one specific insurer), followed by independent agents/brokers and banks. Directly marketed products account for only a few sales, partly because discounts are not substantial and partly because consumers perceive agents work for free when paid by commissions rather than by separate fees.

The Directive 2002/92/EC of the European Parliament and of the Council on Insurance mediation came into effect on Dec. 9, 2002, and was implemented into German law by the "Gesetz zur Neuregelung des Versicherungsvermittlerrechts" (Law for the Reorganisation of the Insurance Agent Regulation), enacted Dec. 22, 2006, and effective May 22, 2007. The main political goals of the EU directive for this were to facilitate the career choice and activities of insurance intermediaries within and across the internal market of the EU, and to enhance consumer protection in this field. The regulation covers the intermediary, who provides a service to a third person in exchange for some kind of economic benefit. Excluded are, among others, distribution channels directly controlled by the insurance company (Directive 2002/92/EC of the European Parliament and of the Council of the European Union, 2003:1–24). The German law was the most significant change to the legislation of intermediaries in Germany for 100 years (Reiff, 2006; similarly Farny, 2011). It addressed two major categories: 1) agent qualifications; and 2) various duties to a client. To improve consumers' knowledge and protect them from abusive behavior by the sales personnel, new laws were imposed on the duties of these intermediaries, creating minimum standards (Hoeckmayr, 2012).

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The laws require insurance salespeople to register and obtain a business license. The registration is issued and published by the CCI if: 1) the agent's financial affairs are in acceptable order; 2) the agent is reliable in the sense of not having a relevant conviction within the last five years; 3) the agent provides evidence of proper liability insurance; and 4) the agent has passed the CCI examination. Exemption from the exam can be through longevity in the profession (since Aug. 31, 2000); if the salesperson provides proof of other qualifications accepted as equivalent; or if an insurer assumes unlimited liability for the agent and is responsible for the agent's education, and the appointment of the agent is through an insurer's central registration. Currently, around two-thirds of all registrations fall into this last category (DIHK, 2012). Another exemption is sales personnel selling insurance contracts as an "accessory" for other, more expensive products. These sales personnel can partly or even completely be excused from the requirements mentioned above, such as car salespeople selling insurance with a new car, or travel agencies selling travel cancellation expenses insurance.

To improve consumer protection and enhance consumer understanding, the new regulation imposes duties on the agent to inform, to advise and to document. The duty to inform encompasses the greatest amount of the changes. The salesperson must inform the customer about his or her business in writing upon the first meeting (§ 11 (1) VersVermV). The salesperson must state his or her full name, address, type of insurance salesperson, registration number and the means of checking this information. The duty to inform also includes a duty to disclose. This requires getting information to the insureds earlier in the process, with the intent to enhance consumer protection by improving consumer knowledge and decision-making. All documents must now be disclosed to the consumer prior to submitting the application to the insurer, with enough time to read and understand the documents. A sufficient time span will depend on the knowledge of the consumer and the complexity of the contract. The client may, by a separate written document, abstain from prior disclosure, but still has to be informed immediately after the contract is effective. This disclosure requirement is tied with a change in the insurance contract law, Versicherungsvertragsgesetz – VVG, effective Jan. 1, 2008, which altered a 100-year practice (Meixner and Steinbeck, 2011). The new law largely adopts what is called the "Antragsmodell." For the intermediaries, this means a change in the way they organize their appointments and could mean that a second appointment with the client is needed to close the sale. The adoption of the Antragsmodell abolished the "Policenmodell," which presented all information when the insurer sent the contract and provided a 14-day period to cancel it. In this case, the client technically applied for a contract, which the insurer accepted—for instance, by simply sending out the policy. A third model, the "Invitatio-Modell," has been developed: The client asks the insurer to make an offer, which the client may later accept.

Additionally, fact sheets must be provided and put in front of all the information material. These fact sheets must contain information about the kind of insurance product, the duration of the contract and ways to cancel, a description of insured and excluded risks, the amount and the timing of premium payments,

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information about exclusions within the contract, and resulting obligations. For life and private health insurance contracts, a disclosure of sales, administration and other costs is required (§ 4 VVG-InfoV).

The duty to advise requires the salesperson to ask the customer his or her wishes and needs, to advise the customer prior to the sale, and to give reasons for this advice. This duty extends throughout the time of the relationship between the intermediary and the client. While the requirement is not well-specified, the idea is that changes in the customer's circumstances may indicate different advice or adaptations.

The third duty imposed on agents is documentation of the transaction. This documentation protocol depends on the complexity of the insurance product in question. The documentation seems of modest benefit to the consumer, while of potentially significant evidentiary benefit to the salesperson in case of claims for compensation for damages. The client, through a separate document, can abstain from the advice and the documentation.

Another change in the law had to do with the representations in the application and the effects on contract enforceability and rescission (as it is called it in the U.S.) by the insurer, not the agent. Previously, the insured was required to strictly comply with the contract, such as to inform about some changes in the risk exposure, or after a loss to completely comply with all duties and conditions; the consequence of minor deviations was to possibly forfeit all benefits recoverable under the insurance contract. The new law changed this: Now slight errors in the application will affect the premium, rather than result in complete contract avoidance or forfeiture. The insured now only has to answer the written questions posed by the insurer, who is now responsible to seek relevant information.

The law also installed an ombudsman to possibly settle disputes without the parties having to go to court. Almost all insurance companies have joined this system and have agreed to adhere to the rulings, if they are below € 10,000; above that amount, they are still free to go to court (Ombudsmann fuer Versicherungen, 2011). This comports with a similar rule in effect since 2001 for the private health- and long-term care insurance (LTCI) (§ 13, Statut des Ombudsmanns Private Kranken- und Pflegeversicherung).

German Experiences of an Agent as Adviser

With respect to the intermediaries, the new laws were expected to create significant additional burdens on the intermediaries. Agents predicted the regulations and multiple duties to inform, to advise and to document would make their job more difficult and time-consuming. The reality turned out differently. Processing burdens were not as severe as expected, generally speaking, though the experience of the intermediaries is diverse (Beenken, 2012). A study by YouGovPsychonomics AG from 2008 estimated an increase of up to 11 workdays per year for exclusive agents if the goal is to keep revenue steady. Schwarzbach,

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Klosterkemper, Lohse and Schulenburg (2011) tested this claim by means of empirical data obtained from two consecutive questionnaires. BVK (Bundesverband Deutscher Versicherungskaufleute e.V., an organization that represents insurance salespeople) supported the data collection. The data were collected before and after the introduction of the legislation in order to allow for a comparison. Contrary to expectations, the time to advise did not significantly increase from 2007 to 2009, which contradicts the agent's subjective perceptions (Beenken, 2012). The two-year interval in the study captures a longer-term perspective on the experience but may not have captured one-time costs borne the first year, such as technical modifications, adjustments in the distribution process or more general learning costs accrued during the adaptation period. These one-time-costs might explain the results of the YouGovPsychonomics study since it was conducted soon after the regulatory change. Some results of learning and familiarization take effect in the longer run (Beenken, 2012).[3]

With respect to consumers, the new laws were expected to get disclosures into the hands of consumers before the insurance was in place, with consumers being able to study them in advance. Studies showed that the disclosures, though timely and containing important information about the insurance coverage, did not facilitate consumer understanding, primarily because the information and format were not standardized. The fact sheets have remarkable diversity and quantity of information, which sometimes makes a comparison of different financial products, and a comparison with the products of other companies, difficult. Special criticism has been directed towards the readability and comprehensibility of the fact sheets (ITA Institut fuer Transparenz GmbH cited from VersicherungsJournal, 2014). This difficulty in comparison exists despite the suggestions of the major lobbying organization of the insurance companies (GDV) for standardized format and content. Simplified and standardized product information likely enables better investment decisions (Decision Technology Ltd., 2010). Companies seem to know about the complexity and shortcomings of the respective fact sheets but are yet to improve them (Schubert, 2013). They face the problem of having to find a compromise between detailed correctness as required by regulation and ease of understanding.

The problem of comparisons also can be found in the required disclosure of costs for life and private health insurance contracts. First, the information is of little use to the purchase decision, since one company might show the cost in total Euro-terms (as required by the VVG-InfoV), and another company might show reduction in yield, calculated in a manner advocated by the main insurers' association (GDV, 2008). Critics of the disclosure say that this information does not provide any additional information that should be relevant for the client's product decision. Second, the disclosure of costs of the contract is flawed because

3. The study did not address changes in the qualification structure because most agents did not have to pass the necessary exam due to their exemption based on professional experience or being centrally registered intermediaries. Beenken (2010) addressed qualification issues as to market entry and exit for the agents.

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the costs included are not standardized, or they are accounted for differently because of incompatible calculation methods or interpretations of the law (Assekurata, 2008). Sometimes all the costs of the insurance company—such as printing, handling of the contract and money paid to the intermediary—are taken into account, and sometimes only parts of these are accounted for. Additionally, the respective explanations and documentation are phrased complicatedly. The value of this information to the consumer is, therefore, doubtful, and a change in the customers' behavior seems not to have occurred (Beenken, Bruehl, Schroeder, Wende, 2012). The consumer-magazine *OeKO-Test* insinuates intentional obscuring and manipulation of the real costs, as well as complication of any comparison by the insurers, in order to appear less costly (OeKO-Test, 2011). Furthermore, the cost disclosures already mislead consumers to believe that the reported sums (especially the apparently higher one-time-costs) are all receivable by the intermediaries. These disclosures in turn might further penalize inexperienced and marginally-literate consumers.

Results of Germany's Implementation to Improve Consumer Insurance Transactions

The ultimate question is: How effective has the law been to raise consumers' knowledge of their insurance purchases? Here, the evidence shows little improvement.

In the first years after the introduction, intermediaries at best only slowly adopted the changes (Schwarzbach, Klosterkemper, Lohse and Schulenburg, 2011; YouGovPsyconomics AG, 2009 cited from VersicherungsJournal, 2009; Beenken, 2012). A test sponsored by the central consumer agency showed that the intermediaries regularly abstained from giving advice (Infratest Dimap, 2010), thereby using a criticized exception installed in the law intended for informed customers (§ 6 (3) VVG). The duty to communicate the intermediary's status is hardly adhered to (Stiftung Warentest, 2009; Beenken, 2012). Also, intermediaries did not ask their client for his or her wishes and needs, or about his or her situation as a whole—contrary to the law's requirement. This resulted in important information being omitted, as shown by mystery shopping tests. As a consequence, the recommended products and limited consultation provided little extra value. (See, for example, DISQ, 2011; DISQ, 2012; Stiftung Warentest, 2009; and Barais, Nauhauser and Weiser, 2015.) One difference is seen in the level of service provided to different clients: In the lucrative part of the market, intermediaries do provide advice to, and spend time with, clients with significant insurance needs. But consumers with smaller or fewer contracts in general or only with the respective intermediary may receive less assistance than before.

Consumers do seem aware of the fact that there are new protocols and compliance requirements, and endorse these (YouGovPsyconomics AG, 2009, cited from VersicherungsJournal, 2009). The protocols documenting the process

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and also stating the reasons for the advice given are used regularly (Schwarzbach, Klosterkemper, Lohse and Schulenburg, 2011) but are (at least for bigger institutions) quite standardized and designed to be filled out quickly, reducing their individual descriptiveness for the respective mediation. This information technology (IT)-based process can become a good business practice and allow for more structured consultations, but it also can be perceived by consumers as pushing unnecessary insurance, or mere compliance.

Regarding the actual impact of providing better information to consumers and consumers actually being better informed, most observers conclude there has been little improvement. Referring to the omission of the Policenmodell, the former Ombudsmann Wolfgang Römer stated that "… it does not matter, if the client does not read the General Terms and Conditions of Insurance before or after receiving the insurance policy"[4] (Roemer, 2006). The required information to be given to the consumer can be documents or electronic files on a compact disc (CD) or universal serial bus (USB) flash drive. The electronic method is efficient but not effective for instilling information. The documents usually are written in a complicated language due to the complexity of the matter and to the actual style of writing, so the average consumer is likely more confused than informed. Also, the large number of pages discourages consumers from studying their content (Schubert, 2013). A CD or USB flash drive usually contains the documents for that transaction with the consumer *and* all other products sold by that insurer, thus overwhelming the insured with more and mostly irrelevant information than necessary for the transaction. This is an example where information, especially excess information, neither helps the customer nor creates any more confidence, although it may provide the insurer with protection against later claims (Goersdorf-Kegel, 2013). In fact, electronic delivery may be, in effect and reality, non-visible information because the consumer does not even glance at the information. This further complicates any intention to have the consumer inform him- or herself. As mentioned above, the fact sheets are meant to facilitate the comparison of different products but in reality are designed differently by almost every company, complicating any such effort.

This outcome of minimal effectiveness is in line with other studies on the need to carefully draft the disclosure forms for readability, structure and context in the form of an educational component "to motivate consumers to read the notice and help them understand what it is about, why it is important and how to use the information in their decision making" (Garrison, Hastak, et al., 2012:228). The experience with the German implementation of the EU directive in requiring disclosures, advice and information, therefore, has not shown much improvement in consumer understanding of insurance transactions nor better advice for those transactions. Part of the problem seems to be the inadequacy of the design of the disclosure, although it contains important basic information about coverage. The lack of standards and simplicity, as well as the resulting diversity of forms,

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4. Translated from Roemer, 2006: "Denn es kommt nicht darauf an, ob der Kunde die Allgemeinen Versicherungsbedingungen vor oder nach Erhalt der Police nicht liest."

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complicate the consumer's ability to compare or evaluate the products. Another problem is that disclosures are not read; this is in line with the other studies on financial literacy and disclosures mentioned above. This is not to argue that disclosures are bad, only to say that effective disclosures must be carefully drafted, and even then their effectiveness will be limited.

On the effects of other changes in the law, the installation of an ombudsman for all insurance lines has simplified disputes between an insurance or an intermediary and the respective client and resulted in their accelerated regulation. This helped to reduce the workload of courts, which is mainly achieved by the insurers accepting any ruling where the amount in question does not exceed €10,000. Relevant to this paper, only a small percentage of the complaints actually concern intermediaries. (Ombudsmann fuer Versicherungen, 2012; Ombudsmann Private Kranken- und Pflegeversicherung, 2012).

Another effect of the new regulations was the decrease in the number of intermediaries from 407,000 in 2006 to 250,000 in 2009 (GDV, 2006; GDV, 2009), although available statistics about the number of intermediaries in Germany are not very reliable or comparable (Beenken and Radtke, 2013a). For example, Beenken and Radtke (2013b) calculate a number of around 370,000 intermediaries for 2013. Further, a big part of the decrease may be accounted for by the departure of part-time intermediaries who mostly dealt with family and friends.

In Europe, partly in response to these outcomes and criticisms, but also due to diverse implementations throughout the EU and criticisms with regard to the insurance intermediation (see European Commission, 2012, European Commission Staff working paper), a successor to the Insurance Mediation Directive (IMD) called the Insurance Distribution Directive (IDD) is coming into effect in the next years (Council of the EU, 2015). Therein the scope of the included intermediaries is extended to include everyone selling insurance as, for example, direct sales and reinsurance brokers. A few exceptions remain—for example, for people providing insurance as an "accessory" to their main service or product. The paragraphs mostly focus on consumer protection—for example, by requiring the intermediaries to act in the best interest of the customers, by defining lower limits for the liability insurance and the available cash of the intermediaries, and by disclosing information about the form, sources and in some cases also the amount of payments to the intermediary in order to make conflicts of interest transparent. The payments may not entice the intermediary to act against the customer's best interest. Furthermore, an approval process for insurance products will be implemented, and the participants will have to ensure their professional knowledge through continuing education. Also, more standardized key information documents (fact sheets) will be implemented for all insurances. Systems like the ombudsman have to be installed, and participation will be mandatory. In case of breaches, sanctions—apart from criminal sanctions— will be implemented (Council of the EU, 2015). In Germany, the discussion focuses on the payment scheme for the intermediaries, with the intention to better align the clients' and the intermediaries' interests. (Among others, see Habschick, M., Evers, J., 2008; Beenken, Bruehl, Pohlmann, Schradin, Schroeder and Wende,

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2011; Beenken, Bruehl, Schroeder and Wende, 2012; and Koehne, 2014.) This important topic extends beyond the scope of this paper.

Insurer Intermediary Law in the U.S.

The German experience in trying to improve insurance consumers' understanding is informative to similar goals in the U.S. Here, we review the U.S. model of insurance regulation and compare it to the German model. In contrast to German federal law on insurance, in the U.S. insurance is regulated at the state level (as is well known), with only a few national laws bearing on the subject. There is some standardization and coordination through the trade groups such as the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL). Despite multiple states' laws, general statements can be made about how states address consumer financial literacy in insurance transactions and, thus, how the German experience can be informative on efforts in the U.S. to improve financial literacy for insurance transactions. Other financial services—such as credit and loans, stock and bond purchases, and investment advisory services—are regulated at the national level through the Federal Reserve, Consumer Financial Protection Bureau (CFPB), and Security and Exchange Commission (SEC), etc. We will note a few of these where relevant.

One consumer protection requirement is that state insurance laws require insurance contracts be written in "plain language" that meets certain readability standards, as measured by "Flesch readability scores" that must be submitted to the states' departments of insurance (DOI).[5] Most states also require that policy forms for consumer insurance be submitted there, either for prior approval or disapproval, under various methodologies not relevant here.

A second protection for consumers is provided by laws that specify a certain minimum coverage that must be provided. Examples for this are financial responsibility limits for automobile liability and for uninsured motorist coverage, which is typically equal to the selected liability limit, and a fire policy (basic homeowner's insurance) meeting at least the classic New York standard fire policy specified by statute. The forms, therefore, are regulated either by approval or disapproval under the various file and use laws, thus assuring some consumer protection and minimal levels of coverage. Major gaps still exist in coverage. (See Fragmented Risk Symposium, 2013.) (A similarity is seen in Germany, which

5. See for example, Conn. Gen. Stat. § 38a-297; Vernon's Texas Statutes and Codes Ann., Ins. Code Art. 5.35, among many statutes; and Cogan, 2010. Flesch readability scores refer to a system devised by Rudolf Flesch, an educator and frequent author on reading and writing, that calculates the readability of text based on the number of syllables per word and words per sentence. Flesch scoring of insurance policies is well-known to U.S. insurance companies because the insurer must submit the score to the state departments of insurance when filing policy forms.

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until 1994 had similar processes for approval of consumer insurance contracts, to be submitted to a central government agency. But the deregulation with the resulting product-diversity significantly reduced the transparency on the market. (Beenken, 2010). There is a new effort in Germany to bring back this sort of standardization and review, as advocated, for example, by Hans-Peter Schwintowski (Goersdorf-Kegel, 2013).)

The plain language laws and the regulatory approval laws should result in a clear, understandable contract. Consumers often do not read their insurance contracts, however, due to complexity and low financial literacy, as noted in the references made earlier in this paper. A further problem with trying to get consumers to read disclosures is low literacy levels in the U.S.: Nearly 50% of the U.S. population reads in Level 1 and Level 2 (the basic levels), according to a 2002 literacy survey done by the U.S. Department of Education (Kirsch, et al., 2002; also Cogan, 2010; Inderst, 2011). This is important because in disputes between insureds and insurers, the common law in all states imposes a duty to read the contract on the insureds (Ben-Shahar, 2009; Weston, 2005), yet even if consumers were to read the disclosures and the disclosures were easy to read, the consumer's understanding would be limited. Despite this duty to read, there is little impact in judicial outcomes because judges and juries do not read their own insurance contracts, so the duty has little impact except to require insureds to at least glance at the declarations page for accuracy of the name, address and maybe coverage limits (Weston, 2005, and, for example, Wiley v. Osmun, 2012[6]). A few jurisdictions stringently impose the duty. The reality is "there appears to be total consensus on this point. Law professors, treaties, commentators, and *The Restatement (Second) of Contracts* all concede that people do not read their insurance contracts … ." (Cogan, 2010:102–103. Similarly, Eigen, 2012, noting empirical studies). The same holds for Europe, where studies show only about one-third of the consumers completely read the terms and conditions of service contracts (European Commission, 2011).

A third means of consumer protection is disclosures. U.S. and states' laws favor disclosures of financial information—the "disclosure regime" (Sovern, 2010:823). Disclosures are used in many types of transactions, particularly financial services contracts. In insurance, the common disclosures pertain to uninsured motorist coverage (where the insured typically must opt out of by signing and checking a box), long-term care (LTC), life insurance, mortgage insurance, and in some states homeowners insurance for additional coverages such as extended replacement cost or guaranteed replacement cost coverage.[7] Federal

6. "[a]n insured is obligated to read the insurance policy and raise questions concerning coverage within a reasonable time after the issuance of the policy … . An insured who decides not to read the policy proceeds at his or her own risk. … Despite the Wileys' belief that they had purchased 'full coverage,' they bore an obligation to determine that they actually received the coverage they sought. Had they done so, they would have readily recognized that the policy did not, in fact, afford 'full coverage,' as it clearly excluded underinsured motorist coverage."

7. For example, Calif. Ins. Code § 789.8 (long-term care disclosure); Calif. Ins. Code § 10102 (residential property disclosure for replacement cost options); Colo. Div. of Ins. Reg. No.

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bank regulations require disclosure when property to be acquired with help of a bank loan is located in a flood zone.[8] Some of the changes to the German insurance laws are similar to what is seen throughout the U.S. jurisdictions, with disclosures given at the time of the application.

A fourth area to compare is with the duty to advise. Here is a major difference between the two countries. As stated above, German intermediaries are (now) expected to advise consumers. The U.S. requirement is to the contrary: There is no duty to advise unless the insured specifically asks for advice (Russ and Segala 4: § 55:5 and cases cited therein). Agents represent the insurer, particularly captive or exclusive agents who represent only one insurer, and are thus salespeople or order takers to the consumer, however much they may seek to do right by their customer. "[A]n agent's job is to merely present the product of his principal and take such orders as can be secured from those who want to purchase the cover offered," wrote a Michigan court (Harts v. Farmers Ins. Exchange, 1999:50. Similarly, the cases Barnett v. Security Ins. Co., 1987, and Albany Ins. Co. v. Tillman, 1995). Independent agents (also called brokers) hold appointments from multiple insurers and may act as dual agents—that is, as agents for the insurer and as brokers for the insured. "An insurance broker is not a salaried insurance company employee or otherwise identified with a single insurer but, rather, is an independent middleman. A broker typically has contracts with a number of insurers and is compensated by way of commissions paid by the insurers with which he places coverage. Brokers are sometimes referred to as independent agents and are generally considered to be the insured's agent" (Richmond, 2004:5, and 6–11). This textbook definition, while legally accurate, may be "too simplistic to provide an adequate description of the insurance marketplace because independent agents and brokers perform many of the same functions and provide services to both insurers and policyholders" (Cummins and Doherty, 2006:361).

Agents have no duty to advise in general or to recommend any coverage or limit, unless there is a "special relationship" (or "special circumstances" as some courts call this) recognized by the law whereby the agent/broker has agreed to undertake that advisory role. Brokers represent the insured, even while they may also hold appointments as agents for insurers (though this arrangement is not permitted in Germany). Absent such special relationship, the agent need not recommend higher limits, note additional coverages or foresee liabilities that might require particular insurance (Fitzpatrick v. Hayes, 1997:927; Avery v. Diedrich, 2007:165–166). Agents with a special relationship, and brokers engaged to advise, will by definition have a special relationship. A special relationship is

72-7 (replacement life insurance); Georgia. Code Ann., § 33-42-6 (long-term care); Ill. 215 ILCS 5/224 (life insurance); Ill. 215 ILCS 5/1305 (mortgage insurance disclosure); Mass. M.G.L.A. 255 § 12G (credit life).

8. 12 Code of Federal Reg. § 208.25, "When a member bank makes, increases, extends, or renews a loan secured by a building or a mobile home located or to be located in a special flood hazard area, the bank shall mail or deliver a written notice to the borrower and to the servicer in all cases whether or not flood insurance is available under the Act for the collateral securing the loan. …"

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assumed in the following cases: 1) an agreement exists (for example, a contract specifying the advisory services to be provided); 2) where there is evidence that the agent/broker held him- or herself out having particular expertise *and* the insured relied on the expertise to the insured's detriment; and 3) where the insured's reliance is shown by the course of conduct between the insured and the agent over a period of years. The existence of an insured-agent relationship alone is not sufficient to create a special relationship.[9] A court in the state of Wisconsin said of this standard position, "The mere allegation that a client relied upon an agent and had great confidence in him is insufficient to imply the existence of a duty to advise. The principal-agent relationship cannot be so drastically expanded unilaterally" (Nelson v. Davidson, 1990:437). Where such relationship exists, the agent/broker has a duty to properly advise the insured and will be liable for failing in that duty (Williams v. Hilb, Rogal, 2009; Jones v. Grewe, 1987; Suter v. Virgil R. Lee & Son, Inc., 1988).

Various reasons are presented why U.S. laws do not impose a duty to advise absent a special relationship. One is that the insured presumably knows his/her situation better than the agent as stranger, and thus the insured should be responsible for determining his/her insurance needs. (Jones v. Grewe, 1987; Suter v. Virgil R. Lee & Son, Inc., 1988). This is largely a fiction, although more likely the insured knows better what he or she does *not* want to disclose and insure, such as a boat the insured admitted he did not disclose to the insurer but later claimed should have been insured when he ran his boat over a swimmer (Deremo v. TWC, 2012). The better reason is that "the creation of a duty to advise could afford insureds the opportunity to insure after the loss by merely asserting they would have bought the additional coverage had it been offered" (Windt, § 6:44[10]). This is what generally happens in the U.S., where a consumer who finds his or her claim uncovered because of inadequate limits or failure to select appropriate coverages then sues the agent or broker claiming the agent or broker should have advised him or her better, or maybe should have provided some advice. In opposition to this contention, a New York court stated (typical of the other courts' statements): "Insurance agents or brokers are not personal financial counselors and risk managers, approaching guarantor status ... permitting insureds to add such parties

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9. Roberts v. Assurance Co. of America, 163 Cal. App. 4th 1398 (2008); Sandbulte v. Farm Bureau Mut. Ins. Co., 343 N.W.2d 457 (Iowa 1984), overruled to extent it limited special relationship to particular factors enumerated in the case, Langwith v. American Nat. Gen. Ins. Co., 793 N.W.2d 215, 223 (Iowa, 2010), then Langwith overruled by statute, Iowa Code § 522B.11.2011 Iowa Acts ch. 70, § 45; European Bakers Ltd. v. Holman, 338 S.E.2d 702 (Ga.App.1985); Bruner v. League General Ins. Co., 416 N.W.2d 318 (Mich.App. 1987); State Auto Property & Cas. Ins. Co. v. Boardwalk Apartments, L.C., 572 F.3d 511, 515 (8th Cir. 2009); Penn-America Ins. Co. v. Zertuche, 770 F. Supp. 2d 832, 844 (W.D. Tex. 2011) (Absent "a long-term relationship with high levels of trust between an insurance agent and an insured, the agent owes only two duties to the insured: (1) to use reasonable diligence to place the requested insurance coverage, and (2) to inform the insured if unable to obtain such coverage").

10. Citing cases such as Blonsky v. Allstate Ins. Co., 128 Misc. 2d 981, 491 N.Y.S.2d 895 (Sup 1985), Peter v. Schumacher Enterprises, Inc., 22 P.3d 481 (Alaska 2001).

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to the liability chain might well open flood gates to even more complicated and undesirable litigation" (Murphy v. Kuhn, 1997:976).

A related point for consumer protection is disclosures with check-off requirements and consumer-advantaged default options. These probably do more good for the consumer's protection, understanding and welfare (Pappalardo, 2012) since the client might engage in an actual and informed decision because of these requirements. Advantages for the insurer and the intermediary arise because the informed choices are documented, which can later be used against claims of malpractice and failure to disclose. Thus, for example, on U.S. automobile insurance, uninsured motorist coverage (mentioned earlier) in most states requires that coverage equal the liability limit unless the consumer checks a box and signs the form to accept lower limits. This has gotten more coverage to consumers because people go with the default (White, 2009:152). The state of California mandates a disclosure for homeowners insurance on the various enhanced replacement cost coverage options on the structure that go beyond the specified Coverage A limits to rebuild the structure (California Insurance Code § 10102). This might be called "bounded choice" to reflect consumers' bounded rationality (White, 2009:172[11]). For other lines of insurance (variable life insurance, variable annuities, LTC) it is harder to see any connection with disclosures and improved consumer selection, although they may facilitate remedies in cases of unfair conduct. Similar outcomes and reasons explain the U.S. DOL's approval for employers to have default options on contributions and investment selections on the employer-provided defined contribution retirement accounts known as 401(k) plans (DOL, 2007; Madrian and Shea, 2001).

Lessons from the German Experience to U.S. Insurance Requirements

From the intermediaries' point of view, the German experience of being able to incorporate disclosures into the business routine rather smoothly also conforms to U.S. experience that these disclosures are just part of the paperwork to the transaction, using pre-printed forms or those that come off the printer along with other documents for the transaction, or on computer discs or drives. This seems to have about the same impact in the U.S. as the new German requirement has had on German consumers—more information, with little obvious real benefit.

11. Speaking of financial products in general, but not insurance, White writes: "Contract terms involving risks and contingent events, such as loan repayment, are particularly problematic. No amount of information will necessarily overcome the optimism bias, the saliency problem, and the availability heuristic, that is, consumers' tendency to believe that negative outcomes will not happen to them, or will happen only based on their available knowledge of actual instances where risks have materialized." Given that insurance is exactly for risks and contingent events, these remarks are very informative.

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The German requirement to advise is a significant difference with the U.S. practice, although the German requirement seems equivalent to the U.S. in those situations where the special relationship exists between the insured and the intermediary so that the common law imposes such a duty to advise. Imposing a duty to advise, as the German law requires, might generate more benefit to the insured in selecting appropriate insurance, although there will always be second-guessing if a loss is not covered but might have been with a different endorsement. Further research will be needed on what impact, if any, this will have on intermediaries' conduct towards insureds. Here, the "knowledgeable intermediary" or "learned intermediary" (a term borrowed from U.S. product liability law) might come into play. If advice is actually sought from the intermediary, and the intermediary actually knows what he or she is talking about, then the intermediary can do some good to improve the consumer's position. That would be the best outcome because, as Cummins and Doherty (2006:362) write, "the role of the intermediary is to break through the complexity by helping buyers to understand and purchase insurance." However, the reality of some intermediaries' competency, dedication, conflicts of interest and self-protection to avoid liability claims against themselves (a practice all financial intermediaries rightly use to protect themselves), might not accomplish the desired result. (See, for example, Furletti, 2005:9-10; and Inderst, 2011, who describe the potential conflicts of interest and the need for appropriate compensation schemes.[12]) There is also the cost to the transaction for insurers and intermediaries where the risks are fairly standard and the advisory needs are relatively simple; in contrast, commercial insureds generally seek and obtain more independent advice from intermediaries (Regan and Tennyson, 1996).

In the U.S., the SEC continues to study whether broker-dealers for financial products (not insurance) should be held to a fiduciary standard rather than the existing "suitability" standard." (See the SEC's *Study on Investment Advisers and Broker-Dealers*, 2011; Michaels, 2013.) Such a change, if enacted, could provide important guidance for whether insurance intermediaries should also have their standard raised. The U.S. DOL, in contrast, has now imposed a fiduciary standard over financial advisers who assist or direct employee/participant retirement contributions rolled over to individual retirement accounts (IRAs). Under the new rule, 25 CFR Parts 2510 et seq., implemented April 8, 2015, and effective (final) June 7, 2016, and applicable April 10, 2017, "the Adviser and Financial Institution must give prudent advice that is in the customer's best interest, avoid misleading statements, and receive no more than reasonable compensation. Additionally, Financial Institutions generally must adopt policies and procedures reasonably

12. Some authors who seek improvement through intermediaries sometimes mean something other than the transaction-type agents and brokers discussed here. Issacharoff (2011) argues for the use of "agents," for him meaning government and plaintiffs' lawyers bringing class action lawsuits, to protect consumers, with resulting improved information to the next round of consumers. Fung, Graham and Weil (2008: 122–124) refer to political interest groups, financial analysts, investigative reporters and unions to analyze the information and advice and advance the individuals' interests.

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designed to mitigate any harmful impact of conflicts of interest, and disclose basic information about their conflicts of interest and the cost of their advice" (DOL, 2016). The DOL explained that it changed the rule now because its original rule was made in 1975, after enactment of the federal Employment Retirement Income Security Act of 1973 (ERISA) but before the advent of directed contribution 410(k) plans, the contents of which are usually rolled over to the employee/participant's personal IRA after departure from that employer. The DOL explained the reason for the new rule:

> "Non-fiduciaries may give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers' financial interests; and act on conflicts of interest in ways that would be prohibited if the same persons were fiduciaries. In light of the breadth and intent of ERISA and the Code's statutory definition, the growth of participant-directed investment arrangements and IRAs, and the need for plans and IRA owners to seek out and rely on sophisticated financial advisers to make critical investment decisions in an increasingly complex financial marketplace, … the Department will replace the 1975 regulations with a definition of fiduciary investment advice that better reflects the broad scope of the statutory text and its purposes and better protects plans, participants, beneficiaries, and IRA owners from conflicts of interest, imprudence, and disloyalty."

The new rule also extends to investment annuity and investment life insurance plans, and the life insurance agents who sell those (29 CFR 2510.03-21). This application was challenged in a court case; the court ruled in favor of the DOL (National Association for Fixed Annuities v. Perez, 2016).

Another area of possible guidance from Germany is the ombudsman. This idea is common in Europe but is disfavored in the U.S., because the U.S.' preferred method of resolution is litigation. Even arbitration is often disfavored in insurance disputes and prohibited by some states' insurance statutes (Dolin and Long, 2013).

Conclusion

Improved knowledge and information through disclosures is always to be preferred, particularly where the model is to equalize information asymmetries in a marketplace or to have the consumer make better decisions about the financial products. But better consumer decisions do not necessarily follow from increased information unless the information is perfectly conveyed in the right way at the right time. The real goal of better consumer decisions is consumer welfare, which requires more than disclosures, whose value remains limited. Unfortunately, numerous studies and now this stringent disclosure and advisory mandate in Germany show that asymmetry reduction fails to improve consumer

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understanding, decisions and welfare. The German experience of insurance disclosure adds to the evidence of constraints in consumer understanding of financial literacy. Further making the comparison useful are studies showing that the U.S. and EU views on consumer rationality, reasonableness and bounded rationality for consumer protection are converging (Hacker, 2015:311–312: “The development of consumer concepts in the EU can be divided into two stages, which track remarkably well the parallel evolution of consumer concepts in the U.S. The process in Germany is representative of the tendency in the wider EU.”). For the U.S. market, which generally favors disclosures as the solution to market inequalities and inequities, and where consumer protection for insurance is addressed by each state rather than at the national level, regulators should be doubtful of the value of more disclosures to consumers who are ever less capable to interpret and process the increasing complexity and sophistication of financial products.

Carefully constructed disclosures can improve consumer understanding of some limitations and options, and may prompt the consumer to ask for advice. A more standardized implementation of the key fact sheets by the IDD has the possibility to bring along improvements. Related to this, the U.S. federal government has begun using research in behavioral economics to draft better forms that result in governmental efficiency and improved consumer decisions (Social and Behavioral Sciences Team 2015 Annual Report). Similar work is being done in the United Kingdom (UK) (Gino, 2015) and Germany (Hacker, 2015:315). Research on such changes in financial products and services in the U.S., Australia and New Zealand show that “nudges” and default opt-outs have been useful, but are incomplete solutions to improve consumer decisions and welfare (Ali, Ramsay and Read, 2014). Disclosures lacking such careful construction will likely accomplish more to insulate the insurer and the agent rather than motivate them to provide better products and service. Within this recommendation, a distinction might be made for sales through intermediaries and sales online, as the online buyers can be guided through opt-outs, defaults and disclosures along the way towards their purchase. The defaults and opt-outs could result in better coverages, though consumers might view these as additional forced sales, while the disclosures could mean more “click-through” terms that are ignored but if crafted well and appropriately could at least make information available at the right time. A salesperson doing the same opt-outs and defaults might also be viewed as trying to sell more, but with a duty to advise, the salesperson could be able to explain why such choices are generally in the consumer’s interest.

As Hacker (2015:317–318) contends, normative models must be informed by empirical studies, and he recommends that a pluralistic view of consumers’ range of rationality and reasonableness be embraced. Similarly, Lunn (2015:323–326) provides a useful analysis that consumer preferences may be too pluralistic such that a remedy designed to move consumers towards a model agent in an ideal market does not fit with the studies of consumer behavior. (Fernandes, Lynch and Netemeyer (2014:1874) discussed the idea of a “smart default” to deal with the

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heterogeneity.) Aligned with this, we suggest that better consumer protection will be accomplished by changing default processes for coverage selection, as is done now in some insurance lines, and changing the intermediary's role to a higher standard of advice. Default coverage selections, which can provide opt-outs, have been effective to improve consumer financial decisions and insurance coverage. The limited range of most consumers' understanding of insurance and financial services indicates the need for ever greater advice by intermediaries' who can put the consumers' interest foremost.

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