

Annex: Detailed Response to the Emerging Thinking

Introduction

This response supplements Aviva's initial response of 5 December 2007 to the Emerging Thinking. It sets out a fundamental concern with the Competition Commission's stated approach to analysing whether an Adverse Effect on Competition exists. A further paper by CEG has been attached as part of the comments on the analysis of the current framework for assessing whether there is an Adverse Effect on Competition. The response also provides more detailed comments on specific paragraphs of the Emerging Thinking and Working Papers.

A. The Analysis of Market Definition and its implications for the assessment of an Adverse Effect on Competition ("AEC")

- The Emerging Thinking proceeds on the basis of an overly rigid separation between market definition at the downstream level and the assessment of AEC. It does not even reflect the analysis in the Downstream Market Definition Working Paper, which at least acknowledges the implications that market definition needs to have for the assessment of an AEC. Therefore as explained in the attached CEG paper and commented on below, the analysis and assumptions in this working paper have some fundamental defects.
- Section 134(1) of the Enterprise Act 2002 (the "Act") provides that:

The Commission shall, on a market investigation reference, decide 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 United Kingdom or a part of the United Kingdom.

- The current favoured approach of the Competition Commission to the definition of the downstream market in the Emerging Thinking is to analyse the relevant market as a series of separate brand product markets for PPI. There is no acknowledgement in the Emerging Thinking paper that the choice of market definition could lead to materially different assessments of whether there is an AEC. This is a significant failing. This is particularly important since, as explained in the attached paper from CEG, the evidence cited could also be readily used to justify a broader market definition that would include

PPI and the credit products sold within the same market. Moreover, such a broader approach to market definition accords with commercial realities and would allow for a more real world economic assessment of the conditions PPI is sold in. At a minimum there should be a recognition that the market definition is not robust and any conclusions drawn from it modulated accordingly.

- The extreme and artificial approach of separating PPI from credit products in a series of brand specific markets runs counter to the intentions of section 134(1) of the Act, which includes the definition of the relevant market as an integral part of the obligation to decide whether there is an AEC. In addition, CC3 makes it clear that market definition and the identification of an AEC are “two related issues”¹ and that “the analysis of market definition and the assessment of competition will overlap significantly, with many factors affecting one being relevant to the other.”² The legal consequences of acknowledging this overlap are important, since it can affect the eventual finding of whether there is an AEC and the analysis that follows from that. Such an approach is consistent with the overall scheme of the market investigation regime introduced by the Act, which places the onus on an economic analysis central to an assessment of competition rather than the old public interest standard that was applicable before the Act.
- Another important aspect of the market that should be reflected in the analysis is the anticipated impact and objectives of the FSA initiatives. At a minimum it needs to be recognised that these will raise the consciousness of PPI and make it more likely that consumers will consider PPI proactively. In turn, this reinforces the appropriateness of using the market definition proposed by CEG in the provided paper.³
- Therefore:
 - the Competition Commission should acknowledge the narrow approach to market definition downstream in the Emerging Thinking;
 - acknowledge the clear weaknesses of its favoured downstream market definition;
 - and

¹ Paragraph 1.2, CC3.

² Paragraph 1.23, CC3.

³ See paper “The Market Definition for Payment Protection”.

- acknowledge the consequences of following its favoured approach of downstream market definition and what alternatives might exist.

B. Comments on specific paragraphs of ET

- Paragraph 24 – the analysis as summarised in this paragraph is artificial and does not reflect economic reality. The market for credit products is clearly impacted by the prices of PPI, as is made evident elsewhere in the Emerging Thinking and Working Papers, where it is noted that distributors compete away returns that they receive from the sale of the PPI through the pricing of the credit portion of the bundled product. This demonstrates the relationship between PPI pricing and the pricing of the credit product.
- Paragraph 25 – the “advantage” that credit suppliers have identified in this paragraph is not explained. The analysis elsewhere in the Emerging Thinking indicates that other PPI products do not compete with PPI sold with a credit product. Therefore it is not clear what the advantage is if consumers in fact do not treat the products as substitutable.
- Paragraph 26 – as explained above and set out in greater detail in the attached paper by CEG (and earlier CEG paper on market definition), the evidence referred to in the Emerging Thinking and Working Papers could more naturally be referred to in support of a broader market definition rather than the favoured narrow market definition for the downstream market.
- Paragraph 36 – the life element of PPI is not only relevant should a policy holder die, but may also be used to cover long term disability. Thus the reference to “life” in this paragraph is not strictly accurate because it only refers to it as a form of cover in the event of death. Moreover, while ASU benefits are usually paid for up to 12 months on mortgage and credit card PPI products, many loan PPI products will pay accident benefits for the term of the loan. If the loan is for a term of 60 months or longer, the cover is then often written in the long term fund of the life company.
- Paragraph 48 – it would be more accurate to say that OFT analysed or rather assumed that PPI is a secondary product, rather than it “found” that this was the case. OFT analysis was necessarily preliminary as befits a first screen.

- Paragraph 49 – a report by the Council of Mortgage Lenders published in 2005 stated that the average age of first time buyers in 2004 was 34.⁴ The finding that MPPI has its highest sales rate among 18-24 year olds is misleading as this age segment is a niche in the main mortgage market and is not an appropriate focus in this context.
- Paragraph 50 and following paragraphs – the analysis in this section does not mention a number of especially important characteristics of PPI. These are that it is not individually underwritten therefore, that those insured form part of an insurance “community”. This is mentioned cursorily in the working paper on Distribution Market Definition, but the appropriate conclusions from this are not drawn. None of the analysis in the Emerging Thinking and Working Papers considers why PPI has come to be designed in the way that it has. This is another important aspect of understanding the product. Thus, the reason for 12 months being the period for unemployment coverage means that the majority of claimants would be covered, as this period is more than sufficient to cover the time between unemployment and finding new employment for all but a minority.
- Paragraph 58 – no evidence is referred to in the Emerging Thinking or Working Papers of an example where a panel of “underwriters” is a viable model. We are not aware of any panels as a viable business model.
- Paragraph 63 – the description of exclusions is simplistic and gives a misleading impression of their importance in controlling the level of risk. Exclusions and conditions do provide some ability to contain risks, but these need to be considered in the context of the asymmetry of information arising from those seeking insurance having a greater knowledge of their condition of employment. Selling PPI with a credit book provides an important control on the level of risk insured by underwriters, since it takes place within the eligibility criteria of a credit relationship. The converse is true: standalone PPI as attempted under the Norwich Union Direct initiative gives a much greater risk of negative selection.
- Paragraph 65 – there is a confusion and imprecision in the reference to “stand-alone” sales of PPI. A true stand-alone sale of PPI is outside a credit relationship. The supply of PPI by a credit supplier after the credit is sold is still within the context of a credit

⁴ See www.cml.org.uk/cml/filegrab/pdf_pub_hf_06-2005_SML.pdf.pdf?ref=3266.

supply relationship and should not be referred to as a stand-alone sale of PPI. This is an important point in appreciating the importance of risk in an insurance market.

- Paragraph 75 – this paragraph also shows a confusion on what is a stand-alone sale of PPI. Only the first of the examples in this paragraph is a true sale of stand-alone PPI. See also comments in letter of 5th September 2007.
- Paragraph 78 – see comments in the letter of 5 December 2007.
- Paragraph 79 – any proper analysis of a constraint that could be provided by stand-alone PPI should take into account differences between products. The analysis that begins at paragraph 178 does not do this and so is materially deficient.
- Paragraph 87 – the example used by Which? is misleading; the PPI cited in their example is covering principal and interest. Thus the benefit from the PPI should not be seen narrowly in relation to the principal borrowed. Moreover, no explanation is given of the relevance of referring to the premium being less than the interest. They are distinct and there is no reason, economically or commercially, to compare them in this way.
- Paragraph 145 – for the reasons explained in the responses to Emerging Thinking and the CEG Paper, we do not agree that these are all questions it is appropriate to ask. Market definition is a tool to set out the context of the economic analysis. This should reflect the commercial reality. The favoured view of the market is a distorted one that ignores the commercial reality.
- Paragraph 149 – the identification of a “one way complementary link” is not accurate. This is self-evident from the impact that PPI has on credit product prices.
- Paragraph 161 – the comments on the complementary relationship with the credit are wrong for the reasons identified.
- Paragraph 174 – there is no clear explanation of what is meant by “the point-of-sale advantage”. As noted in the response to paragraph 25 above, there should be a clear and consistent analysis of what the advantage is compared to other products. This is plainly at odds with the favoured view that there are narrow brand-specific product markets for PPI at the downstream level of the market.

- Paragraph 183 – as noted, the evidence referred to in this section that is described as supporting the brand-specific product markets is consistent with there being broader product markets.
- Paragraph 192 – the analysis does not include, as it should, a proper attempt at comparing the quality of cover including the conditions between the different policies.
- Paragraph 195 – the model used for assessing the “profitability of PPI” does not reflect the realities of insurance markets – neither the price risk nor the cost of claims in the simplistic terms used in the Emerging Thinking. Moreover, the questions should also consider the impact on the appreciation of “outcomes” that arises from the favoured approach in defining the downstream distribution market. This is important as the impression from the Emerging Thinking is that the market definition has been chosen to reach an outcome.
- Paragraph 197 – as previously explained and acknowledged elsewhere in the Emerging Thinking, there are distinct limits to typical financial arrangements when each arrangement is individually negotiated⁵.

⁵ See, for example, paragraph 81, Emerging Thinking.

C. **Comments on Working Papers**

1. **PPI policies - characteristics**

- Paragraph 4 – the point that PPI policies are not being individually underwritten is not adequately reflected in the analysis in this Working Paper or the Emerging Thinking itself.

2. **PPI and its alternatives**

- Paragraph 1 – there is no real attempt to consider what are “similar” benefits. The products are not “similar” from an underwriting perspective and would not appear to be considered substitutable by consumers. In addition, the reference to these being available on a stand-alone basis is not clear. Comments have already been made in response to paragraph 65 and 75 above on the lack of precision in defining what is meant by stand-alone products.
- Paragraph 3 – the FSA’s new rules on protection products define PPI as follows: “*A non-investment insurance contract which has elements of a general insurance contract and the benefits of which are described as enabling a policyholder to protect his ability to continue to make payments due to third parties, or can reasonably be expected to be used in this way.*” The FSA has strengthened its requirements in relation to protection products, including PPI. Any analysis of the supply and distribution of PPI must take into account the fact that the FSA’s rules have been changed and are designed to have an impact on consumers.

3. **The Value Chain**

- One key omission from this Working Paper that fundamentally undermines the analysis in it, is the complete failure to appreciate the economics of insurance and the importance of information asymmetry in the provision of insurance.

- Paragraph 3 – this is one point where a proper analysis of the impact of information asymmetry arising from the nature of the risks insured should be considered.
- Paragraph 5 – it is incorrect to say that underwriters “distribute” PPI through lenders or intermediaries. Rather underwriters provide PPI for lenders or intermediaries to distribute. This emphasis is important as it is fundamental in understanding the nature of PPI as a bundled product and the nature of the relationship between underwriters of PPI and lenders or intermediaries⁶. It is not clear whether the HBOS products are genuinely “stand-alone” PPI products. It is not clear whether these products were offered to customers of HBOS who already had a HBOS credit product. If this is the case then the degree of risk of adverse selection is much reduced. This is not the same as a genuine stand-alone PPI which is sold without any relationship to a credit products, not least because HBOS made the conscious decision to offer the product rather than the consumers seeking them. This is an important point. Similarly the Barclays product is not a genuine stand-alone PPI product since it is linked to existing Barclaycard customers and new Barclaycard customers. In addition, HSBC “life choices” product is also likely to be offered to HSBC’s customer’s with existing credit products.
- Paragraph 14 – see comment on mischaracterisation of who “distributes” PPI. It is not correct to say emphatically that “vertically integrated providers also distribute their products via intermediaries and/or lenders”. Rather intermediaries and/or other lenders distribute PPI from other vertically integrated providers.
- Paragraph 18 – the description in this and the following paragraphs makes no reference to the details and specificity in tenders of what the distributor is looking to underwriters to provide in the PPI product that they wish to sell. The description focuses on process and not content. In addition, there is no reference to the fact that commonly in the final rounds of tenders, two

⁶ See, for instance, MBNA’s response to the Emerging Thinking.

underwriters (which might include a captive underwriter) are sufficient for effective competition.

- Paragraph 27 – this paragraph mischaracterises the relationship between underwriter and the distributor. The correct characterisation is that distributors request tenders to provide the underwriting for the PPI product that they wish to sell. Distributors choose to offer exclusive rights for a PPI product. These are necessary in order to achieve the assumptions in the models of underwriters that underpin the risks that they are willing to underwrite.

4. **The underwriting market**

- Paragraph 10 – it is correct to say that PPI policies are tailor-made for specific credit products offered by distributors. The specificity of each contract is important to understanding the benefits and efficiencies derived from them.
- Paragraph 17 – we can confirm that other general insurance underwriters not currently active in the underwriting of PPI provide credible potential competition.
- Paragraph 20 – we do not agree that underwriters of income protection or “comparable” insurance products are any more or less likely to underwrite PPI than other general or life insurers.
- Paragraph 30 – the sale of the Hamilton insurers to Aviva was completed on 1 November 2007 and is an example of integrated distributors switching to independent underwriters (see also comment on paragraph 42 below).
- Paragraph 42 – an example of a party located outside the UK posing as a competitive constraint is of MetLife with the purchase of Citi Insurance, Citibank’s previously captive insurer, in August 2005. MetLife is a large US life insurer which is developing its business in the UK, including PPI.
- Paragraph 55 – this paragraph also omits the important point that two underwriters are sufficient to provide effective competition in any tender.

- Paragraph 56 – as is evident from distributors switching underwriters, any costs of switching do not prevent this occurring, although it is true that a new underwriter will need to match (or exceed) the efficiencies of an incumbent underwriter to be competitive.
- Paragraph 68 – as noted in the comment above on paragraph 55, this description omits the important point that two underwriters are sufficient to provide competition in any tender.
- There is no analysis of the potential impact of reinsurance arrangements in the value chain.

5. **Downstream market definition**

- Paragraph 1 – as explained, we do not agree with the initial finding of a separate brand-specific markets for PPI. This does not reflect commercial realities. The evidence cited in support of this contention can equally be used to support broader markets as explained in the attached paper from CEG (and earlier CEG paper on market definition).
- Paragraph 2 – the assertion that there is “very little evidence that PPI prices affect demand for credit products” does not reflect the points made elsewhere that revenue from PPI is used to reduce the price of credit products.
- Paragraph 5 – for the reasons explained above and in the CEG paper, we do not agree with the approach outlined in this paragraph. A more detailed response is made on this in comments on paragraphs 27 and 28.
- Paragraph 7 – it is correctly noted in paragraph 9 of this Working Paper that substitutability is merely a “useful tool for identifying the competitive constraints affecting firms”. There is no proper explanation in this analysis of why it is right to exclude the possibility that credit products and PPI are in the same market for the purposes of market definition, but at the same time state that it is a disproportionate use of resources to determine the market exactly. Paragraph 5 of the Working Paper makes the admission that the reason for the

choice of the favoured narrow market definition is to allow for there being an AEC. This approach is circular and would at a minimum weaken any finding of an AEC based on it. This reasoning appears highly selective and suggests that it is designed to achieve a result rather than analyse the market objectively.

- Paragraph 11 – there is no attempt to explain properly what are “competitive levels”. This is highly artificial and likely to lead to distorted results in any analysis if the market is broader to include the credit product. Recognising this and the weakness of the support for narrow branded product markets for PPI is a fundamental reason why any finding of an AEC based on this analysis would be wrong.
- Paragraph 15 – another way, and we suggest the more appropriate way, would be to expand the scope of the market definition to allow for a proper appreciation of market power within the relevant product market.
- Paragraph 18 – this paragraph should reflect the intention of the FSA to change market dynamics through its actions. This can be expected to further strengthen the demand relationship between PPI and credit.
- Paragraph 21 – this and succeeding paragraphs characterise the argument submitted in the second economics paper by CEG submitted on behalf of Aviva. This paper has only recently been published on the Competition Commission’s website, which has reduced the ability of other parties to take account of the views in it as part of their comments on the Emerging Thinking.
- Paragraph 24 – the assertion that there is no “per se reason why PPI and credit should automatically be considered as a bundle” is unreasoned. Given the whole industry has similar arrangements, the CC needs to provide an explanation as to why PPI and credit should not be considered as a bundle. The evidence referred to in support of the contention that there is a separate market for PPI from the credit product supports a broader market. The analysis in this working paper fails to take account of the particular characteristics of insurance markets.

- Paragraph 25 – the approach in this Working Paper is not the “generally accepted approach” as it claims to be: it fails to take account of the particular characteristics of insurance markets, as explained in the attached CEG paper. It also fails to consider properly the relationship between PPI and the credit product and adopts an artificial view of a “constraint”. The interrelationship between PPI and the credit product is self-evident and acknowledged elsewhere.
- Paragraph 26 – it simply does not follow that there is a general approach that can be appropriately applied to PPI and credit products in a market investigation of PPI under the Enterprise Act. The Competition Commission’s investigation of extended warranties took place under the previous regime under the public interest standard. The AEC standard is a conscious attempt to apply an economics-driven analysis. The other cases involved analyses of abuses of dominant positions or the equivalent standard. These too are distinct from market investigations. Moreover, there is no obvious reason why cameras and films; typewriters and typewriting ribbon; batteries and torches; or extended warranties should apply to credit products and specific PPI products that are designed for each credit product.
- Paragraph 27 – these are not “good economic reasons”. If the profits are competed away then there is no consumer detriment and the standard of Section 134(1) of the Act would not be met. Thus, point (a) is unclear; it fails to state what a “competitive level” would be. This would not be price plus marginal cost as identified elsewhere in the Emerging Thinking but should take account of the pricing of risk which is fundamental to insurance economics. It is clear that there is a relationship between the reform of rules governing the distribution of PPI and the pricing of credit products. This will benefit those purchasing credit products with or without PPI as explained in the first CEG paper dated 31 May 2007. Therefore point (d) is not accurate. There is no explanation of what a “distortion” in (b) might be. Beyond the perfect competition story contained in basic economics textbooks, all markets contain some level of theoretical distortion. There is no identification of the

“welfare losses” referred to in (c). This contradicts the evidence that the price of credit is lower through PPI revenue.

- Paragraph 28 – artificially dividing PPI from the credit product is not a sound formation for this assessment and is liable to create its own distortions. This is all too evident with the problems experienced by parties constructing data to meet this theory.
- Paragraph 29 – the reasoning in this paragraph highlights the artificial nature of the market definition exercise that discounts the impact of PPI on credit pricing identifying the product market. It is also at odds with the comments in paragraph 5 of this Working Paper that asserts see-saw and waterbed effects have been considered. At a minimum it is incumbent on the Competition Commission to recognise the alternative analyses and how these would lead to alternative conclusions.
- Paragraph 32 – as already noted, the term “advantage” presupposes that there is a real alternative which is precluded by the favoured product market definition.
- Paragraph 35 – this paragraph ignores the insurance reasons of the point of sale ‘advantage’ to respond to information asymmetries. The analysis ignores the likely benefits in lower cost of credit and lower cost of PPI from addressing the problem of anti selection. Consideration of these are necessary for any convincing analysis. Moreover, this list implies that search and switching costs might be high compared with other secondary markets, whereas the nature of the market suggests otherwise, as consumers are able to go to other providers to check the price of the bundle. This is also the natural conclusion to draw from the comments in footnote 19 to this Working Paper.
- Paragraph 39 – the analysis in this paragraph assumes that distinct PPI products can easily be identified. However, the discussions with the Competition Commission staff in the context of data for completing Workbook LU 2 shows that this is not the case.

- Paragraph 44 – the comment in footnote 19 is artificial. The fact that this website does not have a tool to compare “PPI policies directly” but has one that allows a search for loans with the cost of PPI included, points to there being a market for one bundled product. This is ignored in the analysis.
- Paragraph 48 – this analysis omits any consideration of whether those taking out a personal loan would be able to afford regular premia or the purchase of a policy after the loan is taken out.
- Paragraph 52 – the analysis of “evidence of substitution in practice” is confused and fails to distinguish true stand-alone policies with no link to a credit relationship and those where there is a credit relationship even if there is not a concurrent provision of a credit product with PPI. This is important for adverse selection.
- Paragraph 55 – see points made in relation to paragraph 52 above.
- Paragraph 61 – these comments ignore a key dynamic that distributors have the incentive to increase the penetration of their own PPI product and therefore wish to make it as attractive as possible.
- Paragraph 66 – the question is not the significance of the marketing spend. As has been demonstrated in the evidence relating to Norwich Union Direct, a key issue is adverse selection.
- Paragraph 89 – the point in footnote 35 is not applied consistently in the analysis in this Working Paper or in the analysis in the Emerging Thinking.
- Paragraph 91 – the analysis is entirely descriptive and fails to consider why particular provisions are as described. However, more fundamentally there is no consideration of why income protection policies are individually underwritten or in controlled group schemes. A proper understanding of this is vital for any analysis of the welfare benefits of PPI as PPI products distributed with the credit products are able to balance the risk of adverse selection.
- Paragraph 98 – underwriters are able to bid for contracts with distributors to supply PPI and are not confined to entering via a standalone PPI product.

- Paragraph 99 – the comments in this paragraph are misleading and do not support the underlying conclusion in it. There is no analysis of why these products are “similar” when to the underwriter they are not. Each has different underwriting issues and it is not simply a matter of obtaining distribution. This failure to consider the uniqueness of the insurance underwriting is a consistent failure in this Working Paper and undermines much of the analysis.
- Appendix A – the evidence in this Appendix is out of date in a number of important respects. One key point relates to product innovation where there have been major changes to products by some underwriters, such as the removal of the exclusion of prior medical conditions by one underwriter and the introduction of cover for back and stress.⁷ These are not “limited evidence of product innovation” but are major changes. They are moreover only possible for underwriters to make within the context of conventional PPI arrangements. They would be unviable on a standalone basis as there is too high a risk of being selected against.
- Appendix A, paragraph 43 – no account is taken in these comments of the inconsistencies of appreciating what a new product is. This has proved to be a major issue of discussion in the collection of data from Norwich Union and it is surprising that this paragraph fails to reflect this.
- Appendix A, paragraph 46 – these comments fail to reflect the experience of Norwich Union that the independent underwriter can have a major role in stimulating product innovation.
- Appendix B, paragraph 2 – as reflected in the comments on paragraph 43 of Appendix A, this paragraph does not reflect the difficulties experienced in defining what a product is. These were amply illustrated in the discussions when providing information for Workbook LU2. The reason why this is potentially important is that it can change the number of products identified and call into question an analysis that relies on this data.

⁷ Note also that many parties are considering changes to their PPI products to the FSA’s initiative “Treating Customers Fairly”.