Oxera

Agenda

Advancing economics in business

Competition in secondary products: the case of payment protection insurance

Earlier this year the UK Competition Commission completed its investigation into the market for payment protection insurance. The investigation generated considerable media attention, and one remedy was an outright ban on selling PPI at the credit point of sale. How can competition policy issues in secondary products (such as PPI) be identified, and what does the Commission's analysis of consumer harm and design of remedies have to say on the issue?

Payment protection insurance (PPI) provides cover for consumers who take out credit against events that may prevent them from keeping up with their repayments. Policies tend to pay out following unemployment, accident or illness (depending on the specific terms). By the time the UK Office of Fair Trading (OFT) referred the market to the Competition Commission (CC) in 2007, PPI had developed into a popular retail insurance product, sold alongside personal loans, credit cards, overdraft facilities and mortgages.[1]

The CC market investigation over the last two years has received significant attention in the media, partly because of mis-selling allegations that were being investigated concurrently by the Financial Services Authority (FSA).[2] The CC found that certain aspects of the supply of PPI had an adverse effect on competition, and therefore set out a number of remedies.

Aside from its high profile, the investigation is of wider interest for several reasons. First, PPI is described by economists as a 'secondary product': it is purchased only once the primary product (a mortgage, personal loan, credit card, overdraft or other credit facility) has been obtained. Secondary products can raise specific competition issues.

Second, this case represents the very first UK market investigation into a 'typical' retail financial services market that is regulated by the FSA and also subject to an FSA investigation. The case provides insight into how the CC approaches such a financial services market (from a competition policy perspective) compared with the FSA, which tends to focus more directly on making sure consumers obtain products that are suitable for them.

Finally, perhaps partly inspired by behavioural economics, the remedies in this case—and specifically the ban on selling PPI at the credit point of sale—went much further than in previous investigations into similar products. A 2003 inquiry into the sale of extended warranties (also a secondary product, and a form of insurance policy) resulted in remedies mainly intended to improve transparency and the provision of information to consumers.[3]

Secondary products

PPI is considered a secondary product because it is purchased only once the primary product (in this case, a credit facility) has been obtained. Secondary products are quite common. Examples include travel insurance (possibly purchased from a travel agency after booking a flight); certain accessories (a tie to match a suit or shirt purchased in the same clothes shop); or a satellite navigation system (chosen as a feature when buying a new car).[4]

There are limits to distinguishing primary and secondary products, however. While it is possible to buy a satellite navigation system separately from a new car, it is becoming less common, as consumers may find it more convenient to purchase the car with the device installed. Thus, the way consumers perceive products may change over time.

Why do people buy primary and secondary products from the same provider? While in some instances there may be issues of enhanced compatibility (in buying computer hardware, for example), in many cases consumers simply find it more convenient to buy the primary and secondary products at the same time, in the same place.

From a competition and consumer protection perspective, problems arise with secondary products where consumers are deterred from 'shopping around'

for the product most appropriate for them. Although consumers may do so for the primary product, a failure to thoroughly research the secondary product may result in a lack of competition for that product. This can lead to poor quality and/or high prices—particularly if neither of these factors can be easily observed by consumers prior to purchase. This was the issue examined in the PPI investigation.

Aftermarkets—a specific type of secondary product

It is useful to examine the differences between secondary products and aftermarkets. Aftermarkets can be considered a specific type of secondary product, and the competition issues to which they can give rise are well documented in the economics literature and in competition case law.

Textbook examples of aftermarkets include cars (a primary product) and spare parts (the aftermarket or secondary product); razors and razorblades; and printers and toner cartridges. Competition issues may arise where the choice of aftermarket product is limited to those that are compatible with the primary product already purchased. When buying the primary product, consumers may fail to take into account the ongoing costs and, when they subsequently want to buy the secondary product, may find that they have limited choice—giving the seller the opportunity to exploit its market power. A well-known competition case concerning aftermarkets is that relating to Kodak in the USA, where the company's practice of tying the sales of spare parts for its photocopiers with maintenance services was considered anti-competitive.[5]

There are a number of differences between aftermarkets and the general case of secondary products.

In aftermarkets, the purchase of the secondary product is necessary to be able to use the primary product. In the general case of secondary products, the secondary product—while potentially enhancing the primary product—is optional. Consumers can either choose not to purchase the secondary product or can often purchase alternatives, thereby imposing pressure on the provider to keep prices competitive.

In the case of aftermarkets, the competition policy issue is typically that the secondary product can only be purchased from the same producer (usually under the same brand) as the primary product. This is not generally the case in secondary markets. For example, in the case of PPI, the primary product (credit) could, in principle, be combined with PPI from other brands or retailers. However, in reality consumers tend to buy PPI from the firm from which they obtain their credit facility.[6] In other words, a competition issue may arise because of the primary product provider's point-of-sale advantage rather than any product compatibility advantage.[7]

This also means that, whereas in aftermarkets the competition issue often arises from the conduct of the provider and/or the nature or design of the product, in the general case of secondary products it may be driven by consumer behaviour—ie, consumers find it more convenient to purchase the primary and secondary product at the same time and at the same place.

Generally speaking, it is easier to design remedies that change firms' behaviour (simply by telling them what they can and cannot do) than to change consumer behaviour. Remedies intended to change consumer behaviour tend to focus on providing more information and adjusting incentives. This makes the design of remedies more challenging—as became clear in the PPI investigation.

When does a secondary product raise competition issues?

Markets with secondary products do not always raise competition issues. The following screening questions can be posed to identify where competition issues might exist.

1. **Does consumer behaviour in the market for the secondary product constrain the behaviour of providers?** If consumers are sufficiently aware of the secondary product, and if it is also offered by alternative providers separately from the primary product, they may shop around and choose either to buy the primary and secondary product from the same supplier, or from different ones. This should result in a competitive market for secondary products.

   Travel insurance is a good example. Although some consumers may purchase travel insurance from their travel agent, it is also offered by a wide range of insurers, either directly or indirectly, through intermediaries such as insurance brokers or banks. As long as a sufficient number of consumers compare the cost of travel insurance offered by travel agents with the cost of policies offered by other providers, this can exert pressure on the prices set by travel agents and keep them competitive.

   In the case of PPI, most lenders offer a PPI product only in combination with the credit product sold. At the time of the CC inquiry, while a number of stand-alone PPI products had been launched, sales volumes were still relatively limited. Alternative insurance products were available, but evidence on competitive pressure from these products was mixed.

   One of the most important options available to consumers was, perhaps, simply not taking the PPI

product—in other words, opting for no insurance. The proportion of consumers taking a credit product without PPI increased over time—for example, in the case of personal loans, from 38% in 2002 to 62% in 2008.[8]

2. **Does consumer behaviour in the market for the primary product constrain provider behaviour in the market for the secondary product?** Even if consumers do not shop around for the secondary product separately, competition concerns may not necessarily arise. If, when shopping around, consumers compare the total cost of the products they wish to buy, the secondary product may be subject to competitive constraints. If its price is increased, this will affect the price of the primary and secondary products purchased together, and is therefore also likely to affect demand for the primary product, thereby imposing constraints on the provider's behaviour.

   In many markets, consumers may see through providers' pricing tactics. Not only in aftermarkets (where consumers may look at lifetime costs when buying the primary product), but also in markets where one product is offered but a number of different prices are charged.

   For example, consumers buying flight tickets from a low-budget airline may take into account not only the price of the ticket but also possible additional charges such as luggage and/or the location of the airport, which may be less convenient than that of other airlines, and therefore likely to result in additional transfer costs.

   Transparency of prices and consumer awareness of the full cost of both the primary and secondary products are thus central to the competitiveness of the market for secondary products.

   In the case of PPI, consumer surveys undertaken by the CC indicated that around 61% of mortgage customers and 48% of personal loan customers do think about buying PPI before applying for the credit product.[9] However, the CC concluded that the number of consumers actually comparing the costs of combined credit and PPI products in detail was insufficient to produce genuine competitive pressure on PPI providers.

3. **The waterbed effect: do excess profits get competed away?** A lack of competition is likely to result in high prices and/or poor quality. However, if the market for a primary product is competitive, firms have an incentive to set a relatively low price for that product in order to increase sales of the secondary product. In other words, the excess profits generated by sales of the secondary product may get competed away in the market for the primary product. This is sometimes referred to as the 'waterbed effect'.

   The extent to which excess profits are competed away will depend on a number of factors, including the degree of competition in the market for the primary product. The CC found that, in the case of some products (for example, PPI and personal loans) excess profits on PPI may have been competed away in the credit market. However, it concluded that, given the current financial crisis and recent changes in lending practices, there was no guarantee that this consumer benefit (of subsidised prices for credit) would continue to exist in the future.

4. **Is competition distorted?** Even if excess profits get competed away, in theory, an adverse effect on competition could still arise if, for example, the low prices in the market for a primary product made it difficult for new firms to enter the market.

   In the case of PPI, there was no evidence that lenders not offering PPI were unable to compete with those doing so, and were consequently forced to exit the market. In addition, it is not, generally speaking, difficult for lenders to start supplying PPI: rather than developing it themselves in-house, they can purchase it from an underwriter in the wholesale market, as various existing lenders do.

5. **Does it harm consumers?** Finally, even if there were a waterbed effect, the lack of competition in the market for secondary products could still harm consumers, potentially resulting in the following.

   - **Allocative inefficiencies**. Prices above or below costs may result in allocative inefficiencies: some consumers not buying PPI at high prices who would buy it at competitive prices and, similarly, some consumers taking credit who would not take it if PPI profits were not being used to fund the sale of credit.

   - **A lack of incentives to innovate**. The lack of competition in the market for secondary products may hamper innovation.

In addition, the pattern of low prices for the primary product and high prices for the secondary product may result in a cross-subsidy. Consumers who buy both the primary and the secondary product may be subsidising those consumers who buy only the primary product.

Although this distributional effect may not give rise to competition policy issues as such, it may raise concerns from the point of view of consumer protection if, for example, this were to result in a redistribution from poorer consumers to better-off consumers. In the case of PPI, the waterbed effect resulted in a transfer

of welfare from those consumers purchasing PPI to those who did not. In other words, those purchasing PPI were subsidising those consumers who took up credit facilities without it.

However, the CC found evidence that this cross-subsidy occurred primarily within credit score bands (ie, that PPI purchasers cross-subsidised non-PPI purchasers of similar risk), and did not consider it to be the case that poorer customers (who are more likely to take out PPI) were subsidising the better-off (who were arguably less likely to be in need of it).

Welfare effects

The CC was concerned over potential cross-subsidy (occurring within credit score bands) resulting in allocative inefficiencies. It therefore proposed a number of remedies, the analysis of which raises a number of questions.

First, should a competition authority be concerned about whether, within a market for credit and PPI, some consumers receive a better deal than others? In theory, this may result in some allocative inefficiencies, and low credit prices may encourage consumers to borrow more than they would otherwise; but should a competition authority be concerned about consumers' financial health? The 2008 CC groceries inquiry raised a similar issue.[10] During the course of this inquiry, a number of groups expressed concerns about the potential effects on consumer health of the widespread availability of cheap alcoholic drinks and processed food on consumer health. The CC, however, concluded that it was not within its statutory powers to address these wider concerns.

Second, in the case of PPI, the order of magnitude of any cross-subsidy—and any allocative inefficiencies—is informed by the profitability analysis (and is therefore sensitive to the results of such analysis). The profitability analysis in this case involved allocating the relevant costs and revenues between the credit and the PPI product. Although the tools for profitability analysis have been well developed, it is recognised that the allocation of costs and revenues can be difficult, particularly regarding products that share the same distribution channel and therefore have shared costs.

The CC stated that it did not find PPI to be:

> so inextricably linked with the credit sale as to render any attempt to analyse its costs and revenues meaningless.[11]

The question that remains, therefore, is under what circumstances are products so inextricably linked that a cost and revenue analysis would be meaningless? What does 'inextricably linked' mean?

Finally, an alternative theory suggested that the provision of PPI could be seen as a method of risk-based pricing that could explain, at least in part, the relatively high prices charged. Data from lenders showed that (within each credit score band) consumers with PPI are more 'high-risk' than customers without. Since lenders do not set different interest rates for consumers according to whether they are covered by PPI, this means that lenders may have been recovering the costs of these higher risks through the higher prices charged for PPI.

Remedies—insights from behavioural economics?

The remedies proposed in this case included a number of measures aimed at assisting consumers in making more informed decisions—such as an obligation on providers to give personal PPI quotations in every sale, and to provide information about the costs of PPI together with 'key messages' in PPI marketing material. The CC also recommended that the FSA include PPI in its price comparison tables.

However, the CC's ban on providers offering PPI at the credit point of sale, and its conditions regarding the sale of PPI within a fixed time period of the credit sale, went much further than remedies in previous investigations. Why was this the case? The CC pointed out that remedies imposed following the inquiry into the sale of extended warranties appeared to have had little impact, and concluded that, without a prohibition on selling at the credit point of sale, there would be insufficient impact on consumer behaviour.

This echoes certain insights from behavioural economics, a branch of the discipline which takes into account the impact of imperfect consumer decision-making. Even where consumers have access to sufficient information, and even where they can understand and process it, some may not necessarily act accordingly. Very specific measures may therefore be required to incentivise these consumers to shop around or, in a less charitable sense, to protect them from themselves.

However, encouraging consumers to behave in a way that would be desirable from the perspective of competition policy is not easy. Insights from behavioural economics can be useful not only in assessing the (mal)functioning of a market and in identifying potential remedies, but also in testing whether any proposed remedies are likely to work as intended.

In banning PPI at the credit point of sale, the CC's intention was that consumers would take time to consider PPI, and to shop around before purchasing it. Will this be achieved?

Consumers, in fact, have a number of options: to wait and then purchase PPI from the lender; to shop around and potentially purchase elsewhere; or to simply not buy PPI at all. A survey commissioned by the CC suggests that, in many cases, the main reasons given for buying PPI from the lender were the convenience of buying credit and PPI at the same time; a preference for dealing with a company with which the consumer already had a relationship; and a lack of time to shop around.[12] The remedy proposed in this case does not address these issues, and therefore may not incentivise consumers to shop around—indeed, it may be more likely to increase consumers' transaction costs, persuading them not to purchase PPI at all, and resulting in a protection gap for some consumers.[13]

The CC's decision has been appealed by one credit provider and a number of others have intervened. The appeal is pending and focuses on the prohibition on selling PPI at the credit point of sale, the findings in relation to the relevant market and, more generally, the findings in relation to the factors affecting the nature and extent of competition in the supply of PPI.[14]

---

[1] Competition Commission (2009), 'Market Investigation into Payment Protection Insurance', January.
[2] The FSA began investigating the market for PPI in 2005. See Financial Services Authority (2005), 'The Sale of Payment Protection Insurance—Results of Thematic Work', November; and for a more recent update, Financial Services Authority (2009), 'Update on FSA Work on the Sale of PPI', press release FSA/PN/012/2009, January 20th.
[3] Competition Commission (2003), 'Extended Warranties on Domestic Electrical Goods: A Report on the Supply of Extended Warranties on Domestic Electrical Goods Within the UK', December.
[4] The secondary product is sometimes used as a way to maximise revenue from those consumers who have a higher willingness to pay—for example, by offering bottles of wine in different price ranges in a restaurant, or low-budget airlines offering priority check-in.
[5] *Eastman Kodak Co. v. Image Technical Services*, Inc., 504 US 451 (1992).
[6] Most lenders offer PPI only in conjunction with their own credit product. However, a limited number of stand-alone PPI providers were (and remain) in the market and some alternative insurance products were available.
[7] Although the benefits of enhanced compatibility between the credit product and PPI should not be discounted. For example, in the case of credit card PPI, the purchase of insurance from the same firm providing the credit card would protect repayments on any balance outstanding at any point in time. Other PPI providers would not have access to a cardholder's account details and would typically offer protection only for a fixed amount. This would leave the cardholder potentially exposed, since the amount covered might not necessarily match the cardholder's outstanding balance at any particular time.
[8] Competition Commission (2009), op. cit., p. 26.
[9] Ibid., p. 116.
[10] Competition Commission (2008), 'The Supply of Groceries in the UK: Market Investigation', April, pp. 22–23.
[11] Competition Commission (2009), op. cit., p. 91.
[12] GfK NOP (2008), 'PPI Search Behaviour: A Research Report for the Competition Commission—Final Report', April.
[13] Research indicates that there are some consumers who underestimate the importance of protecting themselves against adverse events. See for example, Association of British Insurers (2008), 'Coping with Crises: Household Protection Needs'.
[14] Competition Appeal Tribunal (2009), '*Barclays Bank PLC v Competition Commission*', 1109/6/8/09, March.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

Other articles in the June issue of *Agenda* include:

- **procyclicality and financial regulation** ***Charles Goodhart, London School of Economics***
- **responding to declining volumes: can postal operators deliver?**
- **water competition: a clear way forward?**

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com

© Oxera, 2009. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.