



# Creditor insurance — the big shake up

Naomi Couchman and Kate Angell advise how companies can gain competitive advantage.

**Creditor insurance has caused much debate in the industry over recent months, and this is set to continue. The way in which creditor insurance can be sold is about to be shaken up following the Competition Commission's investigation and, with the UK at the beginning of a recession, this is a testing time for both distributors and insurers of creditor business. So what effect will these changes have on the creditor insurance industry and what can be done by businesses to overcome these challenges?**

**What is creditor insurance?**

Creditor insurance, also known as payment protection insurance (PPI), is a product sold primarily alongside credit products such as unsecured loans, mortgages and credit cards. If the borrower is unable to make their repayments due to accident, sickness, unemployment or death, the insurance policy covers the repayments for a specified period of time.

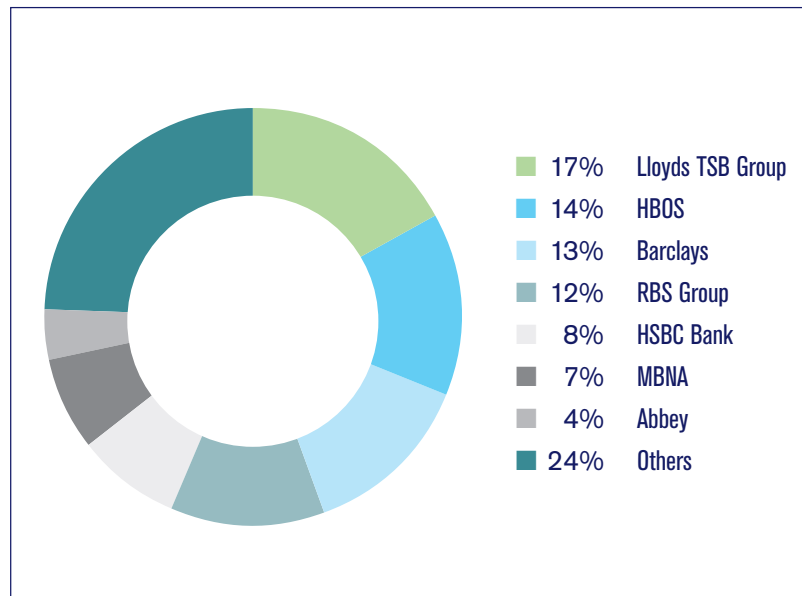
**What triggered the Competition Commission to step in?**

PPI is a large market with approximately £4 billion of premium written in 2007. The market is dominated by a relatively small number of players – 10 distributors were responsible for 84 per cent of the premium written in 2006, and it is a similar story for insurers – the top 10 insurers accounted for 93 per cent of the premium written in the same year, as shown in further detail in Figures 1 and 2.



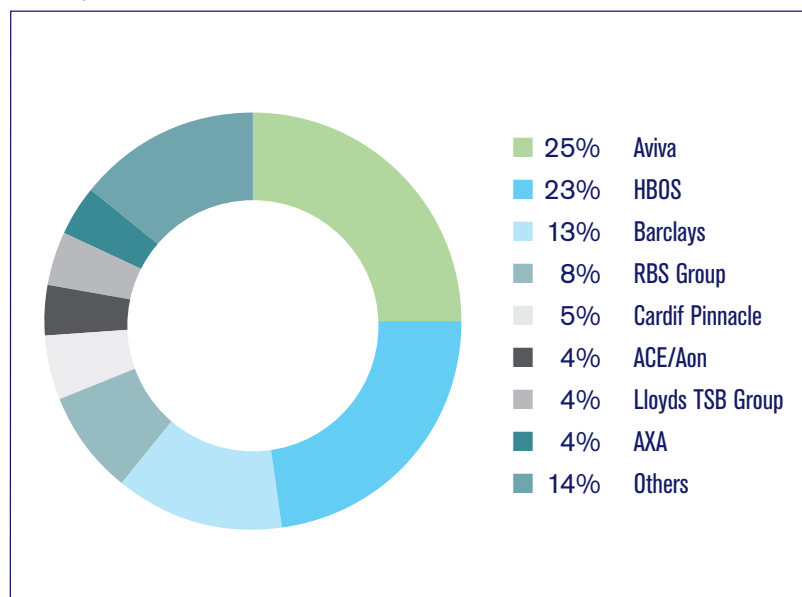
Kate Angell

**Figure 1 | Distributors' share of written premium (2006)**



<sup>1</sup>Source: Mintel report 'Creditor Insurance – UK, Financial Intelligence, July 2008'

**Figure 2 | Insurers' share of written premium written (2006)**



<sup>1</sup>Source: Mintel report 'Creditor Insurance – UK, Financial Intelligence, July 2008'



The investigation into the sale of PPI began following a referral from the Office of Fair Trading (OFT) in February 2007, with the OFT becoming involved following a 'super-complaint' from the Citizens Advice Bureau in September 2005.

### What did the Competition Commission's investigation conclude?

The key finding of the Competition Commission was that businesses which offer PPI alongside a credit product face little, or no competition. As a result, they felt that:

- Consumers faced higher prices and less choice than a fully competitive market would give.

- It is highly profitable for distributors to sell PPI.

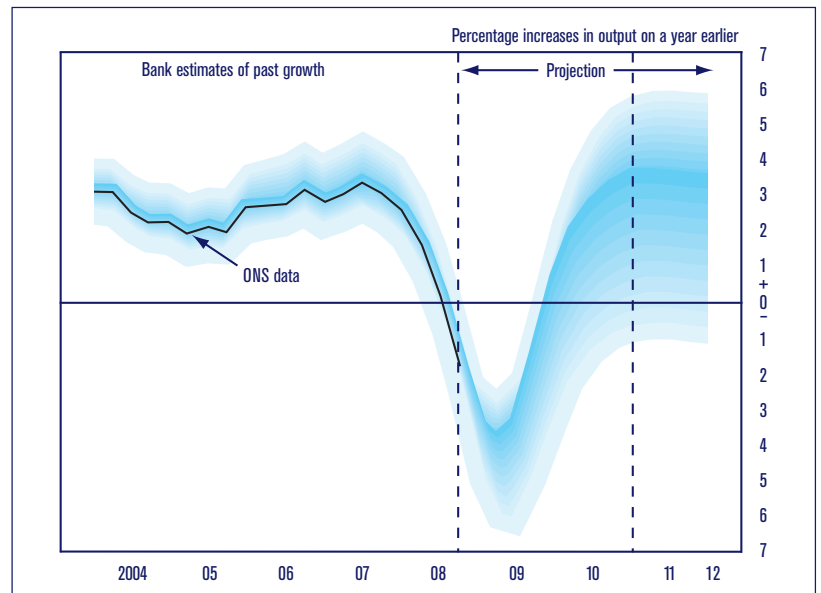
The Competition Commission found that many consumers were unaware that it is possible to buy PPI from other providers — separately from the credit product, that consumers rarely shop around to compare prices and terms and conditions of PPI policies, and that consumers also rarely switch providers.

### The remedies

In response to their findings, the Competition Commission has recently announced a number of remedies which they expect to come into force during 2010. These remedies include:

- A ban on the active sale of PPI by a distributor or intermediary to a customer within seven days of the associated sale of credit to that customer.

Figure 3 | A projection of future economic growth, measured by growth in GDP



- A prohibition on the selling of single premium PPI policies. All future PPI policies must be monthly or annual premium.
- A requirement to provide improved information to consumers to make it easier for them to compare products, either at outset or at a later date. Such improved information includes a 'personal PPI quote' which will clearly state the cost of the PPI policy individually, and when added to the credit product, as well as a requirement to provide an annual statement for customers throughout the duration of their PPI policy.
- A requirement to provide premium information on PPI policies to the FSA and OFT, with a recommendation that the FSA use this information in their publicly available PPI comparison tables.

Following the Competition Commission's published remedies, the FSA sent a 'Dear CEO' letter in February 2009 on the subject of single premium PPI policies. Clearly hoping that companies will quickly switch to selling monthly or annual premium policies, this letter requests that firms stop selling single premium PPI policies as soon as possible, and in any event by 29 May 2009.

### How does the recession affect the situation?

In its February 2009 inflation report, the Bank of England set out their projection of future economic growth, measured by growth in GDP. This is set out in Figure 3 and projects that GDP growth will be lowest in the middle of 2009 and will not return to levels previously seen in 2006 and 2007 until 2011.

“ There is no doubt that the upcoming changes should lead to a more competitive PPI market, with premium rates and sales volumes falling. ”

Claims experience on PPI business is highly correlated to the economic cycle, with an economic downturn leading to both lower volumes of PPI sales – due to lower lending activity – and increasing claims ratios. In addition to the obvious increase in unemployment claims, a secondary effect observed in past recessions is an increase in sickness claims, for example, due to stress-related illnesses.

One key issue for companies will be making an assessment of the likely impact of the recession on the claims ratios for their PPI business. One way of estimating the likely deterioration in claims ratios over the coming months is to compare the current economic projections with the actual economic statistics seen in previous recessions, together with the actual loss ratios experienced historically. Relevant economic statistics include the growth in GDP, together with historical employment levels and the historical flows into and out of unemployment – the latter of these often being more relevant than the actual nominal employment levels when considering PPI claims.

More recent statistics can also help. Data from the ABI shows that unemployment claims on PPI policies increased by 118 per cent when comparing November 2008 with the same period one year earlier.

### What effects will there be on the PPI market?

The amalgamation of the remedies being imposed by the Competition Commission and the difficult UK economic environment is likely to have a number of (sometimes

conflicting) effects on the PPI market. Possible impacts include:

- A reduction in sales volumes, as lending levels continue to be affected by the credit crunch and the benefit of selling PPI to consumers at outset is lost. PPI has historically been sold, rather than bought, and with the prohibition of selling PPI at the time of the accompanying credit product the level of PPI sales are likely to fall, perhaps substantially. Some of this reduction may be offset as consumers recognise the benefit of creditor insurance in the current economic environment.
- Increased competition between PPI providers as consumers ‘shop around’ for cover following the purchase of a credit product. This competition may be further increased through the greater use of comparison websites.
- Increasing claims volumes, which in the short-term are likely to result from the tough economic conditions. Looking further forward, claims volumes may increase due to anti-selection effects, as only those consumers who deem themselves more likely to make a claim may actually decide to purchase PPI. In addition, consumers will be reminded of the existence of their cover due to the provision of the annual statement; this information may remind some people to claim, while others, who may feel they are unlikely to ever claim, may cancel their policy.

There is no doubt that the upcoming changes should lead to a more competitive PPI market, with premium

rates and sales volumes falling. This should present an opportunity for providers to capture a much larger market share than they have had historically. Critically, those providers who understand which risk factors drive their claims experience, and are therefore able to rate their insurance products accordingly, should be able to benefit from the increasingly competitive market while managing their claims costs.

### Summary

#### The future

The combination of the challenging economic environment, together with the current regulatory intervention, means that the future is uncertain for the PPI industry. But challenges also give rise to opportunities, and those companies which have a coherent strategic plan to maximise their benefit from the current environment are likely to benefit from the current upheaval in the PPI market, at the expense of their competitors.

The shake-up may be about to start but, as long as distributors and insurers act now to make appropriate changes to their businesses, they can hopefully weather the storm.

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