

PAYMENT PROTECTION INSURANCE MARKET INVESTIGATION

Emerging Thinking

The Competition Commission has excluded from this published version of the emerging thinking information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂.

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Emerging Thinking

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Part 1—Introduction, background and summary of current thinking

Introduction

1. This document sets out our emerging thinking on competition in the supply of all payment protection insurance (PPI) services¹ except store card PPI² to non-business customers in the UK on the basis of evidence we have analysed to date. It identifies where we are seeking additional evidence and the issues on which we intend to concentrate in the period prior to the planned publication of our provisional findings in May 2008.
2. We have not yet reached any conclusions on the statutory questions we have to answer during this inquiry.
3. However, our thinking is further advanced in some areas than in others. The areas in which we have significant further work to do, such as the retail market, are identified in this document. The purpose of this document is to expose the direction of our thinking and to elicit further evidence in relation to these matters.
4. We are publishing at the same time as this document nine working papers which address a number of the issues discussed in this document in greater detail. These working papers represent our views based on the evidence we have seen to date, and we also invite comments and further evidence from parties in relation to the matters covered in these working papers. We are also publishing at the same time as this document the results of a qualitative survey of PPI customers which was

¹PPI is defined in our terms of reference as: insurance services supplied for the purpose of protecting a borrower's ability to maintain credit repayments in the event that the borrower becomes unable to maintain the repayments due to accident and/or sickness and/or unemployment and, under some policies, death.

²Store card PPI is defined in our terms of reference as payment protection insurance services supplied for the purpose of protecting a store card holder's ability to maintain repayments under the store card agreement. A store card is defined in our terms of reference as a payment card issued with respect to the purchase of the goods, services or facilities of only one retailer or of retailers who are members of a single group of interconnected bodies corporate or who belong to a store card network or who trade under a common name and which has both associated retail benefits and permits the holder of the payment card under his contract with the issuer of the card to discharge less than the whole of any outstanding balance on his payment card account on or before the expiry of a specified period (subject to any contractual requirements with respect to minimum or fixed amounts of payment. For further information see:

www.competition-commission.org.uk/inquiries/completed/2006/storecard/index.htm.

conducted on behalf of the Competition Commission (CC) by BMRB in July 2007. We anticipate publishing the results of a telephone survey of PPI customers, conducted by BMRB, in December 2007.

Background

5. Following a supercomplaint made by Citizens Advice in September 2005, the Office of Fair Trading (OFT) referred the supply of all PPI (except store card PPI) to non-business customers in the UK to the CC for investigation under section 131 of the Enterprise Act 2002 (the Act) on 7 February 2007. The reference followed an initial OFT market study into the sector and public consultation. Our terms of reference are set out in Appendix A.

6. Our inquiry into the supply of PPI is a market investigation under the Act. Section 134(2) of the Act requires us to consider whether 'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK'. The presence of one or more 'features',³ which would represent an adverse effect on competition (AEC), may refer to:
 - (a) the structure of the market concerned or any aspect of that structure;
 - (b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or
 - (c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

7. If the CC decides that there is an AEC, it is required under section 134(4) of the Act to decide whether action should be taken by it, or whether it should recommend the taking of action by others, for the purpose of remedying, mitigating or preventing the

³Section 131(2), Enterprise Act 2002.

AEC concerned or any detrimental effect on customers⁴ so far as it has resulted from, or may be expected to result from, the AEC; and, if so, what action should be taken.

8. We have received to date evidence from a variety of parties by way of both written submissions and oral hearings. We visited 11 suppliers of PPI (including both underwriters and distributors), and have held hearings with 27 interested parties. We have published on our website non-confidential versions of the key views of those who have given evidence to us.
9. We have sought data from distributors and underwriters on prices and sales of PPI and the credit product it insures. To date, our ability to analyse this data has been limited, because the majority of the parties from whom we sought data have experienced difficulties in retrieving the data, matching data from different databases or providing it in the format requested. This has led to significant delays in the data-gathering exercise, with implications for our timetable for conducting analysis. To avoid further delays in the data-gathering exercise, we have discussed with each party exactly what data it can provide. Following those discussions, we considered it appropriate in some cases to use our formal information-gathering powers, pursuant to section 109 of the Act, to require provision of data within a specified timescale.⁵
10. As noted in paragraph 4, we have published on our website the results of a qualitative customer survey conducted on our behalf by BMRB. As the inquiry

⁴Section 134(5) of the Act defines a detrimental effect on customers (or future customers) as taking the form of: (a) higher prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or (b) less innovation in relation to such goods or services.

⁵The CC's ability to fulfil its statutory functions and publish a report within the statutory deadline hinges on the timely receipt of information from parties. The CC has formal information-gathering powers: section 109 of the Act gives the CC power to issue a notice requiring the production of information or documents, or requiring specified persons to give evidence to the CC. Failure to comply with a notice issued under section 109 of the Act within the time specified in that notice can lead to penalties being imposed.

progresses and we receive further evidence, we will continue to make this available, as far as is possible, on our website.

11. We recognize that PPI has been subject to close examination in recent years from a variety of perspectives. This includes ongoing work by the Financial Services Authority (FSA),⁶ and by industry analysts such as DeFaqto and Datamonitor. While such research was not carried out specifically for the purpose of our investigation, it has nonetheless provided us with useful background information. We are mindful of the need to take into account the work of the FSA and any resulting effects on the PPI sector.
12. Our intention is to publish our provisional findings in May 2008. In the event that we need to consider remedies, that process will take place in the second half of 2008, with our final report being published in November or December 2008. A more detailed timetable for the inquiry has been published on our website.

Summary of current thinking

13. PPI covers repayments on credit products if the borrower is unable to do so due to loss of earnings as a result of accident (A), sickness (S), unemployment (U) or death (referred to as life (L) cover). PPI is sold to cover a variety of credit products, but over 90 per cent of PPI sold in the UK in 2006 was either: personal loan PPI (PLPPI), credit card PPI (CCPPI), mortgage PPI (MPPI) or second-charge mortgage PPI (SMPPI). Taking out PPI can entail a significant financial outlay; the price of PLPPI can be more than the interest payable on the loan taken out.
14. PPI has come under increasing regulatory scrutiny in recent years, and the FSA took responsibility for regulation of the sector in 2005. The FSA has since carried out

⁶See the working paper on regulation for further details.

three rounds of a thematic review into the sector, most recently reporting in September 2007.

15. The evidence we have seen suggests that sales of PPI have fallen over the last year or two after several years of growth.
16. These trends form the context for our investigation into the supply of PPI. We summarize in this document our current thinking on the main issues we have so far identified. We do so by looking first at the supply of underwriting services for PPI, then at the retail supply of PPI to customers, and finally at the vertical integration of distributors of PPI and their underwriters.

The underwriting market

Market definition

17. Our emerging thinking on the relevant market for underwriting is that it is at least as wide as the underwriting of all PPI policies in the UK. It may be wider, encompassing other general insurance and life assurance policies, as it appears that there are no fundamental barriers to underwriters moving into the supply of PPI from other general insurance or life assurance policies. However, at this point we do not consider that we need to take a definitive view on whether the market is wider than all PPI policies.

The state of competition in the underwriting market

18. The evidence we have seen to date indicates that the underwriting market is concentrated, and that some distributors think that not all underwriters are sufficiently large to be able to underwrite their business. There do not appear to be significant barriers to entry to or expansion within the market for underwriting PPI policies, though switching costs may be significant and incumbent providers of underwriting

services do appear to have an advantage over other underwriters when re-tendering for a contract.

19. However, the tender process leads to underwriters competing vigorously with each other in order to win contracts that will give them access to a significant number of customers at the point of sale of a credit product. Distributors are contractually entitled to a relatively large proportion of the premium paid by customers in comparison with underwriters. The documentary evidence relating to profitability that we have seen indicates that underwriters appear to be making reasonable rates of return on PPI business.
20. We have, therefore, found little to support the assertion that there are features which prevent, restrict or distort competition in the underwriting market to any significant extent.
21. In light of what we have found to date, we do not currently propose to pursue further analysis or inquiry into the underwriting market for PPI based on the evidence available to us.

The retail market

Market definition

22. In order to define the retail market we look in detail at the extent to which PPI and the credit product it insures are complementary, and, if so, whether the link is symmetric or not.
23. We have relied largely on documentary evidence from, and hearings with, the parties. As stated in paragraph 9, we have sought, and are obtaining, data which should also be of use in answering this question, but we have not yet received

complete data from a sufficient number of parties to enable us to carry out a full analysis. We expect to be in a position to carry out this analysis over the coming few months.

24. None of the evidence received so far in the inquiry indicates that customers' choices in the primary market for credit products are affected by prices in the secondary market for PPI. In particular, evidence from the parties' internal documents shows that when considering changes in PPI prices, firms do not consider that an increase will cause a concurrent impact on their sales of credit products. As a result, our emerging thinking is that a small rise above competitive levels in the price of PPI would not be rendered unprofitable by its complementary relationship with credit.
25. We have also looked to see if different brands of PPI constrain each other. The evidence to date seems to suggest that a small price rise above competitive levels for any individual distributor would be profitable, as the advantage that a seller has as a result of being the only business able to access customers at the point of sale of credit would hinder any demand- or supply-side substitution.
26. Taking this evidence together, initial indications from the product market suggest that, if the further evidence to be gathered and analysed is in line with the evidence seen to date, the relevant product market would be a series of brand-specific product markets—so, for example, a distributor's PLPPI is in a separate market from another distributor's PLPPI. Current indications are that the relevant geographic market is UK wide.
27. We note that this is a preliminary position, and we indicate in this document the sort of evidence which might lead us to find a wider market definition.

The extent of competition between suppliers

28. Once we have reached a view on the relevant market(s) for the sale of PPI, we shall look at the extent of competition between suppliers. Issues we might consider include: the extent to which distributors offer PPI in combinations of its constituent components as opposed to a one-size-fits-all package (for example, some suppliers offer packages which only cover A and S, or only U, as well as the wider ASU package); whether different PPI markets have differing degrees of competitive intensity (for example, because of the prevalence of single or regular premiums in that particular market); customers' search patterns and the costs of searching; switching costs in a market; levels of commission earned by distributors; the price of PPI from credit/PPI distributors compared with the price for which PPI is sold by stand-alone providers; and the profitability of supplying PPI.

Vertical integration

29. Having looked at the two distinct levels of the supply chain—underwriting and distribution of PPI—we have also looked at issues involving companies which operate at both these levels of the supply chain. We have considered four possible issues arising from vertical integration, which we consider might result in reduced competition at one or other level of the supply chain. Our analysis is discussed in detail from paragraph 198. A summary of our findings is set out below.
30. We considered whether vertically-integrated underwriters could be less likely than independents to bid for contracts with lenders, reducing the number of bidders for tenders compared with a situation where all underwriters were independent of distributors. However, we found that vertically-integrated firms are active in bidding for third party business, and do not have advantages over, or disadvantages compared with, independent underwriters.

31. We considered whether vertical integration limited the size of the underwriting market that independent underwriters can bid for (on the basis that at least a proportion of the underwriting business of vertically-integrated distributors is not put out to tender), and whether this prevented independent underwriters from achieving efficient scales of operation. The evidence suggested to us that, even if non-integrated underwriters were unable to compete for customers of vertically-integrated businesses, businesses with relatively small underwriting presences in the PPI market are able to achieve sufficient scale to compete effectively with those with significantly more contracts.

32. We looked at whether vertical integration reduced the competitive pressure on vertically-integrated underwriters. We found that there is limited evidence that vertically-integrated underwriters offered PPI at higher prices than non-integrated underwriters, with most pricing at similar levels. If a vertically-integrated underwriter were causing prices to be too high, we noted that it would be possible for the distributor to divest its underwriting business. Further, we do not consider that vertically-integrated underwriters have limited incentives to innovate. On balance we do not think that there is limited competitive pressure on vertically-integrated underwriters which would lead to a detriment for consumers.

33. Finally, we considered whether vertical integration created an incentive to reject more PPI claims. We do not think that this was the case. Concerns over maintaining reputation, and the risk of losing customers who source multiple services from them, would reduce any incentive a vertically-integrated company may have to maximize claims rejections. Further, we do not think that vertically-integrated companies are uniquely placed to influence the underwriters' claims policies, as non-integrated distributors appear able to influence their underwriters' policy through contractual arrangements.

34. In light of what we have found to date, we do not currently propose to pursue further analysis or inquiry into vertical integration in the supply of PPI.

Part 2—The markets, the participants, and how it operates

What is PPI?

35. PPI covers repayments on credit products if the borrower is unable to do so due to loss of earnings as a result of A, S, U or L. PPI covers repayments for up to a specified period of time. PPI is usually associated with a specific type of credit product. The main types of PPI are PLPPI, MPPI, CCPPI, SMPPI, retail PPI, motor finance PPI (motor PPI) and personal current account overdraft PPI (overdraft PPI).⁷ Sales of PLPPI, MPPI and CCPPI make up the largest proportion of policies sold.
36. The protection offered by PPI is often referred to as ASU coverage. As stated above, many policies also include an element L in the event the policyholder dies (though most MPPI products do not include a life insurance element). Some PPI providers offer the ability to choose some rather than all of the ASU and L elements available.⁸ ASU benefits are usually paid for up to 12 months after an initial exclusion period (which is usually a specified number of days between the time a policy is purchased and the time a customer is permitted to make a claim). Our working paper on PPI policies—characteristics provides more detail on the generic characteristics of PPI policies. Our working paper on features of PPI for different credit products provides details on individual PPI policy types.
37. PLPPI is designed to cover personal loans (which are sometimes referred to as unsecured personal loans and are typically arranged on a fixed interest rate basis with monthly repayments over the term of the loan). It offers cover for ASUL and

⁷PPI is also available to cover store cards, but this is outside the scope of the current investigation.

⁸For example, Northern Rock offers 'Gold', 'Silver' or 'Bronze' on PLPPI policies (Northern Rock, response to issues statement, paragraph 5.5).

some providers also offer critical illness (CI) cover. It is usually paid for by way of a single premium (see paragraph 93) paid up front for the term of the policy (less than 10 per cent of PLPPI policies are paid for by monthly premium).

38. MPPI is designed to cover first-charge mortgages. As stated above, the risks usually covered are A, S and U, or a combination of these. It does not usually offer L. MPPI policies are paid for by way of a monthly premium.
39. CCPPI covers a percentage of the outstanding balance on a credit card. It usually covers L, A, S and U, or a combination of these; some providers also offer the option of CI cover. The premium is paid monthly and is calculated as a percentage of the monthly outstanding balance. The benefit payable is typically calculated as a percentage of either the outstanding balance on the credit card at the time of claim or the monthly statement issued prior to the claim. This percentage varies between providers from 3 to 10 per cent.
40. SMPPI protects a second-charge mortgage (which is also known as a secured loan; it is guaranteed on a customer's home and as such constitutes a 'second charge' on that home). The principal risks covered are L, A, S and U or a combination of these. About two-thirds of policies are paid for by a single premium which is payable up front and covers the term of the policy; the remainder are paid for by monthly premiums.
41. Retail PPI covers a percentage of the outstanding balance owing on a customer's retail finance account or loan; it insures against the risks of A, S, U, L and CI. It is usually paid for either by monthly instalment or a single premium policy, depending on the provider.

42. Motor PPI covers repayments on the loan for the purchase of a motor vehicle; it usually covers A, S, U, L and CI, or a combination of these. It is usually paid for by way of a single premium up front; however, around one-fifth of policies sold are paid for by a regular premium payment.
43. Overdraft PPI protects the repayments a customer is required to make on an overdraft facility. It usually offers cover against the risks of A, S, U, L and CI, or a combination of these, and some policies also offer cover against disability and hospitalization. It is paid for by way of a monthly premium, per person covered.
44. One of the measures used by both underwriters and distributors to assess scale of business is gross written premium (GWP)—which is the amount of money paid by customers. The GWP generated for each type of PPI in 2006, and the number of PPI policies in force in 2006, is set out in Table 1. The overall GWP is significantly lower than that reported by the OFT (based on Mintel data);⁹ we are seeking to understand the differences between the GWP figures provided to us by underwriters and those based on Mintel data.

TABLE 1 PPI: GWP and split between types of PPI, 2006

	<i>GWP</i> £m	<i>Share of total</i> <i>PPI GWP</i> %
Personal loans	2,013	45.7
First charge mortgages	628	14.2
Second charge mortgages	471	10.7
Credit cards	970	22.0
Motor loans	77	1.8
Retail credit	150	3.4
Overdrafts	50	1.1
Other	<u>48</u>	<u>1.1</u>
Total	4,408	100.0

Source: CC, based on evidence provided by parties.

⁹According to Mintel UK, Creditor Insurance, November 2005, the sector had an estimated GWP of £5.5 billion in 2005. As noted in Table 10, Mintel estimated the 2006 GWP as £5.35 billion.

45. The split in the share of supply of PPI between the largest PPI distributors is shown in Table 2. The shares of supply for the different types of PPI policy are shown in Tables 3 to 9. All brands sold by a distributor are included, so, for example, the GWP for RBSG includes sales under the Royal Bank of Scotland and NatWest (and its other) brands. It should be noted that some distributors had difficulty separating first- and second-charge mortgage PPI GWP from their records, which may distort the relative splits of GWP between Tables 5 and 6.

TABLE 2 **Share of supply of PPI in 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>All PPI %</i>
Lloyds TSB	⌋ ⌋ ⌋ ⌋ ⌋ ✂ ⌋ ⌋ ⌋ ⌋ ⌋ ⌋ ⌋	[10–30]
HBOS		[10–30]
Barclays		[10–30]
RBSG		[5–10]
HSBC		[5–10]
MBNA		[0–5]
Abbey		[0–5]
Cattles		[0–5]
Northern Rock		[0–5]
Alliance & Leicester		[0–5]
Nationwide		[0–5]
Capital One		[0–5]
Other		<u>676</u>
Total	4,408	100.0

Source: CC, based on evidence provided by parties.

TABLE 3 **PLPPI: GWP and share of supply, 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>Share of supply %</i>
Lloyds TSB	⌋ ⌋ ⌋ ⌋ ⌋ ✂ ⌋ ⌋ ⌋	[10–30]
RBSG		[10–30]
HBOS		[5–10]
Barclays		[5–10]
HSBC		[5–10]
Northern Rock		[5–10]
Abbey		[5–10]
Alliance & Leicester		[5–10]
Other		<u>475.7</u>
Total	2,012.7	100.0

Source: CC, based on evidence provided by parties.

TABLE 4 **CCPPI: GWP and share of supply, 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>Share of supply %</i>
MBNA	⌈ ⌋ ✂	[10–30]
Lloyds TSB		[10–30]
HBOS		[10–30]
Barclays		[10–30]
HSBC		[5–10]
RBSG		[5–10]
Capital One		[5–10]
Others	<u>158.7</u>	<u>16.4</u>
Total	970.5	100.0

Source: CC, based on evidence provided by parties.

TABLE 5 **MPPI: GWP and share of supply, 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>Share of supply %</i>
HBOS	⌈ ⌋ ✂	[10–30]
Nationwide		[5–10]
Abbey		[5–10]
Lloyds TSB		[5–10]
RBSG		[5–10]
HSBC		[5–10]
Barclays		[0–5]
Alliance & Leicester		[0–5]
Other*		<u>286.5</u>
Total	628.0	100.0

Source: CC, based on evidence provided by parties.

*The large proportion of MPPI sold by others appears to reflect the prominent role intermediaries play in the sale of MPPI.

TABLE 6* **SMPPI: GWP and share of supply, 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>Share of supply %</i>
Barclays	⌈ ⌋ ✂	[>30]
Lloyds TSB		[10–30]
Cattles		[10–30]
HBOS		[0–5]
HSBC		[0–5]
Others	<u>7.6</u>	<u>1.6</u>
Total	471.3	100.0

Source: CC, based on evidence provided by parties.

*One of the parties has expressed concerns about the overall size of the market quoted and therefore the accuracy of the share of supply figures contained in Table 6.

TABLE 7* **Overdraft PPI: GWP and share of supply, 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>Share of supply %</i>
Barclays	(✂)	[>30]
HBOS		[10–30]
Lloyds TSB		[10–30]
RBSG		[5–10]
Alliance & Leicester		[5–10]
Other	<u>0.8</u>	<u>1.7</u>
Total	49.7	100.0

Source: CC, based on evidence provided by parties.

*One of the parties has expressed concerns about the overall size of the market quoted and therefore the accuracy of the share of supply figures contained in Table 7.

TABLE 8* **Motor PPI: GWP and share of supply, 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>Share of supply %</i>
Cattles	(✂)	[>30]
Lloyds TSB		[>30]
HBOS		[10–30]
Other	<u>8.2</u>	<u>10.7</u>
Total	77.2	100.0

Source: CC, based on evidence provided by parties.

*One of the parties has expressed concerns about the overall size of the market quoted and therefore the accuracy of the share of supply figures contained in Table 8.

TABLE 9 **Retail PPI: GWP and share of supply, 2006**

<i>Distributor</i>	<i>GWP £m</i>	<i>Share of supply %</i>
HSBC	(✂)	[5–10]
Lloyds TSB		[0–5]
Other	<u>139.3</u>	<u>92.8</u>
Total	150.1	100.0

Source: CC, based on evidence provided by parties.

46. Mintel estimated that the size of the PPI market in 2006 in the UK was £5.35 billion (see Table 10). It has been reviewing the size of the market since 2001, as Table 10 indicates. We note that in 2006, for the first time since 2001, the growth of PPI GWP was expected to decline. Table 11 shows the GWP of the 12 largest distributors over the period 2002 to 2006, based on data we have received from the 12 largest distributors. This shows a peak of GWP in 2004, with a slight drop in 2005 and a

more significant drop in 2006. We are currently exploring the possible reasons for the differences in our figures compared with those from Mintel.

TABLE 10 Level and growth rates of PPI products in the UK

	<i>£ million</i>					
	2001	2002	2003	2004	2005	2006*
GWP	3,199	4,086	4,563	4,960	5,500	5,352
% growth	-	27.7	11.7	8.7	10.9	-2.7

Source: Mintel Creditor Insurance Report (January 2007).

*Estimated value.

TABLE 11 Level and growth rates of PPI products in the UK of the 12 largest distributors

	<i>£ million</i>				
	2002	2003	2004	2005	2006
GWP*	2,977	3,792	3,912	3,850	3,472
% growth	-	27.4	3.2	-1.6	-9.8

Source: CC calculations based on data provided by parties.

*12 largest participants in PPI market. As noted in Table 1, the total PPI GWP written in 2006 was £4.4 billion.

47. PPI is typically purchased at the same time as the credit product (in the case of CCPPI this is either the time at which the credit card is sold or when it is activated). This results in the credit and PPI being sourced from the distributor (often the lender of credit, or in the case of an intermediary, the intermediary sourcing the credit from the lender and PPI from either the credit provider or an underwriter). Distributors can include banks, building societies, brokers, car dealerships or retailers; a distributor can provide credit using one or more brand (for example, as stated above, RBSG uses several brands including Royal Bank of Scotland and NatWest). While most PPI policies are taken out at the same time as the credit product (this time is usually referred to as the point of sale), either from the lender or an intermediary, PPI may be purchased as a 'stand-alone' policy, independent of the credit product. Stand-alone PPI is discussed further in paragraph 75.

48. The OFT¹⁰ found that PPI is a secondary product, and other parties to the inquiry commented that the demand for PPI was driven (wholly or generally) by the purchase of the underlying credit product.¹¹ We have not come across any instances where purchase of PPI is actually a condition of credit being given. However, evidence from our qualitative survey showed that some customers were under the impression that purchasing PPI was a condition of obtaining the credit. The FSA, in its latest report, found that 92 per cent of the businesses it visited in its mystery shopping exercise did make it clear that the purchase of PPI was optional.¹² Our working paper on regulation explains that, if purchasing PPI were a condition of the credit, the advertised annual percentage rate (APR) would have to reflect the cost of taking both credit and PPI. This may influence a distributor's decision on whether to make purchasing PPI a condition of sale.

Customers

49. Table 12¹³ shows how PPI take-up varies with age, gender and socio-economic group. Information we have received suggests that consumers of PPI are more likely to have income below the national average or come from socio-economic groups C and D. Different types of PPI policies appear to be more popular with different age groups: CCPPI has its highest sales rate among 35- to 44-year-olds; PLPPI among 35- to 44-year-olds and 18- to 24-year-olds, and MPPI among 18- to 24-year-olds. Various surveys we have seen show that the most frequently cited reason for taking out PPI relates to 'peace of mind'. Our working paper on the characteristics of PPI consumers provides further information on this subject.

¹⁰OFT, *Payment Protection Insurance; The OFT's reasons for making a market investigation reference to the Competition Commission; February 2007*, p23.

¹¹Aviva, response to the issues statement, paragraph 2.1.1; Barclays, response to the issues response, paragraph 3.1; Genworth, summary of hearing, paragraph 5; Alliance & Leicester, summary of hearing t, paragraph 7; MBNA, summary of hearing, paragraph 6; ABI, summary of hearing, paragraph 6.

¹²FSA, *The Sale of Payment Protection Insurance Thematic update, September 2007*.

¹³Mintel, *Creditor Insurance, Finance Intelligence, January 2007*.

TABLE 12 PPI penetration by age, gender and socio-economic group, October 2006

	<i>Mortgage</i>	<i>Credit card</i>	<i>Personal loan</i>
Base: all adults with relevant credit product	630	941	270
			<i>per cent</i>
All	45	21	38
<i>Gender</i>			
Men	44	21	40
Women	47	21	36
<i>Age</i>			
18–24	59	24	45
25–34	57	22	30
35–44	49	30	46
45–54	40	20	31
55–64	32	18	35
65+	5	10	23
<i>Socio-economic group</i>			
AB	39	13	19
C1	49	25	43
C2	48	25	39
D	51	23	52
E	5	15	42

Source: NOP/Mintel.

Possible alternative policies

50. There are several other financial insurance policies available to consumers, which have been cited to us by parties to the inquiry as either being complements to, or substitutes for, PPI. Details of these are set out in our working paper on PPI and its alternatives. The policies are described briefly below.
51. Income protection (IP), sometimes known as permanent health insurance, provides a regular income if a customer loses income because he/she is unable to work due to accident or sickness. It is generally a long-term policy, with benefits payable up to retirement.
52. Short-term income protection (short-term IP), sometimes advertised as offering a form of lifestyle cover, typically offers ASU cover for up to 12 months. The customer

will choose the amount for which they wish to be covered (for example, the amount of a monthly credit repayment), and has the choice of how to spend any benefit received if a claim is made. The differences between short-term income protection and stand-alone PPI are limited, and we shall be looking further at the extent to which these are separate types of policy or the same type of policy branded for different uses.

53. Personal accident insurance provides a lump sum in the event of an accident which results in permanent loss of limbs or permanent disability within the term of the policy. Some policies also include life insurance and hospitalization cover.
54. Critical illness insurance (CI) provides a lump sum in the event that a customer develops an illness specified in the policy.
55. Life insurance provides an agreed cash payment if the customer dies during the term of the policy. Policies can be 'whole life', where the term is effectively the life of the customer and so a payout is guaranteed, or 'term life', where a payment is made if death occurs within an agreed policy term. Many PPI policies include a term life element (see paragraph 36).
56. The degree of substitutability of alternatives to PPI will be considered as part of our analysis of the market definition. A feature of relevance to this is the extent to which money received as the result of a successful insurance claim reduces the amount of payment of any state benefits. This is covered in our working paper on regulation.

Organization of the PPI value chain

57. Our working paper on the value chain sets out the participants in the PPI value chain. We set out here the basic structure of the market and a brief overview of the different players in the sector.
58. There are four ways in which businesses sell PPI to customers (and a business may utilize one or more of these ways):
- The PPI is sold to the customer by the business that is providing the credit product, and the PPI underwriter is part of the same group of companies as the lender. In this case the PPI seller is a distributor and is vertically integrated with the underwriter of the insurance.
 - The PPI is sold to the customer by the business that is providing the credit product, and the lender contracts with a dedicated underwriter to provide PPI for the lender to distribute. In this case the PPI seller is a distributor but is vertically separated from the insurance underwriter.
 - The PPI is sold to the customer by an intermediary,¹⁴ who sources credit for a customer, and sources either the PPI associated with the credit product or PPI from another underwriter (either from a panel of underwriters or from a preferred underwriter).
 - The PPI is sold to the customer by a firm which either underwrites PPI itself or sources it from an insurer. However, the firm offers the PPI to insure credit which the customer has taken out elsewhere. In this case the firm is selling PPI on a stand-alone basis.
59. We consider in paragraphs 60 to 79 the various types of businesses involved in the supply of PPI.

¹⁴For the purposes of this inquiry we have chosen to distinguish between intermediaries, who source the credit being insured from someone else, and distributors, who provide the credit being insured themselves.

Vertically-integrated businesses

60. Vertically-integrated businesses are those organizations where the credit function and all or some of the insurance underwriting are provided within the same group of companies. There are five vertically-integrated groups in the PPI market: Lloyds TSB, HBOS Barclays, RBSG and HSBC.¹⁵ Vertical integration was seen by the OFT as a significant feature of the market, with around 60 per cent of the market undertaking both the underwriting and distribution of PPI in the same group (see Table 13 for our own estimates).
61. We received varying estimates of the proportion of PPI underwriting carried out by vertically-integrated insurers, from 43 per cent of PPI GWP in 2004¹⁶ to approximately 66 per cent.¹⁷ Most of the vertically-integrated firms use third party underwriters to a greater or lesser extent; RBSG appears to be the only business which uses its in-house insurer to underwrite 100 per cent of its PPI policies.
62. We consider the effect of vertical integration on the PPI market in paragraphs 198 to 216.

Underwriters

63. The underwriters of PPI policies enter into contractual relationships with individual customers, and take on the risk that a customer may be unable to meet financial obligations arising from a credit agreement due to events stipulated in a contract (typically ASU and often L, as explained in paragraph 36). To insure these risks, underwriters charge the customer a premium. By stipulating the benefits in the

¹⁵HSBC is vertically integrated, to a limited extent, due to its ownership of Hamilton Insurance Limited and Hamilton Assurance Limited. In May 2007, HSBC announced the sale of its Hamilton Insurance subsidiaries to Aviva. As of 30 October 2007 the sale has not been completed.

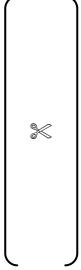
¹⁶AXA, response to the issues statement, paragraph 10.

¹⁷Table 1 of the OFT's October 2006 document *Payment Protection Insurance: Report on the market study and proposed decision to make a market investigation reference*, citing Mintel, showed that the five large banking groups (Barclays, HBOS, HSBC, Lloyds TSB and RBSG) underwrite 66 per cent of all PPI sold in the UK market through their in-house insurers (however, as of 30 October 2007 HSBC was about to sell its in-house insurer).

insurance policy they offer, underwriters can ensure that payments are made to those customers who are eligible to receive them. By stipulating the exclusions in the insurance policy they offer, underwriters can state the circumstances under which a claim would be paid and thus control the level of the risk underwritten.

64. The largest underwriters of PPI in 2006, by GWP,¹⁸ are set out in Table 13. Not all of these underwriters underwrite all elements of PPI; for example, Prudential underwrites only long-term insurance elements (life, critical illness and long-term disability cover) of PPI policies.¹⁹

TABLE 13 Underwriters of PPI and the split between them of GWP underwritten in 2006

Underwriter	GWP £m	Share of PPI under- writing in 2006 %
Aviva		[10–30]
HBOS		[10–30]
Prudential		[10–30]
Barclays		[10–30]
RBSG		[5–10]
Cardif Pinnacle		[0–5]
AXA		[0–5]
Lloyds TSB		[0–5]
HSBC		[0–5]
London General Insurance		[0–5]
Genworth		[0–5]
Others	235.1	5.3
Total	4,397.2	100.0

Source: CC analysis of information provided by underwriters on their GWP in 2006.

Distributors

65. For the purposes of this investigation distributors are lenders (for example, banks, mortgage providers, credit card providers) who offer PPI alongside their underlying credit products, either at the point of sale or subsequently (mostly in the case of CCPPI²⁰). Lenders can also offer PPI on a stand-alone basis.

¹⁸As explained in paragraph 44, the total GWP is significantly different from that calculated by Mintel.

¹⁹See our working paper on regulation for further details.

²⁰We have been told that CCPPI is sometimes offered when a customer phones the credit provider to activate the credit card. Mintel estimated that 81 per cent of CCPPI was purchased at the point of sale; of those who purchased CCPPI at a later date, 95 per cent bought it from the provider of the card—Mintel report *Creditor Insurance, Finance Intelligence, January 2007*.

66. In its consultation document published in October 2006, the OFT²¹ stated that approximately 80 per cent of all PPI policies were distributed by retail banks and building societies. In the typical case of where a borrower agrees PPI with a bank or building society, the lender acts as a 'distributor' for an underwriter's PPI policy. Table 2 lists the largest distributors of PPI in 2006. Appendix B provides a list of the distributors of PPI who have provided evidence during the investigation. Not all distributors offer all forms of credit, and hence do not offer all forms of PPI.
67. Distributors take a commission from the insurance premium paid by the consumer, allowing them to cover their costs and make a profit. The OFT suggested that commission rates paid by insurers to downstream intermediaries look high compared with other general insurance products. We discuss commission rates and profitability further in paragraphs 137 to 140.

Intermediaries

68. Intermediaries can distribute both credit products and PPI (and other insurance policies) or PPI alone. However, they neither underwrite the PPI policies nor finance the credit. Intermediaries make available to customers the credit products and PPI of one or more credit providers and/or underwriters. These products can be distributed under the brand name of the credit provider or of the underwriter. The evidence we have received indicates that intermediaries sell significant numbers of only one form of PPI, namely MPPI.
69. While some intermediaries may be tied to a particular lender and/or underwriter, many more operate independently. This allows an intermediary the option of arranging a credit product from one lender and sourcing PPI from an underwriter not associated with the lender.

²¹Citing data from Mintel UK, *Creditor Insurance*, November 2005.

70. The Association of Mortgage Intermediaries (AMI) told us that its members range from sole practitioners through to large national organizations which employ thousands of people. However a 'typical' mortgage intermediary firm would employ two or three advisers and one or two support staff. If the firm was directly authorized by the FSA, it may employ a compliance officer who could work on a part-time basis.
71. The AMI also told us that small firms commonly join 'networks' (effectively umbrella organizations) which the FSA views as a single firm for regulatory purposes. Examples of networks are Sesame or Legal & General Mortgages. The network is an entity which is regulated by the FSA and takes regulatory responsibility for all of the firms in it. It also acts as a buying group to achieve more competitive rates of commission and levels of service for those firms which are joined to it. Other firms join loose affiliations which are known as mortgage clubs. The purpose of these clubs is to negotiate on behalf of their members for improved levels of service or product exclusives²² from mortgage lenders. The mortgage clubs are not exclusive and firms can belong to as many mortgage clubs as they wish to. There are also what the AMI termed 'pseudo-networks', which operate in the same way as networks except that each firm is responsible for its own regulatory conduct. The firms in a pseudo-network can take guidance and support from it, and it also offers marketing assistance and information and acts as a group to increase its members' buying power.
72. The networks mentioned above would usually employ a team of specialists to survey the market for both mortgages and MPPI (as well as other products) and prepare a panel of providers for the network members to select from when advising customers. The panel would be expected to be made up of providers which were representative of the market as a whole. Neither the network nor any of its members would have a

²²AMI provided us with examples of exclusive products its members had access to.

contractual relationship with any of the providers on the panel. The AMI told us that the majority of its members were independent mortgage advisers who did not have contractual ties with insurance companies for protection products, including MPPI.

73. As noted in paragraph 68, intermediaries appear to have made significant sales of MPPI. Intermediaries often recommend their own choice of MPPI policy to sell with a mortgage, and this appears to have resulted in credit providers seeing lower penetration rates for their own MPPI policies. For example, Northern Rock told us that [over 75] per cent (by value) of its mortgage applications in 2006 came from mortgage intermediaries. Only [less than 10] per cent of these customers took Northern Rock's MPPI product with their Northern Rock mortgage (as opposed to taking out MPPI from another provider or not taking out MPPI at all). At the other extreme, [over half of the] customers who took out a Northern Rock mortgage from a branch also took Northern Rock MPPI.

74. As at 23 August 2007 6,619 firms are authorized by the FSA to arrange and advise on regulated mortgage contracts. The Council of Mortgage Lenders (CML) estimated that the UK's mortgage intermediary market provided 32 per cent of the 263,800 new MPPI policies sold in the second half of 2006.²³ Only three intermediaries (Sesame Limited, Legal & General Partnership Services Limited and Openwork Limited) held more than 3 per cent of the intermediaries market (by mortgage revenue) each in 2006.

Stand-alone provision

75. For the purposes of this investigation, there are two ways in which to provide stand-alone PPI. In both, PPI is offered directly to consumers without offering an underlying credit product, and the stand-alone PPI is not offered at the same time as the credit

²³Source: www.cml.org.uk/cml/statistics, spreadsheet PPI2.

is offered. In the first case the provider does not offer credit in any circumstances; it is either an insurer (such as Cardif Pinnacle) or a firm which contracts with an insurer (such as British Insurance). In the second case the provider is a business that does offer credit and PPI together, but also offers PPI on a stand-alone basis with the aim of gaining PPI business from other credit providers. In this second case the PPI policy could be one made available alongside its own credit products (for example, MPPI policies from HBOS and Abbey) or could be designed specifically to be sold on a stand-alone basis.

76. Stand-alone provision of PPI appears predominantly to take place in relation to PLPPI and MPPI; we have only come across one provider offering a stand-alone CCPPI policy, and sales of this type of policy have been extremely small.²⁴
77. As stand-alone providers do not have access to the customers they seek at the point of sale of the credit, they have to rely on other means of attracting customers. Most appear to have an Internet presence, though some also make telephone sales, and use price comparison websites or sponsored links on search engines to attract customers.
78. We have been told by several parties²⁵ that selling PPI away from the point of sale of credit is very difficult, though it has also been put to us that it is becoming easier due to increased use of the Internet by consumers. Several insurers and distributors have entered and then exited the stand-alone PPI market, including Aviva, AXA and Marks & Spencer. However, we are aware of at least one insurer which underwrites PPI for sale alongside credit and which also offers a stand-alone MPPI policy (Cardif Pinnacle) and several distributors (two of these launched stand-alone policies in the

²⁴Paymentcare told us that it has a stand-alone CCPPI policy but in 2006 sold under [§] policies. Barclays is in the process of introducing a CCPPI policy that can be used to cover other credit cards.

²⁵See, for example, Alliance & Leicester, summary of hearing, paragraph 5; Genworth, summary of hearing, paragraph 6; Citizens Advice, summary of hearing, paragraph 10.

second half of 2007). It was put to us that stand-alone PPI providers run a higher risk of adverse selection than point of sale PPI providers,²⁶ resulting in stand-alone providers facing a higher claims ratio on their insurance policies than point-of-sale insurers do.²⁷ It was also put to us that the higher risk of adverse selection is not an insurmountable barrier to the successful provision of stand-alone PPI.

79. We consider the competitive constraint offered by stand-alone providers of PPI in our analysis of market definition (beginning at paragraph 178).

How PPI is sourced and sold

Contractual relationships between underwriters and distributors

80. The evidence we have received from parties in the sector suggests that distributors have a significant level of input into the design of PPI policies, and set PPI prices relative to their main competitors in the consumer credit markets.
81. Contracts between underwriters and distributors tend to be negotiated on an individual basis (we were told that this reflected the individual nature of different credit products that PPI policies were designed to insure). Contracts tend to be of one to five years in length; and many have an initial period after which the contract continues in force until one party gives notice.
82. Distributors are contractually entitled to a percentage of GWP as commission. Typical commission rates are 50 to 80 per cent for PLPPI and CCPPI and 40 to 65 per cent for MPPI. The remaining GWP is passed to the underwriter to cover expenses, including claims. In the event that claims levels are less than expected,

²⁶Adverse selection, sometimes referred to as anti-selection, occurs as a result of information asymmetries between the insurer and the customer. Customers who know they face a large risk of needing to make a claim on an insurance policy are more likely to take out insurance than those who face small risks; however, the insurer does not know which customers fall into which category and so cannot price its insurance premium accordingly.

²⁷Aviva told us that this was its experience in the stand-alone market; its claims ratio for its stand-alone products was significantly higher (18%) than for its products sold alongside credit.

the resulting profit will be split between the underwriter and distributor according to an agreed profit share percentage; typically 90 to 100 per cent in favour of the distributor. A separate profit share arrangement will typically apply to any investment income earned by the underwriter on premium income and may also apply to tax benefits on life business.

83. The process by which insurers tender to underwrite PPI policies is set out in detail in our working paper on the value chain. Information on tenders and contract lengths can be found in our working paper on the underwriting market.

The sale of PPI to customers

Competition

84. The OFT suggested that competition was centred on the credit product, with the APR used by a consumer as a means of comparison, and noted that the APR does not indicate the price of a credit product including the PPI policy. We have heard different views on the extent to which consumers take account of the price of PPI when choosing their credit and PPI, or choose the most competitive credit offer and then decide whether they can afford to take out PPI.²⁸

Sales methods

85. The FSA authorizes PPI to be sold either on an 'advised' or a 'non-advised' basis, at the discretion of the PPI provider. Any sales on an 'advised' basis, where an adviser can make a personalized recommendation as to the suitability of a product for the

²⁸For example, Nationwide said that customers actively considered the purchase of PPI when considering taking out a credit product, and said that this was borne out by the consumer survey produced for the OFT (Nationwide, response to the issues statement, p3). Northern Rock told us that customers tend to choose credit based on the APR, and then look at the prices of loans with and without PPI (Northern Rock, summary of hearing, paragraph 15). Barclays said that customers generally made their decision based on the affordability of the total monthly repayments of the loan and PPI (Barclays, summary of hearing, paragraph 11). The CML believed that customers searched on the mortgage rather than MPPI, and suspected that the final decision was based on the price of the mortgage or the mortgage plus PPI, rather than the price of the PPI. Lloyds TSB said that customers tended to base their decisions on the price of credit, and then considered the price of the package with PPI (Lloyds TSB, reply to the issues statement, p2). Citizens Advice suspected that customers looked at the price of credit per month, and if they could afford the PPI then they would buy that as well (Citizens Advice, summary of hearing, paragraph 8).

customer's needs, are subject to additional selling conditions compared with those offering PPI on a 'non-advised' basis (for example, in an advised sale the seller must issue a statement of demand and needs to the customer).²⁹ Further details on the difference between advised and non-advised sales can be found in our working paper on regulation.

86. We were told by one company that it had seen a drop in PPI sales when it moved from selling on an advised basis to selling on a non-advised basis.³⁰
87. When advertising credit, lenders have to use APR as the method of showing the price of the loan. Whilst the APR quoted on credit does not include the price of PPI, the monthly repayment quoted often has the price of PPI included in it automatically, though we have been told that quotes with and without PPI are provided. However, showing the monthly price of PPI does not show the lifetime price of the PPI policy. Which? provided us with data it had gathered on the average total amount consumers would pay for a £7,500 unsecured personal loan, repayable over five years, with PPI and without PPI. It looked at 54 products provided by 31 lenders or underwriters. The average interest payable on the £7,500 loan over that time would be £1,566; the price of PPI was less than the interest payable on the loan for only five of the 54 products on the list. We calculated from Which?'s data that the average APR quoted for loans on its list was 7.8 per cent. If the APR calculation had included the price of PPI, the average APR would have been 18.8 per cent.
88. The OFT suggested that the level of information available on PPI before the point of sale was poor; however, a number of parties emphasized to us that information was available prior to the point of sale, and we shall need to consider whether consumers

²⁹FSA, *Advised and non-advised sales: insurance factsheet*, October 2006.

³⁰Nationwide, summary of hearing, paragraph 21. RBSG, summary of hearing, paragraph 9, said that it thought it possible that a decline in penetration rates might have been slightly steeper due to a move to non-advised sales.

seek and use such information before they reach the point of sale of the credit. Several parties told us that PPI was sold at the point of sale rather than bought³¹ (though others told us that this was not the case or was not necessarily the case³²). In its latest report on PPI, the FSA said that around a third of those firms it visited failed to ensure that customers were given the basic information necessary to make an informed decision about purchasing a PPI policy, and that, in its latest mystery shopping exercise, less than half of shoppers were told about the policy limitations and exclusions.³³

Distribution channels

89. PPI is sold predominantly by distributors and intermediaries (as noted in paragraph 68, intermediaries predominantly sell MPPI). Credit products and the associated PPI are sold through several channels:

- (a) face-to-face (eg through a branch network or at an intermediary's office);
- (b) telephone sales;
- (c) the Internet; and
- (d) the post.

90. The OFT³⁴ estimated that about 80 per cent of PPI policies are taken out at the same time as credit. Mintel³⁵ estimated the split for PLPPI sales between sales channels was 42 per cent face to face; 25 per cent over the telephone; 11 per cent over the Internet; 3 per cent by post; and 19 per cent through other means (including car dealerships, intermediaries and door-to-door lenders).

³¹Barclays, summary of hearing, paragraph 24. Barclays did note that there is information available prior to the point of sale; CML, summary of hearing, paragraph 14; Which?, summary of hearing, paragraph 7; and FSA's third thematic update, p12; Aviva, response to the issues statement, p1. Aviva said that its comment that PPI is sold, not bought, was not made in the context of a discussion of sales methods. It was used to illustrate the nature of PPI as a secondary product, bundled with the credit product as well as the fact that consumers do not naturally consider it.

³²RBSG did not agree that PPI was sold and not bought (summary of hearing, paragraph 13), HSBC did not necessarily agree (HSBC response to the issues statement, paragraph 4.10) and Northern Rock said that a large number of customers searched for information on PPI prior to purchase, implying that it was bought rather than sold (summary of hearing, paragraph 10).

³³FSA, *The Sale of Payment Protection Insurance: Thematic Update, September 2007*.

³⁴OFT, *Research into Consumers' Experience of Payment Protection Insurance; A research report for The Office of Fair Trading; October 2006*, prepared by GfK NOP.

³⁵Mintel, *Creditor Insurance, Finance Intelligence, January 2007*.

91. Our own analysis of data provided by the large distributors (see Table 14) showed that for all sales channels there was a similar pattern to distribution across the four main types of PPI, with the majority sold face to face, and smaller volumes sold over the telephone and Internet.

TABLE 14 Sales of new PPI policies by distribution channel 2006, by number of policies

	<i>per cent</i>			
	<i>Personal loans</i>	<i>First charge mortgages</i>	<i>Credit cards</i>	<i>Second charge mortgages</i>
Number of policies sold on a stand-alone basis	0.0	4.1	0.0	0.0
Number of policies sold via your company for use with one of your credit products, of which	99.9	92.0	99.5	99.9
—In branch/face to face	61.2	62.8	50.3	48.9
—Telephone	22.4	20.0	31.0	31.0
—Internet	3.0	0.1	7.3	9.6
—Postal	2.2	0.0	3.2	3.2
—Other	11.2	17.1	8.1	7.3
Total number sold via a downstream intermediary	0.1	3.9	0.5	0.1
All new PPI policy sales	100.0	100.0	100.0	100.0

Source: CC calculations based on data submitted by the 12 largest distributors.

Notes:

1. Percentages as a proportion of all sales where a breakdown was available.
2. The category 'other' consists mainly of sales where the sales channel was unknown.

92. Internet sales are all made on a non-advised basis, and it has been suggested to us that the lower take-up of PPI on credit purchased on the Internet may reflect the lack of advice given on whether to purchase PPI during these sales.³⁶

The insurance premium paid

93. PPI policies can be either 'single premium' or 'regular premium'. This refers to the payment method of the policy. With a single premium policy the total price of the policy for the whole of the contract is paid in one lump sum at the beginning of the contract, generally by increasing the size of the credit being purchased in order to pay for the PPI. This means that a customer accrues additional interest costs as a

³⁶Northern Rock expressed this view in its response to the issues statement, paragraph 3.8.

result of the extra borrowing. Single premium policies tend to accompany unsecured personal loans, motor finance and some second-charge mortgages.³⁷

94. With a regular premium policy a monthly premium is paid to maintain the policy. This has the advantage of being able to cover a credit product, the price of which changes from month to month (for example, the monthly price of a CCPPI policy is based on the outstanding balance on the credit card, and therefore the total payment due on the policy may change from month to month). Payments for PPI on credit cards and mortgages are generally covered by regular premium policies.
95. It has been put to us that the main advantage of single premium PPI is that the insurance remains valid even if the customer misses repayments during the life of a loan. Cattles told us that it considers regular premium policies inappropriate for a majority of its customers, arguing that those customers were more likely to have fluctuations in their levels of disposable income and therefore require repayment 'holidays'. PPI cover paid for by a single premium is unaffected by any breaks in the repayment of the loan.³⁸ When a monthly payment on a regular premium is missed, the contract can in principle be declared cancelled by the provider which would mean that the customer would lose the benefit of the PPI cover, possibly at the precise time at which the customer most needs it. (However, the Financial Ombudsman Service told us that it had not seen any evidence of this occurring and that, although these sorts of conditions are within the policy, it would have doubts about whether this would be fair or reasonable if only one or two payments were missed even if the policy terms permit immediate cancellation.)

³⁷For example: Northern Rock sells single premium policies cover on unsecured personal loans but mortgage and personal secured loans (PSL) are monthly premiums (Northern Rock, summary of hearing, paragraph 13); and Alliance & Leicester sells single premium policies exclusively on its unsecured products, and secured, second-charge products (Alliance & Leicester, summary of hearing, paragraph 12).

³⁸Cattles' response to the issues statement (paragraph 3.9) and Cattles' position paper (paragraphs 3.7 and 3.8).

96. Others have said that single premium policies disadvantage customers. We were told that single premium policies can be more expensive than regular premium policies over the course of a loan as the total price of the PPI is added to the amount being borrowed by the customer. This means interest is charged on the additional amount borrowed. In addition, it was put to us by Which? that a customer may end up paying interest on the premium even though they are no longer covered because the PPI policy covers a shorter period of time than the total loan period. For example, if a consumer takes up a loan of £10,000 for a period of ten years with an APR of 10 per cent and a PPI premium of £2,000 to cover the consumer for five years, the consumer will pay the 10 per cent APR on £12,000 for a period of ten years (ie for five years after their PPI cover has expired).³⁹
97. Customers with single premium policies are entitled to a rebate if they cancel the policy at any time (for example, if they pay off the loan early, or decide to cancel their PPI). We were told that the refunds given reflect a greater risk for insurers early in the life of a policy because of the higher insured balances outstanding, the initial expenses of the policy and the higher risk of default due to adverse selection—so a customer cancelling a policy a quarter the way through its life is likely to get somewhere nearer a half of the premium refunded. Expenses such as administrative costs can reduce the amount of the rebate. The FSA, in its latest report on PPI,⁴⁰ found that customers are now being given rebates on virtually all single-premium policies; however, the refund terms for single premium policies are often not being properly explained to customers.
98. There are several ways of calculating rebates used across the industry; some companies use the ‘rule of 78’, which we were told reflects a higher propensity for

³⁹Which?’s response to the issues statement, paragraph 6.

⁴⁰FSA, *The Sale of Payment Protection Insurance: Thematic Update, September 2007*.

claims at the start of the loan. One company told us that it moved to using its own actuarial-based rebate calculation for PPI refunds, in line with its general insurance business. It said that its actuarial method took account of claims experience over the full terms of similar products.

99. We shall look to see the extent to which single premium policies may be a barrier to switching due, for example, to the level of rebates received when a policy is cancelled.

The price of PPI

100. For policies which cover a fixed loan amount, the price of PPI is typically quoted as a monthly amount and the total price of the policy over the lifetime of the loan is also given in many cases. For policies where the amount covered varies, such as CCPPI and overdraft PPI, the price is quoted as pounds per £100 of the loan amount. The credit that PPI covers is usually advertised based on its APR.
101. The price of PPI does not appear to have changed very much during the period 2002 to 2006. Data we have received from parties on the price of PPI shows that many policies did not change price at all over the five years in question, or rose in price only once during that time. Reductions in the price of a PPI policy were extremely rare. For personal loans, of those products that were available for the entire period, and for which data on PPI price was provided (40 products), 5 did not change price at all over the five years, 34 increased, and 1 decreased. For credit cards, of those products that were available for the entire period, and for which data on PPI price was provided (45 products), 22 did not change at all over the five years, and 23 increased.

102. Further information on the price of PPI is given in the working paper on the characteristics of PPI policies. There are two observations worth mentioning here. First, the comparative price of PPI between credit products varies. For example, Defaqto⁴¹ estimated that the average price per £100 of benefit for MPPI was £4.76, for CCPPI was £11.70 and for PLPPI was £18.23.
103. The second observation is that the price of PPI can vary significantly within a policy type; the OFT commented that the difference in price might not always explain the differences in PPI cover. As set out in paragraph 87, Which? provided us with data it had gathered on the price of taking out a £7,500 unsecured personal loan, repayable over five years. The data showed that the overall price of taking out PPI from these providers varied from £1,104 to over £3,000 (a per month price varying between £18 and £55), with an average price of £2,200.
104. We were also told that the price of stand-alone PPI was significantly less than the price of PPI bought at the point of sale. For example, British Insurance quotes stand-alone PLPPI at prices from £2.65 to £8.45 per £100, depending on age,⁴² and the Post Office told us that showing the cost of a loan per £100 of cover would show that PLPPI obtained at the point of sale typically cost £25 or more per £100 of benefit, and this was five times more expensive than similar stand-alone cover from Post Office Financial Services.⁴³ Evidence from Defaqto⁴⁴ suggested that the median figure for PLPPI per £100 cover was £17.82, with a maximum of £28.25.
105. Variations in the price of PPI could be caused by several things: differences in cover offered by different policies (for example, a cheaper policy may contain more exclusions than a more expensive policy, thus reducing the insurer's risk); different

⁴¹Defaqto, *Payment Protection Insurance, 2007—The Year of Reckoning*, February 2007

⁴²www.britishinsurance.com.

⁴³Post Office Financial Services, response to the issues statement, p5.

⁴⁴Defaqto, *Payment protection insurance 2007—The Year of Reckoning*.

cost bases of the insurance providers and/or distributors; different price sensitivities of customers; or limited searching for policies by customers. We invite evidence from parties as to the reasons for the appearance of (a) large price variations between what appear to be often very similar PPI policies; and (b) very little price variation for a given type of policy over time.

The point of sale

106. As noted in paragraph 47, most PPI is sold at the point of sale of the underlying credit product. It appears that many PPI policies sold by distributors are only available at the point of sale (whilst CCPPI is sometimes sold when the card is activated, other PPI policies only appear to be offered at the point of sale, and it was not clear to us that a customer would be able to buy PPI from his distributor after the point of sale of the credit).

107. The OFT was concerned that customers did not appear to be shopping around for PPI. However, we have been told that the overall market for credit is competitive as borrowers look for the best deals (generally using the APR offered as a comparison tool).⁴⁵ We were shown consumer research which found that for half of all new loans the choice of provider was driven by a customer's existing relationship with the provider, with interest rates being the other significant driver of choice. One party suspected that this does not necessarily translate into high customer search rates for the associated PPI.⁴⁶

108. We were given conflicting views on whether customers shop around for PPI. Some told us that customers only shopped around for the credit (and, as noted in

⁴⁵See, for example, Barclays' response to the issues statement, paragraphs 5.3 and 5.4; Abbey response to the issues statement, paragraph 3.9; Abbey, summary of hearing, paragraph 14.

⁴⁶Alliance & Leicester, summary of hearing, paragraph 14.

paragraph 88, that PPI is sold, not bought).⁴⁷ Others told us that customers increasingly shopped around for the bundle of credit and PPI, taking advantage of price comparison websites, among other things, to find the best overall package.⁴⁸

109. The qualitative research carried out on our behalf by BMRB found that participants had generally shopped around for their primary credit products, but had not considered payment protection options before applying for their chosen loan. There were exceptions to this, however, particularly among those who had recently undergone a change of circumstance and those who reported that they were particularly anxious about personal finance.
110. Another aspect of the point-of-sale advantage for a credit provider is the lack of advertising of PPI prior to point of sale. Customers may be unaware of the types of protective cover available to them as the search focus is on the credit product. This could be exacerbated by the lack of advertising of PPI and its benefits and prices prior to its sale. We have been told that there are a number of initiatives aimed at instructing customers (such as the leaflet *A Guide to Payment Protection Insurance*,⁴⁹ which was produced earlier this year). However, it is not clear how effective these initiatives are or will be, or how they will affect customer behaviour prior to the point of sale.
111. The role of the point of sale is therefore an important feature of the provision of PPI.
112. The OFT was concerned that selling PPI at the point of sale could result in the customer feeling that purchasing PPI is required as a condition of obtaining the loan.

⁴⁷For example, CML, summary of hearing, paragraph 20; Genworth, summary of hearing, paragraph 9.

⁴⁸For example, Barclays, summary of hearing transcript, paragraph 26; HSBC, response to the issues statement, paragraph 4.15; Finance and Leasing Association, summary of hearing transcript, paragraph 19.

⁴⁹This guide is an initiative between the ABI, BBA, CML, FLA and Protect. A copy can be found at: www.abi.org.uk/BookShop/ResearchReports/Payment_Protection_Guide.pdf.

Even if there is an understanding that the PPI is not required, the customer may feel that purchasing PPI will make the application for credit more likely to succeed, or that a delay in the decision to purchase (in order to shop around for a better deal) will result in a delay to the credit application.⁵⁰ We have also heard that some consumers have thought that taking out PPI with credit has been mandatory, though the FSA, in its latest thematic review of PPI, has found that distributors are telling consumers that PPI is optional.⁵¹

113. It has been argued that to sell PPI at any point other than the point of sale significantly reduces the penetration of PPI and increases the likelihood of adverse selection,⁵² a problem identified by some as facing stand-alone providers of PPI (see paragraph 78).

Part 3—Analysis and issues for further consideration

Introduction

114. We set out below our current thinking on those elements of the markets most relevant to our assessment of competition in this inquiry. We have divided the issues into three:

- issues relating to underwriting;
- issues relating to retail distribution; and
- issues relating to vertical integration of providers in the underwriting and retail distribution markets.

⁵⁰The Post Office told us that over 20 per cent of PPI customers assumed that PPI was a mandatory part of the card, loan or mortgage and that some personal loan providers hold on to their credit decision until they have had an opportunity of discussing PPI with the customer. The OFT phase 1 telephone survey asked PPI customers in 2006: 'Did you think it would help your (product) application if you took out PPI?' Based on 952 respondents who had a PPI policy at the time of the survey: 67 per cent said no; 20 per cent said yes, I assumed; 4 per cent said yes, hinted at by lender; 4 per cent said yes, stated by lender; 4 per cent said don't know.

⁵¹Of 106 completed mystery shops by volunteer GfK-trained mystery shoppers, in 97 the shopper was told spontaneously that PPI cover was optional (Source: GfK mystery shopping report, part of FSA Thematic Update, Sep 2007, p7).

⁵²Aviva, response to issues statement, p2.

In each of these sections we set out what we consider to be the main questions, the evidence we have received and analysis we have conducted to date, and what we plan to do in the period leading up to publication of our provisional findings.

The underwriting market

Market definition

115. The following paragraphs, together with our working paper on the underwriting market, set out our approach to determining the relevant market(s) for the underwriting of PPI for the purposes of this inquiry, and our initial thinking regarding the product and geographic market.

Product market

116. In looking at the relevant product market we have followed the approach set out in our guidelines,⁵³ looking at the extent to which there would be demand- or supply-side substitution in response to a small but significant non-transitory increase in price (SSNIP).

117. Demand-side substitution occurs because an increase in price makes a product less attractive to customers who therefore decide to purchase less of it and more of a substitute. Supply-side substitution occurs when a price rise prompts other firms to start supplying, at short notice, an effective substitute to the product in question.

118. The evidence we have received to date indicates that contracts between underwriters and distributors are usually specifically designed and negotiated for a particular credit product, with significant input from the distributors.

⁵³Market Investigation References: Competition Commission Guidelines, CC3, June 2003, Part 2.

119. However, there does not appear to be any significant barrier to an underwriter expanding its business from underwriting one PPI policy to underwriting another type of PPI policy. Most large PPI underwriters provide PPI for two or more types of credit, and have bid in the last five years to provide PPI for at least one credit product they do not currently underwrite, showing a willingness to try to move into the underwriting of new types of PPI policy. In addition, most parties we spoke to told us that they thought that the underwriting market covered all types of PPI policies.
120. We consider that no one incumbent underwriter would be able profitably to impose a SSNIP above competitive levels, for example when the contract is re-tendered, because this would induce the distributor to award the contract to another underwriter. Similarly a hypothetical monopolist of one type of PPI would not profitably be able to impose a SSNIP, since this would induce distributors to award their tenders to another underwriter in another category. We therefore find that the relevant product market is at least as wide as the underwriting of all types of PPI.
121. We did not find that there were separate markets for underwriting life and non-life elements of PPI policies, nor that there were separate markets for PPI underwriting depending on whether or not the underwriter was vertically integrated with a distributor.
122. We then considered whether the relevant product market might be broader, encompassing the underwriting of some non-PPI insurance policies. The evidence we have seen does not appear to suggest there are any fundamental barriers to underwriters moving into the PPI market from other general insurance or life assurance markets, though we are not aware of any significant new entry into the PPI underwriting market in recent years.

123. Our emerging thinking on the relevant product market for underwriting is, therefore, that it is at least as wide as the underwriting of all PPI policies, and may be wider to encompass other general insurance and life assurance policies.

Geographic market

124. We considered whether the relevant geographic market for underwriting is UK-wide, narrower or broader.
125. We have received no evidence to suggest that the geographic market is local or regional; we have seen no evidence of regional restrictions on underwriting contracts or tender documents.
126. We have received evidence on the question of whether the market might be wider, in particular encompassing the Republic of Ireland. At this stage of our investigation we have received one piece of evidence which might suggest a wider market—there have been some tenders to underwrite risk for a pool of both UK and Irish creditors. On the other hand, there are different, albeit similar, regulatory regimes in place in the two countries, and developments in these regimes, even if the developments are similar, will not necessarily occur at the same time. This may militate against underwriting activities in the two countries constraining each other.
127. Our emerging thinking on the relevant geographic market for underwriting is, therefore, that it is at least as wide as the UK, and may also include the Republic of Ireland.

Emerging thinking on underwriting market definition

128. Our emerging thinking on the market definition for the underwriting of PPI is that it is at least as wide as the underwriting of all PPI products in the UK. It may be wider,

encompassing other general insurance and life assurance products, and the geographic scope may be wider to include the Republic of Ireland.

Is there evidence of market power being exerted by underwriters?

129. We have looked at the structure and operation of the underwriting market in order to see if there is any evidence of market power being exerted by underwriters. Our analysis is set out in detail in our working paper on the underwriting market; we present here a summary of our findings. We consider any possible issues relating to how vertically-integrated businesses impact on the underwriting market in our section on vertical integration beginning at paragraph 198.

Concentration of the market

130. We looked at the degree of concentration in the underwriting market. We looked at two measures of concentration, referred to in our guidance:⁵⁴ the concentration ratio, and the Herfindahl-Hirschman Index (HHI). The concentration ratio of the four largest firms in the market is 67 per cent. A concentration ratio in excess of 60 per cent can be considered to raise concern over competition that if, unchecked, may be to the detriment of the market. The HHI for the market is 1,358, also indicating a concentrated market.⁵⁵ The evidence therefore suggests that the market is concentrated.

Capacity

131. It has been suggested that some underwriters may not be large enough to be considered credible bidders for the business of the largest distributors, which might suggest that, for large distributors, the market is more concentrated than indicated in paragraph 130. This appears to be borne out when looking at which underwriters are

⁵⁴CC3, paragraph 3.9.

⁵⁵In its merger guidelines, the OFT states that it is likely to regard any market with an HHI in excess of 1,000 as concentrated, and any market with an HHI in excess of 1,800 as highly concentrated (OFT 516 *Mergers Substantive Assessment Guidance*, May 2003).

invited to bid for contracts by the larger distributors. However, we have seen nothing to date which would suggest that underwriters would be unable to expand capacity relatively quickly and easily.

Entry, exit and expansion

132. The evidence available to us to date suggests that, generally, there are not significant barriers to entry into, or expansion within, the underwriting market. The reputation of the underwriter is important, so entry from a related insurance field may be easier than entry into the underwriting market without any prior underwriting experience.

133. Another possible barrier we have looked at is whether there are significant switching costs which inhibit switching by distributors, and therefore expansion by underwriters. We received evidence that the costs of changing underwriter could be significant, largely in integrating IT. Further, using evidence from a large underwriter, we have seen that there appears to be a pronounced incumbency advantage—underwriters tend to win the majority of tenders they bid for if they are the incumbent provider, and lose the majority of tenders they bid for where they are trying to dislodge an incumbent provider. However, it is clear that distributors can and do switch underwriter as a result of tenders.

134. We looked at the duration of contracts, to see if the length of contracts might inhibit switching. Average fixed-term contract lengths were five years, but most contracts we looked at had an initial period (of average length 3.7 years for the contracts we looked at) and were then rolled forward with, typically, a six-month notice period. We thought that neither the length of contracts nor notice periods were excessively long.

Countervailing buyer power

135. We have looked to see if there is evidence of countervailing buyer power being exercised by the customers of underwriters.
136. Evidence provided by underwriters and distributors indicates that distributors have choices as to which underwriters to use, and underwriters are prepared to compete hard to win business, as having access to customers at the point of sale is an underwriter's only way of gaining access to significant numbers of customers. It is typically the distributor who designs the policy, rather than the underwriter who offers a ready-made policy during a tender (see paragraph 80).
137. We have looked at how the premium paid by customers is split between underwriters and distributors (see paragraph 82). Our analysis suggests that distributors receive a relatively large proportion of the premium in comparison with underwriters and nearly all of any profit sharing after claims have been paid. Typical commission rates are 50 to 80 per cent on PLPPI and CCPPI and 40 to 65 per cent on MPPI. Further, distributors typically take 90 per cent of any profit share and we have seen instances where the distributor receives 100 per cent of any profit share after payout of claims.
138. The evidence seen to date suggests, therefore, that there is a significant degree of countervailing buyer power being exercised by distributors.

Profitability of underwriting

139. The work we have done on the profitability of PPI for underwriters is based on analysis of documentary evidence provided to the inquiry by a range of large underwriters, both vertically integrated and independent.

140. The (mainly documentary) evidence we have seen so far on the profitability of underwriting suggests that reasonable rates of return have been earned on PPI business. The underwriter is typically entitled to a fixed percentage of GWP to cover expenses and will also typically retain some investment income. A small proportion of profit share may also be earned in the event that claims are less than expected, and the underwriter may, in certain circumstances, benefit from the tax treatment applicable to any life business written. Documentation, such as business plans, deal summaries and strategy documents, from a number of parties indicate typical rates of return of around 10 to 30 per cent.⁵⁶ Further work would be required to determine a representative level of profitability for the underwriting side of PPI but, for the reasons set out below, we do not intend to pursue this line of inquiry further.

Emerging thinking on the underwriting market

141. The evidence we have seen to date indicates that the underwriting market is relatively concentrated, and that some distributors think that not all underwriters are sufficiently large to be able to underwrite their business. There do not appear to be significant barriers to entry or expansion, though switching costs may be significant and incumbent providers of underwriting services do appear to have an advantage over other underwriters when re-tendering for a contract.

142. However, the tender process leads to underwriters competing vigorously with each other in order to win contracts that will give them access to a significant number of customers at the point of sale of a credit product. The documentary evidence relating to profitability that we have seen indicates that underwriters appear to be making reasonable rates of return on PPI business.

⁵⁶[X] presentation showed an after-tax ROCE of [X] per cent; [X] strategy document showed a post-tax ROCE of [X] per cent; [X] strategy document showed historic average RoE of [X] per cent, quoted [X] per cent as being reasonable considering the risk profile of the business; and [X] internal figures showed an IRR of [X] per cent for 2006.

143. We have, therefore, found little to support any assertion that there are features which prevent, restrict or distort competition in the underwriting market to any significant extent.
144. We do not, therefore, currently propose to pursue further analysis or inquiry into the underwriting market for PPI based on the evidence available to us.

The retail market

Market definition

Product market

145. In defining the relevant product market(s) for PPI at the retail market, we need to look at four questions:
- (a) Are PPI policies and their underlying credit products in the same market?
 - (b) To what extent do different brands of PPI or the PPI and credit constrain each other?
 - (c) If we find that the answer to question (a) is that they are, do different categories of PPI and credit bundles constrain each other?
 - (d) What constraint is imposed by other products?
146. We look at these questions in paragraphs 147, 163, 177 and 178 respectively.

Are PPI policies and their underlying credit products in the same market?

147. The first question we consider is whether the nature of the complementary demand relationship between PPI and its underlying credit product constrains the behaviour of PPI providers. We were told that PPI and the underlying credit products that PPI policies insure are complementary products. However, there were mixed views as to the nature of that complementary demand relationship.

148. One view put to us was that consumers consider the cost of the combination of PPI and credit when choosing which product to buy. If this is the case, an increase in the price of PPI would result in the price of the combination of PPI and credit being higher. This would result in lower sales of PPI and credit. In this instance, a SSNIP in the price of PPI may be rendered unprofitable because of lost sales of both credit and PPI. If this is the case then prices of either element of the combined product are constrained by the complementary demand relationship with the other and a wider market to include both of them may be appropriate.
149. An alternative view put to us was that PPI is sold and not bought. In other words, consumers have little knowledge of PPI prior to purchasing the credit product, and only consider purchasing PPI at the point of sale of the credit product.⁵⁷ As PPI is not considered by consumers prior to the point of sale in this view of the sector, the price of PPI does not affect their choice of credit product. This results in a one-way complementary link as, if customers make sequential decisions in this way, credit prices will affect the sales of PPI,⁵⁸ but PPI prices will not affect sales of credit. As discussed in our market definition paper, we consider that this would warrant a narrower market definition which does not include credit, as a demand relationship of this type would not render a SSNIP on PPI unprofitable.
150. In order to look at whether credit and PPI constrain each other, we use three main sources:
- (a) evidence from the parties: on the extent to which they operate their PPI businesses as part of a combined package with their credit businesses, and on how they have priced their PPI policies, in particular the extent to which it has

⁵⁷The credit provider has an opportunity at the point of sale to inform consumers about the attributes of PPI cover, and its price. This would seem to have an effect similar to advertising.

⁵⁸As more credit sales will increase the number of customers at the point of sale, and hence the number of opportunities to sell PPI.

been priced as part of a combined competitive offer with the underlying credit product;

(b) evidence on whether customers are looking principally at the price of credit or at the price of credit and PPI combined; and

(c) data from the parties on prices of credit and PPI and sales of credit and PPI. We have requested detailed data from distributors and underwriters on their monthly prices and sales of credit and PPI policies, with the intention of looking to see whether in practice changes in one have affected uptake of the other.⁵⁹

- *Documentary evidence*

151. Our key findings from the internal documentation we received from main parties are set out in detail in paragraph 76 and Appendix A of our working paper on market definition.

152. A summary of our key findings is as follows:

- There is some evidence that firms analyse the price of credit and PPI together and the majority of the distributors say that they do not run PPI as a separate business.
- There is no documentary evidence that firms consider that an increase in PPI prices will have a material impact on credit sales (though there was mixed evidence from parties in hearings on the impact of increasing PPI price on credit sales).
- When planning PPI price rises, firms generally do not consider that there will be a significant effect on their sales of PPI.

⁵⁹The relevant data requested from distributors is sought through spreadsheets called LD3 and LD4. The relevant data from underwriters is sought in a spreadsheet called LU2.

- There is evidence that firms acknowledge that credit and PPI demand are closely related.⁶⁰
- Although little formal research on the elasticity of demand has been able to be conducted, the research that has been conducted by firms appears to indicate that demand for credit is more responsive to changes in credit price than demand for PPI is to changes in PPI price.

153. This evidence suggests to us that distributors of PPI act as though there is an asymmetric demand relationship between credit and PPI—with price of credit affecting uptake of PPI but price of PPI not impacting on the uptake of its underlying credit.

- *Customer search behaviour*

154. Customer search, as an indicator of customer behaviour, will impact on the competitive pressure distributors feel from consumers. The OFT conducted a survey and found that customers tend not actively to seek out information on PPI, nor do they shop around, particularly by comparison to the way they shop for credit.⁶¹ Several parties to our investigation raised concerns about the OFT's survey and its results, for different reasons.

155. We will need to understand the extent of customer search and the reasons behind it (eg if there is little customer search, is this because of customer inertia, a feeling of the relative unimportance of PPI relative to the credit—related to a lack of understanding of the overall cost of PPI, difficulty of comparing the prices of policies, coverage, exclusions, exclusion periods, interest calculations etc).

⁶⁰Given that the price of credit is likely to affect sales of credit, it follows that there would be a knock-on effect on sales of PPI.

⁶¹*Payment Protection Insurance: the OFT's reasons for making a market investigation reference to the Competition Commission*, February 2007, paragraph 5.59.

156. We anticipate that evidence on customer search behaviour for each relevant market will come from:
- the qualitative survey;
 - further survey work to be commissioned, if appropriate;
 - testimony from the parties and any evidence they have provided us with (anecdotal and any survey evidence they have given us) including future oral and written submissions following publication of this emerging thinking document; and
 - any evidence about customer search behaviour from Internet comparison websites (such as moneysupermarket.com).
157. We may carry out more research into consumers' searching behaviour. However, as noted in paragraph 152, the evidence that we have received so far in our inquiry indicates that firms do not perceive that an increase in PPI prices will affect their credit sales. This would seem to indicate that the prevalence of customer searching between bundles of PPI and credit is low, since if customers were searching for credit and PPI, an increase in prices of PPI may be expected to result in lost credit sales.
158. Similarly if consumers are able to switch easily between bundles of credit and PPI, we would expect to see a relationship between PPI prices and sales of credit. This is because an increase in price would induce customers to switch to another, lower-priced, bundle of PPI and credit.
159. Qualitative research carried out on our behalf by BMRB found that, in general, participants had not thought at all about insurance protection when they chose their credit provider, although there were exceptions to this (see paragraph 109). In general, PPI was seen as an 'add on' to the credit product, only considered once the choice of a loan provider had been made and the credit application had been started.

The additional cost of the PPI policy was considered when deciding whether to take it out or not. Participants in the research said that they focused on the amount that the insurance added to the cost of the monthly loan repayments.

- *Data on price and sales*

160. We have sought data from distributors and underwriters on prices and sales of credit and PPI, but our ability to analyse this data has been limited for the reasons set out in paragraph 9. The analysis we have been able to carry out is summarized below, and is set out in more detail in paragraph 58 and Appendix B of our market definition working paper.

- *The balance of evidence on whether PPI and credit are in the same markets*

161. The evidence received so far in our inquiry does not indicate that customers' choices in the primary market for credit are affected by prices in the secondary market for PPI. In particular, evidence from the parties' internal documents shows that when considering changes in PPI prices, firms do not consider that there will be a concurrent impact on their sales of credit products. As a result, our emerging thinking is that a SSNIP in PPI would not be rendered unprofitable by its complementary relationship with credit.

162. However, we are still collecting evidence regarding customer purchasing behaviour. In particular, we have commissioned a quantitative survey of customers who have recently taken out PPI. Further evidence that may change our current thinking would include:

(a) evidence that significant numbers of customers consider the cost of PPI prior to the point of sale when making their choice of credit provider and that this affected their choice of credit provider;

(b) evidence that increases in PPI price in the past have resulted in diminished sales of credit; and

(c) evidence that customers are responding to higher PPI prices by cancelling both credit and PPI and switching to another combination of credit and PPI.

To what extent do different brands of PPI or the PPI and credit constrain each other?

163. Having determined whether our starting point for the product market definition exercise is PPI or PPI and credit combined, we shall need to determine the extent to which different distributors (or brands) of PPI, or PPI and credit, constrain each other.

164. In order to investigate this we are looking at several sources of evidence:

- how PPI providers set prices;
- the extent to which firms monitor competitors;
- how firms react to changes in behaviour of their competitors;
- quantitative analysis to assess whether there is evidence of firms reacting to each other's pricing or other behaviour, or evidence of loss of sales if they do not; and
- evidence of customers switching between PPI providers.

- *Evidence received so far*

165. To date, the evidence we have seen suggests that firms set their PPI prices relative to the PPI prices of others, with a view to avoiding being out of line by charging a lot more or less than other providers. We also have evidence that firms check what their competitors are doing; however, in neither case have we seen evidence to suggest that the aim has been to undercut their competitors' PPI offers. Analysis of sales data may provide evidence of this.

166. An analysis of documentary evidence seen to date (see Appendix A to the market definition working paper) found that:

- There is evidence that PPI suppliers monitor each other's prices. A number of documents indicate that firms increase PPI prices to be in line with PPI prices charged by their peers and there is evidence that firms assess their market position both on the bundle and with respect to PPI prices.
- There is only one instance of a firm attempting to compete on price of PPI or to win sales by undercutting another firm.

167. The evidence we have received to date seems to indicate that the vast majority of PPI sales are made at the point of sale of the underlying credit product, and that individual distributors do not compete to win each other's point-of-sale customers.

- *Customer switching*

168. We shall need to investigate the extent to which customers switch PPI provider without switching loan provider, or the extent to which customers switch the combined product because of a change in PPI price/terms (depending on the market definition reached).

169. Evidence we have seen so far suggests that there is negligible switching of PPI (without also switching credit) to policies provided by any of the 12 largest PPI distributors, with only MPPI achieving above 1 per cent (see Table 15).

TABLE 15 **Proportion of PPI policies sold on a stand-alone basis by the 12 largest distributors of PPI, 2002 to 2006, by number of policies**

<i>Type of PPI</i>	<i>per cent</i>				
	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>
Personal loan	0.0	0.0	0.0	0.0	0.0
First mortgage	1.0	1.0	1.7	3.7	3.8
Credit card	0.0	0.0	0.0	0.0	0.0
Second mortgage	0.0	0.0	0.0	0.0	0.0
Retail credit	0.0	0.0	0.0	0.0	0.0
Motor finance	0.0	0.0	0.0	0.0	0.0

Source: CC calculations based on LD1 data.

Notes:

1. LD1 data represents all sales by the 12 largest PPI distributors.
2. Calculations exclude data from distributors unable to provide a breakdown by distribution channel.

170. For all types of PPI, the incidence of stand-alone sales of PPI is very low. As Table 15 shows, there were no reported stand-alone sales of PPI by the large distributors in the period under review in any category of PPI policy except for MPPI. Stand-alone sales by the major distributors in MPPI have shown some growth. However, they remain below 4 per cent by number of policies.
171. There are a small number of providers of PPI who do not offer any credit products to consumers.⁶² As mentioned in paragraph 76, those providers sell predominantly MPPI and PLPPI, although one does offer CCPPI. The evidence which we have received suggests that these providers achieve very low sales rates of PPI. One of the reasons suggested for this was the difficulty which customers had in switching policies, due to a lack of knowledge that they were able to switch, and to the cost of doing so.⁶³ Whether this is the case or not, the small scale of stand-alone PPI sales, allied to the minimal sales of most PPI policies on a stand-alone basis by the 12 largest distributors, suggests that there may be very limited switching of PPI policies by consumers without switching credit product at the same time.
172. We shall also need to gain an understanding of what the main switching costs or barriers are (for example, customer inertia, or level of rebates for early settlement).
173. In order to gain an understanding of customer switching behaviour in each relevant market, including why there may be a lack of switching, we expect to use several sources of evidence:
- (a) the size of stand-alone PPI providers that customers might switch to if they switch PPI without switching credit product;
 - (b) data on numbers of PPI cancellations;

⁶²Such as Paymentcare and British Insurance.

⁶³British Insurance, summary of hearing, paragraphs 16 and 17.

- (c) data from the quantitative survey on number of customers who have switched (including a possible post-emerging thinking survey on lapsed customers);
- (d) any relevant analysis from the qualitative survey;
- (e) whether there is evidence of differences in switching between customers with single-premium or regular premium policies; and
- (f) testimony from the parties.

- *Balance of evidence on different brands constraining each other*

- 174. The evidence seen to date would seem to suggest that a SSNIP for any individual distributor above competitive levels would be profitable as the point-of-sale advantage would hinder any demand- or supply-side substitution.
- 175. It would therefore seem appropriate to define a series of individual markets such that each PPI distributor has a monopoly over its own credit customers at the point of sale.
- 176. However, we are still collecting evidence on the competitive interaction between PPI distributors. Evidence that may lead to a wider market definition to include multiple brands of PPI may include:
 - (a) evidence that customers search between different PPI policies and will purchase PPI and credit separately in response to high PPI prices; and
 - (b) evidence of customers switching between different PPI policies after the point of sale, without switching their underlying credit product.

Do different categories of PPI or PPI and credit bundles constrain each other?

- 177. In order to answer this question, we will be looking to assess the feasibility of customer substitution between types of PPI. We shall also look at market data from

the spreadsheets provided to us by large distributors to see if there is evidence that different categories of PPI or PPI and credit bundles are substitutes.

What constraint is provided by other products?

178. Having considered the extent to which PPI is constrained by the underlying credit product, by offers from other distributors and by other forms of PPI, we need to understand the extent to which PPI, or the combination of PPI and credit, is constrained by insurance policies not available at the point of sale of the credit.
179. The insurance policies we have considered as potential constraints on PPI are: PPI which is not available at the point of sale of credit (stand-alone PPI); income protection insurance; short-term income protection insurance; personal accident insurance; critical illness insurance; and life assurance.
180. Our analysis of this is set out in paragraph 78 onwards of our working paper on market definition. We find that there is very little demand-side substitutability between PPI and potential alternative financial insurance policies. Supply-side substitution is limited by the inability of sellers of these alternative policies to reach the customer at the point of sale of the credit product.
181. The closest alternative appears to be short-term income protection insurance. However, even if this is a substitute, notwithstanding the point-of-sale disadvantage of selling it to customers, the sales of these policies are very small and unlikely to have a significant effect on our analysis of competition in the relevant markets.

Geographic market

182. We have seen no evidence to suggest that the relevant geographic market for selling PPI is anything other than the UK.

Emerging thinking on retail market definition

183. Initial indications on product market suggest that, if the further evidence to be gathered and analysed is in line with the evidence seen to date, then the relevant product market would be a series of brand-specific product markets—so, for example, a distributor's PLPPI is in a separate market from another distributor's PLPPI. Similarly, early indications are that the relevant geographic market is the UK.
184. However, as discussed in paragraphs 162 and 176 respectively, this preliminary conclusion may be altered leading to a wider market which includes (a) the underlying credit products and/or (b) a wider market to include multiple brands of PPI.
185. Evidence which might lead us to find a wider market for PPI would include evidence that consumers substitute between different PPI policies without substituting the underlying credit product. Evidence which may lead us to a wider market which includes the underlying credit product would include evidence that there are significant numbers of customers searching for PPI before they reach the point of sale of the credit product, and therefore that customers search for and substitute between bundles of credit and PPI.

The extent and nature of competition between suppliers

186. We need to consider the extent to which distributors seek to compete on PPI, through offering lower prices or higher coverage (in addition to competition on headline APR of the credit product).
187. A few companies offer PPI allowing choice from the different elements (AS, U and L). Many do not and we shall consider the effect of this (including perhaps whether the effect is different between advised and non-advised sales) as an element of this competition.

188. We shall need to consider the nature and extent of competition within relevant markets, and look to see if there are differences in competitive intensity between PPI products (eg is there a difference in competitive intensity between markets with single premiums and regular premiums, perhaps related to it being harder to compare prices accurately and switching costs being higher).

Profitability of distribution

189. During a market investigation, we normally find it helpful to consider the outcome of the competitive process in the market. Such outcomes in the PPI distribution market could include the level of prices charged to consumers and the level of profitability earned by firms from the distribution of PPI.

190. We believe that both these outcomes are highly dependent on the level of commission payments made by underwriters to distributors under the terms of their contracts. To date, we have found typical commission rates of 50 to 80 per cent on PLPPI and CCPPI and around 40 to 65 per cent on MPPI. The OFT found evidence that these levels were higher than other types of general insurance (for example, home or motor insurance); however, parties have argued that this is not a fair comparison as the markets are very different.⁶⁴

191. One provider of PPI provided to us details of its activity-based costing model, which calculated the incremental cost (at the final stage of the distribution chain) of selling a single PLPPI policy as being very small relative to the average revenue earned on the sale of a single premium policy. However, the relevant provider drew our attention to what it said were a number of significant deficiencies in the cost model, including assumptions that are significantly out of date.

⁶⁴See, for example, Cattles' response to launch of CC investigation, paragraph 7.3; other companies, including AXA and Lloyds TSB, also highlighted differences between the PPI industry and other insurance industries during hearings.

192. An alternative to calculating the cost of supplying PPI is to compare the selling price of PPI offered at the point of sale with the selling price of stand-alone PPI. There is evidence that the prices of PPI policies sold alongside credit products are significantly higher than those sold on a stand-alone basis (see paragraph 104). Since the provision of PPI on a stand-alone basis does not benefit from the point-of-sale advantage, one might expect the costs of selling it on a stand-alone basis to be higher rather than lower, all other things being equal. Whilst it is not always easy to make an exact comparison between one PPI policy and another, due to differences in terms and conditions, we consider this evidence to be indicative of prices being higher than competitive levels when PPI is sold alongside a credit product.
193. The evidence that we have considered on the profitability of PPI distribution has, to date, been largely documentary. It has included material from board minutes and strategy documents submitted to us by many main parties to the inquiry. There is evidence in these documents that PPI is regarded as a highly profitable product by some distributors.⁶⁵ In addition to the evidence mentioned above on incremental costs (derived from the distributor's activity-based costing system), we are considering the results of a model of economic profitability for retail banking in the UK (jointly developed by one large distributor and a major strategy consultancy), as well as the results of net present value calculations for loans and PLPPI, and various other documentary evidence.
194. There is evidence suggesting that, for the market as a whole, high profits earned on PPI alone have in recent years been partially offset by lower profits or even losses at the credit product level. We are seeking to understand the reasons for low profits or even losses at the credit product level: whilst some parties have made claims that

⁶⁵For example: in 2005 a vertically-integrated underwriter ([§<]) wrote in a strategy document that 'The PPI market has historically been very profitable', referring to the contribution to revenue of PPI for the whole group ([§<]); Another vertically-integrated underwriter stated 'Current profit pool represents super-normal profitability' and PPI is a 'highly profitable market, large share of value accrues to distribution' (both from the document '[§<]').

these losses are due to intense competition in the personal loans market,⁶⁶ for example, we may find that recent losses are more to do with deterioration in credit quality. We are also considering whether this is purely a recent phenomenon (the last two years, say) and whether the large clearing banks have been less affected by this than other parties (because of, for example, the choice of provider being driven primarily by a customer's existing relationship with that provider—see paragraph 107).

195. We intend to consider the combined profitability of PPI and the associated credit product to the extent that it is relevant to our inquiry, for example:
- (a) whether or not profits earned from PPI are 'competed away' in the credit market, and if so what this means;
 - (b) whether prices are interdependent, eg APRs are lower as a result of high margins on PPI; and
 - (c) the extent to which distributors gain from their customers having PPI in the form of reduced bad debts.
196. If prices are interdependent, we shall need to consider whether the profitability of PPI markets, if high, is distorting the credit market, pushing APRs for credit to abnormally low levels.
197. Firms tend to manage and analyse the financial performance of PPI underwriting and distribution separately even when vertically integrated. However, we are mindful of the fact that contractual terms between underwriters and distributors within the same firm may not be negotiated on an arm's-length basis. Therefore, we intend to focus on contracts between non-vertically-integrated underwriters and distributors when considering typical financial arrangements.

⁶⁶There is less evidence of systematic losses in the mortgage or credit card markets.

Vertical integration

198. Having considered the state of the markets at the underwriting and retail levels, we have also considered the effects of vertical integration of the PPI underwriting and distribution functions. As we discuss in our working paper on vertical integration, we consider the issue of foreclosure of downstream customers by vertical integration to be primarily a matter related to the extent of downstream market power, and we will consider that issue in future work on the retail market.
199. Our working paper on vertical integration explains the rationale behind a company being vertically integrated, and considers in detail the possible issues arising from vertical integration in the underwriting and distribution of PPI. We summarize here the issues and our analysis of them.
200. We have focused on four ways in which vertical integration may restrict competition, which have been raised during the course of the inquiry:
- (a) by reducing the number of bidders for non-integrated underwriting business;
 - (b) by limiting the size of the underwriting market that non-integrated underwriters can bid for, and so preventing them from achieving an efficient scale of operation;
 - (c) by removing the competitive pressure on in-house underwriters; and
 - (d) by creating a greater incentive for in-house underwriters to reject PPI claims.

Reducing the number of bidders for non-integrated underwriting business

201. We considered whether vertically-integrated underwriters could be less likely than independents to bid for contracts with lenders, reducing the number of bidders for tenders compared with a situation where all underwriters were independent of distributors. If this were the case, the remaining bidders might have lower incentives to make competitive bids, and prices might be higher than would otherwise be the case.

202. However, we found that most vertically-integrated PPI underwriters do bid to supply insurance services for third parties. Further, we found that in their dealings with third party distributors they appeared not to have any significant advantages over, or disadvantages compared with, independent underwriters.

Limiting the size of the underwriting market

203. It has been put to us that the presence of several vertically-integrated distributors has had the effect of foreclosing a significant portion of the PPI market to non-vertically-integrated underwriters.⁶⁷ We considered whether this reduction in the size of the market made it harder for independent underwriters to achieve economies of scale.

204. Evidence on bids led us to believe that either scale in PPI underwriting is relatively unimportant, or that scale economies are not PPI specific and that firms active in other areas of insurance can achieve scale or scope economies that allow them to compete successfully for PPI underwriting contracts.

205. The evidence suggested to us that, even if non-integrated underwriters were unable to compete for customers of vertically-integrated businesses, businesses with relatively small underwriting presence in the PPI market are able to achieve sufficient scale to compete effectively with those with significantly more contracts.

Removing the competitive pressure on in-house underwriters

206. It was suggested to us that vertically-integrated underwriters face lower competitive pressure than independent underwriters, whose business is put out to tender on a regular basis. The downside is that a lack of competition may lead to vertically-integrated underwriters charging higher prices, which would be passed on to consumers, or having less incentive to innovate.

⁶⁷Cardif Pinnacle, response to issues statement, p2; Cardif Pinnacle, summary of hearing, paragraph 21.

207. The evidence we saw on PPI prices charged by distributors with and without in-house underwriters was inconclusive. However, we note that if a lack of competition was causing an integrated distributor to face higher costs for underwriting (despite the potential efficiency benefits of integration), it would have an incentive to out-source more of its underwriting business, or even divest its in-house underwriter.
208. In terms of the incentive to innovate, we thought that vertically-integrated underwriters have a strong incentive to innovate in order to maximize the take-up of its products, and we saw no evidence that this incentive was weaker than for independent underwriters.
209. Overall, we found that there is limited evidence that vertically-integrated underwriters offered PPI at higher prices than non-integrated underwriters. If a vertically-integrated underwriter were causing prices to be too high, we noted that it would be possible for the distributor to divest its underwriting business. Further, we do not consider that vertically-integrated underwriters have limited incentives to innovate because of vertical integration. On balance, we do not think that there is a limited competitive pressure on vertically-integrated underwriters which would lead to a detriment for consumers.

Creating a greater incentive for (in-house) underwriters to reject PPI claims

210. It has been put to us that where distributors are vertically integrated and therefore part of the same group as the underwriter of their PPI policies, the underwriter has an incentive to maximize profits from the claims reserve. The rationale for this is that :
- If more claims are rejected by the underwriter, the amount of money available for profit sharing between underwriter and distributor is increased.

- As the distributor is usually paid most of the profit share (typically 90 per cent), a non-vertically-integrated underwriter stands to gain little from maximizing the money available for profit sharing.
- If the underwriter and distributor are in the same group of companies, the underwriter has an incentive to maximize money for profit sharing, through rejecting more insurance claims, because the increased profit will go to a business in the same group of companies.

211. No evidence to support this view has been provided by the companies which put forward this theory. This is not surprising; we understand that companies do not have access to data on their competitors' claims payouts.

212. We had doubts that vertically-integrated underwriters had a strong incentive to maximize claims rejections. It has been put to us that the primary reason for choosing a lender for credit (and hence PPI) is an existing relationship with the lender, and we thought it reasonable to assume that this would be the case as much, if not more, for the clearing banks as for other distributors. Rejecting claims would be likely to reduce the satisfaction of customers whose claims were rejected, and increase the risk of those customers switching to another lender. The loss of such customers' business may outweigh the gain from rejecting individual claims.

213. We considered whether there may be different incentives to check claims in detail between integrated and non-integrated underwriters. However, we thought that non-integrated distributors would seek to ensure that their underwriters would act in the way they wanted them to through terms written into contracts. This would lead to integrated and non-integrated underwriters having similar incentives for checking claims.

214. We do not think, therefore, that vertically-integrated businesses have clear incentives to reject more claims than non-integrated companies. Concerns over maintaining their reputation, and the risk of losing customers who source multiple services from them, would reduce any incentive they may have to maximize claims rejections. Further, we do not think that vertically-integrated companies are uniquely placed to influence the underwriters' claims policies, as non-integrated distributors appear able to influence their underwriters' policy through contractual arrangements.

Emerging thinking on vertical integration

215. Our analysis on vertical integration of PPI underwriters and distributors has not identified issues which would restrict competition in the underwriting market to the detriment of consumers. We have not identified any issues with respect to the distribution of PPI policies which are unique to vertically-integrated distributors; any issues there may be appear to be linked to market conditions which non-integrated distributors experience equally. These issues will be addressed in our analysis of the retail distribution markets.

216. In light of what we have found to date, we do not currently propose to pursue further analysis or inquiry into vertical integration in the supply of PPI.