



**An Economics Critique of the Emerging Thinking on the UK PPI
market – prepared for Aviva/Norwich Union**

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In November 2007, the Competition Commission (CC) published its Emerging Thinking (ET) setting out its analysis to date of the supply of Payment Protection Insurance (PPI) based on its fact-finding and information provided by different parties in the sector. In this paper, we first summarize certain of the CC's points of view in the ET and ask whether the evidence relied on by the CC supports the views expressed. We then concentrate on important economic issues that have been inadequately dealt with in the analysis carried out so far by the CC. Our particular concern is that in omitting these issues, the CC is providing an incomplete and distorted economic framework for a proper assessment of competition in the supply of PPI. Finally, we outline what we think the CC still should do now in terms of analysis and data collection to provide a well-argued foundation for the views expressed.

1. CC's Emerging Thinking - a summary from an economics point of view

Market Definition is a means to an end – it is supposed to provide the backdrop for a rigorous discussion of competition and impacts on consumer welfare. The CC's approach to market definition in this investigation demonstrates a failure to analyze this market with an open mind. It also fails to consider the peculiarities of insurance markets. In this case, a narrow market definition leads to a distorted analysis of the possible effects on competition, which renders any analysis of 'welfare loss' incomplete and misleading. It would not be a proper basis for an economic assessment of an adverse effect on competition (AEC).

The CC's ET focuses on the way in which PPI products are sold. For example, for personal loans and credit cards, consumers who consider taking out a primary credit product (a loan, a credit card) are offered PPI at the Point of Sale (POS) of the retailer they have chosen for their primary credit product sale. According to the CC, most consumers are not currently informed about PPI prices or their product characteristics before they enter the POS of the primary credit supplier. At the POS, consumers are informed about the possibility of insuring themselves against the possibility that they cannot pay back their liability under the credit product in case of accident, sickness and/or unemployment (ASU), the price and the terms of the insurance offered. Typically, distributors will currently only offer PPI underwritten by one underwriter.

It follows from the CC's analysis of the market definition that as the credit supplier offers its own PPI at the POS, the only choice a consumer can make at the POS is whether or not to take the PPI insurance offered. Accordingly, a particular distributor of a particular credit product has a monopoly position as far as the sales of PPI are concerned in relation to consumers who have just bought or are about to buy a primary credit product from them: each retailer has a local monopoly. In economic theory, monopoly power is associated with a welfare loss to consumers that could be avoided if the local monopoly power of the relevant distributor is broken.

The CC acknowledges the fact that at least part of the monopoly profits that are generated in this way by distributors of the primary credit product cannot be kept by the retailers themselves, in particular if there is a competitive retail market for the primary credit product. If firms make profits through consumers by selling other products to them, they are willing to compete at least part of these profits away in order to attract the consumer to come to its primary credit offering in the first place. This can be done by offering the primary credit product for sale at a price that is below the price that normally would be charged in what is described as a competitive market where no second add-on product is sold. This is called the 'waterbed effect': profits on the sales of the PPI product are used as a form of cross-subsidization to compensate for lower-than-normal profits (or, in the extreme case, losses) in the primary credit market. The strength of the waterbed effect depends in turn on the intensity of competition in the primary credit market which has not been investigated.

The CC apparently regards the waterbed effect as undesirable as prices for PPI products and prices for the primary product do not (necessarily) reflect the underlying cost of provision (see page 8 and 9 of the Downstream Market Definition Working Paper). Thus, in the view of the CC, competition in both sub-markets (i.e. PPI and credit) is distorted away from an assumed (basic textbook) competitive benchmark, where prices reflect the marginal cost of providing the good to the market. Basic textbook economics states that pricing at non-competitive levels distorts consumers' patterns of consumption. The distortion can lead, so the CC argues, to an undesirable transfer of welfare from customers that buy PPI and credit, to those that buy credit only.

Thus, as far as PPI is concerned, the CC's favoured position is to find "on the evidence submitted to the inquiry so far, [that] the relevant market appears to be no wider than the supply of particular types of payment protection insurance (PPI) by distributors to their own credit customers."³ This view does not properly take into account the relationship between PPI and the underlying credit product. In particular, it does not allow for a proper assessment of any welfare changes⁴, as it undermines any proper economic analysis of the credit product, to which the (current) supply of PPI is intrinsically linked. Furthermore, the CC's approach does not allow for a proper assessment of net welfare benefits. Thus it would not be a proper context in which to assess whether there is an AEC.

2. What is the evidence?

So what is the type and weight of evidence that the CC bases its Emerging Thinking analysis on? An answer from our side is surprisingly little. In this section, we concentrate on the evidence provided for the particular choice of market definition. In its analysis of market definition, the CC focuses on the question of whether a small but significant increase in the price of PPI, above competitive levels, would be rendered unprofitable, 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.

In light of this, we observe that the CC has not made any attempt to measure or otherwise identify the "competitive" price level of PPI. Moreover, there is no attempt to estimate quantitatively the effect of an increase in PPI prices on the profits made on either the PPI product or on the underlying credit product. The CC offers a conceptual analysis informed by selected documentary evidence and hearings, concluding that there is one way complementarity between PPI and the underlying credit product in the sense that the sales of PPI constrain the prices charged in the credit market, but not vice versa. The main reason given for the absence of an effect of PPI prices on the demand for credit, is that most consumers become aware of PPI and the price at which

³ See, the Emerging Thinking Downstream Market Definition paper, page 1.

⁴ See Section 4 below.

it is offered at the POS. As consumers have at this stage already made up their mind where to buy, there is little possibility for substituting away to alternative supplies or products. The evidence on the relationship between PPI and credit markets the CC received from hearings with distributors was conceded by the CC as being mixed, so we are told on page 22/3 of the Downstream Market Definition Working Paper, that quite a few parties argued that there was a strong relationship between pricing of the credit and PPI products (see also the Profitability of PPI Working Paper⁵). We argue the CC should go further than that and analyze quantitatively the effect of an increase in PPI prices on the profits made on the PPI product and on the underlying credit product.

Given that the credit product is the primary product (and given the fact that currently PPI is only bought if a primary credit product is bought), it is not surprising to see that providers and consumers focus more on the pricing and advertising of the primary product. Many firms, however, run PPI not as a separate business, but as a product characteristic that can be added to the basic credit product. As HSBC has stated (cf., Emerging Thinking Downstream Market Definition Working Paper, Appendix A, paragraph 40/Table 4), its customers, if they are minded to take or consider taking PPI, look at the total amount of outgoings. Barclays provided information to the CC that it had carried out a nationwide mailing in which they compared personal loan repayments, with and without PPI payments, with other parties also suggesting that a wider market definition should at least be considered.

We do not claim that the documentary evidence cited so far contradicts the market definition that is chosen. However, the evidence provided is weak and does not rule out an alternative market definition, according to which there is one vertically differentiated market for a credit product, where some products are sold with PPI, and others are not. As noted in our earlier paper⁶ the advantage of the alternative market definition is that it reflects all the key issues involved in this competition issue (as

⁵ See, for example, the comments on ‘The economic analysis of profitability’ at page 1 of the Profitability of PPI Working Paper.

⁶ See, http://www.competition-commission.org.uk/Inquiries/ref2007/ppi/third_party_submissions_issues_statement.htm. If this market definition is chosen, it is natural to study the interaction between the primary product and PPI as they are part of one and the same downstream market.

noted later). Moreover, no quantitative evidence is provided to support the CC's market definition.

We do not believe the qualification in the following passage in the working paper on Downstream Market Definition is sufficient to meet our concerns:

“We have considered whether the possibility that potential impacts on credit prices (so called see-saw or waterbed effects) would warrant the widening of the relevant market to include other bundles of credit and PPI. However, we consider that these effects, while important to our understanding of the operation of the market, do not warrant inclusion in, and any altering of, the analysis of the relevant market at this stage. This is primarily because, for the reasons set out in paragraphs 27 and 28, we consider that the potential for some or all of the profits made on PPI sales to be competed away in the form of lower credit prices does not necessarily preclude that there may be an adverse effect on competition (AEC).”) (cf., Emerging Thinking Downstream Market Definition, pp. 2)

No independent argument is given to support the assertion that a wider market definition is inconsistent with the available evidence. The CC merely states that it has chosen a particular market definition, leaving open that there may be an AEC. In fact, this choice of framework risks distorting and prejudicing the assessment of whether there is an AEC from an economics perspective.

3. Issues not investigated by the CC

The CC explicitly acknowledges that it has not considered the waterbed effect and its impact when assessing market definition: We “consider that the extent to which PPI profits are competed away in the form of lower credit prices to be beyond the scope of our market definition exercise at this stage” (cf., Emerging Thinking Market Definition, pp. 2).

The waterbed effect is, however, one of the crucial economic characteristics of the relationship between PPI and the underlying credit product, one that should not be left

out of a proper economic analysis within the market definition exercise. If distributors are not seriously constrained in the pricing of PPI (as the CC argues), any assessment of the affect on competition must also consider whether the profit made on PPI is given away in terms of lower prices of the primary credit product.

Rather than measuring the waterbed effect and its impact on welfare, the CC suggests that even if there is a waterbed effect, there may be a market distortion as prices for the basic credit product and also the prices for PPI are not at the level they would be if there is “perfect competition” for both products separately (cf., *Emerging Thinking Market Definition*, pp. 2). The CC’s reference point of a perfectly competitive market is a highly theoretical one that exists in the world of economic textbooks where there are no distortions at all. If this highly theoretical benchmark is applied, any subsequent analysis of effects on competition will be unrealistic and liable to lead to distortions. Further, the point of reference is not viable, thus the conclusion of an economic analysis based on it is fundamentally unreliable.

4. The CC needs to do a proper analysis of current arrangements...

In order to assess any welfare changes properly and thoroughly as part of the AEC analysis, the CC should in our opinion, measure the costs and benefits from the current arrangements (with the interaction between underwriters and distributors or upstream and downstream markets), and compare these with the costs and benefits of a *viable* alternative arrangement. In this context, the benchmark of “perfect competition” at the level of the primary credit product and at the level of PPI is fundamentally unreliable for several reasons.

To measure any implications for consumer welfare from the current arrangements, the CC should first investigate how distributors price credit and PPI products and the implications thereof. To measure the impact of the waterbed effect, it also should delve into the competitiveness of the primary credit market in order to assess the implications for distributors earning profits on PPI (and the potential harm thereof). To do this properly, the CC should estimate the cost of providing primary credit products and relate that to the prices charged. As many of the submissions suggest⁷, competition in various primary credit products is fierce. Our initial view based upon the literature is that this is the case, but the CC should independently verify this.

We have written previously on the benefits of bundling PPI.⁸ It is important to note that absent the current arrangements it is not axiomatic that consumers will be able to purchase PPI with similar levels of coverage and price. Thus, when comparing to competitively provided PPI the CC easily loses sight of the higher cost of providing PPI as a truly separate product, independent of the primary credit product and possible lower coverage of alternative (income protection) products.

Any assessment of welfare loss and benefits should therefore take account of the availability to consumers of insurance which is as least as good in price/coverage as the provision under the current arrangements. In considering welfare loss and benefits, it should be firmly kept in mind that insurance markets are typically ruled by complicated informational issues, as insurers do not possess the requisite information

⁷ See, the submission from Barclays Bank plc, Lloyds TSB group plc and HSBC Group on http://www.competition-commission.org.uk/Inquiries/ref2007/ppi/third_party_submissions_issues_statement.htm

⁸ See the paper “The Economic Benefits of Bundling PPI with Primary Credit Products”, submitted on 31 May 2007.

to know whether a consumer is a high or low risk type. Competition in these markets is known to yield different outcomes compared to other non-insurance markets as a consequence of information asymmetries, with only the highest risks buying insurance at high prices (cf., George A. Akerlof, The Market for “Lemons” – Quality Uncertainty and the Market Mechanism, *The Quarterly Journal of Economics*, Vol. 84, No.3. (Aug., 1970), pp. 488-500). The bundling of insurance with a primary product is a way to (partly) overcome or mitigate this adverse selection problem.

At a very minimum the CC should acknowledge that its analysis is far from clear-cut and that this point should be given proper weight in the assessment of AEC. The alternative, which appears to be the intention of the Emerging Thinking and Working Papers, is to reach the theoretical and distorted view of competition in a “perfect” market that ignores facets of insurance markets. This in turn will lead to a distorted analysis.

5. Conclusion

The CC’s ET seems to be based on a simple view adopted by textbook economics that perfect competition at all levels achieves the best of all possible worlds. We have argued that this view does not take peculiarities of PPI (or insurance markets more generally) into account. In particular, it does not take account of the cost efficiency aspects related to the current arrangements. Moreover, the view neglects the presence of (adverse) selection effects in insurance markets. The CC should come up with a quantitative analysis on the basis of real cost and pricing data as part of a proper assessment of welfare benefits.

The CC adopts a narrow definition of the market, according to which the market is no wider than the supply of particular types of PPI by distributors to their own credit customers. We have argued that the evidence provided so far is also consistent with a much broader market definition. This broader market definition provides a proper framework in which to assess welfare benefits as part of an analysis of any adverse effects on competition. Market definition should be second order to a proper assessment of competitive effects – it is after all a means to an end. We are concerned that the future assessment of whether the current arrangements have

positive or negative net competitive effects will be shoe-horned into a restrictive and unrealistic view of how the market operates.