

The profitability of PPI working paper

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Contents

	<i>Page</i>
Summary and conclusions	2
Profitability of PPI distribution	4
Background.....	4
The Market Economics Model	6
A revised model of market economic profitability	10
The share of premium income earned by distributors	11
Levels of interest income earned on PPI premiums	15
The operating costs associated with the distribution of PPI	17
The effect of PPI on impairment losses.....	21
The appropriate capital base and cost of capital for the PPI distribution activity.....	23
Results from the revised model of economic profitability	27
Corroborating evidence from board minutes and strategy documents	29
Conclusions on the profitability of PPI distribution.....	30
PPI distribution, combined with credit product	31
Conceptual background.....	31
Unsecured personal loans.....	32
Credit cards	39
First charge mortgages	41
Conclusions on the profitability of PPI distribution, combined with credit product	42
PPI underwriting.....	43
Introduction.....	43
Financial arrangements with distributors	43
Risk.....	45
Capital requirements.....	46
Financial performance of underwriting.....	47
Claims ratios.....	47
Return on capital	49
Evidence from economic models.....	51
Conclusions on the profitability of PPI underwriting.....	51

Summary and conclusions

1. This paper is based on analysis of material submitted by the main parties to the inquiry in response to our off-the-shelf information request, Market and Financial Questionnaire, and supplementary information requests; and meetings with four significant distributors.
2. During our review of the available material, we concentrated on three main areas of analysis:
 - the profitability of PPI distribution, considering PPI as an add-on product to the underlying credit product;
 - the profitability of PPI distribution, considering PPI and the underlying credit product on a combined basis; and
 - the profitability of PPI underwriting.
3. Since our terms of reference concern the supply of PPI, we believe that evidence relating to the profitability of PPI distribution as an add-on product to the underlying credit product is of direct relevance to our inquiry. However, given that many parties have raised issues in relation to the integrated nature of their businesses, and the common cost base, we also examined evidence on the profitability of PPI distribution together with the credit product.
4. We concentrated on the three main PPI products (personal loan, first charge mortgage and credit card). These products comprised a substantial proportion of the market in terms of gross written premiums (GWP).¹

¹In 2006, these three products made up 83 per cent of the GWP (48, 12 and 23 per cent respectively) underwritten by the largest six underwriters.

5. We looked at the profitability of PPI on an add-on basis, using a model of market economic profitability² supplied by one significant provider ([REDACTED]), a revised model incorporating certain amendments to that model, and evidence from board papers and strategy documents. The results of our own analysis and the material that we have seen from parties on the profitability of PPI as an add-on product consistently indicate that:

- Viewed as an add-on product, PPI distribution is highly profitable. Distributors earn a high proportion of the total income from PPI premiums and in comparison the additional costs incurred in selling PPI are low.
- The distribution of PPI is a low-risk activity for the distributor and consequently the additional capital required to support the PPI distribution business is relatively low.

6. We looked at the profitability of PPI combination with the underlying credit product, using a model of market economic profitability supplied by one significant provider; a range of board papers, strategy documents and analysts' reports; and financial data provided by the parties. The results were generally consistent. The results of our analysis on the profitability of PPI in combination with the underlying credit product suggest that:

- The personal loans business has suffered from declining profits in recent years to the point where in 2006 it appears to have been loss making before taking into account income from PPI. With PPI included, the sector appeared to have been marginally profitable. This appears to be a recent phenomenon: the evidence suggests that prior to 2005, the personal loans sector was profitable, even without PPI income.
- The credit card and mortgage sectors do not appear to have been as reliant on income from PPI in recent years. PPI penetration has historically been lower and

²[REDACTED] stated that it should be called a 'Market Economics Model and an economic profit and capital framework' as these are separate items, and the economic profit framework methodology had not been utilized in the Market Economics Model.

income from PPI generally less significant than for personal loans. The evidence that we have examined suggests that both sectors have been profitable over the last five years, even before taking into account income from PPI.

7. We are considering the implications of the findings in paragraphs 5 and 6 for our inquiry.
8. We looked at underwriting profitability, using a range of board papers, strategy and financial documents provided by the parties; and a model of market economic profitability supplied by one significant provider. This evidence suggested that:
 - a large share of GWP goes to distributors;
 - the insurance risk is borne by the underwriter, most notably because it would suffer any losses resulting from claims exceeding expectations;
 - regulatory capital requirements reflect the above risks; and
 - achieved returns on capital were generally in the range 10 to 20 per cent.
9. We concluded that, on balance, underwriters had not earned unreasonable returns on PPI. Taking this evidence in conjunction with other analysis of the underwriting market in Emerging Thinking, we do not intend to pursue this analysis any further.

Profitability of PPI distribution

Background

10. The CC guidelines³ state that it is normally helpful to consider the effectiveness of competition by examining the outcome of the competitive processes in the particular market. One of these outcomes is profitability. The section in the CC guidelines on profitability states that a situation where, persistently, profits are substantially in

³Market Investigation References: Competition Commission Guidelines, CC3, June 2003, paragraph 3.78.

excess of the cost of capital for firms that represent a substantial part of the market could be an indication of limitations in the competitive process.⁴

11. Most distributors said that it was not meaningful to assess the financial performance of PPI as an add-on product, as it was fundamentally and inextricably linked with the sale of the underlying credit product and there was no meaningful way of allocating the costs between them.
12. For management reporting purposes, the PPI income was generally reported alongside the interest and fee income and costs of the consumer finance business, or alternatively alongside income and underwriting costs from other forms of general insurance. No distributor had a separate management reporting entity for PPI.
13. Whilst we understood that for routine management reporting purposes PPI was not assessed as a separate profit centre, for the purposes of our inquiry we thought that considering any available information on the additional revenues and costs incurred in the distribution of PPI was a useful exercise. In particular, we thought that an assessment of the additional revenues generated, and the additional costs incurred, as a result of the sale of PPI could give a useful indicator of the state of, and nature of, competition in the market. However, for reasons relating to cost allocation explained in paragraph 11, we did not ask the distributors to create a hypothetical profit and loss account on this basis for the purpose of this inquiry. With this in mind, on reviewing the board minutes and supporting strategic planning material submitted to us as evidence, we did find some references to the profitability of PPI on an add-on basis. We also found that one significant provider had developed a model of market economic profitability for the retail banking business (called the 'Market Economics Model') which included PPI on an add-on basis. This model is discussed

⁴Ibid, paragraph 3.82.

below. The other evidence on the profitability of PPI on an add-on basis is discussed in paragraphs 24 to 79.

The Market Economics Model

14. One significant provider supplied us with a model (the Market Economics Model) that attempted to describe the economics of retail banking in the UK in its entirety, considering, among other products, [REDACTED] personal loans, credit cards, mortgages, and PPI (termed 'creditor insurance') as separate profit pools. Later versions of the model also include [REDACTED]. Within each product area, manufacturing (ie in the case of PPI, underwriting) and distribution can be analysed separately (although the provider told us that it no longer used this functionality). It told us that the model had first been developed in conjunction with a large consultancy firm ([REDACTED]) in [REDACTED], and that only limited or partial updates had been made in subsequent years. We looked at three versions of the model produced over several years, the most recent version produced in 2007.⁵ For ease of reference we refer to these versions of the model as the first version, the second version, and the 2007 version. We were told that the consultancy firm did not participate in the update of the model produced in 2007 but that it did amend a subsequent version of the model in [REDACTED] to change the way in which the model calculates equity to reflect the provider's economic capital framework.

15. The provider told us that the model had been commissioned with the aim of estimating the current position and future movements in economic profit pools within the UK retail banking market, as defined in the model. Each version of the model is designed to cover historic actuals, estimates for the current year, and forecasts for the following year and four years out. The provider said that the purpose of the model

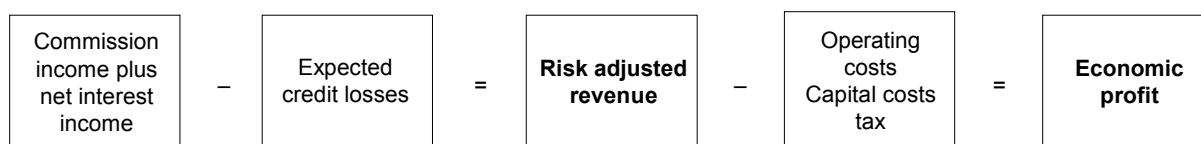
⁵[REDACTED]

was to assist its understanding of the economics of the market in order to compare them against its own position and help identify its differentiating capabilities and competitive advantage.

16. However, the provider said that whilst the model was originally designed to measure economic profit, the model had been updated since then and, since [redacted], had been used only to calculate the risk-adjusted revenue (RAR) of individual lines of business, because it had proved too difficult to allocate capital and other costs to individual lines of business. RAR is defined as income net of funding costs and impairments. Although we noted that in the 2007 version of the model the cost/income and capital allocation fields were still populated, the provider told us that these fields were no longer used and had not been maintained. The RAR calculations from the model are currently used as a backdrop to the development of the provider’s strategy, including medium-term plans and quarterly reviews. We also note that the provider’s retail bank has been the only division using the model, and it has not therefore been updated or refined in so far as it relates to other lines of business (for example, insurance underwriting).
17. Figure 1 illustrates the derivation of RAR and economic profit. For PPI distribution, the model calculates the RAR as simply the distributors’ revenue from PPI (in the form of commission and profit share⁶) and no credit losses are deducted.

FIGURE 1

Derivation of RAR and economic profit



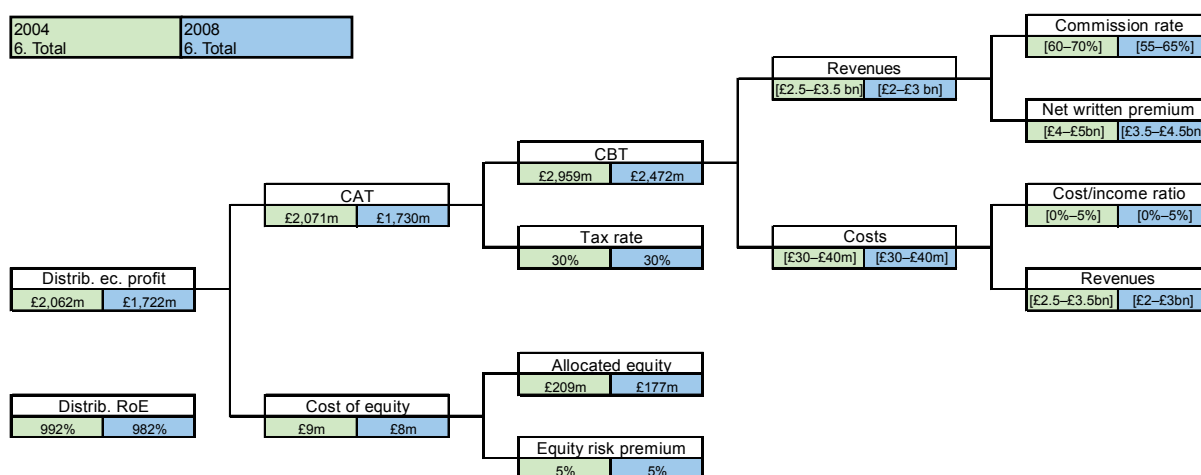
Source: CC based on information from [redacted].

⁶These revenues are described in more detail in paragraphs 113 to 118 on the financial arrangements between underwriters and distributors.

18. Figure 2 shows the derivation (from the second version of the model) of the 2004 actual and 2008 forecast economic profit in the PPI market. This covers PPI on unsecured personal loans and credit cards. The provider was unable to confirm whether the model also included PPI on mortgages.

FIGURE 2

PPI distribution: product economics (second version)



Source: [Market Economics Model].

19. Working from right to left in the above diagram, the model derives economic profit in the following way:

- (a) Revenues are calculated using estimated net written premiums⁷ for the whole market multiplied by estimated average market commission rates ([60–70] per cent in 2004, reducing to [55–65] per cent in 2008).
- (b) Costs are calculated using an estimated distributor cost/income ratio of [0–5] per cent on the assumption that the majority of costs are covered by the respective credit products.
- (c) Costs are deducted from revenues to arrive at contribution before tax (CBT) from which tax is deducted to arrive at contribution after tax (CAT).

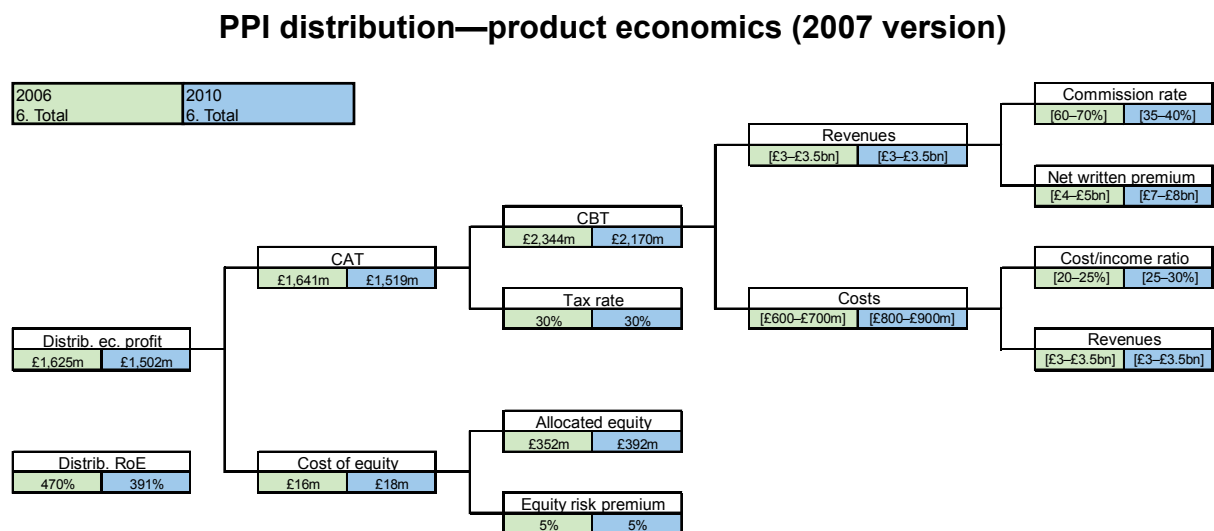
⁷Net written premium = GWP net of rebates and clawback. Clawback refers to the part of any commission received by a distributor of PPI which falls to be paid back to the underwriter, for example where the PPI on a loan is prepaid and the loan is repaid early and thus the PPI cancelled early, and a rebate paid.

- (d) Allocated equity is calculated with reference to operational and business risk factors. Operational risk capital is calculated at [5–10] per cent of revenues and business risk capital is allocated at [20–25] per cent of costs. The provider said that these risk capital allocation assumptions had been applied across the entire distribution business and were not specifically derived for PPI.
- (e) Allocated equity is then multiplied by the cost of capital to arrive at the cost of equity—in this case assumed to be purely the equity risk premium of 5 per cent on the basis that the invested capital can earn returns equivalent to the risk-free rate.
- (f) The cost of equity is deducted from CAT to arrive at Economic Profit.
20. The distributor return on equity (RoE) is calculated by dividing CAT by the allocated equity. The model computes RoE of 992 per cent in 2004 and 982 per cent in 2008. RoE can be compared with an estimate of the cost of equity. As a rule of thumb, we might estimate a post-tax cost of equity at 10 per cent. Clearly the RoEs, as calculated by the above model, are extremely high in comparison with any reasonable estimate of the cost of equity.
21. It is important to note, however, that this PPI distribution model does not include any costs associated with the operation of a branch network, for example staff costs, IT costs and property costs. Neither does it include marketing costs. On the basis that these costs would be incurred irrespective of the decision to sell PPI, they have been allocated to the respective credit products. Allocating any proportion of them to the sale of the PPI product would decrease the RoE.
22. We also note two omissions from the PPI model which, if included, would both increase the RoE. First, interest on PPI premiums is reflected within the loans model

and not within the PPI model. Secondly, any reduction in loan impairment as a result of PPI is not reflected in the PPI model.

23. An extract from the 2007 version of the model for PPI distribution is in Figure 3, showing 2006 estimated and 2010 forecast economic profits. The assumptions in this version are essentially the same as those in the earlier model with the exception of the cost/income ratio which is set at [20–25] per cent in 2006 (this was set at [0–5] per cent for all years in the previous version). The economic profits in 2006 are estimated at £1.6 billion and the RoE is calculated at 470 per cent. The provider told us that it did not use the output of the 2007 version to examine economic profits and used it only to estimate PPI revenues.

FIGURE 3



Source: [X] 2007 model.

A revised model of market economic profitability

24. We thought that the Market Economics Model provided a useful framework for the assessment of the profitability of PPI distribution on an add-on basis. However, we wanted to verify the inputs and assumptions used in the model and revise it to include certain revenue and costs that had not previously been included. We therefore revised the model of market economic profit from PPI distribution to include

certain amendments. In summary, the revised model attempts to measure the profitability of PPI distribution by considering all revenues and costs which are additional to those incurred in selling the underlying credit products.

25. Revisions to the model included:

- the share of premium income earned by distributors;
- levels of interest income earned on PPI premiums;
- the operating costs associated with the distribution of PPI;
- the effect of PPI on impairment losses; and
- the appropriate capital base and cost of capital for the PPI distribution activity.

26. We discuss each of these in turn below. The results of the model are summarized from paragraph 70 onwards.

The share of premium income earned by distributors

27. The distributor typically retains commission, expressed as a percentage of GWP, on each policy sold. GWP is recognized according to the term of the insurance contract entered into by the consumer. Where insurance cover is purchased for a specified period of time, eg three or five years to match the original term of the loan, the policy is known as 'single premium' and the full amount of the premium will be recognized as GWP at the commencement of the policy term. This holds irrespective of whether the policy is paid for up-front or in monthly instalments. In contrast, where insurance cover is typically purchased for one month at a time, these policies are known as 'regular premium' and for these the GWP is recognized on a monthly basis. Typically, PLPPI polices are single premium and CCPPI and MPPI policies are regular premium. The distributor accounts for commission income due on GWP. The distributor may also make a provision for expected refunds as a result of policy cancellations.

28. The distributor may also be entitled to a profit share payment in the event that the amount paid out in claims is less than expected. Profit share payments are normally made some time after the policies have been sold so that the claims experience can be observed. Such payments are normally not returnable and as a result the distributor records the entire sum as income when received. The distributor may also receive a share of any investment income earned on premiums and a share of any tax benefits received as a result of the specific tax regime applying to life business.
29. We looked at large contracts between underwriters and distributors in order to collect data on commission rates and the share of profit. We found that typical commission rates are 50 to 80 per cent for PLPPI and CCPPI and 40 to 65 per cent for MPPI. We also found that distributors typically take 90 per cent of any profit share, although we found instances where the distributor receives 100 per cent of any profit share after payout of claims. Annex A shows details of each contract that we looked at.
30. We collected data on the income (in the form of commission and profit share) that distributors received from the sale of PPI between 2002 and 2006. In the main, distributors were able to provide this information without undue difficulty as it was recorded separately in their accounts. However, some distributors could not provide figures for 2002 on a consistent basis: we therefore excluded this year from our analysis. We used data for 2003 to 2006 to calculate the percentage of GWP that the distributors received as income. These figures should be interpreted with caution as they can be affected by accounting timing differences (ie GWP being recognized in one period and income in another) and rebate provisions.⁸ Nevertheless the data in this table is useful as it corroborates other sources that we have examined (eg

⁸Accounting provisions may be made to cover future rebates of single premium PLPPI policies in the event that the loan is repaid early. Should actual rebate levels turn out to be lower than expected, provisions may be released in future years.

contract summaries and data from underwriters) to ascertain typical distributor income levels.

31. We were also conscious of the fact that some distributors are vertically integrated. In these circumstances the contract between the underwriter and distributor could not be assumed to be on an arm's-length basis. We looked carefully at the levels of income reported by the vertically integrated distributors to establish whether they were unusual in comparison with what we understood to be typical arm's-length arrangements. We noted, for example, that one significant vertically integrated provider's [redacted] distribution business received lower percentages of GWP under its contract with its in-house underwriting function than would typically be the case. [redacted] said that the commission level was set at [redacted] per cent to reflect comparable commission rates set at that time [redacted] across the industry and that it was in the process of reviewing the commission structure for its PPI products. For consistency purposes, the distributor provided us with group income figures on an aggregate basis rather than distributor income.⁹
32. Table 1 shows distributors' income from PPI in £ million and as a percentage of GWP for the period 2003 to 2006. On average, in 2006 income was 68 per cent of GWP. Income as a percentage of GWP was largest for CCPPI, at an average of 77 per cent in 2006, followed by PLPPI (66 per cent of GWP in 2006). Income as a percentage of GWP for first charge MPPI was lower at an average of 52 per cent of GWP in 2006. Income as a percentage of GWP had increased over the four-year period (2003 to 2006), particularly for CCPPI and PLPPI. However, we noted that distributors' total

⁹It said that due to its internal commission arrangements it believed that group income provided a more comprehensive and meaningful estimate of income for our purposes.

income from the sale of PPI was stable over the four-year period, at between £2.2 and £2.6 billion.¹⁰ Annex A shows a breakdown of these figures by distributor.

TABLE 1 Income from PPI: large distributors,* 2003 to 2006

	As % GWP			
	2003	2004	2005	2006
Personal loan	66	61	70	66
Credit card	73	78	79	77
First charge mortgage	53	50	49	52
Other types	44	46	54	58
All PPI	67	66	68	68
Total income (£m)	2,218.6	2,236.7	2,624.7	2,373.9

Source: CC based on information from distributors.

*Sub-category data excludes data from one large distributor [X] which was not able to provide accurate data by sub-category. All 2003 and 2004 figures exclude [X], another large distributor (see footnote 10).

33. We estimated that the average revenue earned by one significant provider at the point of sale of a single premium PLPPI policy was around £1,200.¹¹ The provider said that this was not a meaningful measure of income as ‘the approach to calculating the average revenue earned by the distributor on the sale of the sample PLPPI policy does not take into account matters such as customer rebates, commission clawbacks or other costs not mentioned in the draft text (e.g. costs which are common to selling credit and PPI)’.

34. We noted the provider’s comments and are collecting further information from distributors to confirm the magnitude and frequency of rebates given on PPI policies.

35. Nevertheless, our original figure stands as an estimate of revenue earned at the point of sale because rebates and commission clawbacks might not be incurred at all and if they were, would be incurred at some point in the future. We recognized that, as a

¹⁰Although we noted that total income figures for 2003 and 2004 did not include data from one large distributor ([X]) which was not able to provide data on a consistent basis for those years, we do not believe that this omission has a material effect on our conclusion that income was broadly stable over the period.

¹¹This figure was derived from internal documentation from [X] which suggested that the average loan protection premium sold through a branch was £[X] and the average distribution commission rate was [X] per cent. We multiplied these two numbers

revenue estimate, it did not, and we did not intend it to, include any deduction for the costs incurred in selling PPI.

36. Other distributors gave us estimates of the average revenue earned from the sale of a single premium PLPPI policy ranging from between £388 to £999. These estimates were generally calculated after taking into account the probability of making a partial refund of the premium in the event that the customer settled the loan early. The weighted average was £690. As a reasonableness check, we also calculated income per policy sold using data collected from distributors. This gave an average income per policy of £695 in 2006. See Annex A for more detail by distributor.

37. For the purposes of the revised model of PPI profitability, we calculated average distributor income levels, including commission and profit share, expressed as a percentage of GWP as follows: PPI—all types: 68 per cent; PLPPI: 66 per cent; CCPPI: 77 per cent; MPPI: 52 per cent. We based the revised model on actual income levels reported to us by main party distributors rather than contractual rates to ensure that we took rebates and clawback arrangements into account. The resulting figure for total PPI income of £2.4 billion as calculated by the revised model is therefore consistent with income reported to us by distributors as shown in Table 1.

Levels of interest income earned on PPI premiums

38. A stream of interest income results directly from the sale of PPI on personal loans and, to a lesser extent, credit cards. When a single premium PLPPI policy is sold, the distributor will typically add the premium to the total loan advance and charge interest on the total. Where PLPPI is paid in regular instalments, interest will not become due unless the account falls into arrears. With credit card PPI, PPI premiums are charged monthly based on the outstanding balance on the card. Unless the card holder clears

together to produce an estimate of the average revenue from selling a loan protection policy. It does not take into account any

the entire balance on a monthly basis, the PPI premiums will increase the interest payable. We asked distributors to estimate the amount of interest income that they had earned as a result of PPI premiums in 2006.

39. Distributors generally said that the interest on PPI premiums could not be specifically identified. The five largest distributors provided estimates of net interest income earned on PLPPI premiums in 2006 ranging from 10 to 18 per cent of GWP in 2006. We calculated net interest income in the model at 15 per cent of GWP based on the weighted average percentage estimated by the five largest distributors. See Annex A for more detail by distributor. However, we noted that an estimate based on the current year's GWP was not meaningful as a rate of return, since interest income was earned on policies sold in the current year and previous years. Nevertheless, we thought it provided a reasonable method of estimating aggregate interest income for the market. It might not provide a good estimate of interest income for an individual distributor if there had been a notable increase in the number or average value of single premium policies sold over last few years.
40. In theory, the inclusion of interest income in the revised model means that we should also include an allowance for expected credit losses, and other incremental costs, against that income. We have not done so in the model but do not believe it would have a material effect on the results.
41. Distributors told us that they did not earn significant amounts of interest on CCPPI premiums as these were paid by regular instalments and formed a small part of the overall balances on which interest was paid. Only four of the large distributors were able to estimate interest earned on CCPPI premiums. These distributors estimated a range of between 1 and 8 per cent of GWP in 2006 (£[redacted] and £[redacted]). We did not

additional interest that the distributor might earn from advancing additional sums to pay for the PPI policy.

include this in the revised model as we did not believe it would have a material effect on the results.

42. Distributors told us that they did not earn any interest income on MPPI premiums even if the mortgage was in arrears. This was because MPPI premiums were generally paid directly to the underwriter.

The operating costs associated with the distribution of PPI

43. The costs of supplying PPI are shared with the cost of supplying the underlying credit product, and fall into the following broad categories:
- property costs (eg branches, call centres, offices);
 - sales and administrative staff costs, including training;
 - IT costs;
 - marketing costs; and
 - head office functions, eg HR, legal.
44. Most distributors told us that they did not calculate the costs of supplying PPI separately from the cost of supplying credit, noting that most costs were common to the two sales and that they did not measure them because PPI was not viewed as a separate business. Whilst we recognize the difficulties of cost allocation, we have obtained some evidence about the costs of distributing PPI.
45. One distributor ([REDACTED]) calculated the costs of distributing PPI for us, based on information from its Activity Based Costing (ABC) system. The information it provided from this system showed the extra costs that it incurred as a result of providing PPI in addition to the costs that it incurred in selling the related credit product. The provider pointed out that since PPI was sold in conjunction with the related credit product, there was no single appropriate method of allocating the cost of selling the two

products separately. Moreover, it said that arguably there were no marginal costs associated with selling a single extra unit of PPI, since branch costs, staff costs, training costs, compliance costs etc were fixed in the short term.

46. However, the distributor operated an ABC model which it said could be used to derive an average unit cost of distributing PPI through its retail bank, on the assumption that the costs of selling PPI are the costs which are incremental to the costs of selling the related loan product. In broad terms it described the unit costing process as having two main stages: first, a transfer charging stage where group functions' costs are cascaded down to 'income-generating' business units, and secondly, an activity-based unit costing process involving the allocation of business unit costs to processes and products. The distributor told us that the transfer charging stage resulted in the entire £[redacted] cost base of the group being allocated to 'income-generating' business units. As an illustration it provided a cost schedule for its consumer lending business including personal loans, which is summarized in Table 2. This shows that direct costs made up less than 10 to 20 per cent of the total costs.

TABLE 2 Summary cost schedule for [redacted] consumer lending business, 2006

	£m	%
Direct costs	([redacted])	[redacted]
Total charges in		
Total direct and indirect costs		

Source: [redacted].

47. The direct costs and transfer charges for each business unit form inputs to the unit costing process, along with operational activity data, product volumes and other cost driver data. Therefore the resulting unit costs include all relevant operating expenses. However, the distributor said that the assumptions underpinning the model were updated most recently in 2003 and therefore did not take account of additional costs

arising since the introduction of the Financial Services Authority's (FSA's) Insurance Conduct of Business (ICOB) rules. In addition, it said that the costs were only those incurred by its retail banking division and did not take account of any costs incurred in other parts of the supply chain. Subject to these caveats, it said that the average costs of selling a PLPPI policy through all retail channels (branch, direct, Internet and telephony) was [between £20 and £60]. The distributor said that the average incremental¹² cost per new sale of PPI for the retail bank was as shown in Table 3.

TABLE 3 Average incremental cost per new sale in retail bank

	£	
PLPPI	[£]	[20–60]
CCPPI	[£]	[20–60]
MPPI sold through branches	[£]	[40–80]

Source: [£], based on unit costing data.

48. The distributor gave us the detailed cost card for a PLPPI product sold through its branch network.¹³ This showed a cost of [between £20 and £60]. The costs are subdivided into variable direct costs of £[£] and all other costs (fixed direct and indirect) of £[£]. The variable costs are defined as those resources or expenses whose consumption varies in a linear fashion with movements in the volume, and which can be changed in a 12-month period.
49. Another significant distributor, [£], also provided us with some estimates of the short-run incremental costs of distributing PPI in relation to its personal loans business. It looked at the expenses which were controlled by and charged directly to the loans business (for example, marketing expenses incurred in specific loans direct mailing activity, or remuneration relating to those people directly employed and controlled by the loans business). It then estimated the short-run incremental costs

¹²Incremental in the sense that it includes those costs that would be avoided in the long run if PPI were not sold.

¹³Source: [£].

incurred in the sale of PPI, ie those costs that could be avoided in the short run if PPI were not sold. Costs that were incurred regardless of whether a customer opted for PPI or not (eg postage costs) would not be allocated to PPI on this basis. Out of £[X] direct costs for the loans business in 2006, only £[X] (around 3 per cent) were judged to be short-run incremental costs incurred in the sale of PPI. [X] sold just over [X] PLPPI policies in 2006, which implies that the short-run incremental cost of selling each policy was under £3. This figure is considerably lower than the [X] figure but it must be borne in mind that this only relates to direct costs and excludes any indirect costs; [X] told us that the direct cost base was only a small part of the total cost base for loans. It also told us that it did not include any cost of selling activity through any of its branch, call centre or e-commerce channels. [X] told us that it had incurred additional annual costs estimated at £[X] as a result of the FSA's thematic work on PPI.¹⁴ The additional cost per policy is £9, resulting in an estimated short-run incremental cost incurred in the sale of PPI of £12. [X] said that these were initial estimates of short-run incremental costs and that any meaningful consideration of incremental cost would require detailed consideration of the totality of costs that would be avoided in the long run were PPI no longer provided.

50. We asked other distributors whether they had ABC systems. None had systems with the degree of granularity required to cost individual products. [X] and [X] had systems designed to allocate central costs to some extent but not to PPI. [X] did not have any form of ABC system, and [X] had no ABC system relating to PPI, although it did tell us that it was actively reviewing its cost modelling and was looking towards introducing some level of activity-based costing in [X].

¹⁴These costs relate to additional telephony sales resource reflecting a longer PPI sales process. [X] also estimated that it had incurred additional capital costs of around £[X] in making systems improvements.

51. We considered the degree to which the cost estimates provided by the distributor first mentioned in paragraph 45 might be representative of other distributors. First, we noted that the costs of between [£20 and £80] were relatively small in relation to the average distributor income from a PPI policy estimated at £690 (see paragraph 36). The variable direct cost of £[~~30~~] is even smaller. This means that even if different banks had much higher cost bases than this distributor or markedly different cost structures for PPI, this would be unlikely to affect our observation that the long-run average incremental costs were relatively small in relation to the average income derived.
52. In the revised model, we assume a cost per PPI policy sold of £100. This is higher than the fully-absorbed cost from the distributor above of between [£20 and £80]. It includes an allowance to take account of the additional costs incurred as a result of new FSA rules in relation to PPI, estimated at £9 per policy by [~~30~~]. It also includes a margin of error to allow for the possibility that other distributors had different cost bases or less efficient sales processes.

The effect of PPI on impairment losses

53. A further benefit accrues to distributors as a result of selling PPI on their credit products due to a reduction in credit risk and lower impairment losses. The fact that a proportion of debt is insured means that the distributor is, all things being equal, more likely to recover the debt than if it were not insured.
54. On this basis we would, in theory, want to take into account any benefit to the loan product in the form of reduced impairment losses. Although a number of the parties to the inquiry stated that credit losses would be higher in the absence of PPI, only a small number were able to quantify this benefit:

- [X] estimated that the provision rates would be 100 to 240 basis points¹⁵ (bps) higher (compared with a provision rate with PPI of 5 per cent in 2006). It modelled two scenarios: what the additional provisions would have been if bad debt charges had been incurred equal to the value of PLPPI claims paid; and what the additional provisions would have been if the total value of loans for successful claimants had been written off.
- [X] estimated a provision of up to 24 bps higher for personal loans (compared with a provision rate with PPI of 3.43 per cent in 2006). It is based on an assumption that all the cases which are being paid through insurance would enter into arrears in the absence of PPI.
- [X] gave us a best estimate of a provision of up to 15 bps higher for personal loans (compared with a provision rate with PPI of 4.7 per cent in 2006). This is based on the assumption that the PPI claims went towards reducing the provision by the same amount.

55. One significant main party, [X], stated that there was no intrinsic relationship between PPI and bad debt provision. It also stated that a review of the bad debt rate showed that on average customers who took PPI incurred higher bad debt than customers who did not. It believed that factors driving the difference included adverse selection and causes of bad debt such as over-commitment, bankruptcy, IVAs and relationship breakdown that were not covered by PPI.

56. Whilst we understood that PPI did not completely remove the risk of bad debt, we thought that, all things being equal, it would reduce the costs of bad debts to some extent. However, due to the uncertainties inherent in the estimation; the fact that only a handful of distributors were able to provide estimates; and the wide variation in

¹⁵One-hundredth of a percentage point.

those estimates; we were not able to quantify the benefit to distributors with sufficient confidence to reflect it in the revised model. Notwithstanding this, we believe that it represents a potentially significant advantage for distributors.

57. We are seeking further information about the effect of PPI on impairment charges.

The appropriate capital base and cost of capital for the PPI distribution activity

58. In the banking industry minimum levels of capital for regulated financial institutions are determined by the FSA. The FSA assesses each financial institution to establish the overall risk it poses to the health of the UK financial system. This includes assessing the impact a collapse of the firm would have on the market and the probability of such a collapse, by looking at a number of factors relating to the business risks and the control risks of the firm in question. The risk assessment results in an individual capital ratio (ICR) being determined for the firm. The ICR represents the minimum percentage of its risk-weighted assets that the firm was required to fund using Tier 1, 2 and 3 capital (defined below).
59. The FSA emphasized that the ICR did not simply prescribe the minimum level of equity. Only the Tier 1 element had to be equity (share capital and retained profits, or innovative tier 1 capital having substantially the characteristics of equity and limited to 15 per cent of Tier 1 capital). The Tier 2 element comprised long-term (minimum five-year or 'perpetual') subordinated debt and general and property revaluation reserves. Tier 3 comprised shorter-term (minimum two-year) debt and was available to support trading book positions only, ie not consumer debt. The capital base comprising the three tiers did not include certain items such as intangible assets, investments in subsidiaries and holdings in other banks' capital. Broadly, at least 50 per cent of the ICR had to be Tier 1, and dated (ie capital having a specified redemption date) Tier 2 could not exceed 50 per cent of Tier 1.

60. Under the regulatory regime in the UK prior to 1 January 2008, risk weightings were generally set at 100 per cent for unsecured consumer lending assets and 50 per cent for mortgage assets. The PPI distribution activity did not attract any specific regulatory capital requirement.
61. Basel 2 became effective in the UK from 1 January 2008. Under Pillar 1 of this regime, risk weightings differentiate more between assets types and credit counterparties as well as including an explicit recognition of operational risk. Under Pillar 2, banks also have a greater responsibility for assessing their own capital requirements taking into account a wider range of risk and qualitative factors than covered by Pillar 1. Under the current regulatory regime, therefore, PPI distribution might require some element of operational risk capital. The FSA told us that there were three main methodologies for measuring the Operational Risk Capital Charge:
- The Basic Indicator Approach (BIA).
 - The Standardised Approach (TSA).
 - The Advanced Measurement Approach (AMA).
62. Firms using BIA or TSA would be required to hold a percentage of commission income received from selling PPI as regulatory capital. The FSA said that this could be around 12 to 15 per cent of net income depending on the approach adopted. Firms using AMA were required to model their operational risks but there was not the direct link between sales income and capital charge evident in the BIA and TSA approaches.
63. In this context, one significant distributor told us that it had not found it necessary to attribute capital to individual product lines (such as the distribution of PPI) but instead attributed capital to individual business units.

64. Another significant distributor, [X], told us that its internal capital target was 12 per cent of risk-weighted assets. This target took into account regulatory guidance from the FSA and commercial judgement. [X] On this basis, it calculated its equity capital requirement at 6 per cent of risk-weighted assets. [X] told us that it estimated its pre-tax cost of equity at 12.5 per cent and that this was used as the notional capital charge across the [X] Group.
65. In paragraph 122 onwards we discuss the regulatory capital requirements for PPI underwriting.¹⁶
66. We considered the appropriate basis on which to assess the capital requirements of PPI distribution. One significant distributor told us that it had developed a framework for assessing capital requirements within its business (so-called 'economic capital') and were taking this down to product level where appropriate. This framework had been used in the second version of the Market Economics Model as discussed above. The distributor told us that its economic capital framework had been developed to provide a consistent method of measuring the capital requirements across a diverse range of businesses and activities; a measure of the total capital requirement for the group; and a means for including risk costs into profitability measures (such as economic profit and risk-adjusted return on capital). It said that the framework was the basis of its capital requirements assessment under Pillar 2 of the Basel II guidelines and was currently under discussion with the FSA.
67. The distributor told us that the economic capital requirement could be thought of as an internal measure of uncertainty or volatility in business outcomes. This uncertainty gives rise to a risk that the business cannot meet its obligations because of

¹⁶One provider told us that, for the distributor, regulatory capital was held at [X] per cent of commission income plus an amount of £[X] million held in lieu of PPI. We calculated that this was equivalent to 6 per cent of 2006 GWP.

unexpected losses. The economic capital requirement equals the 'unexpected loss', which is the estimated loss measured up to the point where there is only a [0–10] basis point ([0–0.1] per cent) chance of its being higher, less the long-run average expected loss. It assessed risk across a number of areas as follows:

- credit risk: the risk that the counter-party to a financial transaction will fail to perform according to the terms and conditions of the contract, thus causing a financial loss;
- market risk: the risk of loss from unanticipated adverse price changes in financial instruments, including interest rates, exchange rates, options and commodities;
- life/general insurance risk: uncertainty from unanticipated changes in the assumptions underlying the product design, including claim frequency and magnitude, mortality and morbidity rates;
- operational risk: the exposure to financial or other damage arising through unforeseen events of failure in the group's operational processes or systems; and
- business risk: the uncertainty in expected profits due to changes in the competitive or macro-economic environment that damage the franchise of operational economics of a business.

68. The distributor said that it used models of varying sophistication to determine the unexpected losses for each category or risk, although it noted that its capital allocation model did not provide a robust method for the allocation of capital to individual product lines. It also took into account any reduction in overall risk due to diversification. In the second version of the Market Economics Model, business risk capital is allocated at [20–25] per cent of costs; and operational risk capital is calculated at [5–10] per cent of revenues across all distribution activities, including PPI.

69. We considered that, although the Basel I regulatory capital requirements did not cover PPI, some capital should be allocated to the activity of PPI distribution for the

purposes of assessing economic profit. We thought that the framework developed by the distributor for the assessment of economic capital was useful in this respect. Other distributors said that they could not estimate the economic capital required to support PPI distribution. We thought it plausible that the PPI distribution activity did confer some degree of risk upon the distributor. In addition, having included a measure of interest income arising from sums advanced to cover PPI premiums, a certain amount of regulatory capital would be required as a result. We thought that the capital requirement for these risks might be quantified by using a percentage of total PPI revenues (including interest revenue). We therefore decided to use an estimate of 12 per cent of PPI income to reflect economic capital in respect of the PPI distribution activity. Whilst this methodology results in a considerably higher capital allocation than the distributor's second version of the model (2006: £315 million versus [£150 million - £200 million]), it is similar to the capital allocation in its 2007 model (2006: £352 million), and we believe that it represents a reasonable estimate given the uncertainty in this area. In paragraph 73 we conduct sensitivity analysis on this estimate.

Results from the revised model of economic profitability

70. Figure 4 is a schematic representation of the revised model of economic profitability for PPI distribution (including PLPPI, CCPPI and first-charge MPPI¹⁷), using the assumptions discussed in further detail above. The model calculates that the sector made economic profits of £1.5 billion in 2006 representing a RoE of 499 per cent.

¹⁷Second charge mortgages are not included.

For the economic profit to fall to zero, keeping all other variables the same, the equity allocation as a percentage of revenues would have to increase to 77 per cent.

74. Table 4 shows the results of varying both the cost per policy sold and the equity allocation as a percentage of revenue. At the extreme, if both the cost per policy sold and the equity allocation assumption are doubled, the RoE falls to 206 per cent. This figure is still way in excess of any reasonable estimate of the cost of equity.

TABLE 4 **Effect of cost and allocated equity on RoE**

	<i>per cent</i>			
Equity as % revenues	6	12	18	24
<i>Cost per policy sold</i>				
£50	1,081	541	360	270
£100	996	498	332	249
£150	911	456	304	228
£200	826	413	275	206

Source: CC analysis.

75. On the basis of the above model, including the assumptions discussed in paragraphs 25 to 54, our preliminary conclusion is that the PPI distribution sector is highly profitable. Commission levels are high in relation to the additional costs incurred in selling PPI and the additional capital requirements are low. The profits are sizeable; we estimated that £1.5 billion in economic profits had been earned in 2006.

Corroborating evidence from board minutes and strategy documents

76. Most distributors told us that PPI was not viewed as a separate business and was integrated with the sale of the credit product. Table 2 of our Emerging Thinking: Downstream Market Definition working paper summarizes testimony from PPI distributors on this issue. Notwithstanding this, from our review of board minutes and strategy documents we obtained some evidence that the banks regard PPI as a highly profitable product. Some quotes include: 'highly profitable market, large share

¹⁸Second charge mortgages, motor finance, retail credit, overdrafts, and other.

of value accrues to distribution’;¹⁹ ‘Current profit pool represents super-normal profitability’;²⁰ and ‘The PPI market has historically been very profitable’.²¹

77. It appears that firms involved in the underwriting of PPI also share this view. One significant underwriter, [X], stated in a presentation: ‘Creditor [insurance] highly profitable for distributors ... Selling the product reduces lender risk by reducing bad debts ... Lenders effectively subsidise lower interest rates through gaining on creditor commission ...’.
78. Another significant underwriter, [X], stated: ‘From a distributor perspective, the product is very profitable’.
79. We consider that this evidence lends support to the quantitative evidence described elsewhere in this paper.

Conclusions on the profitability of PPI distribution

80. In summary, we looked at the profitability of PPI on an add-on basis, using a model of market economic profitability supplied by one significant provider, a revised model incorporating certain amendments to that model, and evidence from board papers and strategy documents. The results of our own analysis and the material that we have seen from parties on the profitability of PPI as an add-on product consistently indicate that:
- When viewed as an add-on product, PPI distribution is highly profitable. Distributors earn a high proportion of the total income from PPI premiums and in comparison the additional costs incurred in selling PPI are low.

¹⁹[X]

²⁰[X]

²¹[X] told us that this statement referred to the contribution of revenue of PPI for the whole group.

- The sale of PPI is a low-risk activity for the distributor and consequently the additional capital required to support the PPI distribution business is relatively low.

PPI distribution, combined with credit product

Conceptual background

81. Distributors told us that there were a number of reasons why PPI should not be viewed in isolation but rather considered alongside the sale of the credit product. Table 2 of our Emerging Thinking: Downstream Market Definition working paper summarizes other testimony from PPI distributors on this issue.
82. The following are some representative quotes from responses to the Market and Financial Questionnaire: ‘Our PPI business is fully integrated with our lending business in respect of reporting and customer facing aspects and is not treated as a stand-alone business’; ‘[X] PPI business is focused on the distribution of PPI in conjunction with the credit products we offer. It is not operated as a separate business but is an integral part of our credit business’; ‘PPI is seen as an integral part of [X] mortgage, loan, and credit card offerings. The product is sold alongside the associated consumer credit products through the same distribution channels and is managed as part of the wider credit offering to customers’; and ‘PPI sales are strongly driven by sales of the associated credit product. The commonality of costs between sales of the two products; and the extent of economies of scope between the two products, means that an allocation of costs between the two products is essentially arbitrary.’
83. Since the banks are generally²² organized on a business-line basis, information on income and direct costs is readily available on this basis. However, banks do not routinely allocate shared or central costs (or capital) to business lines, meaning that

profit and loss account information goes only as far as contribution before tax (CBT). This is a measure of a business line's contribution to the shared costs of the business. A further allocation of shared and central costs and capital would be needed to provide a measure of economic profit. The evidence in this section therefore concentrates on ad-hoc analysis that does include some allocation of shared and central costs.

84. In view of these arguments, we decided to examine the profitability of PPI and the underlying credit product when combined together as one business. We looked separately at three major product areas with which PPI is sold: unsecured personal loans; first charge mortgages; and credit cards. We discuss each of these in turn below.

Unsecured personal loans

85. Several firms put it to us that their personal loans business would have been unprofitable without income from PPI. One provider, for example, told us that the pricing of loans and PPI was interdependent:

'Since the products are sold together, and on a portfolio basis, the pricing of them is interdependent, it is most useful to view the costs and revenues associated with the sales of the two products in aggregate.

The disparity in margins earned on the two products separately is particularly marked in unsecured lending. Here, margins on credit products—when the lending book as a whole is considered—are lower than they would be in the absence of the revenue generated from associated PPI sales. Competitive pressure has forced loan rates down to very low levels, primarily because consumers are initially attracted to lenders on the basis of headline APRs. Such APR levels are only

²²HSBC is an exception to this. It organizes itself according to customer groups.

sustainable if margins from subsequent PPI sales are also taken into account. For example, in 2006, [X] total loans book generated a loss before tax of [£180–£200 million]. [PLPPI] generated profit before tax of [£200–£260 million], giving total profit before tax (for the loan book plus [PLPPI]) of [£20–£60 million], as reported in the [X] Report. This suggests that—in the absence of PPI sales—the loan book would need to be re-priced in order to generate profit for

‘Although such an approach to pricing is not ideal, it is difficult for an individual credit provider to alter the balance of pricing. As customer attention is—at least primarily—focussed on credit rates, a single provider offering a portfolio of products where credit rates and PPI prices have been ‘rebalanced’ would be likely to lose customers.

‘The key feature which underpins pricing across the various credit products on offer is that the pricing of PPI, on a portfolio basis, is inextricably linked to the pricing of the associated credit offering.’

86. Another significant distributor, [X], made similar points:

‘Pricing of Creditor Insurance invariably acts as a cross-subsidy enabling lower lending rates.

‘...increasing commoditisation of lending products which has led to the increased cross-subsidy from insurance to lending, with the loan being used as a ‘loss-leader’ to sell insurance’

It pointed out that this was in the context of consumer buying behaviour since the consumer’s choice of provider was dominated by that of the underlying loan. Therefore loan providers considered the lending and PPI as a combined product set and attempted to optimise sales and profitability across the combination.

87. Another significant distributor, [REDACTED], stated in internal documentation that 'Within the direct loan environment certain competitors leverage higher PPI pricing to reduce headline APRs'.
88. We examined evidence in relation to the following questions:
- (a) whether the unsecured personal loan sector, including PPI, has been profitable for providers over the five years between 2002 and 2006; and
 - (b) whether the unsecured personal loan sector would have been profitable for providers had they had no income from PPI (all other things being equal).
89. One significant distributor, [REDACTED], engaged a strategy and management consulting firm, [REDACTED], to undertake a report on its unsecured personal loans business.²³ This showed a performance decline between 2003 and 2006 as measured by profit before tax (PBT) and economic profit. For example, economic profit fell by around 80 per cent between 2004 and 2006 [REDACTED].²⁴ The reasons for the performance decline included:
- (a) declining net interest margin²⁵ (headline APRs down, funding costs up);
 - (b) declining loan volumes;
 - (c) declining PPI penetration rates; and
 - (d) declining credit quality (resulting in increased impairment charges).
90. Another part of its report included an assessment of the strategic situation of the significant distributor compared with the other large market participants. The main findings were that the unsecured lending market was economically unprofitable in aggregate but that the significant distributor was advantaged relative to other market participants due to higher penetration of PPI. It estimated that the market as a whole was only marginally profitable in 2005 (an economic profit margin of 2 per cent or

²³[REDACTED]

²⁴Restated on a comparable basis with IFRS.

²⁵Net interest margin is the average interest rate charged less the average funding cost.

aggregate economic profits of £75 million) and would make economic losses in 2006 (an economic profit margin of –10 per cent).

91. Another significant distributor, [X], had in the past developed a simple model attempting to illustrate the impact of PPI on the profitability of unsecured personal loans and first charge mortgages. [X] The model showed that at zero penetration the loan and mortgage book would earn around 10 and 6 per cent RoE respectively, rising to 36 and 10 per cent at 100 per cent penetration. This was used to support the point that the performance of unsecured personal loans and mortgage products produced lower RoE without the insurance cross-sell.
92. Another significant distributor, [X], in an internal review of its personal loans business, stated that ‘PPI penetration is key to maintaining loan profitability’. As shown in Table 5, PBT and economic profit for loans and PPI was calculated separately by [X] for the purposes of the review and showed that on an aggregate basis the business made an economic loss in 2006 of over £30 million ([X]). Without PPI, the loans would have made an economic loss of over five times that figure ([X]).
93. Not all [X] loan brands appear to have been unprofitable, however. An examination of one of [X] major personal loan brands ([X]) indicates that it made an economic profit on an aggregate basis (with PPI income included): ‘while [X] is EP positive this is purely as a result of PPI income’.

TABLE 5 Sources of PBT and EP (group view)

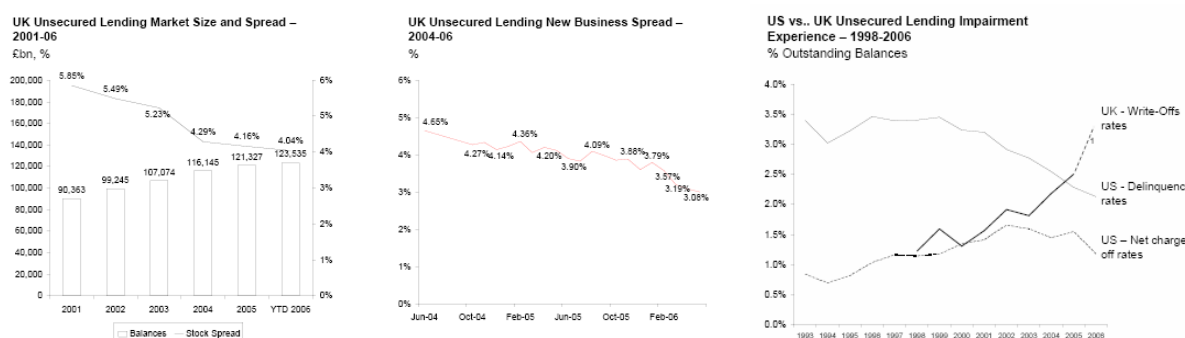
	PBT		CAGR % (2006–2009)	EP	
	2006	2009 goal		2006	2009 goal
Loan					
PPI					
Total					

Source: [X].

94. Further extracts from the distributor's [REDACTED] internal documentation illustrate three key trends in the unsecured lending market; first, declining net interest margins on the loan book as a whole and on new business; secondly, slowing growth in total lending; and thirdly, increasing levels of impairment.

FIGURE 5

Data on UK unsecured lending



Source: [redacted].

95. The same distributor, [redacted], estimated that the economic profits of the unsecured personal loans market as a whole in 2006 ranged from £270 million to £1.39 billion (including PPI income). Without PPI, [redacted] estimated that the personal loans market would have made an economic loss of between £1 and £2 billion in 2006.²⁶ It distinguished between ‘Captive’ and ‘Open’ segments of the market; broadly speaking, Captive being those lenders with existing relationships with current account customers (eg the five large clearing banks: Barclays, HBOS, HSBC, Lloyds TSB, RBSG); Open being all other lenders. It noted that the Open market was considerably less profitable than the Captive market due to lower net interest margins, lower PPI penetration, and poorer quality risk and impairment data.

96. We looked at the second version of the model referred to in paragraph 14 above, which considered the economics of PPI separately from those of personal loans (see above for further details). This model suggests that the market as a whole for personal loans without PPI income was profitable in 2004, earning an RoE of 14 per cent, but was forecast to make an economic loss and earn an RoE of 2.5 per cent in 2008 (likely to be below the cost of capital).

97. The 2007 version of the model considered RAR for the loans market. This was calculated as net interest income and fee income less impairment charges. It does not take into account operating costs or the costs of any regulatory or economic capital required to operate the business. Even before these additional costs are taken into account, the model indicates that the personal loans market was loss-making without PPI in 2006 and forecast to be so in future years. The situation with PPI income included cannot be derived directly from the model but can be estimated. On this basis, we calculated that on a combined basis, risk-adjusted revenue for the personal loans market was positive (albeit marginally so in 2006 to 2008) for all years, as shown in Table 6.²⁷

TABLE 6 Risk-adjusted revenues, personal loans

	<i>£ million</i>			
	2006	2007	2008	2011
<i>Personal loans</i>				
Income	[]			
Provisions	[]			
RAR		[-1,600 to -1,800]		[-1,200 to -1,400]
<i>PPI (personal loans and credit cards)</i>				
Income	[]			
Provisions	[]			
RAR		[2,900-3,100]		
Personal loan share (%) (CC estimate)	61	61	61	61
Estimated RAR from personal loan PPI		[1,800-2,000]		
Estimated RAR on loans and PPI combined		[0-200]		[400-500]

Source: CC based on [] Market Economics Model 2007.

98. In order to augment the market estimates from [] and [], we asked other lenders to provide some high level data on their personal loans businesses. In particular, we asked lenders to supply us with the average net interest margin and average provision rate on their total book of personal loans outstanding in 2006. Theoretically,

²⁶We note that these ranges are wide and include differing assumptions on the methodology for impairment calculation and expected PPI penetration rates.

²⁷The provider told us that it only used the outputs of the model to the nearest £0.1 billion.

if the difference between these two margins is close to zero or negative, the loans book in totality was unprofitable before taking into account income from PPI. The results were as shown in Table 7.

TABLE 7 Unsecured personal loans, weighted average margins (excluding PPI)

Large distributors: weighted average margins as % balances

	2006 %
Net interest	4.02
Provisions	5.30
Difference	-1.28

Source: CC based on information from distributors.

99. In summary, we looked at various sources of evidence on the profitability of the unsecured personal loans sector. There appears to be firm evidence that the personal loans sector was unprofitable in 2006 before taking into account income from PPI. When PPI income is included, the evidence suggests that the sector was profitable. Much of the evidence (with the exception of [§]) points towards the profits being relatively marginal, even when PPI is included. This is a recent phenomenon: the evidence suggests that prior to 2005, the personal loans sector was profitable, even without PPI income.

Credit cards

100. None of the parties said that their credit cards business would have been loss making without revenues from PPI. Nor did we find any prima facie evidence of this from our reading of parties' documents provided, such as board papers, strategy documents and management accounts.

101. We looked at the second version of the model referred to in paragraph 14 above, which considered the economics of PPI separately from those of credit cards. This version of the model suggested that the market as a whole for credit cards (without

PPI income) was profitable in 2004, earning an RoE of 35 per cent, declining to 25 per cent in 2008.

102. The 2007 version of the model calculated RAR for the credit cards market. As with the personal loans business, the situation with PPI income cannot be derived directly from the model but can be estimated. On this basis, we calculated that risk-adjusted revenue for the credit card market was positive for all years, both with and without PPI income, as shown in Table 8.²⁸

TABLE 8 Risk-adjusted revenues, credit cards

	£ million			
	2006	2007	2008	2011
<i>Credit cards</i>				
Income	⌘	⌘	⌘	⌘
Provisions	⌘	⌘	⌘	⌘
RAR	[3,600–3,800]		[3,800–4,000]	[4,000–4,200]
<i>PPI (personal loans and credit cards)</i>				
Income	⌘	⌘	⌘	⌘
Provisions	⌘	⌘	⌘	⌘
RAR		[2,900–3,100]		
Credit cards share (%) (CC estimate)	39	39	39	39
Estimated RAR from credit cards PPI		[1,000–1,200]		
Estimated RAR on credit cards and PPI combined		[4,800–5,000]		[5,200–5,400]

Source: CC based on [⌘] Market Economics Model 2007.

103. We noted that credit card providers also earn a significant amount of income by way of interchange fees, product fees²⁹ and other charges such as late payment charges. The second version of the model (referred to in paragraph 101) estimated this additional income at £2.5 billion in 2006. This augments the £3.3 billion of net interest income received in 2006.

²⁸The provider told us that it only used the outputs of the model to the nearest £0.1 billion.

²⁹Some providers charge an annual fee for the use of the credit card.

104. We also found evidence on net interest margins and provision rates for the UK credit cards market as a whole in a recent equity analyst's note on Lloyds TSB.³⁰ These were 12 and 7 per cent for 2006 respectively, ie a difference of 5 per cent. This is comparable to the 2006 figures we saw in the second version of the model referred to in paragraph 101, which showed a difference of 4.5 per cent.
105. In summary, we looked at two sources of evidence on the profitability of the credit cards sector. The evidence we have seen shows that the credit cards business was already profitable in 2006 before taking into account income from PPI.

First charge mortgages

106. No distributor said that its mortgage business would have been loss making without revenues from PPI. Nor did we find any prima facie evidence of this from our reading of parties' documents provided, such as board papers, strategy documents and management accounts.
107. We looked at the second version of the Market Economics Model referred to in paragraph 14 above which considers the economics of mortgages separately from those of PPI. This model suggests that the market as a whole for mortgages (without PPI income) was profitable in 2004, earning a RoE of 13 per cent, with broadly the same levels of profitability forecast between 2004 and 2008.
108. As with the personal loans market, we also looked at the 2007 version of the model which estimates that the mortgage market has positive risk adjusted revenues (see paragraph 97), as shown in Table 9. Although this does not take into account operating costs or the costs of any regulatory or economic capital

³⁰Lloyds TSB—When the winds stop' written by Fox-Pitt, Kelton and dated 2 February 2007.

required to operate the business, these figures are clearly in contrast to the personal loans market's negative risk adjusted revenues.³¹

TABLE 9 Risk adjusted revenues, mortgages

	<i>Financial performance, £ million</i>				
	2006	2007	2008	2009	2010
Income	✂		✂		✂
Provisions	✂		✂		✂
RAR	[7,600–7,800]		[8,400–8,600]		[7,900–8,100]

Source: CC based on [✂] Market Economics Model 2007.

109. In summary, the evidence we have seen shows that the mortgage lending business was already profitable in 2006 before taking into account income from PPI.

Conclusions on the profitability of PPI distribution, combined with credit product

110. We looked at the profitability of PPI distribution combined with the underlying credit product, using a model of market economic profitability which we have described in paragraphs 14 to 23; a range of board papers, strategy documents and analysts' reports; and financial data provided by the parties. The results were generally consistent. The results of our analysis on the profitability of PPI in combination with the underlying credit product suggest that:

- The personal loans business has suffered from declining profits in recent years to the point where in 2006 it appears to have been loss making before taking into account income from PPI. With PPI included, the sector appeared to have been marginally profitable. This appears to be a recent phenomenon: the evidence suggests that prior to 2005, the personal loans sector was profitable, even without PPI income.

³¹The provider told us that it only used the outputs of the model to the nearest £0.1 billion.

- The credit card and mortgage sectors do not appear to have been as reliant on income from PPI in recent years. PPI penetration has historically been lower and income from PPI generally less significant than for personal loans. The evidence that we have examined suggests that both sectors have been profitable over the last five years even before taking into account income from PPI.

PPI underwriting

Introduction

111. As an underwriter, a firm typically fulfils the following functions:
- (a) risk underwriting;
 - (b) claims handling, although this is sometimes outsourced to a third party administrator (TPA);
 - (c) claims payments to policy holders;
 - (d) policy administration, including record keeping, scheme corporate governance (in conjunction with the distributor), and policy preparation and issuance;
 - (e) some input into product design; and
 - (f) complaints handling.
112. Some underwriters also provide additional services such as a 'back to work service' which may provide advice on finding a new job, or physiotherapy in the case of accident and sickness claims for soft tissue injuries. The commercial rationale for these additional services is to assist the customer in returning to work sooner, which would shorten the period over which the underwriter pays out in claims to customers.

Financial arrangements with distributors

113. Arrangements between underwriters and distributors are negotiated contract by contract and as such differ in various respects. Set out below is what we understand to be the typical contractual arrangements in this industry.

114. The underwriter keeps the GWP less the amount due to the distributor as commission. For single premium policies only (where all the premium is paid upfront), the premium is added to an unearned premium reserve to allow the premium to be earned over the full term of the policy. The underwriter's portion of any subsequent rebates from early cancellations is paid from this reserve.
115. Using experience and actuarial analysis of previous claims patterns and views on future performance, the underwriter calculates a reserve for future claims, sometimes known as the risk premium. This reserve is reviewed regularly to ensure that it is sufficient to pay out future claims. There may be a significant amount of time between the end of the contract with a particular distributor and final payout of claims, for example due to some payments being made on policies for the full length of the loan term, or late reported claims.
116. The underwriter's retention is normally specified in the contract as a fixed percentage of GWP or earned premium, or as a monetary amount. The retention is designed to cover the underwriter's administration costs and a return on capital.
117. Most contracts have some sort of profit share arrangement, whereby any profit, equal to earned premiums less commission paid, claims paid and retention, is split between the underwriter and the distributor according to an agreed profit share percentage. Typical splits are 90 per cent in favour of the distributor although we have seen instances where the distributor receives 100 per cent of any profit share. The distributor's profit share payments are typically made on an annual or quarterly basis.
118. A separate profit share may apply to any investment income earned by the underwriter on premium income. Single premium policies generate higher investment income than regular premium policies as the single premium policy is paid for up-

front. From the figures provided by each underwriter, investment income was between 4 and 5 per cent of total income between 2002 and 2006.

Risk

119. In general, our review of contracts and responses from the parties indicates that the insurance risk is borne by the underwriter, at least in the short term (see paragraph 120).³² The distributor suffers the risk of commission and profit share income streams being lower than otherwise rather than actual losses, and thus lower than anticipated profits. We note the following:

- (a) In the event that claims exceed expectations, any loss is first offset from future profit share. If future profit share is also negative or if the contract has come to an end and the distributor decides to move the business to another underwriter, then the underwriter will bear all of the loss.
- (b) An underwriter is contractually bound to meet all valid claims and thus theoretically there is no limit to an underwriter's losses, subject to the terms and conditions of the policies. These losses cannot be met out of commission payments.
- (c) An underwriter's downside is unlimited whereas its upside is limited to a small portion of profit share and investment income. A distributor's downside is limited to reduced or no profit share, but it will not share in the losses suffered by the underwriter, and its upside is unlimited: the larger portion of profit share and investment income accrues to the distributor. One underwriter ([X]) told us that the contracts were 'designed so as to largely immunise the distributor against adverse claims experience', in other words to allow a buffer for deterioration in claims experience.

³²One life insurer told us that credit life contracts involved the insurance risk increasing for the underwriter with time, with the distributor subject to more risk in the short term.

120. However, we note that the underwriter often has the contractual right to adjust the existing terms of the agreement with the distributor, for example by increasing rates (ie prices) on monthly-paid policies, reducing commission rates or changing the terms and conditions of the policy, with an appropriate notice period. For example, a London General Insurance contract contains a clause which allows the underwriter to increase the price to the customer, with the aim of getting certain loss ratios back within specified limits within six months of the increase.
121. Underwriters told us that in the last five years claims have generally not been higher than the amounts reserved to pay for them and thus this situation has not actually arisen. One distributor ([REDACTED]) told us that the insurer did have the right to amend terms for future policies with a notice period (usually 90 days) but that it was far more likely that terms would remain unchanged and the provisions of a 'continuation clause' would be applied. This effectively ensures that the losses are recovered through natural means and if necessary the contract would be extended to allow time for this to happen, which it did in the late 1980s and early 1990s, and this practice was deemed preferable to increasing rates for the period concerned.

Capital requirements

122. Regulatory capital requirements for PPI underwriting follow the same principles and rules as for any other insurance business in the UK. These are complex and what is set out here is a summary. The main point of note is that the capital requirement for PPI underwriting is significantly higher than the capital required for PPI distribution.
123. In general terms, insurers have to hold minimum capital requirements assessed on two complementary bases, one which is prescribed by the FSA (Pillar I) and one which is self-assessment according to insurers' own views on risks (Pillar II).

124. The regulatory capital for most PPI business comprises a statutory minimum solvency margin and the statutory reserves calculated on a Pillar I basis. For non-life insurers, Pillar I capital for PPI is usually based on a proportion of premium income reduced for any outwards reinsurance. The proportions are 18 per cent, falling to 16 per cent above a certain level of premium income. Historically the FSA has encouraged firms to hold more than this minimum level and an additional 50 per cent or even 100 per cent have been held by UK insurers. For example, London General Insurance typically calculates its solvency requirement at 32 per cent of GWP. For life insurers, Pillar I capital is more complicated involving a proportion of reserves and also a proportion of sums insured for life business. Again, there is credit given for reinsurance ceded.
125. We are aware that some underwriters have agreed the amount of capital required with the FSA on a Pillar II basis.

Financial performance of underwriting

Claims ratios

126. Underwriters were asked to provide data on income, costs, and certain ratios for each PPI product category³³ and by distributor brand for each year from 2002 to 2006 inclusive. In general, underwriters had few difficulties subdividing their income and costs between these categories. This is likely to be due to reporting requirements stemming from contracts with distributors.
127. There are three main ratios which underwriters may use to monitor the performance of their business: claims ratio, expense ratio and combined ratio. The claims ratio is calculated as claims incurred and provided for in the year as a percentage of net

³³Unsecured personal loans, credit cards, first charge mortgages, second charge mortgages, motor loans, retail credit, overdrafts, other PPI.

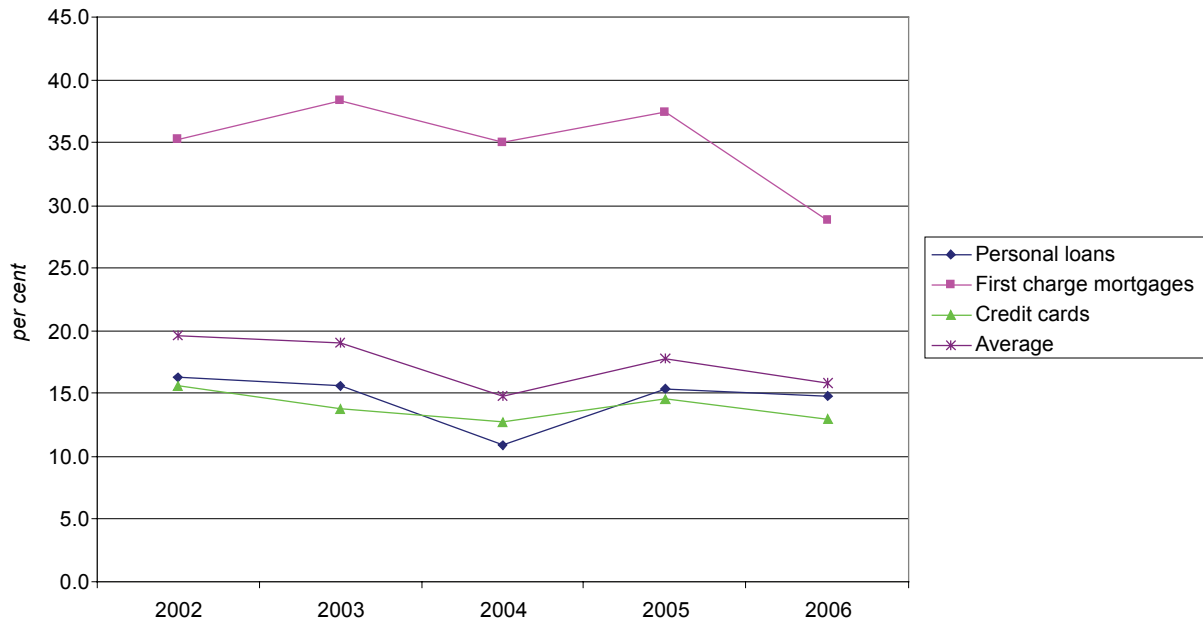
premiums earned. The expense ratio is calculated as operating expenses, including commissions paid to distributors, as a percentage of net premiums earned. The combined ratio is the sum of the two preceding ratios, taking claims and expenses together and expressing them as a percentage of net premiums earned.

128. If the combined ratio is less than 100 per cent the underwriter is making an operating profit on underwriting. A company can still make a profit with a combined ratio of over 100 per cent as there will also normally be investment income (investment income is not included in the combined ratio calculation).
129. We have focused on the claims ratio in this paper as it is the most significant cost of underwriting PPI. Therefore we are interested in the total amount of claims incurred and of levels of variability over time, as this will give an indication of underwriting risk. We know from our review of contracts that, in the short term at least, all the underwriting risk is retained by the underwriter. It is also worth noting that the claims ratio is dependent on the following factors:
 - (a) the price of the policy: all things being equal, the higher the price, the lower the claims ratio; and
 - (b) the number of exclusions in the policy: all things being equal, the greater the exclusions, the lower the claims ratio.
130. These factors may need to be taken into account when making comparisons of claims ratios.
131. Figure 6 shows the following:
 - (a) The claims ratio for first charge mortgages over the five-year period was at least ten percentage points higher (in absolute not relative terms) than the average claims ratio.

- (b) All three claims ratios show a slight overall decline between 2002 and 2006 with first charge mortgages showing the steepest decline, from 35 to 29 per cent.
- (c) The personal loans and credit cards claims ratio shows minimal volatility over the five-year period; the mortgage claims ratio shows minimal volatility between 2002 and 2005.

FIGURE 6

Claims ratios by product, all main party underwriters, 2002 to 2006




Source: CC based on data collected from the parties.

Note: [X] personal loans claims figures for 2003 and 2004 have been excluded from the calculations underlying the chart. Two very large distribution arrangements had been terminated and were in run-off. Although it was making claims payments, it was not receiving new net premium, and as a result its claims ratios were anomalous. [X] told us that it believed that defining claims ratios by reference to the total premium paid rather than the risk premium received by the underwriter resulted in misleading claims ratios as the high levels of commission paid distorted the ratio.

Return on capital











132. We asked underwriters for estimates of their return on capital in recent years, which we set out in Table 10. Not all underwriters were able to provide this, mainly because they did not use this measure in their business. Of those who did, estimates were provided on varied bases, including target and achieved rates, and pre- and post-tax rates. Achieved rates specified by underwriters were generally between 10 and 20 per cent.

TABLE 10 Underwriters' estimates of return on capital

Underwriter	Return on capital evidence
	<p>The hurdle rate has been 14%, and IRRs achieved for 2004–2006 were approximately 15–17%.</p> <p>Return on capital has varied between approximately 10% and 16%.</p> <p>Pre-tax returns on capital (for the general insurance business only, and reflecting an average expense ratio) have ranged between 14.9% and 21.5% between 2002 and 2006.</p> <p>Hurdle rate of 12% post-tax.</p> <p>Has not placed much emphasis on using a return on capital calculation as a key performance target, instead preferring to use contribution targets as a basis for measurement along with the cost/income ratio.</p> <p>Achieved rate estimated to be approximately 15%.</p> <p>Achieved rates have been between 5% and 10%.</p> <p>Do not use rate of return measures—use economic capital measures instead.</p> <p>Aims for a return of 12% or more—this has been achieved.</p> <p>Do not use rate of return measures—use economic profit and risk-adjusted return on capital measures instead.</p> <p>Targets a RoE of 19–20% for its overall group business. RoE targets are not set for individual business areas or products and therefore are not measured.</p>

Source: Evidence provided by the parties.

133. Evidence from board papers and strategy documents corroborates this:

- (a)  presentation dated Sept 2005—credit card PPI (general insurance, not life) shows after tax ROCE of 14 per cent.
- (b)  noted in a recent board paper that its  PPI insurance business had generated an RoE of 14 per cent.
- (c)  noted in an internal strategy document that a post-tax return on capital of 20 per cent could be achieved on the underwriting of PPI.
- (d)  documents discuss whether the external general insurance business written by  for  introduced customers should continue. The  only earns underwriting profit and not distribution profit, as insurance intermediaries distribute the  products primarily to IFAs/mortgage brokers on a non-profit share commission basis. The documentation states that the return on capital appears modest, at 10 per cent in 2002 and 13 per cent as a historic average. The documentation also states that the return on capital is below .

requirements. The document also states that an 'ROE of circa 20–25 per cent would seem reasonable for the overall risk profile of External Business'.

- (e) [redacted] board paper (undated) states that 'whilst distributor margins are high, the margins of the insurer are not so high as to cause unease. [redacted] largest contract with [redacted] provides a return on capital that is around 14% but no more.'

Evidence from economic models

134. We looked at the second version of the Market Economics Model (see paragraph 14) which looks at the economics of retail banking in its entirety, considering, among other products, [redacted], personal loans, credit cards, mortgages and creditor insurance (PPI) as separate profit pools. Within creditor insurance, the profitability of distribution and underwriting were analysed separately. The underwriting part of the creditor insurance industry estimated RoEs of 29 and 38 per cent in 2004 and 2008 (forecast). The provider told us that the model had not been used for the purposes of analysing manufacturing activities.³⁴

Conclusions on the profitability of PPI underwriting

135. In summary, we looked at underwriting profitability, using a range of board papers, strategy and financial documents provided by the parties; and a model of market economics provided by one significant provider. This evidence suggested that:

- (a) a large share of GWP and profit goes to distributors;
- (b) the insurance risk is borne by the underwriter, most notably because it would suffer any losses resulting from claims exceeding expectations;
- (c) regulatory capital requirements reflect this risk; and
- (d) achieved returns on capital were generally in the range 10 to 20 per cent.

³⁴The provider told us that the first version of the model had endeavoured to calculate RoEs for PPI manufacturing activity, but this was discontinued as it was not considered accurate or reliable or of sufficient utility for the provider to invest in further development of the model's capabilities.

136. On balance, although one piece of evidence (the Market Economics Model) suggested that returns may have been quite high, we concluded that, based on the bulk of the evidence that we had seen, underwriters had not earned unreasonable returns on PPI. Taking this evidence in conjunction with other analysis of the underwriting market in Emerging Thinking, we do not intend to pursue this analysis any further.

Information collected from main parties to the inquiry

TABLE 1 Summary of the financial arrangements of third party contracts*

Type	Underwriter	Distributor	Date of contract	2006 GWP £m	Commission %	Profit share %
CC	()	✂			50–77	100
PL					45	100
PL/CC					50-60	95–100
PL					47, 75–80†	No profit share
PL/M					M 42, PL 66	85
PL/M/CC					PL 64-70, M 32, CC 66	90–95
M					45	95
PL					73	99

Source: CC based on contracts and contract summaries provided by the parties.

*One large insurer [✂] told us that reinsurance provided its partners with another option to attract a return from PPI and that it had reinsurance contracts in place with certain partners as part of the commercial arrangements. The commercial arrangements summarized in this table could only be understood with reference to such reinsurance arrangements.

†The lower figure is stated net of future early settlement refunds. The higher rates are contractual commission rates before early settlement refunds.

TABLE 2 Income from PPI as % GWP for each distributor, 2002 to 2006

	<i>Income as % GWP</i>				
	2003	2004	2005	2006	
All PPI					
⌋	46	38	42	58	
	67	70	74	70	
	56	56	58	61	
	65	48	79	60	
	41	34	43	50	
	82	88	68	78	
	N/A	N/A	57	59	
	60	62	52	54	
	60	70	73	91	
	79	81	84	81	
	60	49	48	40	
	80	82	91	87	
	Aggregate	67	66	68	68
	Personal loan PPI				
	⌋	64	41	85	58
N/A		N/A	N/A	N/A	
62		70	68	103	
N/A		N/A	N/A	N/A	
77		81	52	55	
56		49	45	35	
37		30	29	25	
55		54	55	59	
76		76	86	78	
36		30	37	45	
77		84	82	80	
N/A		N/A	63	72	
Aggregate		66	61	70	66
CC PPI					
⌋		81	81	93	89
	N/A	N/A	N/A	N/A	
	N/A	N/A	N/A	N/A	
	65	79	80	82	
	79	81	84	81	
	N/A	N/A	N/A	N/A	
	N/A	N/A	62	59	
	N/A	N/A	N/A	N/A	
	69	73	79	69	
	73	75	80	78	
	51	53	52	84	
	71	78	82	77	
	Aggregate	73	78	79	77
	M PPI				
	⌋	N/A	N/A	N/A	N/A
83		54	50	55	
60		45	45	65	
N/A		N/A	N/A	N/A	
45		46	53	51	
46		48	49	54	
99		30	109	124	
41		57	63	50	
N/A		N/A	35	34	
N/A		N/A	N/A	N/A	
63		70	80	72	
N/A		N/A	N/A	N/A	
Aggregate		53	50	49	52

Source: CC based on information from distributors.

Note: Sub-category data excludes data from one large distributor [X]. All 2003 and 2004 figures exclude [X] a large distributor.

TABLE 3 Average revenue per single premium PLPPI policy sold in 2006 for each distributor

Main party	Average revenue £
<div style="border: 1px solid black; border-radius: 50%; width: 100px; height: 100px; display: flex; align-items: center; justify-content: center;"> ✂ </div>	999
	847
	784
	783
	637
	495
	491
	388
	Average
Weighted average (by GWP)	690

Source: CC based on data supplied by the main parties.

TABLE 4 Net interest on PLPPI premiums, 2006

	Net interest £m	GWP £m	% GWP
<div style="border: 1px solid black; border-radius: 50%; width: 100px; height: 100px; display: flex; align-items: center; justify-content: center;"> ✂ </div>			18
			18
			14
			10
			11
Total	177.38	1,205.74	15

Source: CC based on data supplied by the main parties.

[✂]

