

Competition Commission launch Payment Protection Insurance market inquiry

Introduction

As expected, the Office of Fair Trading (“OFT”) confirmed on 7 February 2007 that they will make a reference to the Competition Commission (“CC”) in respect of the Payment Protection Insurance market. John Fingleton, OFT Chief Executive said:

“Our examination of the evidence presented to date gives us reasonable grounds to suspect that there are features of this market which restrict competition to the detriment of consumers. Despite some evidence of a degree of consumer satisfaction with aspects of the product, the evidence as a whole suggests consumers get a poor deal. This referral will enable the Competition Commission to undertake a thorough investigation of the market and, if necessary, ensure that appropriate remedies are put in place.”

This Payment Protection Insurance (“PPI”) bulletin is the 2nd in our series of PPI-related bulletins. We provide our views on the CC process, and the potential impact for the industry. We also discuss the wider issues for engaging with the CC and what companies need to do now.

CC Process

The CC’s inquiry process can be extremely onerous even with low levels of engagement. It is much more intensive than an OFT inquiry with a far greater degree of transparency. The CC will have a statutory time limit of 2 years within which to carry out its inquiry but will probably aim to complete this in 18 months. The key milestones in the CC’s process will include:

Initial information request, kick off meetings, site visits
Main Information Request (following consultation)
Issues Statement
Submissions of main and third parties (now publicly disclosed)
Issues hearings
Emerging thinking document/consultation
Emerging thinking hearings
Provisional Findings / Possible Remedies
Remedies hearings
Final report

The impact of the inquiry is already starting to be felt. The CC has wasted no time despatching an initial and not-insubstantial information request. Responses are required by 26 February 2007, giving firms little time to prepare appropriate commentary to explain how they believe the CC should interpret the information submitted. Companies may also be requested to comment on the reasons for the referral ahead of the Issues Statement and may be asked to give a description of the market at initial kick-off meetings with the CC.

Information requests can be particularly burdensome with large volumes of data required and in-depth questions on the company, the market, competition, customers, profitability etc. Company submissions are now routinely made public subject to excision of commercially sensitive information.

The preparation of the main submissions is similarly onerous. This reflects the need to develop robust and persuasive arguments that meet the CC's concerns and which are demonstrably supported by empirical evidence. It is important to have as much evidence and fact-based analysis as possible.

Hearings in particular require a lot of preparation. During the course of an investigation companies can be asked to attend up to three or four hearings. There is also the possibility of a public hearing. Private hearings tend to last all day and are a very intensive exercise. The CC likes to speak to the people that run the business and the involvement of senior management will carry weight. Full "dress rehearsals" are a must.

Potential CC outcomes

The exam question the CC will be trying to answer is: does *"any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the United Kingdom or a part of the United Kingdom?"*. If so this would constitute an 'adverse effect on competition' (AEC) a phrase the CC will interpret broadly to include *"circumstances in which several features of the market create a situation in which the suppliers do not compete to the extent they would in a fully competitive market"*. Features of the market include the market's structure and the behaviour of firms and customers within that market.

Where an AEC is found the CC will weigh up the case for intervention in particular to remedy any detrimental effect on customers such as higher prices, lower quality, choice or innovation. Remedies must be reasonable and proportionate in relation to the adverse effect on competition and on customers taking account of costs of implementation and monitoring of compliance.

The CC's powers are wide-ranging and there are no formal restrictions on the remedial action it can take or recommend. Typical remedies include:

- Behavioural remedies; including
 - Directing firms to discontinue certain behaviour or to adopt certain behaviour - for example, information remedies where firms are required to display prices more prominently or even provide margin information; or
 - Price Caps - i.e. direct intervention on prices that can be charged.
- Structural remedies; including
 - Divestment of a business or assets to a newcomer to the market or to an existing, perhaps smaller, competitor; or
 - Reducing entry barriers e.g. by reducing switching costs or recommendations for changes to regulations that limit entry to a market.

In terms of PPI, the OFT have focused on distribution profits and it estimates that the potential consumer savings from making the market more competitive could be around £1bn. Some commentators have suggested this figure is conservative.

The OFT have defined the market very narrowly. In essence, the OFT are arguing that there is a "bottleneck monopoly" at the distributor level (the OFT consider that "with very few exceptions competition does not take place on PPI at all"). Left unchallenged, this leaves open the possibility of direct intervention on prices (as it did in the cases of *SME banking*, the interventions on credit card default fees and mobile termination rates) and/or onerous intervention at Point Of Sale (or very soon after – as with *Extended Warranties*). Less onerous interventions include information remedies designed to increase transparency for customers (see for example *Extended Warranties*); this could involve a form of "soft" price regulation: on *Store Cards* the CC implemented a "wealth warning" where APRs are above a certain level.

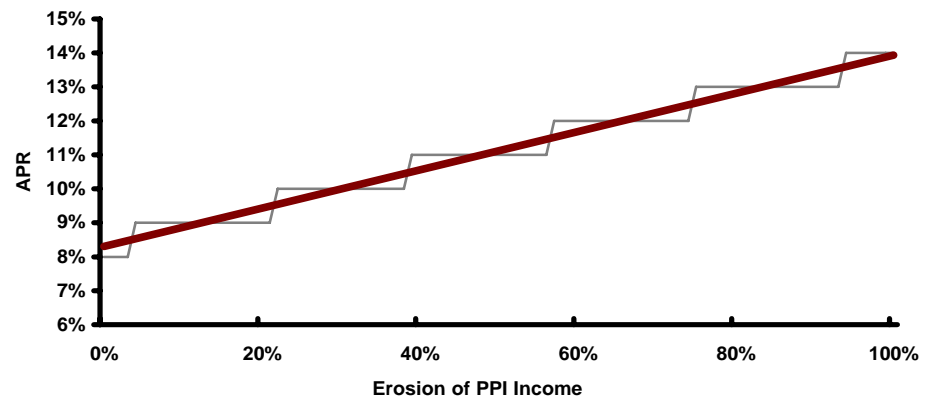
Potential Impact

The potential impact for the industry will vary depending on the nature of the proposed remedies. For example, we would expect:

- Information remedies to lead to lower penetration rates;
- Pricing remedies to reduce margins; this would be unlikely to be offset by higher volumes as demand for the current product is fairly price inelastic; and
- Structural remedies at point of sale to have a significant impact on volumes and possibly some impact on margins.

All of the above may be a potential source of stranded costs if the CC requires remedies to be implemented within a short period of time and the industry is not able to implement new initiatives to offset any reduction in volumes or margins. In addition any remedies relating to "live" policies are likely to result in further stranded costs and significant administration costs if companies are required to change the product pricing or policy terms mid-term. Furthermore, the impact of the CC remedies needs to be considered in the context that penetration levels may further reduce as a result of sales-related improvements required from the FSA thematic work or from a potential deterioration of public perception of PPI if there continues to be the stream of poor publicity.

It is widely considered in the industry that the "waterbed" effect will offset a significant proportion of any reduction in PPI profits through higher APRs for lenders. Graph A illustrates the magnitude of the potential necessary effect on APRs if the loss of profits were to be offset in full for unsecured loan policyholders with PPI:

Graph A: Illustration of the 'waterbed effect' for unsecured loans with PPI

This raises some interesting questions as to whether there will be a full waterbed effect for the more unfavourable CC remedies, given that APRs would theoretically have to increase from 8% to 14% for policyholders currently with PPI. In addition, how will companies apply the APR increase across their portfolio and what would be the impact on demand for consumer credit?

This may provide a catalyst for product innovation, including more detailed customer segmentation risk-based pricing, and growth opportunities for alternative lending products, including second charge mortgages.

Key Decisions for your Organisation

Strategy

Most importantly, companies need to mobilise their thinking and resources rapidly to allow them to engage and proactively influence the CC. Companies will very quickly be inundated with onerous information requests from the CC and will have little time to work on their case and undertake relevant research in support of their arguments.

The CC will probe hard on profitability, value for money and impact analysis of possible remedies. The OFT report is very data intensive and heavily researched and it appears the industry has not come close to matching the OFT in terms of evidence or arguments. As it stands, there is a very strong case for the industry to answer; however, we believe there are fundamental weaknesses in the OFT's position in various areas. It will be important for the industry to put forward sufficient weight and consistency of evidence. The number and strength of voices counts for a lot in CC inquiries.

The appetite for engagement may be influenced by a belief that there is potential to make up any reduced profits on PPI through higher loan APRs (the "waterbed" effect). As described above our initial analysis shows that significant increases in loan APRs (or tightening of loan criteria) would be required to try and compensate for material intervention on PPI margins which may lead to very significant volume responses. In light of this it will be important for the industry to mount some sort of defence of the current structure to try and achieve a "soft landing".

Evidence

Robust empirical evidence is key to persuading the CC of your arguments. The most obvious areas are:

- Value for money – the CC will want to understand the extent of customer benefit from the products, and how this varies by type of customer. This is an area that the

industry has so far failed to address in its dealings with the OFT and in our view is fundamental to influencing the CC. Under competition law prices are only excessive where they bear no reasonable relation to the economic value of the product¹ – although competition law precedent is not binding on a market investigation it is nonetheless of relevance;

- Profitability – the CC will inevitably carry out an extensive analysis of profitability. Unprompted, the CC will rely on the accounting information which is likely to produce profit figures that are greater than economic profitability which is more relevant to the CC analysis – it is important for companies to translate this information into economic/actuarial profits and to persuade the CC of the merits of these adjustments. In our experience these adjustments could be material for PPI; and
- Impact analysis of possible remedies – it will be important for the industry to illustrate the substantial difficulties and risks associated with more onerous interventions. This will need to address possible waterbed effects and degrees of decline in demand. The CC is generally receptive to this kind of evidence: in *Mobile Telephony* a great deal of impact analysis was used to justify less onerous intervention. Similarly in *Extended Warranties* the CC held back from too much intervention at point of sale through concerns of causing an overall decline in demand.

Resources

A CC inquiry lasting up to two years can place a significant strain on a company in terms of cost and time commitment. Generally firms appoint a project sponsor at the board level and a full time project manager who will coordinate a dedicated case team. The project sponsor will make the strategic decisions regarding the case that the company presents and will take the lead in answering questions at the hearings. The involvement of additional senior management for main hearings may also be appropriate. Information requests need to be responded to quickly and comprehensively and this can place a significant burden on the wider business. It is useful for a company-wide project code to be circulated with a commitment for the wider business to prioritise information requests from the case team. Generally, an inquiry of this sort could involve several FTE or thousands rather than hundreds of “man-days” across the organisation.

The experience of the case team and availability of internal resource will dictate the requirements for external support. Most companies tend to employ external legal and economic advisers. There may also be a requirement to commission bespoke consumer or industry research. In light of the increased transparency introduced to CC procedures over the years, many companies now invest in proactively managing the PR side to protect brand / reputation.

The optimal amount of investment in internal and external resource will be a function of what is at stake, and the extent to which firms can hope to influence the outcome. Major market participants will inevitably have more at stake and get more airtime with the CC.

¹ See in particular a recent UK Court of Appeal judgement (*Attheraces v BHB* [2007] EHC civ38). This was the first UK Court of Appeal decision in an excess pricing case and supported the BHB's arguments that a cost-based assessment that ignored economic value was inappropriate. The Competition Practice of PwC provided the expert economic evidence to the BHB. Dr Peter Davis, the Chair of the PPI inquiry, also assisted the BHB on this case.

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PwC Contacts

PwC can assist on all aspects of developing and presenting a robust and persuasive case for the CC. PwC has a dedicated PPI team that includes competition, regulatory, strategy, actuarial, product and pricing experts from across PwC's banking and insurance practices. PwC has one of the UK's largest competition economics practices (The PwC network of firms is ranked 5th largest globally by the Global Competition Review). This combination of deep competition experience and sector expertise gives us a unique ability to present authoritative robust analysis to address the competition authorities' concerns directly.

If you would like to discuss the CC inquiry or PPI please contact the following:

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