

# Financial Services Bulletin

Competition Commission releases Emerging Thinking on investigation into Payment Protection Insurance

November 2007

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## Overview

On 6 November 2007 the Competition Commission (CC) released its Emerging Thinking on the investigation into the Payment Protection Insurance (PPI) market. This is the latest stage in the CC investigation that began on 7 February 2007 when the Office of Fair Trading referred the sector to the CC. This represents the first point in the investigation when interested parties are informed of the CC's thinking and areas that are targeted for further investigation.

The CC has concluded that the focus for the next phase of the investigation is on the retail market and that there are no issues for concern in the underwriting market, or with vertical integration between underwriters and distributors. As regards the retail market the CC has signalled strongly what it believes is the most appropriate market definition based on current evidence, although it is open to persuasion based on further evidence. The CC has identified the areas it intends to focus future work on for the remainder of the investigation:

- Customer purchasing behaviour including extent of search and price sensitivity.
- Customer switching – single premiums, barriers, refunds, and customer behaviour.
- Profitability in the distribution market including cross subsidy, the extent to which profits from the insurance product are competed away in the credit market.

## The Process

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 – 6 November 2007
Deadline for response to Emerging Thinking – 27 November
Results of telephone survey of PPI customers – December 2007
Further hearings with parties – January/February 2008
Report on provisional findings – May 2008
Remedies hearings (if required) – July/August 2008
Final deadline for all parties' responses/submissions – July 2008
Provisional decision on remedies (if required)
Publish report – November/ December 2008
Statutory deadline – 6 February 2009

The release of the CC's Emerging Thinking comes nine months into an investigation scheduled to last until December 2008. To date, the CC has issued information requests; industry participants have submitted their views on the market in writing and, for some industry participants, at oral hearings with the CC; and the CC has released a Statement of Issues (on 12 April 2007).

Following on from the publication of its Emerging Thinking on 6 November 2007, the CC will now issue further information requests, consult on working papers and hold further hearings, after which it will begin the process of verifying information, considering requests for exclusions from disclosure (company submissions are now routinely made public subject to excision of

commercially sensitive information), and drafting its provisional findings.

Provisional findings are expected in May 2008, then possible remedies are scheduled for the second half of 2008, and again there is a process of consultation. This leads eventually to a final report and recommended remedies. This final report is scheduled for December 2008, two months ahead of the statutory deadline in February 2009.

### Underwriting

The CC concluded that there was little evidence of restriction or distortion of competition in the underwriting market, although it noted that the underwriting market is concentrated with the four largest firms having a 67% share of the market.

There were a number of factors that led the CC to this conclusion. Importantly, there was evidence indicating that there was only a reasonable rate of return on PPI underwriting. The CC also found that underwriting capacity was likely to be able to be expanded quickly and easily and there were no significant barriers to entry or expansion. Furthermore, the CC thought that the countervailing buying power of distributors was significant.

### Integration of distribution and underwriting

The CC did not find that vertical integration of underwriting and distribution within the same firm led to restriction of competition in the underwriting business to the detriment of consumers, nor did it identify any concerns about distribution which applied to vertically integrated suppliers only.

The CC found that most vertically integrated underwriters were active in supplying insurance to third parties, that scale factors pertaining to underwriting PPI only were not important, and that there was limited evidence that the PPI prices of vertically integrated underwriters was higher than those of non-integrated companies. Furthermore, the CC found that there continue to be strong incentives for vertically integrated suppliers to innovate and to keep down costs and that they are unlikely to have incentives to reject more claims than non-integrated companies.

## The Retail market

The retail, or distribution, market is the key area where the CC proposes to focus the remainder of the investigation. There are a number of areas of distribution where the CC has received limited evidence to date and where further evidence may affect its thinking.

### Market definition

The CC's current thinking appears to be that each distributor has a monopoly over the provision of PPI to its own credit customers at the point of sale. The CC indicates that it believes there is a sequential buying process with customers first choosing a credit provider without considering PPI, then deciding whether or not to purchase PPI from the credit provider chosen.

The CC tentatively rejects the idea that the credit product is in the same market as the PPI and states that it has not seen evidence indicating that customer choices in the primary credit market are affected by the prices of PPI. Based on current evidence the CC concludes that the different brands of PPI do not appear to constrain each other.

However, the CC recognises that it has not received sufficient information on the nature of customer purchasing behaviour, and the nature of switching, and that further information in these areas could potentially change the appropriate market definition.

- As regards customer purchasing behaviour, the CC will need to investigate areas including: the extent to which customers search for different PPI products or

combined credit and PPI products; whether customers consider the price of credit and PPI combined; whether consumers are able to switch easily between different PPI products or combined credit and PPI products in reaction to changes in PPI prices or terms.

- As regards switching the CC has suggested that single premiums (the sale of PPI as a single lump-sum price, rather than a monthly premium) could be a potential barrier to switching and this is a further area for investigation. The CC has also suggested that it needs to gain an understanding of what the main switching costs or barriers are (for example, customer inertia, or level of rebates for early settlement).

However, the CC appears to recognise that market definition may be a secondary issue and that it needs to take full account of wider market dynamics of the relationship between credit and PPI:

**“We consider that in this case there are a number of good economic reasons for considering whether PPI profits are competed away on credit outside of the scope of our market definition exercise.”<sup>1</sup>**

### Competing products

The CC appears to conclude that there is very little substitutability with other financial products (though the situation regarding PPI on mortgage products may be different). One implication of this is that intervention at the point of sale would not lead to widescale switching to substitute products.

<sup>1</sup>‘Working Paper on Downstream Market Definition’, PPI Inquiry: Competition Commission – 11.07.

## Point of sale

The CC suggests that there is no evidence that PPI is a condition of a loan. However, it finds that some consumers think it is a condition or that purchase will improve their chances of obtaining the loan. Such a conclusion may suggest that the CC is considering an informational remedy to remove this understanding. The Emerging Thinking does not include any mention of potential increased convenience to the consumer arising from PPI sale at the point of loan agreement.

The CC finds evidence that stand alone products are priced below PPI products sold at the point of sale of the associated credit product.

The CC further observes that it might be expected that stand alone product prices might be higher, given the absence of economies of scope that providers of combined products enjoy. This suggests that the CC has, thus far, limited its investigation into a cost-based approach to pricing. It is not clear to what extent the CC has taken into account costs and pricing of the credit product in its pricing analysis thus far.

## Profitability

Whilst the CC has suggested little in the way of findings on profitability thus far, it has recognised the need to take into account the combined profitability of the credit/PPI package in addition to the profitability of the products separately.

The CC notes that high profits from PPI appear to have been “partially offset by lower profits or even losses at the credit product level”. The CC states that some parties have claimed that this may be due to intense competition at the level of the

credit product, in particular the personal loans market, but it believes that it could be that these losses are “more to do with deterioration in credit quality.” Therefore the CC wishes to investigate whether losses at the primary credit product level are a recent phenomenon and whether the large clearing banks have been less affected by this than other parties. It will be important for the CC to understand true long term profitability (in particular taking into account that insurance profitability has benefited from the benign economic environment) and the extent to which credit profitability is influenced by recent trends in bad debts as opposed to pricing of credit products that takes into account anticipated contributions from PPI.

Given the apparent quite different profitability of primary credit products and the linked PPI products, the CC has also recognised the relative impact of current market dynamics on protected and unprotected customers and has indicated it will take into account the different social demographics of those two customer groups in doing so. Specifically the CC notes that “customers who buy PPI and credit may be harmed” and that there “may be a transfer of welfare from customers who buy PPI and credit to those that buy credit only”.

Despite the relative absence of conclusions thus far, profitability issues will, as expected, form an important component of the remaining investigation. The CC intends to undertake considerable profitability analysis including considering the combined profitability of PPI and the associated credit product. In particular the CC states that it wishes to investigate:

- (a) Whether or not profits earned from PPI are ‘competed away’ in the credit market.
- (b) Whether prices are interdependent, e.g. APRs are lower as a result of high margins on PPI.
- (c) The extent to which distributors gain from their customers having PPI in the form of reduced bad debts.

## Next steps

Companies involved in the investigation need to be prepared for further onerous requirements as the investigation proceeds over the next twelve months.

- Initially, companies need to submit their responses to the CC’s emerging thinking by 27 November 2007. This is an important opportunity to influence the direction of the CC’s investigation.
- Subsequently, the CC will issue further requests for information and opportunities to respond will require attention over the course of the investigation.
- Some companies will also be invited for further oral hearings in the New Year.

Companies must be able to present convincing and consistent evidence to support the investigation throughout and should focus on the crucial areas where the CC’s thinking is in the fairly early stages.

## PricewaterhouseCoopers Contacts

PricewaterhouseCoopers can assist on all aspects of developing and presenting a robust and persuasive case for the CC. PricewaterhouseCoopers has a dedicated PPI team that includes competition, regulatory, strategy, actuarial, product and pricing experts from across our banking and insurance practices. PricewaterhouseCoopers has one of the UK's largest competition economics practices. 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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