John K Ashton and Robert Hudson recently carried out some research examining the entire mis-sold Payment Protection episode to work out if the decision to change PPI markets was justified.

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By late last year, more than £8 billion had been paid to customers who complained how they were sold payment protection insurance (PPI).

Even during the past 12 months, these payments have increased from a monthly average of under £200m in 2011, to over £500m in 2012. In light of these increasingly large costs of customer redress, it is unsurprising that the British Bankers Association (BBA) has recently called for a time limit on new PPI claims to be introduced in 2014.

So how did the sale of an insurance service which offered varying combinations of accident, sickness and unemployment protection lead to this situation?

Independent assessment of the judgement which led to customer redress is not only critical for the banking industry saddled with the obligation to repay customers for a mis-sold financial service. There are clear incentives for customer groups to claim they are cross-subsiding other parties if the resulting regulatory judgement is associated with such a substantial pay-out.

Moreover, the PPI judgement could even reflect political decision making by regulators wishing to enhance their public profile and reputation. Despite the significance of this regulatory judgement, independent assessment of this decision has been rather overlooked throughout public discussion of PPI, which has focused on how to claim customer redress, how much has been repaid by the banks and the rapacious nature of the emergent PPI claims industry.

The actual PPI judgement which initiated the process of consumer redress, occurred in January 2009, when the Competition Commission (CC), prohibited the joint sale of PPI with unsecured lending after 2010. This decision followed a long period when PPI was either encouraged or criticised by the Government and regulators.

Mortgage PPI has been recommended by the Government as a complement to the system of state income support for mortgagors. PPI was also repeatedly criticised for providing poor value for money and for being associated with unhelpful sales techniques when sold jointly with a loan.

After repeated investigations by the Financial Services Authority and the Office of Fair Trading, this market was assessed by the Competition Commission.

Central to the CC judgement was the assumption that PPI cross-subsidised credit. Cross-subsidies were identified using three techniques. Initially, the CC interviewed bank staff, with some respondents acknowledging this market employed cross-subsidies. Second, whether profitability of lending and PPI markets was consistent with cross-subsidy conditions was assessed. It was concluded that between 2003 and 2007, lending was only sustainable if PPI cross-subsidised the costs of lending. Lastly, a costing model from the industry was examined and met with reservations. From this multi-method analysis, conditions consistent with cross-subsidies from PPI to lending were reported.

To examine the veracity of this assessment, Bangor Business School and Newcastle University conducted two studies. In the first, the research examined the quality of mortgage

PPI policies. As a starting point to the research, the following question was examined: Do banks which jointly distribute PPI policies with lending offer higher quality policies than firms independently distributing PPI? In the event of a successful claim both the policyholder and bank are beneficiaries: the PPI policyholder benefits from a PPI payout in that their loan payments are made and the bank through guaranteed loan repayments. It's clear here that a bank distributing PPI with lending will benefit from a higher quality PPI policy with more inclusive coverage, greater quality and higher payouts.

The research examined this question through recording the policy details of 281 mortgage PPI policies from 2008, distributed jointly with lending and offered independently. The research discovered that jointly sold policies tended to provide better benefits in some respects but were not generally clearly superior in all their terms and conditions. Comparisons between policies sold jointly and independently indicate that the policies sold jointly are clearly more expensive for a given set of benefits and conditions suggesting uncompetitive premium levels.

Within the second piece of research, the pricing of unsecured lending offered with and without access to PPI was examined. Following the CC judgement we would expect the costs of unsecured lending to fall if PPI is offered with lending. This question was tested using a dataset of unsecured lending interest rates from Moneyfacts PLC for a 219 unsecured loan services offered with and without PPI from

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1998 to 2011. Specifically, we determined if we could predict if an unsecured personal lending product is offered with PPI, by using the interest rates for unsecured lending. If cross-subsidies are not present, we would expect the interest rate and the decision to offer PPI or not to be unrelated. If a cross-subsidy is present from PPI to unsecured lending, then this would reduce interest rates. We identified interest rate setting behaviours consistent with cross-subsidies existing from PPI to unsecured personal loans. In addition, we observed interest rate setting varied with cross-subsidies occurring mostly for proprietary banks and banks lending to general rather than sub-prime markets.

To conclude, the analysis underlying the CC judgement appears to be robust, at least to our enquiries. PPI policies appear to have been used to cross-subsidise lending and policies sold jointly with credit are clearly more expensive for a given set of benefits and conditions suggesting uncompetitive premium levels.

In future, independent academic examinations are essential when regulatory judgements carry such a high cost for banks.

John K Ashton and Robert Hudson work for Bangor Business School and Newcastle University respectively.

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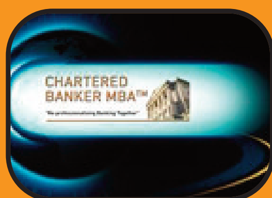

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