

### **Switching costs for single-premium policies with pro-rata rebates**

1. This appendix considers the extent to which a requirement to offer pro-rata rebates for single-premium PPI policies would reduce or remove the switching costs associated with early settlement terms.

### **Analysis of switching costs in provisional findings**

2. In [Appendix 5.2](#) of our provisional findings, we estimated the financial cost to customers of switching by considering whether the rebate from a single-premium policy was sufficient to take out a comparable replacement. We used two methods to estimate switching costs:
  - (a) estimating the cost of changing to a regular-premium policy with the same policy conditions; and
  - (b) estimating the cost of changing to another single-premium policy with the same policy conditions.

### **Comparison of switching costs under different rebate regimes**

3. We revisited the analysis in our provisional findings to assess the extent to which a requirement to offer pro-rata rebates on the PPI insurance premium would reduce or remove the switching costs that we found in our provisional findings.

### ***Cost of changing to a regular-premium policy with the same policy conditions***

4. The first method we used to calculate switching costs was to assess the financial implications for a customer of cancelling their existing single-premium policy and taking out a hypothetical regular-premium policy, which offered an identical quality of cover, for the remainder of the loan term (see paragraphs 34 to 37 of [Appendix 5.2](#) to the provisional findings for details of this method). We developed a spreadsheet

model to calculate switching costs on single-premium PPI for different rebate regimes using this method.

5. We took as a base case a £5,000 loan, repayable over 36 months with an APR of 10 per cent, a PPI premium of £800, on which interest was also payable at an APR of 10 per cent (see Table 1). This is a reasonably typical example of a prime personal loan with single-premium PPI. In this example, the monthly cost of an equivalent regular-premium policy is £16 per £100 monthly repayment.<sup>1</sup>

TABLE 1 **Base case used to calculate switching costs**

|  |       |
|--|-------|
| <i>Details of initial loan and PPI policy</i>          |       |
| Advance (£)  | 5,000 |
| APR (%)  | 10.0  |
| Term (months)  | 36    |
| Monthly repayments (£)                                 | 160   |
| Total amount payable without PPI (£)                   | 5,772 |
| Premium (£)  | 800   |
| Interest on premium (£)                                | 123   |
| Total amount payable with PPI (£)                      | 6,695 |
| Monthly repayments (£)                                 | 186   |
| <i>Monthly cost of taking PPI</i>                      |       |
| Monthly cost of PPI, including interest on premium (£) | 26    |
| Monthly cost of PPI per £100 monthly repayment (£)     | 16    |

Source: CC.

6. This method of calculating switching costs does not take into account the complexities of the single-premium policy structure when calculating the cost of the replacement policy. This is because in this scenario we are assessing the cost of switching to a hypothetical regular-premium policy with equivalent terms. Regular-premium policies are typically priced according to the value of the monthly payment covered and their prices do not vary according to loan amount or loan term. We are not aware of any provider of regular-premium policies that offers a discount to switchers, to take into account their lower-risk profile.

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<sup>1</sup>A number of the parties commented that this method of estimating the cost of a hypothetical replacement regular-premium policy would overestimate the cost of that policy since this calculation includes the premium interest charged on a single premium when added to the loan. HBOS told us that the interest was a legitimate cost associated with providing a guaranteed rate and coverage for single premiums. Our view is that the interest paid on single-premium policies is part of the overall price of a single-premium policy and that the interest cost of a single-premium policy should be included in our analysis.

7. We estimated switching costs under two stylized rebate regimes. The first regime broadly represented the current situation. The rebate on the PPI premium was calculated according to the rule of 78 and the interest on the PPI premium was rebated in line with Consumer Credit (Early Settlement) Regulations 2004.<sup>2</sup> The second regime represents the rebates that would be offered under option 7(c). Here the rebate on the PPI premium is calculated on a pro-rata (ie straight-line) basis and the interest on the credit is, again, rebated in line with Consumer Credit (Early Settlement) Regulations 2004.

TABLE 2 Method of calculating rebates under different rebate regimes

|                       | <i>Rebate regimes</i>                               |   |
|-----------------------|---|---|
|                       | <i>No remedy</i>                                    | <i>With option 7(c)</i>                             |
| Rebate on PPI premium | Rule of 78  | Pro-rata  |
| Rebate on interest    | Consumer Credit (Early Settlement) regulations 2004 | Consumer Credit (Early Settlement) regulations 2004 |

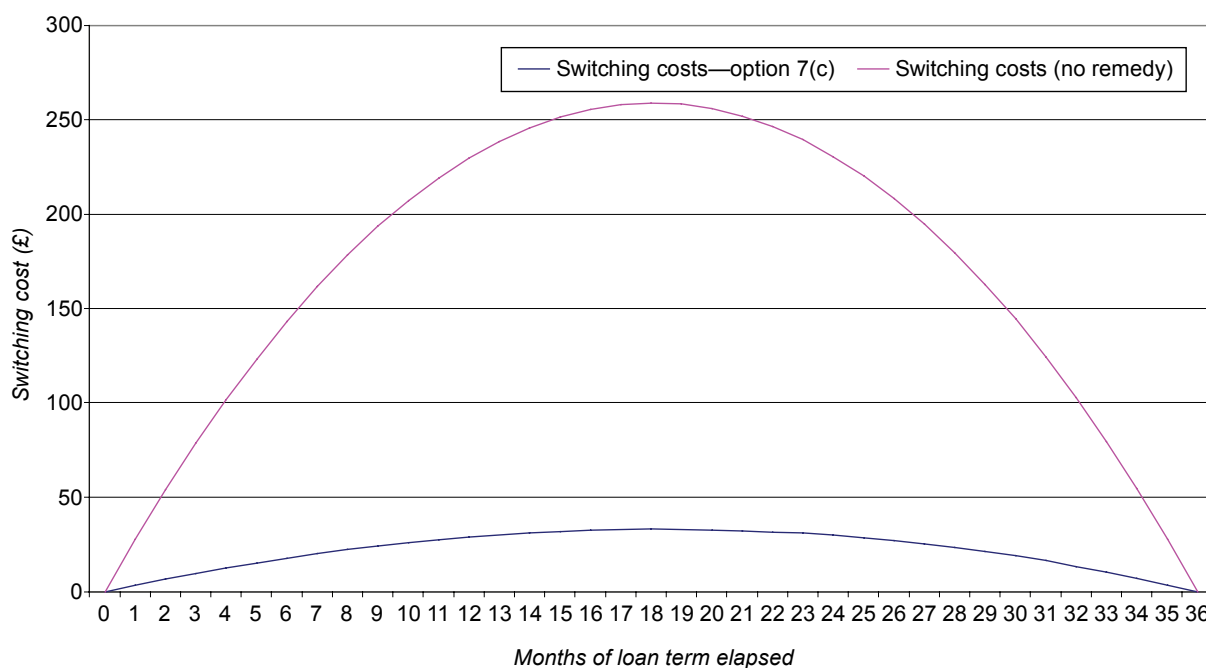
Source: CC.

8. Figure 1 shows our estimates of the switching costs in this base case under the two rebate regimes.

<sup>2</sup>The Consumer Credit (Early Settlement) Regulations 2004 sets out the rules that govern the minimum rebates payable for loans that settle early. These regulations are underpinned by the principle that customers should be rebated the interest remaining on the loan at the point of early settlement. For fixed-term loans, this produces a declining rebate profile, similar in shape to the rule of 78. This is because a large proportion of the early repayments on the loan is put towards paying off interest, with the principal being repaid mostly towards the end of the fixed-loan period. From 2010 early settlement rebates on credit products will be regulated under the Consumer Credit Directive, which will follow a fundamentally similar approach.

FIGURE 1

**Comparison of switching costs in the base case**



Source: CC calculations.

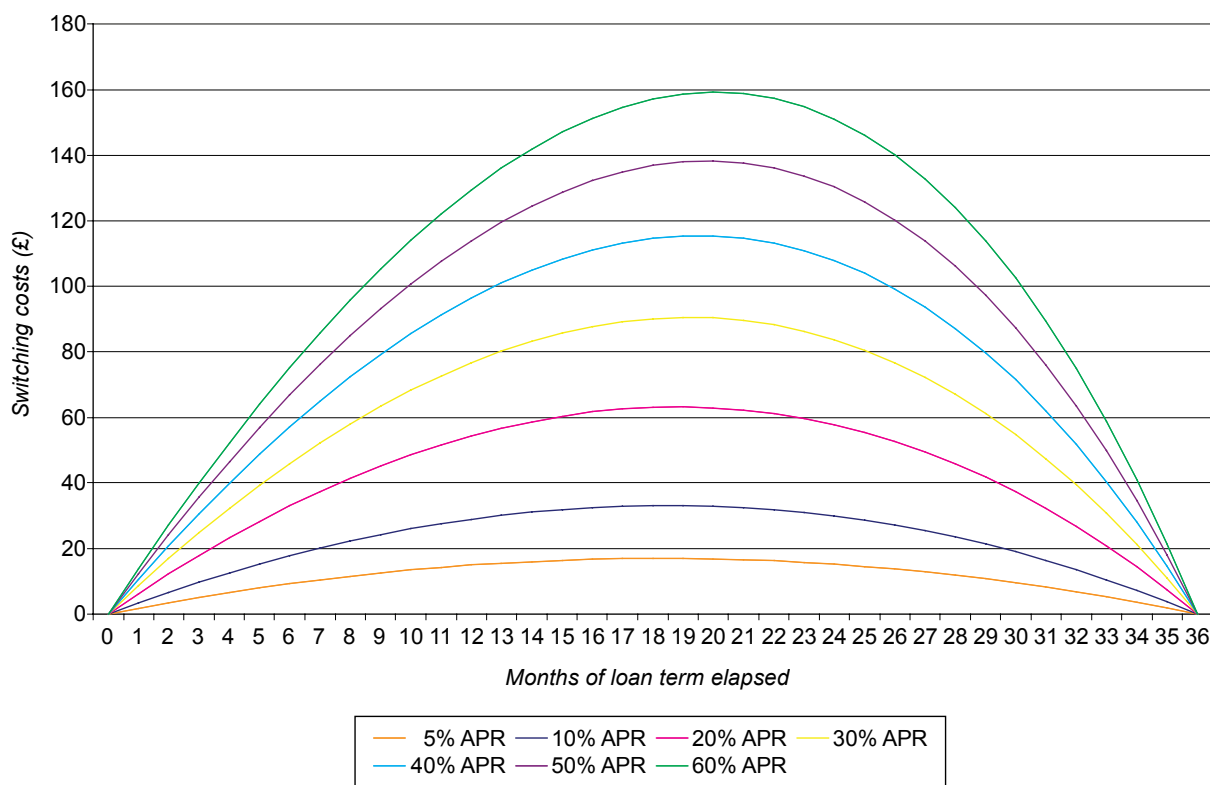
9. Figure 1 shows that a requirement to offer pro-rata rebates, as in option 7(c), would reduce the switching costs in this base case to around one-eighth of current switching costs—ie if rebates continued to be calculated using the rule of 78 formula.
10. The switching cost that would remain under option 7(c) is associated with the interest payable on the single premium, which is not rebated to customers on a pro-rata basis. We therefore considered the sensitivity of our estimates of switching costs under this remedy option to the interest rate charged on the single premium.<sup>3</sup> This is shown in Figure 2.

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<sup>3</sup>As at June 2008, the typical credit APRs for the top-selling unsecured personal loan for nine large PLPPI providers ranged between 8 and 62 per cent, with three providers having typical credit APRs of less than 10 per cent and four providers having typical credit APRs of 20 per cent or more.

FIGURE 2

**Impact of APR on switching costs remaining under option 7(c)**



Source: CC calculations.

11. Switching costs increased with the interest rate charged on the single premium, both in absolute terms and as a proportion of switching costs in the 'No remedy' regime.

Table 3 shows how much of the switching costs calculated absent the remedy would remain under option 7(c).

TABLE 3 Proportion of switching costs remaining under option 7(c)

| APR   | per cent |    |    |    |    |    |    |
|---|----------|----|----|----|----|----|----|
|   | 5        | 10 | 20 | 30 | 40 | 50 | 60 |
| Percentage of switching costs remaining for policy terminating after: |          |    |    |    |    |    |    |
| 12 months   | 7        | 13 | 21 | 28 | 32 | 36 | 39 |
| 18 months   | 7        | 13 | 22 | 29 | 34 | 38 | 41 |
| 24 months   | 7        | 13 | 22 | 29 | 35 | 39 | 43 |

Source: CC.

Note: Based on the loan and PPI in Table 1.

*Cost of changing to another single-premium policy with the same policy conditions*

12. We also revisited our estimates of the switching cost for moving from one single-premium policy to a hypothetical stand-alone single-premium policy offering the same level of cover. To do so, we compared the cost to a customer of paying back a loan with PPI to its full term, against the cost of terminating the PPI early and taking out a new single-premium PPI policy from the same provider to insure the remaining repayments.
  
13. This methodology allows us to take into account other factors which may affect the financial incentives to switch in addition to the rebate regime used by the distributor. The pricing of single-premium policies is complex, being made up of a PPI premium and a loan element. The PPI premium rate and the loan interest rate charged on the single premium can be affected by factors such as the term of the replacement single premium and loan required. The net financial switching incentive (or switching cost) is therefore determined by the interaction of three separate elements: the level of the PPI rebate, the level of the premium for the replacement policy and the cost of the loan used to fund that premium.
  
14. The precise shape of each of these three elements varies considerably between distributors.<sup>4</sup> We therefore asked for information from the distributors to enable us to calculate a switching cost for each of them. We asked the distributors to complete a template which calculated the switching cost at various intervals in the course of a £5,000 36-month policy, and in the course of a £10,000 60-month policy.<sup>5</sup>

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<sup>4</sup> Many distributors operate pricing schedules for PPI and for the underlying loans that are stepped in shape. Loans within a particular band will all be offered at the same APR or at the same PPI premium rate. The results of this method can be affected where there is movement between price bands which causes a change in the APR or PPI premium applied to the replacement policy.

<sup>5</sup> Paragraphs 49 to 54 and Tables 3 to 6 of [Appendix 5.2](#) of our provisional findings set out more detail of the methodology. A number of the parties said that they disagreed with our methodology. In particular, they told us that the APR on a new single premium would not be based on the total amount payable to be insured, but would instead be based on the loan principle outstanding. In our view, this would have very little practical impact on the final switching cost in most instances.

15. Tables 4 and 5 show our estimate of switching costs, absent any remedy, using this method.

TABLE 4 **Switching costs for £5,000 loans over 36 months from providers using current rebate rules\*†**

|     | <i>Switch after (months)</i> |           |           |
|-----|------------------------------|-----------|-----------|
|     | <i>12</i>                    | <i>18</i> | <i>24</i> |
|     | <i>£</i>                     | <i>£</i>  | <i>£</i>  |
| [X] | 43                           | 88        | N/A       |
| [X] | 89.13                        | 127.52    | 87.10     |
| [X] | 120.52                       | 114.40    | 95.76     |
| [X] | 229.44                       | 276.65    | 233.70    |
| [X] | 236.97                       | 262.65    | 175.11    |
| [X] | 350                          | N/A       | 246       |
| [X] | 390                          | 376       | 315       |

Source: Distributors based on CC template.

\*Two parties included an administration charge (one of £10, one of £45), and one of these parties also included a one-month penalty on loan and PPI interest.

†Historic rebate policy rules have been used by one distributor.

Note: N/A = not applicable.

TABLE 5 **Switching costs for £10,000 loans over 60 months from providers using current rebate rules\*†**

|     | <i>Switch after (years)</i> |          |          |          |
|-----|-----------------------------|----------|----------|----------|
|     | <i>1</i>                    | <i>2</i> | <i>3</i> | <i>4</i> |
|     | <i>£</i>                    | <i>£</i> | <i>£</i> | <i>£</i> |
| [X] | -49                         | 40       | 141      | 119      |
| [X] | -8                          | 240      | 473      | 335      |
| [X] | 221                         | 176      | 252      | 152      |
| [X] | 313                         | 382      | 337      | 271      |
| [X] | 451                         | 493      | 486      | 289      |
| [X] | 1,210                       | 885      | 788      | 449      |

Source: Distributors based on CC template.

\*Two parties included an administration charge (one of £10, one of £45), and one of these parties also included a one-month penalty on loan and PPI interest.

†Historic rebate policy rules have been used by one distributor.

16. Tables 4 and 5 show that consumers face financial switching costs, when switching to a hypothetical stand-alone single-premium policy, net of any changes in the price of a replacement policy (due to changes in the term or loan amount at the point of switching) in almost all instances.

17. Tables 6 and 7 repeat this analysis, but with a pro-rata rebate on the PPI premium. This corresponds to a situation where option 7(c) has been imposed.

TABLE 6 Switching costs for £5,000 loans over 36 months from providers using current rebate rules\*†

|     | Switch after (months) |         |         |
|-----|-----------------------|---------|---------|
|     | 12<br>£               | 18<br>£ | 24<br>£ |
| [X] | 100                   | N/A     | 13      |
| [X] | -5.92                 | -1.57   | -11.69  |
| [X] | -9                    | -40     | -25     |
| [X] | -51.17                | -29.12  | -62.30  |
| [X] | -58.96                | -39.95  | -59.78  |
| [X] | -77.44                | -104.37 | -95.60  |
| [X] | [X]                   | [X]     | [X]     |

Source: Distributors based on CC template.

\*Two parties included an administration charge (one of £10, one of £45), and one of these parties also included a one-month penalty on loan and PPI interest.

†Historic rebate policy rules have been used by one distributor.

Note: N/A = not applicable.

TABLE 7 Switching costs for £10,000 loans over 60 months from providers using current rebate rules\*†

|     | Switch after (years) |        |        |        |
|-----|----------------------|--------|--------|--------|
|     | 1<br>£               | 2<br>£ | 3<br>£ | 4<br>£ |
| [X] | -197                 | -352   | -316   | -230   |
| [X] | -304                 | -434   | -349   | -220   |
| [X] | -348                 | -532   | -261   | -173   |
| [X] | -400                 | -478   | -376   | -224   |
| [X] | -535                 | -610   | -385   | -188   |
| [X] | 556                  | -20    | -34    | -38    |

Source: Distributors based on CC template.

\*Two parties included an administration charge (one of £10, one of £45), and one of these parties also included a one-month penalty on loan and PPI interest.

†Historic rebate policy rules have been used by one distributor.

18. We found that, over nearly all of the examples that were covered by our templates, the imposition of pro-rata rebates would result in a switching incentive. In other words, we found that the replacement single-premium policy would be offered at a more favourable price than the original single-premium policy and that this price effect would more than outweigh the residual switching cost as a result of the fact that the interest payable on the initial single-premium policy would not be rebated on a pro-rata basis.