

Vertical integration

Introduction

1. This appendix considers the reasons why PPI distributors and underwriters may integrate vertically and whether such integration has anti-competitive effects. We identified four possible theories of harm arising from such integration, and these are considered in turn.

2. There are four PPI distributors that underwrite at least a proportion of their PPI business using an underwriter within the same group. Table 1 provides a list of the large underwriters. We noted that of the four companies that were vertically integrated in 2006, one underwrote less than 50 per cent of its GWP in-house.

TABLE 1 Large underwriters in the UK PPI market

<i>Vertically-integrated</i>	<i>Independent</i>
Barclays	Aviva
HBOS	AXA
Lloyds TSB	Cardif Pinnacle
RBSG	Genworth
	London General Insurance
	Prudential

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

3. Table 2 shows the proportion of business which was underwritten in-house by product category as at February 2007. HSBC subsequently divested its underwriting business to Aviva and so is not longer vertically integrated.

TABLE 2 **Percentage in-house provision of underwriting, as at May 2007 stage**

<i>Distributor</i>	<i>per cent</i>			<i>Notes</i>
	<i>PL</i>	<i>FM</i>	<i>CC</i>	
Abbey	0	0	0	
Alliance & Leicester	0	0	0	
Barclays	100	100	100	
Capital One	0	0	0	
Cattles	0	0	0	
HBOS	99	99	99	
HSBC	<50	<50	<50	0% since 1 Nov 2007
Lloyds TSB	<50	100	<50	
MBNA	0	0	0	
Nationwide	0	0	0	
Northern Rock	0	0	0	
RBSG	99	99	99	

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

4. Based on the submissions and evidence we received, we were not able to conclude that vertical integration of PPI distributors and underwriters has caused anti-competitive effects. We were not able to find that any of the four theories of harm that we investigated were substantiated by the available evidence. We consider that there are competitive reasons for vertical integration.

Reasons to integrate vertically

5. We identified three competitive reasons why a firm might integrate vertically: (a) elimination of double-marginalization; (b) realizing operational efficiencies; and (c) reduction of transaction costs. During the investigation, four anti-competitive reasons for vertical integration were put to us: (a) 'value extraction'; (b) the risk of losing business; (c) the lack of competition for underwriting business; and (d) the wish to eliminate neutrality in claims handling. We set out below our analysis of each of these seven reasons.
6. First, one advantage of vertical integration is the elimination of the 'double-marginalization' problem. In theory, in a non-vertically integrated model, an upstream firm with market power will be willing to forego some sales in order to maintain a

higher price for the input it produces. The downstream firm takes this input price into account when setting the retail level price. 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 its decision. Other things being equal, a vertically-integrated firm will have an incentive to charge lower retail prices than a firm which is not.¹

7. Second, vertical integration can allow companies to realize 'operational efficiencies'. It was put to us that, if this were the case with PPI, it was unclear whether the benefits of any such efficiencies had been passed on to consumers. We noted that, even in the absence of competition, 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 expect that at least a proportion of any cost savings was passed on to customers.
8. Third, 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 several 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 gained from working with different distributors. Further, smaller distributors may not have sufficient scale to support an in-house underwriter.

¹We noted that double-marginalization problems can be overcome if firms draft sufficiently detailed contracts. We noted that contracts with underwriters of 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.

9. Fourth, with regard to the view put to us that vertical integration allowed distributors to 'extract value' from the exercise of market power, and maximize the level of profits retained, we consider that the ability of a distributor to extract value and retain profits by integrating with an underwriter does not necessarily mean that consumers will suffer any harm.² If the firm's market power derives from its position at the retail level (eg the point-of-sale advantage), we expect that it would extract the maximum rents from this situation. We did not see evidence that bringing an underwriter in-house would raise the price that a distributor could charge downstream.³ In addition, we note in Appendix 6.1 that distributors appeared to enjoy a relatively strong bargaining position with external underwriters. Accordingly, even non-integrated distributors could extract some value via the terms that they 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 from exercising their market power.

10. Fifth, one party put to us that independent underwriters faced the risk of losing business through competition, and that vertical integration removed this risk. We noted, however, that the risk in question was that of the distributor switching underwriter. If the distributor commits to not doing so (by integrating), it then has fewer options if the underwriter under-performs. As such, we considered that the risk was not removed so much as transferred, from the underwriter to the distributor in the integrated firm.

11. Sixth, it was 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

²It may, for example, merely reflect a different allocation of the same profits between firms in the value chain.

³And therefore no evidence that the ability to 'extract value' through vertical integration has any impact on consumers.

high levels of competition among independents underwriters. Accordingly, we did not pursue this issue.

12. Seventh and finally, we were told that vertical integration could reflect a desire to eliminate the neutrality with which independent PPI providers were handling claims. We adopted this as the fourth of our theories of harm, which are discussed below.
13. We note in paragraphs 14 and 15 that a number of parties have linked their concerns regarding vertical integration to downstream market power as a result of distributors having a point-of-sale advantage. So far as any vertical integration concern is dependent on there being market power downstream, we considered it to be ancillary to that issue. As such it can be regarded as an additional way in which downstream market power may result in consumer harm, or a factor that may increase the adverse effects on consumers of a reduction in competition downstream.⁴

The point-of-sale advantage and downstream market power

14. In addition to the theories of harm discussed below, some parties linked vertical integration to the point-of-sale advantage enjoyed by distributors, and the downstream market power that may result from that advantage. For example, one party 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.'
15. We consider the extent of the point-of-sale advantage in paragraphs 5.88 to 5.119. However, we did not see evidence to support the view that the point-of-sale advantage was increased by the distributor having an in-house underwriter, and both

⁴In other words, it is not the fact of vertical integration which would result in consumer harm but the downstream market power of the distributor.

vertically-integrated distributors and distributors that use external underwriters appeared to enjoy the same point-of-sale advantages.

Theories of harm

16. We identified four possible theories of harm that could lead to a conclusion that vertical integration in and of itself could lead to an AEC:
- (a) if integrated underwriters did not bid for external business, vertical integration may reduce the number of bidders for non-integrated underwriting business;
 - (b) 'crowding out': vertical integration may limit the amount of underwriting business that independents could 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 this may increase vertically-integrated distributors' underwriting costs; and if distributors have market power downstream, could result in higher PPI prices; 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 were less likely than independent underwriters to bid for contracts with lenders. We expected that, if they were, the number of bids per tender would be fewer than if all underwriters were independent. In particular:
- (a) with fewer bids per tender, bidders might have weaker incentives to make competitive bids;
 - (b) a smaller number of bidders could help to create conditions for coordinated behaviour; and

(c) a lack of competition would tend to raise lenders' costs (for non-integrated business), and ultimately retail prices.

18. Table 6.1 lists four recent tenders by non-integrated distributors and one by a non-integrated distributor. These tenders had four, six, seven and seven bids respectively, a total of 24. Six of the 24 bids were from integrated companies [REDACTED]. Table 6.2 sets out the results of tendering opportunities in the market from 2002 to 2006. Integrated companies 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). [REDACTED] In summary, vertically-integrated companies were active in bidding for third-party businesses, although arguably they may have been less active than they would have been in a market with full vertical separation.
19. Having found that vertically-integrated companies were 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 we did not identify causes for concern in this area (see Appendix 6.1 for more detail). 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 would not improve the efficiency of the underwriter when dealing with third-party providers, where these transaction costs continue to exist;
 - (b) distributors tended to use independents for more specialized business: independents may have a competitive advantage over integrated companies in these areas, which more commonly come up for tender;
 - (c) more generally, independents may have other competitive advantages such as economies of scope (eg experience gained 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 perceived disadvantages to having a major supplier who is also a rival in the downstream market.
22. We were also told that in-house companies that 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. Further, many independent underwriters are part of larger businesses or offer other forms of insurance. This may 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 did not appear to have any significant advantages over, or disadvantages compared with, independent underwriters.

'Crowding out' of independents

24. Having considered whether vertically-integrated companies were less likely to try to win underwriting business from non-integrated distributors, we 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. The five major banks account for just over 60 per cent of PPI supply at the retail level, and a large proportion 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 was put to us that this business was less likely to be put up for tender. If this was the case, this would reduce the size of the market for which independents could potentially compete. We considered whether this reduction in the tendered portion of the market (relative to the situation in the absence of vertical integration) made 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 companies cannot achieve the necessary scale by virtue of their presence in other insurance markets). We had no direct evidence of the scale of such economies, but we noted some indirect evidence.

27. First, if independents were operating below the minimum efficient scale, they would have a strong incentive to merge and achieve scale economies.⁵ We noted that over recent years there had been limited merger activity among independents (including acquisition by one multi-product insurer of the PPI underwriting business of another).⁶ One exception to this was the acquisition of HSBC's underwriting services by Aviva (which was already the largest independent underwriter).
28. Second, 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 £[redacted]: the next largest independent (Prudential) had GWP of around £[redacted] million a year, while others had at most around £[redacted] million a year).⁷ Table 2 of Appendix 6.1 shows that Aviva was successful in [redacted] the bids it made, [redacted] from 2002 to 2006. However, we also note that [redacted], a far smaller PPI underwriter [redacted], had the same success rate ([redacted] per cent), and won [redacted] bids, with a value of £[redacted] million. Table 6.1 sets out five recent tenders, in [redacted] of which [redacted] and Aviva were both bidders, indicating that the two regularly bid against each other.
29. The fact that [redacted] was successful in winning business when competing against far larger rivals (in terms of PPI underwritten) for underwriting contracts provided 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 could achieve scale or scope economies that allowed them to compete successfully for PPI underwriting contracts.

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 would have an incentive to increase scale and reduce those costs.

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

⁷[redacted]

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

Whether vertically integrated underwriters are insulated from competitive pressure

Introduction and conclusion

31. Our third theory of harm was that vertically-integrated underwriters are insulated from competitive pressure. While integration creates efficiency savings and removes double-marginalization, these effects may be outweighed by the lack of competition for the distributor's underwriting business. If so, the result would be that vertically-integrated distributors faced higher underwriting costs than they would if they were not vertically integrated. As price makers downstream, they could respond to this by charging higher prices. In addition, vertically-integrated underwriters could have less incentive to innovate.
32. We found that in general vertically-integrated distributors seemed willing to outsource their underwriting needs to a third party if it was financially attractive to do so. In addition, one vertically-integrated distributor chose to divest its underwriting business to an independent underwriter during the course of our investigation. This indicated that vertically-integrated distributors can, should the incentive be sufficiently strong, outsource their underwriting needs to a third party.
33. We found no clear evidence that the prices or quality of products offered by vertically-integrated distributors were different from those offered by non-vertically-integrated distributors. Similarly we could not identify any systematic difference in the level of choice offered by vertically-integrated distributors when compared with distributors

using independent underwriters. Finally we found that there was no evidence of a significant difference in the level of innovation between vertically-integrated and non-vertically-integrated distributors although, as innovations in the supply of PPI were rare, it was difficult to draw firm conclusions.

34. We therefore concluded that there was insufficient evidence to support the contention that vertically-integrated underwriters are insulated from competitive pressure. The evidence for this conclusion is set out below.

Are vertically integrated underwriters insulated from competitive pressure?

35. To reach our conclusions, we considered: (a) whether vertically-integrated underwriters were willing to outsource underwriting services and outsourced underwriting services in practice; (b) the price and quality of products offered by vertically-integrated distributors; (c) the degree of customer choice offered by vertically-integrated distributors; and (d) the level of innovation among vertically-integrated distributors.

Willingness to outsource and outsourcing in practice

36. Vertically-integrated distributors expressed a willingness to outsource, should independent underwriters offer a superior proposition. None of the vertically-integrated distributors told us that they would be unwilling to switch to independent provision of underwriting services under any circumstances. Barclays told us that it had a pragmatic, commercial attitude to its vertically-integrated business model. It said that while the vertically-integrated approach provided the most comprehensive product to Barclays' customers, it would continue to use this approach. However, if a third-party provider offered a superior proposition, Barclays could and would be likely to consider switching.

37. Further, vertically-integrated distributors demonstrated that switching to an independent underwriter was feasible in practice. On 1 November 2007, HSBC, which had previously underwritten a proportion of its PPI business in-house, entered into a five-year agreement with Aviva (Norwich Union) to provide home insurance, PPI and travel insurance products for HSBC's UK consumers. In addition, HFC, a subsidiary of the HSBC Group, sold its in-house underwriting business, Hamilton Insurance Company and Hamilton Life Assurance Company, to the Aviva group.⁸ This indicated that barriers to switching were not insurmountable and that the vertically-integrated distributors could switch to third party supply of underwriting services, given sufficient financial incentives.

Price and quality of products offered by vertically-integrated distributors

38. We considered that, if vertically-integrated underwriters were insulated from competition and so deliver higher costs to vertically-integrated distributors, the prices charged by vertically-integrated distributors should be higher than those charged for equivalent products by non vertically-integrated distributors. We compared prices and quality using Defaqto scores, and performed a multivariate analysis.

39. A simple comparison of prices may deliver misleading results, as the level of quality and other factors can vary significantly between PPI policies. Therefore we assessed both the prices of vertically-integrated and non-vertically-integrated distributors' policies and the quality of those policies as measured by their Defaqto rating score.

40. Figure 1 shows the price and quality of the PLPPI products offered by the large distributors.

⁸Source: HSBC press release, HSBC completes new insurance deal with AVIVA. 1 November 2007.

FIGURE 1

The price and quality of PLPPI products distributed by vertically-integrated and non-vertically-integrated distributors



Source: CC analysis of Defaqto Aequos data and information from distributor websites (March 2008).
Note: PLPPI products offered by the largest 12 distributors only.

41. Figure 1 shows that there is no clearly identifiable difference between the price or quality of products offered by vertically-integrated distributors (blue crosses) when compared with non-vertically-integrated distributors (orange circles).⁹
42. It has been put to us that many consumers do not shop around for PPI on a stand-alone basis, and that instead they compare the prices of the combined PPI and credit bundle, ie an insured loan. We therefore repeated our analysis using the price of a bundle of PPI and a personal loan. Figure 2 shows the price and quality of insured loans offered by the large distributors.

FIGURE 2

The price and quality of insured loans distributed by vertically-integrated and non-vertically-integrated distributors



Source: CC analysis of Defaqto Aequos data and information from distributor websites (March 2008).
Note: PLPPI products offered by the largest 12 distributors only.

43. Figure 2 shows that there is little evidence to support the hypothesis that prices for insured personal loans offered by vertically-integrated distributors are higher than those offered by non-vertically-integrated distributors.

⁹In this chart, and in the multivariate analysis, we measured the price of PPI in terms of the proportionate increase in the monthly cost of a loan as a result of taking out PPI. This is because patterns in the price of PPI, measured in £GBP, may be affected by the cost of the underlying loan, rather than differences in the cost of PPI. The measure used here is a more reliable measure to compare between PPI policies when assessing differences in the price of PPI products. However, our analysis is not affected significantly by the choice of PPI price measure.

44. To test the hypothesis that there is a statistically significant, positive, difference between the prices of PPI policies offered by vertically-integrated distributors and those offered by non-vertically-integrated distributors, we undertook a multivariate analysis on the same sample of products which was designed to take account of the variations in the quality of cover offered.
45. Our data was taken from the Aequos database of prices and product characteristics for PLPPI supplied by Defaqto. This database provides a cross-section of premium rates and product characteristics for 113 individual PLPPI products listed.
46. The premium information listed in the Defaqto dataset is not directly comparable between policies as there are a number of different ways in which premium rates can be applied between single premium policies. This data was augmented where possible with pricing information from distributor websites, as at March 2008. This enabled us to create a variable for the price of a single premium policy that was comparable, and also enabled us to assess the overall bundle price, for which the pricing of the underlying personal loan was also important.
47. The variables that we used in our analysis were as follows:
 - (a) *PPI_price*: This variable was used to measure the price of insuring a personal loan. This was measured as the net monthly cost of insuring a personal loan as a proportion of the monthly payment on an uninsured loan. This data was sourced from provider websites based on the cost, with PPI and without PPI, of a loan for £10,000 over 48 months.
 - (b) *costincludingppi*: This variable was used to measure the overall cost of the PPI and credit bundle. This data was sourced from provider websites based on the monthly cost of a £10,000 insured loan over 48 months.

(c) *defaqtoscore*: This variable was used to measure the quality of a PPI policy. This data was drawn from the Defaqto Aequos database.

(d) *vi_code*: This was an indicator variable used to identify those products supplied by a vertically-integrated distributor. For the purposes of this analysis we classified a distributor as vertically-integrated if it underwrote 50 per cent or more of its PLPPI business in-house. This information was sourced from our market and financial questionnaire.

48. It was not possible in our dataset to control directly for differences in the volume of sales of the products in the Defaqto sample. It is possible that the performance of a distributor is affected by scale. As the vertically-integrated distributors are large suppliers of PLPPI, this may bias our results as vertically-integrated distributors may enjoy scale efficiencies that many of the smaller non-vertically-integrated distributors do not. We therefore performed our analysis on policies offered by the distributors classified as 'large distributors' for the purposes of our investigation. This left 41 PLPPI products of which 31 were offered by vertically-integrated distributors and 10 were offered by non-vertically-integrated distributors.

49. The analysis presented below was conducted on a sample of 39 products. This was because two products offered on a pilot basis with a very low PPI price and low Defaqto rating had a disproportionate effect on the results.¹⁰ This does not affect our findings on the key question of vertical integration.

¹⁰In particular, these two products had a disproportionate effect on the coefficient derived for the influence of Defaqto score on PPI price. These observations had a Cooks statistic in excess of 0.11 and were therefore dropped from the analysis. Re-introducing these observations would not change our conclusions on the effect of vertical integration on PPI prices.

50. As discussed above, we used two measures of the price of a PLPPI policy.¹¹ In equation 1 we estimated the impact of product quality and underwriting business model on the price of the PPI policy:

$$PPI_price = \alpha + \beta_1 defqtoscore + \beta_2 vi_code + \varepsilon_i$$

51. In equation 2 we estimated the impact of product quality and underwriting business model on the price of a personal loan with PPI:

$$costincludingppi = \alpha + \beta_1 defqtoscore + \beta_2 vi_code + \varepsilon_i$$

52. The results of our analysis are set out in Table 3.

TABLE 3 The impact of product quality and underwriting business model on the price of PPI

	<i>Equation 1</i>	<i>Equation 2</i>
Dependent variable	PPI_price	costwithppi
Defaqtoscore	0.0007605 (0.000611)	-0.0993135 (0.1755516)
vi_code	-0.0078778 (0.0160295)	-11.43375** (4.605437)
R squared	0.0459	0.1558
Observations	39	39

Source: CC analysis.

*Coefficient significant at 10%.

**Coefficient significant at 5%.

Note: Standard errors in parentheses.

53. As the table shows, in both equations 1 and 2 very little of the variation in the price of a PPI policy was explained by variations in product quality or in differences in the business model operated by the distributor. In both cases the R squared statistic is below 0.16.

54. In equation 1 the coefficient on vi_code is not statistically different from zero. In equation 2 there is a statistically significant difference between the prices offered by

¹¹For both equations we used ordinary least squares.

vertically-integrated and non-vertically-integrated distributors. However, the coefficient on *vi_code* is negative, which indicated that the prices of loans with PPI were lower from vertically-integrated distributors when compared with non-vertically-integrated distributors. This was the opposite of what we would expect if the hypothesis in paragraph 44 was correct (ie that vertically-integrated distributors charge more than non-vertically-integrated distributors).

55. Accordingly, the results of our analysis did not provide any support for the hypothesis and we are unable to accept that PPI prices offered by vertically-integrated distributors are higher than those offered by non-vertically-integrated distributors. In fact, we found that the prices offered by vertically-integrated distributors, when accounting for the quality of the PPI policy, were often lower than those offered by non-vertically-integrated distributors.

The degree of customer choice offered by vertically-integrated distributors

56. We found no persistent pattern between vertically-integrated and non-vertically-integrated providers regarding the choice of different PPI products they offered to their credit customers. We found that there were vertically-integrated distributors that did offer choice, and vertically-integrated distributors that did not. Similarly we found that among the distributors that used independent underwriters, there were distributors which offered a choice of products and distributors which did not.
57. Tables 4, 5 and 6 list the distributors that offer a choice of PPI products (or levels of cover within a product) with the underlying credit product and a list of distributors that offer one product to their customers, Table 4 shows personal loans, Table 5 shows mortgages and Table 6 credit cards.

TABLE 4 Distributors that offer a choice of PLPPI products

<i>One product</i>	<i>Multiple products</i>
Abbey	Alliance & Leicester
Barclays*	HBOS (Bank of Scotland)*
Capital One	HSBC (LifeChoices)
Cattles	LTSB (BHS, BTR) +
HBOS (Halifax)*	Northern Rock
HSBC (HFC)†	RBSG (Nat West, RBS)*
LTSB‡	
Nationwide	
RBS (Ulster Bank)*	

Source: CC, based on information provided by the parties

*Underwritten in-house.

†HSBC has stopped offering PLPPI except to HFC customers (see Appendix 2.3 for details).

‡Partially underwritten in-house.

TABLE 5 Distributors that offer a choice of MPPI products

<i>One product</i>	<i>Multiple products</i>
HBOS (Bank of Scotland)*	Abbey
LTSB (C&G)†	Alliance & Leicester
RBSG (Direct Line)*	Barclays (Woolwich)*
	HBOS (Halifax – via intermediaries)*
	HSBC (LifeChoices)
	Nationwide
	Northern Rock
	RBSG (Nat West, RBS)*

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

* Underwritten in-house

†LTSB sells a second MPPI product, but it is only available to existing mortgage customers.

TABLE 6 Distributors that offer a choice of CCPPI products

<i>One product</i>	<i>Multiple products</i>
Abbey	Capital One
HBOS*	Barclays*
	HSBC
LTSB+	(LifeChoices)
MBNA	
Nationwide	
RBSG*	

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

* Underwritten in-house

The level of innovation among vertically-integrated distributors

58. It was put to us that vertically-integrated distributors were less likely to innovate than those using an independent underwriter. Innovation in general in the supply of PPI was relatively rare. As a result of the limited number of innovations that we observed, it was not possible to draw firm conclusions from the pattern of innovation. However,

we noted that there were examples of vertically-integrated distributors innovating. We noted that Barclays had introduced a CCPPI product that enabled policyholders to insure credit card balances on cards issued by other lenders. Barclays also introduced an MPPI product, Fair & Square, and had tailored PPI in relation to other credit products. RBSG told us that its stand-alone Churchill product was an important innovation. Finally HBOS introduced its Total Mortgage Protection Plan, which can also be used on a stand-alone basis.

59. Therefore, because there were examples of innovation among the vertically-integrated distributors, and because the level of innovation generally was low, we could not conclude that the level of innovation among vertically-integrated distributors was lower than among distributors that used independent underwriters.

Rejection of claims

60. Our fourth theory of harm was that vertically-integrated underwriters may have greater incentives than non-vertically-integrated underwriters. Distributors typically receive a higher share of residual profits after payout of claims than underwriters (as noted in paragraph 57 of Appendix 6.1 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 firm had a greater incentive to maximize money for profit sharing, by rejecting more insurance claims.
61. We noted that firms could achieve a greater amount of profit share income in two ways: (a) firms could adopt a more stringent policy towards accepting claims, resulting in more claims rejected; and (b) firms may have different incentives to

devote resources to checking claims resulting in a principal-agent problem between distributor and underwriter.¹² We discuss both these below.

Incentives to reject claims

62. We were told that vertically-integrated firms might have a greater incentive to reject claims because a vertically-integrated group will receive all 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 containing more exclusions, or to adopt a more stringent policy on claims acceptance.

63. However, we did not regard the incentives facing vertically-integrated firms as being so clear-cut. For example, vertically-integrated firms tended to be multi-product firms, and PPI distributors in general tended to be part of financial services companies that spent significant sums on advertising their brand. Vertically-integrated firms therefore appeared to face an incentive to accept claims that were 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.

64. In any event, both independent and vertically-integrated distributors faced 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 draft sufficiently detailed contracts, they should avoid serious principal-agent problems, for example by specifying the rejections policy. Also, by influencing the design of PPI policies themselves, non-vertically-integrated distributors avoid principal-agent problems in product design. We

¹²The '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 for the 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.

note in paragraph 6.35 that distributors are typically heavily involved in the design of their PPI policies.

Devoting resources to checking claims

65. A further area where independent underwriters and vertically-integrated firms might 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 the possibility of accepting a greater rate of invalid claims (again, this should be predictable if the proportion of valid/invalid claims and their relative cost is known¹³).
66. Assuming that 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 the profits. Such situations would result in a principal-agent problem between the underwriter and distributor as the underwriter would have incentives to devote fewer resources to checking claims than the distributor would likely prefer.
67. As with policy design and attitudes towards rejecting claims, these principal-agent problems can be overcome if distributors and underwriters can draft sufficiently detailed contracts for services. For example, the distributor could include a contract term which required the underwriter to carry out a specific level of claims-checking.
68. Distributors may have difficulty in monitoring contracted underwriters, which could result in a lower level of resources devoted to claims checking in practice, despite

¹³This may be expected to vary by customer group and product type.

contract terms. However, the result of this would be that, if the distributor 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 could 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.

69. We did not consider, therefore, that vertically-integrated businesses had clear incentives to reject more claims than non-vertically-integrated companies. Concerns over maintaining their reputation, and the risk of losing customers who source multiple services from them, would reduce any incentive they might have to maximize claims rejections. Further, we did not consider that vertically-integrated companies were uniquely placed to influence underwriters' claims policies, as non-vertically-integrated distributors appeared able to influence their underwriters' policy through contractual arrangements.