

Vertical integration

1. Third parties have raised concerns that vertical integration between payment protection insurance services (PPI) distributors and underwriters may have anti-competitive effects. Our purpose in this paper is to consider these concerns.
2. We note in paragraphs 5 and 6 that a number of parties have linked their concerns regarding vertical integration to downstream market power as a result of having a point-of-sale advantage. So far as any vertical concern is dependent on there being market power downstream, it is ancillary to that issue. As such they can be regarded as an additional way in which downstream market power may result in consumer harm.¹
3. Any concerns arising from a vertically-integrated company having a similar degree of downstream market power as a non-integrated distributor are not addressed in this paper—these will be considered when we look at competition in the retail market. We only address here concerns arising from vertical integration that do not depend on the company having the degree of downstream market power available to a non-integrated distributor.
4. We also note the possible economic rationales for vertical integration. In the main body of the paper, we identify four possible theories of harm, and consider each in turn. We conclude that the evidence and arguments we have received to date do not support a view that vertical integration in and of itself reduces competition in the supply of PPI.

¹In other words, it is not the fact of vertical integration which would result in consumer harm but the downstream market power of the distributor.

The point-of-sale advantage and downstream market power

5. In addition to the theories of harm discussed below, some of the parties linked vertical integration to the point-of-sale advantage enjoyed by lenders, and downstream market power that may result from that advantage. For example, one company commented that: ‘The lack of choice at the point of sale ... is not conducive to competitive premium rating. The issue is further compounded by ... vertical integration.’
6. We consider the extent of the point-of-sale advantage elsewhere. However, we have seen no evidence or argument to support the view that the point-of-sale advantage is increased by the lender having an in-house underwriter and both vertically integrated distributors and distributors which use external underwriters appear to enjoy the same point-of-sale advantages.

Reasons for vertical integration

7. One advantage of vertical integration is the elimination of the ‘double-marginalization’ problem. In a non-vertically integrated model, an upstream firm with market power will be willing to forgo some sales in order to sustain a higher price for the input it produces. The downstream firm will take this input price into account when setting price at the retail level. If the input price is high, the downstream firm’s cost of producing a unit will be high, so it will have an incentive to charge a higher price and sell fewer units. The inefficiency is in the fact that the upstream firm, in setting prices, does not take into account the effect on the downstream firm of this decision. Other things being equal, a vertically-integrated firm will have an incentive to charge lower retail prices than a firm which is not.²

²We note that double marginalization problems can be overcome if firms can design sufficiently detailed contracts. We note that contracts with underwriters for PPI are relatively detailed and include elements, such as profit share arrangements and commissions which may mitigate the double marginalization advantage of vertical integration in this case.

8. Vertical integration can also allow firms to realize ‘operational efficiencies’. It was put to us that, if this were the case in PPI, it was unclear whether the benefits of any such efficiencies had been passed on to consumers. We note that, even in the absence of competition (ie if every PPI distributor were a monopolist), a reduction in unit costs would give the firm an incentive to sell more units which, assuming at least some degree of price-responsiveness among consumers, it could achieve by reducing prices. As such, we would expect that at least a proportion of any cost savings would be passed on to customers. However, given the apparent insensitivity to price in this market (see paragraph 27 of Market Definition working paper Appendix A), this proportion may be small.
9. A third advantage is that vertical integration can reduce ‘transaction costs’ by overcoming difficulties faced in using relatively short-term arm’s length contracts—such as aligning the incentives of the parties, or monitoring and enforcing service quality. It was put to us that this factor was questionable given that a number of distributors used independent PPI underwriters. We note that such activity may suggest that distributors face a trade-off between reduced transaction costs from in-house provision of underwriting services, and firm-specific advantages which may be on offer from particular independent underwriters—such as specialism in a certain area, or a broader range of experience from working with different distributors. Furthermore, smaller distributors may not have sufficient scale to support an in-house underwriter.
10. During the course of our inquiry three more reasons for vertical integration were suggested to us, which we now consider.
11. One view put to us was that vertical integration allowed distributors to ‘extract value’ from the exercise of market power, and maximize the level of profits retained.

12. However, the ability of a distributor to extract value and retain profits by integrating with an underwriter does not necessarily mean that consumers will face any additional harm.³ If the firm's market power derives from its position at the retail level (eg the point-of-sale advantage), we would expect it to extract the maximum rents from this situation. We have seen no evidence that bringing the underwriter in-house would raise the price that a distributor would charge downstream.⁴ In addition, we note in our working paper on the underwriting market that distributors appear to enjoy a relatively strong bargaining position with external underwriters. It would therefore seem that even non-integrated distributors can extract some value via the terms that they would be able to negotiate with an external underwriter. There may therefore be a small difference in practice in the value that integrated and non-integrated distributors can extract.

13. One company argued that independent underwriters faced the risk of losing business through competition, and that vertical integration removed this risk. We note, however, that the risk in question is that of the distributor switching underwriter. If it commits to not doing so (by integrating), the distributor has fewer options should the underwriter start to under-perform. As such, the risk is not removed so much as transferred, from the underwriter to the distributor in the integrated firm.

14. It was also suggested to us that vertical integration may have been a response to a 'lack of competition' between independent underwriters, although we were told that there was no evidence that levels of integration were falling in response to apparently high levels of competition among independents.

³It may, for example, merely reflect a different allocation of the same profits between firms in the value chain.

⁴And therefore no evidence that the ability to 'extract value' through vertical integration has any impact on consumers.

15. Finally, we were told that vertical integration could have reflected a desire to eliminate the neutrality with which independent PPI providers were handling claims. This is the fourth of our theories of harm, discussed below.

Theories of harm

16. We identified four possible theories of harm that could lead us to a conclusion that vertical integration in and of itself could lead to an adverse effect on competition. These were as follows:
- (a) if integrated underwriters do not bid for external business vertical integration may reduce the number of bidders for non-integrated underwriting business;
 - (b) vertical integration may limit the amount of underwriting business that independents can bid for, and so prevent independent underwriters from achieving an efficient scale of operation;
 - (c) vertical integration may remove or diminish the competitive pressure on in-house underwriters; and
 - (d) vertical integration may create a greater incentive for (in-house) underwriters to reject PPI claims.

Bidding for non-integrated business

17. We considered whether vertically-integrated underwriters could be less likely than independents to bid for contracts with lenders. If they were, the number of bids per tender could be fewer than if all underwriters were independent.
- (a) With fewer bids per tender, bidders might have weaker incentives to make competitive bids.
 - (b) In addition, the smaller number of bidders could help to create conditions for coordinated behaviour.
 - (c) A lack of competition would tend to raise lenders' costs (for non-integrated business), and ultimately retail prices.

18. Table 1 of the underwriting market working paper lists four recent tenders by non-integrated distributors. These tenders had four, six, seven and seven bids respectively, a total of 24. Six of the 24 bids were from integrated firms [X]. [X] Table 2 of the same paper sets out the results of tendering opportunities in the market from 2002 to 2006. Integrated firms accounted for just under one-quarter of bids, for just over one-quarter of successful bids, and for just over one-third of successful bids by (GWP) value. This share is low relative to their share of the underwriting market (around 42 per cent of GWP). [X]. In summary, vertically-integrated firms are active in bidding for third-party businesses, although arguably they may be less active than they would be in a market with full vertical separation.
19. Having found that vertically-integrated companies are active in bidding, we then considered whether they compete effectively with non-integrated underwriters.
20. Independent underwriters did not express concerns about competition between non-integrated underwriters (one party told us that major banks would typically receive eight to ten written proposals in response to a tender, and our working paper on the underwriting market did not identify causes for concern in this area). We were told that if there were significant efficiencies from vertical integration, then one would expect in-house underwriters to have a competitive advantage over independents, enabling them to win tenders. We were told that a failure among in-house underwriters to win business would suggest that in-house underwriters were not inherently more efficient.
21. However, in our view, even if in-house underwriters had limited success in winning third-party tenders, this would not be compelling evidence against the efficiency rationale for vertical integration because:

- (a) to the extent that efficiencies from vertical integration reduce transaction costs *within the firm*, integration will not improve the efficiency of the underwriter when dealing with third-party providers, where these transaction costs will continue to exist;
- (b) distributors tend to use independents for more specialized business: independents may have a competitive advantage over integrated firms in these areas, which more commonly come up for tender;
- (c) more generally, independents may have other competitive advantages such as economies of scope (such as experience from dealing with a variety of businesses) or a specialism (in-house underwriters will typically need to cover a standard range of PPI products rather than specializing); and
- (d) there may be at least perceived disadvantages to having a major supplier who is also a rival in the downstream market.

22. We were also told that in-house firms who submitted a tender would be very aggressive on price. The reason for this was that vertically-integrated underwriters would already have their fixed costs covered and could use their group's existing infrastructure. We note, however, that some independent PPI underwriters could achieve similar results if they already underwrite other PPI contracts. Furthermore many independent underwriters are part of larger businesses or offer other forms of insurance. This may also allow companies to achieve similar scale economies through cost sharing with other areas of their business such as general insurance.

23. In summary we found that most vertically-integrated PPI underwriters do bid to supply insurance services for third parties. Further, we found that in their dealings with third-party distributors they appeared not to have any significant advantages over, or disadvantages compared with, independent underwriters.

'Crowding out' of independents

24. Having considered whether vertically-integrated companies are less likely to try to win underwriting business from non-integrated distributors, we then considered the opposite, namely the possibility that non-integrated underwriters would not be able to win business from vertically-integrated distributors, and whether this would have an adverse effect on these underwriters.
25. As noted in paragraph 32, the five major banks account for just over 60 per cent of PPI supply at the retail level, and a lot of this business is underwritten in-house. As such, a significant amount of demand for PPI underwriting in the UK is accounted for by vertically-integrated underwriters. It has been put to us that this business is less likely to be put up for tender. If this is the case, this would reduce the size of the market which independents can potentially compete to serve. We considered whether this reduction in the tendered portion of the market (relative to the situation in the absence of vertical integration) to make it more difficult for independent underwriters to achieve economies of scale or scope.
26. Economies of scale or scope exist where large scale production, or the production of multiple products, results in unit cost savings for a firm. In particular, this theory of harm depends on there being PPI-market-specific economies of scale or scope (ie the firms cannot achieve the necessary scale by virtue of their presence in other insurance markets). We have no direct evidence of the scale of such economies, but we note some indirect evidence:
- (a) If independents were operating below the minimum efficient scale, they would have a strong incentive to merge and achieve scale economies.⁵ We note that over recent years there has been limited merger activity among independents (including acquisition by one multi-product insurer of the PPI underwriting

⁵A firm that is operating below the minimum efficient scale will not necessarily wish to exit the market—it may be charging prices sufficiently above its costs to earn a positive profit. But it will have an incentive to increase scale and reduce those costs.

business of another).⁶ One exception to this is the planned acquisition of HSBC's underwriting services by Aviva (which is already the largest independent underwriter).

(b) We would expect economies of scale to give the largest firm substantial advantages in bidding. As at 2006 Aviva was the largest independent underwriter by some margin (its annual GWP was over [X]: the next largest independent (Prudential) had GWP of around [X] million a year, while others had at most around £[X] million a year). Table 2 of the underwriting market paper shows that Aviva was successful in [X] the bids it made, [X] from 2002 to 2006. However, we also note that [X], a far smaller PPI underwriter [X], had the same success rate [X], and won [X] bids, with a value of £[X] million. Table 1 of the same paper sets out five recent tenders, in [X] of which [X] and Aviva were both bidders, indicating that the two regularly bid against each other.

27. The fact that [X] has been successful in winning business when competing against far larger rivals (in terms of PPI underwritten) for underwriting contracts provides a strong indication that either scale in PPI underwriting is relatively unimportant, or that scale economies are not PPI specific and that firms active in other areas of insurance can achieve scale or scope economies that allow them to compete successfully for PPI underwriting contracts.

28. The evidence suggested to us that, even if non-integrated underwriters were unable to compete for customers of vertically-integrated businesses, businesses with relatively small underwriting presence in the PPI market were able to achieve sufficient scale to compete effectively with those with significantly more contracts.

⁶We identified 12 insurance mergers investigated by the OFT between 2003 and 2006. PPI underwriting does not appear to have been the primary business affected by any of these mergers.

Competitive pressure on in-house underwriters

29. While integrated underwriters face a degree of competitive pressure (because the company can always outsource all or part of its underwriting requirements), this competitive pressure may be less than they would face if the downstream division was regularly putting its underwriting business out to tender. We therefore considered the following theory of competitive harm:
- (a) While integration creates efficiency savings and removes double marginalization, these effects may be outweighed by the lack of competition for the lender's underwriting business.
 - (b) If so, the result would be that vertically integrated lenders faced higher underwriting costs than they would if they were not vertically integrated.
 - (c) Again as price makers downstream, they would respond to this by charging higher prices.
 - (d) In addition, integrated underwriters could have less incentive to innovate.
30. It was put to us that it was rare for a bank with an in-house underwriter not to use it exclusively across all product lines offered. We were also told that in-house underwriters were effectively protected from pricing pressures. However, it seems that in fact only RBSG uses its in-house insurer to underwrite 100 per cent of its PPI policies.
31. One firm expressed doubts as to whether vertically-integrated distributors could encourage their in-house underwriters to be efficient by putting business out to tender by third parties. It commented that: 'I'm sure the threat is there ... but why would I want to respond to a major bank who have their own captive insurance company? ... the chances of us getting that business are pretty remote.' However, this firm also commented that the major banks did outsource for the 'more unusual or more fringe products or services'.

32. A PwC report commissioned by one party noted that the five major banks (HBOS, HSBC,⁷ Lloyds TSB, RBSG, Barclays) underwrite around 66 per cent of the UK PPI Gross Written Premium, [X]⁸ This would seem to indicate that vertically-integrated firms underwrite third-party business. The evidence we gathered suggested that 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. This evidence would seem to show that the five major banks also contract out a significant proportion of their underwriting needs, in addition to underwriting third-party business.
33. We considered whether PPI products offered by vertically integrated lenders were poorer value than those of non-integrated lenders. This could possibly be evidence of a lack of competitive constraints on integrated underwriters, although other reasons for such price differences might exist. (We note that the following analysis assumes that competition among independents is strong—ie in particular that our first theory of harm does not hold.)
34. PwC compared prices between PPI policies, on the basis of the additional cost of a typical loan when PPI is included. It was unable to find a material difference between the price of PPI from integrated and non-integrated lenders.
35. We compared reported prices between distributors for a typical unsecured personal loan, based on data on eight products from non-integrated firms and 43 from integrated firms.⁹ The results are presented in Figure 1. As illustrated, the average PPI price for one non-integrated firm [X] is less than £10 per month whilst the price from one integrated firm [X] is more than £30. Other firms' PPI prices range from £7

⁷HSBC's underwriters are currently being purchased by Aviva.

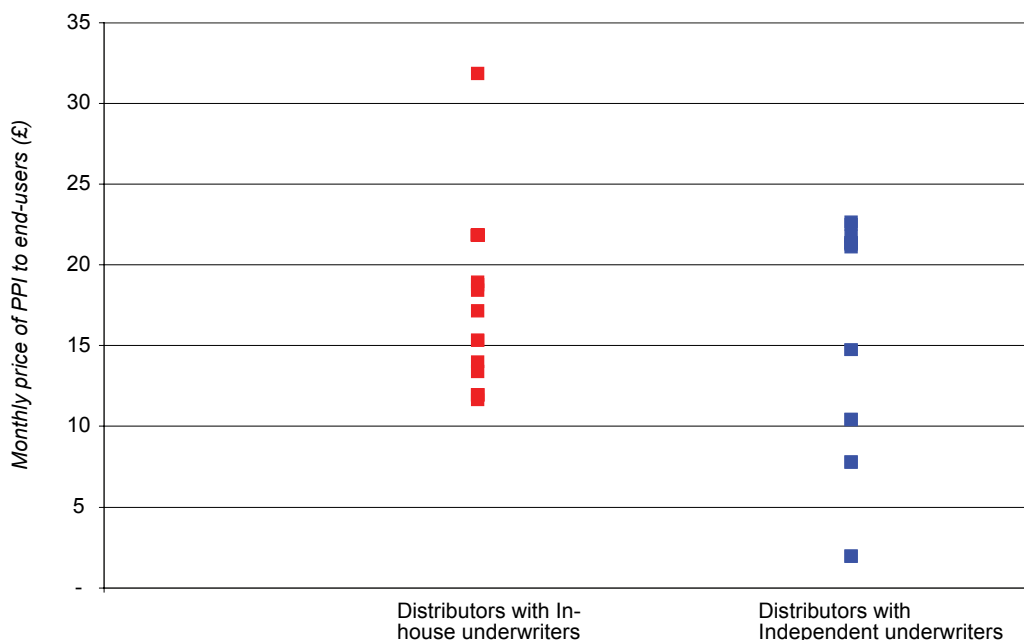
⁸Our own figures, based on returns to our questionnaire put the five major banks share of PPI underwriting at just over 40 per cent and their share of PPI distribution at just over 60 per cent.

⁹[X]

to £22 per month. Non-integrated firms charged on average £13.76 per month and integrated firms charged £19.64 per month—a statistically significant difference.^{10,11} However, at this stage we have considerable concerns about the quality of the available data, which has prevented us from applying a robust methodology to the comparison exercise.¹² In particular, we note that there are no adjustments in such a raw price comparison for the quality of products being sold. We therefore find this evidence inconclusive.

FIGURE 1

The increase in monthly payments caused by adding PPI to an unsecured personal loan



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

36. We note that if (a) vertical integration shielded an underwriter from competition, (b) this led to its being less efficient and raised the integrated firm’s underwriting costs and (c) this effect outweighed the efficiency benefits of integration, then the

¹⁰Tests of statistical significance assess whether differences between samples are reliable indicators of differences in the ‘real world’ from which samples are drawn, based on the number of observations in the samples, and the variability of observations. They are not a test of the quality of the underlying data.

¹¹If the two outlying observations are dropped, the difference in prices between integrated and non-integrated firms decreases; however, it is still statistically significant at the 5 per cent level.

¹²In particular, this analysis was carried out on a sub sample of products for which data was available. Also due to inaccuracies in the underlying data we were unable to control for levels of cover in this analysis.

distributor could profitably divest its underwriting business and source its underwriting business from third parties.¹³

37. We then considered whether there was a lack of incentive to innovate. One firm argued that a particular outcome of the alleged lack of competitive constraint on in-house insurers was a lack of innovation. It said [redacted] that the profitability of PPI meant that banks would have no incentive to change what they were doing as this may negatively impact their profits. Firms not subject to competitive pressure (those who face no active threat to their source of profits) may not innovate if they cannot capture sufficient additional returns from innovation. Even if major banks face no competition from their downstream rivals in the provision of PPI, we note that they might have an incentive to innovate in order to increase penetration of PPI, whether among existing or new customer groups.¹⁴
38. One company argued that innovation had been led by independent underwriters. We note that, even if this is the case, it may not be due to a lack of competitive pressure on in-house underwriters. For example, one company told us that independent underwriters (such as itself) had worked with intermediaries, whose customers were often more sophisticated and more responsive to innovation.
39. Finally, it was suggested to us that we should assess whether tenders have been won on the basis of innovative proposals. We note that, even if we found that when independent underwriters won bids this was always because of innovative proposals, and that when integrated underwriters won bids this was because they offered the lower price, such an outcome could imply a well-functioning underwriting market, with some firms competing by being innovative, and others competing on price. Finally,

¹³The HSBC/Aviva transaction demonstrates that there are purchasers for integrated underwriting businesses and that divestment can be a feasible option for integrated firms.

¹⁴We found that penetration varied widely across product types and suppliers, was in most cases below 50 per cent, and has generally been in decline, suggesting some potential scope for increases.

we note that, as discussed in Emerging Thinking paragraph 136, policy design tends to be primarily the work of the distributor, so the scope for an independent to win a tender on non-price factors is limited.

40. We note in our market definition working paper that innovation in PPI appears to be limited, both for vertically-integrated distributors and for vertically-separated distributors. And as noted above, policy design is often largely driven by distributors rather than underwriters. We therefore consider that a lack of innovation is likely to be caused by a lack of rivalry downstream, and that vertical integration has little additional impact on firms' incentives to innovate.
41. Overall, we found that there was limited evidence that vertically-integrated underwriters offered PPI at higher prices than non-integrated underwriters. If a vertically-integrated underwriter was causing the cost of in-house provision of underwriting services to be too high, we noted that it was possible for the distributor to divest its underwriting business. Further, we did not consider that vertically-integrated underwriters had limited incentive to innovate. On balance we did not think that there was a limited competitive pressure on vertically-integrated underwriters that would lead to a detriment for consumers.

Rejection of claims

42. Lenders typically receive a higher share of residual profits after payout of claims than underwriters (as noted in paragraph 82 of Emerging Thinking, the profit share is typically 90 to 100 per cent in favour of the distributor). If the underwriter and distributor are in the same group of companies, it has been argued that a vertically-integrated group has a greater incentive to maximise money for profit-sharing, through rejecting more insurance claims.

43. We note that firms could achieve a greater amount of profit share income in two ways. First, firms could adopt a more stringent policy towards accepting claims, resulting in more claims rejected. Secondly, firms may have different incentives to devote resources to checking claims resulting in a principal-agent problem between distributor and underwriter.¹⁵ We discuss each of these in turn below.

Incentives to reject claims

44. We were told that vertically-integrated firms might have a greater incentive to reject claims because a vertically-integrated group will receive all of the benefit of rejecting a claim, whereas an independent underwriter will typically receive around 10 per cent of any benefit from rejecting a claim. Vertically-integrated groups may, therefore, have greater incentives to design policies to allow for more exclusions, or to adopt a more stringent policy on claims acceptance.
45. However, we do not regard the incentives facing vertically-integrated firms as being so clear cut. For example, vertically-integrated firms tend to be multi-product firms, and PPI distributors in general tend to be part of financial services companies that spend significant sums on advertising their group brand. Vertically-integrated firms therefore appear to face an incentive to accept claims that are valid, since rejecting valid claims could damage the customer relationship and result in lost sales of other products, and adverse publicity that could damage their brand image.
46. In any event both independent and vertically-integrated distributors face similar incentives to reject claims, and similar incentives when designing products, since independent distributors typically receive 90 per cent of any profit share income. Provided that distributors and underwriters design sufficiently detailed contracts they

¹⁵The 'principal-agent problem' refers to the difficulties that arise under conditions of incomplete and asymmetric information when a principal (in this case the distributor) hires an agent (in this case the underwriter). A principal-agent problem occurs when the incentives faced by an agent do not match those of the principal. Principal-agent problems can often be solved by merging the principal and agent, or by designing contracts that match the incentives of the agent to those of the principal.

should be able to avoid serious principal-agent problems, for example by specifying the rejections policy. Also, by inputting into the design of PPI policies themselves, non-integrated distributors can avoid principal agent problems in product design. We note in paragraph 136 of our emerging thinking that distributors are typically heavily involved in the design of their PPI policies.

Devoting resources to checking claims

47. A further area where independent underwriters and vertically-integrated groups may have different incentives is in the resources that are devoted to checking claims. The underwriter faces a trade-off between devoting more resources to checking claims (likely to be a predictable, variable manpower cost), or accepting a greater rate of invalid claims (again, this should be predictable if the proportion of valid/invalid claims and their relative cost is known¹⁶).
48. Assuming profits are calculated net of the cost of claims, the greater the underwriter's share of profits, the stronger its incentives to reject marginal or invalid claims. If the underwriter bears the full cost of checking claims, but only has a share of profits (and so only bears part of the cost of accepting claims) it will have a weaker incentive to check claims than if it received all of the profits. Such situations would result in a principal-agent problem between the underwriter and distributor as the underwriter will have incentives to devote fewer resources to checking claims than its client, the distributor, would prefer.
49. As with policy design and attitudes towards rejecting claims, these principal-agent problems can be overcome if distributors and underwriters can write sufficiently detailed contracts with each other. For example, the distributor could require the underwriter to carry out a specific level of claims-checking in its contract terms.

¹⁶This may be expected to vary by customer group and product type.

50. Distributors may have difficulty in monitoring contracted underwriters, which could result in a lower level of resources devoted to claims checking in practice, despite contract terms. However, the result of this will be that, if the lender and underwriter are separate businesses, and the number of claims checked is lower than the level that would minimize the net cost of checking and paying claims; these higher costs will lead to higher premiums for non-claiming customers than would otherwise be the case. In that case, vertical integration would be of benefit to the majority of final consumers who do not make a claim.
51. We do not consider, therefore, that vertically-integrated businesses have clear incentives to reject more claims than non-integrated companies. Concerns over maintaining their reputation, and the risk of losing customers who source multiple services from them would reduce any incentive they may have to maximize claims rejections. Further, we do not consider that vertically-integrated companies are uniquely placed to influence the underwriters' claims policies, as non-integrated distributors appear able to influence their underwriters' policy through contractual arrangements.

Summary

52. In summary, it would appear that there are a number of powerful counter-arguments that would need to be overcome in order to show that vertical integration in and of itself leads to an adverse effect on competition or consumer harm as a result of underwriters' incentives to accept claims. On the basis of the evidence available to us at this time, we do not see force in the arguments that vertical integration in and of itself has led to effects on the underwriting market or the retail market that would be to the detriment of consumers.

53. We do not, therefore, propose at this point to carry out further analysis on the effects of vertical integration of PPI underwriting and distribution businesses, based on the evidence currently available to us.