

The value chain

Introduction

1. This paper describes the participants in the value chain for payment protection insurance (PPI), the principal activities they perform and their business models. The paper also describes how contracts for the provision of PPI are awarded, and the main characteristics of the contractual arrangements regulating the relationships between distributors and underwriters.

The participants in the PPI value chain and their activities

2. The main participants in the product development, distribution and administration of PPI are:
 - insurers/underwriters;
 - credit providers or lenders;¹ and
 - intermediaries (eg brokers, independent financial advisers (IFAs)).

Other participants in the value chain include third party service providers such as claim administrators (eg Cassidy Davis) and insurance underwriting brokers (ie providers of insurance broking services to companies). These are not considered further in the paper.

Underwriters

3. The insurers or underwriters² of PPI products take on the risk³ of a customer's inability to meet financial obligations arising from a loan or other credit agreements because of unexpected events such as unemployment, accident, sickness or death. To insure these risks, underwriters charge the customer a premium. As with the

¹We will use the term 'lender' for the rest of this paper and with this term we indicate lenders operating at the retail level (ie distributing PPI to retail customers). Wholesale lenders (lenders distributing credit products and PPI to companies, eg Lloyds TSB Asset Finance Division) are not covered in this paper.

²We will use the term 'underwriter' for the rest of this paper.

³Some of this risk can be taken on by the lender or intermediary through profit-sharing arrangements.

general insurance policies, by stipulating the benefits in the insurance products they offer, underwriters can ensure that payments are made to those customers who are eligible to receive them. By stipulating the exclusions, underwriters can restrict the circumstances under which a claim would be paid, and thus reduce the level of the risk underwritten.

4. The activities typically, but not exclusively, carried out by underwriters include:
 - (a) underwriting;
 - (b) claims management;
 - (c) policy administration:
 - (i) premium collection;⁴
 - (ii) record keeping; and
 - (iii) handling of policy-related complaints;⁵ and
 - (d) distributor support:
 - (i) sales and marketing (to distributor);
 - (ii) training;⁶
 - (iii) provision of management information; and
 - (iv) provision of regulatory information.

Underwriters may use outsourcing arrangements for part of their claim management and policy administration activities (eg [✂]). In addition, product design and development can be undertaken by the underwriter.

5. Underwriters distribute PPI through lenders or intermediaries; they do not generally distribute PPI products on a stand-alone basis⁷—that is to say, separately from a credit product and/or direct to customers. The Cardiff Pinnacle Helpupay product, a

⁴Distributors can also collect premium on behalf of underwriters, undertake record keeping, and deal with complaints and perform all administration, including claims management.

⁵Typically, the distributor handles complaints in relation to the customer service.

⁶This activity can be also performed by the distributor.

⁷These products provide benefits based on a fixed amount or a percentage of gross income.

mortgage PPI product distributed by Cardif Pinnacle through the Internet and by telephone, is one of the very few examples of a stand-alone PPI product distributed direct by an underwriter. Aviva offered stand-alone PPI through its Norwich Union Direct brand, but exited the market in 2004.

Lenders

6. Lenders (eg banks, building societies, mortgage providers, finance houses, credit card providers) offer PPI alongside their underlying credit products. They can also offer PPI products on a stand-alone basis but rarely do. In 2006, HBOS launched a pilot for the sale by direct mail of two stand-alone PPI products, Life Stages and Lifestyles. The pilot was not successful and the two products have been temporarily withdrawn.⁸ Barclays told us that it was launching stand-alone PPI for credit cards for new and existing Barclaycard customers that would allow Barclays customers to purchase PPI for non-Barclays credit cards. There are also products that are offered both alongside a credit product and on a stand-alone basis, for example HSBC's Lifechoices product.⁹
7. Lenders can specialize in the provision of credit to prime customers only¹⁰ or to customers with lower credit scores.
8. Lenders can also specialize in the offer of credit cards, loans, mortgages or overdrafts, for instance, or offer a portfolio of products. For example, banks such as Barclays and RBSG offer credit cards, unsecured and secured loans, mortgages and

⁸Summary of a hearing with HBOS, paragraph 25.

⁹This product offers customers different types of cover—life and/or sickness with the option of adding on trauma and/or unemployment.

¹⁰Customers with a good credit history.

overdrafts, while financial institutions such as MBNA and American Express specialize in credit cards.¹¹

9. Lenders typically take responsibility for product design and development (eg type of benefits offered, type and level of exclusions) branding, marketing and selling the PPI products,¹² including compliance with any requirement covering regulated sales and ongoing relationship with the customer. Lenders can also undertake a wider range of functions including claims handling and ongoing policy administration.

Intermediaries

10. Intermediaries distributing PPI include IFAs, mortgage brokers, car dealers, insurance intermediaries and some smaller building societies (eg Furness Building Society).
11. Intermediaries can distribute both credit products and PPI, or PPI alone. However, they neither underwrite the PPI products nor finance the credit or loan. Intermediaries make available to customers credit products or loans and PPI of one or more lenders and/or underwriters. These products can be distributed under the brand name of the lender or of the underwriter.
12. Some stand-alone PPI (see paragraph 5) is provided by intermediaries. For example, Paymentcare offers loan, mortgage and credit card PPI underwritten by Brit Insurance Ltd and by Templeton Insurance Ltd, through the Internet.

Business models

13. Three main business models can be observed in this industry:

¹¹

¹²Customers enter into the insurance contract with the underwriter, though in the majority of cases the insurance contract will be branded with the distributor's details.

- (a) the vertical integration of lender and underwriter (the vertically integrated model);
- (b) the independent underwriter contracting with an independent lender (the vertically separated model); and
- (c) the 'hybrid'.

The third business model contains elements of the first two, as further described below in paragraphs 16 and 17.

The vertically integrated model

14. In the vertically integrated model, an underwriter is under the same ultimate ownership as the lender, and underwrites the risks of the PPI customers of the lender. Examples of groups that have a vertically integrated PPI underwriter include RBSG and Barclays. In some cases, vertically integrated providers also distribute their products via intermediaries and/or other lenders.

The vertically separated model

15. In the vertically separated model, the underwriter partners with distributors outside its own group of companies to offer PPI to the end-customers. Distributors are typically lenders, including major banks and credit card providers, who sell the underwriter's PPI product—typically under their own brand—in connection with the underlying credit product, and intermediaries (see paragraphs 6 to 12). Examples of independent PPI underwriters include Aviva, Cardif Pinnacle, Genworth and London General Insurance. Examples of distributors who use independent PPI underwriters are Abbey,¹³ Nationwide and Northern Rock.

The hybrid model

16. Some providers of PPI products operate hybrid business models. In these models, underwriting activities are in part carried out by the vertically integrated underwriter

¹³ [redacted]

and in part outsourced to independent underwriters, and PPI is distributed through the vertically integrated lender and/or through third parties. Lloyds TSB is an example of a party operating a hybrid business model where some PPI products are underwritten by independent underwriters (eg Norwich Union for credit card PPI and Cardif Pinnacle for certain Asset Finance Division Loan PPI products), and other products are underwritten by the captive underwriters, Lloyds TSB General Insurance and Scottish Widows.

17. As for the vertically separated business model, in the hybrid business model arrangements between underwriters and distributors are based on commercial contracts.

Tenders and contracts

18. The contracts for the provision of PPI services are generally put out to tender by independent distributors and by providers who operate a hybrid business model for the part of the business outsourced to underwriters. Vertically integrated distributors may also put out the contracts to tender, and we have received evidence that vertically integrated distributors have conducted tenders for the provision of PPI services to their distribution part of the business [✂].

Tender process and contract negotiations

19. Parties told us that the typical tender process can take between three and six months. We were also told that this period could be much longer (eg 18 months). One of the circumstances in which a tender process may take longer to complete is when a large number of companies are invited to tender. The process includes the following stages:
 - (a) Underwriters sign confidentiality agreements.

- (b) The distributor issues invitations to tender¹⁴ to a number of underwriters (between two [✂] and ten [✂]) and requests responses within a specific time period (normally three weeks). Invitations to tender might be preceded by a request for information on areas such as the underwriter's corporate structure, capabilities and credentials as a provider of PPI.
- (c) Underwriters submit their bids, which include a description of the relevant services that they could offer—such as claims handling, product training and IT infrastructure, service levels and the commercial pricing arrangements (see paragraphs 22 and 23).
- (d) On the basis of the bids received, the distributor draws up a shortlist of underwriters from whom additional information will be sought.
- (e) The distributor visits the business sites of the shortlisted underwriters to look for evidence of the quality of services such as claims handling or account servicing.
- (f) The distributor makes a final decision on which underwriter will be awarded the contract.

20. An underwriter told us that, in the tender process, distributors usually make available the following information to underwriters submitting tenders:¹⁵

- (a) depersonalized portfolio information relating to borrowers with PPI products (including age, gender, occupation, claims performance and the existing policy terms and conditions);
- (b) summary level information on past sales volumes; and
- (c) summary level information on future sales.

Underwriters use this information to determine the price of the PPI and the commercial terms to be offered to the distributor.

¹⁴This is also referred to as a Request for Proposal.

¹⁵[✂]

21. Parties told us that distributors sometimes sought bids from various underwriters to benchmark their existing arrangements for the provision of PPI.
22. The same underwriter told us that the starting point for determining the price of PPI to be offered to the distributor was determining the PPI basic price. The underwriter determines this price based on an evaluation of the risk associated with the product (ie life, accident and sickness, and involuntary unemployment insurances, or some combination thereof). The basic price on the non-life insurance element of PPI is based on assumptions about the claim frequency and claim severity (ie average duration of claims). These assumptions are based on portfolio information (see paragraph 20(a)) when that is made available by the distributor, or on the underwriter's analysis and experience of these indicators' performance in other similar portfolios that the underwriter underwrites. The pricing of life insurance instead tends to be heavily influenced by the official UK mortality tables published by the Government's Actuarial Department.
23. Once the basic price has been determined, the underwriter adjusts it to specific variations of the cover being offered, such as wait periods, exclusions and customers' age profile, to arrive at the 'risk price' for each component of the PPI products it is bidding to underwrite. Data on sales plans (see paragraph 20(b) and 20(c)) is then combined with the underwriter's risk price to project the underwriter's estimated profit or loss from the contract. On the basis of these estimates, the underwriter can then determine the commercial terms (eg percentage of profit share, level of service) that can be offered to the prospective distributor.
24. Distributors told us that, in setting the price of PPI, they benchmarked their product to the products offered by their competitors. For example, HBOS said that it sought to offer products whose quality and pricing was competitive relative to its mainstream

competitors, and in setting the price of PPI it considered customer feedback and the position of its products in best-buy tables or lists on price comparison websites (such as moneysupermarket.com). Northern Rock also told us that it priced holistically across its unsecured loans and PPI products, and in pricing the PPI products and the underlying credit products it sought to be in—or close to the top of—best-buy tables or lists on price comparison websites.

Contract terms and length of contracts

25. The contracts between underwriters and distributors for the provision of PPI services are negotiated on an individual basis and set out: the type and level of services to be provided, the financial arrangements, and the rights of the parties to make or request changes to parts of the contract.
26. Contracts tend to have an initial fixed period after which the contract continues until it is terminated, normally by the distributor giving notice to the underwriter. The length of the initial fixed period varies between one and five years. Notice periods for terminating a contract by either party tend to be between one and six months.
27. Typically, the underwriter has exclusivity rights for the provision of the PPI product provided by the distributor in connection with each lending product (eg credit card, mortgage) except in the IFA/broker market. The distributor owns the customer data and the underwriter, in the majority of cases, is not permitted to use this data for marketing or promotional services.
28. Contracts set out the rights of the parties to set the premium paid by customers. In most cases the customer premium is set by the distributor. However, some contracts [X] state that the level of the premium paid by customers should be agreed between the underwriter and the distributor.

29. Lastly, many contracts have provisions regulating the transfer of the PPI policies to the new underwriter when the contract with the incumbent underwriter terminates.