

## COMPETITION COMMISSION MARKET INVESTIGATION INTO PPI

### ABBEY RESPONSE TO EMERGING THINKING

#### 1. INTRODUCTION

1.1 Abbey welcomes the opportunity to comment on the Competition Commission's emerging thinking document and associated working papers ("Emerging Thinking"). Abbey notes that the Commission has not reached any firm conclusions on the questions to be decided under the reference but that, on the basis of the evidence it has reviewed to date, it does not intend to pursue further analysis of vertical integration or the underwriting market during its inquiry. Abbey has no specific comments on these issues.

1.2 The Commission states in its Emerging Thinking that its investigation is at an early stage and that it still has significant work to do in relation to its assessment of the retail market for PPI. Abbey looks forward to working with the Commission in informing its thinking on the various issues arising in respect of the retail market. In line with the preliminary nature of the Commission's thinking and in light of the issues identified, Abbey wishes to comment substantively on only three principal areas raised in the Commission's Emerging Thinking at this stage:

- (a) the Commission's preliminary views on market definition in the retail market;
- (b) the Commission's emerging thinking on competition in PPI; and
- (c) the Commission's joint consideration of all PPI products.

#### 2. MARKET DEFINITION

2.1 The Commission has reached the following preliminary view on the relevant market which will inform its consideration of the competitive conditions relating to the supply of PPI:

*"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." (Paragraph 183)*

2.2 This view has been reached on the basis of an initial consideration of the likelihood that PPI prices would be constrained in the event of a small but significant price rise above competitive levels. The emerging thinking document indicates that the Commission has seen little evidence to date that such a price rise would be constrained:

*"...either because of the complementary link between PPI and credit, or because of the possibility of customers substituting between PPI policies or to other alternatives."<sup>1</sup>*

2.3 Before considering these issues in detail, Abbey notes the comment made by the Commission that market definition is not an end in itself, but rather a framework within which to analyse the effects of market features on competition<sup>2</sup>. Given the judgement involved in defining markets, which the Commission also acknowledges, it is important

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<sup>1</sup> Working paper entitled "Downstream market definition", page 1, paragraph 1.

<sup>2</sup> Working paper entitled "Downstream market definition", page 3, paragraph 9 and Market Investigation References: Competition Commission Guidelines, March 2003, paragraph 2.2.

that the exercise should not dismiss competitive constraints which are deemed to be outside the relevant market but which nevertheless act collectively to influence the decisions of PPI providers. Indeed, Abbey believes that, even if the Commission's preliminary view of the relevant market were to remain unchanged, this certainly should not lead it to the conclusion that PPI providers are free to act without reference to certain important constraints.

- 2.4 Equally, whilst Abbey notes that the Commission is applying the concept of the SSNIP test for the purpose of reaching a view on market definition, it does not appear to have considered the extent of sales losses which would be required in order to render such a price increase unprofitable. Indeed whilst the focus of the analysis appears to be the nature of substitution away from PPI, the Commission should also consider the extent of losses and whether only a small amount of sales would need to be lost in order to render a given price increase unprofitable.
- 2.5 In short, Abbey has some concerns that the analysis undertaken by the Commission to date may fail to take sufficient account of certain relevant constraints relating to the following:
- (a) the constraint arising from the complementary relationship between PPI and related credit products;
  - (b) the scope for customer switching between multiple brands of PPI; and
  - (c) the scope for consumer switching to alternative products.
- 2.6 These are considered in turn below.

***The constraint from the complementary relationship with credit***

- 2.7 Abbey notes that the Commission is not inclined, at this stage, to include credit within the same product market as PPI. The Commission does not consider PPI pricing to be constrained by the prospect that an increase in PPI price may result not only in a loss of PPI sales but also credit sales<sup>3</sup>.
- 2.8 In Abbey's view, a consideration of PPI in isolation from the underlying credit product would ignore the fact that, for many customers, the decision to purchase a credit product is made in conjunction with the decision on PPI. In these circumstances, a PPI product which is poorly priced from a competitive perspective could render the package of PPI and credit uncompetitive such that the customer may choose an alternative package. The facilities available to customers to make comparisons of credit/PPI packages are outlined below.
- 2.9 Abbey also considers that it does take into account the potential impact on credit sales when formulating its approach to PPI pricing. **[Redacted]**. This is driven by the need to ensure that the package of credit and PPI is positioned competitively. In short, Abbey believes that there is an important dynamic between PPI and credit which can act to constrain PPI prices.

Customers can, and often do, consider the overall credit and PPI offer

- 2.10 Abbey considers that, for many customers, their choice of credit products can be influenced by the price of PPI such that the relevant consideration is the overall loan/PPI price, and the relative prices of different packages of PPI and credit. In this regard, Abbey has identified a number of search tools which facilitate comparisons of these

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<sup>3</sup> The Commission's provisional conclusion is that the relationship between PPI and credit is asymmetric – i.e. whilst changes in credit pricing will affect demand for PPI, changes in PPI pricing will not affect demand for the underlying credit products.

combinations. In particular the following sources allow customers to compare prices of credit products both with and without PPI:

- (a) Moneyfacts.co.uk\best buys;
- (b) Moneysupermarket.com;
- (c) Uswitch.com; and
- (d) Find.co.uk\best buys<sup>4</sup>.

2.11 As regards newspapers, a review of 9 best buy tables for UPL produced by major newspapers on the weekends of 17/18 and 24/25 November indicated that four showed figures with and without PPI, namely Mail on Sunday, Financial Times, Observer and Sunday Express<sup>5</sup>. Abbey considers this to be generally representative of the weekly content over a broader timescale. Abbey considers it unlikely that comparisons of different providers' offerings of combined credit/PPI product would continue to be published on websites and in newspapers if they were not being used.

2.12 In addition, the following price comparison sites provide more generic information on PPI which is designed to assist customers in deciding whether or not to opt for the cover:

- (a) Fool.co.uk - in its section entitled "loan guide", this site has a page on PPI which states *"if you must have this peace of mind, shop around for a stand-alone policy from a low-cost provider or consider buying income protection insurance, which will cover all your outgoings rather than just your loan payments"*;
- (b) Thriftyscot.co.uk – this website indicates that, using information provided in a short inquiry form, it can compare over 500 loan plans. Customers are asked to tick a box on the form if they are interested in loan payment protection;
- (c) Ukpersonalloanstore.co.uk – this website also compares 250 loan plans and provides advice and links to UK loan providers. The site has a section devoted to offering loan tips which includes advice on payment protection insurance including the following: *"In an unstable economy, such protection may be welcome and may afford the buyer peace of mind. This in itself can sometimes be worth the cost, but not always. Each program is different in what it covers and what the restrictions are, and buyers need to read the fine print to fully understand what types of situations are covered and in what circumstances;"*<sup>6</sup> and
- (d) Uswitch.com – this website contains a guide to PPI which evaluates the *"pros and cons"* of PPI, and, as noted above, allows customers to compare prices of credit products both with and without PPI.

2.13 Whilst Abbey does not have data on customer usage, it does believe that newspapers and the Internet are amongst the most significant sources of information for customers seeking loans, and the trend towards the provision of quotes with and without the cost of PPI suggests that there is a significant demand for such information in advance of purchase.

2.14 Having said this, Abbey believes that the extent of customer searching is relatively limited in respect of credit products. Research by Drummond Madel Strategies for Growth in

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<sup>4</sup> Extracts from these comparison websites are attached at Annex 1.

<sup>5</sup> Moneyfacts provides data for Mail on Sunday and the Financial Times. Moneysupermarket provides data for all other publications.

<sup>6</sup> Links to two documents are provided "Payment Protection Insurance: The True Cost" and "Do you need credit insurance".

2005 indicated that the average UPL buyer only considers 1.5 providers before choosing a product. To a significant extent, therefore, any inertia identified in relation to customer willingness to search for PPI is reflective of a more general behaviour in relation to the underlying credit product.

**[Redacted]**

2.15 The Commission indicates that it has not, as yet, seen any documentary evidence that firms consider that an increase in PPI prices will have a material impact on credit sales (although it states that there was mixed evidence from the parties in the hearings on this point).

2.16 **[Redacted]**

2.17 **[Redacted]**

***The constraint imposed by potential switching to multiple brands***

2.18 The Commission has examined the extent to which different distributors (or brands) of PPI constrain each other. In this regard, it states that it has identified little evidence that PPI prices are constrained by potential customer substitution between individual PPI distributors' policies.

2.19 Contrary to this view, Abbey considers that there is a growing potential for customer substitution to PPI provided by rivals which has stimulated recent entry into the supply of standalone products. Abbey perceives a growing competitive threat from this development and is responding in a number of ways: through close monitoring of standalone competitors, **[Redacted]**, special offers and innovation in relation to Abbey's products and greater efforts to highlight differentiating features in marketing literature. These issues are considered in turn below.

The growth of standalone PPI

2.20 Abbey considers that the supply of standalone PPI is growing, including significant new entry by established financial organisations with the reputation and financial strength to support such initiatives. Clearly these organisations have undertaken careful market research to underpin the business case for these ventures, and do not regard the barriers which have been identified by the Commission as insuperable. In particular, market opportunities must have been identified and this must be based in part on an expectation of customer churn, as well as the potential for growing the market by attracting previously un-insured customers. Examples of recent entry are as follows:

- (a) Barclays is in the process of introducing a CCPPI policy that can be used to cover other credit cards;
- (b) HSBC launched a new product called LifeChoices in 2007. This is a menu-based protection product which covers life insurance, trauma cover, accident, sickness and unemployment cover. It can be offered alongside a mortgage or on a stand-alone basis;
- (c) RBS has also launched a stand-alone product in 2007 through its Churchill brand;
- (d) the British Insurance and Investment Brokers Association launched a number of stand-alone PPI products, underwritten by British Insurance, in early 2007<sup>7</sup>;
- (e) the Post Office launched its Lifestyle Protection product in June 2006<sup>8</sup>; and

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<http://www.britishinsurance.com/press-pages/Biba-launches-payment-protection-insurance-despite-concerns.html>

(f) as the Commission is aware, Abbey's own Paymentcare is available both at point of sale to customers taking out a mortgage with Abbey (referred to by Abbey as "mortgage related"), and to customers with mortgages elsewhere and Abbey mortgage holders buying other than at point of sale (both referred to by Abbey as "non-mortgage related").

2.21 One of the obstacles identified by the Commission in relation to standalone policies is the potential bias in the customer base towards those who already have an expectation as regards their risk of future unemployment or ill health (otherwise known as adverse selection). Although Abbey acknowledges that adverse selection is a problem for standalone providers, it considers that there are ways in which the effect can be mitigated, and these providers can still be competitive:

- (a) one strategy is for stand alone providers to offer competitive prices in order to encourage switching away from branded PPI, but to reduce the quality of the cover offered (for example through longer exclusion periods, or fewer additional features such as carer cover or cover for industrial action);
- (b) standalone providers may also find ways of attracting a more balanced customer base in terms of their risk profile. For example, providers could allow customers who can show they are switching from existing PPI products to avoid any initial exclusion periods.

2.22 Whilst Abbey would agree that most of the standalone PPI activity to date has been in relation to MPPI, it believes that standalone offerings for PLPPI and CCPPI are emerging (as illustrated above). Moreover, these initiatives are backed by strong and reputable organisations, who have the resources to ensure that they will be successful and replicate the MPPI position in respect of other PPI products. It should also be noted that there is some overlap in this regard since some MPPI (such as Abbey, Alliance & Leicester, Barclays and HBOS policies) can be used to cover non-mortgage related payments. Accordingly, provided a customer has a mortgage, they can apply for an MPPI to cover other loans (as a substitute for PLPPI or CCPPI) or even just general outgoings.

Abbey's response to growing competitive threat

2.23 As indicated above, Abbey perceives a growing competitive threat arising from potential customer switching to PPI provided by rivals, including standalone products. It has responded in a number of ways.

*Close monitoring of standalone competitors*

2.24 The Commission has already seen evidence which suggests that PPI providers monitor the behaviour of their competitors. This is deemed essential by Abbey in order to ensure that its products are competitively positioned. Indeed, all key strategic decisions regarding PPI are informed by a consideration of how this will affect Abbey's competitive standing.

2.25 **[Redacted]**

*Consideration of retention and marketing strategy*

2.26 **[Redacted]**

2.27 Abbey has sought to better understand the behaviour of its MPPI customers in order to improve retention rates. **[Redacted]**

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<sup>8</sup> <http://www.guardian.co.uk/money/2006/jun/17/lifeinsurance.moneysupplement>

- 2.28 **[Redacted]** Abbey has focused on the importance of clear and timely communication with customers in order to emphasise the factors which differentiate Abbey's products. In particular, the high level of cover which Abbey's Paymentcare offers and the additional features such as stress and back cover. The marketing document which is attached at Annex 4A (from November 2006) includes a comparison table which shows the maximum monthly benefit available with Paymentcare (as compared to the products offered by Halifax and RBS), as well as whether the following additional features are available: unemployment back to work service, accident and sickness back to work service, and back and stress cover. Abbey also stresses to potential and existing customers that Paymentcare can be retained even if the customers chooses to switch their mortgage to another provider.
- 2.29 In addition, Abbey has undertaken a number of campaigns to attract new customers and switchers to Paymentcare, in particular, the offer of 2 or 3 months of free cover (see Annex 4B for copies of the marketing documents which advertise these campaigns). These campaigns have proved effective in driving take-up of MPPI. For example, Abbey submitted in response to question 30 of the market questionnaire a number of documents relating to price changes and special offers for PPI. One of these, entitled "Paymentcare 3 month free initiative, 18 February 2005" provided a summary of the results of the campaign from November 2004 to February 2005, which Abbey was seeking to extend for a further month. **[Redacted]** Abbey does not agree, therefore, with the view which emerged from that the Commission's review of internal documents that customers are generally insensitive to PPI price changes.

*Product innovation*

- 2.30 Abbey has responded to the competitive threat from rival products in part, outlined above, by undertaking significant innovation to ensure that its product proposition is differentiated and that customers benefit from additional features<sup>9</sup>. These include the introduction of carer cover, back to work and rehabilitation services. Abbey notes that the Commission indicates that it has seen little evidence that competitive pressure has driven firm's decisions on product changes. Contrary to this view, these innovations were designed specifically to improve Abbey's competitive position by offering additional features which may not be offered by competitors, and thereby to improve value for money for customers.

***The constraint imposed by other competing products***

- 2.31 The Commission's emerging thinking document states that the Commission has found little evidence of PPI prices being constrained by the potential for customers to substitute between PPI and potential alternative policies for all types of PPI<sup>10</sup>. Abbey considers, however, that policies such as income protection, critical illness and term assurance should be considered at least partial substitutes, and do therefore exert a constraint on the behaviour of PPI providers.
- 2.32 The Commission has highlighted the differences in product features between PPI and alternative products. However, as noted above, several large financial organisations have recently launched new hybrid products which provide flexibility to customers in choosing the elements of cover from different products which best suit their circumstances.
- 2.33 As indicated in previous submissions, Abbey's MPPI product covers not only mortgage payments, but also effectively offers income protection – i.e. it allows customers to insure a payment amount of their choosing (subject to certain limits) rather than covering a

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<sup>9</sup> **[Redacted]**

<sup>10</sup> The alternative policies considered by the Commission are (i) income protection insurance (ii) personal accident insurance (iii) critical illness insurance (iv) life insurance or term life insurance.

specific mortgage payment. This means it is a close substitute for income protection, but also a substitute for taking out PLPPI or CCPPI.

### 3. PRICE AND NON-PRICE COMPETITION

3.1 Once the Commission has determined the relevant market in which to assess retail PPI, the next issue for it will be to consider the competitive constraints acting on the various types of PPI. The Emerging Thinking identifies at paragraph 186 that:

*"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)."*

3.2 The Commission has set out some preliminary observations in its Emerging Thinking on a number of issues related to competition between PPI distributors, both as regards competition on price, and in respect of competition on non-price elements, which Abbey wishes to address at this stage.

#### ***The Commission's observations on non-price elements of competition***

3.3 The Commission has attempted, in its working paper "*Downstream market definition*", to assess the extent of non-price competition between distributors for the purposes of assessing the relevant market for its market definition assessment. Notwithstanding the points made above and the relevance of these points to the assessment of market definition, the assessment of the way in which PPI providers compete with one another on non-price elements of competition will be important to the Commission's consideration of competition in the relevant markets (however these are ultimately defined). As noted above, even if the Commission were ultimately to define brand specific PPI product markets, this would not preclude other products from imposing a competitive constraint on the sale of an individual provider's PPI.

3.4 The Emerging Thinking reports on distributors' behaviour as regards product innovation and product launches<sup>11</sup>. The range of developments in PPI set out include the following:

- (a) the introduction of new PPI products (for example new PLPPI introduced by Northern Rock in 2004 and new MPPI introduced by HBOS in 2001);
- (b) new short-term income protection products (including HBOS Life Stages and Life style products launched in 2006 and an HSBC product called Life Choices launched in 2007);
- (c) changes in the level of cover and other benefits in relation to existing PPI products (for example Abbey's introduction of carer cover, back to work and rehabilitation);
- (d) the introduction of tiered PPI products (i.e. the provision of greater flexibility in relation to the components covered by the PPI). Barclays, A&L, Capital One and Northern Rock have undertaken product innovation in this regard. Abbey provides flexibility to MPPI customers in whether they choose to take Accident and Sickness, Unemployment, or the full Accident, Sickness and Unemployment package (see flyer – Abbey's Paymentcare Mortgage Payment Protection Insurance attached at Annex 4A); and
- (e) the provision of additional services, for example, Nationwide's offer of a job service initiative to help claimants find employment.

3.5 The Emerging Thinking states, however, that:

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<sup>11</sup> Evidence for market definition, paragraphs 41 to 52

*"in the majority of cases internal documents appear to show that decisions to change PPI products are based on customer surveys that characterise purchasing behaviour and pressures from regulatory change, to avoid accusations of mis-selling. There is very little evidence that competitive pressures has driven firms' decisions to change product decision".*

- 3.6 Abbey considers that product innovation, product range and product quality are key aspects of competition in the supply of PPI in the UK and believes that the Commission's current thinking that the majority of changes are to avoid regulatory problems is misinformed. The various activities outlined above are predominantly driven by the need to attract and retain customers and are therefore intrinsic to a full assessment of the competitive pressures in the market.
- 3.7 Whilst the Emerging Thinking document indicates that little evidence has been identified that competitive pressures have driven firms' decisions, it does acknowledge that decisions are based on *"customer surveys which characterise purchasing behaviour"*. In Abbey's view, the main purpose of canvassing customer opinion through surveys and responding through product initiatives, is to increase take-up and retention rates. In part, this is achieved by increasing the size of the market (i.e. attracting previous "non-users" of PPI), but it is equally important to maintain and increase Abbey's market share in competition with other distributors. Accordingly, Abbey would consider it a peculiar conclusion if the view were taken that changes to PPI products based on surveys of customer preferences are indicative of a market that is not competitive. Competition is not merely about firms noting what others in the market are doing and immediately responding in a similar manner.
- 3.8 Abbey considers that the various product developments by distributors referred to above are indicative of a market which is constantly evolving, and where distributors must constantly review their products and their market position with regard to the products being offered by their competitors in order to remain competitive. As set out at paragraphs 2.24 – 2.30 Abbey not only monitors competition from other providers, but actively responds to changes in the market in order to keep its product competitive.
- 3.9 As set out in its Response to the Issues Statement, Abbey is constantly seeking to improve the quality of its PPI products relative to the competition<sup>12</sup>. Abbey monitors its performance against its competitors both internally and externally. For example, Defaqto produces annual reports on the various features and prices of PPI products, rating them on a star system. Abbey uses these tables to ensure that its products are performing well for customers in the features that are offered, and its products are rated in the upper quartile in terms of features provided. Examples of charts based on Defaqto ratings are attached at Annex 5. These charts are not only used by Abbey (and other PPI providers) internally in comparing the competitiveness of their PPI offering, but are also used by mortgage intermediaries in advising clients on the relative merits of MPPI products.
- 3.10 **[Redacted]**
- 3.11 The Commission should not dismiss the importance of non-price features of PPI to customers. As the Commission acknowledges, these new features are often developed as a result of surveys seeking the views of customers. As already noted in section 2 above, the differences as compared to competitor products are used by Abbey to promote the quality of its products to customers. (See further paragraph 2.28 above and Annex 4A which sets out on page 3 a comparison of the main features of Paymentcare with MPPI offerings from Halifax and RBS.) **[Redacted]**
- 3.12 In this regard, as already set out in section 2 above, in addition to product literature, Abbey believes that customers are increasingly using search tools to compare packages of

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<sup>12</sup> Response of Abbey National plc to the Competition Commission's Issues Statement, paragraph 3.10.

credit and PPI before the point of sale, and these tools, in addition to providing information on price, highlight special features offered by different PPI providers. Abbey considers the Commission to be well placed to request data from price comparison websites on the use of their price comparison sections including PPI.

- 3.13 The next stage of the Commission's analysis will inevitably involve an assessment of the competitive constraints acting on providers of PPI. Abbey believes that focusing solely on prices and profits will give an incomplete picture of the nature of competition in the supply of PPI in the UK. Non-price competition is a key aspect of competition, and the variety and quantity of initiatives adopted by distributors in recent years suggests that distributors are compelled to ensure that their products are responsive to customer demands in order to retain and expand market share.

***The Commission's observations on price competition***

- 3.14 Abbey notes that the Commission will, during the next phase of its investigation, be considering the pricing of PPI as one of the factors relevant to a consideration of the constraints on PPI providers. In particular, Abbey notes paragraph 105 of the Emerging Thinking, which states:

*"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 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."*

- 3.15 In particular, the Commission has identified differences in pricing between different types of PPI products, and differences in prices between different providers of the same type of PPI. First, the Commission has, at paragraph 102 of the Emerging Thinking, compared the average cost per £100 of cover between MPPI, at £4.76, CCPPI at £11.70, and PLPPI at £18.23<sup>13</sup>. Secondly, the Commission has, at paragraph 103, considered the differences in price between different PLPPI policies, finding that these varied from £1,104 to over £3,000.
- 3.16 As regards the former point, Abbey considers in more detail in Section 4, below, the Commission's general treatment of the various different types of PPI as being comparable. As Abbey notes below, such an approach is not likely to be meaningful. MPPI, CCPPI and PLPPI are directly related to the underlying credit products with which they are sold. As such, there are significant differences between the different types of PPI products, reflecting the differences between the credit payments which the policy is insuring.
- 3.17 As regards the second point, Abbey considers that these sort of headline price comparisons can be highly misleading and tell the Commission very little about the degree of competition in the market. By way of illustration, Abbey ran a comparison of the cost of an unsecured personal loan of £5,000 repayable over five years without PPI for customers with a good credit rating through the price comparison website [www.moneysupermarket.com](http://www.moneysupermarket.com). The cheapest total repayment was £5,870 (cost of credit £870, from [yourpersonalloan.co.uk](http://yourpersonalloan.co.uk)) and the most expensive (non-car credit) loan was £8,111 (cost of credit £3,111, from Citi Financial). By way of further contrast, the most expensive poor credit rating product was £11,929 (cost of credit £6,929 from UCC Loans). Abbey doubts that the Commission would seek to suggest that the UPL market is anything other than extremely competitive (indeed some providers are making negative margins)

<sup>13</sup> The Commission considers this in more detail in its working paper "*PPI policies – characteristics*" at paragraph 19 *et seq.*

and yet the variation in the cost of credit even for those with good credit ratings is greater than that observed by the Commission in respect of PLPPI.

- 3.18 A logical conclusion would therefore appear to be that comparisons of the price of PPI (or loans) of the type that Which? has carried out, and which the Commission has cited as requiring explanation, are of little value in seeking to analyse competition in the relevant market.
- 3.19 Furthermore, unlike personal loans, which are effectively offering a homogenous product (e.g. £5,000 repayable over a certain term), there are a significant number of features of PPI that can vary between different policies which can explain the differences in price paid. For example, the Commission notes in its document "*Evidence for market definition*" that there are a number of distributors who offer tiered PPI products, offering different levels of cover. It would only make sense for customers to select lower tiered products instead of higher tiered products if these were cheaper. Thus, the Commission notes that Barclays has introduced a step-down CCPPI which consists of a half price, half benefit option. Accordingly, even without looking at this issue in significant detail, it is apparent that significant differences in products can be explained by differences in cover terms. Even within one product, for example Abbey's Paymentcare option, customers can choose to pay different amounts to receive different levels of cover. Details of the options and costs are set out in detail in Abbey's promotional literature - Abbey's Paymentcare Mortgage Payment Protection Insurance (attached at Annex 4A). Unemployment cover is £4.31 per £100 per month, Accident and Sickness is £3.26 and Accident, Sickness and Unemployment is £6.04 – i.e. cover can be 85 per cent more expensive depending on the choices made by the customer. Accordingly, even without considering other potential differences in policy coverage, such as exclusion periods, excluded conditions and exemptions, it is evident that significant price differences are inevitable.
- 3.20 In summary, the Commission needs to be cautious before relying on any apparent price differences between different types of PPI, or different PPI policies of the same type, to reach conclusions as to the competitiveness of the PPI market.

### ***Profitability***

- 3.21 The Emerging Thinking sets out that the Commission intends to devote some of the remainder of its inquiry to considering the profitability of PPI as a possible indicator of the competitive constraints on PPI providers. However, it is important to note the following potential difficulties in conducting such a profitability analysis in insurance markets:
- (a) the rate of return on PPI varies considerably over the insurance cycle, reflecting factors such as changes in unemployment, increases in interest rates, and growth in the UK economy. It is important that the Commission's profitability analysis considers the full PPI insurance life cycle (e.g. from peak to peak) so as to include periods of high claims (and thus low profitability) as well as periods of low claims and higher profitability. As the UK economy has gone through an unprecedented period of sustained growth in recent years, were the Commission's analysis to focus on only a short period of the insurance life cycle (e.g. the last 3-5 years), then it would risk giving rise to misleading conclusions regarding the true extent of the profitability of PPI over the full insurance cycle;
  - (b) there are different dynamics affecting different types of PPI: such as differences in the level of risk associated with different PPI products; differences in the frequency and predictability of the claims for different products insured; and the magnitude of the potential liability at stake;
  - (c) there are many methodological problems with using profitability as an indicator of a lack of competition:

- (i) there are a wide range of measurement issues as regards the treatment of various items used in the profitability analysis which makes it hard to measure profits with any degree of accuracy. For example, were the Commission's analysis to be largely based on accounting data, then it will be subject to variation in accounting practices between different PPI providers;
  - (ii) there is a real risk that different PPI providers will have different interpretations of profitability (including different classifications, different product mixes etc.), which means that comparing responses between insurance providers will be problematic;
  - (iii) the analysis will need to consider a benchmark against which to compare the profitability of PPI providers. For any profitability analysis to be persuasive, it needs to be shown to be robust to a range of measurement errors and differing assumptions;
  - (iv) the definition of costs is open to different interpretations by PPI providers. Furthermore, allocating costs for multi-activity firms (such as Abbey) is extremely difficult. Some costs may be directly attributable to the particular line of business, but costs which are joint or common across multiple lines of business must be allocated using an appropriate methodology. Clearly, were different PPI providers to use different methodologies for allocating costs, it would significantly undermine the validity of the overall analysis; and
- (d) there are many reasons why profits may exceed the cost of capital in a competitive industry. For example, firms may be expected to earn more than their cost of capital due to superior efficiency; profits may be high in markets where there is innovation; and profits may reflect successful risk taking. The Commission's profitability analysis will need to consider whether the profitability observed reflects any of these factors.

3.22 In summary, profitability is just one of a number of measures used to assess the performance of firms within a market, which in isolation says very little about the process of competition in the market. In this regard, it is important that the Commission does not place undue weight on a single piece of analysis, especially one that is subject to the numerous data and interpretation problems set out above.

3.23 Having made those introductory comments, Abbey notes that one of the ways in which the Commission has set out that it could consider profitability is to compare point of sale PPI with standalone PPI. Accordingly, the Commission sets out at paragraph 192 of the Emerging Thinking, that:

*"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."*

3.24 Whilst appreciating that this is only a statement of the Commission's Emerging Thinking, Abbey considers that the Commission's assumptions need to be analysed very closely. There are a number of features of the sale of standalone PPI which may contribute to the price of standalone PPI being lower than that of PPI sold alongside credit.

- 3.25 First, standalone PPI (particularly that offered by companies specialising in PPI) is typically sold on price. This reflects to a certain extent the perception by these companies that customers can be persuaded to switch their PPI on the basis of a low price product which has minimum features (and therefore more significant exclusions). This is one business model for PPI. Whether it proves to be successful for these providers is yet to be seen.
- 3.26 Second, there are a number of new and relatively recent entrants into the standalone PPI market. New entrants often seek to win market share with deep discounts and focus on price rather than quality. It is possible that their current prices are below the competitive level designed to drive market awareness and market share before increasing prices to more sustainable levels. Once they have established market share and brand, they can then focus on providing better features, with price as less of an important factor.
- 3.27 Furthermore, Abbey does not necessarily agree with the Commission's contention that "*one might expect the costs of selling it on a stand-alone basis to be higher rather than lower*". It is true that standalone providers are likely to have to deal with a greater cost of adverse selection and with costs associated with acquisition of PPI customers. However, stand-alone providers may be smaller operations with lower overheads. For example, they may be internet only, whereas point of sale providers will typically have branch networks and telephone sales overheads.
- 3.28 Finally, as set out above, price is only one aspect of competition in PPI. The Commission should therefore be cautious before relying on assumptions that the products being offered are comparable. In particular, due to the adverse selection issue, stand-alone policies will invariably have less broad cover than point of sale policies.

#### 4. THE CC'S JOINT CONSIDERATION OF ALL PPI PRODUCTS

- 4.1 Abbey notes that the Commission's approach in the Emerging Thinking appears to be to consider each aspect of its analysis in respect of MPPI, PLPPI and CCPPI together, noting relevant evidence and examples from some or all of the providers of these products to inform its current thinking. Abbey acknowledges that the Commission recognises some of the differences between the products, but considers that an approach which considers all of the various types of PPI together may not necessarily be the most appropriate way to approach an assessment of competitiveness with respect to different types of PPI.
- 4.2 Although each of the products is a type of insurance covering payments on underlying credit products, the nature of the underlying credit products are very different, which impacts on the type of insurance which is appropriate and the terms on which it is economical to provide insurance. Clearly, the nature of the credit offered on a credit card is very different from the credit offered on a mortgage. The level of the former varies from month to month, depending on expenditure and any credit advanced on a particular month is subject to minimum repayment levels. A mortgage on the other hand represents a large advance of credit secured on a property – it is also likely to represent the largest monthly commitment of the borrower. Typically the amounts repayable on the mortgage will not vary significantly (aside from due to interest rate changes) from month to month. As the Commission acknowledges, these differences may make it more difficult, for example, for a standalone provider of CCPPI to provide the correct cover on the amount of credit, whereas this is relatively straightforward for a provider of standalone MPPI.
- 4.3 The varying nature of the underlying credit products has an impact on the nature of the PPI products associated with them. For example, as noted in the Commission's working paper on *PPI Policies – Characteristics*, at table 1, the typical types of cover provided in respect of MPPI, PLPPI and CCPPI differ from one another. These various products typically have different prices per £100 of cover, reflecting differing levels of cover and different exclusions and typical excess periods. In addition, the sales process for different types of PPI, and in particular MPPI (which is often sold through intermediaries) may vary,

as may the available effective substitutes (including both the willingness of customers to purchase standalone or non-credit related PPI – see table 2 of the working paper "*Downstream market definition*" and the extent to which customers consider alternatives to PPI to represent effective substitutes).

- 4.4 With respect to features, PLPPI and CCPPI typically include life cover, whereas MPPI does not. In the event of a successful claim, Abbey's PLPPI benefit is paid out for the duration of the term of the loan (with respect to Accident and Sickness claims), whereas CCPPI and MPPI cover gives rise to a maximum benefit period (typically 12 months).
- 4.5 Accordingly, Abbey considers that it may be more appropriate for the Commission to consider issues such as market definition, competitive constraints and price and non-price elements of competition on a product-specific basis for each of MPPI, PLPPI and CCPPI, rather than attempting to analyse the relevant issues with respect to all types of PPI as an indivisible whole.

**28 November 2007**