  
**The Actuarial Profession**  
 making financial sense of the future

# Re-Designing PPI – Opportunities for Life Insurers .

7 November 2006  
David Gulland & Jerry Staffurth

Re-designing PPI - opportunities  
 for Life Insurers

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## Agenda

- What's the problem?
- What can we do about it?

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## What's the problem?

- What is PPI?
- What are the regulators' concerns?

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## What is PPI and when is it sold

- “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.”
- (OFT August 2006)

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## Typical features

- Benefit triggers can include accident, “sickness”, unemployment and death
  - With different providers having different designs
  - But with a “one-size fits all” approach to product design
- Benefit amounts can be complex to unravel – particularly on credit card protection
- Benefit frequently capped (eg 1 or 2 years of benefit only under the “sickness” features)
- Sold at point of sale as part of loan/credit facility with minimal advice
  - “bundling” with low APRs contingent on purchase of PPI
- Single Premium versions on loans can have SP added to loan
- Simple rating structure – either single rate or minimal age bands if life cover included

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## Some market data

(source: London Economics report for OFT)

Gross written premiums in UK					
£ millions					
	Personal loan	Mortgage	Credit card	Car Finance	Total
2003	2,813	885	662	203	<b>4,563</b>
2004	2,975	992	742	251	<b>4,960</b>
2005	3,300	1,100	825	275	<b>5,500</b>

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## Some market data

(source: London Economics report for OFT)

- Top 6 writers insure 85% of GWP
- Retail banks/building societies distribute 80%
- 6.5m-7.5m policies issued pa

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## Some market data

(source: London Economics report for OFT)

Estimated PPI Penetration rates, %		
	Datamonitor (2003)	Mintel (2004)
Unsecured Personal Loans	60	39
Credit cards	45	24
Mortgages	26	25-30
New mortgages	37	28

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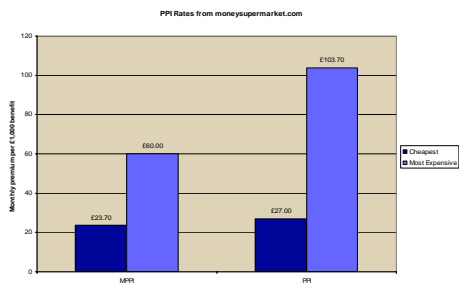
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## Premium rates vary considerably between providers



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## What are the regulators' concerns?

- FSA: problems with TCF driven by product and sales process
- OFT: problems with efficiency of market and lack of competition

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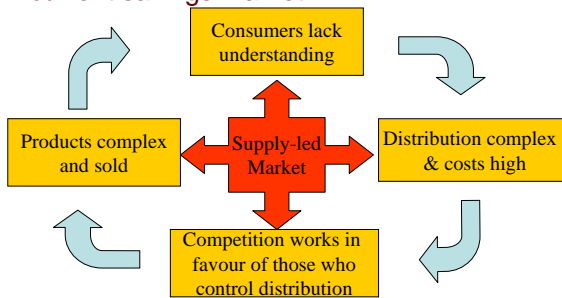
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## Comparison with Sandler's analysis of current savings market:



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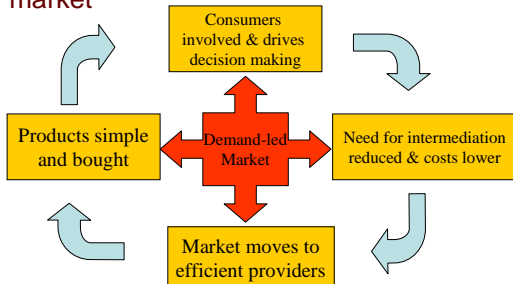
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## Sandler's desired outcome for savings market



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## Calendar of events - FSA

- November 2005: publication of results of Phase 1 of thematic work:
  - Reasonably relaxed about PPI in prime mortgage market
  - Many concerns with rest of sector

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## FSA's November 2005 report on Phase 1 of thematic work on sale of PPI

- Product design and selection
- Selling practices
- Product and price information
- Training & Competence
- Systems & Control

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## Product design and selection

- Complexity of eligibility make it hard for sales staff to explain and for customers to understand
- This can include selling add-ons to customers who could never claim
- Single Premium versions with SP added to loan have structural problems (impact on APR and no refund on early redemption – now addressed by main lenders)
- Smaller intermediaries say that they are “given” the PPI by the supplier of finance, with no input to appropriateness for customer base

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## Selling practices

- Inadequate checks over eligibility of customer to claim (eg policy with a 65 age limit sold to a 68 year old, lack of enquiry into employment and health history)
- Insufficient checks on other aspects of "suitability" (eg existence of other cover, price of the PPI)
- Ambiguity over advised or non-advised sales
- Potential for remuneration structures to encourage inappropriate sales

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## Product price and information

- Exclusions were dealt with badly, for both telesales and face-to-face
- Poor explanation (and poor distributor knowledge) of Single premium versions
- Lack of refund on SP on some versions is regarded as contrary to Unfair Terms
- Misleading comparisons between SP and RP versions

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## Training & Competence, and Systems & Control

- Shortcomings in T&C, particularly among smaller firms where for many procedures were "inadequate"
- Serious shortcomings in SYSC in 40% of firms eg lack of separation between sales and compliance monitoring of performance
- Use of MI to monitor issues was "generally poor or non-existent in medium-sized and smaller firms"

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## Calendar of events - FSA

- November 2005: publication of results of Phase 1 of thematic work:
  - Reasonably relaxed about PPI in prime mortgage market
  - Many concerns with rest of sector
- Summer 2006: discussions with industry and receipt of Undertakings by certain insurers
- 19 October 2006: publication of follow-up thematic work

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## FSA's October 2006 Report on follow-up thematic work – main findings

- Still lack of information during sales conversation, eg explaining PPI's optional status and its price
- Still insufficient explanation that there may be benefit triggers under which the specific policyholder may not be able to claim because of his situation, and insufficient evidence of how policy was deemed suitable
- Still some potential bias towards SP versions even if it is not suitable

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## FSA's October 2006 Report on follow-up thematic work – main findings (continued)

- "Particularly poor standards among firms, such as motor dealers and retailers, for whom the sale of PPI is a minor activity.."



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### FSA's October 2006 Report on follow-up thematic work

- "none of this is new, much of it was discussed in our November 2005 report"
- Variation in standards across firms remains
- Lengthy list of specific outcomes that the FSA wants to see– essentially ensuring compliance with ICOB Rules and Principles 6&7
- Useful examples of good and bad practice seen
- FSA view market is flawed, eg small loan brokers say they are required to use PPI from lender, and hard for stand-alone providers to increase their market share

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### Regulatory action

- September 2006: £56,000 fine on Regency Mortgage Corporation for sales practice on MPPI – First fine in respect of PPI
- And:
  - "follow through the detailed programmes of urgent remedial action which a number of firms are implementing to improve their sales standards;
  - pursue formal disciplinary action against firms who fall below the required standards;
  - conduct further work next year to ensure that senior management are addressing the areas of concern and embedding the behaviours and standards we expect;
  - continue to work with industry trade associations to help improve overall standards
  - consider, as part of the existing wider review of the effectiveness of the regulatory regime for general insurance products, whether there is a case for new rules in the area of PPI sales."

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### 26 October 2006: FSA fines Loans.co.uk £455,000

- Fined for failing to treat customers fairly when selling PPI
- Did not have appropriate systems and controls in place to minimise the risk of unsuitable sales.
- PPI was sold on an advised basis over the telephone and the firm failed to gather and record information to show the policy recommendations it made were suitable.
- Customers did not receive enough information to make an informed decision
- Remedial action plan for consumers has been implemented
- FSA head of enforcement Margaret Cole says: "We have highlighted Payment Protection Insurance as an FSA priority due to the potential level of risk to consumers."
- Considering enforcement action against 10 further firms

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## Potential new rules

- More work being carried out (will be subject to usual CBA)
- Will form part of wider review of ICOB
- Results of work to be published 1Q07
- Consultation on potential Rule changes in 2Q07
- Make Rule changes 4Q07
- Will recognise any impact the Trade Associations' efforts will have had

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## What are the regulators' concerns?

- FSA: problems with TCF driven by product and sales process
- OFT: problems with efficiency of market and lack of competition

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## Calendar of events - OFT

- September 2005 Super-complaint from Citizens Advice
- OFT launched market study in April 2006
- OFT published "emerging issues" in August 2006 highlighting:
  - Consumer difficulty in getting information on alternatives
  - High barriers to entry for stand-alone providers
  - High price variability in market
  - Gross profits appear high (claims ratio low)
- OFT published full Report October 2006 with proposed decision to refer to Competition Commission

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## OFT Report of October 2006 – areas of concern

- Nature of consumers' understanding, information and buying habits
  - Lack of evidence of any competitive pressure "downstream" at consumer level
  - Indications that consumers are receiving poor value from product
- All of which in combination suggestion market failure

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## Consumers

- Minimal shopping around, driven by "huge POS advantage"
- Complex product makes comparisons difficult
- Minimal upfront advertising
- "consumers display poor understanding of PPI"
- Perception that taking PPI would help in getting credit
- Lack of awareness of impact on aggregate APR

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## Impact on APR...

6.16 For example, one distributor advertised an APR of 6.1 per cent for a five year unsecured loan of £5,000. 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 £5,000. The approximate equivalent APR including PPI was 13.7 per cent, a difference of 8 per cent.

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## Competition

- POS advantage means little competitive pressure at point consumer buys cover
- Alternative products (eg IP) do not appear to constrain PPI price
- Stand-alone providers face significant barriers
- Levels of lapse or switch do not exert any serious pressure on price

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## Value for money

- Low claims ratios compared to other insurance products
  - Mean of 20% for 2005 (highest for MPPI at 33%, lowest for retail credit at 12%)
- High commission rates in comparison with other general insurance products
  - Average for SP was 59% (50% for MPPI, 67% motor finance), and for RP 53% (35% for MPPI, 70% retail credit)
- Wide differentials in price for the same level of cover
  - Real-life quotes from £16-£40pm for a sample policy on unsecured loan
  - Defaqto quotes vary by factor of 4 for a 4 year unsecured loan
- Possible cross-subsidisation to keep APR low

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## Agenda

- What's the problem?
- What can we do about it?

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### Potential impact of FSA/OFT reports

- Removal from market of “firms that do not have financial services as their main line of business and sell PPI as a tertiary product”
- Other firms will need to review their economics if information and potentially advice roles increase
- One possible outcome could be the growth of “stand-alone YRT PPI” in same way as Travel Insurance has changed

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### 6.4 Comparison with other Insurance Sectors

We have also considered, by way of comparison, two other insurance categories extended warranties (based on the Competition Commission’s inquiry of 2003 following referral by the OFT) and travel insurance (based on a market research report by Mintel (2005) and other industry information. Analysis and comparison of the market characteristics of these sectors suggests that the travel insurance market may generally work better for consumers in the UK.

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### High levels reasons for Life Companies to be optimistic...

- Potentially more advanced in “embedding” TCF into their businesses than GI competitors
- More used to having (and selling) multiple variants of product so as to meet varying client needs
- More used to seeking new distribution models
- Already aware of importance of FSA’s Financial Capability initiative

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## Technical obstacles/aspects

- Unemployment cover
- Disability cover
- Embedding TCF

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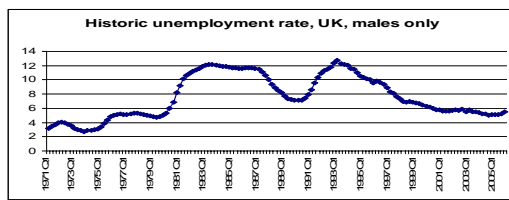
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## Actuarial considerations – unemployment

- Rate of change can be extreme
- Current “complacency” ignores historical variations
- Variations in prevalence rates understate variations in incidence rates



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## Actuarial considerations – disability

- Will be to a currently relatively un-tapped segment of market (principally “Class 3” ?)
- Current IP underwriting process is lengthy and expensive, not feasible for necessary simplicity of new-style PPI
- Current use of claims management techniques unlikely to be cost-effective

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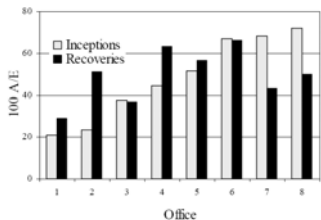
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### Inter-office variation 1999-2002 (CMIR 22)

(a) Deferred period 4 weeks




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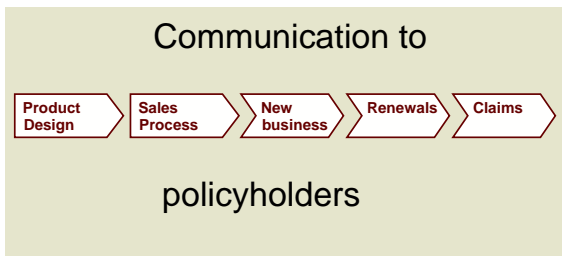
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### TCF influences all stages of the product life cycle




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### Embedding TCF into new-style PPI

- Ensure product is suitable for target audience
- Literature should be clear on when and why PPI is suitable
- Ensure clarity of responsibilities between provider and distributor (DP06/04)
- Collect MI on business sold to verify that it is being sold to target audience
- Retain MI on claims and claims declined to highlight any remaining potential problems

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## Strong Corporate Governance is vital to avoid future problems



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## Features of a life insurance PPI market?

- Sale is detached from loan/credit facility
- Single sale used to cover multiple "PPI" needs (credit cards, store cards, unsecured loans, mortgage repayments)
- Marketed as Payment Protection rather than Income Protection
- Use of multiple distribution channels divorced from provider of credit/loan
- Underwriting uses lessons being learned from developments in Term and IP markets

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## The Post Office have taken steps in this direction

- Covers several debts in one place, and more than just covering debts
- Strong brand, and underwritten by Axa
- Cheaper than many alternatives

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## High levels reasons for pessimism...

- Difficulties in stream-lining application process for other protection contracts
- Complexity of benefit trigger in other protection products
- Lack of control over distribution
- All of which leads to current inability to expand "own" core protection market

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## Agenda

- What's the problem?
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