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05 December 2007

Anthony Pygram
Inquiry Director
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Dear Anthony,

Market Investigation: The Supply of Payment Protection Insurance Services in the United Kingdom: response to the “Emerging Thinking” and related working papers

I am writing to you further to the letters of 5 and 21 November 2007, with Aviva/Norwich Union’s response to the Emerging Thinking Paper and the Working Papers and to the information that the group does not currently envisage requesting that Aviva/Norwich Union attends a hearing and after my email to Helcia Knap of 27 November 2007.

Comments on specific paragraphs on the Emerging Thinking and Working Papers will be provided in the annex to this letter that will be submitted shortly.

The underwriting market

Aviva/Norwich Union welcomes the overall analysis on the competitive condition of the underwriting market and does not currently intend to seek a further hearing prior to notification of the provisional findings.

The comments on underwriting that follow do not alter the conclusions on the highly competitive nature of the underwriting market. However, Aviva/Norwich Union believes that it is necessary to understand and apply the comments below to carry out a proper analysis of the distribution market. These comments relate to:

- Adverse selection;
- Sales penetration of PPI; and
- The fact that PPI is not underwritten on an individual basis.

Adverse selection

The single cursory reference in paragraph 78 of the Emerging Thinking to insurers' concerns over adverse selection does not acknowledge the importance of this issue and the key role that it plays in the economics of this type of insurance.

Paragraph 78 states "... It was put to us that standalone PPI providers run a higher risk of adverse selection than point of sale providers, resulting in standalone providers facing a higher claims ratio in their insurance policies than point-of-sale providers do. It was also put to us that the higher risk is not an insurmountable barrier to the successful provision of standalone PPI."

The thinking behind this extract raises a number of significant concerns:

- it seemingly places the view that there is a higher risk of adverse selection on the same level as the view that adverse selection is not an "insurmountable barrier". There is no attempt to even refer to the overwhelming evidence of failure in establishing a viable standalone PPI underwriting business.¹ If this evidence was considered properly then it would be clear that these are not two "views". Rather, on the one hand there is clear evidence that underwriters with a proven track record of selling insurance direct to consumers have not been able to establish a successful standalone PPI business, compared with the "view" that it is not an "insurmountable barrier";
- no reference is made in this context to Norwich Union's evidence of its well-funded initiative to establish a standalone PPI product through Norwich Union Direct, which manifestly failed to meet reasonable commercial objectives;² and
- there is no attempt to weigh up this evidence as well as the importance underwriters place on having information to assess this risk of adverse selection in the tendering process.

When referring to the underwriting market the Emerging Thinking ignores the importance of obtaining a balance of risk across a PPI book to protect against adverse selection. Paragraph 136 refers to "gaining access to significant numbers of customers" but does not acknowledge that it is not just numbers of customers that are relevant to its long term viability but the spread of risk associated with a credit book. If an appropriate balance of risk is not struck then a PPI insurance book will not, as the evidence provided shows, be viable. Where the balance is wrong and the underwriter believes it is being systematically selected against then typically it will take action to address this. This action would include: tightening up on conditions; raising premiums; and if these are not successful in addressing the adverse selection, withdrawing the PPI product.³

¹ See, for instance, AXA Group's response to the Issues Statement and Marks & Spencer's launch of a standalone product. This is a matter of public record and is also referred to at the Oral Hearing (see transcript of the Oral Hearing).

² See response to Questions 97-100 the Market Questionnaire and comments made at the Oral Hearing with Aviva on 17 July 2007 (the "Oral Hearing") (see summary and transcript of the Oral Hearing).

³ See response to Question 100 of the Market Questionnaire.

Sales Penetration of PPI

One important element in ensuring that a PPI scheme is viable is to make sure that there is adequate sales penetration among purchasers of a particular credit product. Thus underwriters require sales data and evidence of penetration of PPI from distributors as part of the tender process.

PPI is not underwritten on an individual basis

PPI sold through distributors is designed to be a simple product appropriate to be sold with a particular credit product. It is not individually underwritten which means that any consumer taking out the credit product will be eligible for the insurance, subject to employment and age.⁴ The nature of the risks covered, particularly unemployment, mean that consumers will have more knowledge of their job security than underwriters. Underwriters accept the risk inherent in this information asymmetry within the context of a relationship with distributors because they have the assurance that there will be sufficient quantity and diversity of risk to make the particular book sustainable. Without this assurance then a logical move would be to require PPI to be individually underwritten. If PPI was individually underwritten, this would not only increase the costs of providing it, but would be likely to lead to the exclusion of those considered less good risks, who are currently able to be underwritten under arrangements with distributors.

Further detailed comments on the analysis of the underwriting market will be provided in the annex that will follow this letter.

Distribution of PPI

As will be explained in detail in the annex that will follow this response, the analysis in the Emerging Thinking that identifies a separate market for PPI within a very narrowly drawn market for each branded credit product is unconvincing. The rejection of the suggestion in the paper submitted by Aviva/Norwich Union of a mixed bundling market for credit products and PPI is essentially unreasoned and does not form a sound basis on which to base a finding of market definition, still less on which to analyse any AEC. This artificially narrow approach to the relevant product market distorts the competitive analysis as, among other things, results in important competitive constraints being pushed to the post AEC analysis. This means that too little weight is attached to these competitive constraints.

Lack of precision in definition of Standalone PPI

Overall there is a lack of precision of what is meant by standalone PPI.⁵ This feeds through into the various comments in the Emerging Thinking on standalone PPI that confuses the sale of PPI wholly outside a credit supply relationship with one where PPI is sold within a credit supply relationship. This distinction is important because the concerns over adverse selection do not arise in the comparatively few occasions where a distributor sells PPI to its existing borrowers even though they might not be taking out a new credit product. The precision in definition is necessary as it is the supply of PPI wholly outside the credit relationship that carries the greatest risks of adverse selection and low penetration that undermine the

⁴ A customer must be employed and satisfy age criteria.

⁵ See pages 3-4 of the annex to Aviva/Norwich Union response to the working paper entitled "The Value Chain" dated 21 September 2007.

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sustainability of a PPI book. In contrast, the existence of a credit supply relationship provides some protection against these problems.

Comparing PPI with Standalone PPI

The intention in the Emerging Thinking of comparing the cost of standalone PPI with PPI distributed through partnerships is highly problematic. It is not comparing similar products. If PPI is sold outside a relationship with a partner then the assumptions behind the underwriting of the PPI will need to be altered. Any comparison that does not properly acknowledge these differences is fundamentally flawed.

Positive characteristics of supply of PPI at point of sale

In addition, the analysis of the positive aspects of supplying PPI with a credit product does not currently envisage the very significant benefits arising from the distribution of PPI with credit products. These are only seen as negative points.

Finally, we request that the second economics paper provided, 'Market Definition for Payment Protection Insurance', that is referred to at some length in the working papers is published. We have annexed this second paper to this letter.

Please contact me if you or your colleagues have any questions.

Yours sincerely,



John D. Colahan

cc: Philippa Short, Inquiry Secretary
Lanze Gardiner, Inquiry Secretary