

Claims profile for 36-month PLPPI and 60-month PLPPI and SMPPI policies

Introduction

1. This appendix looks at data provided by the five largest PPI distributors, and two non-standard PPI distributors, describing the number and value of claims made on PPI policies taken out on all 36-month personal loans incepted in 2004, all 60-month personal loans taken out in 2002 and all 60-month second-charge mortgages taken out in 2002. We use this data to assess the argument that non-linear rebate systems such as the rule of 78 are appropriate, given the variance in providers' claim costs over time. We then go on to discuss the extent to which we might see a movement to a linear rebate system, or regular premiums impact upon providers' costs from claims, as a result of any asymmetry in the profile of claims over the loan term.¹
2. The first part of this appendix analyses the data for combined samples of 36- and 60-month PLPPI products. We look at the distribution of claim costs over the length of the loan for this cohort, and discuss the extent of the differential in claim costs which exists between the earlier part of the loan and later periods. We find evidence that the cost of claims incurred by producers declines over the length of a loan—in particular, for the longer-length loans. We estimate that, because claim costs are small relative to the gross premiums collected by providers, any increase in claim costs as a result of higher rebates or a move to regular premiums would have only a modest potential impact on prices.

¹Following our consultation on further analysis to support decision-making on remedies, one third party (P&G) suggested that we should also include up-front administrative costs in our analysis. However, this party did not offer any information on the scale of these up-front administrative costs. We consider it unlikely that up-front administrative costs are a more significant factor than the claim costs over the life of a policy. We also see no reason why up-front administrative costs for PLPPI should be significantly higher than in other types of PPI where a regular-premium charging structure is commonly used, such as MPPI or CCPPI.

3. The second part of the appendix looks at the profile of claims for 60-month SMPPI policies taken out in 2002. The limited data available to us suggests that claim costs will again be skewed towards the earlier part of the loan for SMPPI, but this asymmetry is likely to be less pronounced than that observed for 60-month PLPPI policies. Again the expected implications of banning single premiums or requiring pro-rata rebates for providers' costs from claims appear relatively small.
4. The third and final part of this appendix concentrates on the profile of claims incidence and value across the life of 36- and 60-month loans for two large non-standard lenders, [redacted] and [redacted]. Again, claim costs appear skewed towards earlier in the loan term for these providers—indeed [redacted] 36-month PLPPI data shows a skew which is more pronounced than that implied by the rule of 78. However, were single premiums to be banned or pro-rata rebates required, our analysis suggests that the implications of the asymmetry in claim costs for PLPPI prices would again be of limited size because of the small size of claim costs relative to the price of PPI.

The profile of PLPPI claims

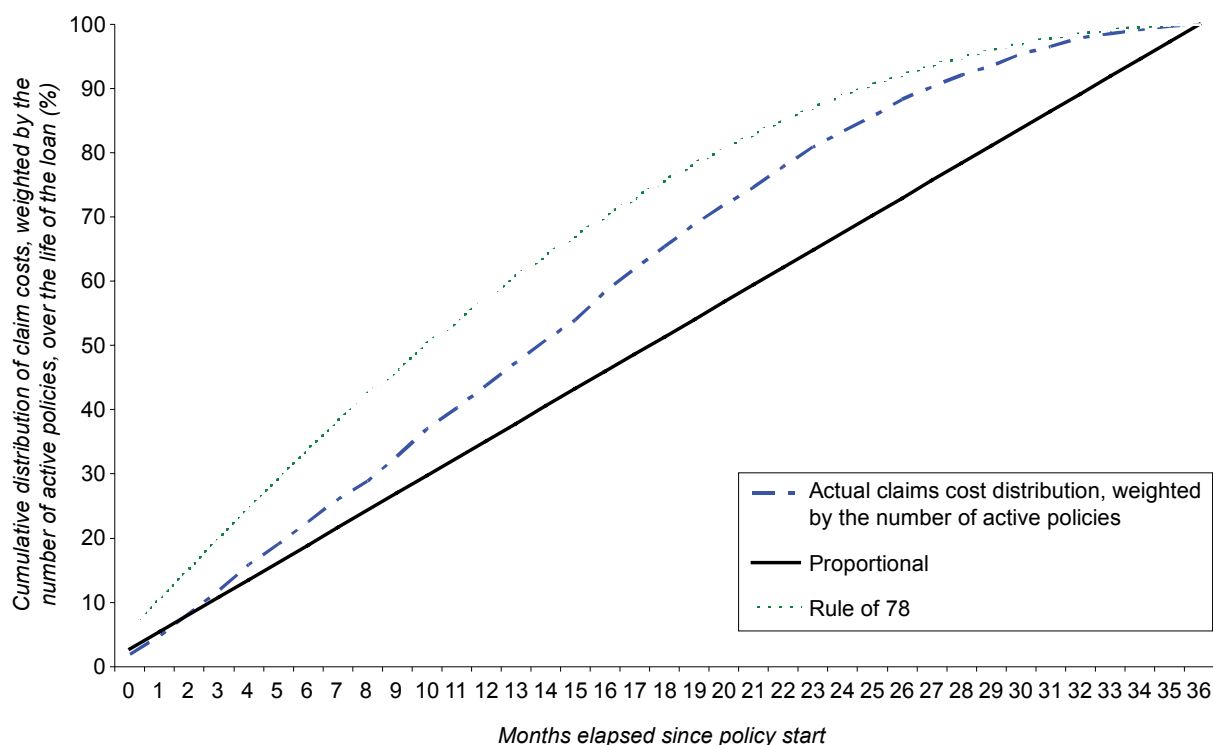
5. This section looks at the profile of PLPPI claims for a combined sample made up of the aggregated data of Barclays, HBOS, HSBC, Lloyds TSB and RBSG. The data charts the number of policies active in each month after the loan begins, the number of claim events occurring in each month, and the total lifetime value of these claims.
6. The blue dashed line in Figure 1 shows the cumulative distribution of claim costs per active policy across the life of the loan, for the combined sample of 36-month PLPPI sold in 2004. We divide the lifetime value of claims occurring in a month by the number of policies still in force in that month in order to control for the decline in the number of PLPPI policies which remain active over time, as policy-holders cancel

their PLPPI or pay off their balances.² The curve can be interpreted as showing, for each month, the proportion of the total of the costs from all claims made which is accounted for by claims which occurred up to and including that month, after controlling for the number of active policies in each month.

7. The black line illustrates how claim costs would be distributed if they were spread evenly across the life of a loan. Wherever the blue curve lies above this line, this implies that providers' claim costs up to this month are asymmetrically skewed towards earlier in the loan period. As the chart makes clear, claim costs are skewed towards earlier in the loans' lives.

FIGURE 1

Cumulative distribution of claim costs, weighted by the number of active policies, across the life of the loan: combined sample of 36-month PLPPI policies



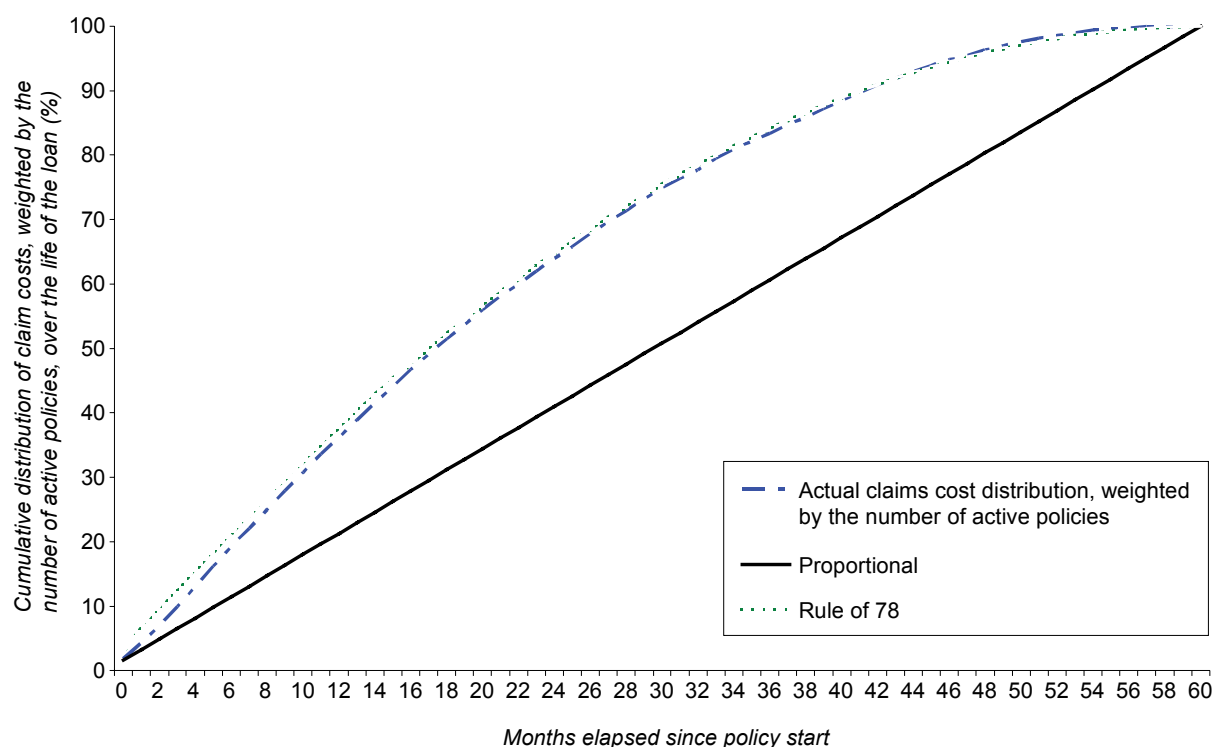
Source: CC analysis.

²It was put to us that weighting the data in this way could reflect the distribution of claim costs over the term of the loans inaccurately if customers from some risk groups are more likely to terminate their policies than others. However, we consider that failing to account for the substantial attrition in the number of active policies would distort our results to a much greater extent, and that weighting the value of claims the way that we have done provides our best available estimate of the distribution of risk across the loan term. Another party told us that this method overstated claims in later periods because of selective lapses, whereby lower-risk customers were more likely to claim their policy. We note, however, that the proportion of PLPPI customers who cancel their policies, but retain their loan, is around 1 per cent of all policies active at the start of a year (see Table 4.2 of our [provisional findings](#)). We therefore regard this effect as negligible.

8. Figure 2 displays the same information for the combined sample of PPI policies on 60-month loans taken out in 2002. Here the skew in claim costs towards the earlier part of the loans is more pronounced.

FIGURE 2

Cumulative distribution of claim costs, weighted by the number of active policies, across the life of the loan: combined sample of 60-month PLPPI policies



Source: CC analysis.

9. The green dotted lines in Figures 1 and 2 show the hypothetical distribution of claim costs which is implied by the rule of 78. For the 60-month loans, the rule-of-78 profile appears to follow the actual distribution of claim costs. Hence, for these longer-term loans, the rule of 78 would appear to be a good approximation of the distribution of claim costs over the term of the loan. For the 36-month loans, the actual distribution of claim costs, although skewed towards earlier in the loan period, is not as biased towards the beginning of the loan as the rule of 78 would imply.

10. Given this asymmetry in claim costs, we considered what would be the impact of forcing providers to offer pro-rata rebates or prohibiting single-premium policies for their costs from claims, and therefore potentially for PLPPI prices. Looking at 36-month PLPPI products, in Table 1 the lifetime cost of claims, per active policy, initiated in (a) the whole term and (b) the first year has been expressed as a monthly average for that period. For all of the providers, mean claim costs per active policy are above average in the earlier period. The 'cost differential' records the extent of this difference in the form of a percentage. The penultimate row shows that, for the combined sample, average costs per active policy were nearly a quarter higher when we compare the first year with the full 36 months.

TABLE 1 **Monthly average of lifetime cost of claims per active policy for claims initiated in that period: 36-month PLPPI policies**

<i>Distributor</i>	<i>Period</i>		<i>Cost differential, first year %</i>
	<i>Whole term £</i>	<i>First year £</i>	
[X]	2.69	3.50	+30.35
[X]	2.00	2.24	+11.95
[X]	2.39	2.61	+9.33
[X]	2.43	3.04	+24.87
[X]	1.30	1.72	+31.86
Combined sample cost differential, first year			+23.98

Source: CC analysis.

11. Table 2 gives the same data for the 60-month PLPPI products. Again we observe that average claim costs per active policy are higher in the first year for four of the five providers. The cost differential between the first year and the 60-month average for the combined sample is equal to 70.95 per cent.

TABLE 2 **Monthly average of lifetime cost of claims per active policy for claims initiated in that period: 60-month PLPPI policies**

Distributor	Period		Cost differential, first year %
	Whole term £	First year £	
[X]	2.66	4.10	+54.30
[X]	4.31	6.77	+57.06
[X]	5.00	8.98	+79.32
[X]	3.60	5.03	+39.88
[X]	2.45	3.99	+62.80
Combined sample cost differential, first year			+70.95

Source: CC analysis.

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12. Some of the parties said that, because of the asymmetry in the incidence of claims over the length of the loan, their costs would increase under a regular-premium framework, or with pro-rata rebates, if a disproportionate number of customers claimed a refund in the earlier—more costly—period of the loan. They said that this would then force them to charge a higher monthly premium than implied by the current single premium to cover for this possibility.

 13. We attempted to derive an estimate of the maximum extent of the potential increase in PLPPI prices that could result from an increase in claim costs as a consequence of pro-rata rebates, or a ban on single premiums. Our methodology was as follows. Assuming that every PLPPI customer terminated their policy within a year of the loan’s start date, then the data presented in Table 2 suggests that—averaging across the providers—their costs from claims would increase by around 24 per cent for the 36-month PLPPI and 71 per cent for 60-month PLPPI.

 14. If we assume that all of the resulting increase in average claim costs was passed on to customers, then we can derive a rough estimate for the maximum extent to which prices might be expected to increase, under these extreme assumptions. Parties were asked to submit data on the gross written premiums (GWP) earned on the loans sold in each cohort. These figures—which are gross of rebates paid to

customers for early termination, as well as taxes—reflect the total initial amount paid by loan customers for PLPPI. By comparing the total cost of claims over the loan term with these figures, we are able to derive an estimate of the importance of claim costs to PPI prices (we note that the GWP figures do not include the interest revenues earned by PLPPI providers and so overstate the size of claim costs relative to the prices consumers pay for PPI).³

15. Table 3 presents some key descriptive statistics relating to the claim profile of the PLPPI products considered, including the GWP earned. The final column reflects the ratio of the total value of costs from claims made in each cohort of loans to initial GWP, gross of taxes and rebates. The table shows that, for 36-month PLPPI products, the average of this ratio, taking the providers' data together, was equal to 7.79 per cent, 8.18 per cent for 60-month PLPPI.

TABLE 3 PLPPI claims profile descriptive statistics, by provider

<i>Loan provider</i>	<i>Total claims (total policies)</i>	<i>GWP £</i>	<i>Total claims payout £</i>	<i>Claim costs as a proportion of GWP %</i>
<i>36-month PLPPI</i>				
[X]	1,826 (42,434)	33,080,597.00	2,521,187.52	7.62
[X]	876 (26,914)	20,851,660.21	1,124,664.01	5.39
[X]	550 (24,915)	9,405,419.09	800,386.46	8.51
[X]	888 (29,722)	18,888,274.16	1,134,008.94	6.00
[X]	2,201 (55,695)	29,754,000.13	3,146,707.92	10.58
Total/average	6,341 (179,680)	111,979,850.59	8,726,954.58	7.79
<i>60-month PLPPI</i>				
[X]	2,718 (93,188)	54,273,466.47	6,491,661.72	11.96
[X]	5,002 (127,060)	162,078,151.49	9,453,000.91	5.83
[X]	7,766 (124,365)	225,407,092.00	15,115,440.59	6.71
[X]	26,483 (433,089)	779,592,756.00	71,597,418.84	9.18
[X]	4,901 (94,218)	134,158,000.00	8,210,197.02	6.12
Total/average	46,870 (871,920)	1,355,509,465.96	110,867,719.08	8.18

Source: CC analysis.

16. By combining the data on the ratio of claim costs to GWP with our estimate for the increase in average claim costs were every customer to switch PPI providers after a

³Some of the parties suggested that GWP net of taxes or rebated would be a more appropriate figure on which to base our price estimates. However, the purpose of this analysis is to relate a cost increase to the prices that consumers pay for their PPI policies. The price to the consumer will include insurance premium tax and any future refund costs. We therefore consider that using a GWP figure net of these items would materially overstate the relative size of any price effects.

year, we are able to derive an estimate of how much initial PLPPI prices—reflected in GWP—would have to increase for these two cohorts of loans in order to offset the increase in costs, all else held equal. That is, if the monthly average of the lifetime cost of claims per active policy over the course of the loan was to increase to its level after the first year of the loan, how big is the maximum increase in initial prices this could imply? In particular, in doing this we assume that there is no change in costs other than those associated with claims, that the number of initial policies remains unaltered, and that the profile of early terminations and rebates over the course of the loan is unchanged.

17. When we perform this exercise, we find that the maximum increase in PLPPI prices for 36-month PLPPI would be under 2 per cent for 36-month PLPPI, and just under 6 per cent for 60-month PLPPI.
18. We would expect these figures to overestimate the actual price effect of banning single premiums or enforcing pro-rata rebates, as not every PPI customer would switch providers within the first year, and we would expect part of any increase in costs to be absorbed by the providers, given the high profit margins. Finally, we would expect that a remedy designed to reduce switching costs would result in some downward pressure on prices as a result of increased competition between providers. We conclude therefore that, while there is some evidence that claim costs are asymmetrically distributed across the loan period, it does not seem likely that the introduction of minimum rebate terms or the banning of single premiums would, via their effect on providers' costs from claims, have a large impact on PPI prices.

The profile of SMPPI claims on 60-month second-charge mortgage loans commencing in 2002

19. We also considered the profile of claim costs across the loan term for a cohort of two providers' (☒) 60-month second-charge mortgage loans commencing in 2002. The

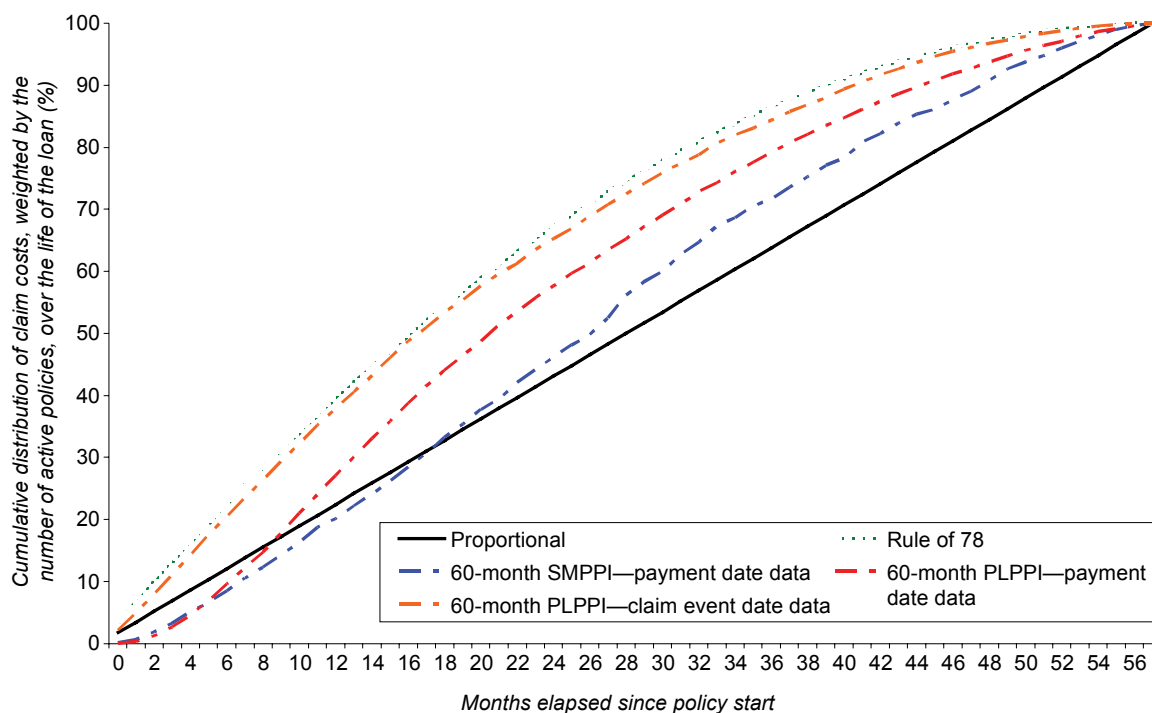
data for these providers reflected the lifetime cost of claims sorted by the date on which payment commenced on a claim, rather than the date on which the claim event occurred. We would expect this to cause our analysis of the claims profile to underestimate any skew in the distribution of claims costs across the life of the loan to some extent, as delays will exist between a claim event occurring and payment commencing on that claim.

20. The blue dashed line in Figure 3 charts the cumulative distribution of claims costs per active policy over the length of the loan for 60-month SMPPI for the two providers.⁴ The red dashed line illustrates the distribution for the two providers' PLPPI when we use payment date data. The orange dashed line illustrates the distribution of claims for the two providers' PLPPI where claims are sorted in the preferred method, on the basis of the month in which the claim event occurred.
21. The orange dashed line lies well to the right of the red one, illustrating clearly that the skew in PLPPI claims is underestimated when we sort claims by the month in which payment began on them, rather than when the event occurred. This implies that the blue dashed line may significantly understate the extent of the asymmetry in claims costs for 60-month SMPPI.

⁴The final three months of the loan term were not included in the analysis because of some irregularities in the data provided to us on SMPPI claims for these months. In order to maintain consistency, we have also dropped the final three months from the PLPPI data used to derive the red and orange dashed lines in Figure 3. We do not expect this significantly to affect our results given the very small volume of claims in these months (0.2 per cent of total claims costs were made up of claims on which payment began in the final three months for the 60-month PLPPI combined sample). However, it should be kept in mind that this may be causing us to slightly underestimate the skew in claims costs in all three curves.

FIGURE 3

Cumulative distribution of claim costs across the life of the loan, weighted by the number of active policies, for two providers' 60-month PLPPI and SMPPI



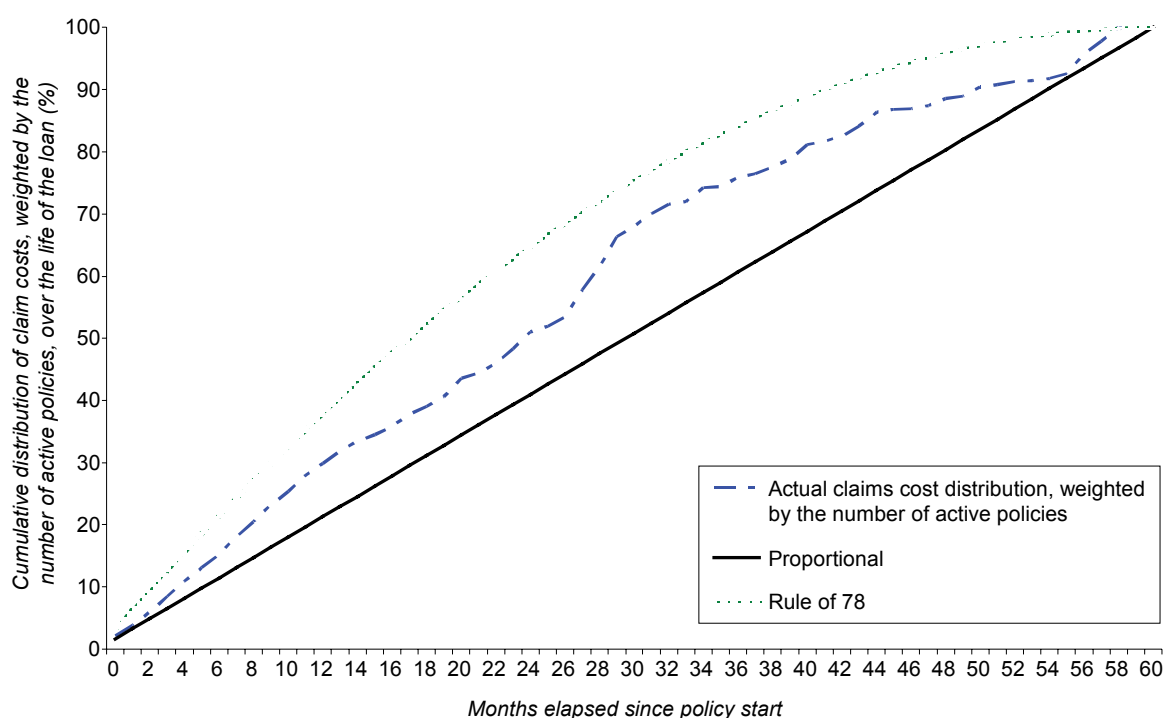
Source: CC analysis.

22. We observed, however, that the blue SMPPI dashed line lies to the right of the red PLPPI dashed line—on the basis of the less-preferred data, the skew in claims costs towards the beginning of the loan period is more pronounced for 60-month PLPPI than for 60-month SMPPI. On the assumption that there is not a large difference in the time taken to process a SMPPI and a PLPPI claim, this suggests that, if we were able to correct for the use of payment date rather than claim event date data, the skew in SMPPI claims, while more pronounced than that implied by the blue dashed line in Figure 3, would likely be less pronounced than that observed for 60-month PLPPI (the red dashed line). At the least, we would not expect the skew to be more accentuated, and so we would not expect the differential in the monthly average of the lifetime claim cost per active policy between the first 12 months and the whole loan term for SMPPI to exceed the 71 per cent observed for 60-month PLPPI.

23. This conclusion is supported by our analysis of the one SMPPI supplier for which we did have access to data on the basis of claim event date ([X]). Figure 4 illustrates the profile of claim costs per active policy across the life of the loan for this provider's 60-month SMPPI beginning in 2002. While there is evidence of a skew in claim costs towards the early part of the loan period, the skew is not as pronounced as implied by the rule of 78.

FIGURE 4

Cumulative distribution of claim costs across the life of the loan, weighted by the number of active policies, for [X] 60-month SMPPI policies



Source: CC analysis.

24. Accordingly, although it is difficult to draw strong conclusions for SMPPI given the data we have, the evidence available to us suggests that the asymmetry in claims costs will be less pronounced for 60-month SMPPI than for 60-month PLPPI. The ratios of total lifetime claim costs to GWP for the two SMPPI providers which submitted the data necessary for this calculation to be carried out are again low—and indeed even lower than those observed for PLPPI, at [<10] per cent and [<10] per cent (for [X] and [X] respectively). Because of this, we conclude that the maximum

plausible increase in SMPPI prices, were claims costs to increase to their average level a year into the policy, would most likely not lie above that calculated for PLPPI.

The profile of PLPPI claims for some non-standard personal loan suppliers

25. We also considered two large non-standard lenders—[X] and [X]—separately, in order to check whether their claim costs followed a different pattern to those of prime lenders. Table 4 presents some statistics for both the incidence and value of claims made on the two providers' 36- and 60-month personal loan and second-mortgage products for the chosen cohort.

TABLE 4 Descriptive statistics for 36- and 60-month PLPPI, non-standard providers

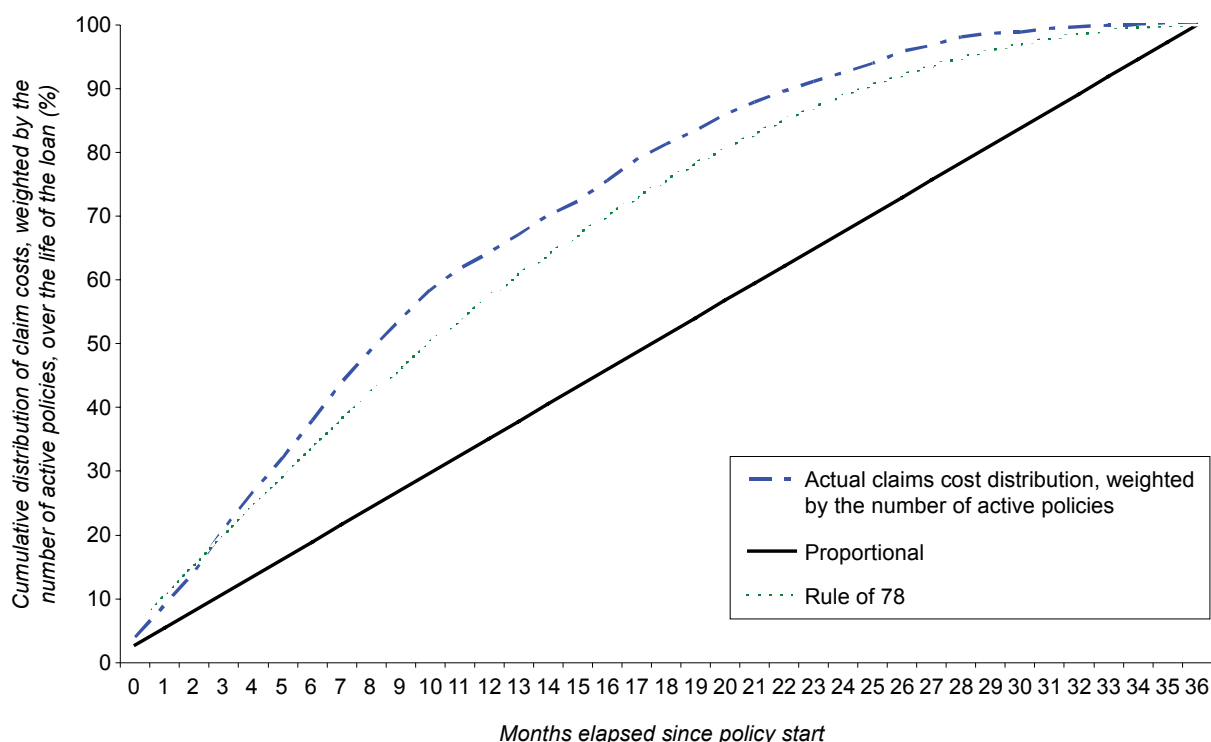
<i>Loan provider</i>	<i>Total claims (total policies)</i>	<i>GWP £</i>	<i>Total claims payout £</i>	<i>Claim costs as a proportion of GWP %</i>
<i>36-month PLPPI incepted in 2004</i>				
[X]	[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]	[X]
Total/average	[X]	[X]	[X]	[X] <15
<i>60-month PLPPI incepted in 2002</i>				
[X]	[X]	[X]	[X]	[X] <15

Source: CC analysis.

26. Figure 5 shows the cumulative distribution of claim costs per active policy across the life of [X] 36-month protected loans taken out in 2004. The chart shows that the profile of claims is significantly more skewed here than for the combined sample of 36-month PLPPI analysed previously; claim costs exhibit a more pronounced bias towards the beginning of the loan period for [X] non-standard loans than for the other providers' 36-month loans. Indeed the skew is actually more accentuated than that implied by the rule of 78—rebate rules based on the rule of 78 would be overly fair to loan customers in terms of reflecting the risk assumed by the insurer across the loan term.

FIGURE 5

Cumulative distribution of claim costs across the life of the loan, weighted by the number of active policies, for [redacted] 36-month PLPPI policies



Source: CC analysis.

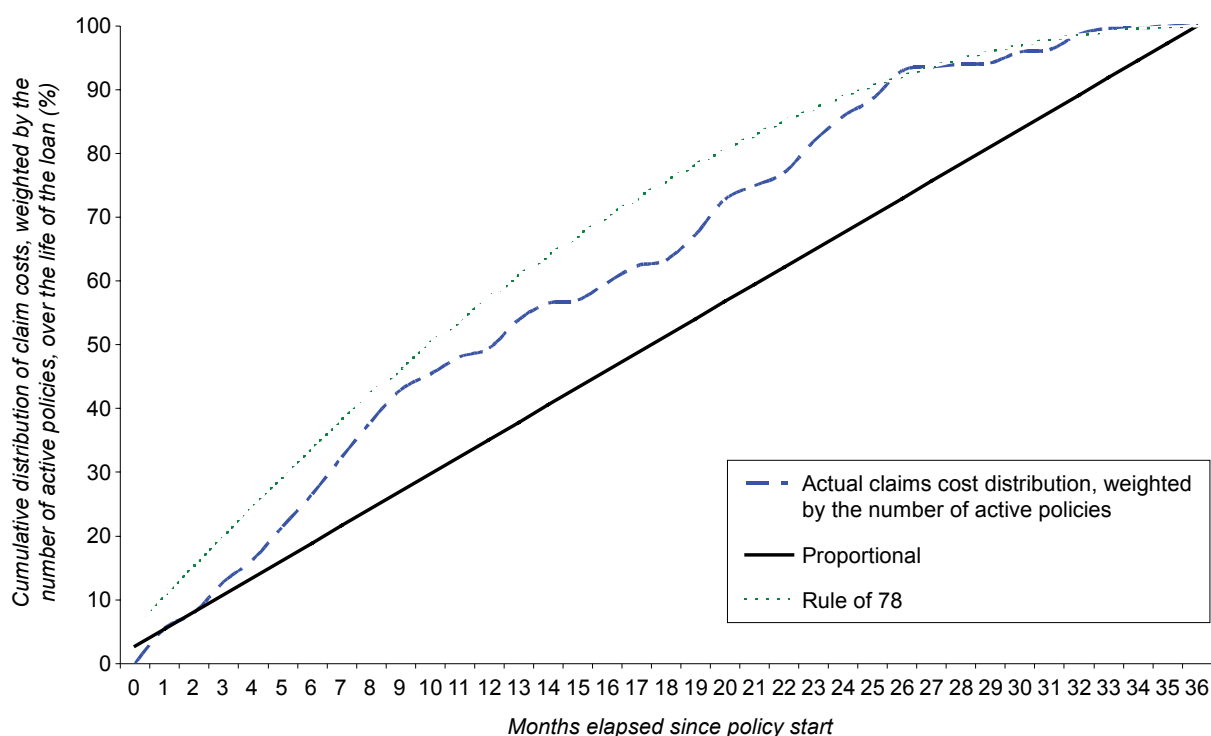
27. [redacted] average cumulative claim costs per active policy are [>75] per cent higher one year into the 36-month loans than after the full 36 months. As before, we can think of this as the maximum plausible increase in claim costs which could result were single premiums banned, or pro-rata rebates enforced. The figures in Table 4 suggest that for this cohort of loans, total lifetime claim costs made up a very small proportion of premiums —[<10] per cent. Using the same methodology as previously (see paragraphs 13 to 18), we can estimate an upper bound on the potential price rise associated with this increase in claim costs, all else held equal, of around 3.5 per cent.

28. Figure 6 charts the cumulative claim costs per active policy through the life of 36-month protected loans for the other non-standard lender—[redacted]. Claim costs are again skewed towards earlier in the life of the loan, although like the 36-month PLPPI

providers, the asymmetry is not as accentuated as implied by the rule of 78. The monthly average of lifetime claim costs per active policy are around [X] per cent higher after one year of the loan than across the entire loan term. Taken together with the ratio of claim costs to initial GWP of [<15] per cent, this implies an increase in PPI prices of under 3.5 per cent, were claim costs per active policy to increase to their level one year into the loan term.

FIGURE 6

Cumulative distribution of claim costs across the life of the loan, weighted by the number of active policies, for [X] 36-month PLPPI policies



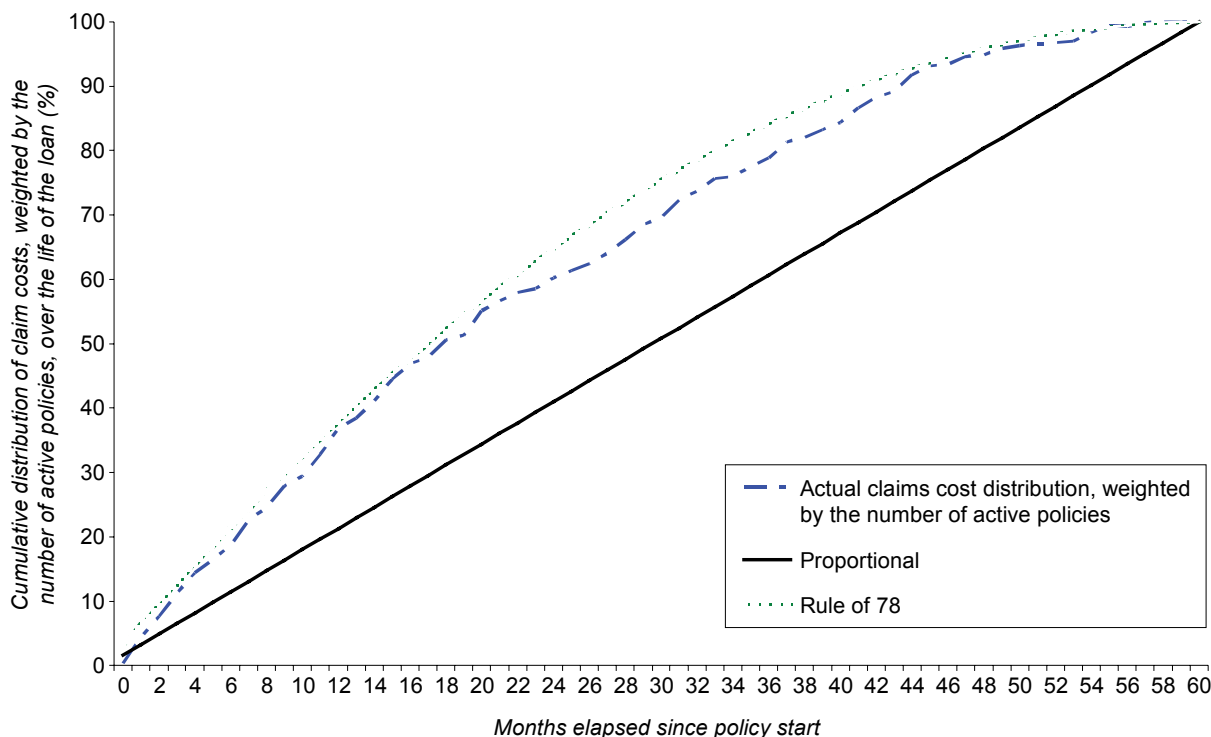
Source: CC analysis.

29. The claims profile for [X] 60-month PLPPI product (Figure 7) exhibits a clear skew towards earlier in the loans' lives, exhibiting a similar degree of asymmetry to the sample made up of the large providers' 60-month PLPPI products. The cost differential after a year is equal to about [>50] per cent. The upper-bound increase in PPI prices associated with this cost differential, all else held equal, is just under 7.5 per cent, given the ratio of claim costs to premiums. Again, we would expect this

figure to greatly overstate the actual effect on prices resulting from the impact of a movement to pro-rata rebates or regular premiums on providers' costs from claims.

FIGURE 7

Cumulative distribution of claim costs across the life of the loan, weighted by the number of active policies, for [X] 60-month PLPPI policies



Source: CC analysis.

30. Our analysis of non-standard policies has shown that claim costs do appear to be skewed towards the beginning of the loan period after taking into account the attrition in the number of active policies over the length of the loans, and for [X] 36-month PLPPI, this skew is actually more accentuated than that implied by the rule of 78 (which is used by many providers for calculating rebates). Based on our analysis of the implied increase in claim costs were every customer to switch policies within the first year of the loan, and the ratio of claim costs to GWP, we concluded that it did not seem likely that the introduction of minimum rebate terms or banning of single premiums would, via their effect on providers' costs from claims, have a large impact on PPI prices for non-standard personal loans.