

# PAYMENT PROTECTION INSURANCE

## Statement of issues

1. On 7 February 2007, the Office of Fair Trading (OFT) referred the UK supply of payment protection insurance (PPI) to non-business customers to the Competition Commission (CC) for investigation. The reference followed an initial OFT study into the sector, which was undertaken in response to a super-complaint from Citizens Advice.
2. PPI is defined in our terms of reference as:

insurance services supplied for the purpose of protecting a borrower's ability to maintain credit repayments in the event that the borrower becomes unable to maintain the repayments due to accident and/or sickness and/or unemployment and, under some policies, death.
3. Store card PPI<sup>1</sup> services have been excluded from the terms of reference. These services were covered by an earlier CC inquiry, with remedies not taking effect until 1 May 2007. It was the view of the OFT that it would be disproportionate to include store card PPI in the terms of another reference.
4. The CC is required to determine whether any feature, or combination of features, of the PPI market or markets prevents, restricts or distorts competition.<sup>2</sup> If this is so, there will be an 'adverse effect on competition' and we will seek to answer the following additional questions:<sup>3</sup>
  - (a) whether action should be taken to remedy, mitigate or prevent the adverse effect on competition concerned or any detrimental effect on customers<sup>4</sup>, and if so what those actions should be; and
  - (b) whether it should recommend the taking of action by others for the same purpose and if so, what those recommendations should be.
5. We must distinguish competition issues from other issues of public concern associated with the supply of PPI which we have no power to investigate. While we can consider issues, such as mis-selling, where they have competition implications, we cannot, for example, either decide the merits of individual cases or indeed make decisions on wider issues such as responsible lending. Public concern about these issues may interact with competition issues and provide background and context for our investigation, but our focus must be on the competition issues.

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<sup>1</sup>Store card PPI is defined in our terms of reference as payment protection insurance services supplied for the purpose of protecting a store card holder's ability to maintain repayments under the store card agreement. A store card is defined in our terms of reference as a payment card issued with respect to the purchase of the goods, services or facilities of only one retailer or of retailers who are members of a single group of interconnected bodies corporate or who belong to a store card network or who trade under a common name and which has both associated retail benefits and permits the holder of the payment card under his contract with the issuer of the card to discharge less than the whole of any outstanding balance on his payment card account on or before the expiry of a specified period (subject to any contractual requirements with respect to minimum or fixed amounts of payment. For further information see: [www.competition-commission.org.uk/inquiries/completed/2006/storecard/index.htm](http://www.competition-commission.org.uk/inquiries/completed/2006/storecard/index.htm)

<sup>2</sup>Section 134 of the Enterprise Act 2002.

<sup>3</sup>*Market Investigation References: Competition Commission Guidelines*, CC3, Competition Commission, June 2003 (a copy of this document is on the CC's website [www.competition-commission.org.uk](http://www.competition-commission.org.uk)), paragraph 1.8.

<sup>4</sup>A detrimental effect to customers may take the form of higher prices, less choice, lower quality of available products, or less innovation than if competition was working effectively. (*Market Investigation References: Competition Commission Guidelines*, CC3, Competition Commission, June 2003, paragraph 1.9.)

6. This issues statement is based on our consideration of the OFT's decision document,<sup>5</sup> and on our initial consideration of the issues we propose to investigate. We are publishing this statement before we have received main submissions from interested parties in order to assist those submitting evidence to focus on the issues we envisage being central to this investigation. If parties consider that there are additional issues which we should consider, they are invited to identify them and to explain why these are relevant to our statutory questions. We recognize that other issues may arise in the course of our investigation; we will consider these carefully and will pursue substantive issues which bear on competition.
7. We plan to hold hearings with interested parties during the period May to July 2007. Following these hearings, we expect to publish an 'emerging thinking' document for consultation. We may then hold further hearings before publishing our provisional findings. If we were provisionally to find that there were adverse effects on competition, we would then consider possible remedies.

### **Presentation of the issues**

8. The issues which appear to be relevant to the decision as to whether any feature, or combination of features, of the market prevents, restricts or distorts competition are discussed in more detail below.<sup>6</sup> While the competition issues set out in this statement are those which may be of relevance in our eventual decision, we may in the course of our investigations narrow or widen the scope of the issues we should examine. Naturally, since we are at the beginning of our investigation, we have not yet reached conclusions on any issue set out in this statement.

### **Market definition**

9. The CC identifies the relevant market, or markets, in order to provide the framework within which our assessment of competition and the effects of market features can be carried out. We will need to define the relevant product market(s), and establish the geographic dimension of the relevant market(s), in order to assess competition within them.<sup>7</sup>
10. In its analysis, the OFT identified four main PPI product categories:
  - (a) PPI on first-charge mortgages;
  - (b) PPI on second-charge mortgages and other secured loans;
  - (c) PPI on unsecured loans (mostly comprising PPI for personal loans, but also including PPI on retail credit, such as car loans, hire purchase and catalogue purchases); and
  - (d) PPI on credit card repayments.

We will need to consider whether these are appropriate product categories and also understand any other PPI products that may exist, such as PPI on overdrafts.

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<sup>5</sup>*Payment Protection Insurance: The OFT's reasons for making a market investigation reference to the Competition Commission*, OFT899, February 2007. [www.of.gov.uk/shared\\_of/reports/financial\\_products/oft899\(1\).pdf](http://www.of.gov.uk/shared_of/reports/financial_products/oft899(1).pdf)

<sup>6</sup>In addressing the issues that appear to arise in this inquiry, the CC has adopted the approach set out in the guidelines for market inquiries in its published document *Market Investigation References: Competition Commission Guidelines, CC3*, Competition Commission, June 2003. (The relevant sections of CC3 for the purposes of this statement of issues are Parts 2 and 3).

<sup>7</sup>See *Market Investigation References: Competition Commission Guidelines, CC3*, Competition Commission, June 2003, part 2 for further details.

11. In reaching our own view on product market definition we will consider:
  - (a) whether there are distinct markets relating to different stages of the supply chain, for example as between insurers and distributors;
  - (b) whether the relevant markets are wider than the four product categories identified by the OFT. This might be the case, for example, if customers perceived PPI products in each category to be good substitutes for each other or because suppliers could easily switch from supplying one type of PPI product to another; Alternatively, it might be the case that other products, such as income protection insurance, are within the same product market as some or all PPI products; and
  - (c) whether the relevant markets are narrower than the four product categories identified by the OFT. For example, markets might be segmented by distribution channel.
12. In reaching our view on geographic definition, we will consider whether we agree with the OFT's findings that the relevant geographic market(s) are UK-wide. We will consider:
  - (a) whether narrower geographic markets exist within the UK. This might be the case, for example, if prices varied substantially between different parts of the UK or if branch location were very important to customers' choice of PPI distributor; and
  - (b) whether competition takes place over a broader geographic area than the UK. This might be the case, for example, if there were no impediments to supplying PPI from outside the UK.

### ***Competitive effects***

13. We will assess the extent of competition in the relevant market(s) and whether there are any features that might adversely affect competition. Features that may have the effect of preventing, restricting or distorting competition include the structure of the market, the conduct of firms whether as sellers or buyers, or the conduct of customers.
14. The supply of PPI has both retail and wholesale dimensions. At the retail level, PPI is sold to customers by distributors. Distributors are often, but not always, the providers of the credit product that is insured by the PPI. At the wholesale level, insurers provide PPI products through individual distributors (in some cases as the result of winning a competitive tender to do so). Different categories of costs are incurred at the different stages of production. For example, distribution costs include the costs of selling PPI to individual customers, whereas administering and paying out claims is a major cost at the wholesale level.
15. Most issues identified by the OFT relate to the retail supply of PPI, but we recognize that it will be necessary to understand the whole supply chain at both wholesale and retail levels.
16. We will therefore consider:
  - (a) issues arising in the relevant retail market(s);
  - (b) issues arising in the relevant wholesale market(s); and

(c) issues arising from the relationship between different stages of the supply chain.

In considering competition at each stage of production, we will look at the nature of demand, the costs and competition between providers at each stage of production.

### ***The retail market(s) for PPI***

#### *Customer behaviour*

17. We will consider customer demand for PPI. Relevant factors may include:

(a) the extent to which customers demand PPI as a standalone product or consider it to be part of a credit package with the underlying credit product. The purpose of PPI is to insure customers against risks that would make it difficult for them to meet repayments on a credit product<sup>8</sup>. We are interested, in particular, in the reasons why some customers purchase PPI alongside the underlying credit product, whether these customers take account of the whole cost of the credit package (ie credit product and PPI) and how easy it is for them to do so. This requires an understanding of how customers choose their credit provider and their PPI provider as well as of the information which is available to a customer on the PPI product;

(b) the factors that determine customer demand for PPI; for example:

(i) the way in which identifiable customer groups have differing tastes for PPI (eg the way in which demand for PPI varies with customer demographics);

(ii) what trade-offs customers make between product quality and price. For example, some customers may accept narrower policy cover for a lower price; and

(iii) whether customers are more likely to purchase PPI if it is offered to them at the same time as the insured credit product. One consequence of this may be that the credit distributor has what is sometimes referred to as a point-of-sale advantage over other potential providers of PPI;

(c) customers' patterns of substitution; ie the ways in which customers can, and the extent to which customers do, substitute between providers of PPI. Substitution could occur in at least two ways:

(i) substitution at the time of purchase: either by comparing PPI products on a standalone basis, or by comparing packages of credit with PPI and selecting the provider who offers the best value;

(ii) substitution at a later date (ie switching provider): for example, a customer may take out PPI with one provider, but subsequently terminate that contract and secure cover for the same loan from another PPI provider. Alternatively, a customer may buy a package of credit with PPI from one provider and subsequently switch to another provider for both credit and PPI.

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<sup>8</sup>There is therefore a link between a customer's demand for PPI and their demand for the insured credit product. Products with this characteristic are sometimes called secondary products and are not unusual in either insurance (eg extended warranties) or other sectors (eg spare parts for motor vehicles).

We may therefore consider the degree of customer switching and the costs that customers face when switching PPI providers and the extent to which customers are sensitive to the price of PPI products;

- (d) The role of information in customers' decisions. Customers may not know the full extent of the products on offer in the market. To understand the extent of the information customers have when making choices, the following aspects are of relevance:
- (i) the amount and nature of information provided by firms to customers
  - (ii) the incentives on both sales staff and the retailer organization to provide information,
  - (iii) the extent to which customers search for alternative products, and the incentives on customers to undertake search; and
  - (iv) customers' capability to process information provided on different PPI products in order to compare the value offered by each.
- (e) other information shortfalls. There may be other asymmetries in the information held by customers and firms and understanding the extent and implications of those information asymmetries may be relevant. In some ways, customers may have better information than firms. For example, some customers may have superior information about the likelihood that they will make a claim and hence the risks that they pose to insurers.<sup>9</sup> In other ways, firms may possess superior information; for example customers may not know the extent to which taking out PPI will help their application for credit whereas the firm selling the product will.

### *Retail costs of providing PPI*

18. To the extent that they are relevant to our assessment of the extent of competition in this market, we shall seek to understand the costs associated with providing retail PPI. These retail costs may be directly attributable to the sale of PPI or shared with the costs incurred in the provision of credit products.

### *Competition between retail providers of PPI*

19. In considering competition between retail providers of PPI, we will consider:
- (a) the extent to which competition is centred around the sale of the credit product, the sale of the PPI or the sale of a package of credit with PPI. In particular, we will seek to understand the extent to which, if at all, firms make the sale of the credit product conditional on customers buying the associated PPI product;
  - (b) whether there is evidence of vigorous price competition between retail suppliers of PPI;
  - (c) whether firms compete on non-price aspects of PPI. These non-price aspects may include:

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<sup>9</sup>It is well known in insurance markets that this can lead to problems of moral hazard and adverse selection. A classic academic article on this subject is *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information* by M Rothschild and J Stiglitz, *The Quarterly Journal of Economics*, 1976.

- (i) the main product characteristics including the levels of cover, such as the circumstances under which someone is not eligible to claim under their policy;
  - (ii) service quality at the point-of-sale and after the sale has taken place (including ongoing queries and claims handling);
  - (iii) marketing (including advertising aimed at inducing customer switching between providers); and
  - (iv) innovation;
- (d) the extent to which firms have incentives to provide information to customers and its implications for competition between providers. For example, we may consider the extent to which customers are made aware of the price or other terms of the PPI, how, and at what stage of the purchasing process this disclosure takes place;
- (e) the degree of complexity of the PPI products offered to customers, and the incentives to reduce this complexity and facilitate comparison of value;
- (f) the extent to which there is any point-of-sale advantage enjoyed by the provider of the underlying credit product. The OFT found that PPI was normally sold to the customer by the provider of the credit product at the point-of-sale of the credit product. This is not always the case with secondary products;<sup>10</sup> and
- (g) the structure of the relevant market(s) and the implications, if any, of market structure on competition between retail providers.

### *Barriers to entry and expansion*

20. We will consider the extent to which there are any barriers to entry and expansion in the provision of retail PPI. Relevant factors may include:
- (a) whether the distributors of the credit product enjoy a point-of-sale advantage over other potential providers of PPI and, if so, whether this provides a substantial barrier to other providers wishing to enter, or expand within, the relevant market(s);
  - (b) whether stand-alone providers of PPI incur substantial costs and risks in raising customer awareness of their products that can be at least partially avoided by credit providers who offer PPI alongside their credit products;
  - (c) whether the need to develop a distribution network (possibly including, for example, developing a network of branches) constitutes a barrier to entry or expansion; and
  - (d) whether difficulties in obtaining relevant information (for example, on the balance or monthly repayments to be insured) preclude stand-alone providers from offering an effective substitute for some or all PPI products.

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<sup>10</sup>See footnote 8.

### *Regulatory context*

21. To the extent that it has an impact on competition, we will need to understand the regulatory framework relating to PPI, in particular the work being carried out by the FSA and other regulatory stakeholders.

### ***The wholesale market(s) for PPI***

22. Most issues identified by the OFT relate to the retail supply of PPI. While we expect the primary focus of the investigation to be on the retail market(s), we will also examine competition in the wholesale supply of PPI (see also paragraph 26).

### *Customer behaviour*

23. The customers at the wholesale level are the lenders and other firms who distribute PPI to final customers. PPI insurers seek to win the business of these distributors. The services provided to distributors at the wholesale level may include: designing the products that are sold to customers, underwriting the risks associated with the contracts sold, and providing related services (eg claims handling). We will seek to understand the nature of distributors' demand for wholesale PPI services and the competitive pressures that they pose on insurers, for which the following may be of relevance:
  - (a) the way in which wholesale customers specify their demand for PPI services, for example, whether they put such services out to competitive tender and the nature of the tender process; and
  - (b) the factors that are important to wholesale customers in choosing a provider of PPI services.

### *Wholesale costs*

24. To the extent that they are relevant to our assessment of the extent of competition in this market, we shall seek to understand the costs of underwriting PPI. These include commissions and other amounts paid to distributors; amounts paid out in claims; and administrative expenses.

### *Competition between wholesalers*

25. Wholesale suppliers of PPI are either vertically-integrated providers or insurance companies seeking to win the business of distributors. The OFT found evidence of some competitive pressure between wholesalers, with those distributors who operated a tendering process having several bidders for each contract. We intend to form our own view of this issue, by considering the structure of the relevant wholesale market(s) and the strategies and behaviour of wholesale suppliers, including the way in which they seek to win business in response to competitive tenders.

### ***Vertical issues***

26. The OFT described the fact that some large lenders also underwrite PPI as a potentially significant market feature. In addition to considering the upstream and downstream markets, we will consider the role of vertical relationships in the PPI market.

- (a) We will consider whether vertical integration has an adverse effect on competition, for example by raising barriers to entry or foreclosing parts of the market to non-integrated players. We will consider whether vertical integration will adversely affect customers—for example through inefficiencies resulting from limiting the opportunities for non-integrated providers to compete for lenders' business in the wholesale market—or by reducing the incentives on firms to innovate or improve service quality.
- (b) We will also consider the role played by vertical contracting arrangements, including commission payments, between insurers and lenders, and the nature of any tender process, and the nature of contractual relationships between insurers and PPI retailers, including the commission rates and structure.

### ***The role of intermediaries***

27. We will consider what role, if any, intermediaries (for example mortgage brokers) play in competition affecting the supply of PPI in either the retail or wholesale markets.

### ***Indicators of the extent of competition***

28. We will consider various other indicators of the extent of competition in wholesale and retail markets. These may include prices, profitability, indicators of customer behaviour and, where relevant, international comparisons.

- (a) *Prices.* We may consider whether the prices of PPI are set at competitive levels. Issues which are likely to be relevant include:

- (i) the extent to which PPI prices are reflective of costs and the extent to which any differences between providers' prices can be explained by differences in cost or other factors, such as differences in demand conditions facing providers. We may for example analyse claims ratios (the value of successful claims against the value of insurance premiums written) of different PPI products and compare them to other insurance products;
- (ii) any variations in the level of prices over time, and whether these reflect changes in costs and/or demand. Prices may change due to cost factors, for example changes in the level of risk;
- (iii) variation in the level of prices for similar products across PPI providers. Price variation across firms for products of similar quality may be useful for understanding the nature of customer search in a market and that, in turn, can be helpful for understanding competition. We may therefore make comparisons of the prices and contractual features of different PPI policies; and
- (iv) whether regulatory or other changes have affected customers' price sensitivity and whether that, in turn, has affected the level of prices.

- (b) *Profitability.* We may consider whether, and to what extent, the profitability of the underwriting and retailing of PPI can be usefully measured. Factors to be considered in such an analysis include;

- (i) appropriate methods for measuring the profitability of underwriting and retailing activities;

- (ii) appropriate bases for the allocation of shared revenues, costs, assets and liabilities;
- (iii) the extent of cyclical factors on profitability, and hence the appropriate period over which to assess it;
- (iv) the distribution of profits between insurers, intermediaries and distributors;
- (v) levels of profitability of underwriting and retailing and the trends in levels of profitability over time; and
- (vi) whether profits from the sale of PPI are being used to subsidize lower prices for credit products than would otherwise be the case if they were sold on a stand-alone basis.

*(c) Indicators of customer behaviour:*

- (i) we may consider the search behaviour of customers and the amount and nature of the information customers have when making purchases; and
- (ii) we may consider the degree of consumer switching and the costs customers face when switching PPI providers.

***Possible detriment***

29. We will identify any detrimental effect on customers in the form of higher prices, lower quality of service, less choice or innovation in relation to PPI, which result from any adverse effects on competition.