

PPI policies—characteristics

1. The purpose of this appendix is to provide details of the typical characteristics of PPI policies, including what the policies cover, what they do not cover, waiting periods and price.

What is covered

2. PPI policies are not underwritten on an individual basis; many companies charge the same premium to all customers for the same cover, though some do charge varying premiums according to, for example, age.¹ Once a customer is deemed to be eligible for a credit product, PPI is made available if the customer is eligible for it (and also if the policy is suitable, if the sale is made on an advised basis²). PPI will typically cover either all, or a combination, of A, S, U and L. Unemployment cover typically covers only involuntary unemployment. Some policies also offer cover for CI.³ First-charge MPPI does not usually contain a life element in its cover (see Table 1).

TABLE 1 Typical covers provided by three main policy types

Cover/benefit	MPPI	CCPPI	PLPPI
Accident/Sickness cover	Usually standard, may be optional	Standard	Standard
Unemployment cover	Usually standard, may be optional	Usually standard	Usually standard
Life cover	Rarely	Nearly always	Nearly always
Critical Illness cover	Rarely	Sometimes	Sometimes
Hospitalization cover	Sometimes	Often	Often
Disability Benefit Period	12 months	Usually 12 months	12 months or loan period
Unemployment Benefit Period	Usually 12 months	Usually 12 months	12 months
Excess Period Disability	0, 30, 60, 90 days	15 or 30 days	15 or 30 days
Excess Period Unemployment	0, 30, 60, 90 days	30 days	30 days
Payments made to	Lender	Lender	Lender
Maximum benefit	Mortgage repayment plus additional amount	Monthly credit card minimum balance	Monthly loan repayment
Payment method	Monthly, fixed amount	Monthly, depending on balance	Initial lump sum, fixed amount

Source: Defaqto *Payment protection insurance 2008—The party's over*.

3. There are some minimum requirements a customer must satisfy to be eligible for PPI cover. These are generally that the customer must:

¹British Insurance, Lloyds TSB and HBOS are three providers we are aware of that vary the price of some of the PPI policies they offer based on the age of the customer.

²The FSA's ICOB Rules and its TCF rules set out the requirements for an advised sale and a non-advised sale of PPI. For more information, see Appendix 2.5.

³Barclays, HBOS and Lloyds TSB told us during hearings that their PPI offering included CI cover; it is also offered by many motor finance PPI providers, by some credit card PPI providers and some retail finance PPI providers.

- be between 18 and 65 years of age;⁴
 - be living and working in the UK;⁵ and
 - be actively employed for at least 16 hours per week.⁶
4. In order to make an unemployment claim, customers must usually both have held the PPI cover for a period of time and have been in continuous employment for a period of time (the lengths of both periods would be specified in the policy).
 5. If an event for which the customer is entitled to claim under a PPI policy occurs, payment will be made for the time period specified in the policy. This time period is usually up to 12 months (for unemployment claims), and for accident and sickness claims is often up to 60 months, but can be for the life of the loan.

What is excluded

6. Exclusions vary between PPI policies. However, as a general rule, if the cause of the claimable event is deemed to have been within the control of, or known to, the customer at the time of purchasing the insurance, the customer will not be able to claim against the policy. For example, as stated above, most PPI unemployment cover is limited to involuntary unemployment, so it is not usually available to those who are self-employed, have been dismissed or have taken voluntary redundancy. In addition, customers cannot generally claim for a 'pre-existing condition' (which is an illness they had and were aware of at the time of purchasing the policy).
7. In the past it was common for stress-related illnesses and back complaints to be excluded from the scope of PPI cover, even if the policyholder was unable to work as a result of those conditions. However, recent developments in the industry have seen an easing of exclusions such as back complaints and stress-induced illnesses by some providers.⁷

Calculation of benefits

8. PPI benefits for personal loans and mortgages typically cover the monthly repayments on the loan for a specified period (which is normally 12 months). PPI for credit cards typically covers either a percentage of the outstanding balance at the time the claim is made (policy terms range from paying 3 to 15 per cent of the outstanding balance)⁸, or the minimum payment requirement for up to 12 months.
9. CCPPI policies differ where the benefit payable is a percentage of the outstanding balance on the credit card at the time the claim is made. This is because some policies provide for calculation of the benefit as a percentage of the balance outstanding at the time the claim is made (constant rate); and some provide for calculation of the benefit as a percentage of the balance outstanding each month, ie

⁴Some policies offer cover beyond the age of 65. For example, MBNA offers cover up to 70 years of age, some RBSG products are available to over 65s without unemployment cover, and SDGFS's retail PPI policy allows for claims on unemployment up to the age of 75 and on hospitalization cover beyond 75 years of age.

⁵MBNA offers cover if the customer is paying National Insurance contributions, even if they reside outside the UK. Under SDGFS's retail PPI policy customers who are not working in the UK are still eligible for PPI for hospitalization and life cover.

⁶Under SDGFS's retail PPI policy if the policyholder is not actively employed for 16 hours per week the policyholder's partner is covered for life, accident, sickness and unemployment.

⁷For example, some PPI policies offered by Abbey, Barclays, Cattles, HBOS, HSBC, Lloyds TSB, London General Insurance and RBSG (among others) have been expanded to include back complaints and stress-related illnesses. MBNA has offered cover for back complaints and stress-related illnesses since it began offering PPI for personal loans and credit cards.

⁸See Appendix 4.2.

on the reducing balance (reducing rate). An example of how these differences work in practice is set out in Table 2.

TABLE 2 Example: outstanding balance of £1,000; benefit payable 10 per cent of the outstanding balance

Type of cover	Benefit payable, month 1	Benefit payable, month 2	Benefit payable, month 3
Constant rate	£100 (leaving a balance of £900)	£100 (leaving a balance of £800)	£100 (leaving a balance of £700)
Reducing rate	£100 (leaving a balance of £900)	£90 (leaving a balance of £810)	£81 (leaving a balance of £729)

Source: CC, based on evidence provided by parties.

Waiting periods

10. All PPI policies include one or more of the following waiting periods:
 - (a) *Exclusion period*: the specified number of days between the time a policy is purchased and the time the customer can make a claim. We have been told that this is typically 30 days, although there are some policies which only have a 14-day exclusion period.
 - (b) *Excess period*: the time between the occurrence of a claimable event (for example, sickness) and the time the policyholder is entitled to begin receiving benefits. We have been told that this period varies, but can be up to 30 days.
 - (c) the time it takes for the first benefit payment to be made, which under some policies is up to 30 days after the expiration of any excess period.
11. In its 2006 annual report following a review of PPI, Defaqto⁹ stated that while PPI was designed to cover the cost of regular payments to a lender, it was not a homogenous product. Policies often used complicated terminology, and payments were not necessarily made in the same way by each provider. Most types of PPI policies (such as MPPI or PLPPI) appeared, at first glance, to have similar excess periods and waiting periods. However, Defaqto noted that in practice the ways in which benefits accrued and were paid under the various policies varied markedly.
12. Defaqto sought to illustrate the differences between the way in which benefits accrued and were ultimately paid with reference to the following example: a policyholder becomes sick and is unable to work for four and a half months. His PPI policy provides for 12 months' cover with a 30-day excess period in the event of sickness. In those circumstances there are four main types of PPI policy structure, each with a different claims payment method. Table 3 contains an illustration of the differences between payment types.

⁹Defaqto, *Payment Protection Insurance in the UK Annual Review of the PPI Market—February 2006*.

TABLE 3 Differences between benefit payment types

Payment type	days		
	Benefit provided (45-day sickness)	Benefit provided (135-day sickness)	Benefit provided (180-day sickness)
30-day excess;* benefits accrue monthly	0	90	150
30-day excess; benefits accrue daily	15	105	150
30-day retrospective;† benefits accrue monthly	30	120	180
30-day retrospective; benefits accrue daily	45	135	180

Source: Defaqto, *Payment Protection Insurance in the UK Annual Review of the PPI Market—February 2006*.

*First payment is due 61 days after the event (not eligible to be paid until 30 days after the expiry of the excess period).

†First payment is due 31 days after the start of the event.

13. Each of the methods for payment of benefits under PPI policies set out in Table 3 materially affects the amount of benefit which the customer will receive. However, all the policies may be described as having a 30-day exclusion or 'waiting period'. The differences in the way benefits are paid will not necessarily be clear to the customer when the policy is purchased.
14. There is a further factor which contributes to the differences between payments made to a policyholder illustrated by Table 3, which has a material impact on the amount of benefit a policyholder will receive in the event a claim is made. That is whether the policy provides for benefits to be calculated on a monthly basis or on a daily basis.
15. If a policy provides for monthly calculation of benefits, policyholders may not be eligible for benefits until up to 61 days after the claim is made, because they are required to wait until the (often 30-day) excess period has expired and thereafter until they have been off work for a further month. Therefore, if they are unable to work for four and a half months due to sickness, they will receive payments for three of those months (because they lose one month at the start of the period due to the excess, and half a month at the end of the period because benefits are paid only for each whole month off work).
16. If the policy provides for daily calculation of benefits, the policyholders must wait for the expiry of the (up to 30-day) excess period before being eligible for payment of benefits. Payments are made for each single day they are unable to work, and those payments are made at the end of each month off work. When they return to work they receive payment for any part-months. Accordingly, if they are unable to work for four and a half months, they will receive benefits for three and a half months.
17. Some providers offer payments which are known as 'retrospective', or 'back to day one' policies. These can also be calculated on either a monthly or a daily basis. There will usually be a waiting period before the first benefit payment is due, but payments will be calculated from the first day the policyholder was unable to work. If the benefits are calculated on a monthly basis, and the policyholders are unable to work for four and a half months, they will only receive benefits for four of those months. If the benefits are calculated on a daily basis, in the same scenario they will receive benefits for the entire four and a half months they are unable to work.

Price of policies

18. Details of the price dispersion of PPI can be found in Appendix 4.2 and an explanation of single-premium and regular-premium policies is in paragraphs 2.74 to 2.78.

19. There seem to be at least three different methods which providers use to calculate the price of a single-premium policy. Different providers calculate premiums using different methods. Moreover, individual providers apply different premium rates according to the length of the policy.
20. Each method applies a constant, term-specific insurance premium rate to some measure of the total amount payable (TAP) on the loan. This rate varies according to the period over which cover is provided (normally the term of the insured loan) but not according to other factors (for example, the APR).
21. The three methods differ in their treatment of interest paid on the single premium (where this is added to the loan and repaid in instalments) and whether the term-specific rate is calculated as a percentage of the TAP including or excluding the PPI premium.
22. We illustrate below the three methods by way of worked examples. In each example, we consider a £1,000 loan with a two-year term and APR of 13.8 per cent.

Method 1: 'All-inclusive' insurance premium rate

23. Using Method 1, a constant, term-specific insurance premium rate is applied to the TAP excluding the insurance premium.
24. The premium that is calculated in this way covers both the insurance premium and any costs of funding the premium.

Example: Method 1

1	Loan (£)	1,000	
2	Term (years)	2	
3	APR (%)	13.8	
4	Cost of credit (£)	141	Calculated using APR on the loan
5	TAP without PPI (£)	1,141	Equals 1 plus 4
6	'All inclusive' insurance premium rate (%)	13.1	As a percentage of 5
7	Insurance premium (£)	150	Equals 5*6
8	TAP with PPI (£)	1,291	

25. Where a firm uses Method 1 to set premiums, then the premium rate, in this example, for a two-year loan would be 13.1 per cent.

Method 2: Constant percentage of TAP excluding PPI

26. Using Method 2, a constant, term-specific insurance premium rate is applied to the TAP excluding PPI. Interest is then calculated on this premium, using the APR on the loan.
27. Under this method, the TAP with PPI is the sum of:
 - (a) the TAP without PPI;
 - (b) the PPI premium; and
 - (c) interest on the PPI premium.

Example: Method 2

1	Loan (£)	1,000	
2	Term (years)	2	
3	APR (%)	13.8	
4	Cost of credit (£)	141	Calculated using APR
5	TAP without PPI (£)	1,141	Equals 1 plus 4
6	Premium rate as a percentage of TAP without PPI (%)	11.5	Set as a percentage of 5
7	Premium (£)	131	Equals 5*6
8	Interest on premium (£)	18	Calculated using APR on the loan
9	TAP with PPI (£)	1,291	Equals 5 + 7 + 8

28. Where a firm uses Method 2 to set premiums, then the premium rate, in this example, for a two-year loan would be 11.5 per cent.

Method 3: Constant percentage of TAP including PPI

29. Using Method 3, the premium for loans of a given term is calculated by applying a constant, term-specific premium rate to the TAP on the loan including PPI. Interest is then calculated on this premium, using the APR on the loan.

30. The single premium can be calculated as a (fairly complex) function of the size of the loan, the premium rate, the term of the loan and the APR on the loan. Under this method, the TAP with PPI is the sum of:

- (a) the TAP without PPI;
- (b) the PPI premium; and
- (c) interest on the PPI premium.

Example: Method 3

1	Loan (£)	1,000	
2	Term (years)	2	
3	APR (%)	13.8	
4	Cost of credit (£)	141	Calculated using APR
5	TAP without PPI (£)	1,141	Equals 1 plus 4
6	Premium rate as percentage of TAP with PPI (%)	10.2	Set as a percentage of 9.
7	Premium (£)	131	Calculated using the following formula:*
			$P = \frac{L * p * n * r * (1+r)^n}{[(1+r)^n (1-p * n * r) - 1]}$
8	Interest on premium (£)	18	Calculated using APR on the loan
9	TAP with PPI (£)	1,291	Equals 5 + 7 + 8

*Where 'P' is the premium payable, 'L' is the loan amount, 'r' is the monthly interest rate on the loan, 'n' is the number of monthly repayments and 'p' is the PPI premium rate (defined as the ratio of the premium to the total amount payable including insurance).

31. Where a firm uses Method 3 to set single premiums, then the premium rate, in this example, for a three-year loan would be 10.2 per cent.

Refunds

32. When a customer terminates a regular-premium policy, we understand that they stop making payments towards it and, after the expiration of any notice period specified in the policy, it will be cancelled. The situation is different for single-premium policies,

for which customers have paid in advance at the commencement of the loan period. See Appendix 5.2 for details of the calculation of refunds for single-premium policies.

33. Refunds for single-premium policies have been consistently given since March 2006, following an agreement between the FSA and some of the trade associations for PPI—ABI, BBA, CML, FLA and Protect.
34. However, the FSA has not required firms to calculate refunds for single-premium policies in a standard way. It stated that refunds should be calculated to take into account the reasonably incurred costs of each firm, which will vary, but may include administrative costs, proportion of commission and the uneven spread of risk over the course of the policy.
35. Accordingly, refunds for single-premium policies are not calculated on a pro-rata basis in accordance with the proportion of the contract remaining. Each payment for a single-premium policy will be the same during the time the policy is in place. However, the PPI provider usually deems more premium to have been paid at the beginning of the loan, in line with the risk profile of the loan, and any amount available to be refunded will reflect that uneven spread of risk. Expenses such as administrative costs which are incurred by the provider may also be deducted from the amount which is refunded to the customer.
36. The FSA¹⁰ has indicated that while all providers now offer refunds on single-premium PPI policies, the terms of those refunds are often not being properly explained to customers.

¹⁰FSA report *The Sale of Payment Protection Insurance Thematic Update* (September 2007).