
Payment protection insurance market study: emerging issues

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Introduction

1. The aim of this paper is to set out the emerging issues which have arisen during the course of the market study based on the information gathered. We are providing the industry with an opportunity to comment on the issues identified and to offer further views.

Background

2. On 13 September 2005 Citizens Advice (CitA) submitted a super-complaint to the Office of Fair Trading (OFT) about payment protection insurance (PPI). The super-complaint was based on the CitA report *Protection racket: CAB evidence on the cost and effectiveness of payment protection insurance*. In its super-complaint CitA stated that the evidence presented in its report suggests that features of the PPI market are seriously harming the interests of consumers.
3. In response to CitA's super-complaint the OFT decided to carry out a market study into PPI, which was launched on 3 April 2006.¹ The main focus of the study has been on how well the market delivers good value for consumers. As set out in paragraph 3.18 of the OFT's Guidance,² the possible outcomes of a market study are:

- giving the market a clean bill of health

¹ Press notice 66/06 www.offt.gov.uk/News/Press+releases/2006/66-06.htm.

² *Market Studies: Guidance on the OFT approach* November 2004 (the Guidance).

- publishing information to help consumers
 - encouraging firms to take voluntary action
 - encouraging a consumer code of practice
 - making recommendations to the Government or sector regulators
 - investigation and enforcement action against companies suspected of breaching consumer law or competition law, and
 - a market investigation reference to the Competition Commission (CC).
4. Were the OFT to decide it was minded to pursue a reference to the CC, we would, as legally required consult formally with those significantly affected. This paper is in no way intended to pre-empt such a decision or formal consultation. Rather it aims to be transparent at a point where the market study has started to identify issues³ about how the market is working, and is in addition to any formal consultation that may follow.

Overview of the sector

5. PPI protects borrowers' ability to maintain repayments and should help them avoid getting into debt should they be unable to keep up their repayments due to accident, sickness or unemployment.
6. PPI can be applied to a number of credit products including mortgages, unsecured loans as well as credit and store cards. It is sold almost exclusively as a secondary product, typically introduced and sold to the consumer at the point of sale of the credit agreement.

³ There is also another set of issues on PPI, to do with consumer protection (e.g. preventing mis-selling). Those issues are primarily for the FSA and are not addressed here (though results of some of the research conducted within the market study may also be useful to FSA in shaping its consumer protection policies).

7. The vertical distribution structure characterising the UK PPI sector suggests a distinction between the wholesale (upstream) and retail (downstream) markets. Although vertical integration is a feature of the PPI market [we have been told that vertically integrated companies account for approximately 60 per cent of the market] the upstream/downstream market distinction is still valid.
8. In the upstream market underwriters compete to provide PPI policies to lenders (the main distributors of the product). The PPI contract is the focal point of competition. Contracts are secured through competitive tendering, with contracts usually lasting one to five years (on average three years). Profit sharing agreements are a common feature of the contracts and some may contain provision for bonus agreements and/ or sales targets between distributor and insurer. The top six PPI insurers appear to earn around 85 per cent of the gross written premium (GWP) earned in 2005.⁴
9. We have also identified five downstream retail market sectors in which the insurers' policies are sold to final customers along with the lenders/distributors loan agreements:
 - credit card
 - unsecured loan PPI
 - secured loan PPI
 - first charge mortgages PPI (MPPI)
 - store card PPI.⁵
10. The distribution of PPI policies to consumers is largely controlled by the lender, principal among which are the high-street retail banks and building societies, which together account for approximately 80 per cent⁶ of all policies provided. Their extensive branch networks and position as leading credit providers give them unique access to consumers, which is a key feature of PPI distribution.

⁴ *Research into Payment Protection Insurance in the UK*, a report prepared for the OFT by London Economics 2006.

⁵ Store card PPI is included for completeness although it has already been the subject of a CC report and is therefore in a different situation.

⁶ London Economics 2006.

11. In the downstream market, unlike upstream, consumers typically consider the loan agreement as the 'primary product' and the PPI policy as the 'secondary' or 'add-on' product. PPI may even be a 'tertiary' product, for example, where a car or TV is the primary purchase.
12. Datamonitor⁷ estimates that PPI generated £5.4 billion in premiums in 2003 of which 60 per cent of premium income was from the sale of unsecured loans PPI. This was followed by credit cards and mortgages which each accounted for 15 per cent of premium income. Around 6.5 to 7.5 million policies are taken out annually with approximately 450,000 claims made each year (around one claim for every 15 policies taken out).⁸

Emerging issues

13. The issues raised during the course of this market study can be grouped under three headings: **value for customers; how customers buy PPI and the information they have; and the competitive pressure on prices.**

Value for customers

- 13.1 **Claims ratios** – we have defined the claims ratio as claims paid as a percentage of earned premiums. On the whole claims ratios across PPI are low compared with other insurance products. This could suggest that gross profits are high in the UK PPI sector, and implies customers are receiving poor value. Our business survey of underwriters⁹ shows that the median claims ratio in 2005 were highest for first charge mortgage PPI (35 per cent), 18 per cent for unsecured personal loans, but just 11 per cent for retail credit, motor finance and credit card PPI, and only ten per cent for secured loan PPI. This represents a median claims ratio of 17 per cent for all PPI policies. Our financial pro-forma exercise shows an overall claims ratio for the sector of 19 per cent in 2005. Over 50 per cent of underwriter profits appear to be earned from unsecured personal loans (over 70 per cent in 2005). These figures

⁷ Datamonitor UK Creditor Insurance 2004 *A comprehensive analysis of the PPI market in the UK.*

⁸ CitA report *Protection racket: CAB evidence on the cost and effectiveness of payment protection insurance.*

⁹ Minor data updates expected.

compare to claims ratios of 74 per cent in motor insurance and 55 per cent in household insurance.¹⁰ These differences look to be sufficiently large to put them beyond any questions of direct comparability or differences in risk.

13.2 High commission rates paid by insurers to downstream intermediaries (distributors and non lending intermediaries, including profit sharing deals). Our business survey suggests that median commission rates for single premium policies vary from 50 per cent for first charge mortgage PPI to 66 per cent for those selling unsecured loan and motor finance PPI. For those selling single premium second charge mortgage and retail credit PPI, commission rates were 64 per cent and 61 per cent respectively. Median commission rates for regular premium PPI policies varied from 35 per cent for first charge mortgages to 70 per cent for retail credit. Rates for other regular PPI premiums were 44 per cent (second charge mortgage), 55 per cent (unsecured personal loan), 59 per cent (motor finance) and 61 per cent (credit cards). The average commission rate was typically lower for all regular premiums than single premiums excepting motor finance PPI. Our financial pro-forma exercise show average commissions paid as per cent of net earned premiums by underwriters to downstream intermediaries of over 60 per cent in 2005. It is interesting to note that new entrants into this market have not competed rates down and it is difficult to see how commissions at this level can be driven by the costs of selling this product alongside the associated credit.

13.3 Prices for PPI differ greatly which cannot be accounted for by differences in quality. This is particularly the case in respect of unsecured personal loans and credit cards, although less so for first charge mortgages. For example from our own research we found that for a £5000 unsecured loan over five years monthly PPI repayments for an accident sickness and unemployment policy (ASU) range from **£16** for the cheapest to **£40** for the most expensive with very little obvious difference in the cover provided. The variation in PPI repayments for a £100k 20 year mortgage was less extreme with **£32** a month for the cheapest ASU policy and **£45** for the dearest (though the most expensive is still 40 per cent more than the cheapest).

¹⁰ London Economics 2006.

13.4 In 2004 Datamonitor¹¹ surveyed 50 firms providing PPI for unsecured personal loans and found that the cost for the most expensive policy premium was almost three times greater than the cheapest available PPI policy premium. This was not accounted for by any difference in the quality of the cover provided. London Economics has subsequently carried out an analysis of this data on behalf of OFT in relation to the personal loan market, wherein the difference in PPI premiums for equivalent policies is found to be as large as four times the cost of the cheapest policy. This implies poor value for those consumers paying more than those at the lower end of the range.

13.5 **'Cross-subsidy' issue** – we have heard anecdotal evidence that some unsecured personal loan providers, and possibly some credit card providers, are offsetting low margins on their credit offerings with profits generated from the sales of PPI. Our research suggests that, broadly, there may be some evidence of unsecured loans with very low APRs being loaded with expensive PPI policies. The outcome of this practice is that those consumers who do not take out PPI [our business survey shows the mean take-up rate across all PPI products is 23 per cent] are effectively being subsidised by those who do. Not only is this an issue of fairness, but it is also an issue of transparency. Our research suggests that this is not the case for all distributors, but it was highlighted as an across the board issue by a number of players in the industry.

How customers buy PPI /information issues

13.6 **PPI is a product which is sold not bought** i.e. consumers rarely set out to buy this product on their own. Instead, cover is promoted in some way by the distributor of the associated credit. PPI is a secondary and possibly even a tertiary purchase e.g. car/credit/PPI. Over 39 per cent of respondents to the OFT consumer survey had not given PPI any thought before they went to take out their credit. Of those who had taken out PPI, nearly 90 per cent took it out with the credit provider at POS. Of the remaining 10 per cent who had not bought their PPI at POS most subsequently bought it via a follow-up from the credit provider.

¹¹ Datamonitor UK Creditor Insurance 2004 p34.

13.7 **Consumers do not tend to shop around for PPI** and even if they wished to **the wide variety of products and prices makes comparisons difficult**. OFT's consumer survey showed that whilst 41 per cent of respondents said they had shopped around for their credit product, only 12 per cent of those who had bought PPI for their credit product claimed to have shopped around for the PPI. Research by Harris International for the Finance and Leasing Authority [FLA] (2005) showed that web searches on PPI are low. Industry discussions 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.

13.8 PPI is complex and can be confusing. The range of cover available is huge, with 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 or
- unemployment only, to
- life, sickness, accident, unemployment with added hospitalisation cover and carer cover.

Policies had different 'excess' or waiting 'periods' (30, 60 or 90 days) with some benefits being accrued daily and some accrued monthly.

13.9 Product complexities were also highlighted in research by Defaqto Limited¹² which set out the different terms used throughout the industry to describe the same thing, e.g. excess period/waiting period both describe a period of time after the claim date during which the customer is not eligible to receive benefit payments. Defaqto found that products that appear to have the same waiting period, for example, are in fact different, and choosing the wrong type of policy could disadvantage customers in the way benefits are paid to them.

¹² Payment Protection Insurance in the UK, Annual Review of the PPI market – February 2006 Defaqto Limited.

13.10 Our research found that the information on websites about PPI is mixed. Whilst there appears to be a lot of detail on cover, information about exclusions tends to be more hidden and on occasions the text can be misleading and discouraging consumers to search out exclusions. This is highlighted by the following quote found on one lender's website:

Like all insurance policies there are some common sense exclusions but we try to keep these to a minimum. Mainly these are things that you already know about such as pre-existing medical conditions, impending unemployment or anything self inflicted. For full details of the main features and exclusions of the policy please see the Policy Summary

13.11 The issues set out above also contribute to the **lack of switching** by consumers. The secondary (or tertiary) nature of PPI products, the informational difficulties brought about by the inclusion of many detailed and complex 'small print' items, as well as the presence of perceived excessive product differentiation all create a high barrier to consumers considering switching PPI provider. Most PPI policies are sold only with the associated credit product and not to consumers of other credit products. So the only option for the consumer who does not want to switch the credit may be a standalone PPI policy. It also implies that consumers are not necessarily selecting the best PPI cover [for them] if they are just taking the creditor's PPI, which vary significantly. From our consumer survey, only 16 per cent of those who cancelled their policies switched to another PPI provider. The presence of single premium policies may also provide a disincentive to switching, as in the event that these are cancelled early the customer may not receive a *pro rata* refund. The Financial Services Authority¹³ are currently considering, with the relevant trade associations, whether policy terms that provide no refund of the single insurance premium if the customer wishes to cancel the PPI policy without early repayment of the loan are fair under the Unfair Terms in Consumer Contracts Regulations 1999. They are also considering whether the amount of the refund is fair and proportionate and if it is clear from the policy how the refund is calculated.

13.12 **Headline APR** – it seems to be a fairly common practice for distributors to make use of a headline APR to draw people into a credit deal. The

¹³ FSA Payment Protection Insurance 13/7/06.

price of the PPI is not upfront, yet the inclusion of PPI within the loan may significantly alter the total cost of the overall credit deal ('effective APR') which had the consumer known upfront, may have influenced their choice of provider. The OFT consumer survey found that when choosing a provider and a product, **APR rate** is usually the only stated discriminator, effectively ignoring the cost of the PPI.

- 13.13 London Economics carried out an analysis of cost and found that 37 of 40 credit providers showed a greater than 100 per cent increase in the advertised APR as a result of including the PPI premium in the repayment calculation – the overall cost of the loan does not closely reflect the advertised APR.
- 13.14 Research by Defaqto Limited 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.
- 13.15 The issue grows in significance when take up rate of PPI is high. In the case of secured loans we found evidence of take up of PPI as high as 70 per cent. This may be down to the fact that those who take out secure loans are more likely to be financially insecure and possibly vulnerable, and so see 'peace of mind' in taking out PPI. But when a customer can neither determine the total cost of the loan with PPI added nor the quality, the potential for customers who may already be financially vulnerable to get value for money is significantly reduced.
- 13.16 **Poor information on PPI prices.** We did come across some good practice of lenders of unsecured loans giving consumers upfront information about the cost of PPI with many 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 across the board and it was not uncommon to see marketing literature without any information about the cost of PPI (note comments on headline APR), providing the customer with little idea of how much they would pay if they considered PPI.
- 13.17 **PPI automatically included in quotes.** Conversely, and equally unsatisfactory to the point at 13.16, our research found that nearly all unsecured loan providers [87 per cent] who we contacted automatically

included PPI in the quote for the loan. For mortgage PPI the figure was lower at 40 per cent.

- 13.18 **Poor information on product details.** We also found evidence of providers of PPI not being particularly effective at putting across information about their products. We contacted a number [24] of unsecured loan providers and not one mentioned the exclusions associated with their relevant PPI policies without a prompt from the caller. Only 30 per cent of unsecured loan providers detailed the criteria required to qualify for PPI at the quotation stage.
- 13.19 In some instances, 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 customer would be provided with the full information required for them to make an informed choice or whether they would be left to find their way through policy documents and terms and conditions themselves. Our view is that providing information at the application stage is one stage too far, by which time the customer has been 'captured' having been credit checked and possibly approved for a loan, and would be reluctant to refuse the offering of PPI because of an obligation to carry the process through.
- 13.20 However, Defaqto research highlighted that 37 per cent of loan providers and over half of credit card providers allow the customer to see a copy of the full policy terms and conditions prior to applying for the loan or credit card.
- 13.21 **Lack of marketing/promotion of PPI** – It was noticeable that whilst there was a mass of upfront marketing information readily available for consumers to read on the credit, 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 for example, information specifically relating to PPI was usually given very little attention in 'pick up ' leaflets and was quite often difficult to find. Over the internet the picture is similar. Most sites we visited did have a section on PPI but in many 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. London Economics found that in 2004 a total of £635,000 is estimated to have been spent by creditor insurance companies on advertising in the UK (of which 56 per cent of the total was spent by one company) compared to £3.94m on advertising travel insurance. Whilst consumer apathy may have contributed to this low level of advertising, failure to highlight PPI on a widespread basis is unlikely to help raise consumer awareness of the product and ultimately help them receive good value for money.

13.22 Furthermore, whilst consumers from our consumer survey on the whole appeared to be satisfied with the information that they received on PPI, 53 per cent did not know what they paid for PPI monthly, 34 per cent thought that there were no exclusions on the policy 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 49 per cent could name these (13 per cent of all PPI consumers).

13.23 **Belief that taking out the PPI helps the application for credit.** A worrying 27 per cent of consumers from the OFT consumer survey either assumed or were told or given the impression by the distributor that this was the case

Competitive pressure on prices

13.24 Whilst there appears to be some competitive pressure operating in the upstream market (i.e. where insurers compete for distributors business), this does not seem to be feeding downstream. [Possible] cross subsidy in unsecured personal loans and secured loans, profit sharing¹⁴ and common cost issues make analysis difficult and whilst we have attempted to establish where profits are going, most distributors were unable to identify costs attributable to PPI products at all, which makes assessment of profitability very difficult.

¹⁴ Another issue, revealed in meetings, is that profit share arrangements are sometimes in place between underwriters 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 underwriters were bearing all the risk.

- 13.25 Based on the financial information received, the claims ratios reported by underwriters declined from c28 per cent to c19 per cent between 2003 and 2005. However, the benefit of this appeared to pass to distributors, as commission paid as a proportion of net earned premiums increased by c13 per cent from 51 to 64 per cent over the same period.
- 13.26 In the absence of cost data, no estimate can be made of distributors' profitability. However, claims ratios of below 30 per cent leave over 70 per cent of net earned premiums to cover costs and profit of underwriters and distributors. Given pressures to restrain costs and the potential benefit of spreading costs and profit across a range of business within the larger operators, it seems reasonable to suggest that distributor profitability is sizeable.
- 13.27 **'Alternative products' do not appear to provide competitive pressure.** Products such as income protection policies are not considered to be direct substitutes in the sense of posing a constraint on PPI prices. They vary in their terms and conditions - are longer term in nature and vary in the benefits paid (e.g. do not cover unemployment).
- 13.28 **Point of sale (POS) advantage.** On average our business survey showed that overall 98 per cent of PPI policies are sold at the POS of the credit product being insured. Distributors who responded to our survey indicated that 100 per cent of unsecured loan policies are sold at POS. Credit card PPI is the least likely to be sold at POS (only 64 per cent of sales), although even when credit card PPI is not sold at POS it is more likely to be sold via a follow-up exercise, for example, when the credit card is activated. It could be argued that this should also be considered POS. MPPI is the only sector where the POS advantage appears weaker, with a stronger presence from stand-alone products and PPI vying with other products (e.g. life insurance, critical illness, home insurance etc) for a slice of the consumer's purse – often pushing it a long way down the list in terms of consumer choice. More generally, the absence of advertising reflects the point of sale advantage; if consumers are not actively shopping around for a good deal there is no need to advertise.
- 13.29 **This POS advantage strengthens with the sale of single premium PPI.** On the whole consumers tend to pay for 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 that took out a secured loan PPI purchased the policy from the credit provider. For unsecured loan PPI the figure is 91 per cent.

- 13.30 This POS advantage means that there is little competitive pressure on PPI at the key point in which the consumer buys the insurance. **Stand-alone suppliers face difficulties in accessing the consumer at POS** and we came across very few examples of insurers selling direct to the customer. Even when this did happen, it tended to be in very limited circumstances (products). At least one major insurer has tried to sell directly to the consumer, but was unable to achieve reasonable penetration and pulled out of direct sales.
- 13.31 The nature in which PPI is sold also means that stand-alone suppliers also face the additional disadvantage of **greater start-up costs and direct marketing costs** in order to try to attract sufficient volume of customers to trade successfully over the long term. Statistics produced by the Council of Mortgage Lenders¹⁵ on MPPI sales suggests the number of MPPI policies sold directly has fallen from six per cent in 2002 to only one per cent in 2005.
- 13.32 Whereas face to face and telephone sales appear crucial for sellers of PPI, **the internet does not appear to have opened up the sector** as an effective sales channel for those wishing to purchase PPI. Our business survey found that just over 20 per cent of PPI sales were done on-line. For stand-alone businesses the internet is one of the primary sales channels. The low take up rate of PPI over the internet puts standalones at a further disadvantage.
- 13.33 **For credit cards, not having access to the balance of an account is a barrier to stand-alone players** [although we note that at least one stand-alone supplier has found an innovative way around this based on an allotted level of monthly cover. The lack of this kind of innovation at the

¹⁵ CML research 2/5/2006 Table PPI3 Mortgage payment protection policies in force.

current time may reflect a lack of competition implying a large potential for improvements and innovation.]

- 13.34 The issues set out above all suggest that, with the possible exception of MPPI, stand-alone suppliers are not acting as a competitive pressure within the PPI sector.
- 13.35 **Neither initial purchase decision nor cancellation acting as a pressure on prices.** It could be said that in the absence of pressures from competitors the careful weighing up of value for money by customers before buying or the risk of consumers cancelling the PPI could act as some pressure on prices. However, where PPI is purchased at POS it is doubtful that careful weighing up takes place. And our survey suggested that few consumers cancel [16 per cent] and even when cancellations do occur very few consumers switch to another PPI provider. Just over one quarter [27 per cent] of consumers in our survey did not know whether they could cancel a PPI policy and nearly 10 per cent did not think that they could.

Next steps

14. There is no obligation to respond to this paper, but we welcome comments from the industry on the issues we have identified, either in writing or at the session we have arranged on 24 August. Comments in writing on the issues identified should be submitted by email to ppi@oft.gsi.gov.uk no later than 24 August 2006.
15. No decisions have been taken yet on the issues set out in this paper and any observations or comments which are made in response to the issues identified either in writing or at the 24 August session will be taken into account in the OFT's decision on the outcome of this market study.