Institute and Faculty of Actuaries

DP18/9: Fair Pricing in Financial Services

IFoA response to the Financial Conduct Authority

01 February 2019

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We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Chris Gee
Strategy & Competition Division
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

1 February 2019

Dear Chris,

IFoA response to DP18/9: Fair Pricing in Financial Services

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA's discussion paper (DP) on fair pricing in financial services. In our response, we have considered fair pricing primarily within the context of insurance products. However, we have also referred to pricing practices in some banking products.

2. Given the scope of the DP, a range of relevant IFoA Committees and practice Boards have been involved in the drafting of this response; these include our General and Life Insurance Standards and Consultations sub-Committees, and General Insurance, Life Insurance and Finance & Investment Boards. Members of the Committees and Boards work for a range of providers and consultancies in the general/ life insurance and banking sectors.

3. It is important to note however that, as for any IFoA consultation response, we have considered the issues set out in the DP from the perspective of the public interest.

General Comments

4. We recognise that price discrimination is a complex area, and that judgements relating to what is deemed 'fair' are not straightforward. The publication of this DP is thus helpful, and we hope it generates useful input from a range of stakeholder perspectives.

5. The concept of cross-subsidy within a group of policyholders is fundamental to insurance. It is reasonable to consider whether the cross-subsidy is always fair - for example, in healthcare, if younger people cross-subsidise older people, who are more likely to claim.

6. It is also important to consider the trade-off between cross-subsidy and personalisation. At one extreme, uniform pricing in insurance for all customers would have cross-subsidies which might be seen as unfair. At the other extreme, increasing personalisation of pricing, made possible by data science techniques would reduce the benefits of risk-sharing and lead to higher prices for some customers, who could include vulnerable customers. We therefore see the need for an appropriate trade-off between cross-subsidy and personalisation.

7. Insurance provides social benefits such as protecting people from loss, and so greater coverage is to be encouraged; as alluded to in paragraph 3.3 of the DP. There could be scenarios where greater price flexibility increases the overall take-up of insurance; for

example, where insurers can offer discounts to encourage new consumers to take out insurance, or where individuals with specific health conditions can get coverage as part of a pool.

8. The value that an individual places in a product will depend on a variety of factors, including psychological drivers. A risk-averse consumer may value the peace of mind that insurance brings, and hence may be more likely to be willing to pay more for insurance, compared to a less risk-averse consumer. This is not in itself unfair, in that it reflects the total value the risk-averse consumer places on their insurance. In theory, insurers may then be able to 'reinvest' some of this premium to incentivise others who are more neutral towards insurance.

9. Increasing insurance costs over time could also relate to a change in the underlying level of risk, such as the cost of life insurance coverage as a policyholder ages. Some long-term contracts also include contractual escalation of premiums.

10. Still in a life insurance context, there can also be significant benefits to consumers in remaining with their original provider: for example, obviating the need for further medical underwriting (which they may consider beneficial if their health has deteriorated over time).

11. It is also worth noting that the insurance sector is a relatively fast-moving market, with digital disruptors and significant new competition. It is important that the proposals on pricing do not lead to limitations on this which could ultimately be detrimental to consumers as a whole.

12. A further pricing differential exists between individual and group insurance business. Such differentials arise in insurance, pension, investments and other contexts and reflect a variety of factors, including the relative costs to administer and degree of negotiation power between individual and group contracts.

Consultation Questions

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?

13. We agree with the idea of having a structured approach to consider fairness. In considering the potential harm arising from price discrimination, the definition of 'harm' needs to be clear. We note that in the FCA research note 'Price discrimination in financial services' (linked within this DP), 'harm' seems to have a broader definition, with economic, procedural fairness and distributive fairness considerations. This DP focuses on distributive fairness, but it could be argued that beneficial economic outcomes might outweigh distributive unfairness in some circumstances.

14. We have a number of observations around the evidential questions in Figure 1:

- **Question two** refers to product profitability. Actual profitability in insurance can only be known after the risk has materialised, or not. The greater the uncertainty for the provider, the higher the expected profitability that the provider will seek to take on the risk. So higher expected profitability might reflect greater variability in profitability, rather than harm to individuals. We think that this variability should be seen as part of the 'cost of serving', to which reference is made in paragraph 4.10 in the DP;
- **Question four** relates to transparent versus hidden price discrimination. We believe the question over transparency is particularly important. Where discrimination is not obvious to

the consumer, they may be unaware it is taking place. We concur that less transparency would be of greater concern;

- Essential products considered in **question five** should certainly include those compulsory i.e. where required by law, and the reference to motor insurance alludes to this. However, as the corresponding text also notes, essential products extends beyond products with a legal obligation to hold. Personal current accounts may be essential for receiving salary or benefit payments, and for making utility payments by direct debit. This is true of vulnerable consumers and otherwise.

- **Question six** relates to societal attitudes. It is important to recognise that society's views can change over time. This could be an issue if a long-term commitment made between a provider and a policyholder is later viewed as unfair because society's views have shifted over time;
- One example of shifting views (in a positive direction) is mentioned in the FCA research note referred to above, in relation to variable airline ticket prices. It may be helpful to consider this in more detail to see if there are any learnings which could be applied more widely: what led to this airline practice becoming regarded as fair over time?

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?

15. We agree that the scale of price differential is relevant. It may also be useful to consider whether the scale of the price differential is increasing over time, and the extent to which changing differentials reflect the behaviour of providers, when cross-subsidies become a central market dynamic.

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?

16. In principle, it might be perceived to be more unfair when vulnerable consumers lose out, and fairer when vulnerable consumers benefit. In practice though, we believe it may be difficult to differentiate between vulnerable and non-vulnerable customers. Most prices are system-generated, and it would usually be impossible for a system to determine certain circumstances which could indicate whether a consumer were vulnerable at the point of making a purchase decision. For example, a pricing system may not normally be able to recognise where a consumer:

    - had suffered a recent bereavement; or
    - did not have access to the internet, and so was less able to take advantage of competition in the market.

17. However, it is also fair to acknowledge that certain indicators of potential vulnerability are typically recorded by insurance pricing systems, such as age and indicators of a consumer's financial status.

c) The reasons why existing consumers do not switch to a better deal?

18. This factor is entirely relevant, but we believe it could be difficult to measure. A wealthy consumer recognising that the time-cost of shopping around would not be offset by any potential savings made is entirely different to, for instance, a home insurance customer who falsely believes that they are obliged to keep their home insurance with their mortgage provider.

19. From a banking perspective, a matter of particular concern relates to consumers who do not switch to a better deal because they cannot switch. In a mortgage context, this could include 'trapped' consumers on standard variable rates; a corresponding example with credit cards would be consumers whose risk characteristics make it difficult for them to obtain a new card. If these consumers in these situations are vulnerable, their inability to switch to better deals may well increase their vulnerability.

d) The transparency of firms' pricing practices?

20. As we have already noted, we believe transparency of pricing is a particularly important consideration. In our view, pricing transparency relates not just to the price that will actually be paid, but also the freedom to take custom elsewhere, together with any new business discounts. However, it will often be difficult to judge how transparent pricing practices are: they may vary by product type, and different consumers may also have a different understanding of price transparency.

21. It is also important to note that the fact that pricing structures are transparent does not inevitably mean that they are fair. For example, 0% introductory rates on credit cards are transparent, but the pricing practice of 0% introductory rates and higher subsequent rates does not seem fair to consumers (including vulnerable customers) on higher rates - particularly if these consumers are unwilling or unable to switch. The focus on introductory deals on some products such as credit cards and mortgages may mean that the long-term rate, after the introductory period, is 'hidden in plain sight':i.e. it is transparent, but consumers do not pay as much attention to it as they do to the introductory rates.

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

22. We agree that the extent to which an insurance product is essential is a relevant factor. As mentioned above, some insurance products come with a legal obligation, such as motor insurance. However we would extend this to other non-compulsory products, but where they are well established, and have high market penetration (such as homeowners' buildings/ contents insurance).

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 (e.g. through predictive modelling, product design, communication with the consumer)? Please provide reasons to support your answer.

23. There are three groups of consumers we would like to consider in our answer:

    I. **Cash rich, time poor:** having bought a financial product, the opportunity cost of shopping around and switching to another product may outweigh the expected economic benefits of switching;

II. **Cash poor, time rich**: for these customers, the economic benefits of switching are more likely to justify the opportunity costs of switching to another product; and

III. **Vulnerable consumers**: where the ability to shop around or switch to another product is impaired for some reason, such as poor health or limited financial confidence.

24. If the population consisted only of the first two groups (I) and (II), then price discrimination through inertia pricing may not be considered harmful and, in fact, could represent a cross-subsidy of the relatively less affluent by the more affluent. However, the existence of the vulnerable group (III) means that some of the cross-subsidy would come from vulnerable consumers, which we believe is not appropriate.

25. We believe it is entirely fair to tailor pricing to reflect consumers' risk profiles in relation to both underlying and additional *risks*. For example, in home insurance the price could reflect the underlying insurance risk, but also additional risk relating to early cancellation and fraud. However, pricing of these risks should be supported by predictive modelling

26. In many cases the true risk premium for new consumers may be higher than that for renewing policyholders to reflect greater uncertainty of a 'new' risk to the insurer. However, in the case of renewing policyholders, the insurer may build up a view on the risk from the claim experience over the year. We do not consider this approach to be unreasonable.

27. There is a further dynamic to consider between new and renewing insurance policies. The cost of renewing a policy is usually less than the cost of securing new business. Currently, it is not uncommon for this cost to be spread with the renewal business picking up some of the expense of the new business. Again, we do not consider this feature of pricing to be unreasonable.

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

28. In theory, if consumers understand that they are free to move their business elsewhere and that there is an open market to support this, this requirement could be met. In practice however, it may be challenging. Insurance language - such as on renewal - can be difficult to make understandable to all policyholders.

b) the amount of effort required to make their choice

29. We believe this is a market-driven factor rather than one for individual firms. We note there is a wealth of evidence suggesting that the rise of price comparison websites has driven deeper new business discounts in motor insurance, together with greater differentials between new business and renewal prices.

c) not discouraging switching or shopping around

30. We agree that it is in the public interest that firms should not discourage switching or shopping around. We believe that firms and regulators should support the development of innovative online services which make it easy for consumers to compare products and to switch between products and/or providers. We note the suggestion in paragraph 5.11 in the DP that longer-term contracts might be made compulsory. This would reduce the ability of consumers to switch if they wanted to do so, and might lead to cancellation charges for early terminations.

d) being transparent about pricing and what factors are used to determine pricing

31. We fully support the concept that pricing should be transparent. However, some products - such as personal loans and motor insurance - are individually priced for risk and it can be extremely difficult to explain all the factors that go into setting the rate/ premium. In an open market where final prices are clearly displayed and shopping around is not discouraged, then details of factors used beyond data protection and transparency requirements could potentially confuse, rather than enlighten, decision-making for 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?

32. Longstanding customers should expect their provider to be transparent. They should also expect that differences between new business and renewal premiums are not excessive, and do not unfairly penalise longstanding customers. However, the extent to which a difference is deemed excessive or otherwise is a matter of judgement, and will vary by product/ market.

b) the default outcome in the event of prolonged inactivity (e.g. contract renewal, contract termination, or automatic switching to a different product)?

33. We believe it would be appropriate for existing providers to be proactive in contacting their customers to ensure that their products are still suitable in meeting the customer's needs.

c) the maximum price differential they are paying relative to the best available rate for that provider?

34. This suggestion is good in theory, and could be useful in helping to prevent vulnerable consumers from being unduly harmed. It would also be beneficial for consumers who are less/not vulnerable. However, disclosing an appropriate price differential could be challenging given individuals' differing risk characteristics.

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.

35. We have a degree of pessimism over the likely success of the demand-side remedies set out in the DP. They may have little real impact as consumers have proven to be stubbornly inert in the face of disclosure and significant price differentials. However, better disclosure of the existence of a discount for new customers may, at least, raise awareness with more consumers.

36. In relation to the proposed supply-side remedies, we have a range of associated concerns:

   I. **changing the product's default structure**: removing auto-renewals by default could have a harmful impact because it could lead to some consumers incorrectly believing that they are still insured, even though they have not followed the now-required non-automatic renewal process;

II. **breaking up product packaging:** this remedy could lead to some consumers having less cover than they should have or previously had, because they are unwilling to follow several purchase journeys rather than the single journey that has previously been sufficient, and convenient, for them;

III. **simplifying tariffs:** this may lead to less competition in the market; the *final* price is easy to explain and understand today. As well as reducing competition, simplifying tariffs could still end up with similar levels of price differential to those that currently exist.

For example, with personal current accounts in banking, simplifying the currently complex pricing structure by banning fees and requiring banks to charge a single interest rate for overdrafts will make it easier for consumers to understand and compare the pricing of personal current accounts. However, it may only lead to greater switching if there are sufficient differences between the interest rates charged by different banks: it may be more likely that the interest rates will be clustered together, as prices are in many product markets;

IV. Although a **relative price cap** could potentially be a sensible approach, determining the extent of the price 'collar' could prove difficult, and could increase new business prices;

V. We believe a **price discrimination ban** could be difficult to define and difficult to implement. At its most extreme, it would mean trying to achieve the same profit margin on a customer in their first year (when there are significant acquisition costs to cover) and in subsequent years (when there are not). If acquisition costs were, say £120 for a policy, then the price for new business would be £120 higher than the price in subsequent years, all other things being equal. This is presumably not the intention of this proposal.

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.

37. A more general form of remedy relates to the culture and level of transparency within individual financial service firms, whether insurers, banks or otherwise. As the FCA will realise, firms are expected to have fair treatment of customers as the key component of their business model, and to be able to demonstrate this. This expectation relates to the issues discussed within this DP, including the ability to switch provider.

38. Many firms will have a culture embedded consistent with fair treatment of customers, rather than seeing it as a 'tick box' compliance requirement. We believe that transparency within firms (through different lines of defence and at Board level) and also between firms and their regulators have a role to play, aside of the supply/ demand side remedies set out in the DP. This could include, for example, quantitative analysis of the pricing outcomes for loyal groups of consumers – including a particular focus on more extreme impacts. Such analysis may already be produced by some firms, but it could recommended as good practice to others.

39. We also note that the possible remedies set out in the DP focus on the FCA's first operational objective, securing protection for consumers, including for vulnerable customers. We support the intention to encourage fair pricing of financial products and fair treatment of vulnerable customers. However, we suggest that, if the FCA takes any of these possible remedies forward, it should also consider whether they would also support the FCA's other two operational objectives: protecting and enhancing the integrity of the UK financial system and

promoting effective competition in consumers' interests. We believe that some of the proposed remedies could inhibit competition and, potentially, create new barriers to entry.

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.

40. We suggest that the FCA could consider the 2002 Competition and Markets Authority enquiry into Small and Medium sized Enterprise (SME) banking, and the subsequent withdrawal of associated remedies in 2007. Conclusions reached in this context including the impact on SME banking in terms of consumer engagement/ switching, product pricing/ innovation, and consumer satisfaction may also provide insight to this is fair pricing review.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager at Steven.Graham@actuaries.org.uk or on 020 7632 2146 in the first instance.

Yours sincerely,

Jules Constantinou
President, Institute and Faculty of Actuaries