

## Downstream market definition

### Summary and conclusions

1. Our initial findings are that, on the evidence submitted to the inquiry so far, the relevant market appears to be no wider than the supply of particular types of payment protection insurance (PPI) by distributors to their own credit customers. This means that there would appear to be a series of individual markets, where each distributor enjoys a monopoly over sales of PPI to its own credit customers. There is little evidence available to us at this time that would indicate that a small but significant increase in the price of PPI, above competitive levels, would be rendered unprofitable, either because of the complementary link between PPI and credit, or because of the possibility of customers substituting between PPI policies or to other alternatives.
2. We see PPI as being in separate markets to the underlying credit products. This is because whilst credit prices may be affected and constrained by PPI prices,<sup>1</sup> there is very little evidence that PPI prices affect demand for credit products. We call this asymmetric demand relationship 'one way complementarity'. Because PPI prices do not appear to affect credit sales PPI prices are not likely to be constrained by their complementary demand relationship with credit.
3. We discuss below at paragraphs 37 to 69 the evidence regarding the extent to which substitution between different PPI policies occurs. We also discuss at paragraphs 78 to 101 the extent to which wider alternatives to PPI, such as income protection insurance, are likely to provide a competitive constraint on PPI providers. There is currently very little evidence that PPI prices are constrained either by potential

---

<sup>1</sup>Credit prices may be constrained because a price rise in credit will reduce PPI sales in addition to credit sales lost. A credit price rise that would have been profitable absent any link with PPI may therefore be rendered unprofitable once the consequent loss of PPI profits is taken into account.

customer substitution between individual PPI distributors' policies or by the potential for substitution to any alternative product.

4. On the evidence currently available to us it would appear that this narrow market definition applies across the main types of PPI, although it may be that on further analysis we come to a different conclusion. This is particularly the case regarding the sale of PPI on mortgages (MPPI).
5. We have considered whether the possibility that potential impacts on credit prices (so called see-saw or waterbed effects) would warrant the widening of the relevant market to include other bundles of credit and PPI. However, we consider that these effects, while important to our understanding of the operation of the market, do not warrant inclusion in, and any altering of, the analysis of the relevant market at this stage. This is primarily because, for the reasons set out in paragraphs 27 and 28, we consider that the potential for some or all of the profits made on PPI sales to be competed away in the form of lower credit prices does not necessarily preclude that there may be an adverse effect on competition (AEC).

## **Introduction**

6. This working paper considers the evidence available to us on the relevant product and geographic markets for PPI. We are still collecting evidence that may be relevant to market definition; and this paper therefore represents a preliminary view based on evidence we have received to date.
7. The Competition Commission's (CC's) guidelines state that the key to market definition is substitutability—being the extent to which customers can readily switch

between products, or suppliers can readily switch their facilities between the supply of alternative products.<sup>2</sup>

8. In assessing the likelihood of this substitutability, we apply the test known as SSNIP (small but significant non-transitory increase in price) at the 5 per cent level, consistent with CC guidelines. Where we refer to price increases in this paper, we are therefore referring to a 5 per cent increase. In a market inquiry, applying the SSNIP test in practice is typically made difficult because of the Cellophane fallacy.<sup>3</sup> This, and the difficulty caused by the potential for strong complementarity, makes the precise definition of the relevant market in this case particularly challenging. Each of these problems for market definition is discussed in paragraphs 10 to 11 and 12 to 29 respectively below.
9. CC guidelines note that market definition is not an end in itself, but rather a framework within which to analyse the effects of potential market features on competition. As such, market definition is a useful tool for identifying the competitive constraints affecting firms. However, there is inevitably an element of judgement involved in market definition and it is important to note that, whilst a precise market definition is desirable, the CC may decide not to devote disproportionate resources to determining exactly whether a competitive constraint results from within or from outside the relevant market.

### ***The cellophane fallacy***

10. The cellophane fallacy presents a particular challenge to market definition, and the practical application of the SSNIP test, in the context of a market investigation. If a market is less than fully competitive, prices may already be in excess of competitive

---

<sup>2</sup>Market Investigation References, Competition Commission Guidelines, CC3, June 2003.

<sup>3</sup>CC3, paragraph 2.9.

levels. At higher price levels customers tend to display a higher propensity to substitute to other products than they would at lower price levels. In other words the elasticity of demand tends to be higher at higher price levels. Evidence of substitutability at current price levels may erroneously lead to the conclusion that a SSNIP from the competitive level would be unprofitable, when the reverse is true. This could lead to a market definition that is too broad.<sup>4</sup>

11. Conceptually, the SSNIP test should be applied to the profitability of a price rise from competitive levels. Unfortunately we are only able to observe prices at current and historic levels. The results of any analysis, using evidence of substitution at current price levels, therefore require careful interpretation. For example, if the SSNIP test shows that a price rise would be unprofitable at current prices, because two goods are substitutable at current prices, this may be attributed to genuine substitutability, or alternatively to the cellophane fallacy. Such a finding would, therefore, be inconclusive. However if the test shows that a price rise at current prices would be profitable, and that there would be insufficient substitution to alternative products, this indicates that these products are poor substitutes under all circumstances and this can be taken as good evidence that the products in question constitute distinct economic markets. Evidence of substitutability must therefore be complemented with any available evidence of whether prices are at or near competitive levels, which will form part of the next phase of our inquiry.

### ***Complementary goods and market definition***

12. An additional difficulty in the definition of the relevant market with respect to PPI is the nature of the complementary link between PPI and the underlying credit product that it insures.

---

<sup>4</sup>CC3, paragraph 3.29.

13. Economic theory suggests that where firms produce two complementary products, this can affect their pricing decisions, and the existence of a complementary demand relationship between products can potentially act as a constraint on the pricing of one or more of those goods.
14. As discussed above, when defining the relevant markets, we usually frame the markets in terms of substitute products. A group of products will constitute a separate market if a hypothetical monopolist of those products could profitably impose a SSNIP. Typically the SSNIP test will 'fail', and the price rise will be unprofitable because demand-side substitution to, or supply-side substitution from, another substitute product will make the price rise unprofitable.<sup>5</sup>
15. However, where there are strong complementarities between products, a focus purely on substitute products can lead to a market definition which would not give an accurate reflection of market power, and so may be of limited use for the assessment of market power.
16. The implications of a complementary demand link for market definition depend on the nature of that link. In the case of PPI we consider three possibilities for the demand relationship between PPI and credit.
17. First it may be that the complementary demand relationship between PPI and credit is weak. In this instance changes in PPI price would have little impact on sales of credit products, and changes in credit prices would have little impact on sales of PPI. This would imply separate markets for PPI and credit.

---

<sup>5</sup>If this is the case, then that product is added to the 'candidate market' and the exercise is repeated. Products are added incrementally until the SSNIP test is 'passed' and a SSNIP is profitable. The set of goods over which a SSNIP is profitable is considered a relevant market.

18. The second possibility is that there is a strong and bilateral demand relationship between PPI and credit. Changes in PPI prices affect demand for credit, and vice versa. In this instance we would expect PPI prices to be constrained by the complementary demand relationship with credit, since an increase in PPI prices would not only lead to a loss in PPI sales, but also to a loss in credit sales. The reverse would also be true. In this situation, PPI and its underlying credit product might be expected to be within the same relevant market.
19. Finally, there may be an asymmetric demand relationship between PPI and credit. A number of the parties told us that PPI is sold and not bought. In other words most consumers have little knowledge of PPI prior to purchasing the credit product, and only consider purchasing PPI at the point of sale of the credit product.<sup>6</sup> If PPI is not considered by most consumers prior to the point of sale, the price of PPI does not affect their choice of credit product. This would result in a one-way complementary link as, if customers make sequential decisions in this way, credit prices will affect the sales of PPI,<sup>7</sup> but PPI prices will not affect sales of credit.
20. If there is a one-way complementarity between PPI and credit, as described above, we would expect PPI prices to be higher than they might otherwise be, and we would also expect credit prices to be lower than they might otherwise be.<sup>8</sup> As a result, although the complementary link with credit does not constrain the price of PPI, there is a concurrent effect on the prices of credit.

---

<sup>6</sup>The credit provider has an opportunity at the point of sale to inform consumers about the attributes of PPI cover, and its price. This would seem to have an effect similar to advertising.

<sup>7</sup>As more credit sales will increase the number of customers at the point of sale, and hence the number of opportunities to sell PPI.

<sup>8</sup>This arises because when firms raise prices of credit they may expect to lose both credit and PPI sales. A SSNIP that would have been profitable for a firm producing only PPI could therefore be unprofitable for a firm that sells both credit and PPI, because of the complementary demand relationship. On the other hand, because PPI prices do not affect sales of credit, there is no difference in the pricing incentives of a firm that sells only PPI and one which sells both PPI and credit. This see-saw effect on prices is often termed the 'waterbed effect'. In this paper we refer to these effects as a 'divergent effect on prices' to avoid any confusion with so called 'waterbed effects' that may result from the exercising of buyer power.

21. Aviva told us that where there was an asymmetric relationship between PPI and credit there were two possible market definitions. First, one could conclude that there were distinct PPI markets for PPI with each credit product. Alternatively one could conclude that PPI represents a point of differentiation between credit products. In this instance PPI represents an additional characteristic of the credit product and therefore there is no separate market for PPI.
22. Aviva said that the purpose of market definition was to identify who competes with whom and who is constrained by whose (pricing) decisions. It also noted that typically in competition cases analysis was restricted to players that were active in the market that was defined. Interactions between markets are often left out of the analysis (or minimized). Aviva noted that if, in this case, analysis was limited to narrowly-defined markets, this would have very different outcomes for how the market analysis was conducted.
23. Aviva argued that if the first of the two possible market definitions that it outlined was chosen, then any interaction between PPI and credit would be ignored. They stated that the fact that any profits made in the PPI market were (partly) competed away in the primary credit market would erroneously be ignored in the economic analysis. For this reason its preferred market definition was the wider market where PPI and credit were considered together.<sup>9</sup>
24. We note that in terms of the characteristics of PPI, there would appear to be no per se reason why PPI and credit should automatically be considered as a bundle, or as one combined product. PPI is optional, and penetration rates for PPI vary considerably. PPI and credit are not consumed or produced in fixed proportions, and PPI is technically available on a stand-alone basis, at least from a minority of PPI

distributors. We therefore consider it is sensible to consider all of the possibilities regarding market definition.

25. Aviva argued that a proper competition analysis would need to consider the impact of changes in PPI prices on the credit market and the extent to which any profits on PPI were competed away in the credit market. However, the generally accepted approach to market definition for secondary products is to define markets more widely where the prices of the secondary product are constrained by the interaction with the primary product. For example, the Office of Fair Trading (OFT) guidelines on market definition note that a 'system market' may be appropriate where customers engage in whole life costing or where reputation effects mean that setting a supra competitive price for the secondary product would significantly harm a supplier's profits on future sales of its primary product.<sup>10</sup> In other words, do customers respond to secondary market prices by altering their purchasing decisions in the primary market? Therefore, a wider market definition is appropriate where there is evidence that competition in the primary market prevents exploitation in the secondary market.
26. This has also been the approach generally in other cases involving primary and secondary markets, where the focus of investigating authorities has been on the extent to which customer behaviour in the primary market is affected by prices in the secondary market.<sup>11</sup>
27. 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. These include:

-----  
<sup>9</sup>A number of other distributors told us that they believed the relevant market definition should include the underlying credit product.

<sup>10</sup>Market definition: understanding competition law, Office of Fair Trading, December 2004, paragraph 6.3.

<sup>11</sup>See, for example, *US vs Kodak*, *Hugin v Commission* and *Koycera vs Commission* and the CC's *Extended Warranties on Domestic Electrical Goods*, December 2003.

- (a) if PPI prices are higher than competitive levels this will result in a deadweight loss and a loss of consumer surplus in that market;
- (b) if prices of PPI and credit are not at competitive levels, this may distort consumers' patterns of consumption;
- (c) if credit prices were driven below their economic cost, this may result in concurrent welfare losses in the credit market; and
- (d) those customers that buy PPI and credit may be harmed and there may be a transfer of welfare from customers who buy PPI and credit to those that buy credit only.

28. As a result, we consider that it is useful, as a first step in our analysis, to use market definition to assess whether firms have the ability to raise PPI prices above competitive levels. We regard this as a necessary first step in the identification of any potential market features that may result in an AEC. We therefore follow the established approach to market definition and consider the extent to which consumer purchasing decisions in the credit markets are affected by prices in the secondary market for PPI.

29. Any concurrent effects on credit pricing, whilst important to our understanding of the markets and firm behaviour, we consider beyond the scope of our market definition exercise. We will, however, return to this question when evaluating potential features that may lead to an AEC.

### **The relevant product market**

30. Our approach is to start with the narrowest conceivable market definition and look for evidence that a SSNIP from competitive levels would prove unprofitable. In the case of PPI, the narrowest conceivable market would appear to be that there are a series of markets for each PPI distributor's individual PPI policies (for example, a PPI policy

sold by one particular distributor in relation to its own personal loan products may constitute one distinct economic market).<sup>12</sup>

31. We begin with this narrow candidate market and look for evidence that a SSNIP, above competitive levels for any one PPI policy, would be rendered unprofitable by any of the following:
  - (a) substitution to other PPI policies, including those of other firms;
  - (b) a consequent loss of sales in the credit market associated with that particular policy, because of customer substitution to other bundles of credit and PPI; and
  - (c) substitution to other alternative insurance policies.
  
32. Before doing so we discuss briefly the point-of-sale advantage. The majority of market participants who have provided evidence to our inquiry have told us that there was a point-of-sale advantage to suppliers of the credit products that PPI insured. By this they mean that customers are generally far more likely to buy PPI at the same time and place as buying the credit product (hereafter the point of sale) than at any other time.<sup>13,14</sup>
  
33. We note that sales of PPI away from the point of sale are very limited for all types of PPI (see paragraph 53), and that attempts by non-credit suppliers to sell PPI in the past have been unsuccessful.
  
34. The incumbent seller of a credit product would therefore seem to have a significant advantage when selling PPI to its own credit customers, and a disadvantage when selling PPI to credit customers of another credit distributor. Any other PPI provider

---

<sup>12</sup>It is possible to get cover for some but not all of the constituent parts of PPI (A,S,U, L) from some providers—for example, Northern Rock offers four levels of PPI cover on its personal loans. We cover this in paragraphs 39 and 40.

<sup>13</sup>There is therefore a significant saving in terms of marketing costs for PPI providers who have access to credit customers at the point of sale.

<sup>14</sup>In the case of credit cards, PPI may be sold at the point of activation of the credit card. In either case the supplier of the underlying credit product has an advantage over other rivals when selling PPI.

that does not have access to credit customers at the point of sale will also face significantly higher costs than the incumbent credit provider.

35. There are a number of potential explanations for the point-of-sale advantage including:
- (a) the apparent lack of PPI-specific advertising by firms and any consequent lack of awareness by consumers of PPI prior to the point of sale;
  - (b) search costs which make it difficult or costly for consumers to shop around on PPI prior to the point of sale;
  - (c) economies of scope<sup>15</sup> as a result of reduced marketing costs when selling PPI to credit customers at the point of sale because of one-way complementarity; and
  - (d) economies of scope as a result of shared facilities for selling credit and PPI at their common point of sale.
36. We have reached no firm view at this stage regarding the cause of the point-of-sale advantage and we will carry out more work in this area during the next stage of our inquiry. We note, however, that the existence of a point-of-sale advantage for suppliers of PPI that also supply credit products, regardless of its causes, is important for our market definition exercise.

### ***Substitutability of individual PPI policies***

37. As discussed in paragraph 31(a) it is necessary to assess the extent to which, within any one type of PPI (eg personal loan PPI (PLPPI)), the policies sold by different distributors are substitutable. As discussed in paragraphs 32 and 34, each distributor of credit has a point-of-sale advantage over sales of PPI to its own credit customers. This raises the prospect, should this advantage be sufficiently large, and should there

---

<sup>15</sup>Economies of scope are sometimes referred to as supply side complementarities. They result where the cost of producing two goods together is lower than the cost of producing those goods separately.

be insufficient constraints from other sources such as the demand relationship with credit, that each distributor has a monopoly over sales of PPI to its own credit customers. Each PPI policy sold by each individual distributor could therefore constitute a separate economic market.

38. However, if different PPI policies are interchangeable, and customers would substitute to PPI policies supplied by other distributors in response to a SSNIP on any one distributor's PPI policy, such that that price rise above competitive levels was not profitable, then this would warrant a market definition that includes all PPI policies sold by all distributors.

#### *Substitutability within brand*

39. A number of PPI distributors offer several distinct PPI policies at the point of sale of their credit products. Typically consumers may be offered a choice of cover levels which may include a combination of Unemployment (U) cover, Accident (A) and Sickness (S) cover and Life (L) cover.
40. It is unclear from the available evidence whether consumers would substitute between these various options in response to changes in relative prices. However there would appear to be no particular barriers to the distributor, present at the point of sale, offering any configuration of cover levels to its own credit customers. We therefore consider that supply-side substitution within brand would warrant a wider market to encompass all of the cover levels offered at the point of sale.

#### *Substitutability between brands of PPI*

41. There is also a possibility that there could be substitutability between different brands of PPI since PPI is technically available on a stand-alone basis, at least for a limited number of policies.

### *Substitution in principle*

42. It is often useful, as a first step, to assess the characteristics of individual policies as this can provide some insight into the potential for consumers to substitute between them.<sup>16</sup>
43. In principle there are a number of potential differences between the major types of PPI, regarding ease with which consumers may substitute between them. In general, the ability of consumers of credit and PPI to substitute between different PPI policies will depend in part on search costs, switching costs, the appropriateness of alternative policies and customer preferences.
44. It would appear that search costs could be lower for MPPI, compared with other types of PPI.<sup>17</sup> A relatively large proportion of mortgage sales appear to be made via intermediaries that may be in a position to provide key information to consumers regarding PPI and may encourage mortgage customers to consider a range of PPI policies at the point of sale. In addition, there are websites that allow consumers to search between alternative MPPI policies, including stand-alone MPPI.<sup>18</sup> For the remaining PPI categories search would appear to be more difficult, in principle, because sales are rarely via intermediaries and because searching tools such as websites or comparison tables do not yet exist for these types of PPI.<sup>19</sup>

---

<sup>16</sup>However, an assessment of substitution possibilities in principle may not provide a reliable guide to substitution in practice and therefore should be used only in conjunction with an assessment of the available evidence of substitution in practice.

<sup>17</sup>However, even if MPPI may have relatively low search costs, compared with other categories of PPI, this does not necessarily indicate that there would be sufficient searching in absolute terms to warrant a wider market definition. This would require evidence which shows that a SSNIP above competitive levels by an MPPI provider would not be profitable because sufficient consumers would search, and substitute into alternative products in response to that price rise.

<sup>18</sup>For example, Moneysupermarket.com offers a facility which allows consumers to search between stand-alone MPPI policies based on monthly payment and level of cover required. The FSA will also be publishing comparative tables to facilitate consumer searching on PPI (see [www.fsa.gov.uk/Pages/Library/Communication/NewsLetters/Bulletins/tables8.pdf](http://www.fsa.gov.uk/Pages/Library/Communication/NewsLetters/Bulletins/tables8.pdf)). We will be looking at the extent to which customers use these search tools at a later stage in our inquiry.

<sup>19</sup>Moneysupermarket.com does, however, offer a facility which allows consumers to search for personal loans based on the combined cost of the loan payment with PPI included. However, there is no facility to compare PPI policies directly. It does also offer a short-term income protection comparison service.

45. Stand-alone policies typically require consumers to specify a set amount of cover. As a result these policies are more viable substitutes for credit products with a large and stable monthly payment, so that the level of PPI cover can be matched to the customers needs, and to minimize the transaction cost of arranging multiple policies. Stand-alone policies are therefore more likely to be viable substitutes for MPPI and possibly also PLPPI and second charge mortgages (SMPPI) (which also have predictable payment schedules). Credit card PPI (CCPPI) is typically priced as a fixed payment per £100 of outstanding balance. Any PPI policy other than the policy offered by the incumbent credit card supplier is likely to be of limited effectiveness. This is because the customer is as likely to be over- or under-insured as insured for the right amount in any given month, as the customer's credit card balance varies from month to month but the amount insured remains fixed.
46. Once a consumer has chosen a PPI and credit bundle, it may still be possible to substitute between PPI policies by switching. Switching costs for consumers would appear to be lower for policies that charge a regular premium than for those policies that charge a single premium. This is because regular premium policies can typically be cancelled at one month's notice, without penalty. Single premium policies, however, are paid up front, and are often added to the loan.
47. Customers who have single premium policies face higher switching costs for a number of reasons. Firstly, rebates on single premium policies are not offered on a pro-rata basis. Typically firms offer a lower sum based on the rule of 78 or an actuarial assessment. This is because claims are more likely to occur in the earlier parts of the loan term, and many distributors argue that rebates should reflect that risk profile<sup>20</sup>. However, this policy means that the rebate received on a single

---

<sup>20</sup> We were told that the refunds given reflect a greater risk for insurers early in the life of a policy because of the higher insured balances outstanding, the initial expenses of the policy and the higher risk of default due to adverse selection.

premium policy is likely to be lower than the sum of payments that would have been outstanding on an equivalent regular premium policy. We have seen no PPI policies which take into account the difference in risk between new loans and loans part way through their term. As a result, any customer that attempts to switch is likely to face a shortfall between the value of their rebate and the cost of a new policy to cover the remainder of the term.

48. In addition, the cancellation process with regard to single premium policies would appear to be more difficult in practical terms since, in contrast to a regular premium policy, customers would need to apply for cancellation and a rebate settlement. The combination of the lower than pro-rata rebate and practical difficulties of switching would therefore appear to pose a significant barrier to switching for single premium policy holders.

49. Table 1 shows a breakdown of premium charging structure by type of PPI.

TABLE 1 Proportion of single and regular premium policies in force by type of PPI

Credit type	Total number of active policies distributed by the 12 largest distributors of PPI at end of 2006			% single	% regular
	Single premium	Regular premium	Total number of PPI policies		
Personal loans	3,948,504	292,731	4,241,235	93.1	6.9
First charge					
mortgage	0	1,174,842	1,174,842	0.0	100.0
Credit card	0	7,676,777	7,676,777	0.0	100.0
Second charge					
mortgage	145,817	79,847	225,664	64.6	35.4
Retail credit	63,007	201,167	264,174	23.9	76.1
Motor finance	156,467	38,626	195,093	80.2	19.8
Overdraft	0	721,862	721,862	0.0	100.0
Other	29,671	23,083	52,754	56.2	43.8

Source: CC, based on data submitted by the 12 largest PPI distributors.

50. As the table shows, MPPI, CCPPI and overdraft PPI are entirely sold as regular premium policies. For retail PPI, the majority of policies are regular premium. For

PLPPI, SMPPI and motor PPI the majority of policies are sold as single premium policies.

51. It would therefore seem that it would be easiest, in principle, for MPPI customers to substitute between MPPI policies. This is because search costs would appear to be lower than for other types of PPI, because stand-alone policies would appear to be more suitable substitutes for MPPI and because MPPI policies are predominately regular premium policies, which would make it easier for MPPI customers to switch. In addition, as mortgages typically involve a larger financial commitment in terms of overall debt than any other type of credit product, consumers' incentives to search and switch may be higher.

*Evidence of substitution in practice*

52. For all types of PPI, the incidence of stand-alone sales of PPI is very low, in part because it remains relatively rare that the large distributors of PPI offer PPI for sale without the sale of a credit product. Of the large distributors Alliance & Leicester, Abbey, Barclays and HBOS currently offer MPPI for sale without the concurrent sale of a mortgage. HSBC (via its Lifechoices policy) and RBSG (via its Churchill payment protection policy) currently offer PPI on a stand-alone basis to cover other products and Barclays is in the process of introducing a CCPPI policy that can be used to cover other credit cards.<sup>21</sup> Tables 2 and 3 show the proportion of stand-alone sales of PPI policies reported by the large distributors for each type of PPI.

TABLE 2 Proportion of PPI policies sold on a stand-alone basis by the 12 largest distributors of PPI, 2002 to 2006

Type of PPI	<i>per cent</i>				
	<i>By number of policies</i>				
	2002	2003	2004	2005	2006
Personal loan	0.0	0.0	0.0	0.0	0.0
First mortgage	1.0	1.0	1.7	3.7	3.8
Credit card	0.0	0.0	0.0	0.0	0.0
Second mortgage	0.0	0.0	0.0	0.0	0.0
Retail credit	0.0	0.0	0.0	0.0	0.0
Motor finance	0.0	0.0	0.0	0.0	0.0

<sup>21</sup>However, the stand-alone products offered by HSBC and RBSG (Churchill) were only launched in the second half of 2007.

Source: CC calculations based on LD1 data.

---

Notes:

1. LD1 data represents all sales by the 12 largest PPI distributors.
2. Calculations exclude data from distributors unable to provide a breakdown by distribution channel.

TABLE 3 Proportion of PPI policies sold on a stand-alone basis by the 12 largest distributors of PPI, 2002 to 2006

*per cent*

*by Gross Written Premium*

Type of PPI	2002	2003	2004	2005	2006
Personal loan	0.0	0.0	0.0	0.0	0.0
First mortgage	0.8	0.6	1.1	1.4	1.2
Credit card	0.0	0.0	0.0	0.0	0.0
Second mortgage	0.0	0.0	0.0	0.0	0.0
Retail credit	0.0	0.0	0.0	0.0	0.0
Motor finance	0.0	0.0	0.0	0.0	0.0

Source: CC calculations based on LD1 data.

---

Notes:

1. LD1 data represents all sales by the 12 largest PPI distributors.
2. Note: calculations exclude data from distributors unable to provide a breakdown by distribution channel.

53. As the tables show there were no reported stand-alone sales of PPI by the large distributors in any category of PPI policy except for MPPI. Stand-alone sales by the major distributors in MPPI have shown some growth; however, they remain below 4 per cent by number of policies and below 2 per cent by Gross Written Premium (GWP).<sup>22</sup>

54. A number of the distributors told us in their hearings that they were in the process of introducing or had recently introduced PPI policies that were available without purchasing the underlying credit product or that could be used to cover other credit products held by the customer.<sup>23</sup> We will be interested in the level of take up of these policies going forward, and the extent of demand for these policies on a stand-alone basis. However, at this stage we are unable to draw any conclusions from the introduction of these policies.

---

<sup>22</sup>These sales were reported by two firms, Abbey and HBOS.

<sup>23</sup>Specifically Barclays credit card product due for introduction on October 2007, HSBC's Life choices product introduced in 2007, and RBSG's stand-alone product (through its Churchill brand).

55. We have received some evidence that there are significant sales of ‘third party’ MPPI as many mortgages are sold via mortgage intermediaries. Mortgage intermediaries may offer their own proprietary ‘white label’ MPPI policies, or alternatively they may recommend that their customer takes out a MPPI policy offered by a supplier with no link to the mortgage provider or the mortgage intermediary. These two alternatives are distinct in terms of their implications for market definition. In the first instance, consumers are offered one choice of PPI, and therefore, are likely to face a similar choice set to a customer at the point of sale of a large distributor. However, if intermediaries are encouraging their customers to consider a choice of several PPI policies, this may imply that there is greater substitutability between MPPI policies. We are carrying out more work in this area; however, we note below that sales of non-proprietary stand-alone MPPI policies appear to be very low.
56. Our evaluation of the distributors’ internal documentation in Appendix A showed that there is evidence that distributors assess their market position, and that they benchmark their prices against those offered by other firms. However, we found very little evidence that firms were reacting to price changes or were attempting to compete with each other by offering lower PPI prices.
57. In general the distributors appear to perceive that demand for PPI is unresponsive to changes in prices.<sup>24</sup> This would not appear to be consistent with a wider market with strong competition between brands.
58. We also looked at the parties’ sales data. A preliminary assessment of this data is provided at Appendix B. This analysis showed the following:
- (a) the general trend over time is for PPI prices to increase, or stay flat;

---

<sup>24</sup>For example, see Table 1 of Appendix A.

- (b) price changes on PPI are infrequent; and
- (c) at a product level, PPI prices appear to vary less frequently over time than credit prices for most products. This appears to apply to all four of the main categories of PPI; however, we have very limited data on first and second charge mortgages.

59. This would appear to support the view that price competition between PPI providers is limited as there is little evidence of PPI providers trying to compete for each other's customers by offering lower PPI prices over the five-year period for which we collected data.

60. We also assessed evidence from the parties' internal documents, to assess whether there was vigorous non-price competition between distributors. The results of this exercise are provided in Appendix A. Our findings on non-price competition include:

- (a) very few firms advertise their PPI offerings on a stand-alone basis, and where PPI is advertised, the emphasis of this advertising is on the credit product;
- (b) there is some evidence of firms changing their PPI policies but the majority of distributors told us that they had not introduced any entirely new policies;
- (c) new innovations within existing policies include: changes in the level of cover on offer (for example, removal of some exclusions from policies) introduction of tiered PPI policies and changes in pricing structure; and
- (d) in terms of reacting to competitor behaviour, little evidence has been found that demonstrates competition or distributors reacting to policy changes and innovation of their competitors.<sup>25</sup>

---

<sup>25</sup>For example, there is no evidence that the rationale for any of these innovations was in order to win customers from a rival, or to react to customer losses to a rival had instituted a similar change.

61. We saw some evidence that suppliers did make some changes to non-price features of their PPI policies. However, insufficient evidence has been brought to our attention that PPI has been sold to customers by emphasizing the superior quality of the non-price features of a particular policy compared with other policies available for sale (for example in advertising or sales scripts). We therefore do not consider that there is sufficient evidence of non-price competition to warrant a wider market definition.

*Sales of PPI and short-term income protection from non-credit suppliers<sup>26</sup>*

62. As discussed in paragraph 53, stand-alone sales of PPI by the large distributors appear to be very small. However, it is possible that prices of proprietary PPI by credit providers are constrained by the potential for consumers to substitute to PPI policies sold by providers that do not sell credit products.
63. However, the major underwriters also report very limited sales of PPI policies away from the point of sale. The large underwriters told us the following about their attempts to sell PPI on a stand-alone basis.
64. Aviva does not currently sell PPI to consumers directly; however, it has sought to do so in the past, with little commercial success. Between 2002 and 2004, Aviva sold a total of less than 10,000 PPI policies on a stand-alone basis.
65. AXA has sold a very limited number of stand-alone PPI policies over the past five years. It sold less than 500 policies of its AXA Direct Creditor product between 2002 and 2004. This product was sold to AXA Direct motor and home insurance customers and the policy was withdrawn in 2004. AXA also sells the Post Office Lifestyle Protection policy through AXA services Ltd under the Post Office brand. This

---

<sup>26</sup>We use the terms PPI products sold by providers that do not sell credit products and short-term income protection interchangeably here as there is little difference between them. For example, short-term income protection taken out by a customer to cover a specific loan payment could be classed as stand-alone PPI or short-term income protection.

arrangement started in June 2006, and AXA sold less than 7,500 between June and December 2006. For all of AXA's stand-alone PPI policies the benefit is paid to the customer rather than the lender.

66. AXA has commissioned research into sales of stand-alone PPI. This research shows that customers in general are not aware of the availability of stand-alone PPI policies. Becoming a large player in the stand-alone market requires a significant marketing spend, the cost of which needs to be spread among the number of policies sold. A further key benefit to distributors of PPI is that their policy can be tailored to the credit product. This is particularly advantageous in the supply of CCPPI and overdraft PPI as balances are unpredictable. Stand-alone providers do not have access to this information and therefore cannot tailor cover to the customer's balance each month.
67. AXA has also identified a number of barriers to switching which may inhibit the growth of stand-alone providers. First, where individuals take out single premium policies, there may be refund terms which erode the price benefit of switching to stand-alone PPI. Second, PPI policies include exclusion periods for pre-existing medical conditions. Customers who have developed a condition since taking the distributors policy may therefore have difficulty switching to a stand-alone PPI policy which will cover them for this condition.
68. Cardif Pinnacle sold stand-alone PPI policies with GWP totalling £[redacted] between 2002 and 2006. The majority of this (£[redacted]) was from its MPPI Helpupay policy. Cardif Pinnacle's experience to date shows that, compared with PPI sold alongside credit, sales volumes are lower and adverse selection for unemployment cover has been greater. Cardif Pinnacle believes that in general, when customers are sold PPI at the point of sale of the credit product, they are prompted to give thought to the risk of A, S and U. In the stand-alone market, customers are more likely to buy PPI when they

have already been told they are likely to be made unemployed, or are on the verge of being unable to work due to illness.

69. Neither Genworth nor London General Insurance offer PPI on a stand-alone basis. Genworth said that it was very difficult to sell PPI on a stand-alone basis because of a combination of the preference of consumers to purchase PPI at the point of sale, and because stand-alone providers faced greater adverse selection issues. London General Insurance considered that adverse selection issues made the sale of stand-alone PPI difficult to achieve in a commercially viable manner.

### ***The relationship between PPI and credit***

70. As discussed in paragraph 31(b), an important aspect of our market definition exercise is to identify the nature of the demand relationship between PPI and the credit products that PPI insures. In order to evaluate the nature of this relationship we assessed evidence from the parties' internal documents to evaluate firms own perceptions of the demand relationship between PPI and credit.

### ***Oral and documentary evidence***

71. The evidence we received from the distributors in hearings was mixed. A number of distributors told us that they believed that PPI was part of a wider system market which included the underlying credit product. For example, HBOS told us that customers were concerned about the affordability of the PPI and the underlying credit product as part of a package.<sup>27</sup> Northern Rock said that its policies were priced in response to competition in the market and that it priced the whole package rather than PPI individually and sought to remain competitive on its prices with and without PPI.<sup>28</sup> MBNA said that if it were to increase the price of its PPI policies, there might

---

<sup>27</sup>HBOS, summary of hearing, paragraph 27.

<sup>28</sup>Northern Rock, summary of hearing, paragraph 5.

be a fall in demand for the underlying credit product.<sup>29</sup> Nationwide recognized that there were some customers who based their purchasing decisions on the Annual Percentage Rate (APR) of the loan, and other customers who made comparisons based on the bundled price. Information available to customers via the Internet and print media was increasing, making it easier for customers to compare policies. Nationwide believed that a price decrease in PPI or a free period of PPI would increase the demand for the credit product (but it did not have any direct evidence to support that view).

72. Other distributors noted that PPI and the underlying credit product were linked, but stopped short of saying that customers' decisions in the (primary) credit market would be affected by prices in the (secondary) market for PPI. For example, Abbey said that PPI and the underlying credit product were inter-related in the sense that the number of sales of PPI was directly related to the number of sales of loans.<sup>30</sup> Abbey also said that it would be dangerous to look at the PPI market in isolation.<sup>31</sup>
73. However, a number of distributors told us that there was no link between PPI prices and demand for credit, which we consider would indicate that PPI and credit are in separate markets. For example, Alliance & Leicester said that if it changed the price of PPI, it would not affect the demand for the underlying credit product and that there was no link between the credit decision and the decision to take out PPI. Similarly, HSBC said that it viewed PPI and the underlying credit product as belonging to separate markets.<sup>32</sup>
74. Lloyds TSB said that credit and PPI should be viewed as one market as the products were marketed and purchased together. However, it also noted that competition had

---

<sup>29</sup>MBNA, summary of hearing, paragraph 8.

<sup>30</sup>Abbey, summary of hearing, paragraph 2.

<sup>31</sup>Abbey, summary of hearing, paragraph 1.

driven down prices of the underlying credit product, and lenders had compensated to a degree by increasing the price of PPI. We note in paragraph 20 that we regard a divergent effect on prices, as described by Lloyds TSB, as consistent with one-way complementarity and therefore separate markets.

75. We also assessed the internal documentation supplied to us by the parties in three key areas. This analysis is provided in Appendix A. First we looked at documents that showed how the distributors set their PPI prices. We also assessed how the distributors view PPI internally, and how they set their PPI strategy. Finally we looked at how the distributors assess the performance of their PPI businesses internally.

76. Our key findings were as follows:

(a) There is some evidence that firms analyse the price of credit and PPI together and the majority of the distributors say that they do not run PPI as a separate business.

(b) There is, however, no documentary evidence that firms consider that an increase in PPI prices will have any impact on credit sales.

(c) When planning PPI price rises firms generally do not consider that there will be a significant effect on their sales of PPI.

(d) However, there is evidence that firms acknowledge that credit and PPI demand are closely related.<sup>33</sup>

77. We therefore consider that the available evidence from internal documentation indicates that the distributors view the demand relationship between PPI and credit to be asymmetric. The distributors appear to be of the view that changes in their PPI pricing will not affect demand for their credit products. However, there is some evidence that the distributors do perceive that changes in credit pricing will affect

-----  
<sup>32</sup>HSBC, summary of hearing, paragraph 8.

<sup>33</sup>Given that the price of credit is likely to affect sales of credit, it follows that there would be a knock-on effect on sales of PPI.

demand for PPI. We consider that the documentary evidence supplied to us is consistent with a one way complementarity between PPI and credit.

### ***Substitutability of PPI and alternative policies***

78. This section evaluates the evidence received to date regarding the competitive constraint offered by the closest alternative policies to PPI.
79. The alternative policies that consumers may potentially substitute for PPI include:
- (a) income protection insurance (IP);
  - (b) personal accident insurance (PA);
  - (c) critical illness insurance (CI); and
  - (d) life insurance or term life insurance (TA).

### ***The views of market participants***

80. Views among the major distributors regarding the competitive constraint imposed by other alternative policies were mixed. Some distributors did not think that there were any policies that were an effective substitute for PPI policies. Others considered that, whilst alternative policies do exist, these are only partial substitutes and offer an insufficient constraint to warrant inclusion in the appropriate market definition. Some distributors, however, considered that alternative policies and in particular IP did offer an alternative to PPI and had the potential to provide a powerful constraint.
81. There appears to be a broad consensus among the distributors that IP policies are the closest alternative to PPI, and therefore the most likely to provide a competitive constraint on the pricing of PPI policies.
82. However, views were mixed as to the strength of that constraint. Three of the large distributors did not consider that alternative policies such as IP, CI and TA were a

sufficiently powerful constraint on the behaviour of PPI distributors to warrant inclusion in the relevant product market.

83. Lloyds TSB said that customers presently do not shop around for PPI cover independently of the underlying credit product. In Lloyds TSB's experience when considering whether to buy a particular PPI policy, customers do not shop around for an alternative combination of insurance cover as a substitute for PPI either. Lloyds TSB notes that none of these policies, whether on their own or in combination, offers a perfect substitute for PPI. Lloyds TSB believes that, whilst these policies impose some form of constraint on the pricing of PPI policies, none of these policies is regarded as a sufficiently close substitute to justify being treated as part of the same relevant product market. Similarly Northern Rock said that in its view customers probably did not regard other policies (such as IP, CI and TA) as substitutes for PPI. Alliance & Leicester said that PPI was designed to meet a very specific customer need and that it did not believe that there was an effective substitute for the cover that PPI provides.
84. HBOS considered that potential substitutes to PPI could theoretically include: IP, CI, TA, stand-alone PPI policies or customers' personal savings. However, HBOS said that it was arguable that these alternative policies performed a different role to PPI. HBOS believes that alternative policies and savings place a competitive constraint on PPI for certain consumers and for certain circumstances. However, these policies do not enjoy the position of convenience and heightened awareness of credit risks faced by consumers as is enjoyed by PPI policies at the point of sale of the credit product.
85. Other distributors considered that policies such as IP, CI and TA were at least partial substitutes for PPI, and that they had the potential to offer some constraint. However, consumers may need to purchase a portfolio of alternative policies to cover the same

risks covered by PPI. For example, Nationwide noted that IP typically does not offer L or U cover. Similarly RBSG considered that whilst IP was the policy most similar to PPI, the cover provided by IP is typically less comprehensive. HSBC considered that although IP performs a broader function, it may be an adequate substitute for some customers, and that other policies replicate certain aspects of PPI cover, although often these policies will offer a different level of cover over a different timeframe. Similarly, Cattles said that no alternative policy provided a full substitute for PPI, but that they may be potential substitutes for different parts of the PPI policy.

86. Capital One noted that whilst IP and in particular short-term IP policies offered similar functions to PPI, CCPPI specifically protects the outstanding balance of the protected card, so to substitute one of these policies customers would be required to decide what level of cover they would like to purchase. This requires the customer to make an additional decision about their likely borrowing needs, and could lead to them being over- or under-protected at different points in time as the level of cover is fixed.
87. The remainder of distributors considered that alternative policies were constraints on PPI suppliers. MBNA said that although other insurance policies, such as IP, are different in that they are paid to the customer instead of to the lender, in MBNA's view they were clear substitutes for PPI because a customer could take out insurance for exactly the same amount as their credit payments.<sup>34</sup> MBNA also considered PA was a substitute for PPI. Abbey noted that its MPPI policy allowed customers to insure a payment amount of their choosing rather than covering a specific mortgage payment and in this respect it was similar to an IP policy. Abbey said that its financial intermediaries had informed it that customers frequently preferred IP over MPPI. Barclays noted that there had been an ongoing decline in

---

<sup>34</sup>This may be more viable for MPPI and PLPPI than for overdraft PPI and CCPPI where it is more difficult to predict monthly credit payments in advance.

PPI penetration rates, which it considered was at least partially a result of customers switching to available alternatives or choosing not to be covered at all.

### *Policy characteristics*

88. As noted in paragraph 81, there appears to be a general consensus that IP policies are the closest potential substitutes for PPI. The views of market participants, in this regard, reflect our findings regarding the characteristics of PPI alternatives.
89. The characteristics of PPI and its potential alternatives were discussed in our working paper 'PPI and its alternatives'. The typical characteristics of PPI policies include the following:
- (a) PPI is typically underwritten on a community rather than an individual basis;<sup>35</sup>
  - (b) PPI generally pays out within 30 days of a successful claim;<sup>36</sup>
  - (c) PPI covers credit repayments for a period of up to 12 months;<sup>37</sup>
  - (d) PPI cover is usually related to the payment on the underlying credit payment;
  - (e) PPI is commonly, but not always, paid to the creditor rather than the customer;
- and
- (f) PPI typically covers A, S and U (and sometimes also L).
90. The key similarities between IP and PPI include that IP and PPI generally provide cover against A and S. IP and PPI also both provide a monthly payment to the customer rather than a lump sum (which is more common for PA, CI and TA policies).

---

<sup>35</sup>The majority of distributors price PPI on a community basis, where all customers pay the same price regardless of demographics. Notable exceptions include some stand-alone PPI providers who differentiate prices by age band. HBOS changed its pricing policy on PLPPI in 2006 and now operates a risk based pricing system based on age, gender and the terms of the loan. PA insurance is also underwritten on a community basis; however, IP, CI and TA tend to be individually underwritten.

<sup>36</sup>See our working paper, PPI and its alternatives.

<sup>37</sup>See our working paper, PPI and its alternatives.

91. In general, IP policies have longer deferment periods and will pay benefits to the customer for a longer period (for example, until he/she returns to work, or in some cases until retirement).<sup>38</sup> They are also typically underwritten individually on the basis of customer age, health, employment and other demographic factors.<sup>39</sup>
92. PPI is usually related to the underlying credit product, so, for example, the level of cover is tailored to the payments on a loan or the outstanding credit card balance. Alternative policies such as IP do not have this feature, although for certain types of PPI policies where repayments are stable or predictable (eg MPPI, SMPPI, PLPPI and motor PPI) this can be replicated by taking out IP cover for a similar amount. Most PPI policies appear to pay the benefit to the creditor directly; however, there are a number of exceptions. For example, Abbey, HSBC and HBOS said that their MPPI policies were credited to the customer's current account from which the loan repayment are debited.
93. Finally in terms of the risks covered by PPI, there appear to be few alternative policies that cover the same risks as a typical PPI policy. In particular IP, PA, CI and TA policies rarely cover U.<sup>40</sup>

#### *Other evidence provided by the main parties*

94. None of the distributors were able to provide evidence that showed that alternative policies were a competitive constraint on PPI providers. As a result the available evidence at this stage is limited.

---

<sup>38</sup>[X] said that IP policies allow the customer to select the deferred period before benefit payments start (up to 112 weeks). This allows PPI and IP policies to be combined. According to [X] PPI products have a set deferment period of 14 to 60 days. [X] said that IP would pay a monthly benefit up to retirement if required whereas PPI provides shorter-term protection, ie 12 to 24 months or (in cases of accident or sickness) for the term of the personal loan.

<sup>39</sup>[X] told us that IP policies offer cover to a specific age whereas PPI policies offer cover related to the term of lending. Similarly [X] said that IP was underwritten and premiums varied by risk whereas PPI was not risk based and premiums only varied depending on the credit amount

<sup>40</sup>It is possible that customers could try to replicate a PPI policy by purchasing a suite of products; however, this would be likely to result in very high transaction costs, as customers would have to fill out multiple applications. As IP, CI and TA tend to be individually underwritten; the applications processes for these products may take longer.

95. As part of the market and financial questionnaire we asked distributors what factors were taken into account when setting prices. Typically these factors included costs, underwriting performance, the level of cover offered and competitor pricing. None of the examples of distributors' price comparisons and monitoring that have been provided to the CC included monitoring of alternative policies. For example, [✂]

### *Supply-side substitution*

96. Suppliers of alternative policies could potentially impose a competitive constraint on PPI policies through supply-side substitution.
97. CC guidelines state that supply-side substitution occurs when a price rise prompts other firms to start supplying, at short notice, an effective substitute to the policy in question.<sup>41</sup> Supply-side substitution occurs in the short run; with little or no investment required.
98. However, as discussed in paragraphs 32 to 34, any insurance provider seeking to switch to the supply of PPI would not have access to the credit point of sale in the same way that a distributor which already sells the underlying credit product would. As a result general insurers are only likely to be able to substitute into the supply of stand-alone PPI.
99. It would therefore seem that whilst providers of IP, PA, CI and TA insurance could potentially substitute into the supply of policies which cover similar risks and have similar terms and conditions to PPI, they are likely to face significantly increased distribution costs as a result of their lack of access to the point of sale for the

---

<sup>41</sup>CC3, paragraph 2.19.

underlying credit product. It would therefore appear unlikely that the major PPI distributors are constrained by the potential for supply-side substitution.<sup>42</sup>

### *Summary*

100. On the material received so far there is very little evidence of demand-side substitution between PPI and potential alternative policies for all types of PPI.

101. Supply-side substitution between general insurance products and PPI is limited by impact of the point of sale. PPI suppliers without a suite of credit products and the facilities to sell them are therefore likely to face increased distribution costs compared with PPI distributors who also supply credit.

### **The relevant geographic markets**

102. All the distributors of PPI that we received evidence from considered the relevant geographic markets to be the UK. We have received no evidence so far in our inquiry that would indicate that there are any regional differences in prices or policy offerings which may suggest narrower geographic markets, nor has any distributor indicated to us that they are planning to do so in the future.

103. We do not consider that defining regional geographic markets would alter our analysis to a significant extent. We therefore consider that it is appropriate at this stage, as a framework for the analysis of competitive constraints, to define the relevant geographic market as the supply of PPI by distributors to customers within the UK.

---

<sup>42</sup>A lack of access to the credit point of sale would also impose additional distribution costs on existing suppliers of PPI seeking to supply the credit customers of another distributor. Since whilst each distributor has access to its own credit customers, it has only indirect access to the credit customers of others.

## **Conclusion on the relevant markets**

104. There would appear to be very little evidence that the complementary demand relationship between credit and PPI operates as a constraint on PPI pricing. We have found insufficient evidence to support a contention that consumers' decisions in the primary market for credit are affected by pricing or other decisions by firms in the secondary markets for PPI. As such the evidence available to date appears to indicate that there is an asymmetric demand relationship between PPI and credit.
105. Evidence of substitution between brands of PPI and between PPI and alternative policies is also limited. It would therefore seem, based on the evidence currently available, that a SSNIP on PPI, at the point of sale, would not result in a significant loss of credit sales, nor would it induce customer substitution to alternative policies. As such we consider that a price rise above competitive levels for an individual supplier of PPI is likely to be profitable and therefore we consider that the appropriate market definition with regard to PPI is that there are a series of individual proprietary markets for PPI. As such each credit distributor would appear to enjoy a monopoly over sales of PPI to its own credit customers.
106. Furthermore, we consider that the conditions are in place such that PPI prices may already be in excess of competitive levels. As noted in paragraph 76 the distributors' internal documents indicate that they view PPI demand as being unresponsive to PPI price, and as noted in Emerging Thinking, there is documentary evidence which may suggest that the profitability of distributing PPI is regarded to be high by some distributors.<sup>43</sup> As there is little evidence of any constraint on PPI prices at current prices, either as a result of the complementary demand relationship with credit or substitution to other policies, it would seem therefore that there is some likelihood that no constraint would operate at competitive price levels either.

107. On the evidence currently available to us it would seem that this applies to all of the main categories of PPI. However, we consider that the market definition for MPPI may be less clear cut and that further analysis may yield a different outcome.
108. We consider that the extent to which PPI profits are competed away in the form of lower credit prices to be beyond the scope of our market definition exercise at this stage. However, we will be carrying out further work in this area in the next stage of our inquiry.

-----  
<sup>43</sup>See paragraph 193 of Emerging Thinking.