

The underwriting market

Summary

1. On the basis of the evidence we have received so far it appears that the relevant market is for the underwriting of all payment protection insurance (PPI) policies in the UK. There is some evidence that both the product and geographic market may be wider than this. However, a wider market definition is not considered to have a substantive impact on the competition assessment and we therefore leave the question open.
2. The market for underwriting PPI policies is concentrated, and there is some evidence of switching costs that give incumbent underwriters an advantage when bidding for repeat business. However, our assessment of competition in the underwriting market indicates that overall the market for underwriting PPI appears to function competitively with healthy competition between underwriters, an effective tendering process for underwriting contracts and with distributors enjoying a strong bargaining position relative to underwriters.
3. On the basis of the evidence currently available to us there would appear to be little prospect of there being features of the underwriting market that would lead to an adverse effect on competition (AEC). We therefore do not propose to undertake further analysis in this area.

Introduction

4. This paper presents an overview of the market for underwriting (PPI) (the underwriting market). Approximately half of the large underwriters in the market are part of a vertically-integrated group, wherein distributors have in-house underwriters

to underwrite creditor insurance.¹ Distributors that use in-house underwriters are referred to as vertically-integrated in this paper. The remaining underwriters are independent of distributors and may specialize in creditor insurance or be part of a larger general and life insurance group.

5. The paper begins by outlining our preliminary view on market definition in the underwriting market, which is based on the data and information provided to the inquiry up to this point. We then discuss the nature and extent of competition within the underwriting market.

Market definition

Product market

6. On the basis of the evidence we have received so far in our inquiry we consider relevant product market in relation to this inquiry is the market for the underwriting of all PPI policies.
7. In its report on the market² for PPI the Office of Fair Trading (OFT) identified four main types of PPI policies; first charge mortgage PPI (MPPI); second charge mortgage (secured loan) PPI (SMPPI), personal loan PPI (PLPPI), and, Credit Card PPI (CCPPI).³
8. In the case of PPI the underwritten risks for all types of PPI will typically include accident (A), sickness (S) and unemployment (U) cover. Some PPI policies may also include life (L) cover.

¹The term large underwriter is used to describe an underwriter with in excess of £100 million gross written premiums (GWP) on their books in 2006.

²OFT, *Payment Protection Insurance, The OFT's reasons for making a market investigation reference to the Competition Commission, February 2007.*

³Store card PPI was also part of the OFT's list of products; however, store cards were excluded from the terms of reference of this investigation.

9. In defining a market, we primarily consider the extent to which there is demand- and/or supply-side substitutability between products. 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.⁴ The identification of products with different characteristics may indicate that substitution may be limited. However, it does not necessarily preclude these products from sharing the same market.
10. Responses from the large distributors⁵ and underwriters indicate that PPI policies are typically tailor-made for the specific credit products offered by the distributor.⁶ As such, each underwriting contract could be considered a distinct ‘product’ with specific characteristics. Distributors, therefore, have limited ability to substitute between contracts, as the characteristics of each product are different. However, they may be able to substitute between contractors.
11. The key question for the purposes of market definition is whether a hypothetical monopolist of one contract, or of one type of contract (eg a monopolist in the underwriting of PLPPI policies) would be able to profitably impose a SSNIP.
12. We received mixed views from the parties regarding the relevant product market for underwriting. One view put to us was that different types of PPI policies (such as MPPI and PLPPI) represented different risks and in turn were priced differently.⁷ This may suggest that distributors could be limited in the degree to which they can substitute between underwriters from different categories.

⁴ *Market Investigation References, Competition Commission Guidelines, CC3.*

⁵ A large distributor is used to describe a distributor which sold in excess of £90 million GWP in 2006.

⁶ For example, Genworth, HBOS, Lloyds.

⁷ Summary of hearings—Cardif Pinnacle, paragraph 2; London General Insurance, paragraph 19.

13. However, a number of the underwriters told us that there was no reason why a firm underwriting one type of PPI would not be able to underwrite all types of PPI policies.⁸ It was noted that mortgage PPI may be slightly different as it typically will not include cover for L; however, this was not considered to be a barrier to switching.
14. We note that the large underwriters typically underwrite several different types of PPI and most underwriters told us that they were willing to tender for PPI policies irrespective of whether they currently underwrite those policies.⁹
15. It would therefore seem that the relevant product market is at least as wide as the underwriting of all types of PPI, as a hypothetical monopolist in the supply of any subset of underwriting contracts (either individual products or a particular type of PPI) would not be able to profitably impose a SSNIP as this would induce the distributor to switch to another underwriter.
16. The underwriters told us that PPI was not a complex insurance policy to underwrite, relative to investment insurance policies,¹⁰ and that general insurance companies should have little trouble entering the creditor insurance market.¹¹ There are two large independent general insurance companies already active in the PPI underwriting market with significant market share (AXA, Aviva).
17. This may indicate that the relevant product market definition is broader than the market for underwriting PPI and may include other general insurers. However, we have seen only limited evidence so far that indicates any attempt of other general insurance companies to bid for PPI underwriting contracts and no examples of an

⁸Summary of hearings—Aviva, paragraph 1; AXA, paragraph 1; Cardif Pinnacle, paragraph 1, Genworth, paragraph 3; HSBC, paragraph 1.

⁹See Table 1.

¹⁰Genworth, summary of hearing, paragraph 13.

¹¹Genworth, summary of hearing, paragraph 15; HSBC, summary of hearing, paragraph 2.

underwriter not active in the underwriting of PPI winning a tender for a PPI underwriting contract.¹² There may, therefore, be some constraint on PPI underwriters as a result of potential competition from insurers in other markets. However, at this stage of our inquiry we do not need to conclude on whether this constraint is sufficient to warrant a widening of the relevant market as this will not affect our analysis significantly.

18. We considered whether there may be separate markets for PPI, one for relatively short-term risk (general insurance) and a second concerning long-term risk (life insurance/assurance). This might be the case given that each of these risks has to be underwritten by separate companies, as the current regulatory regime prohibits the underwriting of general insurance and life assurance by the same entity. There is, however, no barrier to a company creating two companies under the one brand umbrella in order to offer all personal lines insurance.
19. An assessment of the tenders offered by companies indicates that there are in fact typically offered on an ASU basis or an ASU plus L basis. In instances where life cover is included, a tender for the underwriting of ASU and L was requested. The evidence we have seen to date therefore suggests that many tenders do not separate out life cover from non-life cover, and although these elements are required to be underwritten by technically separate companies, in practice this does not have a significant impact on the tendering process.
20. We also considered whether a small subset of general insurance policies which are similar to PPI (such as income protection and short-term income protection) should be included in the relevant product market definition. Underwriters of these policies

¹²[X] did invite tenders for its business from 2005 and invited bids from ten insurers, established underwriters in the creditor insurance market and a small number of new entrants. Only seven companies responded to the tender opportunity and none of the potential new entrants were included in the shortlist of three insurers in the final stage.

with no experience of underwriting PPI, may experience some difficulty in switching to the underwriting of PPI contracts. The inclusion or otherwise of insurers of policies such as income protection insurance and short-term income protection insurance within the relevant product market does not appear to affect our analysis significantly, and so we leave this issue open.

21. We considered the possibility of there being a narrower market definition based around the integrated and independent insurers in the market. A large underwriter [X] told us that it believed that there were separate markets for independent and vertically-integrated underwriters and that whilst competition between the independent underwriters was intense this did not apply to vertically-integrated underwriters.

22. For there to be two separate product markets for the underwriting of PPI, based on insurers being vertically-integrated or independent, we would need to accept that the activity of one group does not present a competitive constraint on that of the other group.¹³ No evidence of this was presented by the parties that made the assertion. However, they pointed to the fact that where tenders were not issued by vertically-integrated insurers, independent insurers were not able to gain access to the vertically-integrated distributors' pool of customers. However, this does not of itself suggest that there are two separate markets as it does not directly address the issue of constraints. This is an issue of customer foreclosure and not one of market definition.¹⁴

¹³In other words that a SSNIP by a hypothetical monopolist of in house underwriting would not be rendered unprofitable by distributors substituting to independent underwriters, and that a SSNIP by a hypothetical monopolist of independent underwriting would not be rendered unprofitable by distributors switching to in-house underwriters.

¹⁴We assess customer foreclosure arguments in our working paper on vertical issues.

23. One of the large independent underwriters [redacted] told us that the integrated insurers posed a competitive constraint on independent insurers and furthermore, independent insurers would almost certainly present a competitive constraint on the activity of integrated insurers. It noted the recent entry of Lloyds TSB into the market for third-party business and the fact that HBOS (St Andrews) also underwrites third-party business. These companies are now seen to operate in both the integrated and independent areas of the market.
24. The underwriter also told us that it considered the constraint to be two-sided, because integrated distributors benchmarked their PPI underwriting costs and constantly reviewed their position in relation to the most profitable means by which to underwrite PPI. Both integrated and independent insurers told us that vertically-integrated distributors regularly benchmarked their in-house underwriting services against the wider market.
25. One independent underwriter [redacted] said that it was reluctant to submit bids to tenders of vertically-integrated distributors because it considered there was little prospect of winning a bid. This would seem to indicate that there are some switching costs, which give incumbent underwriters an advantage.¹⁵ However, the fact that distributors are benchmarking their in-house underwriters against the wider market indicates that they would be willing to switch to an independent underwriter if the costs of in-house provision were high enough to warrant this. We also note that other independent underwriters are prepared to bid in response to tenders from vertically-integrated distributors.
26. An assessment of the tendering history of underwriters in the underwriting market indicates that both integrated and independent underwriters bid for the same

contracts. Independent distributors accept bids from integrated underwriters,¹⁶ and integrated distributors accept bids from independent underwriters.¹⁷ Table 1 presents results of tenders for some contracts for which bidding information was available. The table indicates that there are a range of integrated and independent insurers tendering for and winning contracts in the underwriting market. There is also some evidence of switching between in-house and independent underwriters with both Aviva (an independent underwriter) and Lloyds TSB (a vertically-integrated underwriter) winning tenders to underwrite PPI for Lloyds TSB.

TABLE 1 **Examples of market tenders and parties that have responded**

<i>Parties issuing the tender</i>	<i>Parties that submitted a bid</i>
Lloyds TSB*	Aviva and Lloyds TSB (Scottish Widows)* were successful in bids for different policies; bids were received from three other underwriters, although none of these were vertically-integrated firms.
Capital One	AXA was the successful bidder; bids were received from six other underwriters including one vertically-integrated firm.
MBNA	HBOS* (St Andrews Group) was the successful bidder; bids were received from six other underwriters, although none of these were vertically-integrated firms.
BMW Financial Services (GB) Ltd	HBOS* (St Andrews Group) was the successful bidder; bids were received from three other underwriters, including one vertically-integrated firm.
Countrywide	AXA was the successful bidder; bids were received from five other underwriters, including two vertically-integrated firms.

Source: CC, based on information provided by the parties.

*Indicates vertically-integrated companies.

27. Only one vertically integrated underwriter [X] reported not to have bid for third-party PPI underwriting contracts during this period.

28. The data returned by the parties indicates that over the period 2002 to 2005, 45 tender opportunities arose with a total GWP of £3.32 billion. There were 118 responses to these tenders submitted.

¹⁵As discussed in paragraph 56, there would also appear to be some incumbency advantages for independent underwriters.

¹⁶For example, MBNA in Table 1.

¹⁷For example, LloydsTSB in Table 1.

29. Table 2 presents a summary of bidding activity by underwriters in the market for underwriting PPI.

TABLE 2 Summary tendered opportunities in the UK PPI market (2002-06)

	<i>Bids submitted</i>	<i>Tenders won</i>	<i>GWP £m</i>	<i>Success rate* %</i>	<i>Average GWP £m</i>					
Aviva))	✂))					
AXA										
Barclays										
Cardif Pinnacle										
Genworth										
HBOS (St Andrews)										
HSBC										
London General Insurance										
Lloyds TSB (Scottish Widows)										
RBSG										
Total (2002–06)						120	45	3319.7	37.5	73.8
Vertically-integrated						26	12	1163.9	46.2	97.0
Independent	94	33	2155.8	35.1	65.3					

Source: CC, based on information provided by the parties.

Notes:

1. Many underwriters were unable to supply complete and accurate information on their bidding activity, this table therefore represents a summary of the information that is available.
2. Does not include contracts with GWP of less than £5 million. Does not include contracts to underwrite PPI for store cards.

30. Table 2 shows that integrated insurers impose a constraint on independent insurers as they bid for many of the same underwriting contracts. There is less evidence indicating that independents impose a constraint on integrated insurers, as there appear to be very few examples of integrated distributors switching to independent underwriters in practice. However, this may simply be because the benchmarking exercise is an effective constraint on integrated underwriters and therefore they have not needed to switch. Indeed there would seem to be little point in undertaking a benchmarking exercise if there was no possibility of awarding contracts to an independent underwriter, should this prove to be more cost-effective and therefore more profitable.

31. At this stage, therefore, the relevant product market definition at the underwriting level for the purposes of this inquiry appears to be at least as wide as the market for the underwriting of all types of PPI policies.

Geographic market

32. The evidence that we have received in our inquiry so far indicates that the relevant geographic market for the underwriting of PPI is the UK.¹⁸
33. None of the underwriters considered the relevant market definition to be narrower than the UK. The idea of regional markets was not considered to be a reality by the parties and a preliminary assessment of the geographic scope of PPI underwriting contract tenders confirms this. In tender documents supplied to us as part of this inquiry the distributors sought underwriters to cover all of their PPI sales throughout the UK.
34. We note that particular tenders may concentrate on underwriting risk predominantly associated with a particular area or socio-economic group. However, this would appear to be an actuarial matter and does not affect the definition of the relevant geographic market.
35. In considering whether the relevant market definition is wider than the UK, one underwriter commented in the oral hearings that the Republic of Ireland could form part of the relevant market. There are a number of reasons why this may be the case:
- (a) several underwriters have located offices or call centres in the Republic of Ireland (Barclays, HBOS, Genworth);
 - (b) a number of UK underwriters have entered the market for PPI in the Republic of Ireland;

¹⁸This is also the conclusion reached by the OFT in its report *Payment Protection Insurance, The OFT's reasons for making a market investigation reference to the Competition Commission, February 2007*.

- (c) market tenders have been issued requiring insurers to underwrite risk for a pool of both UK and Irish risk in relation to personal loan and credit card PPI (MBNA);
and
 - (d) the regulatory regimes in the UK and the Republic of Ireland are similar.

- 36. The relevant question for the purposes of market definition is whether a hypothetical monopolist of PPI underwriting within the UK could profitably impose a SSNIP above competitive levels.

- 37. The decision by some of the vertically-integrated companies to locate their underwriting arm in the Republic of Ireland is not necessarily indicative of a competitive constraint arising from the Irish market. It may instead be a strategic decision on behalf of these companies to avail of lower corporate tax rates. We have not seen any evidence of Irish companies tendering for market opportunities in the UK, or of UK distributors seeking tenders from Irish insurers.

- 38. The decision of some insurers to enter the underwriting market for PPI in the Republic of Ireland does not indicate that the market is wider than the UK market, per se. The presence of UK-based companies in the Irish market may indicate that UK firms place some constraint on underwriters in Ireland; however, our primary concern is the UK and therefore we are interested, for the purposes of our market definition, in the constraint that underwriters located in Ireland place on UK underwriters.

- 39. The treatment of the UK and the Republic of Ireland as a common pool of risk to be underwritten by insurers is potential evidence that the geographic scope of the market for underwriting PPI may be wider than the UK. However, the activity of insurers in the market is not expected to be constrained by the geographic widening of the pool of risk.

40. The regulatory environment can also be considered to be a contributory factor in defining the relevant geographic market. Insurers underwriting risk in the UK must comply with Financial Services Authority (FSA) rules and regulations. Potential entry into the UK market is constrained to the extent that companies need to comply with FSA regulations. Although the regulatory environment in Ireland is broadly similar, it will nevertheless be the case that conditions of supply and demand will be to some extent determined by the regulatory environment.¹⁹ The regulatory environment therefore indicates that the geographic market encompasses the UK market and further suggests that there are limitations to extending this geographic market definition.
41. At this stage, therefore, the relevant geographic market appears to be at least as wide as the UK. There is some evidence to suggest that the geographic market may also include the Republic of Ireland. However, a wider market definition to include the Republic of Ireland would not be expected to have a significant impact on our assessment of the market for underwriting PPI.
42. One of the large underwriters indicated in their oral hearing that there may be a competitive constraint imposed by other European PPI providers.²⁰ However, we have seen no evidence that shows that underwriters located outside the UK and the Republic of Ireland bid for contracts to underwrite PPI in the UK, or that underwriters from outside the UK and Ireland impose any other constraint on the behaviour of underwriters within the UK.
43. To summarize, the relevant market definition is considered to be at least as wide as the underwriting market for all PPI products in the UK. To the extent that the market

¹⁹OFT, *Payment Protection Insurance, The OFT's reasons for making a market investigation reference to the Competition Commission, February 2007.*

²⁰Axa, summary of hearing, paragraphs 19 and 20.

may be wider than this definition, it is not considered to have an effect on the assessment of competition in the market.

Market structure

Market size and market shares

44. For general reference, the large underwriters from which data has been requested are contained in the following table. Underwriters are divided into two groups, those that are part of a vertically-integrated company and independent insurers.

TABLE 3 Large underwriters in the UK PPI market

<i>Vertically integrated*</i>	<i>Independent</i>
Barclays	Aviva
HBOS	AXA
HSBC	Cardif Pinnacle
Lloyds TSB	Genworth
RBSG	London General Insurance
	Prudential (long-term only)

Source: CC, based on information provided by the parties.

*In 2006 three of these companies underwrote 80 per cent or more of the PPI they distributed, whilst the other two underwrote less than 50 per cent of PPI they distributed.

45. We had two main sources of evidence regarding the size of the relevant market and the market shares of individual underwriters. First we saw evidence from Mintel, which reports annually on the PPI market (the Mintel report). Second we sent a questionnaire to every underwriter that we were able to identify which asked for data on volumes of PPI underwritten.

46. According to the Mintel report, the estimated size of the UK PPI market in 2006 was £5.35 billion. The following table indicates the evolution of the market since 2001. For the first time since the reports have been compiled there was expected to be a decline in the growth of PPI GWP in 2006.

TABLE 4 Level and growth rates of PPI policies in the UK (£ million)

	2001	2002	2003	2004	2005	2006*
GWP	3,199	4,086	4,563	4,960	5,500	5,352
% growth	-	27.7	11.7	8.7	10.9	-2.7

Source: Mintel Creditor Insurance Report (January 2007).

*Estimated value.

47. The report also allows for a breakdown, by broad product type, of the GWP in the UK PPI market. The level and growth rates are contained in Table 5.

TABLE 5 Level and growth rates of PPI policies, by policy type, in the UK

	<i>£ million</i>					
	2001	2002	2003	2004	2005	2006*
<i>Personal loans</i>						
GWP	1,993	2,650	2,813	2,975	3,300	3,185
% growth	-	33.0	6.2	5.8	10.9	-3.5
<i>Mortgage</i>						
GWP	608	670	885	992	1,100	1,120
% growth	-	10.2	32.1	12.1	10.9	1.8
<i>Credit card</i>						
GWP	455	580	662	742	825	780
% growth	-	27.5	14.1	12.1	11.2	-5.5
<i>Other (motor finance)</i>						
GWP	143	186	203	251	275	267
% growth	-	30.1	9.1	23.6	9.6	-2.9

Source: Mintel Creditor Insurance Report (January 2007).

*Estimated value.

48. The Mintel report also provides market share information for underwriters in the UK PPI market (see Table 6). From the data contained in the following table one can see that the estimated CR(4) measure in the UK PPI market is 61 per cent.²¹

²¹In the absence of market share data on all market participants, an HHI measure is not computed at this stage. However, this will be undertaken along with an update of the CR(4), when the data provided by the companies has been fully extracted, checked and validated from their responses. We similarly refrain from further comment on the level of concentration in the market, until the figures are presented based on the companies' data.

TABLE 6 Market share of underwriters in the UK PPI market, 2006*

<i>Underwriter</i>	<i>Market share</i> %
Norwich Union (Aviva)	18
Lloyds TSB	15
UKI (RBSG Insurance)	14
St Andrews (HBOS)	14
Barclays	12
Hamilton (HSBC)	11
Cardif Pinnacle	7
Others	<u>9</u>
Total	100

Source: Mintel Creditor Insurance Report (January 2007).

*Estimated value.

49. It is important to note that not all of the large underwriters are represented in this table.

50. Our own estimates of market shares, based on returns from our questionnaire to underwriters are provided in Table 7.

TABLE 7 Market shares for PPI underwriting by Gross Written Premiums, 2006

<i>Underwriter</i>	<i>GWP</i> £m	<i>Share of PPI</i> <i>underwriting</i> <i>in 2006</i> %
Aviva	⌈ ⌋	[10–30]
HBOS		[10–30]
Prudential		[10–30]
Barclays		[10–30]
RBSG		[5–10]
Cardif Pinnacle		[0–5]
AXA		[0–5]
Lloyds TSB		[0–5]
HSBC		[0–5]
London General Insurance		[0–5]
Genworth	[0–5]	
Others	<u>235.1</u>	<u>5.3</u>
Total	4397.2	100.0

Source: CC calculations based on data from large and small underwriters.

Note: We are aware of the apparent inconsistencies between Table 6 (based on Mintel data) and Table 7 (based on returns to the CC questionnaire) and are exploring the reasons for this.

51. Based upon returns from the underwriters to our market questionnaire, the total size of the PPI underwriting market was approximately £4.4 billion. The four largest

underwriters account for 67 per cent of the market which indicates that the market is concentrated. The largest underwriter is Aviva with a market share of [X] per cent.

Assessment of competition in the underwriting market

52. Our assessment of competition in the underwriting market for PPI in the UK, based on the evidence we have received so far, indicates that whilst there are a number of characteristics of potential concern in the market, overall the underwriting market appears competitive.

Concentration

53. As one can see from the preliminary assessment of market shares, there is an estimated concentration ratio for the four largest firms (CR4) of 61 per cent (based on Mintel data) or 67 per cent based on returns from underwriters to our questionnaire. This indicates that the market is concentrated.

Capacity

54. Some of the large distributors told us that only the larger underwriters had the capability to underwrite their business. For example, a large distributor [X] told us that there were seven or eight possible companies that they would consider to underwrite their PPI business.²² This view is supported to an extent by the evidence we saw from the tenders of large distributors. Bids for underwriting contracts with large distributors appear to be predominantly from larger underwriters.²³

55. However, we have not seen any evidence to date that would indicate that any of the seven large underwriters in the market are capacity constrained. It would, therefore,

²²One may note that the reference to seven or eight firms in the market is likely to cover almost all of the large insurers, those with annual GWP in excess of £100 million.

²³See Table 1.

seem that distributors can choose between several large underwriters with the capability to supply their needs.

Switching

56. Evidence provided in a number of the oral hearings indicated that there were likely to be some switching costs associated with changing underwriter.²⁴ In particular switching underwriter would result in costs from infrastructure and communications equipment required to facilitate IT integration. AXA said that this cost could range from tens of thousands to millions of pounds. The incumbent underwriter therefore would seem to have an advantage over other bidders when a benchmarking exercise or tender is undertaken by the distributor.

57. The evidence received to date indicates that in practice incumbents are more likely to win tenders for their existing business, and non-incumbents are less likely to win when they tender for new business. For example, a large underwriter [X] provided information on its bidding activity between 2002 and 2006. Table 8 summarizes its response.

TABLE 8 Summary of [X] tendered opportunities in the UK PPI market, 2002 to 2006

	Submitted	Won	Lost	% win
<i>New deals</i>				
Tenders	[X)	25.0
GWP (£m)				14.8
<i>Renewals</i>				
Tenders	[X)	81.3
GWP (£m)				66.6

Source: CC, based on information provided by the party.

Note: [X] are unable to confirm that their bidding data is complete. This table therefore represents a summary of the available information on [X] bidding activity.

58. Table 8 shows that [X] was more successful in winning bids to keep existing contacts (with a 67 to 81 per cent success rate) than it was in bidding for contracts

²⁴Summaries of hearings—Aviva, paragraph 2; AXA, paragraph 2.

where it was not the incumbent underwriter (with a 15 to 25 per cent success rate). This would appear to confirm the view that distributors face some switching costs and that therefore incumbent underwriters have an advantage over their rivals.²⁵

59. However, it is also important to note that despite this switching cost, distributors nonetheless do switch between underwriters and underwriters do win new business on a regular basis.²⁶ This would seem to suggest that any switching costs are not a substantial barrier to effective competition in the market for underwriting PPI contracts.

Contract duration

60. Contract duration can potentially have detrimental effects on switching and competition. Very long duration either explicitly contained in the contract or implicitly applied through rolling-over of the contract after its cessation date may inhibit switching in the market and reduce the effectiveness of the tendering process in the underwriting market.
61. We looked at the length of existing contracts between underwriters and distributors with a total annual GWP above £5 million.
62. From a total of 67 contracts, 54 were found to be rolling contracts with an initial fixed period and the remainder (13), fixed duration contracts. The fixed duration contracts were found to have an average duration of five years. The average length of the initial period for rolling contracts was 3.7 years and of the 37 rolling contracts 32 (86 per cent) are running beyond their initial period and on average they have been running for five years. The notice periods on the contracts tend to be six months long.

²⁵We note that this evidence was received from only one, albeit large, underwriter. However, we consider this evidence nonetheless informative.

²⁶[REDACTED]

63. Overall this evidence does not appear to indicate that contracts are excessively long or that there is likely to be any significant anti-competitive effects arising from the duration of contracts and the rolling nature of many of them, particularly as they can typically be cancelled within a relatively short timeframe.
64. The relatively high proportion of contracts that roll past their indicated termination date may be further evidence of the role of reputation in the underwriting market, but may also simply reflect the opportunity cost of issuing a tender to market with some companies reporting the whole process to implementation being up to a year in duration.

Entry, exit and expansion

65. In general, as discussed in paragraphs 16 and 17 on market definition, barriers to entry for the underwriting of PPI contracts appear to be low. A number of the underwriters told us that PPI was not a difficult insurance policy to underwrite and that general insurers would have little trouble entering the market.²⁷
66. However, as noted above in paragraph 54 there would appear to be some reluctance among large distributors to switch to underwriters outside the largest seven or eight currently active in the market. There may, therefore, be some reputation barriers that would give the incumbent underwriters an advantage over new entrants.

Countervailing buyer power

67. From the evidence presented to the inquiry to date, it would seem that the distributors enjoy a relatively strong bargaining position when negotiating contracts with underwriters.

²⁷Genworth, summary of hearing, paragraph 13.

68. The tender process appears to be effective in delivering benefits to distributors, as there are several large underwriters that a distributor can choose between and there appears to be healthy competition between bidders. In addition, the underwriters would appear to have little ability to access PPI customers without going through a distributor because of the point-of-sale advantage. This enhances the bargaining position of distributors. The point-of-sale advantage is discussed in more detail in our market definition working paper and our emerging thinking document.
69. Evidence provided by underwriters and distributors indicates that typically it is not the underwriter that offers terms of trade to the distributor but rather the underwriter who agrees to accept almost the minimum amount for which they would be willing to enter into contract with the distributor.²⁸ One of the large independent underwriters referred to the falling margins in underwriting in recent years and of this being absorbed by distributors benefiting from competition in the market.
70. Details of the commission and profit-sharing arrangements between underwriters and distributors may also provide insight into the degree of competition between underwriters and of countervailing buyer power in the market for underwriting PPI. We asked the parties to provide a breakdown of a £100 premium and show the flow of premium income between underwriters and distributors.²⁹
71. Distributors retain a percentage of GWP as commission. Typical commission rates are 50 to 80 per cent for PLPPI and CCPPI and 40 to 65 per cent for MPPI. The remaining GWP is passed to the underwriter to cover expenses, including claims. In the event that claims levels are less than expected, the resulting profit will be split

²⁸London General Insurance indicated in its oral hearing that in fact the tendering process was about an underwriter buying a route to market from a distributor. This is somewhat counter-intuitive to way one typically views the operation of vertically separated markets and how the upstream market operates in particular.

²⁹This question has not been answered in a uniform fashion and may require a number of clarification questions in order to allow for a full comparative analysis to be undertaken.

between the underwriter and distributor according to an agreed profit share percentage; typically 90 to 100 per cent in favour of the distributor. A separate profit share arrangement will typically apply to any investment income earned by the underwriter on premium income and may also apply to tax benefits on life business.

72. The results of this limited comparison, although far from conclusive, indicate that the bargaining position of the distributors is strong relative to underwriters.

Tax treatment

73. Two of the parties (Lloyds TSB, AXA) told us that the tax treatment of life insurers could impact on competition between underwriters. Life insurers are taxed on investment income less expenses (an 'I minus E' basis). Commission payments to distributors are treated as expenses. We have been told by the FSA that in order to benefit from this regime, the life company must have sufficient investment income against which to offset expenditure in the year in question and hence must ensure an appropriate mix of business.
74. We were told by the FSA that there is no particular benefit accruing to independent underwriters compared with integrated underwriters as the tax regime applies to all underwriters with life insurance businesses; it is simply that a life underwriter without the appropriate mix of business may not have sufficient investment income against which to offset expenses and might be at a disadvantage to one which can.
75. We have seen some evidence that distributors have been able to negotiate with underwriters to receive a share of the underwriters' benefit under the tax regime. This can be regarded as a further indication of the relative bargaining strength of distributors when negotiating contracts with underwriters. However, we do not

consider that the tax treatment of investment income for life business has a significant effect on our analysis of the underwriting market as a whole.