

Financial Services Consumer Panel

AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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By email: dp18-09@fca.org.uk

Dear Chris,

DP18/9: Fair Pricing in Financial Services

The Financial Services Consumer Panel welcomes the opportunity to respond to the FCA Discussion Paper on fair pricing in financial services.

The Panel firmly believes that pricing issues are a matter of fairness. Discriminatory pricing is a conduct issue that breaches Principle 8 (which says that a firm must manage conflicts of interests fairly, both between itself and its customers and between a customer and another client)¹ as it represents a conflict of interest between different groups of consumers.

As an outcome of this Discussion Paper, we would like to see the FCA take more robust and swift action against unfair pricing practices wherever they arise. As we have articulated previously, the FCA in our view relies too heavily on information disclosure as its 'go-to' remedy to unfair pricing. This means that unfair and excessive prices may continue to be applied for long periods of time, causing consumer harm. This has happened across a wide range of markets. For example, we have seen charges for overdrafts of 30%-50% a day far exceeding the costs of a payday loan, loyal customers paying excessive costs in a range of insurance markets, excessive investment charges levied on longstanding customers, and pension firms defaulting consumers into annuities which can be 10-15% below the market best price.

We also call on the FCA to place more onus on the fact that unfair pricing practices (or what the FCA calls cross-subsidies) may result in transfers between consumers and firms and therefore higher profits for firms. For example, if the market for loans is not perfectly competitive, higher default charges will enable firms to increase their profits at the expense of defaulting consumers. In the case of mortgage customers of what was formerly Northern Rock, the fact that some are now worse off because they are paying a higher Standard Variable Rate (SVR) results in additional profit for the private equity owners of those loans (rather than improving the position of other groups of consumers). In other circumstances, there may be transfers between consumers and intermediaries – particularly where intermediaries are remunerated by commission. The FCA should not take at face value any claims by firms that tackling cross-subsidies or excessive contingent charges will always result in other groups of consumers losing out through higher charges (sometimes referred to as a 'waterbed' effect). In the US, tackling excessive credit card default and over limit charges did not result in any offsetting increase in interest rates.²

Answers to the questions posed in the Discussion Paper are set out below.

¹ <https://www.fca.org.uk/about/principles-good-regulation>

² <https://www.nber.org/papers/w19484.pdf>

Q1: Do you agree with our 6 evidential questions to help assess concerns about fairness of individual price discrimination cases? Are there any other questions that are as, or more, important than the ones listed? If so, what are they?

Figure 1 in the Discussion Paper helpfully sets out the evidential questions to help assess concerns about fairness in price discrimination. Additional factors, or enhancements to the questions which the FCA should consider, include:

- **How long has the practice continued for and how long might it continue?** The FCA should also consider how long the practice has continued for. If the practice has been going on for a number of years then the aggregate consumer detriment will be higher.
- **Are customers trapped with their provider?** For long-term insurance products and mortgages, consumers could have experienced a change in circumstances which means they are trapped with their existing provider and cannot switch. The FCA should always take action if the price discrimination involves trapped customers.
- **Are consumers in financial difficulty?** The FCA should consider whether the consumers harmed by the price discrimination are in financial difficulty.
- **How much are these individuals harmed?** This answer focusses too much on profitability whereas it should focus on the total detriment to consumers from paying higher prices on an individual and aggregate level. A mortgage lender which has undertaken a significant amount of irresponsible lending could have low profitability but might be charging its remaining customers excessive interest rates. An investment firm may excuse charging its consumers high fees on the basis that it has high costs. These would both be unacceptable practices.
- **Would encouraging consumers to switch only benefit consumers who switched?** The FCA and CMA have tended to propose information and switching remedies to remedy shortcomings in the way markets work. These may benefit those who switch but will still leave a significant number of consumers who don't switch harmed by the pricing practice. The FCA's conventional theory of a 'virtuous circle' of competition where a small proportion of consumers switching, or threatening to switch, encourages firms to improve their treatment of all consumers simply doesn't work in practice.

The FCA needs to calculate the aggregate level of harm for consumers from the price discrimination or unfair pricing strategies. Its current approach tends to ignore the aggregate harm to consumers and therefore prioritises information solutions or a 'wait and see' approach. The 'wait and see' approach means that the detriment continues whilst the FCA is experimenting with information-based remedies.

Q2: Where consumers who shop around get good deals but those inert ones not shopping around do not, what factors should determine whether this trade-off is fair? In particular, to what extent are the following factors relevant:

- a) The scale of the price differential between consumers?**
- b) The characteristics of the consumers who are affected? In particular, is it only unfair when it is vulnerable consumers who lose out, or is it also unfair when non-vulnerable customers lose out? Can it also be unfair even when the vulnerable benefit?**
- c) The reasons why existing consumers do not switch to a better deal?**
- d) The transparency of firms' pricing practices?**

In general, the Panel supports the FCA framework for assessing the fairness of inertia pricing. However, it is important that the FCA's analysis reflects the real-life experience of consumers. In practice, consumers do not possess perfect knowledge and do not carefully weigh up the costs and benefits of an activity before undertaking it. Historically, the FCA has failed to take into account that switching involves consumers using time to search the market and switch, and ignored the time and resource costs incurred by consumers when they switch. We are therefore pleased the FCA is looking to take account of this in the Discussion Paper at Question 4 below.

The Panel consider that inertia pricing can also take the form of:

- **Incomplete contracts:** This is an agreement that does not specify actions and payments for all possible contingencies. For example, a mortgage contract may specify the interest rate that will be charged for the first two years but then the consumer is placed onto a 'variable' rate with no controls over the subsequent rate that can be charged. Another example is a protection insurance contract that allows the firm to vary the monthly premium in the future. In these circumstances consumers are not able to take these factors into account when choosing products.
- **Confusing product ranges:** Firms deliberately design a range of products which have similar names and are confusing for consumers to understand whether they are in the best value product. Research we carried out in 2017³ found that, although there are many firms and they appear to compete vigorously, they strive to inhibit consumers' ability to shop around by developing products, prices and information that are complicated and sometimes misleading. So even if consumers do want to switch, they face barriers to doing so.

Q3: To what extent is it appropriate for firms to target and tailor their pricing approach to consumers who are not likely to respond to future price rises? Does the answer depend on the techniques that firms use to achieve this (eg through predictive modelling, product design, communication with the consumer)?

Firms may also use personalised pricing based on price optimisation and big data to increase charges for consumers who, because of their behaviour and personal characteristics, the firm considers less likely to switch. The FCA needs to set clearer boundaries in this area. For example, are home insurers allowed to discriminate against people with Hotmail email accounts because their algorithm says that they are less price sensitive?

These issues matter because initiatives like Open Banking mean that consumers will be able, and indeed be encouraged, to share more of their data. For example, would a credit card company be able to increase an interest rate on a credit card because a consumer has used it or another payment card with the same firm to pay for relationship counselling services? It is imperative that an appropriate framework is proactively applied now before services which make use of greater data sharing become more widespread, and the way in which firms exploit this data becomes accepted as normal practice.

Q4: What should we expect firms to do to help reduce the cost to consumers of shopping around and, if necessary, switching to another provider, in particular with respect to:

- a) helping consumers understand their choices**
- b) the amount of effort required to make their choice**
- c) not discouraging switching or shopping around**
- d) being transparent about pricing and what factors are used to determine pricing**

We are pleased that the FCA has recognised that consumers incur search costs in lost time and effort when they shop around for deals, as well as when they select and switch to a deal. As we state above, it is important that the FCA's analysis reflects the real-life experience of consumers, recognizing that they do not possess perfect knowledge and do not carefully weigh up the costs and benefits of an activity before undertaking it.

The Panel considers that relying on better information disclosure will not adequately address harm in the market. The Panel notes that research suggests that markets can function more competitively, with lower prices and less price obfuscation, when computers replace consumer decisions⁴. This is already happening in financial services, and the Panel has set out how

³ https://www.fs-cp.org.uk/sites/default/files/fscp_consumers_and_competition_position_paper.pdf

⁴ Kalayci, K. and Potters, J. (2011) 'Buyer confusion and markets prices' in International Journal of Industrial Organisation, Vol 29, Issue 1, January, pp.14-22

consumers could delegate choice to new types of services that automate decision-making based on consumers' own profiles and preferences⁵. This has the potential to provide better consumer outcomes, and to improve competition. However, we are concerned about the reliance on algorithms to decide whether a firm offers a customer access to a product, and the terms on which it does so. This can give the impression that a decision has been reached based upon robust analysis of relevant data, which may not be the case. The use of algorithms also enables firms to use non-relevant information about a consumer (e.g. their online search history) to identify their propensity to pay an inflated price.

The Panel also considers that the FCA should not place undue emphasis on reminders and nudges to tackle harm. While such actions may prove effective for certain consumer groups, they are not a panacea and can fail to prompt action among the least engaged consumers, and potentially vulnerable consumers.

Q5: What should longstanding consumers be able to expect of their provider when they become inactive in that particular market? In particular what should be expected of:

- a) the support the provider gives their customers to ensure they are making informed product choices?**
- b) the default outcome in the event of prolonged inactivity (eg contract renewal, contract termination, or automatic switching to a different product)?**
- c) the maximum price differential they are paying relative to the best available rate for that provider?**

The Panel notes the limits of disclosure in encouraging inactive customers to become more engaged. Even in markets where there is greater disclosure about the availability of cheaper deals, the results have been disappointing. For example, in the energy market suppliers must include the cheapest tariff message on bills, which sets out how much a consumer could save by switching to another tariff with their current supplier. However, while 34% of consumers surveyed remembered getting a cheapest tariff message, of all the consumers who switched gas or electricity supplier or tariff, or compared suppliers or tariffs in the past 12 months, only 3% were prompted to do so by the cheapest tariff message⁶. Robust supply-side regulation is required to ensure firms do not exploit consumers' behavioural biases. The Panel encourages the FCA to think creatively about more interventionist policies to ensure longstanding consumers are not exploited by firms.

One possible solution to address the harm experienced by longstanding consumers is some form of automatic upgrade. The Panel is in the process of commissioning research to explore the idea of automatic upgrades for customers who are trapped in poorly performing products (e.g. with high costs and charges or low returns). An automatic upgrade would mean that firms were required to move customers who were in poorly performing products onto a better, comparable product. The planned research aims to estimate the likely financial detriment to consumers when they are trapped in poorly performing products, and identify the benefits and drawbacks of a range of policy solutions for trapped financial services consumers such as price benchmarking; RU64-style rules; restricting product ranges, as well as exploring the consequences of introducing a policy such as automatic upgrades. The Panel would be happy to share the research findings with the FCA.

⁵ https://www.fs-cp.org.uk/sites/default/files/fscp_consumers_and_competition_position_paper.pdf

⁶ https://www.ofgem.gov.uk/system/files/docs/2018/05/policy_consultation_-_domestic_supplier-customer_communications_rulebook_reforms.pdf

Q6: On the discussion on potential remedies in this paper:

a) Do you agree with the types of remedies that we have set out? If not, please explain which type of remedy you disagree with and why.

b) Are there other types of remedies that we should consider that do not fit into these categories? If so please explain them and what adverse effect you think they would remedy, mitigate or prevent.

c) Are there particular examples from other sectors, or other countries, that you think we should consider to inform our approach?

It is not clear why the FCA has previously excluded more robust price interventions and supply-side remedies when discussing or considering options to address harm. Yet demand-side remedies are inherently uncertain and it could be many years before they deal with the detriment identified.

A key problem is that the FCA interprets its requirement to conduct a cost-benefit assessment to apply solely to the policy proposals it is going to implement. In general, this means that it does not weigh up or consider the costs and benefits of other interventions, including price interventions. Going forward, it will be important for the FCA to conduct cost-benefit assessments featuring a wider range of options, including greater interventions on price.

For price interventions, this will require the FCA to conduct an assessment of the overall level of harm caused by price discrimination. For example, when assessing whether to implement a price cap of 0.75% on income drawdown we would expect the FCA to calculate:

- The total amount of charges consumers are paying which currently exceed 0.75%
- Given reasonable assumptions about switching rates and the effectiveness of information solutions how much would this detriment reduce by due to information solutions.
- How much and how quickly might the detriment reduce by if the FCA implemented a price intervention such as a 0.75% charge cap.

In the home insurance market, the FCA would need to take account of:

- The total extra amount that long-standing insurance customers are paying in charges compared to the reasonable costs of serving them?
- Given reasonable assumptions about switching rates and the effectiveness of information solutions, how much would this detriment reduce each year?
- Over this timescale how much additional detriment might be caused to consumers who become long-standing customers during this time period?
- Would demand-side remedies only benefit those consumers who switch?
- How much more quickly would the detriment be addressed by a supply-side intervention?

The Panel suggests the FCA consider which of the following interventions might be most appropriate, taking account of the characteristics of the market in questions and the nature of the consumer detriment identified:

- **Ancillary charges / default charges:** Restricting the level of ancillary charges or default charges incurred when consumers pay late, default or exit a product.
- **Bans / restrictions on price discrimination:** Requiring firms to charge all customers the same price or restricting the ability of firms to charge different types of consumers different prices.
- **Go-to rates / inertia pricing:** Capping or controlling the price which is charged to consumers after a certain period of time or after the initial deal has finished.
- **Headline price caps:** Capping or controlling the headline price of the product.
- **Opt-out / default option price caps:** Capping or controlling the price of the default option but allowing customers to opt-out or select a more expensive/alternative option.
- **RU64 style restrictions:** Requiring firms to justify why the product they are selling / recommending is more suitable / better than a price-capped product.

- **Market-based price caps:** Requiring firms to check the price they are proposing to charge against what is available elsewhere in the market.
- **Governance reforms:** Requiring firms to act in the best interests of consumers and justify the prices they are charging. In its response to the FCA's Discussion Paper on duty of care⁷ the Panel set out arguments for raising the level of protection available to consumers, suggesting this could be achieved by amending the FCA's principles to require firms to act in the best interests of their customers and treat them fairly.

Yours sincerely

Mark Chidley
Interim Chair, Financial Services Consumer Panel

⁷ https://www.fs-cp.org.uk/sites/default/files/fscp_response_duty_of_care_dp.docx_.pdf
Page 6 of 6