Fair pricing in financial services

DP18/9

Restricted
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Introduction

The Building Societies Association (BSA) welcomes the opportunity to respond to the FCA's Discussion Paper 18/9 Fair Pricing in Financial Services. The BSA represents all 43 UK building societies, as well as 4 credit unions. Building societies are owned by their 25 million customers, or members, and operate to create value for them rather than generating profit for external shareholders. Building societies have total assets of over £400 billion and, together with their subsidiaries, hold residential mortgages of over £315 billion, 23% of the total outstanding in the UK. They hold almost £280 billion of retail deposits, accounting for 19% of all such deposits in the UK. They employ approximately 42,500 full and part-time staff and operate through approximately 1,470 branches.

The BSA strongly endorses the FCA's statement in its Approach to Competition that "As a competition regulator our primary role is not to regulate prices or profitability directly" (FCA, October 2018). However, the Approach document goes on to note that there may be times when more direct intervention on price is needed, though it is recognised that these instances should be rare.

We agree that prices should be determined by market forces as far as possible, particularly in well-functioning markets where consumers have all the relevant information they need and there are no unfair barriers to them accessing or changing products or provider, and firms don't have excessive market power. Of course, the presence of customers who may be vulnerable puts greater onus on firms to ensure their practices are not unfair.

However, in DP18/9 the FCA is suggesting that even under these general conditions there may be instances where the outcome in terms of pricing is unfair for certain consumers, and that sometimes intervention might be needed. A particular example given is long-standing customers who do not appear to act in their own best interests, and stay on uncompetitive rates of interest. Building societies do have a responsibility to engage with their customers and ensure that they are taking steps to understand and tackle any harm caused by inertia.

The judgement of when price discrimination is fair is not always straightforward, as the FCA acknowledges, and it is therefore important that the regulator's approach to assessing and dealing with these issues is clear and well understood by firms and the public. A further difficulty is that remedies that might address any unfairness should preserve the conscious decisions of other groups of customers.

Key issues in such instances then include:

- Properly assessing the harm or potential harm
- Determining where the limits of consumer responsibility and freedom of choice lie
- The risk of unintended consequences

Apart from exceptional circumstances, strong regulation, competition and an effective ombudsman service can deliver all the benefits of price control, without the unforeseen consequences. The effective application and enforcement of the existing, significant consumer protection laws and regulations (including the Consumer Rights Act, Equalities Act and the FCA's consumer protection agenda) already help to make consumer outcomes less unfair.

We give some thoughts on these issues below, before answering the consultation questions from the DP.

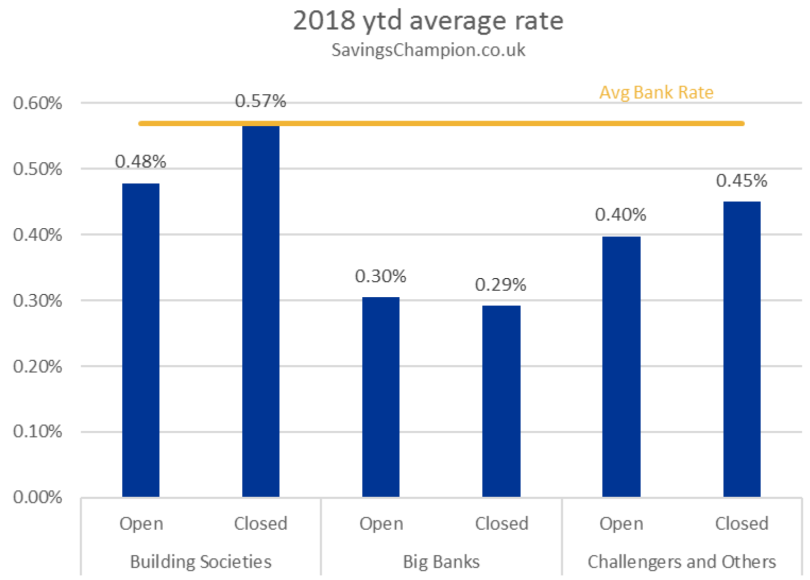
Ensuring harm is properly assessed

In the DP the FCA notes that one of the factors that can affect why some consumers are less price sensitive is due to their *intrinsic preferences* whereby some may be naturally more attracted to the specific features of a product than others (Para 3.6). These preferences are not observable, but could be very significant. For example, the specific features could include things like service standards, convenience, flexibility, trust, and so on. The value placed by the consumer on these features should not be neglected when assessing the harm from pricing strategies.

For example, in the mortgage market, many customers are actively making the decision to remain on a reversion rate, such as an SVR, because of the flexibility it offers, for example because they plan to move or to redeem the mortgage in the near future, value the ability to pay off large sums, or take advantage of product features. More generally, the Mortgage Market Study found that the market was working well.

The recent DP on Price Discrimination in the Cash Savings Market also highlights the importance of properly assessing harm. The analysis in the DP uses historic data from the Cash Savings Market Study, but more recent data suggests that the description of harm in DP, with long-standing customers typically receiving lower rates of interest, is not representative of all types of deposit taker. Chart 1, using data from price comparison service SavingsChampion.co.uk shows that, on average, building societies pay higher rates on their instant access back book than their front book, and that rates on both the front and back book are significantly higher than at the big banks. Therefore, the universal application of the Basic Savings Rate to remedy low pricing on the back book looks disproportionate, with the potential for unintended consequences that disrupt parts of the market that are working, whereas a more targeted approach to address the harm would be preferable.

Chart 1: Instant access savings account interest rates



The FCA's recent Retail Banking Business Model Review Final Report analyses the rates paid on deposits, and finds a similar pattern to that presented above (FCA, December 2018). In mortgages, the same review found little difference in the all-in yields on mortgages across large banks, small banks and building societies.

Consumer responsibility

In considering this framework, we need to be extremely cautious about overriding consumer responsibility, and must also be respectful of people's freely made choices. The general principle that consumers should take responsibility for their decisions is set out in section 3B FSMA 2000, and must be taken into account.

The BSA therefore welcomes that in its Approach to Consumers document, the FCA says that it expects consumers to take reasonable responsibility for their choices and decisions, though there are very real factors that might limit their ability to do so such as vulnerability or potential vulnerability (FCA, July 2018).

We were also struck by the principles set out in the joint FCA/CMA paper for the UK Competition Network, "Helping people get a better deal: learning lessons about consumer facing remedies", particularly the recommendation that successful remedies work with the private sector and place an importance on customer control:

> "Let consumers stay in control – The most successful remedies we looked at are those which recognise that consumers are not to 'blame' for poor market outcomes, but provide them with the necessary framework, support and tools to make their own robust decisions."
> (UK Competition Network, October 2018)

Say, for example, Customer A and Customer B are both in receipt of proper information and neither is vulnerable in any sense. Customer A decides to shop around for a better deal, but Customer B has other priorities. If it means anything at all, consumer responsibility must mean that it is fair for Customer A to end up with a better deal.

The risks of unintended consequences

In most instances the introduction of a pricing intervention will produce winners and losers. For example, if there is a floor set on interest rates on savings accounts, those savers that see the interest rate that they receive increase will be better off, but this may be too costly for providers to bear, so that they seek to reduce costs or raise revenue elsewhere, such as by cutting savings rates for other customers, or by raising interest rates for borrowers, or both.

Remedies could also affect the range or structure of available products, and product innovation, and therefore limit consumers' choice. For example, if the Basic Savings Rate (BSR) proposed in DP 6/18 were introduced this could have implications on the range of products in the market and which are valued by various consumers, for example by effectively preventing providers from offering loyalty rates, tiered rates of interest, etc, or even hampering the provision of relatively more costly channels such as branches. In mortgages, pricing reflects the various terms of the loan, including the riskiness of the loan, and constraining pricing could make some products or features unviable or unattractive to offer. Historically, the low take up of CAT standard mortgages indicates how it can be difficult for supply-side measures to work as intended.

A potential unintended consequence of constraining a firm's ability to set prices is that it could affect the viability of its business, and ultimately lead to firms leaving the market. (If a firm's viability depends on egregious pricing, then this may not be a bad thing.) Again, the BSR could limit a firm's ability to manage their liquidity and funding. (NS&I should also be covered by any savings remedies, but they will require flexibility to attract new customers, in the same way as other providers.) But what may work well in one period, may be become dysfunctional as conditions change, and may be particularly acute at times of stress. For example, had price regulation been introduced prior to the last recession in expectation that Bank Rate would always average around 5%, it may have constrained firms' ability to respond when Bank Rate was cut to an unprecedented 0.5% in 2009. Today, with the potential for radical change driven by new technologies in coming years, any regulation that limits how prices can be set could restrict the range of viable business models in unforeseeable ways.

Summary

In summary, the BSA therefore believes that in making judgements on whether to act on the fairness of price discrimination, the threshold to act needs to be high. There needs to be a well-evidenced, precise and unambiguous case that significant harm is being caused, that it is unreasonable to expect consumers to avoid the harm (whether or not that is the firms' intention), and that a remedy can be introduced that does not reduce the harm for one group while disproportionately limiting the choices of others, and that the remedy does not distort the sustainable provision of services or involve excessive implementation costs. It is certainly worth exploring if demand-side measures such as more effective communication can reach specific target groups of consumers where there are particular concerns. These should work with how people think, for example framing costs or losses in monetary terms rather than percentages.

We now respond to the questions in the DP.

Price discrimination in financial services

Q1: Do you agree with our six 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?

The BSA understands the basis of the six evidential questions, though the importance of non-price factors, such as better service, for example, is not explicitly covered in the six questions. An additional question could be the extent to which there are other aspects of the product or service that are valued by affected consumers to a greater extent than the higher price. If there was evidence of various non-price factors that were valued by customers, the regulator may be less concerned than price discrimination in the absence of such factors. Alternatively, this might be a sub-question of question two, "How much are these individuals harmed?" if harm is measured on a net basis.

The BSA strongly supports the FCA's acknowledgement that each instance of price discrimination is specific to the context, and should be reviewed on a case-by-case basis. The framework therefore helps to add some structure to informing the regulator's judgements, without setting strict parameters. We agree that concerns around fairness will likely be greater for customers in vulnerable circumstances.

Question 4, "How are firms price discriminating" appears to be the most pertinent question on fairness, as it assesses a firm's 'intent'. Questions 1-3 are essentially an assessment of the size of harm due to demand-side factors, ie the characteristics of the customers, their numbers, and their willingness to pay. Question 5 is about whether there are substitutes or if the consumer is locked-in in some sense. The assessment of the sixth question, about the views of society, should be on metrics that are as objective as possible to avoid it being unduly influenced by a vocal minority or special interest group. The basis on which public opinion is sought also needs to be factored in, as in some markets it might be difficult to explain all the factors that influence prices so that it is difficult for people to form fully informed views.

How firms set prices for existing customers

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?

When considering how firms set prices for customers it is important to recognise that different firms operate for different purposes, which can affect pricing decisions. For example, member ownership means that building societies aim to deliver value to current and future members, rather than maximising profits for shareholders. Research indicates this can result in different approaches to setting prices in product markets[1,2].

In relation to the above question, where consumers who shop around get good deals but inert consumers do not, differential pricing need not necessarily be unfair. Factors that make it more fair are: clear and transparent pricing, clear communications just prior to substantial price changes (including an explanation of the consequences and options), clear contractual terms at the time of taking out the product or service explaining the basis of future price changes (so far as is reasonably practicable), and there being no undue barriers to changing product or provider.

The scale of the price differential between different consumers may give an indication, but again there is no threshold above which the differential can automatically be deemed unfair.

Obviously, firms need to consider the needs of vulnerable consumers and ensure that they are not treated unfairly because of their circumstances. However, vulnerability does not, in itself, automatically make differential pricing unfair, but if the vulnerability causes the person to be less able to compare prices and/or switch provider then this could indeed be the case. Conversely, a consumer does not have to be vulnerable to be treated unfairly, and there will be instances where some vulnerable consumers benefit and others are treated unfairly.

Not all discrimination against these customers is down to price. Some vulnerable consumers are (inadvertently) discriminated against by concentration of price comparison and provider switching services online. Online services are of no use to consumers who for a range of reasons - geographical location, lack of privacy, technophobia, physical inability to work a smartphone / keyboard, etc. - do not have access to the internet. This issue can become particularly acute where bank branch closures has removed the main alternative source of information in their locality.

However, there will also be cases where the circumstances that make a consumer vulnerable to being less able to compare / switch providers are not in the gift of service providers to sort out. For example, the issue for many individuals affected by a serious physical or mental health condition or caring for someone else in those circumstances is availability of time in their day to investigate price comparisons. Although these customers will be hard to identify, particularly given the limited data held for some long-standing customers, firms should ensure these customers are on the most appropriate available product for their needs.

As mentioned above, there may be reasons why consumers in the mortgage, savings and insurance markets do not switch to a better deal, because they value features of the product or provider that mean they find the provider's offer attractive. Also, in the general low interest rate environment there may be little benefit in switching, particularly for consumers with low balances. In terms of Figure 2 of the DP, these would be in box G1.

We believe there is generally a good level of transparency of pricing in the mortgage and savings markets, so that most consumers are aware of the consequences of not acting after price rises. For example, this is demonstrated by the high proportion of customers that do

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[1] Rajan, A, and Willison, M, Working Paper 767, 2018, Bank of England

[2] "The influence of product age on pricing decisions: An examination of bank deposit interest rate setting" Anderson, R, Ashton, J, Hudson, R, 2014, Journal of International Financial Markets, Institutions and Money

move when their mortgage term comes to an end. In recent years this has been supported by changes in communications following the Cash Savings Market Study and the MMR. The FCA's ongoing work with lenders to address the issues with SVR 'prisoners' shows how specific problems in relation to ability to act can have targeted solutions.

The characteristics of the product, including whether it is an essential service?

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)?

Please provide reasons to support your answer.

The fairness will depend on the approach used by firms. There is a difference between a firm actively targeting a specific group of customers with certain characteristics who are unlikely to respond, and merely being aware that there is always a certain proportion who don't respond. It is inappropriate for firms to exploit inert customers directly. Firms should be making reasonable efforts to contact their customers and make them aware of the options available to them.

Many societies price their products on the basis of the cost of the features (including risk) and design rather than at an individual customer level, balancing the margin with a desire to offer long-term good value to customers, who are the owners of the business. Whilst channel pricing can be justified (i.e. online is cheaper for firms to administer than through branch), firms need to ensure that this isn't a way of pricing out cohorts who are less likely to take action.

It is likely to be challenging to distinguish between pricing differentials that are due to price discrimination and those reflecting pricing for an individual's risk. In addition, some characteristics or data points (eg income, employment status) may correlate to both riskiness and price sensitivity.

Particularly with regards to fairness, research from Nottingham University Business School finds that building societies are systematically scored as more fair than most other financial services providers. The research looks at various aspects of fairness (Distributive, Procedural and Interactional) and trust. The results for distributive fairness are shown below in Chart 2, as are the descriptions of the components of the metric, as scored by consumers. Mutual ownership does not guarantee fair outcomes, but these findings indicate that consumer-owned firms can provide more of a competitive pressure on other providers to act in a fair manner.

Chart 2: Distributive Fairness Index

FSIs = Financial Services Institutions

Distributive Fairness

FSIs make sure that customers only end up with products which are suitable and take account of their circumstances
FSIs provides products which perform as customers have been led to expect
FSIs keep their promises
FSIs deliver what they say they will
Customers benefit from interactions with their FSI as much as their FSI does
FSIs ensure that any charges customers pay are fair
FSIs give customers a fair deal
FSIs ensure that any terms and conditions attached to products are fair

"Trust in financial services: Retrospect and prospect," Devlin J., Ennew, C., Singh Sekhorn, H., Kumar Roy, S., Journal of Financial Services Marketing, December 2015. Presented at BSA Seminar, April 2017

How might we address the harm

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
Please provide reasons to support your answer.

Firms should provide the relevant information in a way that is clear and not misleading, and should not erect barriers to prevent consumers from shopping around and changing provider.

There have been a variety of interventions in various retail financial services markets over the years to help customers to shop around and to switch provider, though sometimes with limited success. Yet there may be more that could be done to help consumers to understand their options, and how communications could be made more effective (including with the application of new technologies) should continue to be explored before price interventions are made. Any further interventions by FCA on the demand side should be proportionate and targeted at areas or cases of highest potential detriment.

The BSA has previously urged the FCA to consider the factors beyond price (such as trust, convenience, customer service, ethos, etc) that may explain why the switching rate is not the most appropriate indicator for the level of competition in a financial services market.

Time and effort is required to shop around and that will be hard to overcome, but firms should not automatically assume that the customer wants the same again and that their circumstances haven't changed.

In Q4(d) it is not clear how transparency in the factors used to determine pricing across various financial services would necessarily help consumers to make good choices; instead it could lead to disengagement or confusion.

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?
Please provide reasons to support your answer.

A balance needs to be struck between keeping the customer informed about their product and its performance, and inundating a consumer with information when they are aware and satisfied to be holding the product for an extended period.

Firms are required to ensure their communications are clear and that the customer is fully informed at the time of the contract of what will happen at maturity. Customers should also expect continued communication on their options towards the end of the life of the product and what will happen if they do not act. A carefully considered communications strategy should include using the appropriate channels for different customers.

For long-standing mortgage borrowers, building societies actively prompt their customers to refinance, and will continue, through the annual mortgage statement and associated communications, to remind any customers that do move onto the SVR.

All our members have contact strategies where they write to customers prior to the mortgage deal expiring, many then follow up with phone calls and further letters. There are numerous examples of good practice such as offering discounted Standard Variable Rates (SVR). Moreover, a lender's SVR forms part of its broader strategy for retaining borrowers, so that there are various valid approaches across the market. This is also demonstrated by the analysis is the FCA's recent Retail Banking Business Models Review, which found that although the societies in the FCA's sample had higher SVR rates, the proportion of their borrowers on these rates was much lower. In addition, the SVR is not always higher than the initial rate, with this often the case in lending on properties under construction, for example.

In the savings market, our members generally offer long-term good value, as demonstrated by the relatively higher back book rates shown above. More specifically, customers with fixed rate bonds are made aware when they take out the product of the default account that the bond will roll into (which could be another similar fixed rate bond), and are contacted prior to maturity, given active support about the products available and what the options are, and able to give instructions if they want to choose a different option. Many societies offer a free savings review. If a saver then does not subsequently engage, they will be communicated with on the terms of the default account, including an annual statement that sets out the interest received by the saver.

In terms of default outcomes, care needs to be taken not to make assumptions about the customer's intentions. Termination of a contract poses a particular risk to consumers, and is likely to be inappropriate in almost all circumstances.

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? If so, please provide detail and references where possible.**

Demand-side remedies can help increase awareness and engagement of some inert customers. Communications need to be simple and targeted. However, as we have seen in the past with some regulatory interventions, there can be a problem of too much information for consumers. For example in mortgages, Key Facts Illustration (KFI) documents haven't obviously led to more shopping around, and have been complicated by the introduction of the ESIS which has led to more information but in inconsistent formats being provided.

Supply-side remedies that alter the design of products or restrict pricing need to be extremely carefully designed to avoid adverse shifts in response across the market, such as firms withdrawing products with certain features, as mentioned above.

In both demand- and supply-side measures, proportionality is a key consideration. As mentioned above, we believe this is a problem with the Basic Savings Rate proposal. Where harm is properly identified, targeted remedies will have fewer unintended consequences.

The work on mortgage SVR prisoners shows how the industry and regulators can work in a targeted way to address long-standing customers who may be better off on other products but have not switched because of regulatory changes to affordability criteria.

Education that improves consumers' financial capability will continue to be relevant to ensuring consumers are protected from unfair practices. Many building societies are heavily engaged in delivering financial education in their communities, though low financial capability is a wider social issue and cannot be solved by either the industry or the FCA in isolation.

Another type of remedy that does not fit into these categories is making competition more effective. Various research suggests that an important dimension to this could be having a diverse range of firms with different structures and business models, and which therefore operate to different incentives. As mentioned above, building societies do not aim to generate profits to distribute to external shareholders, but instead aim to make sufficient profit to build capital while returning value to members in better prices overall.

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £400 billion, and account for 23% of the UK mortgage market and 19% of the UK savings market.