Office of Fair Trading

Payment protection insurance

The OFT's reasons for making a market investigation reference to the Competition Commission

February 2007

OFT899

CONTENTS

Annex

1 EXECUTIVE SUMMARY

1.1 The Office of Fair Trading (OFT) has decided to make a reference to the Competition Commission (CC) under section 131 of the Enterprise Act 2002 (the Act) for an investigation into the supply of all payment protection insurance (PPI) services except store card payment protection insurance services to non-business customers in the United Kingdom.[1] This confirms the OFT's Proposed Decision, which was published on 19 October 2006 following a market study, and on which the OFT publicly consulted.

1.2 The OFT has based its decision on evidence of features of the market that it suspects are preventing, restricting or distorting competition and thereby harming consumers. In deciding to make a reference, the OFT has taken account of the views expressed by respondents to the consultation, particularly in relation to the evidence and analysis set out in the Proposed Decision.

1.3 The PPI market is large with over 6.5 million policies purchased every year worth over £5.5bn in 2005. PPI can provide worthwhile cover against unforeseen events that cause repayment difficulties and it can offer valuable peace of mind whether or not a claim is made. But, while some of the evidence might suggest a degree of consumer satisfaction with aspects of the product, we are concerned that when the evidence is examined holistically, a less rosy picture emerges with many consumers getting a poor deal.

1.4 We recognise that the industry has been working with the Financial Services Authority (FSA) to try to remedy the problems relating to sales standards which were identified by the FSA during their two thematic reviews. The FSA has announced a further round of thematic work to be undertaken during 2007, and is also currently reviewing its conduct of business rules for PPI markets as part of its more general review. The focus of the FSA's work is to improve selling practices and standards to ensure consumers receive suitable products that meet their needs.

---

[1] Full terms of reference for the investigation are attached at Annexe A.

Neither we nor the FSA believe that these initiatives will resolve the broader competition issues which we have identified in these markets. We have liaised closely with the FSA throughout the market study and the consultation and we do not believe that the FSA's consumer protection powers nor its ongoing work with trade associations make a market investigation reference inappropriate.

1.5 We remain concerned that there are a number of features of this market that we suspect prevent, restrict or distort competition and lead to poor value for consumers. Whilst some of the features may be less marked for mortgage PPI (MPPI) they still exist and the evidence points to a need for MPPI to be examined further.

1.6 In summary, the evidence presented to the OFT during the consultation period has not altered our concern that the following features of the PPI market are harmful to consumers:

Structural features adversely affecting competition:

- PPI is a secondary purchase, bought only as a result of taking out the primary credit.
- The point of sale (POS) advantage experienced by distributors means that there is little competitive pressure at the key point at which the consumer buys the insurance.
- The complex nature of PPI makes comparison between different policies difficult.
- Lack of product information prior to POS adversely affects competition.
- Present levels of cancellation or switching by consumers in this market do not exert any serious pressure on the prices of PPI.

- Stand alone[2] providers, who might otherwise be thought to offer a competitive pressure, have difficulty accessing consumers and face substantial start-up and marketing costs to attract custom.

- Vertical integration is a significant feature with around 60 per cent of the market undertaking both the underwriting and the distribution of PPI within the same group.

Conduct of firms adversely affecting competition:

- Competition is centred on the sale of the credit and not the PPI.

- PPI is often automatically included in the quote for credit without a customer's knowledge.

- Consumers in some cases either assume or are told or given the impression by the distributor that taking out the PPI will help the application for credit.

- Headline APR is used to draw consumers into the credit deal - but the APR for the credit is not necessarily a good indicator of the best deal once the PPI gets factored in.

- There is poor upfront information, making it difficult for consumers to weigh up whether they will get a good deal.[3]

- Firms' practices in giving refunds do not reflect cost or consumer risk profile on cancellation of single premium PPI.

---

[2] We interpret 'stand alone' as policies which are sold at a different time to the core credit transaction and by an organisation other than the lender involved in the core credit transaction i.e. are not sold as a 'linked' product to the credit.

[3] Although the FSA's rules require firms to provide consumers with information about PPI in good time before the sale is concluded.

Conduct of consumers adversely affecting competition:

- Consumers do not shop around for the best deal on PPI. A contributing factor to this is the huge POS advantage enjoyed by distributors.

- Consumers display poor understanding of PPI, its price and the detail of their cover, with suppliers initially doing little to remedy this situation.

Performance information indicating competition is adversely affected:

- PPI has low claims ratios when compared to other insurance products, and with no evidence to suggest costs are high, it seems reasonable to assume that distributor profitability is sizeable with little evidence that this is being competed away.

- Commission rates paid by insurers to downstream intermediaries look high compared with other general insurance products.

- The pricing of different PPI products cannot always be explained by differences in cover offered.

1.7 In view of the size and importance of the market and the breadth of concerns that have been raised, the OFT remains of the view that a market investigation by the CC is the most appropriate way of resolving these issues and, if necessary, imposing remedies.

1.8 These concerns apply across **all** PPI products. We are not proposing to include store card PPI within the reference. Whilst we acknowledge the legitimate concerns of one respondent that store card PPI should be included to ensure a holistic approach to the PPI market, we believe that, on balance, the arguments against inclusion set out in our consultation document (that store card PPI was covered by the CC store cards inquiry with remedial measures due to come into force in 2007), outweigh the arguments against inclusion. We have therefore decided to exclude store cards PPI from the terms of reference.

1.9 This report can be found on our website at http://www.oft.gov.uk/Business/references/reference+cases.htm

2 INTRODUCTION

2.1 On 19 October 2006, the OFT announced its proposal to refer the UK market for payment protection insurance services (PPI) to the CC for a market investigation. Our reasoning was set out in *Payment protection insurance: Report on the market study and proposed decision to make a market investigation reference* (OFT869) ('The Proposed Decision').

2.2 The OFT's consideration of the PPI market followed a super-complaint made by the designated consumer body Citizens Advice (CitA)[4] on 13 September 2005. We responded to the super-complaint on 8 December 2005 with a commitment to carry out a market study, which was launched on 3 April 2006.

2.3 Taking into account all the evidence gathered during the course of our market study, the OFT took the view that the section 131 test for a market investigation reference to the CC was satisfied. Under section 169 of the Act, where the OFT proposes to make a market reference to the CC, it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact. The OFT invited comments on its Proposed Decision over a six week period ending on 30 November 2006. In total, we received responses from 22 bodies, consisting of six trade associations, four consumer organisations, eleven businesses and the Financial Services Authority (FSA). The OFT has considered all responses received carefully in reaching its final decision.

2.4 This present document ('the Final Decision') sets out the OFT's reasons for deciding to confirm its Proposed Decision to make a reference to the CC. Where respondents commented on particular elements of the analysis in the Proposed Decision, these views have been included, wherever possible, within the analysis presented in this Final Decision document. Where respondents made more general comments on

---

[4] The National Association of Citizens Advice Bureaux is designated by the Enterprise Act 2002 (Bodies Designated to make Super-complaints) Order 2004 (as amended) SI 2004/1517. (Citizens Advice is the operating name of The National Association of Citizens Advice Bureaux – see www.adviceguide.org.uk)

features of the market, these have also been summarised within this document.

2.5 The structure of the remainder of this document is as follows:

- market structure and definition (Chapters 3 and 4)

- the case for a reference (Chapter 5)

- scope and terms of the reference to the CC (Chapter 6).

3 MARKET STRUCTURE

3.1 PPI protects a borrower's ability to maintain loan repayments should they be unable to keep up their repayments due to accident (A), sickness (S) or unemployment (U). These are the main risks covered by PPI policies; some unsecured, second charge mortgage, and credit card PPI policies also cover risk to life (L). The principal forms of personal credit that PPI policies are available for are:

- First-charge mortgage payment protection insurance (MPPI)
- Second-charge mortgage or secured loan PPI
- Unsecured loan PPI (which includes motor loans, hire purchase and catalogue purchases)
- Credit card PPI
- Store card PPI.

3.2 Typically, PPI cover is purchased at the same time as the credit agreement with both the credit agreement and insurance cover being arranged by credit institutions/lenders,[5] the vast majority of which are the high-street retail banks and building societies. On the whole PPI is not mandatory in the sense of being a prerequisite to a consumer obtaining credit. However, in the case of mortgages, some lenders may insist on MPPI as being 'appropriate' for certain types of consumers.

3.3 Once the credit product is agreed, PPI is available accordingly, reflecting the fact that PPI is a 'secondary' or even 'tertiary'[6] product (whose existence may only become known to the consumer at the POS).

3.4 Claims are generally payable in the event of a policy holder experiencing A, S or U, and are usually paid at monthly intervals for a period not exceeding 12 months (although a few policies can pay out for 24

[5] Referred to as distributors in this document.

[6] For example, after the sale of a car, and the sale of the finance to pay for the car, the PPI is sold to protect the payments on the finance.

months). Loss of earnings resulting from factors largely under the control of the insured party (such as relationship breakdown, job dismissal or voluntary unemployment) is generally excluded by PPI policies. In most cases, policyholders cannot make a claim for an illness they are already aware of or have had before (pre-existing conditions).

3.5 Common minimum eligibility requirements for PPI are that a consumer must be living and working in the UK, be aged at least 18 and under 65 years, and be actively employed for at least 16 hours per week and have been so for a specified period of time. PPI also entails terms and conditions relating to contract work and to borrowers that are self-employed, and there are also a number of conditions attached to the claims process itself, including specification of the period between purchase of the policy and when a claim can be made and the period between the risk occurring and the insurer's payments commencing.

3.6 Consumers purchasing PPI have a statutory cancellation period under the FSA's rules in which they can cancel their policy. This period is typically 14-30 days, but is 30 days if the product is sold alongside life or pure protection insurance policies.

Size and growth of the PPI sector

3.7 It is estimated that the stock of live PPI policies in force is approximately 20 million and the sale of new policies is between 6.5 and 7.5 million annually.[7] By gross written premiums (GWP), the sector is estimated to have totalled £5.5bn[8] in 2005. On a compound annual growth rate (CAGR) basis, the value of total GWP rose by 18.8 per cent per year between 2000 and 2005.[9] Both the number of policies and the GWP data indicate a very rapidly growing sector – with a rate of growth that has exceeded that occurring in the personal credit sector over 2000-2004 (8 per cent).[10]

---

[7] CitA report *'Protection racket: CAB evidence on the cost and effectiveness of payment protection insurance'*

[8] Mintel UK *Creditor Insurance* November 2005

[9] London Economics. *Research into payment protection Insurance in the UK*. April 2006

[10] London Economics. *Research into payment protection Insurance in the UK*. April 2006

Structure of PPI sector

3.8 According to London Economics, integration of underwriting and distribution of PPI (and credit) is a feature of the sector with vertically integrated providers accounting for over 60 per cent of the market. In addition a small number of insurance providers sell direct to intermediaries or consumers.

3.9 Insurers compete to provide PPI policies for distributors, which then sell these PPI policies alongside their credit agreements (personal loans, credit cards, mortgages etc) to final consumers - often in return for commission and/or some form of profit share. The consumer's contract is with the insurer, who they would subsequently approach in the event of having to make a claim. (Alternatively, consumers may go through the intermediary who arranged their PPI).

3.10 A lender normally[11] appoints one insurer (whether it be an in-house or external insurer) to underwrite the PPI policies that it distributes with its credit products. In selecting insurers lenders will generally have regard to price, quality of product and service, track record, reputation and logistics. Contracts may also include bonus agreements, profit-sharing arrangements and/or sales targets between lender and insurer (although qualitative evidence suggests that the latter are not widely used). With limited exceptions, at any given point in time, lenders will deal with one insurer in providing the PPI products that they distribute with their credit agreements.

3.11 The distribution of PPI policies to consumers is largely controlled by the lenders, principal among which are the high-street retail banks and building societies, which together account for approximately 80 per cent[12] of all PPI policies sold. Their extensive branch networks and position as leading credit providers give them unique access to consumers, which is a key feature of PPI distribution. One consultation

---

[11] In some instances some lines of insurance may be tendered separately, for example, the Life element.

[12] Mintel UK. *Creditor Insurance.* November 2005

respondent pointed out that there are structural differences for the distribution of non-standard or prime credit. These include longer distribution chains creating higher costs and different consumer behaviours and motives when purchasing.

New entry

3.12 The main entry requirements for insurers at the upstream end of the market relate to the distributor's requirements regarding the nature of the PPI policies it wishes to sell. These include solvency requirements and reputation. These requirements may not be significant in the case of an established insurer but may be more important to a *de novo* provider or a cross-border insurer from another country – there has not been market entry for some time. Sterling Insurance and St Andrews entered in the early 1990s and the latter is today part of the HBOS Group which accounts for 13 per cent of the UK PPI market.

Stand alone providers

3.13 New entry has included stand alone providers, which tend to concentrate on MPPI, unsecured loan PPI and credit card PPI. Stand alone providers include British Insurance, BIBA, Payprotect and Paymentcare. They tend to operate mainly on-line. The data is less clear on how much of the UK market they account for with anecdotal evidence suggesting anything from 1-7 per cent. Research from the Council of Mortgage Lenders[13] suggests that direct sales currently occupy only one per cent of the market.

[13] www.cml.org.uk/cml/statistics

4 MARKET DEFINITION

4.1 In making a reference to the CC, the OFT's guidance says that it must give 'some consideration to the definition of the relevant market', but 'the effects on competition of some features may be clear enough that firm conclusions on the definition of the relevant market by the OFT are unnecessary'.[14]

4.2 Market definition is not an end in itself but a key step in identifying the competitive constraints acting on a supplier of a given product or service. Market definition provides a framework for competition analysis.

4.3 In brief, the relevant market comprises all those substitute products/services and regions providing a competitive constraint on the product/service and region of interest.

Product market

4.4 PPI is a secondary product. The OFT's Guidelines[15] consider the market for a secondary product to be a product (here, PPI) that is purchased only as a result of buying a primary product (here, credit). We distinguish between three possible relationships between the primary and secondary products in the definition of an aftermarket:

i) System market: a unified market for the primary product and the secondary product. In a system market the buyer will consider the combined price of the primary and secondary product[16] before deciding which products to purchase. It is not necessary that every consumer buys a bundle. What is important is that there are sufficient numbers of consumers purchasing the bundle (having searched the market) to encourage the firm to competitively price the primary and secondary product as a bundle (see figure 2).

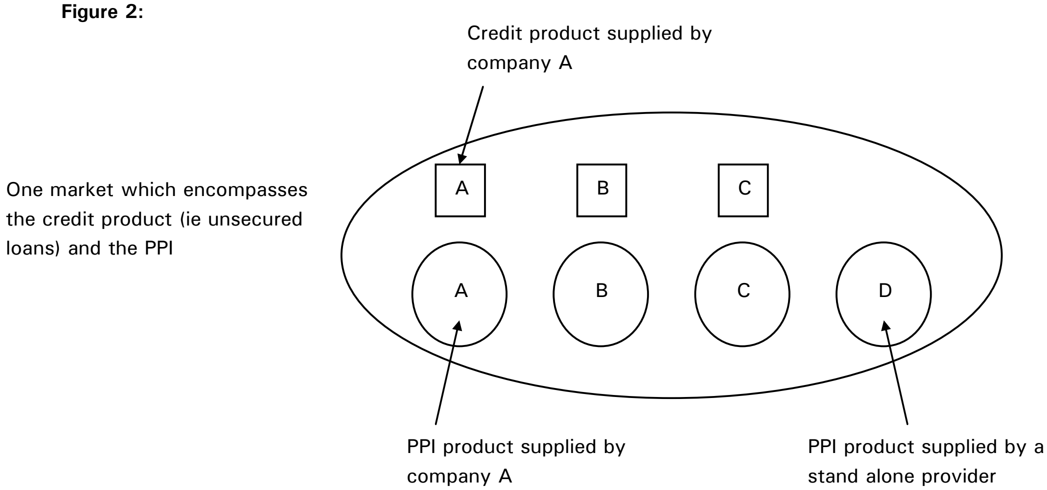
---

[14] *Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act* (OFT511), paragraph 4.8.

[15] OFT 403, Competition Act 1998 Guideline on Market Definition, paragraphs 5.4 to 5.11

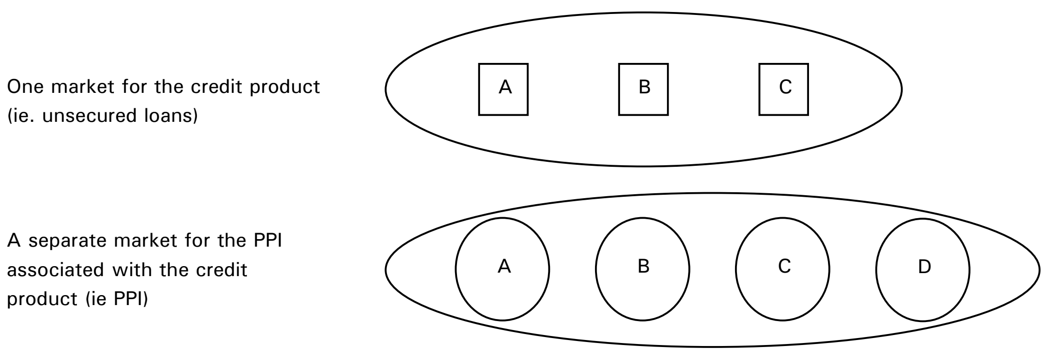
[16] This may involve an element of 'whole life costing' of the secondary product, eg ink cartridges.

Figure 2:



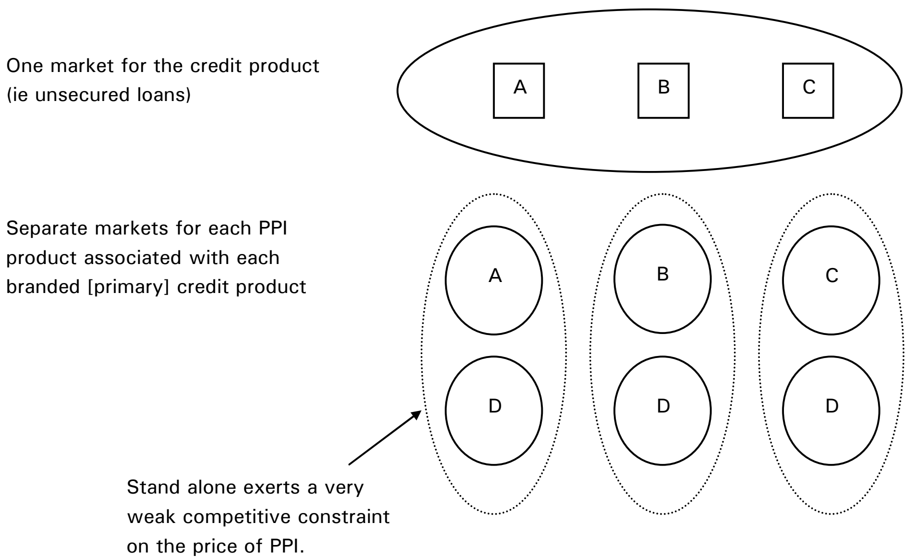
ii) Dual market: a market for the primary product and a separate market for the secondary product (see figure 3); and

Figure 3:



iii) Multiple market: a market for the primary product and separate markets for the secondary product(s) associated with each primary product (see figure 4).

Figure 4:



4.5 Which definition applies depends on the extent to which competition to supply the primary product constrains the price charged for the secondary product,[17] and also on the degree of post sale consumer lock-in or switching inertia.

4.6 Using the aftermarket framework, we have adopted a two stage process when thinking about market definition.

4.7 First, separate primary markets can be defined (primarily on demand-side considerations) for credit cards, store cards, unsecured loans (personal loans, motor loans, and hire purchases), secured loans (excludes mortgages and re-mortgages), and mortgages on the basis of differing term structure, loan amount, security, APR, purpose etc. This is broadly

---

[17] In other words, do consumers consider the price of the secondary product when shopping for the primary product?

consistent with the view taken by the CC in the Abbey National/ Lloyds TSB merger inquiry.[18]

4.8 Then, given that the credit purchase opens up the PPI purchase, it seems likely that separate, secondary, PPI markets exist for each credit product:

- First charge MPPI
- Secured loan PPI
- Unsecured loan PPI
- Credit card PPI, and
- Store card PPI

4.9 Depending on which secondary market structure exists, markets could be defined more narrowly still. If PPI currently operates as a multiple secondary market, for example there would be a market for HSBC MPPI, a separate market for Lloyds TSB MPPI, and so on. However, it may be that different forms of PPI currently operate differently in the secondary market – for example some may tend towards dual markets, others multiple or even system. We are not required to reach a final view on the precise type of secondary market operating in each case, and have not done so.

Individual product market analysis

4.10 The broad competitive characteristics of the markets for PPI on unsecured loans, secured loans, store cards and credit cards are sufficiently similar to allow us to combine their discussion, although their product markets remain distinct. First charge MPPI is discussed separately because it appears to operate slightly differently to the other markets.

[18] http://www.competition-commission.org.uk/rep_pub/reports/2001/458lloyds.htm#full

Unsecured loan PPI, secured loan PPI, store card PPI and credit card PPI

Supply side considerations

4.11 On the supply side, the majority of PPI policies in these four markets are sold by lenders or credit intermediaries. Stand alone players are not a significant aspect of these markets.

4.12 The main obstacle to entry for PPI providers appears to be consumer access and this reflects the fact that most PPI policies are offered at the POS of the (primary) loan agreement.

4.13 The consumer survey reveals that overall 88 per cent of PPI holders took out PPI at the same time as their credit product (and thus presumably accepted the PPI product that was sold by the credit provider). The breakdown is as follows: 98 per cent for secured loans, 91 per cent for unsecured loans and 83 per cent for credit cards. This is reinforced by our business survey, which indicated that over 90 per cent of PPI policies are sold at the POS of the credit product being insured.

4.14 Of those who did not take out their PPI at the same time as the credit, overall 73 per cent took out the PPI product offered by the credit provider at a later date. By individual market the figures were 67 per cent for secured loans, 79 per cent for store cards, 79 per cent for unsecured loans and 94 per cent for credit cards. This emphasises the POS advantage of the incumbent PPI provider that has established a sales relationship with the credit provider.[19]

4.15 Consumer access is particularly important in the case of credit card and store card PPI, for which the card issuer may be the only party in possession of information on the outstanding balance on the card, which is critical to setting the premium and calculating the claim payments. Any PPI product not sold by a card issuer would need to define cover

[19] Please note a low number of respondents (95) answered this question and this result should be considered with caution.

and collect premiums on a different basis, eg on balances up to some predefined limit.

Demand side considerations

4.16 In all four markets consumer search and demand side substitution between PPI products appears to be low. Businesses we spoke to indicated that the majority of consumers do not consider buying a PPI policy until it is mentioned at the point of the credit sale. Consumers only seem to shop around for low APRs on the credit product, rather than the cheapest combination of the credit and PPI.

4.17 This behaviour is symptomatic of the fact that the information relating to the PPI product is complex (a finding of our mystery shop survey). Moreover, a high degree of PPI product differentiation,[20] limited outside options (stand alone products) and extremely low advertising levels makes comparison between products very difficult and costly.

4.18 Product compatibility issues and search costs (because of the low advertising levels) - also significantly limit the scope for switching post sale. Unsecured loan PPI and secured loan PPI may feature additional switching costs associated with the fact that most of these policies are sold as single premium policies. Consumers do not generally currently receive pro rata compensation for early termination of a PPI policy with single premium policies. That is, consumers switching between unsecured loans or second charge mortgages cannot switch the PPI easily.

System market qualities?

4.19 One lender has argued that the unsecured loan PPI market has system market properties. They argued that most lenders take a holistic approach to price setting: 'the APRs on loans are based on what consumer characteristics reveal about the expected risk of default and likely PPI take-up on the portfolio.'

---

[20] Differences in the coverage, the product exclusions, and the way benefits accrue and are paid.

4.20 We are unconvinced that the unsecured loan PPI market is akin to a system market. Simply because a firm chooses to take a holistic approach does not mean that there is a competitive constraint acting on the price of the PPI. The same lender submitted that 'most consumers do not consider the benefits of PPI and the risks they are insured for until they are explained during the sales process', and this was confirmed by our consumer survey.

Conclusion on unsecured loan PPI, secured loan PPI, store card PPI and credit card PPI

4.21 With very little demand or supply-side substitution, we believe that separate markets for unsecured loan PPI, second charge MPPI, credit card PPI and store card PPI exist.

First charge MPPI

4.22 The MPPI market seems to operate slightly differently from the other PPI markets. The existence of stand alone products and a greater role for financial intermediaries (brokers etc) might result in less of a POS advantage for the distributors of the credit.

Supply side considerations

4.23 On the supply side, stand alone products are a more prominent aspect of MPPI than in other PPI markets. That said, MPPI products sold alongside mortgages still have around 95 percent of the total MPPI market. Stand alone providers include British Insurance, BIBA, Payprotect and Paymentcare. They tend to operate mainly on-line.

4.24 Some providers such as Marks and Spencer, Norwich Union and AXA have tried to sell stand alone PPI policies direct to consumers but have subsequently withdrawn. Their withdrawal and the limited penetration accounted for by other stand alone suppliers seems to stem from a combination of low consumer demand (consumers generally do not rate PPI as an important financial product) and the high fixed costs of the marketing needed to overcome the lack of direct access to consumers.

4.25 Intermediaries are an important aspect of the MPPI market. MPPI sold via intermediaries increased from 14 to 21 per cent between 2000 and 2004[21]. We considered whether such intermediaries are facilitating competition by shopping around for the best deal for the consumer, acting in a similar fashion to Independent Financial Advisors (IFAs) in relation to investment products. If that were the case, then the MPPI market would be exhibiting some of the characteristics of a dual market. At least one insurance firm noted that many intermediaries act in a similar way to lenders - ie they do not offer consumers a choice of PPI products. Responses to our consultation and anecdotal evidence from other stakeholder meetings corroborate this viewpoint. It seems that on the whole intermediaries sell the PPI products linked to the credit rather than picking from, say, a panel of suppliers.

Demand side considerations

4.26 On the demand side, it would appear that the POS advantage is weaker for MPPI than for other PPI lines. A few MPPI consumers seem to be more price sensitive than consumers of other PPI products, and tend to shop around for a good MPPI deal. This may be because the MPPI premium represents a larger share of a consumer's budget when compared to other PPI policies, and more stand alone alternatives exist.

4.27 In terms of switching, exit costs for regular premium policies are lower compared with single premium policies. The consumer survey shows that 14 per cent of MPPI holders cancelled. Of these less than half reported that they switched to another MPPI[22] provider. Anecdotal evidence suggests that most of these consumers are likely to have switched because they have changed mortgage providers.

Conclusion on MPPI

4.28 Nevertheless, on the basis that the stand alone market is small and that intermediaries do not appear to be facilitating competition, we believe

[21] Council of Mortgage Lenders

[22] To be considered with caution as the base is just 35 MPPI holders

that the characteristics of the MPPI market are sufficiently similar to other forms of PPI that we have included it in our consideration.

Sub-prime MPPI – a separate market?

4.29 We have considered whether sub-prime[23] MPPI might constitute a separate market to prime MPPI, but whilst we found that there are a number of differences between the `sub-prime' and `prime' products, distributors and insurers have told us that they do not draw a distinction in a way that would indicate a clear structural break between the two. We have not, therefore, defined a separate market for sub-prime PPI on the basis of supply-side substitution.

Potential substitutes to PPI

4.30 We have also considered a number of potential demand side substitute products for PPI. Potential substitutes must be considered close enough by consumers to constrain the price of PPI.

4.31 The three main potential alternatives to PPI are life cover, critical illness cover and income protection (IP). All differ from PPI in terms of benefit, term, exclusion period, eligibility, application process and pricing (PPI is underwritten on a group basis). IP is arguably a substitute for MPPI. However, it does not cover against death and unemployment, payments are taxable and can affect benefit payments, and the monthly repayments are made up to a selected age whereas those of PPI are usually limited to 12 to 24 months.

4.32 Hybrid products, for example the Post Office's 'Lifestyle Protection' product (a short term income protection product) might be an effective substitute for PPI. However, it is too early to say if such products will be sufficiently successful so as to constrain the prices of PPI.

4.33 Overall we do not believe that any of the aforementioned products exercise a sufficient constraint on the price of the PPI products so as to be considered an effective substitute.

---

[23] Sub-prime first charge mortgages represent a small part of the first charge mortgage market.

Geographic market

4.34 In addition to the definition of the relevant product market(s), there is also a question of the relevant geographical market(s). The conditions of supply and demand are to some extent determined by the regulatory framework, which applies to the whole of the UK. Further there is no evidence of insurers or distributors partitioning the markets geographically. We therefore take the relevant geographic market to be [at least as wide as] the UK.

Market definition conclusion

4.35 It seems likely that the following five UK wide PPI markets exist:

- First charge MPPI
- Secured loan PPI
- Unsecured loan PPI
- Credit card PPI, and
- Store card PPI

4.36 One consultation respondent expressed concern that in defining the markets this way, the OFT had failed to acknowledge the possibility of PPI linked with 'non-prime' credit sold by lenders other than banks being a separate market. We were told that there are structural differences (longer chains and higher costs) and almost certainly different customer behaviours and motives for buying. The respondent felt that it was unrealistic not to recognise this market. We have noted this comment, but reiterate our earlier statement that we are only giving an overview of the possible relevant economic markets, defining them no more narrowly than is necessary. A central task for the CC in any investigation would be to come to its own view of the appropriate market definitions.

5 FINAL DECISION ON A REFERENCE

5.1 In order to make a market investigation reference, the OFT must have reasonable grounds for suspecting that any feature or combination of features of a market in the UK for goods or services, prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or part of the UK (the 'section 131 test'). Where this threshold is met, the OFT has discretion as to whether in fact to make a reference. This section sets out the two stages of our decision making process: the section 131 test and appropriateness of a reference.

The section 131 test

5.2 Section 131 sets out the three types of market feature that could have an adverse effect on competition: **structural features, conduct of firms, and conduct of consumers**. Our guidance says that there will often not be clear separation between structural features and those relating to conduct, and the evidence supporting a reference set out in this chapter covers both together, but here we summarise the features which in our view form the basis for a reference and meet the section131 test under these three heads. In addition we set out performance indicators (eg on commissions and pricing) which can be a useful supplement in assessing the case for a reference.

5.3 In the course of the consultation we received consultation responses from 22 bodies, consisting of six trade associations, four consumer organisations, eleven businesses and the FSA. All were received by the closing date of 30 November or shortly after.

5.4 In responding to the consultation, the majority of industry respondents expressed concern about the data, primarily the consumer survey data, on which the proposed decision on a reference was based. The underlying view appears to be that there is insufficient basis for the OFT's suspicion that competition in the PPI market is restricted. They argued that OFT relied too much on the 'negative data' from the consumer survey and failed to acknowledge the 'positive data' which showed consumer satisfaction with some aspects of the product. This data, respondents argued, is indicative of the market working well.

5.5 We acknowledge that PPI can provide worthwhile cover against unforeseen events that cause repayment difficulties and that it can offer valuable peace of mind whether or not a claim is made. However, looking at individual statistics on their own does not provide a true picture. When the data is interrogated and the evidence looked at holistically the picture which emerges is of a market that is not working well. For example, whilst the majority of consumers (61 per cent) thought PPI was value for money, 53 per cent of those paying for PPI monthly did not know how much they were paying and 60 per cent thought PPI was expensive. The apparent satisfaction with PPI needs to be seen in the context of poor consumer understanding and other indicators that the price may be too high. Alternative data was not provided by consultation respondents to dispute these findings. OFT's provisional decision to refer this market to the CC was based on an analysis of **all** of the evidence, not just the consumer survey.

5.6 The following describes the features that we suspect have an adverse effect on competition and the reasons for our concerns. We also summarise the main points made in respect of some of them by those we consulted and our responses to their points.

Structural features adversely affecting competition

Secondary product

5.7 PPI is a secondary (or even tertiary) purchase, typically bought only as a result of buying a primary product, which is the credit, its demand derived from demand for the credit product. While the mere fact of being a secondary purchase would not normally be a feature adversely affecting competition, our view is that the nature of this secondary market, in conjunction with other features, does make it one in this case.

5.8 While no one disputed that PPI was a secondary product one respondent questioned whether we had done enough to analyse the interaction between the sale of PPI and the primary credit product. This may be an area in which the CC could undertake further work.

POS advantage

5.9 The POS advantage is a key feature of the PPI sector. It is the feature to which most other features link in some way, and which appears to give rise most directly to low claims ratios and the other concerns we have that competition is adversely affected.

5.10 On average our business survey showed that 91 per cent of PPI policies are sold at the POS of the credit product being insured. Distributors who we spoke to indicated that it is common for 100 per cent of unsecured loan PPI policies to be sold at POS. Credit card PPI is least likely to be sold at POS (on average only 64 per cent of sales), but even there PPI tends to be sold via a follow-up exercise such as when the card is activated, which is directly linked to the sales process. We only came across one stand alone provider who sold stand alone credit card PPI cover and they indicated that the number of policies sold was small.

5.11 POS advantage appears weaker in the case of MPPI than it does for PPI on other forms of credit however at least one stakeholder indicated that the majority of MPPI is sold at POS. There is a stronger presence from stand alone providers in the MPPI market than in other PPI markets – although even in MPPI stand alone providers account for a small percentage of sales. Furthermore when purchasing a house, MPPI is vying with other products (eg life insurance, home insurance) for a slice of the consumer's limited purse – often pushing it a long way down the list of the consumer's priorities.

5.12 More generally, the absence of advertising reflects the POS advantage; if consumers are not actively shopping around for a good deal there is no need to advertise.

5.13 The POS advantage strengthens with the sale of single premium PPI. On the whole consumers pay for the single premium PPI by adding the cost of the PPI to the loan. Whilst the consumer could look elsewhere for credit to pay for the PPI, this would involve taking out a separate credit agreement – an unlikely scenario. Our consumer survey showed that 98 per cent of those who took out secured loan PPI (which is predominantly single premium) purchased the policy at POS. For unsecured loans, which again tend to be predominantly single premium, the figure is 91 per cent.

5.14 A few of the responses to our consultation have stressed the importance of the POS sales opportunity, stating that without it most customers would ignore the need for PPI or seek alternative insurance from elsewhere. We note this point but we remain concerned that consumers come to the POS without any prior consideration of the need for or the cost of PPI. This is a key feature which restricts competition in this sector. Furthermore, given the way the market currently operates, we are not convinced that consumers would find it easy to seek alternative insurance elsewhere.

Complexity of product makes comparisons difficult

5.15 Our research shows that shopping around is not easy. Although the concept of protecting credit payments in the event of accident, sickness or unemployment is a simple one, the complex nature of PPI makes comparison between different products difficult for consumers. There is a wide variety of contracts and prices, and PPI policies tend to include a relatively large number of terms and conditions compared with other financial products. There are wide variations in exclusions, product structure, the way benefits are paid and use of general terminology. Our own research found cover ranging from:

- Accident and sickness only, to
- Unemployment only, to
- Life, sickness, accident, unemployment some with added hospitalisation cover and carer cover.

5.16 Policies had different `waiting periods' before benefit can be claimed or paid (30, 60 or 90 days) with some benefits being accrued daily and some accrued monthly.

5.17 Such product differentiation makes it difficult for consumers to compare products on offer, even where these are aimed at similar needs. As a result consumers may pay more than is necessary and inevitably purchase, on occasion, inappropriate policies.

5.18 The issue of product complexities were also raised in research by Defaqto Limited[24] which highlighted the different terms used throughout the industry. Defaqto used the example of excess and waiting periods, explaining that to the lay person such terms may appear to describe the same thing, when in fact they do not. Defaqto found that products that appear to have the same waiting period before any benefit is paid can in fact be very different, and choosing the wrong type of policy could disadvantage consumers.

5.19 Respondents put to us that PPI is not a complex product at all and that it is misunderstood only because of low levels of customer interest and the way it is distributed. This may be the case and we accept that some customer apathy does exist, but given our own observations we are not persuaded by these arguments and we still believe that PPI is an inherently complex product.

5.20 We are aware that some in the industry have made efforts to simplify their products by adopting industry standard terms and to keep exclusions and waiting periods to a minimum. However this would need to be an industry wide initiative to be successful in helping consumers to choose confidently between different products.

Lack of product information prior to POS

5.21 Where consumers are well informed, and able to choose without facing sales pressure, they are in a position to make efficient choices. Their purchases will provide useful information to sellers about consumer preferences, which can then provide signals to potential entrants and possibly stimulate innovation. The existence of information asymmetries

[24] Payment Protection Insurance in the UK, Annual Review of the PPI market – February 2006 Defaqto Limited.

may result in making markets fail to work effectively, and price competition and quality of service may be reduced, even where there are many firms operating in the market.

5.22 Our research found a lack of advertising and marketing information before the consumer has decided to sign up for the credit (and the PPI), which makes shopping around for PPI all the more difficult. We noticed during the course of the study that whilst there was a mass of upfront marketing information readily available for consumers to read on the credit product, it was very different for the PPI element. Our research highlighted that while it was easy to obtain information about credit products from a lender's branch, information specifically relating to PPI was usually given very little attention in 'pick up ' leaflets and was quite often difficult to find. Lenders have argued that increasing the level of marketing of PPI within branches (face to face is the most popular sales channel for PPI) could simply confuse consumers.

5.23 Over the internet the picture is similar. Most credit websites we visited did have a section on PPI, but in some cases it was difficult to locate and more often than not we had to find the policy summary for details about the policy, and this was often located at the bottom of the page and could easily be missed.

5.24 Whilst it is possible to find information on cover, information about exclusions tends to be less easy to find and on occasions the way the text is worded could effectively discourage consumers from searching out information about exclusions.

5.25 We did come across some good practice of lenders of unsecured loans giving consumers upfront information about the cost of PPI, setting out examples of the cost (monthly and/or total) of the credit AND the cost of the PPI in marketing literature. However, this was not the situation across the board. Two consultation respondents argued that the total costs can be found in the credit agreement which the customer has to sign twice if the loan is funding the PPI. This, along with FSA rules on disclosure, should ensure that all consumers are able to determine the total costs. However this was offset by the views of some consumer organisations who were less convinced of the merits of the dual signature. Our view is that this comes at a late stage in the transaction. We note that marketing literature, which consumers could use as a starting point for weighing up whether they would get a good deal, often contained no information about the cost of PPI. Adding PPI to the deal may significantly alter the total cost of a loan.

5.26 As presently structured PPI policies are complex products which are relatively difficult for consumers to understand or assess. While consumers from our survey, on the whole, appeared to be satisfied with the information that they received on PPI, it was telling that, when probed, many knew little about what they were paying for. For example 53 per cent of those paying for PPI monthly[25] did not know how much they were paying; 34 per cent thought that there were no exclusions on the policy (and we saw no policies without exclusions) and 38 per cent did not know whether the policy contained any exclusions. Of the 27 per cent of consumers who said there were exclusions on their policy only 48 per cent could name these (13 per cent of all PPI holders). Consumers are asked for a quick decision on a complex product (usually at POS) and given the lack of pre-POS information it would be very difficult for them to work out whether the cost (premium) represents value for money.

5.27 Pre-existing conditions are a common exclusion of which consumers need to be aware, yet insurers report that these are the main reasons for turning down claims, which suggests that the consumer did not know or understand what these exclusions meant. Defaqto highlight the fact that consumers sometimes do not attach relevance to pre-existing medical conditions as they may be unaware of what such `conditions' are. This could come up as an issue only once they try to claim and then discover that the policy they have purchased perhaps does not live up to expectation.

5.28 We found that providers of PPI are not particularly effective at putting across key information about their products. We contacted 24 unsecured loan providers by telephone and not one mentioned the exclusions

[25] 91 per cent of current PPI holders paid monthly.

associated with their relevant PPI policies without a prompt from the caller. Not one of the unsecured loan providers mentioned to our researcher that the policy was based on a single premium without a prompt. Just under one third (30 per cent) of unsecured loan providers detailed at the quotation stage the criteria required to qualify for PPI.

5.29 In some cases, particularly with secured loans, we found very little information given out unless we were prepared to go through an application stage. Even at this stage we are unsure whether a consumer would be provided with sufficiently clear information required for them to make an informed choice, particularly given the FSA's thematic work which showed that providers place too much reliance on written disclosure.

5.30 Consultation responses suggest that providing more information following the application is fairly common practice, applying to more than secured loans. One respondent, for example, argued that the mystery shop was of limited value since mystery shoppers are obliged to discontinue their inquiries before the sales process is complete. OFT was not, therefore, in a position to know to what extent the provider would have provided key information about PPI before conclusion of the contract, if the full sales process had been completed.

5.31 Our view is that providing information at such a late stage will typically be too late, as at that time, to all intents and purposes, the consumer has been 'captured' possibly having been credit checked and approved for a loan, and hence may be reluctant to refuse the offering of PPI because of a perceived obligation to carry the process through. It is not difficult to reach the conclusion that the timing of information provision, and the way in which it is presented, is likely to play an important role in consumers' choices.

5.32 Nevertheless, as mentioned above, the FSA's rules require consumers to be given key information about the PPI policy in good time before the contract is concluded. If these were complied with, this ought to improve the information available to consumers to help them consider alternative products.

5.33 Some parties questioned the extent to which information asymmetries exist, claiming that providers of PPI are improving their systems and processes in order to make PPI more transparent for their customers so aiding them in purchasing a product that will be suitable for their needs. We have already acknowledged that the industry is committed to improving consumer education but we are not convinced that such measures go far enough (not least because they tend to be available at a late stage in the transaction) to remedy the competition problems that exist in this market.

5.34 Other consultation respondents argued that poor customer understanding and lack of information can be applied to any number of general insurance products, not just PPI, and that even the most financially astute customers are not clear about the exclusions on their policies and how to shop around effectively. We are not particularly swayed by this argument and believe that PPI differs from most other general insurance products in terms of the limited choices available to consumers at the point at which they buy the product, the fact that it is a secondary product with little thought given to the product itself or the risk until it is sold at POS, little or no shopping around and the limited upfront information available even if the consumer wanted to shop around.

Low level of switching

5.35 It could be said that in the absence of pressures from competitors, the careful weighing up of value for money by consumers before buying, or the risk of consumers cancelling the PPI, could exert some pressure on prices. However, where PPI is purchased at POS it is doubtful that any careful weighing up takes place (or indeed could take place given the limited information available). Nor do most consumers appear to change their minds after the event. Our survey shows that most consumers were content with their PPI purchase even if their understanding of it was poor. Few consumers cancel (14 per cent). Consumers may have been deterred by less than proportionate refunds of premium on single premium policies. Just over one quarter (27 per cent) did not know whether they could cancel and just under one in ten (nine per cent) did not think that they could cancel the policy. The main reason given for cancelling a policy was because it was too expensive (43 per cent) or because the holder's situation had changed (39 per cent).

5.36 Of the small number who did cancel, only 16 per cent switched to another policy (the majority of which were MPPI consumers). However we saw no evidence that those who switched did so in order to get a better deal. As we said earlier, a lack of comparable information on other PPI products could act as a barrier to switching and the pricing of single premium policies (the consumer may not receive a pro rata refund) may effectively prohibit switching given the potentially high redemption costs.

5.37 It seems unlikely that present levels of cancellation or switching by consumers in this market exert any serious pressure on the prices of PPI.

Difficulties for stand alone providers

5.38 Stand alone providers, who might otherwise be thought to offer a competitive pressure, have indicated that given the POS advantage, they have difficulty accessing consumers and face substantial start-up and marketing costs in order to try to attract sufficient volume of consumers to trade successfully over the long term. Their main sales channel is the internet. However, the Harris International work commissioned by the Finance and Leasing Association (FLA)[26] showed that web searches for PPI are low. Our recent business survey did not ask distributors or lenders about the proportion of PPI sales via the internet; however we did ask a similar question during our consultation for the 2005 super-complaint. Although few respondents were able to provide much data on this, most told us that only a small number of PPI policies were sold online and that these were mostly stand alone products.

5.39 Stand alone PPI providers tend to focus on MPPI where policies are more likely to be sold through intermediaries and consumers seem to be more willing to shop around. However, even MPPI stand alone providers have

---

[26] *Payment Protection Insurance Research* - November 2005.

a limited presence. Council of Mortgage Lenders (CML) data[27] shows direct sales dropping from six per cent in 2002 to only one per cent in 2005.

5.40 Intermediaries have a stronger presence in the MPPI sector and could, in theory, shop around for their clients, accessing the whole market. It is not clear that this happens in practice. In fact our consultation produced contradictory evidence. Anecdotal evidence suggests that many act in a similar way to distributors ie they do not offer consumers a choice of PPI products. On the whole they sell linked (to the credit) products (often just one) rather than picking from, say, a panel of suppliers. This appears to be a more practical way for them to operate. One respondent argued that this is beneficial to the consumer who would benefit from a better quality product with preferential terms. But it also means that they are not acting as an alternative sales channel to distributors and the POS advantage is, albeit slightly weaker, nevertheless still operating.

5.41 For credit card PPI, where premium is normally based on the account balance, not having access to that balance could be a significant barrier to entry for stand alone providers. Whilst one stand alone provider appears to have found a way around this based on an allotted level of monthly cover, they have themselves indicated that this is a small part of their business. One consultation respondent demonstrated the difficulty of designing alternative products to PPI by arguing that this particular credit card product is neither innovative nor PPI but is simply another income protection product. Nevertheless, it may indicate potential for innovation and improvement and, in the long term, offer the possibility of a competitive pressure. Our consumer survey found that 94 per cent of credit card PPI purchasers bought it directly from their credit card provider.

5.42 The POS advantage also means that insurers have themselves been unable to provide an alternative competitive pressure by selling direct to consumers. At least one major insurer has tried to sell directly to the

[27] CML research 2/5/2006 Table PPI3 Mortgage payment protection policies in force.

consumer, but was unable to achieve reasonable penetration and pulled out of direct sales.

Alternative products do not appear to provide competitive pressure

5.43 Products such as income protection policies are not considered to be direct substitutes in the sense of posing a constraint on PPI prices. As we indicated earlier, they differ in their terms and conditions (tending to be longer term in nature and varying in the benefits paid eg they do not cover unemployment). In any event, given the complexity of the PPI products and the lack of comparable information on PPI which we discussed earlier, it seems unlikely that consumers would look wider than PPI when considering the risk. Hybrid products such as the Post Office's Lifestyle Protection product may offer a competitive alternative in the long run but it is too early to assess their impact and it has been argued that they are not actually PPI products but income protection products.

5.44 One respondent said that we had not done enough to come to this conclusion and in addition that we had not considered the potential for supply-side substitution.

5.45 We disagree. As stated above we are not persuaded that other forms of protection product are sufficiently substitutable on the demand side to offer a strong competitive constraint on PPI providers. Overall the prospect for supply-side substitution appears to be limited.

Vertical integration

5.46 Vertical integration is a significant feature of this market with around 60 per cent of the market undertaking both the underwriting and the distribution of PPI within the same group. We suspect that this may reduce the level of direct competitive pressure on those organisations in respect of rates or product design.

5.47 One respondent told us that vertical integration is the **key** feature of this market and our market study document recognised that it may reduce the level of direct competitive pressure on those organisations in respect of rates or product design. However, while we have said that vertical integration is a significant feature, we do not believe that it is the **key** cause of problems in PPI. In our view the main issue remains the POS advantage. Vertical integration may be the result of the problems as banks try to make sure they capture the significant PPI profits or it may be an efficient way to manage the risk, for example. The CC will be able to explore this further.

Conduct of firms adversely affecting competition

Competition on credit product only

5.48 The striking feature of these markets is that, with very few exceptions, competition does not take place on PPI at all. Rather, competition is on the sale of the credit product and only a single insurer's PPI product is offered for sale on whatever terms the lender makes available. It appears that it is obvious to all lenders that selling an add-on product for which there is no effective competition is to the advantage of each of them, and all they need to do is to avoid disturbing that situation.

PPI automatically included in quote

5.49 Our research found that nearly all unsecured loan providers (87 per cent) who we contacted automatically included PPI when quoting for the loan. For MPPI the figure was lower at 40 per cent. This does not mean, as one respondent pointed out, that the PPI was compulsory, but it does increase the *potential* for consumers to interpret it that way and increases search costs/reduces the likelihood of consumers wishing to shop around for the PPI and the credit separately.

5.50 The FSA's rules require the consumer to be given the price of PPI separately from the price of the credit in good time before the contract is concluded. Again if these were complied with, this ought to improve the information available to consumers to help them make informed decisions.

Potential to mislead

5.51 A particularly worrying finding was that nearly a third (30 per cent) of consumers in our survey who went on to buy PPI assumed, were told, or were given the impression by the distributor that **taking out the PPI would help the application for credit**. The FSA's rules require firms to treat consumers fairly and to communicate information in a way that is clear, fair and not misleading. It is difficult to see how giving such impressions would be consistent with these rules. Whilst the number who were told by the supplier was small it is disturbing that something about the way the market is operating leads consumers to make these kinds of assumptions. We believe that there is an onus on lenders to make clear that that is not the case; and that failure to do so is a feature adversely affecting competition.

Use of a headline APR

5.52 The OFT consumer survey found that when choosing a provider and a product, the **APR rate** (for the credit product) is usually the only stated discriminator, effectively ignoring any differences in the cost of the PPI or in the cover provided.

5.53 The results of our `mystery shop' exercise suggest that it is not uncommon for some distributors to make use of a headline APR[28] to draw people into a credit deal. Consumers appear to look at the APR (the cost of credit) and not at either the cost of PPI or the cover it provides. Results from our consumer survey indicate that 22 per cent chose the product because of the APR and 16 per cent because of the 0 per cent interest or finance deal. The actual APR for the credit is not necessarily a good indicator of the best deal, once the PPI gets factored in.

5.54 Research by Defaqto also found that some loans which have very low headline APRs become much more expensive when PPI is added to the loan. Our own research found evidence of this too.

[28] Rate that is advertised as available but may not be what is actually offered by an individual lender.

5.55 For example, one distributor advertised an APR of 6.1 per cent for a five year unsecured loan of £5000. Our researcher was offered an actual rate of 7.4 per cent which changed to an approximate equivalent 22 per cent when PPI was added (as a single premium), a difference of 14.6 per cent. Even where the headline rate was the same as the actual rate offered, the addition of PPI can still make a big difference to what the consumer eventually pays. For example, one distributor offered a low APR of 5.7 per cent for a similar loan of £5000. The approximate equivalent APR including PPI was 13.7 per cent, a difference of 8 per cent.

5.56 The issue grows in significance when take- up rate of PPI is high. Anecdotal evidence and responses to our business survey indicate that take-up rates for PPI on secured loans are high (perhaps as high as 70 per cent). When a consumer can determine neither the total cost of the loan with PPI added nor the quality of cover, the potential for them to get value for money is significantly reduced.

5.57 Whilst we were unable to reach a firm conclusion on whether cross-subsidy between PPI and the credit[29] is happening in this market it is worth noting that, if it is, a possible outcome is that it could exacerbate the extent to which consumers are misled by the APR about which is the best credit deal and PPI deal.

Refunds on single premium policies

5.58 If the underlying loan is settled during the term of the policy or the PPI policy is cancelled, a refund of a proportion of the premium will usually be given. The basis of the calculation will vary but it reflects the fact that the insurer's liability reduces as the term of the loan progresses. The FSA has indicated, and trade associations have agreed, that firms should not include nil refund terms in their PPI policies when a consumer cancels a policy for any reason, except where a claim has already been paid under the insurance policy or the consumer has instead chosen to take continuing PPI cover for another loan.

---

[29] Offsetting low margins on the credit offering with profits generated from the sale of PPI.

Conduct of consumers adversely affecting competition

Lack of shopping around

5.59 Consumers tend not actively to seek out information on PPI, nor do they shop around, particularly by comparison to the way they shop for the credit. They would appear to regard search costs on such a complex product as too high against the expected cost of PPI: but search is already more difficult because of the ways firms make information available.

5.60 Whilst 40 per cent of respondents to our consumer survey claimed to have shopped around for their credit product, just 12 per cent shopped around for the PPI.

5.61 Whilst 26 per cent of MPPI holders claimed to have shopped around for PPI and 13 per cent of those with PPI covering secured loans, just 5 per cent of credit card holders with PPI, 3 per cent of store cards holders with PPI and 5 per cent of those with PPI on unsecured loans had shopped around for their PPI. Given that unsecured loans make up a large/majority share of the PPI market, it is of particular concern that only five per cent of consumers shop around for this product.

5.62 Many within the industry indicated that consumers are not prepared to look beyond the PPI product that is offered by the credit provider. We were frequently told by stakeholders that PPI is a product which is sold not bought ie consumers rarely set out to buy this product on its own. Instead cover is promoted in some way by the distributor of the associated credit. PPI is a secondary and even a tertiary product. This lack of shopping around might explain why, when consumers do take out PPI, the vast majority take it out with the lender who sells the credit. The consumers who indicated that they did shop around tended to be MPPI buyers. The general lack of shopping around limits the scope for competition to work to the benefit of the consumer.

5.63 Discussions with the industry suggest that consumers decide whether they can afford the PPI they are offered (in relation to their overall monthly payments) rather than whether it represents good value in comparison to other products or against bearing the risk themselves.

Performance information indicating competition is adversely affected

Low claims ratios

5.64 We define the claims ratio as claims paid as a percentage of gross written premium (GWP). The market is characterised by extremely low claims ratios, compared with all other insurance products. Our business survey of insurers shows that the mean claims ratio in 2005 was highest for first charge MPPI (33 per cent); it was18 per cent for unsecured personal loans PPI; just 12 per cent for retail credit PPI; 22 per cent for motor finance PP; 14 per cent for credit card PPI; and 16 per cent for secured loan PPI. This represents a mean claims ratio of 20 per cent for all PPI policies. This was broadly in line with the figures extracted from our financial pro-forma exercise which show an overall claims ratio for the sector of 19 per cent in 2005. Over 50 per cent of insurer profits appear to be earned from unsecured personal loan PPI. These figures are low compared to comprehensive motor insurance (82 per cent of GWP), household insurance (54 per cent of GWP), pet insurance (72 per cent of GWP) and medical insurance (80 per cent of GWP).[30]

5.65 Respondents to our consultation questioned the validity of comparing claims ratios on PPI across a host of general insurance products citing differences in characteristics. While we appreciate that it is difficult to draw direct or precise comparisons with other insurance products, claims ratios of below 20 per cent for PPI compared to ratios of between 54 per cent and 82 per cent for other general insurance products, are sufficiently different to be beyond questions of differences in comparability or risk. Whilst claims ratios for MPPI are higher they are still notably lower than for other general insurance products.

5.66 Respondents also argued that we should not have too great a regard to claims ratios as they are cyclical, affected by macroeconomic factors,

---

[30] Larger insurer firms, FSA return for the accident year 2005.

reflect different cost structures on different types of insurance, and may be partly offset by cross-subsidy between credit offering and PPI. This has been a common argument throughout the study but despite numerous opportunities and specific requests for information, we have not been provided with any evidence to show the economic cycle at work in PPI. Nor have we been provided with evidence that premiums are set aside for downturns in the economy. Contract terms mean that the industry exposure to a downturn is limited - single premium contracts are limited by their length (five years maximum) and annual premiums are reviewable.

5.67 Our view is that with such low claims ratios when compared to other insurance products, and with no evidence to suggest costs are high, it seems reasonable to assume that distributor profitability is sizeable with little evidence that this is being competed away. We explore this a little further below.

Potential for sizeable earnings

5.68 Possible cross-subsidy between PPI and credit-related income in relation to unsecured personal loans and secured loans, profit sharing[31] and common cost issues make analysis difficult, and whilst we have attempted to establish where profits are going, most distributors were unable to separate out the element of their costs attributable to PPI products, which makes assessment of profitability very difficult.

5.69 Based on the financial information received, the claims ratios reported by insurers declined from around 27 per cent to 19 per cent between 2003 and 2005. However, the benefit of this appeared to pass to distributors,

[31] Another issue is that profit share arrangements are sometimes in place between insurers and distributors. Consequently some of the risk of losses will effectively transfer to distributors, especially if there is a 'claw back' arrangement, if required against prior year profit share. This means that the relationship is more complicated than if insurers were bearing all the risk.

as commission paid as a proportion of net earned premiums increased by around 13 per cent from 52 to 65 per cent over the same period.[32]

5.70 In the absence of cost data, no estimate can be made of distributors' profitability. However, claims ratios of around 20 per cent leave over 80 per cent of GWP to cover the costs and profits of insurers and distributors.

5.71 It was noted in the consultation that we had not conducted a full scale profitability exercise to support our argument. OFT is a first stage investigator. The CC may wish to explore this area further as part of its investigation. However, we believe it was reasonable for OFT to base our conclusion that the potential for some in this sector to earn sizeable profits is substantial on claims ratios, commissions and a limited profitability exercise.

High commission rates

5.72 The evidence from our survey of insurers suggests that commission rates paid by insurers to downstream intermediaries (distributors and non-lending intermediaries, including profit sharing deals) look to be high by comparison with other general insurance products. For example we have anecdotal evidence to suggest that commissions paid by motor insurers can be as low as 10 per cent. By contrast, our business survey suggests that average commission rates for single premium PPI policies vary from 50 per cent of GWP for first charge MPPI to 67 per cent of GWP for those selling motor finance PPI. The average commission rate for all single premium PPI policies was 59 per cent. Rates for single premium second charge mortgage, unsecured loan and retail credit PPI were 66 per cent, 59 per cent and 61 per cent respectively.

5.73 Average commission rates for regular premium PPI policies varied from 35 per cent for first charge mortgages to 70 per cent for retail credit. The average commission rates were typically lower for regular premiums than single premiums, excepting retail credit PPI; with the average rate

[32] From our financial pro-forma.

for all regular PPI polices being 53 per cent.[33] One consultation respondent indicated that 'the commission level earned by lenders is the single biggest deficiency with the PPI market at present'.

Prices for PPI differ greatly which cannot be accounted for by differences in quality

5.74 Our analysis confirmed the presence of price differentials, which could not be accounted for by differences in cover offered.

5.75 Obtaining comparable information in order to reach this conclusion was actually quite difficult as PPI is complex. The wide range of policies on offer and the lack of clear information did not make it easy for an OFT researcher who knew what he was looking for. It is difficult to see how a consumer, with limited knowledge of PPI, would fare better. Nevertheless, we were able to ascertain that prices for PPI differ greatly, and to an extent which cannot be accounted for by differences in quality. This applies particularly to unsecured personal loans and credit cards, although less so for first charge MPPI. For example, we found that for a £5000 unsecured loan over five years, monthly PPI repayments for an accident, sickness and unemployment (ASU) policy range from £16 to £40 with little obvious difference in the cover provided. The variation in PPI repayments for a £100000 20 year mortgage was less extreme with £32 a month for the cheapest ASU policy and £45 for the most expensive (though the most expensive is still 40 per cent more than the cheapest).

5.76 In 2004 Datamonitor[34] surveyed 50 firms providing PPI for unsecured personal loans and found that the most expensive policy premium was almost three times greater than the cheapest available PPI policy premium. London Economics on behalf of OFT recently carried out a similar analysis of more up to date Defaqto information (2006) on the cost of PPI covering a £5000 unsecured personal loan over four years.

---

[33] From our business survey.

[34] Datamonitor UK Creditor Insurance 2004.

The cost of the most expensive cover was nearly four times more expensive than the cheapest. In the absence of a higher quality product in return for a higher price, it would appear that consumers are receiving poor value for money and the market is not serving its function of keeping prices in check.

Appropriateness of a reference

5.77 Given our view that the section 131 test for making a reference is met, the decision on whether to make a reference rests on the exercise of the OFT's discretion. The OFT's guidance on market investigation references sets out four criteria that must in our view, be met before we decide to make a reference:[35]

- Proportionality – the scale of the suspected problem, in terms of its adverse affect on competition, is such that a reference would be an appropriate response to it
- Availability of remedies – there is a reasonable chance that appropriate remedies will be available
- Alternative powers – it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT, and
- Undertakings in lieu – it would not be more appropriate to address the problem identified by means of undertakings in lieu of reference.

These four factors are considered below.

[35] OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1.

Proportionality

5.78 A critical factor in assessing whether a reference is appropriate is whether it is proportionate to the scale of the concerns identified. The OFT guidance identifies three criteria as relevant to whether adverse effects on competition are significant, and thus whether a reference to the CC may be appropriate. These three criteria are in our view met by the supply of PPI.

5.79 First, we recognise that a reference to the CC would have considerable resource implications for the CC itself, and impose a substantial burden on the businesses affected. The market for PPI in the UK is however, worth some £5.5 billion annually with around 6.5 to 7.5 million policies being taken out annually. The benefits of remedying any adverse effects which might be found to exist could, therefore, be expected to outweigh these costs: indeed consumer detriment appears to be a significant fraction of the total market value.

5.80 Second, a significant proportion of the sector is affected by the features that prevent, restrict or distort competition: the features identified generally apply across the sector. A number of respondents argued that MPPI should be excluded from the reference, as given the differences in the way the MPPI market operates compared to other types of PPI a reference would be a disproportionate response to the problems identified in that market. The points raised are discussed in more detail in the next chapter. However, our view is that while some of the features, such as the POS advantage, appear to be less marked within the MPPI market they are still present and the evidence supports the need for the CC to have a closer look at MPPI.

5.81 Third, the features identified as adversely affecting competition are unlikely to be short-lived: while there is some evidence that the industry is taking steps to improve the situation for consumers by, for example, providing better information, they are not in our view sufficient to address all of the features we have identified or to lead to major improvements to competition in the market.

Availability of remedies

5.82 There is no statutory requirement for OFT to come up with a set of remedies; however our guidance indicates that we need to be satisfied that there is a reasonable chance that appropriate remedies will be available.

5.83 We have thought hard as to whether there are potential remedies available to meet the competition concerns we have outlined (and we are aware that the industry itself and the FSA have considered if there are routes to making the market operate more competitively – in addition to their primary dialogue on conduct of business concerns). We believe there are potential remedies that might contribute to such a solution but identifying the best combination is far from straightforward:

- All the indications are that a number of measures would be needed: there is no magic bullet

- Interactions have to be worked through: for example, how much effect will some other remedies have if consumers cannot at the same time be stimulated to shop around and make informed choices?

- Some possible measures would have significant trade-offs: for example, requiring separation of PPI sale from credit sale (to address POS advantage) would appear likely to increase costs

- While preferred remedies would naturally be aimed at strengthening competition in the market, realistic assessment is needed on how far that is achievable; and perhaps alternative measures are needed to address the consequences if competition is likely to remain limited

- The optimum set of measures on PPI may differ in the different credit product sectors.

5.84 Many of the industry responses to the consultation drew attention to the steps already being taken by the industry, most of which focus on improving consumer information/education, as a means of addressing the problems identified. Whilst these steps are to be welcomed they are not, in our view, sufficient to address all of the features we have identified or to lead to major improvements to competition in the market. Consumer organisations who responded to our consultation made it clear that they do not believe merely providing consumers with more information is going to be the **only** solution.

5.85 In addition to drawing attention to the various industry initiatives as a means of remedying the problems identified, a number of respondents put forward ideas for/views on remedies. We make no comment here on the merits of these responses, but they demonstrate the difficulties and complexities in finding suitable remedies in this market. Ideas/views include (note this is not an exhaustive list and is set out in no particular order):

- Unbundling/de-linking – ie separating out the sale of the PPI and the credit. One respondent was very much in favour of this idea, arguing that consumers would benefit as it would enable them to purchase those elements of cover which best suit their needs and their circumstances. This view was not shared by all, with many industry responses expressing concern about the impact of this on the market, arguing that it would result in a significant reduction in take-up of PPI

- At pre-contract stage

  - Separating out PPI cost (premium plus the interest) from the total cost of borrowing

  - Details of monthly payments included with and without PPI

- Contract stage (POS)

  - (Regardless of whether cost is included in the loan) PPI should always be signed for separately in order to reduce the risk of consumers not knowing what they signed for

- Consumers to be informed that alternative providers of PPI exist and that there is no requirement to purchase PPI offered by the distributor

- Price comparison tables – for the cost of traditional PPI v stand alone PPI.

5.86 We have stated previously that OFT is a first stage investigator and it is the CC's role, if it finds that there are adverse effects on competition, to do the detailed analysis of the causes and devise the optimal suite of potential remedies taking into account interactions, which would be for further detailed consultation. At least some of what may be required is likely to involve the CC's order-making powers to impose remedies or at least to orchestrate their implementation.

Alternative powers

5.87 We have considered whether it would be more appropriate for the OFT to use alternative powers to deal with certain features of the market(s) identified above. None of the evidence points to the possibility of using powers available to OFT to deal with the features identified. There is no indication that any individual agreement or conduct meets the threshold for enforcement of Article 81 and/or Article 82 of the EC Treaty or of the CA98, nor are we aware of any breaches of the Consumer Credit Act 1974 to justify enforcement action.

5.88 A recurring argument arising from the consultation was the widely held view that the work of the FSA has dealt or will deal with the issues the OFT has identified. Respondents argued that in reaching our provisional decision OFT failed to take account of this work and the impact it might have on the market and that it would take time for the benefits of this work to be realised and a reference to the CC therefore would be unnecessary.

5.89 OFT and the FSA have liaised closely on PPI and in reaching our decision the OFT has taken account of the work which is being done to address the issues identified during the course of the two rounds of thematic work carried out by the FSA. Alongside its continuing thematic programme in this market, the FSA is currently reviewing its conduct of business rules for PPI markets as part of its more general review. The focus of the FSA's work is on improving selling practices and standards and it will be designed to ensure consumers receive suitable products that meet their needs. It cannot remedy the range of problems relating to competition in the sector that OFT work has identified.

5.90 We are concerned that the industry has failed to appreciate the different but also in part overlapping roles of the OFT and FSA. There are a number of questions on how far FSA powers might form part of a package of measures to encourage the market to operate more competitively.

5.91 In practice, even where there is some degree of overlap of FSA and competition authority powers, it may be more appropriate for the competition authorities to address problems that derive primarily from pricing and competition concerns. The FSA has a range of powers it can use to achieve an appropriate degree of consumer protection, and when it intervenes in selling practices for regulated products it can do so in ways which strengthen competition. However, given that the FSA does not have a statutory objective to promote competition and the competition concerns we have about the PPI market, we do not believe that the FSA's consumer protection powers, nor its current work programme on PPI markets make a market investigation reference inappropriate.

Undertakings in lieu of reference

5.92 Finally, we needed to take account of any undertakings in lieu (UIL) of a reference that are offered by the industry to address the concerns raised without the need for a market investigation reference. Whilst a number of respondents mentioned UIL, primarily in the context of the industry self-correcting measures being a possible option, no UIL were put forward during the consultation. In addition, given the industry wide-nature of the features we have identified and the number of parties which operate in it, it is not clear to us that sufficient consensus on any possible UIL could have been reached to enable us to accept UIL[36].

Conclusions on the case for a reference

5.93 Taking account of the relevant factors outlined in the OFT's guidance document on market investigation references, and following the consultation carried out in accordance with section 169 of the Act, we believe that the statutory test for a reference is met and the balance of arguments points in favour of making a reference to the CC under section 131 of the Act.

---

[36] In considering any UIL we are required by statute to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effects on competition.

6 SCOPE AND TERMS OF REFERENCE

6.1 Having concluded that there is a case for a reference to the CC, the OFT has considered the appropriate terms of this reference, taking account of the features we have identified. Section 133(1) of the Enterprise Act requires the OFT, when making a market investigation reference under section 131, to set out a description of goods or services to which the feature or combination of features concerned relates. In addition section 133(2) permits, but does not require, the OFT to frame the reference so as to require the CC to confine its investigation into the effects of features of markets in the UK for goods or services of a description specified in the reference to the effects of features of such of those markets as exist in connection with either: a supply, of a description specified in the reference, of the goods or services concerned, or, an acquisition, of a description specified in the reference, of the goods or services concerned.

6.2 A number of respondents commented on what the scope of the reference should be. Comments from respondents primarily fell into two groups:

- Whether an investigation should include store card PPI
- Whether an investigation should include MPPI.

Store card PPI

6.3 Store card PPI has recently been looked at by the CC[37] in the context of the store card market investigation reference and there are therefore arguments that it would not be appropriate to include it within the scope of the proposed reference. (We consulted on the issue in our consultation on this reference).

---

[37] http://www.competition-commission.org.uk/inquiries/completed/2006/storecard/index.htm

6.4 Only one respondent argued that store card PPI should be included in the scope of a reference to the CC for a number of reasons including the need to ensure that the PPI market is looked at as a whole, that the conclusions reached in OFT's market study apply equally to store card PPI, that different requirements relating to store cards and credit cards could cause confusion and concerns that the remedies arising from the CC's investigation of store card PPI in the context of the store card market investigation will not be sufficient to ensure greater choice for consumers. In addition they questioned the extent to which parties could easily divide data between different types of PPI or might want to draw attention to similarities and dissimilarities between store card and other PPI. However these arguments formed a minority viewpoint, with many of the responses to our consultation favouring the exclusion of store card PPI from the terms of reference.

6.5 Although we acknowledge the legitimate concerns of those who favoured the inclusion of store card PPI, we believe that, on balance, the arguments against inclusion outweigh the reasons for inclusion.

6.6 We do not believe that excluding store card PPI from the terms of reference would prevent the CC from comparing store card PPI to other types of PPI. Indeed one industry respondent specifically made this point during the consultation. On the question of data division, one industry player confirmed that for them at least, excluding store card PPI causes them no significant difficulties in data division and we have found no problems in this respect during the course of our inquiry

6.7 We do not consider that the exclusion of store card PPI from this proposed reference would cause difficulties for the CC in the conduct of its inquiry and it would remain open to the CC to define the market as it considered appropriate.

6.8 As explained above store card PPI has already been covered by an earlier CC inquiry and the remedies do not take effect until 1 May 2007[38]. We are therefore of the view that it would be disproportionate to include

[38] http://www.competition-commission.org.uk/inquiries/completed/2006/storecard/index.htm

store card PPI in the terms of another proposed reference, and we do not consider that this will prevent the effective conduct of the market investigation of PPI under the Terms of Reference at Annex A. Therefore we have decided to exclude store cards PPI from the terms of reference.

MPPI - Arguments for limiting the terms of reference

6.9 Respondents argued that there are a number of reasons why MPPI should not be included in the terms of reference. Primarily these were:

- That the POS advantage is weaker
- That many of the concerns OFT set out do not apply to MPPI – particularly the information features which, it is argued, are addressed by Mortgage Conduct of Business rules
- That PPI has an important role in the broader sustainable home-ownership strategy
- That our view of the role of mortgage intermediaries in facilitating competition is not entirely correct. It was on this point that the consultation responses were contradictory. Some argued that intermediaries do facilitate shopping around, but at the same time it was also acknowledged that it is common for intermediaries to use one provider on a regular basis in order to secure preferential terms and price for their client.

6.10 Taking into account the consultation responses we have not changed our views on the inclusion of MPPI. We have already indicated that whilst the features we identified appear less marked for MPPI they do nevertheless still exist. The conflicting arguments on whether intermediaries are facilitating competition merely underline the need for MPPI to be explored further by the CC. We note the point that MPPI has a role in the broader sustainable home-ownership strategy, but stress that it would not be in the consumers' interest if this important cover were over-priced. Moreover, improving affordability ought to increase take-up.

6.11 OFT is a first stage investigator and a more detailed look may lead either to a conclusion that there are no adverse effects from features that the CC identifies as relating to MPPI or to a conclusion that different remedies are appropriate for MPPI (see paragraph 5.83 above about remedies potentially being different for the different credit products) but at this stage, whilst we have taken on board the arguments which have been put to us, we still have reasonable grounds to suspect that features of the MPPI sector of the market prevent, restrict or distort competition.

Other views of respondents

6.12 One respondent argued that there are differences between home shopping PPI and other types of PPI which mean that home shopping PPI should be excluded from the reference. These differences include a wider breadth of cover, longer time for the consumer to consider whether to purchase PPI and variable cover over the long term. Our view is that PPI varies from product to product and the degree to which the features we have identified apply across the various products will also vary. We do not believe that the differences between home shopping PPI and other types of PPI are sufficient to warrant exclusion from the reference. The optimum set of measures to address problems are likely to vary between products and this will need to be explored by the CC.

Conclusions on terms of reference

6.13 We have carefully considered the arguments made by respondents, particularly in relation to whether there should be the inclusion of either store card PPI or MPPI in the terms of reference.

6.14 Based on the reasons set out above we consider that the supply of all payment protection insurance services to non-business customers in the United Kingdom should be referred for the CC's investigation with the exception of store card payment protection insurance services. The terms of the market investigation reference are set out in **Annexe A.**

A TERMS OF REFERENCE – PAYMENT PROTECTION INSURANCE

The OFT, in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002, hereby makes a reference to the Competition Commission for an investigation into the supply of all payment protection insurance services except store card payment protection insurance services ('the reference services') to non-business customers in the United Kingdom.

The OFT has reasonable grounds for suspecting that a feature or a combination of features of the market or markets in which the reference services are supplied prevents, restricts or distorts competition in connection with the supply of the reference services in the United Kingdom.

For the purposes of this reference:-

'payment protection insurance services' means insurance services supplied for the purpose of protecting a borrower's ability to maintain credit repayments in the event that the borrower becomes unable to maintain the repayments due to accident and/or sickness and/or unemployment and, under some policies, death.

'store card payment protection insurance services' means payment protection insurance services supplied for the purpose of protecting a store card holder's ability to maintain repayments due under the store card agreement.

'store card' means a payment card issued with respect to the purchase of the goods, services or facilities of only one retailer or of retailers who are members of a single group of interconnected bodies corporate or who belong to a store card network or who trade under a common name and which has both associated retail benefits and permits the holder of the payment card under his contract with the issuer of the card to discharge less than the whole of any outstanding balance on his payment card account on or before the expiry of a specified period (subject to any contractual requirements with respect to minimum or fixed amounts of payment).

'payment card' means a card, the use of which enables the person to whom it is issued ('the holder') to discharge his obligation to a supplier in respect of payment for the acquisition of goods, services or facilities.

'issuer' means a person who contracts or proposes to contract with a consumer for the issue of a store card.

'credit' means any form of financial accommodation.

'non-business customers' means individuals purchasing payment protection insurance in their own right and not for the benefit of any business or company.