

### **Evidence for market definition**

1. This appendix sets out evidence we received on:
  - (a) how distributors set PPI prices;
  - (b) how distributors view PPI internally; and
  - (c) how distributors assess the performance of their PPI businesses internally.
  
2. This appendix also sets out our findings based on the evidence described in (a) to (c).

### **Price setting**

3. With regard to how distributors set PPI prices, we specifically considered:
  - (a) whether the PPI price and the price of credit were set together, or whether distributors set the price of PPI alone; and
  - (b) what factors distributors took into account when setting PPI prices.
  
4. There are three general observations from the documentation we saw about price setting. First, it appeared that there was very limited variation in the way prices were set between different PPI categories (therefore we did not consider that looking at each category separately would affect our analysis of this issue; and as such our discussion incorporates all categories of PPI). Secondly, distributors appeared to require approval from a board or pricing committee before they were able to implement a PPI price change. Lastly, there did not appear to be consistency between distributors with regard to the timing of PPI price changes; nor was there any annual PPI pricing review.

### ***What prices were set?***

5. The documentation indicated that PPI policies were not sold to credit customers on an inclusive basis (ie the cost of both the PPI and the credit were not combined). However, we noted that in the past some distributors had offered insurance to customers either for free (as an introductory offer) or integrated with a credit product. The three examples we noted were: Cattles had offered an insurance product which was integrated with a home credit product but it had been withdrawn in 2004; HSBC had offered MPPI on a fee-free basis for a specified introductory period but this was withdrawn; and Nationwide had had two promotions where it offered MPPI at no charge, one for 12 months, and one for a three-month period.
  
6. There was limited evidence to indicate that distributors considered setting a joint price for credit plus PPI. In 2005, Abbey had considered increasing PPI rates and reducing the APR concurrently for its cahoot Internet sales; however, this option was ultimately not recommended to its board.
  
7. Most of the PPI pricing documentation did not mention the price of credit. However, some distributors told us that credit was an influencing factor when they set PPI prices (see paragraphs 14 to 20).

### ***Factors considered when setting PPI prices***

8. The primary factors we noted that were considered when setting PPI prices were:
  - market positioning;
  - importance of underlying credit;
  - customers' willingness to pay; and
  - factors such as underwriting cost; business strategy, penetration rates and internal costs.

We considered each of those factors in turn.

### *Market positioning*

9. Market positioning (ie where one distributor's offer sits relative to that of other distributors) was cited by all distributors as a factor that influenced the way the price of PPI was set. [REDACTED]
10. We considered that, if the competitive constraint on an individual brand of PPI was other brands of PPI, we would see evidence that distributors both monitor and react to their competitors.
11. We saw some evidence which suggested that firms did monitor their market positions with regard to their PPI products, as follows:
  - comparative tables of PPI were often included within documents which recommended a PPI price change; and
  - a rationale for at least one price change was quoted as being the desire to stay in line with competitors' prices.<sup>1</sup>
12. HBOS told us that its pricing for PLPPI and CCPPI looked at package pricing of other banks. It said that it looked to ensure that its prices remained competitive and that value for the product was being offered. HBOS said that it set prices according to market conditions and that it actively researched the 'package prices' offered by its competitors.
13. However, we found only one example of a distributor reacting to price changes made by its competitors in order to win business: this was a [REDACTED] document which said that it proposed to undercut the price of PPI offered by [REDACTED] in order to maintain its position [REDACTED].

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<sup>1</sup>[REDACTED]

### *Underlying credit*

14. We considered whether distributors took the price of the credit product into account when setting their PPI prices. If there was a two-way complementarity between PPI and credit (ie if an increase in PPI price led to a loss in credit sales (and vice versa)), we expected to see evidence that changes to PPI prices affected demand for credit (and vice versa). However, if there was a one-way complementarity between PPI and credit, we expected to see evidence that credit prices affected demand for PPI but PPI pricing did not influence credit sales.
15. We requested information from the parties about the extent to which the pricing of the underlying credit influenced the way they set their prices for PPI. Some of the responses are set out in paragraphs 16 to 19.
16. Lloyds TSB said that its PPI pricing was linked to its credit pricing. It said that the profitability of PPI should be analysed in conjunction with the profitability of credit (see below); and cross-subsidization by another provider was mentioned within Lloyds TSB's documents: '[redacted] has a significantly higher LP [PPI] price and have been using it to subsidise loan pricing [redacted].'
17. Documentation from [redacted] showed that personal loans were cross-subsidized by PPI profits. For example, one document stated that: 'the negative unsecured loan EP<sup>2</sup> pool is cross subsidised by the positive PPI EP pool. PPI is core to the profitability of Unsecured Loans—the product is clearly being used to cross subsidise low APR's.' This might indicate that [redacted] was influenced by the profits it expected to earn from PPI when it set the prices of its personal loan products; however, we did not consider that it was informative as to whether PPI prices were affected by a demand relationship with credit.

18. Northern Rock said that when it considered the price and profitability of PLPPI, it assessed the viability of the package of the PPI and the loan, taking into account the income from the credit product.
19. RBSG told us that it considered the price of the primary product (credit) and associated product (PPI) as a package.
20. Although the evidence from some distributors was that the underlying credit influenced the PPI price, we did not find any reference to credit demand or pricing within any of the documents we received.

#### *Customers' willingness to pay*

21. We considered that the amount customers were willing to pay for PPI would provide us with an insight into the extent to which distributors are able to increase their PPI prices without fear that their customers would switch to another provider or that they would cause a reduction in sales of PPI or the underlying credit.
22. Northern Rock told us that when it set PPI prices, it took into account the price of similar products offered by its competitors with a view to setting the price at a level which it believed was competitive and customers would be willing to pay. We did not see evidence from other distributors to indicate that they had considered consumers' willingness to pay when setting the price of PPI.
23. We saw documents that stated that customers were generally insensitive to PPI price changes, so distributors were not concerned that a small price rise might lead to a reduction in customer demand. We found an example that implied that a distributor

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<sup>2</sup>Economic profit.

viewed its PPI customers as price sensitive; however, that document, provided by [REDACTED], was not clear (see Table 1). A summary of quotes<sup>3</sup> is contained in Table 1.

TABLE 1 Price sensitivity quotes

PPI provider	Price sensitivity quotes
[REDACTED]	Cards: PPI is rarely bought on the basis of price and an increase is not expected to significantly impact take-up or cancellations. [REDACTED] cards increase price of PPI product in [REDACTED] and did not experience any negative effect on either take-up of new policies or cancellations.
[REDACTED]	[REDACTED] price rise introduced with no adverse reaction.
[REDACTED]	[PL]PPI sales are relatively price inelastic, the focus for consumers is primarily when comparing the cost of the main loan product against competitor offerings. However there is an external focus on the relative value for money.
[REDACTED]	Main reason for customers cancelling is price.
[REDACTED]	Price increase ... penetration continued to increase & no impact from price increase ..., price increase in April shown no impact on sales. [REDACTED] experience price has very little impact on propensity to take up of UPL.
[REDACTED]	Loans PPI: reduce discount from [REDACTED]% to [REDACTED]—very little impact on PPI sales.†
[REDACTED]	Price increase in unemployment cover [REDACTED]. Previous experience of [REDACTED] increase is little impact on sales.
[REDACTED]	[REDACTED] price rise introduced with no adverse reaction.
[REDACTED]	In [REDACTED], commission levels were reduced from [REDACTED]% to [REDACTED]% in order to generate additional [REDACTED] value and increase strike rate. No material increase in strike rate was achieved. Whilst the monthly cost of [REDACTED] to the customer will increase by c.15% ... customers' total monthly loan repayment (loan with [REDACTED]) will increase by c.1-2% ... no detrimental impact on loan volumes or strike rate is envisaged.
[REDACTED]	[REDACTED] price rise introduced with no adverse reaction.
[REDACTED]	'Rough' testing in 2000 suggests that there is little price sensitivity for PPI, but that prices over [REDACTED] do hit conversion.
[REDACTED]	Sales would not decrease with the higher prices—sales are not price-sensitive and the product is sold to need*
[REDACTED]	HR test results: New customers seem to have no price sensitivity.
[REDACTED]	Despite reducing PPI discount we have seen an increase in take up ... largely down to attracting less price-sensitive customers with higher APR; Propose to remove discount to further test price sensitivity.
[REDACTED]	It is not anticipated that a price increase would be detrimental to overall penetration rates. Industry experience indicates that PPI take up is largely price inelastic.
[REDACTED]	The PLP price increase from [REDACTED] per £100 to [REDACTED] per £100 was implemented as planned on [REDACTED]. We received no adverse customer reaction whilst adding a further [REDACTED] to monthly earned premium.
[REDACTED]	... for price rises we have seen very little change in demand and we have no experience of price reductions and whether this would result in any significant increase in demand.

Source: CC, based on information provided by the parties.

\*[REDACTED]  
†[REDACTED]

24. The majority of distributors told us that they had not conducted any analysis which attempted to estimate the elasticity of demand of PPI. Lloyds TSB was able to

<sup>3</sup>[REDACTED] submitted that its quotes were taken out of context; and that it should be expected that a small price increase that leaves [REDACTED] PPI as one of the most competitive in the market should not have a significant effect on take-up rates. [REDACTED] submitted that it cannot be inferred from this that customers would display insensitivity to price changes outside this range, for example if [REDACTED] moved from being first quartile to third quartile.

provide two surveys it had commissioned<sup>4</sup>, one from October 2003 and the other from March 2007.

25. Both the surveys provided by Lloyds TSB attempted to simulate price elasticities of demand based on consumer survey results. The methodology used appeared to be robust for this type of analysis<sup>5</sup>; but neither survey provided any confidence intervals around their simulated-elasticity estimates to reflect sampling error, so we treated the results with caution.
26. The October 2003 survey report<sup>6</sup> produced simulated charts called 'Take-up of current specification at different price levels' for CCPPI, MPPI and PLPPI. It said that it was not possible to derive an estimate for price elasticity given the scope of statistical error. It appeared to us that the emphasis of the survey report was the value of different product features to customers rather than price sensitivity.
27. The March 2007 survey report<sup>7</sup> [REDACTED]. The results of the simulation was supported by Lloyds TSB's evidence during its hearing that demand for loans was elastic, and demand for PPI less elastic.

### **How firms view PPI internally**

28. We looked at the documentary evidence to see how distributors assessed the financial performance and profitability of PPI.

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<sup>4</sup>[REDACTED]

<sup>5</sup>Both surveys have robust numbers of respondents for the type of analysis being presented (though there is no confirmation in the March 2007 [REDACTED] work that all survey respondents provided data for the conjoint experiment). There is no confirmation in the March 2007 [REDACTED] work that all survey respondents provided data for the conjoint experiment.

<sup>6</sup>[REDACTED]

<sup>7</sup>[REDACTED]

29. In circumstances where there is either two-way or one-way complementarity between PPI and credit we would expect to see distributors viewing PPI and credit as an integrated business.

30. 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 provides evidence from the distributors reflecting their views in this regard.

TABLE 2 **How distributors view PPI (oral evidence)**

<i>PPI provider</i>	<i>How PPI is assessed</i>
Abbeey	Whilst PPI was sold at the same time as the credit product, responsibility for PPI fell within the separate insurance division
Alliance & Leicester	At group level PPI monitored alongside underlying credit.
Barclays	PPI not treated as a stand-alone business.
Capital One	PPI is not reported as either a stand-alone business or reported alongside other businesses. It is consolidated within the business line reporting, with PPI contributing to the cross-sell revenue line of the P&L accounts. This feeds into 'non-interest income' within accounts.
Cattles	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.
HBOS	Group level, the performance of PPI business is assessed by reference to both the primary lending product and the related secondary PPI products. At divisional level (one level down) more detailed information is provided on performance.
HSBC	Management accounts assess and analyse business performance (a) on a stand-alone basis (and split this further by distribution channel), (b) combined with other GI business, (c) with PPI combined with loan/mortgage/credit card business results to enable an overview of those lines' total performance.
Lloyds TSB	PPI business is aggregated along with other products and reported as a whole in Group reports. Generally not reported on a stand-alone basis.
MBNA	PPI is not regarded as a stand-alone business and is, therefore, not included as a separate line item in the group consolidated accounts. PPI is considered to be a revenue component of its lending business
Nationwide	Reported in two ways (a) within the business's management accounts for the three associated credit products (b) within the General Insurance which reports the consolidated income from all general insurance activities.
Northern Rock	PPI is not viewed as a stand-alone business but is an integral part of the credit offering and is assessed as such at Group level.
RBSG	Does not operate a stand-alone PPI business.* Income performance of families is reviewed ... PPI is an associated fee income.

Source: CC, based on information provided by the parties.

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\*RBSG owns Churchill which offers a stand-alone IP product. See Appendix 2.3 for further details.

31. The evidence from distributors indicates that they all considered that there was a link between credit and PPI; however, on the evidence it was not possible to distinguish whether there was a one-way or a two-way complementarity between the products (or something in between).

## PPI assessment and review

32. We considered the way distributors conducted PPI assessment and review by focusing on evidence of factors which affected the demand for PPI and credit.
33. Distributors cited numerous factors that impacted on PPI sales. Some of the factors include: regulation, customer risk profile and awareness, competitiveness of underlying credit including demand and cost for credit, PPI price, monthly cost of loan, cross-selling initiative, advertising, sales process, adviser confidence, training and macroeconomic activity.
34. We saw a small amount of documentary evidence that distributors considered both credit and PPI and that sales of PPI were affected by the sales performance of the associated credit product. Some examples are provided in Table 3.

TABLE 3 **How distributors view PPI (documentary evidence)**

<i>Bank</i>	<i>Quote</i>
Abbey	There is a strong correlation between the loan price positioning (APR) and CP strike rate. Aggressive loan pricing leads to the attraction of better quality customers (credit score) & more price sensitive customers, making it more difficult to sell PPI.
Capital One	PPI sales are closely linked to card acquisition volumes.
HBOS	PPI profitability is heavily influenced by Unsecured lending market.

*Source:* CC, based on information provided by the parties.

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35. We were interested in whether the price of PPI affected the demand for the credit product. There was limited information relating to credit demand; however, evidence from the parties suggested that distributors generally did not expect to see a fall in credit demand following an increase in the price of PPI. Some examples of that evidence are contained in Table 4.

TABLE 4 Evidence relating to credit demand

Abbey	If it were to increase the price of PPI, Abbey would not typically take any counter-action with respect to the price of the credit product. ... The only exception to this rule was mortgages, where joint campaigns were sometimes undertaken.
A&L	If it changed the price of PPI, it would not affect the demand for the underlying credit product.
Barclays	No reference to credit demand.*
Capital One	No reference to credit demand.
Cattles	It had not made any assessment of whether a change in its PPI prices would affect the demand for the credit product.
HSBC	HSBC initially viewed PPI and the underlying credit product as belonging to separate markets. In regard to whether an increase in credit prices would affect the demand for PPI, HSBC stated that its customers, if they are minded to take or consider taking PPI look at the total amount outgoings. In its response to Emerging Thinking HSBC said it thought that there were separate markets for:  Unprotected credit (ie without PPI); and  protected credit (ie with PPI)..
Lloyds TSB	If Lloyds TSB increased the price of PPI, it would be unlikely that this would affect sales of the corresponding credit products in the short term, but it would likely affect cross-sales of PPI. In the longer term, dissatisfaction among customers with the value for money offered would be likely to have a knock on effect on the reputation of the group as a whole, with consequential effects on sales of other products.
MBNA	If it was to increase the price of its PPI products, there might be a fall in demand for the underlying credit product.
Northern Rock	No reference to credit demand.
RBSG	Could not comment on whether the PPI market included the underlying credit product. It did not agree with the concept of the PPI being 'sold and not bought', as it had adopted a non-advised sales process. RBSG said that changes in PPI price cannot be analysed separately from a change in price in loans.

Source: CC, based on information provided by the parties.

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\*In relation to income stream.

36. Our findings on the evidence are as follows:

- (a) There was some evidence that distributors analyse the price of credit and PPI together but the majority of distributors said that they did not operate PPI as a separate business.
- (b) Distributors do not consider that an increase in PPI prices will have an impact on their credit sales.
- (c) When planning PPI price rises, distributors do not generally appear to consider that there would be a significant affect on their sales of PPI.
- (d) There was evidence that distributors believed that credit and PPI demand were closely related. Given that the price of credit affects the demand for credit, we consider that it follows that there will be a knock-on effect on the sales of PPI.

- (e) Although little formal research on elasticity of demand had been conducted, the research we did see indicated that demand for credit was more responsive to price change than was demand for PPI.
- (f) There was evidence that distributors set PPI prices with reference to each other; a number of documents indicated that distributors increased their prices in line with the wider market and there was evidence that distributors monitored and assessed their market position.
- (g) We did not see evidence that distributors competed on price and only one piece of evidence showed a firm attempting to win sales by undercutting a competitor.