Should the joint provision of credit insurance with unsecured lending be prohibited? An examination of the UK payment protection insurance market

BACKGROUND

- After 2010, the joint sale of lending and credit and payment protection insurance in the UK will be prohibited, following a decision by the Competition Commission in January 2009.
- This decision represents a retreat from the move to deregulation of banking practices in both the UK and the USA which resulted in the joint selling of banking and insurance services.
- The impact of the prohibition is expected to be substantial, since in 2006 there were estimated to be 20 million credit insurance contracts in existence.
- The principle underlying the study is that customers with weaker decision making abilities may be exploited by the joint pricing of loans and credit insurance and that cross subsidies represent a transfer from naive to more sophisticated consumers.

METHODOLOGY

- A theoretical model of the joint provision of credit insurance and unsecured lending is developed, and its predictions drawn out.
- The model is tested empirically on UK data covering the period January 1998 to December 2007. Empirical analysis is by means of regression analysis and non-parametric tests.

KEY FINDINGS

- The model predicts that joint pricing of unsecured loans and credit insurance by proprietary banks leads to cross subsidy from naive to sophisticated consumers; this prediction is confirmed by the empirical analysis. The authors show that it is the joint sale rather than variation in the cognitive abilities of consumers that drives this result.
- In the case of mutual banks, cross subsidies between these products do not necessarily arise.
- Both proprietary and mutual banks set distinct lending and insurance prices, but mutuals are less likely to set proportionately high credit insurance premia.

POLICY ISSUES

- The study lends support to the Competition Commission’s prohibition on the joint selling of credit insurance and lending. In particular, it shows that proprietary banks cross-subsidise unsecured loans and credit insurance, which has a negative impact on naive consumers.
• The prohibition may deliver benefits for boundedly rational consumers at relatively little cost.
• Financial literacy alone is not sufficient to eradicate cross-subsidies, which are persistent but diminishing over time.

THE CCP
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