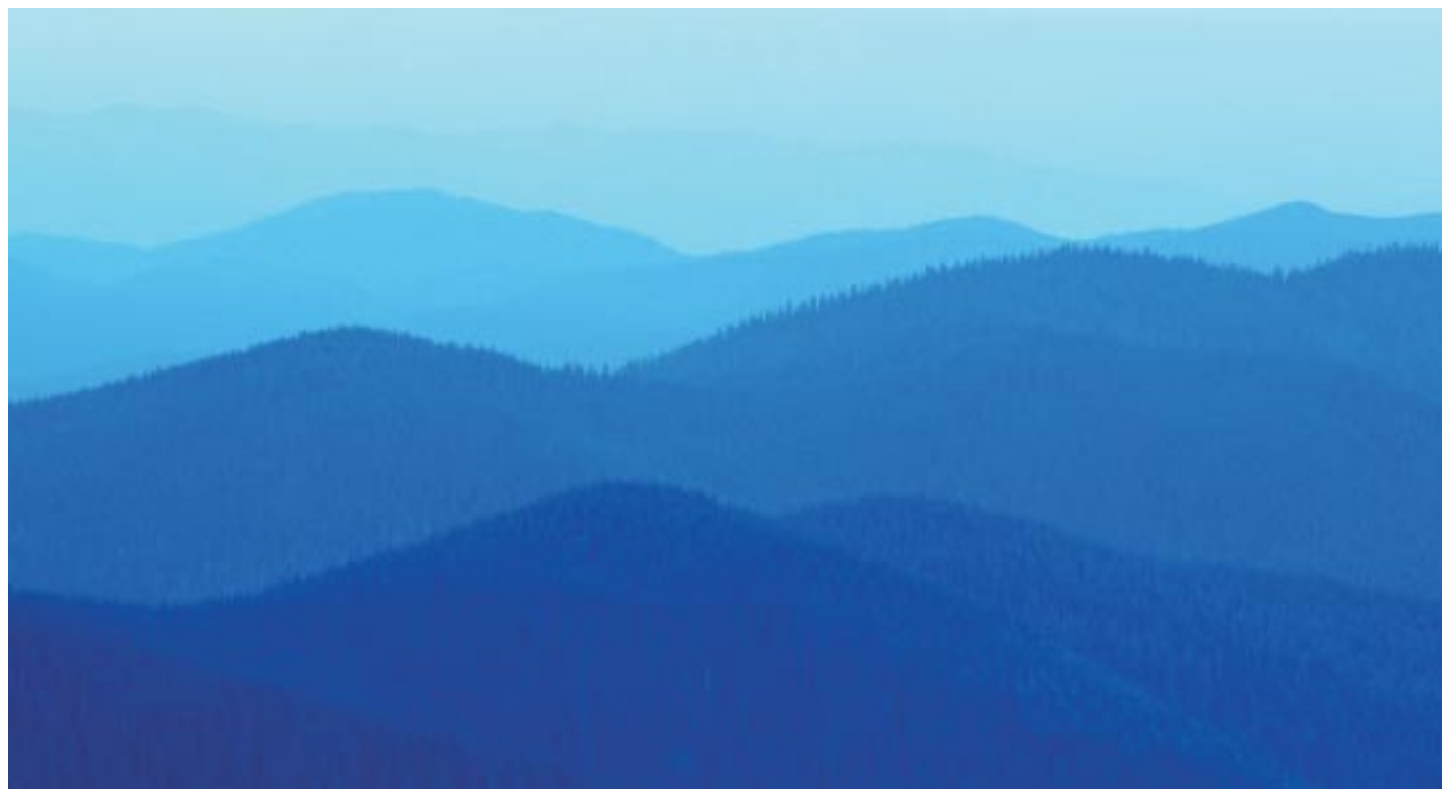


Payment Protection Insurance ('PPI') – the balloon is inflating

'We recommend that once the transfer of responsibilities for insurance regulation to the FSA has been completed the FSA should begin an investigation into the selling of Payment Protection Insurance. This should include the safeguards in place to prevent the mis-selling of PPI to customers who would not be able to benefit from it due to exclusions, how more competition could be introduced into the market, and how the provision of information to consumers could be improved to allow better informed choices about whether to take out PPI and about which policy is appropriate for individual circumstances.' The Treasury Select Committee Report (5 April 2005).



The publication of the above report is an example of the unprecedented scrutiny that PPI has attracted in the last six months. To put this into context PPI is being debated by all the industry stakeholders including consumer groups, regulators, trade bodies, the Competition Commission, the media and investment analysts. The media comments on PPI are increasing month-on-month.

What is PPI?

PPI, also known as Creditor Insurance, is an insurance product, sold as a package with unsecured loans, mortgages or credit/store cards. In a case where the borrower becomes sick, unemployed or has incurred an accident that prevents

the claimant from working, the insurance will make repayments towards the loan up to a pre-specified amount over a pre-specified period.

Why is PPI in the spotlight?

Despite the benefits of PPI, there are three main areas under scrutiny:

- Potential mis-selling;
- Treating Customers Fairly; and
- Competition, product margins and commissions.

An interesting theme that runs through all of these issues is disclosure and transparency, which for obvious reasons would improve consumer awareness

about what coverage they are buying and its cost. A secondary impact of this greater transparency, disclosure and more informed consumer buying would be an increase in the propensity for consumers to shop around to purchase the best value product, possibly unbundled from the underlying credit sale.

The short-term focus appears to be on potential mis-selling and fair treatment. Pressure from various stakeholders, including politicians, has prompted the FSA to put the selling of PPI to the top of its list of emerging financial services market risks. In addition, PPI has been under increasing scrutiny from the national press for being overpriced and the

Competition Commission has extended the review of store cards to include PPI. Many companies are grappling with understanding what Treating Customer Fairly means in the context of PPI. However, as TCF principles are likely to impact how PPI is sold, marketed, priced and how claims are handled, they cannot be ignored.

What is the potential impact on the PPI industry?

To put into context the potential impact on the PPI industry, we believe that there are three possible industry scenarios:

- a) Status quo;
- b) Product meltdown; or
- c) Product overhaul.

If the current scrutiny from the various stakeholders is short-term in nature and the current regulatory threats are successfully rebutted by both PPI product providers and distributors without any significant operational change then the status quo would be maintained.

The product meltdown scenario could occur if there is a significant loss in consumer appetite for PPI as a result of sustained adverse media and consumer group coverage. This may at first appear sensational, but interesting parallels can be drawn with endowment sales which have fallen dramatically over the last four to five years causing a fundamental shift in the life assurance market. In the event of this scenario, we would expect the sales of legacy PPI products to fall dramatically and there to be a radical shift in consumer behaviour to buying new 'substitute' untied protection products and the emergence of new 'substitute' channels of sale.

Product overhaul would be required if the current regulatory and consumer environment requires remediation and significant change in all, or part, of the following areas: product design, pricing, marketing, sales process, claims handling, remuneration, disclosure etc. As a result this may lead to lower PPI volumes and more pressure on margins as consumers are making more informed decisions and greater transparency increases competition. We would also expect a degree of migration from the legacy PPI products to the new substitute protection products and channels of sale.

In addition to the regulatory and consumer environment, any challenges arising from the above scenarios may be further compounded by any deterioration in the economy and the subsequent impact on unemployment. Recent reports by the UK lenders indicate that consumer bad debt is on the increase, which may be an early indication that claims ratios are on the rise.

What are companies doing to respond?

The eventual outcome of the PPI industry is, of course, all conjecture, but what are companies doing to prepare and respond to the current environment? There are three emerging positions being taken:

- a) Continuing to reap the margins and worry about the adverse scenarios if they arise;
- b) Preparing a robust defence and addressing gaps relative to best practice; or
- c) Leading the market by researching the development of new business models and strategies for radically different PPI and alternative protection products.

Companies are now taking action; a CEO of a UK banking group advised us recently that for them the regulatory risk and bad publicity from PPI is considered the number one risk to group profits. To this end, most companies have done some risk assessment on the potential impact on their PPI profits, but few have included the product meltdown scenario which, for most distributors, would elevate the issue to the board agenda. However, the recent interest in PPI from the city analysts and the potential knock-on impact for share prices is likely to keep PPI on the senior executives' radar.

As a general rule, the product providers are being more pro-active and are considering the latter two options, whilst the distributors are naturally more resistant to change that may threaten the existing PPI profit stream.

Each of the approaches identified above carries its own risks and potential rewards however, firms should now be fully analysing these risks, and understanding the profitability of the product across the entire economic cycle, both from an insurer's and distributor's perspective. They should also be looking to design solutions to increase profitability of the current book as well as the profitability

of any new business given the changed environment. In addition, management information should be designed to monitor and control the risk and performance of your creditor business, including the critical controls over potential mis-selling.

The balloon is inflating, but there is plenty that can be done to avoid a nasty bang!

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