Financial Services Authority

The Sale of Payment Protection Insurance

Thematic update

September 2007

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1 Introduction

This report outlines the interim findings from our third phase of work to review the sales processes and systems and controls around the sale of payment protection insurance (PPI) policies. It follows reports on two earlier phases of work published in November 2005[1] and October 2006[2].

Following that earlier work, we issued a letter to the chief executives of medium and large firms[3] in which we set out our expectations, a factsheet for small firms[4] to help them understand their obligations, a Consultation Paper proposing new rules for carrying out general insurance business (including the sale of PPI)[5] and information to help consumers who are considering taking out PPI[6]. We have already taken enforcement action against ten firms for failures relating to the sale of PPI that we identified during our first two phases of work.[7] In March 2007 we published details of our agreement with the PPI industry to ensure customers are given a refund if they cancelled a single premium PPI policy.[8]

In January 2007[9], we announced we would undertake a further and more extensive programme of work to test the industry's progress in ensuring that customers are:

1. told that PPI is optional, where this is the case;
2. given clear information about the product and what it will cost;
3. given the assistance they need to be clear about what they are eligible for under the policy and what the exclusions are;
4. where advice is given, recommended a policy that meets their needs; and
5. offered a fair refund if they cancel their policy.

We believe that a suitably tailored product can provide valuable protection for consumers.

1 www.fsa.gov.uk/pubs/other/ppi_thematic_report.pdf
2 www.fsa.gov.uk/pubs/other/ppi_thematic.pdf
3 www.fsa.gov.uk/pubs/ceo/ppi.pdf
4 www.fsa.gov.uk/pages/Doing/small_firms/insurance/pdf/paypro.pdf
5 www.fsa.gov.uk/pubs/cp/cp07_11.pdf
6 www.moneymadeclear.fsa.gov.uk/news/payment_protection_insurance.html
7 See Annex A for a list of the firms.
8 www.fsa.gov.uk/pages/Library/Communication/PR/2007/043.shtml
9 www.fsa.gov.uk/pages/Library/Communication/PR/2007/003.shtml

Summary

Our expectation of firms operating in this market is straightforward. We expect them to meet our Principles and Rules when selling PPI, including Principle 6 regarding the fair treatment of customers (TCF)[10] and the Insurance Conduct of Business rules (ICOB).

As part of our third phase of work we visited 150 firms across the market and commissioned an external party to mystery shop unsecured personal loan providers.

We found that:

- there have been improvements in two of the outcomes above, namely in making it clear that PPI is optional and providing refunds on virtually all single-premium policies, but little or no improvement in the remaining three, including the disclosure of price and policy details as well as firms' consideration of eligibility and suitability;
- around two thirds of firms visited and nearly all of the firms mystery shopped failed to meet the ICOB requirements;
- around a third of firms visited and less than half of firms mystery shopped failed to insure that customers are given the basic information necessary to make an informed decision about this product; and
- many PPI products do not appear to be designed to meet the needs of the customers to whom they are sold. We believe that customers would generally benefit from a more flexible product that can be tailored to meet their needs and is targeted accordingly.

We expect firms to:

- take active steps to ensure they are meeting the five outcomes we identified above and in our previous PPI reports;
- assess their corporate culture against our expectations and deliver any cultural change needed to ensure the fair treatment of PPI customers; and
- review our guidance on the product design process and carefully consider whether their existing products meet their customers' needs. If the products do not, firms should consider what changes they may need to make to the product design to meet their TCF obligations.

10 Firms should be focused on delivering the six TCF consumer outcomes:
1. Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
2. Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
3. Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
4. Where consumers receive advice, the advice is suitable and takes account of their circumstances.
5. Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and also as they have been led to expect.
6. Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

In light of the continued failures identified, we have decided to:

- conduct further mystery shopping on firms to gather additional information on PPI sales. We intend using the mystery shopping results as part of future enforcement proceedings against firms where appropriate;
- undertake further assessment through visits to those firms where we have identified potential failings; and
- seek to impose higher fines for firms in the PPI market where standards fall below required levels.

The FSA is seeking to increase the level of fines for firms in the retail market where this is warranted. This is in line with our general framework as set out in the FSA's Decision Procedures and Penalties Manual (DEPP) Chapter 6[11], and is to both discipline the firms and provide a stronger deterrent to others operating in this market. We believe that the failure to treat customers fairly when selling PPI is one area where such action is deemed necessary.

Our approach

As part of our latest programme we completed new and follow-up visits to 150 firms that together sell over 1.6m PPI policies a year with a premium value of over £750m. These firms, large and small, represented a wide range of sectors including banks, building societies, friendly societies, mortgage brokers, credit/loan brokers, retailers and motor dealers. We looked at PPI sold alongside unsecured personal loans, revolving credit (credit cards and instalment finance), prime mortgages, other insurance policies and secured loans. We considered sales of both regular and single-premium PPI policies on an advised and a non-advised basis.

Together with our earlier PPI work, over the past two years we have visited a total of 214 firms selling PPI.

We also commissioned market research company GfK NOP to undertake 114 mystery shops on our behalf across firms selling single-premium PPI alongside unsecured personal loans. This sector of the PPI market is one of the largest and was one where we had previously identified poor selling practices around single-premium policies. Through the mystery shopping, we have been able to gain better insight into branch-based face-to-face sales of PPI by these firms.

Visit findings

We found that over 90% of the firms visited are now making it clear to customers that PPI is optional. Firms also appear to be taking a more balanced approach to staff remuneration structures and thus the incentives that drive staff behaviour.

11 DEPP 6.5.2 G among the 13 factors that may be taken into account when determining the appropriate level of financial penalty are deterrence; nature, seriousness and impact of the breach; duration and frequency of the breach; amount of benefit gained or loss avoided and FSA guidance and any other published materials.

Our visits and subsequent desk based work also showed us that, in line with our March 2007 agreement with the PPI industry, firms have taken positive steps to change their contracts to provide refunds on nearly all single-premium policies, when appropriate. Our work with firms indicates that by the end of 2007 they will have contacted over 1.1 million affected customers about these new refund terms.

However, our findings indicated that some firms' sales processes still fall short of expectations in the following areas.

- A third of the firms we visited were unable to demonstrate to us that they had properly established whether customers were eligible to claim under the different elements of the policy.
- A third of firms were not properly explaining the significant exclusions and limitations of the policy to customers.
- One-third of firms selling single-premium policies could not demonstrate to us that sales staff had given customers sufficient information ie. that the PPI premium is added to the loan and interest is paid on that amount, which is fundamental to consumers' understanding of the cost of this product.
- Almost half also could not demonstrate that staff had given a proper explanation to the customer of single-premium refund terms.
- Of the firms selling PPI on an advised basis, 40% failed to demonstrate to us that they had properly determined whether the particular PPI policy was suitable. ICOB[12] makes it clear that an adviser must take steps to ensure that the policy is suitable for the customer, taking into account the customer's demands and needs, including whether or not they have any existing cover. It was clear from the sales processes reviewed and in Statements of Demands and Needs that they were not always tailored to the individual customer and did not explain why the product was actually recommended.
- In just over a third of the firms visited we found there were inadequate systems and controls in place around the sales process. Inadequate systems and controls of this sort indicate that the firm and the senior management have not given appropriate priority to compliance with regulatory obligations that were designed to provide positive outcomes for consumers.

Just under two thirds of firms visited could not demonstrate they had taken sufficient steps to ensure their sales processes meet the required standards. This was particularly the case for those selling single-premium PPI alongside unsecured personal loans. We found differences in the quality of the systems and controls for telephone sales and branch sales in some of these firms. There is evidence that some of the larger firms moved very slowly in response to our last report, only recently initiating major changes to processes and sales scripts.

12 ICOB 4.3.1R & 4.3.2R.

Around one third of our visits were to firms for whom financial services is not their main line of business and sell PPI as a tertiary product. Of these nearly a half had not properly engaged with their regulatory responsibilities and had in general failed to meet the standards of TCF and ICOB.

Motor retailers have shown some of the biggest improvements since our earlier work, for instance, they have been proactive in changing their sales processes to better align them with TCF objectives.

Our latest work has confirmed our earlier findings that sales of regular premium prime mortgage PPI, on an advised basis, are most likely to meet our requirements. We found that the processes and controls around the selling of this specific product are likely to result in a more thorough assessment of the customer's demands and needs when arranging protection insurance.

Mystery shopping findings

GfK NOP[13] has produced a separate report outlining the full results of the mystery shopping; we have published this on our website.

GfK NOP carried out 114 mystery shops on unsecured personal loan providers and focussed on the PPI sale alongside the loan.

The mystery shopping programme was focused on assessing the extent to which, when selling PPI, firms had addressed the key concerns identified in our second phase of PPI work. In our October 2006 Report we described the outcomes we wanted to see and set out some of the issues firms needed to consider and act upon to satisfy themselves that they are meeting the relevant ICOB rules, treating their customers fairly and providing clear, fair and not misleading information.

More specifically, the mystery shopping programme assessed the following outcomes, the results of which are illustrated in the chart on page 9:

1. Was the customer told that PPI is optional? (**Optionality**)
2. Did the customer not feel pressured to accept PPI? (**No Pressure**)
3. Was the customer told of the monthly and total cost of the PPI? (**Price**)
4. Was the customer told whether the sale was made on an advised or non-advised basis? (**Advice**)
5. Was the customer given a compliant statement of price and policy summary? (**Documentation**)
6. Was the customer told of the significant exclusions and limitations? (**Exclusions & Limitations**)
7. Was the statutory cancellation period explained to the customer? (**Cancellation Period**)

13 http://www.fsa.gov.uk/pubs/consumer/crpr61.pdf.

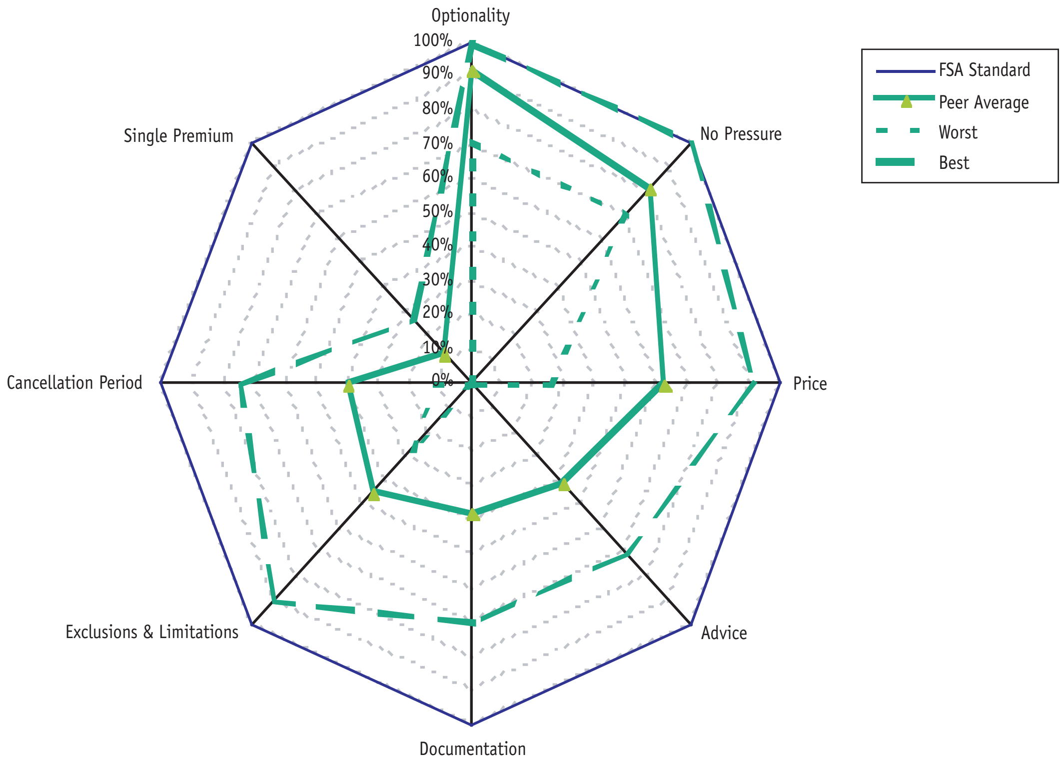
8. Was the customer told this was a single premium product and that interest would be added to the price of the premium? (**Single Premium**)

Our expectations of firms operating in this market have been published on several occasions and the questions used in the mystery shopping relate to ICOB and TCF requirements for a PPI sale. Our standard for each issue is therefore 100% compliance and is illustrated in the following diagram by the solid blue line around the outside of the chart.

Findings against each question have been plotted on the diagram, the solid line joins up the average result of all the shops (as a percentage). For example, in 92% of shops the shoppers answered 'yes' to the question 'Did the salesperson say that PPI was optional?'

The result for the best performing firm on each issue is highlighted by the outer dashed line. The chart illustrates that in the best performing firm in all of the shops on that firm, shoppers said 'yes' to the question 'Did the salesperson say that PPI was optional?'.

The inner dashed line indicates results for the worst performing firm for each issue. For example, when considering the question 'Was the customer told whether the shop was made on an advised or non-advised basis?' in the worst-performing firm, no shoppers were told the basis on which the sale was made.



The chart illustrates that the expected standard was reached on only two issues, namely 'optionality' and 'no pressure', and this was only by the best-performing firms.

On average, 92% of shoppers stated that the salesperson told them PPI was optional. In addition, over 80% of shoppers did not feel pressured to buy PPI. These positive findings show an improvement during the period of our PPI work and are consistent with the findings from our visits.

However, the remaining results are generally poor.

- While 87% of shoppers were told how much PPI would cost them each month, only 62% of shoppers were told how much PPI would cost them in total over the term of the loan.
- Almost half of the shoppers said that they were not told whether the PPI sale was on an advised or non-advised basis. Of those that were told the basis of the sale, a few were given incorrect information by the salesperson.
- In relation to the written documentation firms gave shoppers, only half were given a policy summary and less than half were given a compliant Statement of Price. Only 26% of shoppers said they were told of the importance of reading the documentation.
- In less than half of shops shoppers said they were told about the policy limitations and exclusions. Only 28% were asked in some way about their health, despite the accident and sickness element of PPI cover typically not covering claims resulting from an existing medical condition.
- Only one third of shoppers were told their statutory cancellation rights. In one firm, it was mentioned in less than 15% of shops.
- Despite all PPI policies shopped in this sample being single premium, only 13% of shoppers said they were told it was a single premium policy and the firm explained it so they understood the nature of the product. In two firms, single premium policies were not explained at all. Consequently, several shoppers mistakenly thought they were being sold a regular premium product and many did not understand that interest would be charged on the single premium.

The mystery shopping identifies potentially significant failings in the PPI sales processes of some firms. Several of the firms shopped did not comply with the specific regulatory requirements in ICOB or treating their customers fairly when undertaking these transactions.

The mystery shopping results highlight standards of behaviour that fall below our expectations and raise questions about firms' systems and controls. They may also indicate failures in the quality of staff training and competence. For example, several shoppers were unclear whether they were being sold a single or regular premium policy or whether the sale was on an advised or non-advised basis as they were given incorrect information by the sales staff.

We will conduct further mystery shopping on firms to gather additional information on PPI sales. We intend to use the mystery shopping results as part of any future enforcement proceedings against firms, where appropriate.

Market and product concerns

We have been clear about our expectations of firms operating in this market and we also expected that by now all firms would have made substantial improvements in PPI sales practices.

Treating customers fairly

As we reported in May 2007[14], the TCF "implementation" deadline tested whether firms were implementing necessary changes in a substantial part of their business. Firms were expected to have allocated appropriate resources and responsibilities, developed plans and processes, and created capability to meet the TCF principle. We would expect a firm's implementation plan to identify and tackle any gaps in their ability to ensure customers are treated fairly, including the designing and selling of PPI.

We have set firms a deadline of December 2008 to complete their work on TCF and to demonstrate they are consistently treating their customers fairly in all aspects of their business, including PPI. Embedding TCF requires firms to follow up on TCF implementation through continuous monitoring of TCF performance along with a commitment to maintaining standards in the future. This is a significant challenge, particularly for large complex organisations.

Firm culture

It is only through establishing the right culture that senior management can convert their good intentions into actual fair outcomes for PPI consumers. We expect firms' senior management to drive a TCF culture that is reflected in the firm's corporate strategy and applied throughout each firm at all working levels. Firms may wish to use the framework set out in our publication *Treating Customers Fairly – Culture* to assess their firm against these expectations.[15]

Market structure

The Office of Fair Trading (OFT) said the PPI market had the following features:

- low claims ratios compared to other insurance products;
- high commission rates in comparison with other general insurance products;
- wide differentials in price for the same level of cover;
- possible cross-subsidisation which could keep Annual Percentage Rates low;
- consumers that do not shop around or switch; and
- lack of competitive pressure on prices.

In February 2007 the OFT referred the payment protection market to the Competition Commission for further investigation.

14 www.fsa.gov.uk/pubs/other/tcf_implementation.pdf
15 www.fsa.gov.uk/pubs/other/tcf_culture.pdf

Based on our visits and mystery shopping, we think that consumers are more likely to get poor outcomes in the PPI markets which have these features.

The purchase of PPI is usually a secondary focus for customers; their primary purpose is to get another financial service or product such as a secured or unsecured loan. PPI is also a product that is generally sold to consumers, rather than one they actively choose to buy. In these circumstances, the sale of PPI policies together with the loan/credit can lead to unfair outcomes for consumers by blurring the separate elements of the sale and constraining firms from offering potentially more suitable PPI products to their customers. Firms should consider these issues where they might affect their obligation to treat customers fairly.

Product design

Our visit and mystery-shopping results indicate that there is a higher risk of customers being treated unfairly where firms sell single-premium PPI policies[16].

One of the key TCF consumer outcomes is that products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly. While single-premium PPI can be a useful product for some, it is not necessarily appropriate for all consumers. Despite this, it appears that many firms assume that nearly all customers have a potential PPI 'need' and, in most cases, those customers will be sold a single-premium product. This is often because firms have chosen to only offer a single-premium product at the point of sale, regardless of whether or not it is appropriate for their customer base.

Indeed, we have found that some firms are selling five-year single-premium PPI policies alongside unsecured loans, even when there are strong indications that customers are likely to consolidate/repay/refinance their loan before it reaches full term. In such cases, firms should consider whether a more flexible product would provide a fairer outcome for customers. In addition to this, we found many instances of customers being recommended an extensive and costly PPI policy, even where they only had a very narrow gap in their existing cover where a more tailored product could more appropriate.

In our July 2007 *Regulatory Guide on the responsibilities of providers and distributors for the fair treatment of customers*[17] and our publication on *Treating Customers Fairly in product design*[18] we gave the following guidance on the product design process. Firms should:

- identify the target market;
- consider stress-testing the product to see how it might perform in different environments and how the customer could be affected;

16 This is because firms are not clearly explaining the structure of the product and its main elements of it to consumers (such as price and refund terms).

17 www.fsa.gov.uk/pubs/policy/ps07_11.pdf

18 www.fsa.gov.uk/pubs/other/tcf_product_design.pdf

- consider which systems and controls will be needed to manage the risks posed by product design; and
- consider how to ensure the information produced for consumers is clear, fair and not misleading and that it is appropriate for the intended user.

Both firms and customers would benefit from firms reviewing their PPI products against these TCF objectives. While we do not seek to dictate how products should be designed, we do expect firms to design them with the intended market firmly in mind.

Here is an example of one firm (a motor retailer selling PPI) that has reassessed its PPI product to determine whether it is the best product it can offer its customers.

Following an FSA visit, this firm proactively took steps to improve its sales process and to source a PPI product that would better suit the needs of its customers. In the past, it had only offered its customers single-premium PPI policies that were provided by the lenders and were therefore specifically linked to the underlying credit product.

The firm decided that single-premium PPI was not the best PPI product for its customer base. It subsequently approached an insurance provider to source a regular-premium product that it could offer its customers and replace the lender's own PPI product. Regular-premium PPI is now the only PPI product this firm offers its customers.

The firm believes that not only will the customer benefit but so will the firm itself, especially over the longer term. It thinks the new PPI product will offer better value, be easier to explain to its customers and will remove the detrimental early settlement penalties of single-premium PPI.

FSA action

We have responded to the visit and mystery shopping findings by taking a range of actions designed to deal with those firms that fail to treat their customers fairly and to improve PPI sales standards in the future.

We have referred four firms to Enforcement for further investigation and are actively considering referring around 20 more. Eleven firms have stopped selling PPI either permanently or temporarily until such time as they improve their sales processes and/or retrain their staff. A further three firms cancelled their permissions after we visited them and four firms are undertaking a past business review. We have instructed two firms to provide an independent skilled person’s report regarding their PPI sales processes in line with the Financial Services and Markets Act 2000 (s166). We have asked almost all of the 150 firms we visited this year to take specific action to improve their PPI sales.

In line with its general approach, the FSA is seeking to increase the level of fines where this is warranted by the nature, seriousness and impact of the breach in question, and by the likely impact on deterrence. Firms have been given due warning of their obligations to treat customers fairly, both generally and on PPI in particular. Consequently, the FSA will now seek to impose higher fines for firms in the PPI market where standards fall below required levels.

We will also consider using a range of other enforcement penalties, where appropriate, including the variation or cancellation of a firm's permission to sell PPI and the suspension of its sales forces.

In September 2007 we fined a firm and its CEO for inadequate systems and controls when recommending re-mortgages and PPI to customers.[19] This is the first time we have fined both a retail firm and its chief executive.

We have also worked with firms[20] to change the way they sell PPI over the internet. Some firms were offering personal loans on their websites where PPI was automatically included, using techniques such as a 'pre-ticked' box. Firms have agreed to change their websites so that, in future, it is up to the customer to choose to buy PPI rather than it being sold automatically.

In CP07/11[21] we have proposed additional rules relating to PPI sales, including greater emphasis on oral disclosure of price and key limitations and exclusions and specific obligations for firms selling PPI to carry out eligibility checks. If adopted, these rules will come into effect next year. In finalising these rules, we will take into account the findings from our PPI thematic work.

As a result of our visits, we have already seen some firms take steps to improve the PPI aspects of their business, as well as the way they treat their customers when selling this product.

Some of the worst performing firms have taken the following action to improve their sales practices following our visits:

- stopped selling PPI alongside loan/credit products until they are able to satisfy themselves that their sales processes meet the expected standards;
- commissioned independent external reviews of their PPI sales processes and engaged experts to oversee re-writes to sales scripts and re-training of sales staff;
- instigated an end-to-end review of the entire PPI process coupled with a gap analysis;
- undertaken a preliminary consumer contact exercise to check whether any of them could have been adversely affected by inappropriate sales of PPI in the past;
- worked with insurers to design and launch a new PPI product that is simpler with fewer exclusions and that is easier for customers to understand;
- undertaken staff retraining exercises; and
- contacted customers sold PPI to offer them a refund of interest paid on PPI premiums for the life of the loan.

19 www.fsa.gov.uk/pages/Library/Communication/PR/2007/099.shtml

20 www.fsa.gov.uk/pages/Library/Communication/PR/2007/084.shtml

21 www.fsa.gov.uk/pages/Library/Policy/CP/2007/07_11.shtml

As well as our work with firms we are also working to improve consumers' understanding of PPI to strengthen their role in this market and help them shop around when buying it. Earlier this year we ran a campaign to encourage consumers to access and use insurance information, including information on PPI, on our Moneymadeclear website[22]. We continue to receive around 1,000 visits to our PPI web pages each month.

We are extending our suite of online comparative tables to include PPI to help customers compare products and shop around. We expect to publish these tables in March 2008.[23]

We welcomed the consumer-facing PPI guide the industry recently published. Several firms operating in the PPI market have made this guide available to consumers either via their websites or at the point of sale.

Next steps

As noted earlier, this report does not represent the end of our PPI work. Given our findings, we will continue to work to improve sales processes and we intend to escalate our action against those who fail to meet their obligations.

We will:

- pursue formal disciplinary action against firms where there is sufficient evidence that their actions and behaviour falls short of the standards which we require and, where appropriate, seek to impose higher fines on them;
- undertake further focused visits to those firms where potential failings have been identified to determine whether formal investigation is required;
- conduct further mystery shopping on firms to gather additional information on PPI sales. We intend to use the mystery shopping results as part of any future enforcement proceedings against firms, where appropriate;
- follow-up the detailed remedial action plans that some firms are now implementing;
- ensure that the refunds firms provide are calculated in line with their obligation to treat customers fairly. We will follow up with those firms where we believe this is not the case.
- undertake further focused work on issues that cut across the PPI market, e.g. reviewing the commission arrangements between firms; and
- continue to work closely with the Competition Commission to help inform their market investigation.

22 www.moneymadeclear.fsa.gov.uk/news/payment_protection_insurance.html

23 www.fsa.gov.uk/Pages/Library/Communication/NewsLetters/Bulletins/tables8.pdf

Enforcement action against firms

We have previously taken enforcement action against ten firms for breaches in relation to the selling of PPI policies. We have fined them a total of £1.8 million. However, the eventual total cost to firms of remedial programmes and redress will be significantly higher. We have also required firms to contact over 1.5 million consumers[24] and, where appropriate, offer them redress.

We have publicised the findings of these investigations to raise awareness in the market of the standards we expect.

Firm	Action	Date
Hadenglen	Fined £133,000 and CEO fined £49,000	September 2007
Cathedral	Public Censure	February 2007
Capital One	Fined £175,000	February 2007
GE Capital Bank	Fines £610,000	January 2007
Redcats	Fined £270,000	December 2006
EW Motor Group	Public Censure	December 2006
Home and Country Mortgages	Fine of £52,500 included PPI failures	December 2006
Capital Mortgage Connections	Fine of £17,500 included PPI failures	November 2006
Loans.co.uk	Fined £455,000	October 2006
Regency	Fined £56,000	September 2006

24 www.fsa.gov.uk/pages/library/communication/speeches/2007/0314_sk.shtml

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