

PPI policies—characteristics

Summary

1. The purpose of this paper is to provide details of the typical characteristics of payment protection insurance (PPI) policies, including what the policies cover, what they do not cover, waiting periods and price. The paper is divided into sections which reflect those issues.
2. Information and data contained in this paper have been compiled with reference to industry research, responses from parties to our issues statement and market questionnaire, and evidence given during the oral hearings with parties.
3. Our analysis with regard to all the issues discussed in this paper is ongoing.

What is covered

4. PPI policies are not underwritten on an individual basis; many companies charge the same premium to all customers for the same cover, though some do charge varying premiums according to, for example, age. Once a customer is deemed to be eligible for a credit product, PPI is made available if the customer is eligible for it (and also suitable, if the sale is made on an advised basis¹). PPI will typically cover either all, or a combination of, accident (A), sickness (S), unemployment (U) and life (L). Unemployment cover typically covers only involuntary unemployment. Some policies also offer cover for critical illness (CI).² First-charge mortgage PPI (MPPI) does not usually contain a life element in its cover (see Table 1).³

¹The FSA's Insurance Conduct of Business (ICOB) Rules and also its Treating Customers Fairly (TCF) rules set out the requirements for an advised sale and a non-advised sale of PPI. For more information see our working paper on regulation.

²Barclays, HBOS and Lloyds TSB told us during the hearings that their PPI offering included CI cover; it is also offered by many motor finance PPI providers, by some credit card PPI providers and some retail finance PPI providers.

³Defaqto *Payment protection insurance 2007—The Year of Reckoning*.

TABLE 1 Typical covers provided by three main policy types

Cover/benefit	MPPI	PLPP	CCRP
Disability Cover	Always	Always	Always
Unemployment Cover	Always	Nearly always	Nearly always
Life Cover	Rarely	Nearly always	Nearly always
Critical Illness Cover	Rarely	Sometimes	Sometimes
Hospitalisation Cover	Sometimes	Often	Often
Disability Benefit Period	12 months	12 months or loan period	Usually 12 months
Unemployment Benefit Period	Usually 12 months	12 months	Usually 12 months
Wait/Excess Period Disability	0, 30, 60, 90 days	15 or 30 days	30 days
Wait/excess Period Unemployment	0, 30, 60, 90 days	15 or 30 days	30 days

Source: Defaqto *Payment protection insurance 2007—The Year of Reckoning*.

5. There are some minimum requirements a customer must satisfy to be eligible for PPI cover. These are generally that the customer must be:

- between 18 and 65 years of age;
- living and working in the UK;
- actively employed for at least 16 hours per week; and
- must have held that employment for a specified period of time.

6. Payment under a PPI policy will be made in the event of a loss of earnings resulting from A, S, U (or L or CI), and is usually paid for a period not exceeding 12 months (although there are some PPI products which pay benefits for up to 24 months).

What is excluded

7. Exclusions vary between PPI policies. However, as a general rule, if the loss of earnings is deemed to be caused by an event which was within the control of the customer or known to the customer at the time of taking out the insurance, the customer will not be able to claim against the policy. For example, as stated above, most PPI unemployment cover is limited to involuntary unemployment, so it is not available to those who are self-employed, have been dismissed or have taken voluntary redundancy. In addition, customers cannot generally claim for a 'pre-

existing illness' (which is an illness they had and were aware of at the time of purchasing the policy).

8. In the past it was common for stress-related illness and back complaints to be excluded from the scope of PPI cover, even if the policyholder was unable to work as a result of these problems. However, recent developments in the industry have tended to result in an easing of exclusions such as back complaints and stress-induced illness.⁴

Calculation of benefits

9. PPI benefits for personal loans and mortgages typically cover the monthly repayments on the loan for a set period (which is normally 12 months). PPI on credit cards (CCPPI) typically covers either a percentage of the outstanding balance at the time the claim is made, or the minimum payment requirement for up to 12 months (policies range from paying 3 to 10 per cent of the outstanding balance).⁵
10. CCPPI policies differ where the benefit payable is a percentage of the outstanding balance on the credit card at the time the claim is made. This is because some policies provide for calculation of the benefit as a percentage of the balance outstanding at the time the claim is made (constant rate); and some provide for calculation of the benefit as a percentage of the balance outstanding each month, ie on the reducing balance (reducing rate). An example of how these differences work in practice is set out in Table 2.

⁴For example, some PPI policies offered by Abbey, Barclays, Cattles, HBOS, HSBC, Lloyds TSB, London General Insurance and RBSG and (among others) have been expanded to include back complaints and stress-related illnesses.

⁵Evidence given by parties during hearings.

TABLE 2 Example: outstanding balance of £1,000; benefit payable 10 per cent of the outstanding balance

Type of cover	Benefit payable, month 1	Benefit payable, month 2	Benefit payable, month 3
Constant rate	£100 (leaving a balance of £900)	£100 (leaving a balance of £800)	£100 (leaving a balance of £700)
Reducing rate	£100 (leaving a balance of £900)	£90 (leaving a balance of £810)	£81 (leaving a balance of £729)

Source: CC, based on evidence provided by parties.

Waiting periods

11. All PPI policies include one or more of the following waiting periods, which are commonly defined as follows:

(a) *Exclusion period*: the specified number of days between when a policy was purchased and when the customer can make a claim. We have been told that this is typically 30 days, although there are some policies which only have a 14-day exclusion period.

(b) *Excess period*: the time between the occurrence of a claimable event (for example, sickness) and the policyholders' entitlement to begin receiving benefits. We have been told that this period varies, but is typically between 0 and 30 days.

(c) The third waiting period which affects customers is the time it takes for the first benefit payment to be made, which under some policies is up to 30 days after the expiration of any excess period.

12. In its 2006 annual report following a review of PPI, Defaqto⁶ stated that while PPI was designed to cover the cost of regular payments to a lender, it was not a homogenous product. Policies often used complicated terminology, and payments were not necessarily made in the same way by each provider. Most types of PPI policies (such as MPPI or personal loan PPI (PLPPI)) appeared, at first glance, to

⁶Defaqto, *Payment Protection Insurance in the UK Annual Review of the PPI Market—February 2006*.

have similar excess periods and waiting periods. However, Defaqto noted that in practice the ways in which benefits accrued and were paid under the various policies varied markedly.

13. In its report, Defaqto sought to illustrate the differences between the way in which benefits accrued and are paid with reference to the following example: a policyholder becomes sick and is unable to work for four and a half months. His PPI policy provides for 12 months' cover with a 30-day excess period in the event of sickness. In those circumstances there are four main types of PPI policy structure, each with a different claims payment method. Table 3 contains an illustration of the differences between payment types.

TABLE 3 Differences between benefit payment types

<i>Payment type</i>	<i>days</i>		
	<i>Benefit provided (45-day sickness)</i>	<i>Benefit provided (135-day sickness)</i>	<i>Benefit provided (180-day sickness)</i>
30-day excess;* benefits accrue monthly	0	90	150
30-day excess; benefits accrue daily	15	105	150
30-day retrospective;† benefits accrue monthly	30	120	180
30-day retrospective; benefits accrue daily	45	135	180

Source: Defaqto, *Payment Protection Insurance in the UK Annual Review of the PPI Market—February 2006*.

*First payment is due 61 days after the event (not eligible to be paid until 30 days after the expiry of the excess period).

†First payment is due 31 days after the start of the event.

14. Each of the methods for payment of benefits under PPI policies set out above materially affects the amount which the customer will receive. However, all the policies may be described as having a 30-day exclusion or 'wait period'. The differences in the way benefits are paid will not necessarily be clear to the customer when the policy is being purchased.

15. There is a further factor which contributes to the differences between payments made to a policyholder illustrated by Table 3, and which has a material impact on the amount of benefit a policyholder will receive in the event a claim is made. That is

whether the policy provides for benefits to be calculated on a monthly basis or on a daily basis.

16. If a policy provides for monthly calculation of benefits, the policyholder will not be eligible for benefits until 61 days after his claim is made, because he is required to wait until the 30-day excess period has expired and then until he has been off work for a further month thereafter. Therefore, if he is unable to work for four and a half months due to sickness, he will receive payments for three of those months (because he loses one month at the start of the period due to the excess, and half a month at the end of the period because benefits are paid only for each whole month off work).
17. If the policy provides for daily calculation of benefits, the policyholder must wait for the expiry of the 30-day excess period before being eligible for payment of benefits. Payments are made for each single day he is unable to work, and those payments are made at the end of each month off work. When he returns to work he receives payment for any part-months. Accordingly, if he is unable to work for four and a half months, he will receive benefits for three and a half months.
18. Some providers offer payments which are known as 'retrospective', or 'back to day one' policies. These can also be calculated on either a monthly or a daily basis. There will usually be a waiting period before the first benefit payment is due, but payments will be calculated from the first day the policyholder was unable to work. If the benefits are calculated on a monthly basis, and the policyholder is unable to work for four and a half months, he will only receive benefits for four of those months. If the benefits are calculated on a daily basis, in the same scenario he will receive benefits for the entire four and a half months he is unable to work.

Price of policies

19. The price of PPI is an area on which our analysis is ongoing.

Price dispersion

20. The comparative price of PPI *within* product categories varies, as does the price of PPI across different credit products. It is easier to compare prices within a product category than across the categories.

21. Defaqto⁷ has prepared a comparison table based on the price for each £100 of repayment covered per month by MPPI, PLPPI and CCPPI. However, only the price of MPPI is generally quoted in this way; the cost for CCPPI is most frequently quoted as a fixed monthly amount for the outstanding balance (no matter how much of this amount is paid off by the customer at the end of the month); and the cost for PLPPI is generally quoted as the cost of PPI for the whole loan, rather than a cost per £100 insured. The table prepared by Defaqto is Table 4 below.

TABLE 4 The comparative cost to consumers of PPI

	<i>£ per £100 of repayments per month*</i>			
	<i>Minimum cost</i>	<i>Median cost</i>	<i>Average cost</i>	<i>Maximum cost</i>
Mortgages	2.40	4.95	4.76	6.50
Credit cards	5.00	7.90	11.71	28.33
Personal loans*	10.50	17.82	18.23	28.25

Source: Defaqto, *Payment protection insurance 2007—The Year of Reckoning*.

*Prices are based on premiums for cover for a £5,000 loan which is repayable over 48 months.

22. The Office of Fair Trading (OFT) commented that the price of PPI did not always explain the differences in cover.⁸ Which? found that there was a range of prices across PPI products, and commented that it could not find a reason for the disparity.⁹

⁷Defaqto, *Payment protection insurance 2007 – The Year of Reckoning*.

⁸*Payment Protection Insurance: the OFT's reasons for making market definition investigation reference to the Competition Commission*, February 2007.

⁹Which? summary of hearing, paragraph 16.

The Post Office submitted that it could see 'little justification for the differing cost of PPI'.¹⁰

Types of premium

23. PPI policies are either 'single premium' or 'regular premium', which refers to the payment method of the policy.⁷

Single premium

24. A single premium policy requires payment of the total price of the policy to be made up front. Single premium policies usually accompany personal loans, motor finance and second-charge mortgages.¹¹
25. We have been told that there are at least three different ways in which lenders calculate the price of a single premium policy.¹²
26. We have been told that the credit provider will usually lend the customer the amount payable for the policy, in addition to the amount of the loan. Therefore the customer borrows the price of the PPI in addition to the loan, and interest accrues on the combined sum. The customer repays both the loan and the price of the PPI at the same time.
27. Which? provided us with details of the interest charged on a personal loan for £7,500, repayable over five years, with PPI and without PPI. This showed that, looking at 54 products from 31 lenders and underwriters, the average payments were:

¹⁰Post Office, response to issues statement, paragraph 28a.

¹¹For example: Northern Rock sells single premium policies for unsecured personal loans but regular premium policies for mortgage and PSL (Northern Rock, summary of hearing, paragraph 13); and Alliance & Leicester sells single premium policies exclusively on its unsecured products, and secured, second-charge products (Alliance & Leicester, summary of hearing, paragraph 12).

¹²Appendix A to this paper summarizes the different methods which are used calculate the price of a single premium policy.

(a) *Without PPI*: the total loan repayment was £9,065.76; the total interest paid was £1,565.76; and the monthly payment was £151.10.

(b) *With PPI*: the total loan repayment was £11,265.82; the total interest paid was £3,765.82; the total amount of PPI paid was £2,200.07; and the monthly payment was £187.76.

28. While the calculations in the paragraph above are a general overview, they illustrate the effect that a single premium PPI policy can have on a loan. The evidence we have received indicates that customers are focused on the price of the repayment each month and not on the total price of the loan and the PPI over the life of the loan.

Regular premium

29. A regular premium policy provides for the price of the PPI to be paid by the customer by monthly instalment, which is generally added to the credit repayment for that month.

30. PPI for credit cards, mortgages, retail finance and overdrafts is generally regular premium. For CCPPI the monthly price of the policy is based on the balance outstanding on the card at the end of the month. Accordingly, the price of the policy will change from month to month; and if the outstanding balance on the credit card is nil, then there is no amount payable for the CCPPI policy.

Comparison between single and regular premium

31. While the price of single premium and regular premium policies is calculated in a different way, it may appear that both types of policies are paid for by way of monthly instalments. This is because the single premium policy is, in effect, repaid by way of monthly instalments, and the regular premium policy is paid for on a month-to-month

basis. Therefore, customers may not be aware of the difference between the premium types, or the implications of the differences on the total price they will pay.

32. We have been told that the primary advantage of single premium policies is that if a customer misses a few loan payments throughout the year, their PPI policy will not be affected throughout the life of the loan. Cattles told us that it considered regular premium policies inappropriate for the majority of its customers. It argued that its customers were more likely to experience fluctuations in their level of disposable income and require repayment holidays. A single premium PPI policy meant that their cover would be unaffected by any breaks in the repayment of the loan.¹³

33. In contrast, we were told that when a monthly payment on a regular premium policy was missed, some PPI contracts provided, in principle, for the policy to be cancelled by the provider, which would mean that the customer would lose the benefit of the PPI cover from that time. However, the Financial Ombudsman Service told us that although some regular premium policies contained those sorts of conditions, it had not seen evidence of this occurring; and also that it would have doubts about whether cancellation of the policy would be fair or reasonable if only one or two payments were missed.

Refunds

34. We have been told that many customers settle their loan early either by paying out the amount owed, or by refinancing. Therefore the issue of refunds for PPI policies which were bought to cover loans is an important one.

¹³Cattles, response to issues statement, paragraph 3.9; and Cattles, position paper, paragraphs 3.7 and 3.8.

35. The parties to the inquiry were asked in a questionnaire to provide details of the method they used to calculate refunds for PPI policies and their reasons for using that method. Our analysis of those responses is ongoing.
36. With regard to regular premium policies, when a customer terminates their policy we understand that they will stop making payments towards it. The situation is different, however, for single premium policies, for which the customers have paid in advance at the commencement of the loan period.
37. Prior to early 2006 many single premium PPI policies contained clauses which specified that should the policy be cancelled for any reason, the customer would not be entitled to a refund of any part of the premium.
38. After the Financial Services Authority (FSA) began its review of the PPI market in 2005, it approached the Association of British Insurers (ABI), the British Bankers Association, the Council of Mortgage Lenders and the Finance and Leasing Association to discuss the issue of refunds of single premium PPI policies which were cancelled. We understand that the FSA was concerned that refusal to provide a refund of a premium for a single premium policy which was cancelled may amount to an unfair contract term.
39. In March 2006 the members of the ABI agreed to provide a refund to customers who cancelled their single premium policy.
40. The FSA has not proposed a standard way of calculating the refund for a single premium PPI policy. It has stated that it believes that refunds should be calculated to take account of the reasonably incurred costs of each firm, which will vary, but may

include administrative costs, proportion of commission and the uneven spread of risk over the length of the policy.

41. Accordingly, refunds for single premium policies are not normally calculated on a pro-rata basis, according to the proportion of the contract remaining. Thus, while each repayment for a single premium policy is the same during the time the policy is in place, we have been told that the PPI provider deems more to have been paid at the beginning of the loan, in line with the risk profile of the loan, and any amount available to be refunded will reflect that uneven spread of risk. Expenses such as administrative costs which are incurred by the provider may also be deducted from the amount which is refunded to the customer.

42. The FSA¹⁴ has indicated that providers now offer refunds on single premium PPI policies; however the refund terms are often not being properly explained to customers.

¹⁴FSA report *The Sale of Payment Protection Insurance Thematic Update* (September 2007).

Pricing of single premium PPI policies

1. The evidence we have seen to date suggests that there are at least three methods used by firms to calculate the premium for single premium PPI policies.
2. Each method applies a constant, term-specific insurance premium rate to some measure of the total amount payable (TAP) on the loan. This rate varies according to the period over which cover is provided (normally the term of the insured loan) but not according to other factors (for example, the APR).
3. The three methods differ in their treatment of interest paid on the single premium (where this is added to the loan and repaid in instalments) and whether the term-specific rate is calculated as a percentage of the TAP including or excluding the PPI premium.
4. We illustrate below the three methods by way of worked examples. In each example, we consider a £1,000 loan with a two-year term and APR of 13.8 per cent.

Method 1: 'All-inclusive' insurance premium rate

5. Using Method 1, a constant, term-specific insurance premium rate is applied to the TAP excluding the insurance premium.
6. The premium that is calculated in this way covers both the insurance premium and any costs of funding the premium.

Example: Method 1

1	Loan	£1,000	
2	Term (years)	2	
3	APR	13.8%	
4	Cost of credit	£141	Calculated using APR on the loan
5	TAP without PPI	£1,141	Equals 1 plus 4
6	'All inclusive' insurance premium rate	13.1%	As a percentage of 5
7	Insurance Premium	£150	Equals 5*6
8	TAP with PPI	£1,291	

7. Where a firm uses Method 1 to set premiums, then the premium rate, in this example, for a two-year loan would be 13.1 per cent.

Method 2: Constant percentage of TAP excluding PPI

8. Using Method 2, a constant, term-specific insurance premium rate is applied to the TAP *excluding* PPI. Interest is then calculated on this premium, using the APR on the loan.
9. Under this method, the TAP *with* PPI is the sum of:
- (a) the TAP without PPI;
 - (b) the PPI premium; and
 - (c) interest on the PPI premium.

Example: Method 2

1	Loan	£1,000	
2	Term (years)	2	
3	APR	13.8%	
4	Cost of credit	£141	Calculated using APR
5	TAP without PPI	£1,141	Equals 1 plus 4
6	Premium rate as a percentage of TAP without PPI	11.5%	Set as a percentage of 5
7	Premium	£131	Equals 5*6
8	Interest on premium	£18	Calculated using APR on the loan
9	TAP with PPI	£1,291	Equals 5 + 7 + 8

10. Where a firm uses Method 2 to set premiums, then the premium rate, in this example, for a two-year loan would be 11.5 per cent.

Method 3: Constant percentage of TAP including PPI

11. Using Method 3, the premium for loans of a given term is calculated by applying a constant, term-specific premium rate to the TAP on the loan *including* PPI. Interest is then calculated on this premium, using the APR on the loan.
12. The single premium can be calculated as a (fairly complex) function of the size of the loan, the premium rate, the term of the loan and the APR on the loan (see Annex A for a derivation of this formula). Under this method, the TAP *with* PPI is the sum of:
 - (a) the TAP without PPI;
 - (b) the PPI premium; and
 - (c) interest on the PPI premium.

Example: Method 3

1	Loan	£1,000	
2	Term (years)	2	
3	APR	13.8%	
4	Cost of credit	£141	Calculated using APR
5	TAP without PPI	£1,141	Equals 1 plus 4
6	Premium rate as percentage of TAP with PPI	10.2%	Set as a percentage of 9.
7	Premium	£131	Calculated using formula at Annex A
8	Interest on premium	£18	Calculated using APR on the loan
9	TAP with PPI	£1,291	Equals 5 + 7 + 8

13. Where a firm uses Method 3 to set single premiums, then the premium rate, in this example, for a three-year loan would be 10.2 per cent.

Summary

14. There is no single metric for comparing prices of single premium PPI policies across all suppliers. Different providers calculate premiums using different methods. Moreover, individual providers apply different premium rates according to the length of the policy.