Financial services bulletin

PRICEWATERHOUSECOOPERS

The OFT sets out its early thoughts on the Payment Protection Insurance market investigation

Introduction

Back in December 2005 the Office of Fair Trading (OFT) announced its intention to launch a market study into PPI. The study officially started on 3 April 2006 and one of the OFT's first actions was to issue questionnaires to the market participants. On 7 August the OFT published a paper setting out the 'emerging issues' from their PPI market study. This bulletin is the first in a series following the progress of this market study. It looks at the key issues being raised and gives some thought to what firms might wish to consider in their responses.

Overview of OFT observations

At first sight the OFT's observations make for depressing reading for the industry, with the OFT gathering what appears to be substantial evidence that the market is not working well for consumers. Notably, the OFT points to:

- Poor and decreasing claims ratios.
- High commission rates.
- A high degree of price variation not explained by quality differences.
- An absence of choice for consumers, and substantial barriers to switching suppliers.
- Low levels of transparency and customer awareness.

The OFT has focused on whether consumers are getting good value for money. Such an exercise inherently involves a classic cost benefit analysis i.e. a comparison of the prices consumers pay with the benefits the products generate. On both counts the OFT has incomplete information and it has tried to draw inferences from the partial data it has. The industry now has the opportunity to demonstrate how, and to what extent, such inferences are misguided and flawed.

The OFT has not examined the source of any particular problems it has identified and has not sought to directly identify possible remedies. However, the paper does hint at possible remedies and the industry may want to begin to address these.

Prices to consumers

It is clear that the OFT would like to gauge the reasonableness of prices by looking at whether there are excess profits in the industry. However, they are hampered in this task by the lack of financial data, and, in particular, on how to allocate common costs[1]. The OFT has therefore addressed this question from a number of separate but related angles.

First, the OFT point to a 'cross subsidy issue'[2] whereby higher PPI prices lead to lower loan APRs resulting in an unfair structure of charges. Although, the OFT do accept that lower loan charges need to be taken into account when assessing whether consumers are,

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[1] Note that the European Commission has in the past rejected very high profitability figures as indicative of excess prices due to difficulties of common cost allocation (see Swedish Ports case).

[2] It is worth noting that any potential cross subsidy is criticised solely from a consumer fairness perspective; there is no suggestion of a competition problem. In some situations cross subsidy can lead to exclusion from the subsidised part of the market of firms that only supply that product. This is not the issue here.

on average, getting value for money they argue that the resulting structure of charges is essentially 'unfair' for customers that do take out PPI compared to those that do not.

The OFT refers to anecdotal evidence of cross subsidy which in their view is also supported by their research into APRs and PPI prices on individual products. This research suggests that *"there may be some evidence of unsecured loans with very low APRs being loaded with expensive PPI policies"*. This correlation could be significant given the OFT has found what appear to be significant differences in PPI prices (apparently unexplained by differences in quality/terms). Concerns of 'unfair' cross subsidy are compounded by alleged low average take-up rates for PPI (23% across all products[3]).

A key issue here is whether there is 'strict' cross subsidy (i.e. loan products below incremental cost) or simply the existence of substantially different margins on different products. The 'evidence' the OFT has so far suggests the latter: *"providers… are offsetting <u>low margins</u> on their credit offerings with profits generated from the sales of PPI products"*, (emphasis added), in which case the OFT should not be concerned. However, although the OFT refers to low, not negative, margins it does describe this as a 'subsidy': *"consumers who do not take up PPI…are effectively being <u>subsidised</u> by those who do"* (emphasis added[4]).

Essentially it appears that the OFT is using loose wording here. They have not demonstrated a strict cross subsidy but appear convinced that there is a commercial link between PPI prices and APRs. This is enough for them to raise the equity issue. Unless able to prove there is no link (which seems highly unlikely) tactically it will probably be better for the industry to accept that there is a link but to demonstrate that nonetheless loan products do cover incremental costs, and that different contributions from different products are the feature of normal competitive markets.

Secondly, the OFT implies that margins are excessive compared to other insurance products on the basis of comparison of claims ratios. However, this is not comparing like with like – the incidence of claim events in mortgage PPI may be different and more volatile than motor and home insurance (there may also be significant differences in direct costs associated with what is a more complex product). The OFT's assertion that "*these differences look to be sufficiently large to put them beyond any questions of direct comparability or differences in risk"* will stand unless robustly challenged by the industry.

Thirdly, the OFT states simply that commission rates appear 'high' and that "it is difficult to see how commissions at this level can be driven by the costs of selling this product alongside the associated credit". This suggests they may be paying lip service to the importance of common costs in measuring profitability. However, the importance of common costs is illustrated by the fact that stand alone cost is clearly very high as demonstrated by the failure of stand alone entry ("at least one major insurer has tried to sell directly to the consumer, but was unable to achieve reasonable penetration and pulled out of direct sales").

To counteract this emerging position, the industry needs to show the following:

- Loan products do cover incremental costs – there is no cross subsidy.
- Returns on PPI are reasonable when compared to stand alone cost and potentially also based on a reasonable allocation of common costs.
- Combined returns across both PPI and loan products are reasonable (this is one reason why comparisons of claims ratios as currently carried out are inappropriate).

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[3] This figure sounds low – the number for secured and unsecured loans, the products of most concern (see paragraph 3.24) is likely to be significantly higher.

[4] Although the OFT then tempers this at paragraph 13.24 inserting the word possible (for some reason still in square brackets) in the statement that there is *"[possible] cross subsidy in unsecured personal loans and secured loans"*.

- Different margins on different products and different customers / customer groups are the feature of competitive markets (this was accepted in the recent OFT report on magazine distribution[5]).
- There are sound commercial reasons (for example volatility and selling costs) why commissions are higher on PPI products than motor or home insurance.

Benefits to consumers

What is also missing from the OFT's analysis is whether consumers believe that PPI products represent good value for money. Without a notion of the value placed by consumers on PPI products, it is not possible to reach a conclusion on whether too many or too few insurance products are sold. Indeed, it is notable that the OFT makes no reference to whether consumers are under- or over-insured.

This is a critical point. The OFT's superficial comparison of claims ratios gives the impression that PPI consumers are worse off, on the basis that the financial value of their claims compared to their premiums is lower on average than other insurance products. However, a proper understanding of the product and the value it generates is required. This needs to take into account the long term costs to the consumer of either (i) severe financial difficulty in the event of accident, sickness or unemployment and/or (ii) the implications for a consumer's debt rating and long term ability to obtain credit (and the cost of doing so). The fact that the OFT makes no mention of credit ratings suggests that its own survey was incomplete. Industry players should urgently carry out and present their own research in this crucial area[6].

Sources of alleged problems and possible solutions

So far, whilst the OFT has found substantial, albeit largely circumstantial, evidence of a significant problem in the industry, there is little analysis as to the source of the problem, or how these problems might be solved.

A key issue is whether the alleged industry problems can be solved primarily through providing consumers with better information. It is clear that the OFT does see information provision, including codes of conduct as a major plank in achieving better value for consumers. The OFT makes much of a mystery shopping survey in which it was difficult to find information on exclusions. They also express concern that APRs are seldom presented with and without the additional cost of the PPI product.

Whether information provision would be a sufficient remedy depends on whether the OFT believes that having more informed consumers will help protect consumers who are less well informed and therefore deemed to be more vulnerable. There is however more than one hint from the OFT that more radical remedies are contemplated. Notably, the OFT questions whether it is right that consumers have no effective choice of PPI product given that over 90% of sales are made at point of sale (PoS). The OFT also expresses concern about the difficulties in switching between PPI providers, suggesting that they are keen to promote alternative distribution channels.

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[5] See also the substantial literature on this including influential papers by Mark Armstrong and John Vickers, the previous chairman of the OFT.

[6] This should be complemented by industry's own assessment of the value created for consumers. For example what would the long term costs of paying a higher interest rate associated with someone having a bad debt record be for the average mortgage in the UK over the lifetime of the mortgage multiplied by the average probability of defaulting on the average personal loan?

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A PoS type remedy is clearly very attractive to the OFT given the considerable variation in PPI prices it claims to have found across suppliers. A levelling down to the average would create massive savings to consumers (especially if the OFT ignores any readjustment of APRs on loans[7]). However any actions beyond making information more transparent (for example a cooling off period where consumers are pointed to alternative providers) may present a risk to adequate rates of take-up and the industry will ultimately need to make its case on the potential downside of onerous and over-interventionist remedies.

Next Steps

The OFT has given only a very short deadline (to 24 August) to respond to this emerging issues paper.

Although the paper can hardly be described as good news for the industry, it does make clear that the OFT is open to persuasion on a number of issues. The first and most pressing of these is to obtain better measures of any possible consumer detriment in the industry than those currently used by the OFT. In our view this requires focusing on profitability analysis (with appropriate treatment of common costs and taking account of the relationship between loan and PPI products) and more extensive survey or other evidence on the value that consumers place on PPI products.

In the longer term, the OFT will need more help in determining the most appropriate solutions to the industry problems that they set out and that stand up to further scrutiny. In addition to information remedies, it is clear that the OFT is open to ideas on how best to develop new and alternative supply channels.

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[7] The cross subsidy or commercial link issue the OFT identify suggests this would be the case. In the Competition Commission inquiry into mobile termination charges the authorities presented price cuts as delivering £800m of consumer benefits in spite of explicitly acknowledging a "waterbed effect" i.e. that lower termination charges would lead to higher prices for other services – a factor the £800m figure ignored.