

Consultation on further analysis conducted to aid decision-making on remedies for the PPI market investigation

Introduction

1. This paper sets out further analysis which has been conducted in order to decide what remedies, if any, should be imposed to remedy the adverse effect on competition found in our provisional findings published on 5 June 2008. This paper does not cover retail PPI, which is subject to a separate set of provisional findings published on 10 October 2008.

2. We have decided that in the PPI market investigation the most appropriate way in which to proceed to a provisional decision on remedies is to consult interested parties on the further technical analysis we have carried out, which will feed into our provisional decision. We will take parties' responses into account before finalising our provisional decision on remedies. The provisional decision on remedies will, therefore, draw on responses to the remedies notice (written responses can be found on our website) and to this analysis. There will be a consultation on our provisional decision on remedies prior to publication of our final report.

Relevant customer benefits

3. In deciding the question of remedies, the CC may 'in particular have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned'.¹ Relevant customer benefits are limited to benefits to relevant customers in the form of:
 - (a) 'lower prices, higher quality or greater choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate)'; or

¹Enterprise Act 2002, [section 134\(7\)](#).

(b) 'greater innovation in relation to such goods or services'.²

4. A benefit is only a relevant customer benefit if the CC believes that:
 - (a) 'the benefit has accrued as a result (whether wholly or partly) of the feature or features concerned or may be expected to accrue within a reasonable period as a result (whether wholly or partly) of that feature or those features'; and
 - (b) 'the benefit was, or is, unlikely to accrue without the feature or features concerned'.³
5. Relevant customer benefits put to us by parties included benefits associated with single-premium policies, and lower credit prices. We have conducted analysis which feeds into our consideration of both these potential customer benefits.

The benefits of charging on a single-premium basis

6. We received two arguments as to why there were benefits associated with single-premium policies. In order to consider one of these, we conducted some analysis on which comments are invited.
7. We were told that single-premium charging was more efficient than a regular-premium charging structure and that, consequently, this allowed providers to offer lower prices and/or better-quality products than would be the case under a regular-premium charging structure. A similar argument would apply to potential changes in the rebate structure for single-premium policies, for example moving to a pro-rata rebate structure.
8. The main reason put forward as to why single premiums and their associated rebate structure offer efficiency benefits, or lower costs, was because of the profile of the

²Enterprise Act 2002, [section 134\(8\)](#).

³Enterprise Act 2002, [section 134\(8\)](#).

risk on a policy over the life of that policy. Many parties told us that the incidence and value of claims was higher in the early part of the loan and that therefore the risks covered by the policy were higher in the early months of the policy.

9. The parties told us that, given this uneven claims profile, the simplest and most logical response was to charge a single premium and provide a rebate for the unexpired cover upon early termination. We were told that this rebate was non-linear because of the uneven risk profile, so the value of the cover provided in the earlier months of the policy was greater than the value of cover provided in later months.
10. Under a regular-premium structure, or with pro-rata rebates, those terminating the policy early would receive greater cover, in proportion to the premium they had paid, than those holding the policy for longer. The only way to reduce the impact of this, we were told, would be to reduce the benefits on offer to try and 'flatten' the risk profile to make it more like a pro-rata rebate profile.
11. We analysed data on claims. Details of this analysis are set out in Appendix A. The analysis looked at how actual claims compare to the 'rule of 78' profile, which is a profile used by some parties to calculate the amount of rebate which should be given if a PPI policy is terminated early.
12. Further, some of the parties said that 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. To evaluate the scale of any cost efficiencies associated with single-premium policies, we considered how

much claims costs and prices might increase if single premiums were replaced with regular premiums or if pro-rata rebates were given.

13. The main results of the analysis are set out below:
 - We found that the claims profiles of all but one policy or group of policies we looked at were between a straight-line profile and the rule-of-78 profile—that is to say, the lenders' costs are asymmetrically skewed towards the early part of the loan, but not as much as implied by a rule-of-78 rebate for these policies
 - The additional costs faced by providers if every PLPPI customer were to terminate their policy within the first year, as per the argument set out in paragraph 12, were estimated to make up less than 5 per cent of the price of the relevant PPI policies—though we would not expect all these costs to be passed on to consumers through higher prices.
 - We are, however, seeking additional data from some parties. This will enable us to check that the impact on our analysis of the date at which the claimable event occurred (see paragraph 11 of Appendix A) has been correctly allowed for.

14. We invite comments on the analysis conducted in Appendix A, the results, and the implications of the results for our consideration of whether there are efficiencies associated with single-premium policies which mean we should consider the sale of single-premium policies to be a relevant customer benefit.

The benefit of lower credit prices

15. We were told that, if we imposed remedies to lower PPI prices, credit prices would rise and /or credit acceptance cut-off scores would rise—and that lower credit prices were a relevant customer benefit.

16. Distributors told us that a reduction in PPI income would result in major changes to distributors' (secured and unsecured) personal loan businesses; for other forms of credit, we were told that PPI generated a much smaller proportion of overall revenue and so would not result in such major changes. Details of their views are set out in Appendix B.
17. We undertook an econometric assessment of the distributors' sales data in order to assess whether there was any evidence that credit prices were affected by changes in PPI income. We looked at the correlation between personal loan APRs and PPI prices.
18. We found a negative correlation over time between PPI prices and credit prices for personal loans. This means that for an individual product we observe that as PPI prices rise (fall) the credit price is lower (higher). This would be consistent with a waterbed effect of a reduced PPI price causing credit prices to rise.
19. However, this is a weak result, as there may be other circumstances and trends that could lead to lower credit prices and higher PPI prices over time. We also have a large range in size of products and these results could therefore be driven by very small products. To overcome these potential problems, we included monthly dummy variables to represent wider trends and weighted observations by their volume of sales. Doing this we found no significant correlation between PPI prices and credit prices.
20. Details of this analysis are provided at Appendix C.

21. We invite comments on the evidence set out in Appendix B and the analysis conducted in Appendix C, and the implications of these appendices for our consideration of whether there is a relevant customer benefit of lower credit prices.

Intervention in the PPI markets

22. We considered whether we should exercise our discretion with regard to any relevant customer benefits we found.
23. We noted that all our proposed remedies, alone or in combination (except for a price cap on its own) are aimed at increasing competition, and that we expect that a successful intervention would bring PPI prices down. If the premise that profits from PPI prices are passed through to consumers as lower credit prices were correct, the imposition of any remedy would impact on credit prices. If we imposed remedies, PPI consumers may be expected to benefit from lower PPI prices but all credit consumers, and all PPI consumers, would face higher prices for their credit products; if we did not intervene, PPI consumers would continue to face high PPI prices.
24. We considered whether our remedies might be expected to have a positive or negative impact on total consumer welfare. To do this, we considered two different examples: a remedy which increased information such that all consumers were able to search effectively for both credit and PPI before arriving at the point of sale of credit, and a remedy where PPI prices were reduced but there was no increase at all in the amount of searching for PPI before the credit point of sale. These two examples represent the two ends of a spectrum in terms of the potential impact of remedies on customer search. Our analysis of this is set out in Appendices D, E and F.
25. The results of our analysis are set out below:

- We found that for MPPI and SMPPI, under any reasonable set of assumptions, any effective intervention in the PPI market that brought PPI prices down towards competitive levels always had a positive net consumer welfare effect (taking both PPI and credit market effects into account). We would expect similar effects for CCPPI and credit cards, because PPI income on credit cards forms a small percentage of overall income for credit card providers.
- For PLPPI, we found that a remedy which increased search resulted in positive net consumer welfare under any reasonable set of assumptions. For a remedy which reduced prices towards competitive levels but did not increase the extent of customer search at all, we found that, under certain sets of assumptions, such a remedy could have a negative overall impact on net consumer welfare. However, under other, more realistic, assumptions it would likely have a positive effect.

26. We invite comments on the analysis conducted in appendices D to F, the results, and the implications of the results for our consideration of whether, if we find a relevant customer benefit, we should exercise our discretion to modify our remedies to preserve the relevant customer benefit of lower credit prices.

Switching costs associated with single-premium policies and pro-rata rebates

27. In paragraph 5.76 of our provisional findings we found that the rebate profiles used for calculating rebates when cancelling a single-premium policy were a barrier to switching. In our Notice of possible remedies we consulted, among other options, on whether we should ban single-premium policies or require a pro-rata rebate on single-premium policies (options 7(a) and 7(c) of the Notice).
28. We considered whether requiring pro-rata rebates would be sufficient to remedy the switching barrier we identified.

29. In light of the submissions that we received, we revisited the work we did in our provisional findings on switching costs,⁴ to see the extent to which switching costs would remain if providers were required to offer pro-rata rebates. This further analysis is set out in Appendix G.
30. We looked first at the cost of switching to a regular-premium policy. We found that, for a typical example of a prime personal loan with PPI, an obligation on providers to offer pro-rata rebates would reduce switching costs to about one-eighth of their current level.
31. We then looked at the costs of switching to another single-premium policy, by reference to a specific three-year prime personal loan. In the example that we considered, we found that customers continued to face a switching cost with pro-rata rebates, but that more than half of the remaining switching cost was associated with an administration charge. Without the administration charge, switching costs would remain if a customer terminated the PPI policy one-third or (to a lesser degree) halfway through its term, but not if they terminated the policy two-thirds of the way through.
32. We are seeking additional data from some providers to replicate the analysis referred to in paragraph 31, to check whether there are significant variations in the results when other firms' data is used.
33. Our analysis of switching costs therefore showed that a pro-rata rebate was insufficient to buy an equivalent regular-premium PPI policy and was not always sufficient to buy an equivalent single-premium policy.

⁴See [Appendix 5.2](#) of our provisional findings.

34. We invite comments on the analysis conducted in Appendix G, the results, and the implications of the results for our consideration of whether, if our provisional findings on single-premium policies stand, pro-rata rebates would be sufficient to remedy the adverse effects identified.

Next steps

35. A copy of this consultation document will be posted on the CC website. The parties to this inquiry and any other interested persons are requested to provide any views in writing, to arrive no later than **4pm on Tuesday 28 October**. To submit evidence, please email: PPI@cc.gsi.gov.uk, or write to:

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