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

An ESRC Research Centre
CCP CENTRE FOR COMPETITION POLICY

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An examination of the UK payment protection market

CCP Policy Briefing

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.

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- 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

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

FOR MORE INFORMATION

The full working paper (CCP Working Paper 09-8) and more information about CCP and its research is available from our website: www.ccp.uea.ac.uk

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