

Payment protection insurance

The Competition Commission's emerging thinking

A report for Barclays

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Section 1

Introduction and summary

Introduction

- 1.1 The Competition Commission ('the Commission') has published its Emerging Thinking ('ET') on its market investigation into the supply of payment protection insurance ('PPI').¹
- 1.2 Barclays has asked us to assess whether the ET is based on sound economics and takes full account of the relevant evidence. In particular, Barclays has asked us to analyse the following questions:
 - a. Does the ET take all relevant economic evidence, including recent market developments, into account?
 - b. Does the analysis in the ET allegedly indicating a lack of competition and consumer detriment reflect sound economic principles?
 - c. What impact do these issues have on the conclusions in the ET?
- 1.3 In this paper we provide our analysis of these questions. We address each question in turn in sections 2 to 4 below.

Summary of our conclusions

- 1.4 In our opinion, the ET does not properly consider all of the relevant economic evidence. In particular it fails to properly analyse evidence in the following areas:
 - It fails to analyse the implications of evidence on product developments.
 - It fails to analyse the implications of changes in the regulatory regime.
 - It ignores or incorrectly analyses evidence of product innovation.In general, the analysis is backward-looking and fails to take account of current and future developments.

¹ Competition Commission, *Payment Protection Insurance market investigation: Emerging Thinking*, 6 November 2007.

- 1.5 In addition, the analysis of price changes (which are said to indicate a lack of price competition) and price levels (which are said to indicate excessively high prices) do not reflect sound economic principles.
- 1.6 These problems with the analysis have significant implications for the Commission's developing conclusions.
- 1.7 First, since the analysis is largely backward-looking and focuses on the past rather than the future, there is a significant risk that the Commission's analysis could already be out of date by the time it reports. Should the Commission identify an adverse effect on competition and impose remedies these will not take effect until 2009, at the earliest. Its analysis should therefore focus on how the market will look in 2009 and beyond, not how it has worked in the past.
- 1.8 Second, the only evidence in the ET that might suggest consumer harm, is the finding that PFI prices may be excessive – higher than would be found in a competitive market. However, the analysis behind this finding is not convincing. In the absence of this finding, there is no evidence in the ET to suggest any consumer detriment in the supply of PFI.

Section 2

The ET does not take full account of the relevant economic evidence

Introduction

- 2.1 The ET provides a static analysis of competition and fails to take account of important current and future developments in the supply of PPI. In this section, we identify three areas where the ET ignores important evidence:
- It fails to analyse the impact of new product developments;
 - it fails to analyse the implications of regulatory changes; and
 - it either ignores or incorrectly analyses evidence on product innovation.
- 2.2 We explain each of these issues in turn below.

The ET ignores the impact of new product developments on the alleged point-of-sale advantage

The alleged point of sale advantage

- 2.3 The ET finds that most PPI is sold alongside a credit product. In other words, the PPI is sold at the point of sale of the credit product.² The ET also finds that many PPI policies sold by distributors are only available at that time.
- 2.4 The ET concludes that the role of the point of sale is an important feature of the provision of PPI. Sales of stand-alone PPI (PPI sold away from the point of sale) are stated to be very limited for all types of PPI, and the attempts by non-credit suppliers to sell PPI in the past are said to have been unsuccessful.
- 2.5 The ET finds that suppliers of credit products therefore seem to have a significant advantage when selling PPI to their own credit customers.³ Any other PPI provider that does not have access to credit customers at the point of sale will face significantly higher costs than the credit provider.

² ET, para. 47.

³ Working paper on downstream market definition, para. 34.

- 2.6 The ET has reached no firm view at this stage regarding the cause of the alleged point-of-sale advantage. However, it notes that the existence of a point-of-sale advantage for suppliers of PPI that also supply credit products, regardless of its causes, is important for the market definition exercise.
- 2.7 PPI is a secondary product. It is purchased by consumers to protect payments on a primary product, such as a loan or other credit facility. Given the secondary product characteristics of PPI, the key question the Commission has considered when defining the relevant market, is whether the market should include (i) PPI *and* its underlying, complementary, credit product or, (ii) only PPI.
- 2.8 The ET concludes that the relevant market should not include both PPI and the underlying credit product. It notes that PPI is optional and is not purchased on all credit sales. It also concludes that prices of PPI are not constrained by the potential impact of an increase in PPI prices on sales of the associated loan product.
- 2.9 Moreover, given the alleged point-of-sale advantage described above, the ET concludes that there are separate markets for PPI on the products of each loan provider. The PoS advantage makes it impossible, or at least very difficult, for anyone other than the supplier of the credit product to provide PPI on that product.

New product developments are likely to overcome the point-of-sale advantage

- 2.10 In our opinion, the Commission's analysis of the point-of-sale advantage and its impact on market definition is incomplete, because it fails to take account of the impact of new product developments. The ET refers to new product developments but fails to analyse how these new products may affect the analysis above. These developments are likely to impose significant competitive constraints on providers that sell PPI alongside credit products, changing the nature of competition in the provision of PPI.
- 2.11 The conclusions in the ET are based on past experience, which shows that firms offering stand-alone PPI have achieved very low market penetration. The ET refers to a number of large financial institutions which are in the process of launching stand-alone products: HSBC (via its Lifechoices policy) and RBSG (via its Churchill payment protection policy) now offer PPI on a stand-alone basis to cover other products; and Barclays has recently introduced a credit card PPI policy that can be used to cover other credit cards.⁴ The ET declines to draw any implications from the launch of these products, and instead focuses on the historic experience where stand-alone PPI products have achieved a very low penetration.
- 2.12 We believe that the ET is ignoring an important development in the market, and ignoring the logic of its own analysis. According to the ET, existing providers of stand-alone PPI have been hampered by the fact that they do not have the opportunity to sell PPI alongside an associated loan product. The three institutions launching these new stand-alone products will not face that disadvantage, since they are all major suppliers of loan products. This provides them with opportunities to sell PPI which previous suppliers of stand-alone PPI lacked.
- 2.13 [TEXT REDACTED]

- 2.14 Imagine, for example, a consumer who obtains a mortgage from bank A and a personal loan from bank B. When the consumer takes out his or her mortgage, bank A will have an opportunity to offer PPI on the mortgage, but could also offer PPI on the personal loan from bank B. Similarly, when the consumer takes out the personal loan, bank B could offer PPI that covers both the personal loan and the mortgage. Banks A and B will have other opportunities to market their stand-alone PPI product, such as when customers apply to reschedule their loans. In this way banks A and B will be competing to offer PPI across the customer's portfolio of credit products. Neither bank will suffer a point-of-sale disadvantage.
- 2.15 We note that the three financial institutions launching the products cited in the ET are three of the largest high-street banks in the UK. They will have ample opportunity to sell stand-alone PPI on their competitors' credit products.
- 2.16 We also observe that these institutions would be unlikely to launch stand-alone PPI products unless they expected them to be a commercial success. While individual businesses may from time to time launch products which fail to meet their commercial expectations, the fact that three large high-street banks all believe that there is commercial opportunity to market stand-alone PPI products is quite telling.
- 2.17 While competition between these three providers to sell stand-alone PPI would in itself be a significant development, the launch of these products may have wider implications for the analysis in the ET. The development of these products could lead to a fundamental shift in consumer perceptions of PPI. Consumers would see PPI not as simply an add-on to a loan product, but as a product in itself which can be sourced from a different provider from the underlying loan. Such changes in consumer perceptions would significantly reduce, if not eliminate, the alleged point-of-sale advantage identified in the ET.
- 2.18 In summary, we are surprised that the ET does not attempt to analyse the implications of new product developments. The analysis of the alleged point-of-sale advantage in the ET is fundamentally backward looking, and fails to consider the impact of current market developments. Consequently, it does not provide a sound basis for drawing conclusions on the future development of competition in the provision of PPI.

The ET fails to analyse the impact of the changing regulatory environment

- 2.19 The supply of PPI is heavily regulated. It is well known that the nature of regulation has a significant impact on the conditions of competition. Regulation can, for example, affect entry barriers, suppliers' costs, consumers' switching costs and their search costs. Depending on how it is designed, regulation can have pro or anticompetitive effects.
- 2.20 The regulation of the sale of PPI is the responsibility of the Financial Services Authority (FSA), which has been conducting an extensive thematic review of this product. While the ET acknowledges the importance of these developments, and the importance of the

⁴ *Working paper on downstream market definition*, para. 52. See also Barclays response to the Issues Statement, 31 May 2007, para 5.8

Commission working cooperatively with the FSA, we are concerned that the ET does not in practice take sufficient account of regulatory developments. An example of this failure to fully analyse the impact of the changing regulatory environment is the impact of regulation on single premium policies.

Single and regular premium and potential barriers to switching

- 2.21 PPI policies can be either 'regular premium' or 'single premium'. This refers to the payment method of the policy. With a single premium policy the total price of the policy for the whole of the contract is paid in one lump sum at the beginning of the contract, generally by increasing the size of the credit being purchased in order to pay for the PPI.
- 2.22 Customers with single premium policies are entitled to a rebate of the premium if they cancel the policy early (for example, if they pay off the loan early, or decide to cancel their PPI). The amount of refund actually paid will reflect the insurer's greater risks during the early years of a policy (because of the higher insured balances outstanding), the initial expenses of the policy and the higher risk of default due to adverse selection. As a result, according to the ET, a customer cancelling a policy a quarter of the way through its life, for example, is likely to get somewhere nearer half of the premium refunded.
- 2.23 The ET finds that that the rebate received on a single premium policy is therefore likely to be lower than the sum of payments that would have been outstanding on an equivalent regular premium policy.⁵ Consequently, customers who have single premium policies face higher switching costs than monthly premium customers.
- 2.24 As a result, the ET speculates that any customer that attempts to switch is likely to face a shortfall between the value of their rebate and the cost of a new policy to cover the remainder of the term, which will create barriers to switching.⁶

The impact of the FSA's proposals on alleged barriers to switching

- 2.25 As part of its thematic review, the FSA has suggested that the majority of firms selling single premium PPI policies did not give the customer sufficient information on the lack of refunds or the fact that refunds would not be on a pro-rata basis if the customer cancelled the policy after the statutory cancellation period.⁷
- 2.26 The FSA's action to remedy this issue will affect not only the provision of information to consumers but also the design of policies, including the level of cancellation rebates. The FSA has secured undertakings from firms and the agreement of trade associations to make the practice of refunds on single premium PPI policies fairer and more transparent to customers.⁸

⁵ Working paper on downstream market definition, para. 46.

⁶ In addition, the ET finds that the cancellation process with regard to single premium policies would appear to be more difficult in practical terms since, in contrast to a regular premium policy, customers would need to apply for cancellation and a rebate settlement.

⁷ See Financial Services Authority: *The sale of payment protection insurance – results of thematic work*, November 2005, p. 4.

⁸ See Financial Services Authority: *The Sale of Payment Protection Insurance – results of follow-up thematic work* October 2006, p. 3.

- 2.27 The FSA's proposals regarding single premium PPI policy rebates are likely to significantly reduce any barriers to switching.⁹ Single premium policies will become similar to monthly premium policies in their cancellation and rebate characteristics.
- 2.28 However, the ET seems to ignore the impact of this FSA action. In particular, the ET does not take into account the impact of those proposals in reducing the alleged barriers to switching.¹⁰
- 2.29 More generally, the ET draws conclusions based on historic evidence that shows how the market has operated in the past. Clearly, it is wrong to simply extrapolate forward this past experience. Past conditions of competition will have been heavily influenced by the past regulatory regimes. Future conditions of competition will depend on how regulation develops in the future. We believe that the Commission needs to fully analyse the impact of the changing regulatory regime on future competition in the supply of PPI.

The ET ignores evidence of product innovation

Product innovation: the alleged lack of non-price competition

- 2.30 The ET finds some evidence of firms introducing new PPI products in recent years,¹¹ and of new short-term income protection products (e.g. 'lifestyle protection' or 'hybrid' products). The ET also acknowledges that there is some evidence of product innovation.¹²
- 2.31 However, the ET claims to find very little evidence that competitive pressure has driven firms' decisions to innovate. Overall the level of innovation is considered to be 'limited' and, by implication, less than might be expected in a fully competitive market.¹³

The ET does not provide a framework for assessing the level of innovation

- 2.32 While the ET finds that there is limited evidence on product innovation,¹⁴ paragraphs 43-49 of Appendix A to the working paper on downstream market definition list many examples of new PPI product launches and product innovation. These include:
- the introduction of new products;
 - the introduction of new short term protection products;
 - changes in the level of cover on offer and various other benefits;
 - the introduction of tiered PPI products;
 - changes in pricing structures; and

⁹ ET, para 95.

¹⁰ See <http://www.fsa.gov.uk/pages/Doing/Regulated/consumer/tackle/ppi.shtml> (downloaded 26 November 2007)

¹¹ Working paper on downstream market definition, Appendix A, para. 43.

¹² Working paper on downstream market definition, Appendix A, paras. 45-49.

¹³ Working paper on downstream market definition, Appendix A, para 3(i).

¹⁴ Working paper on downstream market definition, Appendix A, para 3(i-j).

- the introduction of additional services.
- 2.33 The ET appears to either ignore this evidence on innovation or concludes that the observed level of innovation is less than would be expected in a competitive market.
- 2.34 However, it is not clear to us what level of innovation the Commission would expect to see in a competitive market. The ET does not set out a competitive benchmark against which the observed level of innovation can be compared. In the absence of such a benchmark it is not clear on what basis the observed level of innovation is found to be 'limited'.

Conclusions

- 2.35 In summary we find that the ET either ignores or fails to properly analyse evidence which is of fundamental importance for its conclusions. In particular, it fails to take full account of important developments such as:
- the development of new products;
 - changes in the regulatory environment; and
 - the level of product innovation.

Section 3

The evidence on a lack of competition and consumer harm is inconclusive

Introduction

- 3.1 The ET makes two key findings regarding the evidence on prices:
- PP prices do not change, which is said to show that price competition between PPI providers is limited;¹⁵ and
 - the prices of PPI sold alongside the credit product are higher than the prices of stand-alone PPI, which is said to be indicative that prices are above the competitive level.¹⁶
- 3.2 In our opinion, it is far from clear that prices are actually as stable as the ET suggests. In any case, there is no sound economic basis for inferring a lack of competition from evidence on the stability of prices.
- 3.3 In addition, the ET fails to provide a robust analysis to show that prices are excessive. The evidence in the ET actually suggests that stand-alone PPI is likely to be a poor proxy for the competitive price level.
- 3.4 We explain both of these concerns in turn below.

A lack of price variation does not provide evidence of a lack of competition

The evidence on price variation

- 3.5 The ET finds that during the period 2002 to 2006 the price of PPI did not change significantly. In particular, for many policies the price did not change at all during that

¹⁵ *Working paper on downstream market definition*, para 58.

¹⁶ *ET*, para 192.

period, or changed in price only once. Reductions in the price of PPI were extremely rare.¹⁷ This is said to provide evidence of a lack of competition.

This evidence does not indicate a lack of competition

- 3.6 As a preliminary point, we note that it is far from clear that the *effective* price of PPI has been as stable as the ET suggests. As explained in section 2 above, the ET ignores evidence on non-price competition and product innovation. Even if *nominal* prices have not changed, if the terms of the PPI product have been improved, its value to consumers will have increased. In practice PPI providers have introduced changes to the terms and exclusions of their PPI products, either increasing coverage or increasing benefits for consumers.¹⁸
- 3.7 It is evident that if PPI providers have been innovating in a way that increases consumer benefits *and* PPI prices have not changed, the effective price of PPI cover will have decreased.
- 3.8 In any case, even if effective prices had in fact been stable, there is no economic basis for concluding that this indicates a lack of competition. Prices are determined by various factors other than competitive conditions. They can vary in markets where there is no competition or can be stable in competitive markets.
- 3.9 First, economic theory suggests that prices are determined by various demand and supply factors, such as costs. The ET does not seem to consider any evidence on costs of claims or other direct costs. Everything else being equal, if these costs have not significantly changed we would not expect PPI prices to change.¹⁹
- 3.10 Second, even if the cost of claims has changed, this may reflect the business cycle. We would not necessarily expect PPI prices to change from year to year to reflect changes in costs across the business cycle. Insurance, the business of buying individuals' risks, involves spreading risks across individuals at a particular point in time and over time. Insurers can be expected to smooth prices over the business cycle so that high returns in one year compensate for lower returns in others.

The evidence on price levels is inconclusive

Evidence of excessive prices

- 3.11 The ET finds that the prices of PPI sold alongside credit products are significantly higher than the prices of PPI sold on a stand-alone basis.²⁰ It concludes that this is indicative of prices being higher than the competitive level. This comparison between products appears to be the only evidence provided in the ET that might indicate that the price of

¹⁷ ET, para. 101

¹⁸ See Earclays Response to the M&F questionnaire, Qs27, 29, and *Working paper downstream market definition* Appendix A at para 43 to 49.

¹⁹ In addition, even if these costs vary by small amounts, PPI prices might not change because the implementation of price changes might itself be costly.

PPI is excessively high. It also appears to be the only evidence of possible consumer harm.

This evidence is inconclusive

- 3.12 In our opinion, the evidence in the ET provides no basis for a finding of excessive prices.
- 3.13 The European Courts have set a substantive test for deciding whether prices are significantly high or excessive. Of course, the Commission is not applying European law, so it might argue that it should not be bound by such a precedent. However, it seems to us that the underlying economic principles for establishing whether a price is excessive should be no different under European law or the Enterprise Act. The underlying question (is the price higher than would be charged in a competitive market?) is the same.
- 3.14 The substantive test put forward by the European courts for assessing when prices are excessive is as follows:²¹
- The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products.*
- 3.15 This substantive test involves two necessary and cumulative conditions. The first limb of the test is to compare actual costs and prices, while its second limb is to find out whether a price is excessive in itself or by comparison to competitors' products.
- 3.16 The cumulative nature of the test is essential to the analysis. In particular, clear and robust evidence satisfying *both* limbs of the test is necessary in order to find excessive prices. We note that the ET provides no analysis at all of the first limb of this test: whether prices are excessive when compared to costs. Instead it uses only the second limb, comparing the price of PPI sold alongside credit products to the price of a competing product. Since it only applies one of the necessary cumulative conditions, the analysis in the ET does not conform to the principles established in European law.
- 3.17 In any case, we find the ET's application of the second part of the test unconvincing. The ET uses the stand-alone PPI price as a benchmark against which to compare prices of PPI offered alongside credit. If the Commission intends to use the price of stand-alone PPI as a benchmark for assessing PPI sold alongside the credit product, it has to provide robust evidence to show that stand-alone PPI is an appropriate benchmark. The evidence in the ET does not show that stand-alone PPI an appropriate benchmark.
- 3.18 First, the Commission needs to assess whether the prices charged by stand-alone providers represents a competitive equilibrium. Current prices may reflect the fact that these are relatively new products and may therefore be set at low levels in order to establish an initial level of market penetration. It is not clear from the evidence presented in the ET whether or not the prices of these products cover their long-term costs.

²⁰ ET, para 192.

²¹ Case 27/76, *United Brands Company v Commission* [1978] ECR 207, para. 252.

- 3.19 Second, the ET does not analyse possible differences in costs between the two products. For example, we understand that stand-alone products often had low prices, but also low coverage and additional conditions.²² In other words, stand-alone PPI is not an appropriate benchmark if it does not provide a like-for-like comparison.

Conclusion

- 3.20 In our opinion the ET fails to provide a robust analysis of evidence on price variations and price levels. The evidence and analysis set out in the ET does not provide compelling evidence of a lack of price competition or that prices are excessive.

²² See Summary of hearing with Aviva/Norwich Union held on Tuesday 17 July 2007, para. 16.

Section 4

The Commission's developing conclusions are not supported by the evidence or by sound analysis

Introduction

- 4.1 The Commission is less than one year through a two-year inquiry into the supply of PPI, and we understand that its ET document is not intended to set out its final conclusions, or even draft conclusions. It is intended to report on what it has found out at this stage in its inquiry and indicate its lines of proposed further enquiry. However, the ET inevitably sets out a number of interim conclusions or findings. As explained in sections 2 and 3 above, we believe that these interim conclusions are not supported by the evidence and analysis set out in the ET and its supporting documents.

The analysis is backward-looking and ignores current developments

- 4.2 Our first concern is that the ET focuses on historic evidence and places little if any weight on evidence of current developments. As explained in section 2 above, the ET ignores important new developments.

Conclusions on market definition and the alleged point-of-sale advantage

- 4.3 The ET fails to properly analyse the impact of the launch of new products. We believe that these new product developments could radically alter the nature of competition in the provision of PPI.
- 4.4 Perhaps the most significant finding in the ET is the adoption of a very narrow market definition, which implies that each credit supplier is a market in itself. This finding appears to rest on the importance attached to the alleged point-of-sale advantage. If new product developments allow competing suppliers to overcome that alleged barrier this will have significant implications for the Commission's conclusions on market definition.
- 4.5 In addition, even if the Commission maintains its narrow market definition, any developments which increase the ability of suppliers to compete for each other's

business must have a significant impact on the Commission's conclusions on whether a feature of that market has an adverse effect on competition.

Impact of regulation

- 4.6 The ET also fails to properly analyse the impact of regulatory developments, such as the outcome of the FSA's thematic reviews. Regulation has a significant impact on competition in the supply of PPI. Changes in the regulatory environment could have a significant impact on the development of competition over the next few years.

Consequences for the outcome of the inquiry

- 4.7 Should the Commission conclude that an adverse effect on competition exists and needs to be remedied, those remedies would in practice not take effect until 2009 at the earliest. In our opinion, the focus of this inquiry should therefore not be on how the market looked in 2007 or before, but rather on how the market is expected to look in 2009 and beyond. We are concerned that the analysis and evidence in the ET provides little basis for reaching conclusions on how the market would look in 2009 and beyond. The Commission therefore needs to take care that its conclusions are not overtaken by events before they are implemented.

The analysis provides no evidence of consumer harm

- 4.8 While the Commission's analysis is at an early stage, it is clear from the ET that the Commission has concerns that:
- there is insufficient (price) competition between suppliers of PPI;²³ and
 - this is leading to prices above the competitive level.²⁴
- 4.9 We find the evidence on both of these points unconvincing, for the reasons set out in section 3 above. In addition, the ET ignores evidence of significant levels of non-price competition and innovation, as explained at paragraphs 2.32 to 2.34 above.
- 4.10 The problems with these areas of analysis appear to be of fundamental importance for the Commission's developing conclusions. The suggestion that a lack of price, and non-price, competition is leading to excessive prices appears to be the only potential consumer detriment identified in the ET. Given the problems with this analysis, we can find no evidence in the ET to suggest that there is consumer detriment in the provision of PPI.

²³ *Working paper on downstream market definition*, paras. 58-59.

²⁴ *ET* para. 192.