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The price, quality and distribution of mortgage payment protection insurance: A hedonic pricing approach

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ABSTRACT

Mortgage payment protection insurance (hereafter MPPI) provides varying combinations of accident, sickness and unemployment insurance and is used to protect the mortgage payments of policyholders in the event of a fall in income. Despite alleviating housing market failures, this service has been heavily criticised for providing poor value for money and being associated with unhelpful sales techniques especially when sold jointly with a mortgage in the UK. Consequently, the Competition Commission (2009) ruled that after February 2011 MPPI should not be sold jointly with mortgage lending within seven days of the credit transaction. We examine whether this prohibition was justified and if the form of distribution, either jointly with the mortgage or independently influences the premium levels. This assessment uses a hedonic pricing approach with details and premiums of MPPI policies in 2010 and 2012. Despite the success in reducing MPPI premium levels, we conclude that the Competition Commission judgement has raised concerns as to mortgagee protection.

1. Introduction

Mortgage payment protection insurance (hereafter MPPI[1]) is an ‘add-on’ service providing varying combinations of accident, sickness and unemployment insurance and is used to protect the mortgage payments of policyholders in the event of a reduction in income. The provision of this insurance service has long been a UK policy priority to compliment the system of state income support for mortgagors (Department for Environment, Transport and the Regions, 2000). Nonetheless, this product has been heavily criticised for providing poor value for money and for being associated with unhelpful sales techniques especially when sold jointly with a mortgage (see Office of Fair Trading, 2006 [hereafter OFT]; Competition

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[1] Through the paper Mortgage payment protection insurance is denoted MPPI and payment protection insurance is denoted PPI. Different regulators are also referred to by their acronyms; the Office of Fair Trading as the OFT, the Financial Services Authority as the FSA and the Financial Conduct Authority as FCA.

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Commission, 2007; 2008, 2009).[2] In 2009 the Competition Commission ruled that after February 2011 MPPI should not be sold jointly with lending. A joint sale is defined as one within seven days of the credit agreement. We investigate if this far-reaching ruling is justified and specifically whether MPPI policies sold jointly with a base good, mortgages, are more expensive than policies sold independently for a given set of benefits and conditions, as predicted by regulators and extant theory (e.g. Ellison, 2004; Gabaix & Laibson, 2006).

MPPI is a highly complex service combining a number of different types of insurance and has characteristics which vary across providers. We allow for this complexity by using the hedonic regression technique formalised by Rosen (1974) as a method of deriving monetary values for the attributes of composite goods. Through examining a nearly complete population of UK MPPI policies from August 2010 and June 2012 (797 policies offered by 98 firms) we report that premium size declines together with the quality of MPPI policies, and that the take up in this market has declined. While independently and jointly distributed policies possess different characteristics, significant difference in premiums are reported, with MPPI policies sold independently having lower premiums than policies distributed jointly. The premium falls are robust to such quality changes and we conclude the Competition Commission (2009) prohibition of joint MPPI and mortgage sales is justified in terms of premium costs. Nonetheless, concerns persist as to the social welfare implications of this regulatory decision.

This investigation is important for four reasons. Firstly, there are clear economic incentives for firms distributing MPPI policies with mortgages to offer higher quality policies than firms independently distributing these policies. MPPI provides mortgage repayments in the event of a policyholder suffering a fall in income due to unemployment, critical illness or accident. In the event of a successful claim the policyholder and firm jointly providing a mortgage loan with MPPI are both beneficiaries of these pay-outs. The MPPI policyholder benefits from a pay-out in that their mortgage payments are made, they will not default on their mortgage and will not face the repossession of their home. The mortgage provider jointly distributing MPPI will also benefit through guaranteed mortgage repayments and reducing the trust required within the lending relationship (Lapavitsas, 2007). A firm jointly distributing MPPI with mortgage lending therefore benefits from a policy with inclusive coverage, greater quality and higher pay-outs in the case of a successful claim. Conversely, an independent supplier of MPPI is not a recipient in the case of a successful claim and has no incentives to offer a higher quality MPPI policy. Subsequently providing MPPI jointly should lead to higher quality policies than providing MPPI independently.

Secondly, while only a small proportion of households default on their mortgage debt (Figueira, Glen, & Nellis, 2005) the costs of this outcome are high. For lenders mortgage default increases provisions for bad and doubtful debts. For government mortgage default can result in the re-housing the homeless and payment of housing support. For mortgagors default and repossession can significantly increase the incidence of mental illness (Pevalin, 2009) and cause emotional costs akin to marital breakdown or job loss (Taylor, Pevalin, & Todd, 2007). Subsequently developing methods to reduce the number of mortgage defaults is socially and economically advantageous. MPPI has been widely promoted by successive UK governments to alleviate the problems associated with such defaults. However, the prohibition of selling MPPI jointly with credit within seven days of a sale may reduce the uptake of this form of private insurance, potentially creating wider social and economic costs.

Thirdly, while the examination of add-on goods or services and their distribution has become a significant and influential theoretical theme in industrial and competition economics, empirical assessments of these circumstances are rare (Grubb, 2015). The MPPI market is a useful test of such theory, which predicts an add-on service provided jointly with a base good of primary interest to the customer (in this case a mortgage) would be priced differently to a service distributed independently. Specifically it has been argued that distributing a good jointly will influence how customers' search for appropriate products (e.g. Ellison, 2004; Gabaix & Laibson, 2006). While the customer may actively search for the cheapest/highly quality base good, the aftermarkets for jointly sold add-on goods may display distinct competitive conditions. In such aftermarkets the conditions of sale may not be clear and the add-on goods' utility, quality and cost may all be obscured using complex pricing formats and small print (Piccione & Spiegler, 2012; Sato, 2014). Therefore, some customers may make a purchase decision for an add-on good without realising the costs of this action. Thus price competition can be constrained and higher prices develop. Payment Protection Insurance (hereafter PPI) stands out as an important case due to the scale of the markets involved. Through examining a market where a service is both sold as an add-on and as an independent service the application and efficacy of the underlying theory can be explored.

Lastly, at a time when questionable practices by banks in the levying of additional fees and charges for add-on services are seen globally (Tennant & Sutherland, 2014), the sale of PPI, its high profitability and the considerable costs of customer redress, make this a market worthy of further examination. The UK market for PPI peaked with around 20 million policies in operation in 2006 (OFT, 2006) and prior to the 2009 regulatory intervention, this market was highly profitable and characterised by low pay-out ratios and high commissions. Similar features existed in other national markets.[3] After the Competition Commission (2009) ruling a process of customer redress was initiated by the Financial Services Authority

[2] The provision and regulation of private mortgage insurance has a considerable lineage and has consistently raised disparate policy concerns internationally. PPI was developed in the USA in 1917 (Baker & Siegelman, 2014) and has raised concerns since the 1950s (see Baker & Siegelman, 2014; for further discussion).

[3] For example PPI pay-out ratios ranged from 40% to 80% of premiums in the USA (Federal Trade Commission, 2001) with average commissions on PPI averaging 59% (OFT, 2006) in the over the 2000 to 2005 period in the UK.