

**A REVIEW OF THE
COMMISSION'S EMERGING THINKING
ON VERTICAL INTEGRATION
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Introduction

I have reviewed the Commission's Emerging Thinking on Vertical Integration, and provide my independent opinion concerning the Commission's analysis.

The Commission reviewed four theories of possible harm from vertical integration:

1. Insufficient bidding by captive underwriters in tenders conducted by distributors.
2. Harm to independent underwriters from the denial of an opportunity to bid for the business handled by integrated distributors.
3. Insufficient competitive pressure on captive underwriters, which could yield higher costs or could reduce innovation.
4. A greater tendency to reject valid claims.

The Commission's reasoning and conclusions are sound with respect to the first two theories of harm. In Part II I explain my endorsement.

The Commission has used incomplete or poor reasoning with respect to the theory of harm involving insufficient competitive pressure. This theory of harm raises serious questions, and the Commission has cited supporting evidence that warrants further exploration. It is premature to dismiss the possibility of insufficient competitive pressure when the Commission has found prima facie evidence of integrated underwriters charging 43% more than the independents (¶35). In the main text I discuss some specific avenues for analysis, which I summarise in Part III. I would welcome an opportunity to discuss this with the Commission's economists on this case. We would also explore how, subject to appropriate arrangements to ensure confidentiality, I could assist with the analysis.

In a separate paper the Commission has concluded that independent and integrated underwriters compete in the same market. However, significant tension exists between the paper on the underwriting market and the Commission's assessment of insufficient competitive pressure. I discuss the tensions, and explain why they warrant further empirical analysis.

I disagree with some of the Commission's comments concerning the reasons why vertical integration may have developed in the industry. The history of vertical integration is interesting primarily as a source of insights into the possible theories of harm. When discussing the theory of insufficient competitive pressure below I include comments on the history of vertical integration.

The Commission sees no reason to investigate whether vertical integration prompts underwriters to reject more valid claims than independent companies. The Commission in essence speculates that independent underwriters could present a countervailing problem: insufficient screening of frivolous claims. I offer no comment on this section of the Commission's analysis.

1 Insufficient Competitive Pressure

1.1 The Chicago School Theory

The Commission rejects the competitive pressure argument by applying standard “Chicago School” theory. The Chicago School theory provides powerful insights into vertical integration, but relies on a set of assumptions that are often unrealistic. The Commission’s reasoning is incomplete because it does not explore the realism of the underlying assumptions.

The main reasoning of the Commission is that the integrated underwriter competes indirectly with the independent companies. Although an integrated distributor may not issue tenders, a rational integrated company should keep a watchful eye on the costs of its integrated underwriters. If costs get out of line, then the integrated company can always close down the business. Under the Chicago School theory, an integrated company would have a natural self-interest in closing down its own underwriting business and contracting with an independent underwriter if the independent company had lower costs.

The Commission does not refer directly to the Chicago School, but follows the reasoning closely: “we note that if (a) vertical integration shielded an underwriter from competition, (b) this led to its being less efficient and raised the integrated firm’s underwriting costs and (c) this effect outweighed the efficiency benefits of integration, then the distributor could profitably divest its underwriting business and source its underwriting business from third parties” (§36).

The Chicago School logic works under a rather narrow set of assumptions. In reality, integrated companies face obstacles to the perfectly efficient behaviour posited by the Chicago School. An integrated company is a set of managers who develop complex interrelationships. Established relationships, company politics and other strategic considerations such as tax planning can make it extremely difficult for a company to take the decision to divest under-performing subsidiaries. In reality, companies can tolerate significant under-performance before divesting. The under-performance can last several years before prompting divestiture. Incomplete information complicates matters. A tender process has the advantage of making poor performance highly visible, as several competitors offer a uniform product simultaneously. In an integrated company, an under-performing underwriter may resist going out to tender and often prevent this occurring, and then argue that external benchmarks are not directly comparable.

If there is significant market power downstream, then the integrated company will have a higher tolerance threshold for the underperformance of its underwriter. An increase in marginal costs leads the integrated monopolist to sell slightly less output but at a higher price. The price response is a mitigating factor to the higher marginal costs, which is not available to a competitive firm. The price response translates into consumer harm.

In more formal terms, the monopolist has an ability to move the price in a market, which is not available to a competitive firm. If the costs of a competitive firm are £1 per unit out of line with the industry, then the competitive firm will bear a loss of £1 per unit sold. Each pound in excess cost translates into £1 in loss because the competitive firm has absolutely no scope to move the market price. Now imagine a monopolist that has market power downstream, and that is vertically integrated. If the upstream subsidiary has costs that are £1 pound per unit out of line with the industry, the monopolist can decide to mitigate that loss by raising the price charged to consumers

downstream. In formal terms, the monopolist shifts the price of its products until marginal revenue is equal to marginal cost. As marginal cost increases, the monopolist maximizes profits by charging a higher price. Excess costs of £1 per unit output may still translate into some loss for the monopolist, but the loss would only be a certain fraction of the relative inefficiency. The ability to increase the price cushions the loss.

Unfortunately, consumers suffer in the process of a monopolist tolerating under-performance by its integrated underwriter. If it takes six years before the monopolist divests an unprofitable division, then consumers will suffer for the full six years. Finally when the monopolist completes the divestiture, and replaces its underwriter with an efficient provider, then its profit-maximizing price to consumers will fall to reflect the new-found efficiency.

Another reason exists to expect inefficiency among the integrated underwriters. The economics of divestiture entail a comparison of the integrated company's "avoidable costs" upstream against the price offers of independents. In this calculation the monopolist ignores the sunk costs of its integrated underwriter, while considering the return on capital that the independent underwriter would demand.¹ In an industry with substantial sunk costs, the independent's demand for a return will make its offer look unattractive. The integrated monopolist may not prefer divestiture even if its variable costs substantially exceed those of the independents. Divestiture would only look attractive if the integrated monopolist faced a moment where it had to renew most or all of its investment in the affiliate. At that point in time the independent's demand for a return on capital of its sunk costs would not present a comparative disadvantage in the divestiture equation. However, most industries are characterised by the continuous replenishment of investment. An incumbent monopolist is unlikely to face a specific point in time where it needs to replenish most or all its investment in the integrated affiliate. Nobel prize economists George Stiglitz and Dan McFadden published an important paper explaining how the presence of substantial sunk costs undermines the Chicago School theory.²

A significant body of economic literature has confirmed that monopolists tend to be inefficient.³ The inefficiency record of monopolies would not make sense if the Chicago School theory were correct. Under the Chicago School's logic, the market power of a company would have no consequence for its efficiency, because a company with any high-cost business unit would simply divest it and seek the same services or products from efficient alternatives. The poor performance of monopolists is support for the theory of harm from insufficient competitive pressure.

¹ This is not to say that the monopolist will graciously charge end-users a price that provides no return on capital.

² Stiglitz, G. McFadden, D. and Peltzman, S. "Technological Change, Sunk Costs and Competition" *Brookings Papers on Economic Activity* (vol. 1987), No. 3. The paper focussed on the "contestability theory" of the Chicago School, which is about potential entry into a market. The insight also applies to the Chicago School's reliance on the prospect of divestiture ensuring efficiency in a vertically integrated market. Professor McFadden is a principal of The Brattle Group.

³ Porter, M. *The Competitive Advantage of Nations* (The Free Press)(1990), pp. 71, 117-22, 169.

The Commission has already found a problem with significant downstream market power, which supports the prospect of insufficient competitive pressure on integrated underwriters. The Commission's current thinking is to define a series of individual markets such that each PPI distributor has a monopoly over its own credit customers at the point of sale."⁴ There is no greater example of market power than a monopoly. Perhaps the Commission trusts that applying remedies to the downstream market will naturally solve the issue of insufficient competitive pressure among underwriters. However, there are two problems with this approach. First, an inquiry into remedies belongs to a subsequent phase of the investigation, and should not cloud a diagnosis of consumer harm. Second, the Commission faces legal and practical constraints on its ability to impose remedies, and therefore cannot trust that it can convert a set of individual downstream monopolies into a perfectly competitive market.⁵ Furthermore, to fashion appropriate remedies from a limited set of available tools, it will be important to understand how downstream market power can have repercussions on integrated underwriters.

The Commission's generic Chicago School reasoning would have been available to the OFT in 2006. The OFT is clearly aware of the Chicago School approach, but still suspected that vertical integration "may reduce the level of direct competitive pressure" on integrated underwriters "in respect of rates or product design."⁶ The OFT never cited the possibility of divestiture creating sufficient competitive pressure. Since the Commission's conclusions rely on a generic theory, instead of the facts that have emerged in its investigation, it is hard to see the finding as an "emerging thinking" as opposed to an a priori position that is inconsistent with the OFT's expressed concerns.⁷

Most economists appreciate the insights of the Chicago School. They approach vertical integration cases as an exercise in determining the realism of the assumptions behind the Chicago School approach. The chief economist of the European Commission's competition directorate, Damien Neven, has recently endorsed this approach. The Commission in this case should explore whether the prospect of divestiture does in fact ensure sufficient competitive pressure. The Commission should be concerned that the prevalence of inefficiency among monopolists undermines the Chicago School theory, and should check in this case whether integrated underwriters are less efficient.

⁴ *Payment Protection Insurance Market Investigation: Emerging Thinking*, ¶175.

⁵ This is illustrated by the Extended Warranties case where the remedy which was most likely to be effective (package 2) was considered to be disproportionate and difficult to implement (citation).

⁶ *Payment Protection Insurance: Report on the Market Study and Proposed Decision to Make a Market Investigation Reference* (October 2006), ¶7.3.

⁷ The Commission cites the November 2007 sale by HSBC of its captive underwriter Hamilton to Aviva. However, the existence of one transaction in the history of the industry is not a serious empirical finding in support of the divestiture theory. The Commission has not disclosed any analysis of this transaction. The transaction could actually support the theory of insufficient competitive pressure if it was only a late response to an extended period of serious underperformance by Hamilton.

1.2 Innovation

The discussion above focused on the prospect of an integrated underwriter being less efficient, and the examples involved higher costs. The Commission also considers whether insufficient competitive pressure might lead to reduced levels of innovation. The Chicago School logic applies equally to the prospect of higher costs and insufficient innovation. Moreover, the inefficiency of monopolists has been confirmed both with respect to high costs and insufficient innovation. One text remarks that integration deprives a business activity “of market discipline that spurs innovation.”⁸ Professor Mota dedicates a section of his textbook on competition policy to the reduced incentives of monopolists to innovate. He cites empirical evidence and describes a simple theoretical model of reduced incentives.⁹

The Commission notes that independent underwriters seem to be good at specializing and offering unique products. These are demonstrations of innovation. The Commission attributes most of the innovation to the independent distributors rather than the underwriters. However, the role of the distributor does not undermine concerns over vertical integration. The distributor fuels innovation through the tender process, placing demands on the independent underwriters, and motivating them to respond. If the integrated companies held more tenders, then we might see significantly more innovation. The insufficient use of a tender process is the whole reason why integrated underwriters face insufficient competitive pressure. The Commission cites the scepticism of one market participant concerning potential tenders by integrated companies, but the market participant seemed to be expressing mistrust in the fairness of the outcome. This would be something to consider in any remedies phase of the proceedings, but is not relevant to vertical integration’s impact on consumers.

1.3 Low Participation Rates in Tenders

The Commission has uncovered evidence supporting concerns of insufficient competitive pressure. Unfortunately, the Commission discusses some of that evidence solely when addressing other theories of harm. The Commission first considers a theory that independent distributors might benefit from greater competition if the integrated firms were more active in tenders. In this discussion, the Commission notes the low participation rates of integrated underwriters when tendering for business. Integrated companies account for only 25% of bids in tenders, even though they handle 42% of the market based principally on the work handed to them by their affiliated distributors. The Commission never mentions that low participation rates are consistent with insufficient competitive pressure reducing the interest of integrated underwriters in bidding for outside work. An alternative scenario is that integrated underwriters would like to handle more outside work, but that insufficient competitive pressure causes them to perform relatively poorly, and they respond by avoiding tenders that they would not expect to win.

The Commission states that low participation in tenders does not provide compelling evidence against the efficiency theory of vertical integration. Conceivably vertical integration permits a firm

⁸ Sudarsanan, S. *Creating Value from Mergers and Acquisitions: the Challenges* (FT Prentice Hall) (2003), p. 143.

⁹ Mota, M., *Competition Policy: Theory and Practice* (Cambridge University Press)(2004), p. 58.

to avoid the transactions costs of writing and monitoring contracts that might not align incentives well. The Commission is correct in theory, but the relevant issue is not to reject or confirm the efficiency theory of vertical integration. Vertical integration can harm consumers even if companies originally integrated out of a desire to improve efficiency. Moreover, as I explain later, the evidence does not support the efficiency theory.

Even if companies save transaction costs by integrating, the savings are irrelevant to interpreting tender activity. A tender places all participants on an equal footing. An integrated underwriter may enjoy low transactions costs when dealing with its affiliated distribution business, but faces the same transactions costs as all other firms participating in a tender. An integrated underwriter should not anticipate performing worse at a tender than an independent one, unless the integrated underwriter has become inefficient due to the lack of sufficient competitive pressure for the majority of its business.

The Commission noted that the low participation of integrated underwriters may reflect their disadvantage when it comes to specialised products, which may be a particular preference of independent distributors. However, specialisation may be no more than a way of describing the responsiveness of independent underwriters to the particular tender requests of distributors. It would be troubling to see that integrated underwriters can only offer a standard product on attractive terms, unable to respond effectively when asked for variations. Ineffective responses to customised requests can be a logical consequence of insufficient competitive pressure.

The Commission identified another possible explanation why integrated underwriters do not participate much in tenders. Independent underwriters could have a comparative advantage in dealing with a number of different businesses. However, winning tenders with competitive offers is the way to get experience dealing with a variety of businesses. Lack of experience with different businesses may be nothing more than evidence of inadequate offers in previous tenders. It is inappropriate to cite a lack of experience as an excuse rather than the sign of a problem. Furthermore, an economist would naturally worry that “experience dealing with a variety of businesses” is an indirect way of describing an independent underwriter’s reputation for providing quality customer service. If there is strong competitive pressure within an integrated company, then the distribution affiliate should demand high service quality from the affiliated underwriter. If an integrated underwriter can provide high service quality to an affiliated business, then the underwriter should be able to repeat the success with others. If integrated underwriters lack a sufficient reputation for good service, the cause may be the lack of sufficient competitive pressure within integrated firms.

Of the various explanations offered for low participation rates in tenders, only one would not support the theory of insufficient competitive pressure. The Commission notes that “there may be at least perceived disadvantages to having a major supplier who is also a rival in the downstream market” (¶21(d)). However, the mere suggestion of such a possibility should not justify the abandonment of an inquiry into vertical integration. Whether competitive sensitivities deter participation in bids is an empirical matter amenable to investigation. The Commission could ask distributors if they prefer to avoid assigning work to integrated underwriters, or if the distributors deliberately exclude integrated underwriters from invitations to tender. If the Commission finds evidence of deliberate exclusion, it would then be relevant to determine whether the exclusion relates to a reputation for inefficiency or poor service quality, or to possible competitive sensitivities.

1.4 The Higher Prices Charged by Integrated Underwriters

To assess the theory of harm from insufficient competitive pressure, important empirical work would include a comparison of the prices charged by vertically integrated underwriters and independent underwriters. The Commission has commenced this analysis, which showed integrated underwriters charging far higher prices than independent firms (in fact some 43% higher). The initial findings should warrant further investigation.

The Commission expressed concerns about the reliability of its initial findings, noting that it had not controlled for possible differences in quality between the products offered by independent and integrated underwriters. The Commission's hesitance on this point is in tension with its willingness to rely on a comparison between just one large underwriter and one small one when assessing the issue of scale economies.¹⁰ Moreover, the theory of insufficient competitive pressure would raise concerns that the integrated underwriters offered lower quality products as well. This is not a case where the theory gives reason to believe that the unexplored empirical issues would mitigate the initial findings. The theory predicts that the initial findings may just get worse as the Commission explores the question of quality. It is therefore appropriate to carry the analysis to its conclusion.

It should be possible to understand whether the average product offered by the integrated company gives less complete coverage than the product offered by the independents. The relatively low number of firms in the industry should facilitate the task. If the independent product on average gives better coverage, then its lower price would only understate its superiority, and the Commission could conclude that vertical integration had reduced the competitive pressure on integrated underwriters. If the integrated underwriters offered superior coverage, then the remaining task would be to quantify the difference. In my experience, it has been feasible to quantify the value of differences in financial products to enable appropriate price comparisons. It would be interesting to know whether the Commission's reference to the possible specialization of independent underwriters was the result of any concrete analysis of the products outsourced by integrated companies. With access to the Commission's underlying data, I could assess the feasibility of such an analysis and would welcome an opportunity to discuss this.

1.5 Tensions with the Commission's Market Definition

Together the Commission's comments regarding specialisation and experience dealing with different business are in tension with its market definition. The Commission defined the upstream PPI market to include all types of PPI,¹¹ and also determined that integrated and independent underwriters competed in the same market.¹² According to the Commission, the "specialised" business is not in a separate market, nor is it a different market to cater to independent distributors. A tension arises if the Commission distinguishes between the businesses of integrated and

¹⁰ ¶26(b) (comparing Aviva's success in tenders to a smaller underwriter).

¹¹ *Payment Protection Insurance Market Investigation: Emerging Thinking*, ¶120-1 (p. 41).

¹² *The underwriting market*, ¶¶21-31.

independent underwriters to explain the low level of participation by integrated underwriters in tenders.

When deciding that integrated and independent underwriters were part of the same market, the Commission noted that “a number of the underwriters told us that there was no reason why a firm underwriting one type of PPI would not be able to underwrite all types of PPI policies.”¹³ The Commission also noted that “large underwriters typically underwrite several different types of PPI and most underwriters told us that they were willing to tender for PPI policies irrespective of whether they currently underwrite those policies.”¹⁴ The Commission’s findings in the underwriting paper would not excuse the low participation rate of integrated underwriters as a phenomenon of specialization. Based on the Commission’s underwriting paper, the low bidding rates of integrated underwriters would appear to reflect insufficient competitive pressure.

When discussing the prospect of insufficient innovation, the Commission states that it might expect to see some vendors compete on price and others on quality. However, different strategies for competition would suggest different markets, in tension with the Commission’s theory of a single upstream PPI market in the underwriting paper.

In its paper on the underwriting market, the Commission states that “there appear to be very few examples of integrated distributors switching to independent underwriters in practice,”¹⁵ which would suggest insufficient competitive pressure. However, the Commission’s paper on vertical integration does not mention the scarcity of switching.

The Commission discussed the concept of a SSNIP test when defining markets, and concluded that an integrated underwriter could not profitably sustain prices higher than an independent underwriter. However, in the vertical integration paper the Commission found that the average price charged by an independent underwriter was £13.76 per month, while the average integrated underwriter charged £19.64. According to the Commission, the integrated underwriter charged 43% more than the independents. The Commission never acknowledged that a 43% difference would easily pass a SSNIP test for defining separate markets. Moreover, the standard intellectual approach with the SSNIP is to start out with narrower market definitions and then progress with wider definitions until detecting the possibility of a sustained difference in price of more than 5% to 10%. Given the detection of a 43% price difference with a possibly narrower market definition, it is surprising to proceed to a broader definition without remarking upon the numbers. The significant differences between the two types of businesses would support close scrutiny of the 43% before drawing conclusions on market definition. Inter-group transfer pricing dominates one type of PPI business. The other relies exclusively on competitive tenders, arms length negotiations and detailed contracts.

In its vertical integration paper, the Commission expressed a lack of confidence in its numbers, opining that the price difference may reflect differences in the average quality of the products

¹³ *Ibid.*, ¶13 (footnote omitted).

¹⁴ *Ibid.*, ¶14 (footnote omitted).

¹⁵ *Ibid.*, ¶30.

offered. However, the Commission never recognized that quality differences would simply reinforce the notion of separate markets for independent and integrated underwriters. Perhaps it is legitimate for luxury perfumes to cost 43% more than the average perfume, but analysing the quality differential would confirm the existence of different product markets. Raising the price of the luxury perfume by 5% will not send consumers flocking to mass-market products.¹⁶ If quality differences among PPI policies explain the observed price differences, then the Commission will only confirm that competition among independent underwriters exerts insufficient competitive restraint on integrated ones.

Earlier I quoted the Commission's statement concerning the scarcity of examples where "integrated distributors switch to independent underwriters in practice." This is a statement of asymmetry in competitive constraints. Apparently competitive constraints may work in one direction, from integrated underwriters to independent ones, but not the other. An asymmetry in competitive constraints is consistent with the existence of a separate market, possibly explaining the observed 43% price differential.

To summarise, there is no easy way out of the finding of a 43% price difference between integrated and independent underwriters. If differences in quality explain the finding, then integrated and independent underwriters are not in the same market, and no extent of competition by independent underwriters can discipline the integrated ones. If an investigation confirms no difference in quality, then the enormous price difference signals a problem with insufficient competitive pressure due to vertical integration, despite the presence of independent and integrated underwriters in the same market.

Further empirical investigation in such a case is of critical importance to determine the type of competitive problem, which can have repercussions for the remedies. If there is no explanation for the 43% difference in price, and it applies to products of similar quality, then the problem appears to be one of vertical integration yielding insufficient competitive pressure. If, however, the integrated underwriters are offering a substantially higher quality at a higher price, then the Commission may conclude that there is a problem of foreclosing independent underwriters from a separate market, or that a problem exists with extremely high market concentration for the type of underwriting done by integrated companies.

The Commission states that some integrated distribution companies appear to contract up to half of their business from independent underwriters. However, two of the top five companies appear to contract only 20%. This is something that also invites further investigation. I find the data in tension with other statistics cited in the decision. I explain the tension in the appendix. The conclusions of the investigation may differ depending on whether the underwriting work tendered to independent companies is of the same quality and nature as the underwriting kept in-house. If the integrated issuers do indeed outsource only the "more unusual or more fringe products or services" (¶31) and keep the plain vanilla PPI in-house, this is highly suggestive of separate markets. At the very least this merits further investigation.

¹⁶ The European Commission defined a separate market for prestige perfumes in and mass-market perfumes in Case No. *COMP/M.4193 - L'Oreal / The Body Shop*.

1.6 Possible Causes of Vertical Integration

When discussing the possible causes of vertical integration, the Commission cited potential offsets to insufficient competitive pressure. The Commission cited the avoidance of “double-marginalization” and potential savings on the transaction costs associated with arms-length contracts that might not align incentives well between distributors and underwriters. The Commission repeats in several places the prospect of transaction costs savings. At one point the Commission discusses a specific possibility of transaction costs savings. If contracts are difficult to monitor, then, the Commission suggests, perhaps independent underwriters devote insufficient resources to checking the validity of claims submitted.

Transaction cost savings and the double-marginalization theory distract from the evaluation of potential harm from vertical integration. While in theory they could offset the effects of insufficient competitive pressure, the Commission should recognize that these issues only require investigation in two general cases: if the empirical investigation of insufficient competitive pressure does not yield clear results, or at the point that the Commission considers remedies.

If integrated underwriters systematically charge higher prices, then potential transaction cost savings and the avoidance of double-marginalization are evidently insufficient to protect consumers as a whole. The same concept applies to insufficient innovation. If it becomes clear that the independent underwriters lead innovation, then a problem appears to exist. Even if correct, the avoidance of transaction costs or double-marginalization does not address the problem of innovation.

If the evidence of insufficient competitive pressure is unclear, then it makes sense to consider the theories of double-marginalization and transaction cost savings. Since the Commission has found evidence of insufficient competitive pressure, the next step is to pursue the question concerning possible quality of service differences that could strengthen or cloud the analysis. Only afterwards might it be necessary to consider double-marginalization and transaction cost savings.

If the Commission eventually concludes that there is a problem involving insufficient competitive pressure, then the theories of transaction cost savings and double-marginalization will become relevant for a different purpose: to help determine appropriate remedies. If vertical integration has benign origins in the desire to avoid transaction costs or double marginalization, then the Commission should focus on remedies that address the competitive problem while retaining to the extent possible any benefits of vertical integration. If it appears that the only explanation for vertical integration was to extract value by eliminating competitive pressure from the underwriting business, then the trade-offs facing the choice of remedies will differ.

Even though the Commission’s discussion of double-marginalization and transaction cost savings was largely speculative and premature, I offer some thoughts on the two subjects below. The preliminary discussion in the Commission’s document tends to overstate the possible importance that these theories may have in the event of inconclusive evidence on the issue of competitive pressure, or in the eventual analysis of remedies.

Double-marginalization can be a problem when there is market power both upstream and downstream in a vertical chain, and each element of the chain therefore imposes a significant markup over variable costs. Together the two markups may exceed the optimal markup from an integrated perspective. Double-marginalization is not a compelling theory if the upstream industry

is competitive. The Commission has cited evidence of strong competition among independent underwriters in tenders, which undermines the double-marginalization argument. The Commission also recognizes that the multi-year contracts awarded in tenders can avoid double-marginalization problems.

The possibility of significant transaction costs savings seems speculative. The Commission fails to note that PPI is a type of product where contracts should and do work well. Contracts allow for an alignment of interests between the underwriter and distributor, for example by the use of profit sharing arrangements. The underwriting business is itself one of issuing and administering contracts on a large scale. It is natural that contract issuance and administration can be handled efficiently through a master contract between an independent underwriter and a distributor. The Commission discusses the theory that independent underwriters might devote insufficient resources to checking the validity of claims. However, independent distributors are sophisticated. They establish tenders with contractual provisions providing strong rights to monitor and audit the performance of the underwriter. Contracts tend to dominate in similar industries that the Commission has investigated, like extended warranties or store cards. Neither industry is dominated by vertical integration.

If the Commission has lingering doubts, it could assess the significance of any transaction cost savings. The Commission could ask independent distributors whether they have disputes with the tendering firms, or whether contracts have ended up in litigation or suffered early termination. The Commission could compare the transaction costs of conducting a tender against the volume of business handled by the winning firm. If the costs are a small fraction of the business handled, then it is difficult to believe that the transaction costs savings are significant.

2 Other Theories of Harm

Insufficient Bidding from Captive Underwriters

In theory, independent underwriters could lack sufficient competition from integrated underwriters. The Commission analyses the low participation rate of integrated underwriters in tenders. The Commission says that independent underwriters may have an advantage at specialization and in dealing with different businesses. Earlier I pointed out that these factors may reflect poorly on the integrated underwriters, demonstrating poor customer service or less responsiveness to specialized requests by distribution companies. If integrated distributors are poor competitors, then the possibility remains that the independent distributors themselves lack sufficient competitive pressure. However, the Commission makes a persuasive case that competition succeeds among independent underwriters without the need for active bidding by the integrated ones. The strongest evidence on this point is the high average number of offers in response to tenders.

No Opportunity to Bid for the Business of Integrated Distributors

The Commission considers whether independent underwriters might suffer from the lost opportunity to serve integrated distributors. The lost opportunity could in theory condemn independent underwriters to insufficient scale. The Commission considers the bidding success of a small independent underwriter compared to a large one. I cannot comment on the validity of the

analysis without access to the underlying data. Even a two-company comparison could be persuasive if the two companies had significantly different scale. However, I would also look at the growth and profitability of the smaller company. I would screen for the possibility that the smaller company might have higher costs, but accepts lower profits to win tenders in the hope of expanding market share and reaching efficient scale as soon as possible. In addition to checking the smaller company, I would want to review in general the range of sizes among industry players. I would examine whether the smaller companies have been around for a sustained time period or reflect new entry starting out small and hoping to grow. Although the Commission does not report any findings on these specific issues, in general the Commission's comparison between the large and the small company is a logical way of assessing the potential role of scale. As noted above, integrated underwriters do not participate in tenders as much as would be suggested by their size. Earlier I indicated that this finding is consistent with a lack of sufficient competitive pressure on integrated underwriters. Since the independent underwriters tend to be smaller than the integrated ones, the low participation rate in tenders is also consistent with the idea that scale is not important.

3 Further Empirical Work

The Commission should assess the differences in PPI products offered by integrated and independent underwriters. The assessment would shed light on the significant price differences observed. If the products are fundamentally different, then a choice would arise between two approaches. One would be to screen the data sample, to focus the price comparison only on comparable products. Another would be to assess the differences in the terms of PPI coverage. The simplest form of assessment would stop with a conclusion whether the independent underwriters offered more or less coverage than the independents. The Commission would then have either greater or less confidence in its preliminary finding of substantial price differences. A deeper assessment would proceed with a quantification of the costs associated with more or less coverage, to derive a more accurate comparison.

A second task is to investigate the “conflicts of interest” theory behind low participation rates in tenders. The Commission thought that integrated underwriters may participate less in tenders for fear that the independent distributors would not award work to an underwriter affiliated with a competing mortgage lender. Empirical investigation could confirm the theory. The Commission could ask independent mortgage brokers whether all tenders are indeed open to integrated underwriters, or whether the independent mortgage brokers consider the affiliation of an underwriter important when allocating work.

The Commission has noted significant variability in the percentage of underwriting that the large 5 banks assign to independents. The significant difference raises questions worth investigating. Furthermore, the data seem inconsistent with figures cited elsewhere. I discuss this issue in the Appendix.

If the investigation into insufficient competitive pressure produces results that are not clear, then the Commission could look at the theory of transaction costs savings from vertical integration.

Appendix: Market Share Data

I have calculated the market shares of the integrated and independent underwriters based on the figures from the Commission's *Emerging Thinking on Vertical Integration*. Data from different sections of the report do not appear to be consistent.

Paragraph 32 states that five major banks underwrite the PPI distribution business. The Commission asserts that “*in 2006 three of these companies underwrote 80 per cent or more of the PPI they distributed, whilst the other two underwrote less than 50 per cent of PPI they distributed*”. If all the banks distributed the same amount of PPI then integrated underwriters on average supplied well over 50% of the PPI sold by integrated distributors.

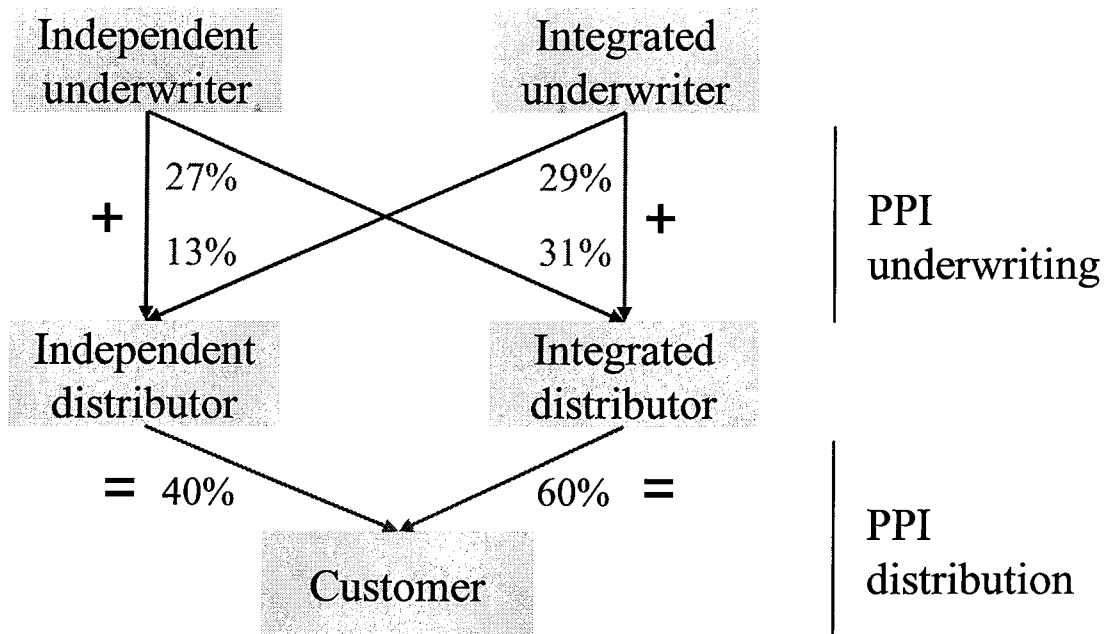
However, other figures suggest that overall integrated underwriters supplied only 48% of the PPI sold by their affiliated distributors. The only possible way to reconcile these two findings is if the two banks that underwrote less than 50% of their own PPI were large enough to outweigh the other three banks. Suppose that the two banks with the low underwriting shares underwrote only 40% of the PPI they distributed. To explain the 48% on average, the banks with the low underwriting shares would have to represent 80% of the PPI sold by integrated distributors ($48\% = 80\% \times 40\% + 20\% \times 80\%$). However, it seems unlikely that the two banks with low underwriting shares dominate the industry. The Commission has disclosed that RBS, one of the largest banking groups, apparently underwrites 100% of its PPI business through its captive (¶30).

Integrated underwriters supply both independent and integrated distributors. Similarly, independent underwriters supply both independent and integrated distributors (Fig. 1). Footnote 8 of the Commission's *Emerging Thinking on Vertical Integration* states that integrated distributors account for 60% of the PPI distribution business¹⁷. This means that independent distributors supply the remaining 40% of PPI.

Paragraph 18 notes that integrated underwriters supplied just over one third of all independent distributors' business. This means that integrated underwriters accounted for 13% ($40\% \times 33\%$) of all the PPI distributed while independent underwriters supplied integrated underwriters with 27% ($40\% \times 66\%$) of the PPI distributed. Figure 1 illustrates.

¹⁷ Footnote 8 on p. 11 reads: “Our own figures, based on returns to our questionnaire put the five major banks share of PPI underwriting at just over 40 per cent and their share of PPI distribution at just over 60 per cent.

Figure 1. Share of PPI Underwriting and Distribution



Paragraph 18 also states that integrated underwriters supply 42% of the total PPI distributed, of which we have just shown that 13% is supplied to independent distributors. Consequently, the remaining 29% (= 42% - 13%) must be supplied to integrated distributors. By deduction, the remaining 31% of the PPI supplied must be provided by independent underwriters to integrated distributors.

Under the Commission's figures, it follows that integrated underwriters supplied only 48% (= 29%/60%) of the PPI distributed by integrated distributors. As mentioned above, this finding seems implausible, implying that the two integrated banks that outsource the majority of their underwriting must be significantly larger than the other three. The numbers do not seem to be correct given that RBS is one of the largest banking groups and underwrites 100% of its PPI in-house.