Financial Conduct Authority: Fair Pricing in Financial Services

Consultation response from the

Centre for Competition Policy

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This response is in two parts. Neither part directly addresses the questions posed, but both relate mainly to **Question 1** on the evidential questions necessary to identify unfair price discrimination. Part 1 aims to clarify what the FCA means by fair and unfair pricing, in particular by distinguishing distributional from transactional unfairness. Part 2 highlights some important practical details in defining price discrimination in markets where the cost of serving customers differs, and in providing sufficient evidence for appropriate regulatory intervention.

Part 1: Transactional Unfairness and Price Discrimination in Financial Services

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Part 2: Defining Price Discrimination and Informational Requirements for Enforcement

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This consultation response has been drafted by the named academic members of the Centre, they retain responsibility for the section of content to which their name is attached.

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Part 1: Transactional Unfairness and Price Discrimination in Financial Services

(by Bruce Lyons, Robert Sugden and Tim Vickers)[1]

Initial response to Q.1

Question 1 relates to "six evidential questions [the FCA proposes to use] to help assess concerns about fairness of individual price discrimination cases". When is fairness a concern? Paragraph 1.15 of the FCA paper sets out how the FCA decides what is fair:

> "When supervising the firms we regulate, we assess firms' behaviours against a fairness standard.[2] In some instances where practices are more clearly unfair than others then we could act. For example, we may take action where we find firms have not treated customers fairly in their pricing practices and/or not been clear, fair and not misleading when communicating to consumers about prices. Our competition objective and powers also provide a basis to deal with cases of anticompetitive behavior that may lead to high prices."

The fairness standard in the *footnote* is explicit that the firm must act fairly "in accordance with the best interests of its client". This suggests a notion of fairness that relates to each *transaction* between a firm and an *individual* client. However, the main economic approach used in the FCA paper is *utilitarian* or *welfarist*, i.e. the overall effect on 'consumer welfare' is treated as an unweighted or weighted *sum of the effects* on individuals. This is, indeed, the standard economic approach to measuring the effects of regulatory interventions. When weights are used, they are interpreted as representing the 'social value' of increments of income to the relevant class of individual. The usual assumption is that given amounts of money have greater social value to poorer individuals. This approach allows losses to some consumers to be traded-off against gains to others to appraise the social efficiency of a pricing practice.

The traditional economics of price discrimination concentrates on these *efficiency* effects within this framework. In particular, for nearly a century the literature has discussed whether price discrimination:

a) results in an increase in output (e.g. a lower price to a group of consumers with low valuations may allow them to consume when otherwise they would be priced out of the market),
b) may allow products to exist that would otherwise be unviable due to fixed costs,[3]
c) may create a distortion as potential consumers in the high price market are excluded from consumption, while some lower valuation consumers are able to consume because they happen to be in the low price market.

In addition to these classic concerns, competition economics considers the *competitive* importance of price discrimination in:

d) promoting competitive entry into market segments that might otherwise remain monopolised.[4]

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[1] Bruce Lyons and Robert Sugden were supported in the research behind this submission by the Economic and Social Research Council [grant number ES/P008976/1].
[2] The Conduct of Business sourcebook requires firms to "…act honestly, fairly and professionally in accordance with the best interests of its client…", see COBS 2.1.1R.
[3] For example, there is a long-established literature on Ramsey pricing.
[4] For example, low prices may be necessary to cover consumer switching costs with the overall effect of making price cuts more attractive to firms (compared with uniform pricing). Careful analysis is necessary in

We agree that these are four highly important considerations and must always be an issue for regulators. The FCA paper also recognises this.

However, the motivation behind the FCA paper, and the FCA's own COBS 2.1.1R, seem to be much more ambitious than this. The title of the paper is Fair Pricing, not Efficient Pricing, and it is trying to address genuine public concern about pricing practices that seem 'unfair' separately from any welfarist efficiency considerations. In this context, we believe that the evidential questions summarised in Figure 1 are unfocussed and unhelpful because they fail to identify a clear and coherent view of what "fair" or "unfair" pricing really means.

The questions in Figure 1, therefore, are unable to guide either principled regulatory interventions when there is a "concern" or, just as importantly, corporate compliance to avoid such concerns developing in the first place. While making this criticism, we accept that the focus of modern economic analysis has been on efficiency, rather than fairness, so clear economics guidance for policy makers has not been brought to the surface.[5] In this response, we provide a framework for thinking about unfair pricing separately from any efficiency concerns, and illustrate our principles of unfairness in relation to financial services markets.

We begin by answering a question the FCA failed to ask.

On what basis should the FCA decide whether price discrimination is fair or unfair?

We begin by distinguishing two quite separate and potentially complementary concepts of fairness:

- **Distributional fairness** derives from inequalities in wealth or, more generally, in access to resources. Distributional fairness is an ethical judgement. While a degree of inequality is widely considered to be fair (e.g. inequalities due to differences in effort, risk taking or scarce talent), it is also generally considered that the current wealth distribution would be improved by a reduction in inequality, particularly with respect to the poor.[6]

- **Transactional fairness** derives from the process behind individual purchase decisions. It is also an ethical judgement. While individuals must be responsible for their own choices, they should be able to do so with reasonable assurance that they are buying from a seller who is providing sufficient and not misleading information about their own prices and associated terms.[7] Transactional fairness requires:
  - a sufficiently informed purchase decision,
  - for ongoing/client relationships, sufficiently updated information and ease of revisiting the purchase decision, and
  - a 'not unethical' basis for discriminating between consumers.

Distributional fairness considers the overall wealth and spending power of a consumer, which is influenced only marginally by the price of most transactions. In contrast, transactional fairness

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specific cases to evaluate the overall effect. See part 2 of this response by Morten Hviid and Catherine Waddams.

[5] An exception on which we draw throughout this response is Robert Sugden (2018) *The Community of Advantage: A Behavioural Economist's Defence of the Market*, Oxford University Press.

[6] Some types of chronic illness and disability increase a person's needs beyond those of the healthy (while not impairing their capability to make decisions – see footnote 12). We would include such additional needs in distributional fairness but refer to the "poor" for short.

[7] The ethical limits to c*aveat emptor* may depend on the context of the transaction. For example, the ethics of a car-boot sale may reasonably differ from the ethics of financial services.

considers each transaction individually and the fairness of the process behind it. It does not refer to the wider financial circumstances of an individual consumer.

It is worth noting two other implications of transactional fairness, both deriving from its focus on a single firm and its customer. First, it holds an individual seller responsible for its own actions (and inactions) but places no obligation on a seller to inform buyers about offers by other sellers in the market. Second, it differs from distributional fairness in not allowing a firm to use a 'water-bed' argument to weigh an unfair transaction with one customer against a fair one to another.

Particular importance of transactional unfairness to financial services

Transactional fairness is grounded in widely accepted ethical behaviour. This also underpins market efficiency because it provides the foundation for consumer trust in the market and in the accepted fairness of market outcomes.[8] Unless the process behind market outcomes is accepted as fair, consumers may adopt costly verification and avoidance behaviour, so the benefits of a market economy will be eroded. For example, consumers may 'waste' frustrating amounts of time checking that they are not being 'cheated', or their distrust may prevent their purchase of a beneficial product. This negative externality of distrust is additional to the direct ethical justification for transactional fairness.[9]

Trust is particularly important in financial services markets because financial services are typically, often fundamentally, based on trust (e.g. insurer will pay up, bank will keep your money safe). Unfair price discrimination by financial services firms is likely to be a negative signal of trustworthiness, so it is particularly important for pricing to be seen as based on fair criteria. While this may be, in part, a point of difference for a firm that might be used to develop a trusted brand, there is also likely to be a substantial externality because either competitive pressures may make it difficult for one firm to deviate from wider industry practice, or in public perceptions they are all tarred with the same brush, not least because consumers deal so irregularly with different firms.

"Big data" available to firms is an increasing feature of financial services (e.g. insurance). This creates a marked imbalance of information between insurer and customer and facilitates personalised pricing. It is particularly difficult for a customer to compare personalised prices. For example, consumers might approach a number of insurance companies which sell insurance direct to customers, or use an insurance broker (with undisclosed commission), or use an inevitably imperfect price comparison website. Each is time consuming, and none is perfect. Some consumers will spend considerable amounts of valuable time checking for better deals. Others may be shocked when they eventually find out how much they have been discriminated against, and lose trust in the market.

Identification of transactional and distributional unfairness

While the FCA may have an advocacy role to promote fairness, its enforcement role should be to deter or prohibit *un*fair pricing. It would be a slippery path to over-regulation to try to specify precisely what

[8] A market can be seen as a network of individual transactions (Sugden, 2018).

[9] We suggest that something like our concept of transactional fairness implicitly lies behind both the FCA's Principles for Business and a wide range of Codes of Conduct agreed by most professional and business associations. The FCA Handbook sets out 11 Principles for Business, including Principle 6 discussed below. Ethical codes that incorporate widely accepted social values are also standard for professional associations. For example, the 'statement of ethics' of the American Marketing Association sets out three 'ethical norms': do no harm (by commission or omission); foster trust in the marketing system (including a special commitment to the vulnerable); embrace ethical values (including honesty and responsibility). See https://archive.ama.org/Archive/AboutAMA/Pages/Statement%20of%20Ethics.aspx

is fair, but the FCA should be clear as to what it considers to be unfair. For this reason, we set out three ***principles of transactional unfairness***:

1. ***Transactional unfairness pre-purchase***. It is unfair to entice a buyer by providing misleading information, or by hiding obviously relevant information, including by presenting information with misleading salience that draws attention away from what is likely to be most relevant. This principle is well-established in consumer protection law.

2. ***Transactional unfairness in ongoing relationships***. Once a consumer enters a continuing relationship with a seller, there should be an implicit contract such that it is unfair if the seller does not periodically provide an existing customer with obviously relevant information about the prices it currently offers other existing customers or if it provides misleading information.[10] The customer must be able to act on such information, so it is further unfair if the seller makes it more difficult to leave the relationship than to enter it.[11]

3. ***Transactional unfairness across customers***. It is unfair to discriminate on the basis of an individual's impaired capability to make rational, well-informed decisions (including temporary impairment). We call this impaired capability "transactional vulnerability", which seems consistent with the FCA definition of vulnerability (p.20).[12] On the other hand, we do not consider it *per se* unfair to charge different prices to different customers, not least because there may be positive economic reasons to do so on the basis of differing costs of supply, or efficiency and competitive effects.[13] We propose that a 'benefit principle' is helpful in clarifying what may be viewed as transactionally unfair (see below).

Meanwhile, we suggest the following intuitive test for the transactional unfairness of price discrimination (or other pricing practices). Price discrimination is unfair if the answer to the following questions is not affirmative:

> ***Can the firm provide a reasonable explanation of its pricing practice, locating it as part of a business model based on mutual benefit, and would the firm be willing to give this explanation to its customers and expose it to public debate?***

Returning to distributional unfairness, we can add a fourth fairness principle:[14]

4. ***Distributional unfairness across consumers***. Price discrimination is distributionally unfair if it has the effect of charging higher prices to poorer people.

Note an important difference between *Principle 3*, which relates to *how* firms are discriminating, and *Principle 4*, which relates to *who* is being discriminated against. This reveals a limit to the

[10] To be clear, it is fair to offer new customers a time-limited enticement (lower price) to sample the seller's product on the basis that a buyer needs to experience a product before a proper judgement of its quality and fit with the buyer's requirements can be assessed. Consequently, it is not unfair to withhold such offers to customers who have already experienced the product.
[11] For example, by making continuing payment a default, then requiring a more difficult procedure to reverse this. The principle of entry/exit equivalence is in the CMA's report on the Loyalty Penalty.
[12] Elsewhere in the FCA paper, the difference between vulnerability and distributional issues is less clear. Following on from footnote 6 where we mention distributional fairness and health needs, some serious disabilities (e.g. loss of an arm) may have little effect on transactional vulnerability, while other disabilities and illnesses (e.g. dementia, depression) may have extreme effects.
[13] See Sugden (2018) for why this should be considered fair (as well as possibly efficient). On cost of supply, see part 2 of this response by Morten Hviid and Catherine Waddams. On efficiency and competitive effects, see the opening section to part 1.
[14] This is proposed in Lyons (2017) 'Inequality and Competition Policy', *Antitrust Chronicle*, October.

implementability of distributional fairness, even if may be ethically attractive.[15] For example, there would be a severe problem of consumer privacy if a seller were to try to act on distributional fairness by some form of means testing. Nevertheless, many forms of price discrimination (e.g. discounts for families, students, pensioners) are both rough-and-ready applications of distributional fairness and rough-and-ready applications of the benefit principle discussed next.

Applying the benefit principle to transactional unfairness in price discrimination

Public finance economists judge overall tax systems according to their "vertical equity".[16] Vertical equity is the principle that higher income individuals should pay more tax than those with lower incomes. A similar principle can be applied directly to distributional fairness.[17]

Another strand of the fair taxation literature more naturally lends itself to the transaction level. The "benefit principle" states that taxes paid by individuals should be proportional to benefits received (e.g. people who own more property gain more from government activities that protect property, so should pay higher taxes). An analogous benefit principle can be applied to transactional fairness in price discrimination: *higher prices should be tied to characteristics of the purchase or purchaser that indicate higher benefit* (measured in willingness to pay). For example:

- *Characteristics of the purchase*: e.g. on return air tickets, higher prices for shorter stays; lower prices for customers who buy tickets in advance; price premia for 'high-specification' features which cost relatively little to produce; price premia for quicker delivery.
- *Characteristics of the purchaser*: e.g. lower prices for children, students, pensioners.

Significantly, these forms of price discrimination are typically transparent, because firms have no need to hide them. Such bases for discrimination are compatible with the idea that a market is a network of mutually beneficial transactions, in which gains from trade are shared between buyer and seller. Other things being equal, higher willingness to pay implies greater gains from trade, and so it is not unfair if the seller makes more profit when it deals with consumers with higher willingness to pay.

The mutual benefit approach supports a principle of fairness according to which the parties to a transaction should intend that (or have a reasonable expectation that) the transaction is mutually beneficial.[18] Some cases that seem *not* to meet this principle, and so may be considered *unfair*, include:

(i) Low-price introductory offers with built-in roll-overs to higher prices, and with unnecessary obstacles to exit at the roll-over stage. Introductory offers are consistent with mutual benefit if the intention is to showcase the benefits that the firm can give to its customers, but if the benefit was genuine, the customer who had experienced them would be willing to buy at the standard price after the introduction. More generally, if a continuing trading relationship was

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[15] It is also highly questionable to expect firms to apply a redistribution policy that goes beyond what governments are willing to do through the tax and benefits system.

[16] Public finance theory also considers horizontal equity, which is the principle that people with the same income should pay the same taxes. It is usually justified on the grounds that it provides a safeguard against arbitrary discrimination. While attractive in the context of tax setting, horizontal equity considerations do not extend well to price discrimination. For example, individuals of similar income will buy a wide range of products and in the absence of transactional unfairness considerations, it seems no great issue if person A buys one half of her shopping basket cheaper than does person B, and the other half more expensively.

[17] See Lyons (2017).

[18] See Sugden (2018) for the ideas that mutual benefit is the fundamental organising principle of a well-functioning market economy, and intending mutual benefit should be a principle of 'market virtue', aka business ethics, aka transactional fairness. Compare also the FCA's COBS 2.1.1R requirement that a firm must 'act honestly, fairly and professionally in accordance with the best interests of its client'.

mutually beneficial, the parties would not want to exit from it and so the firm would have no reason to restrict exit. The CMA principle of 'exit/entry equivalence' (*Tackling the Loyalty Penalty*, p. 6) is a good mutual benefit principle.

(ii) A firm has multiple tariffs that a given customer is eligible for, but sells to the customer on a tariff that is clearly not the best for her, relying on her not searching. The firm is acting contrary to the principle that it should intend its relationship with the customer to be mutually beneficial. (The customer should not expect the firm to tell her about better offers available from other firms, but she is entitled to expect the firm to tell her about *its own* offers.)

(iii) A firm puts a product/ tariff on the market without having a realistic expectation that significant numbers of well-informed customers might want to buy it – i.e. the business model is not to cater to a niche demand, but to trap unwary customers. This relates to the FCA's concept of 'reasonable responsibility' by consumers (p. 24). Consumers should bear responsibility for choosing products that meet their personal preferences, *out of the set of market offerings that meet the range of preferences in the market*.

(iv) Inertia pricing which discriminates against a firm's long-standing customers (e.g. price walking). A customer who repeatedly transacts with the same firm is conferring an extra benefit on the firm (e.g. reducing variation in sales, reducing the need for expenditure on attracting new customers). The principle of mutual benefit implies that, if anything, the firm should confer extra benefits on its long-standing customers, not discriminate against them.

Why the framework in Figure 1 is inadequate

There is ambiguity in the reference to 'vulnerable' consumers in the first question in Figure 1. As we say above, the FCA definition of vulnerability (p. 20) implies impaired capability to make rational, well-informed decisions. However, is the FCA view that vulnerable consumers are a class of individuals (analogous with low-income individuals) whose welfare should be given special weight (i.e. a *welfarist* argument)? Or is it that it is an unfair practice to use vulnerability *as a means of* price discrimination (i.e. a *fairness* argument)? If the latter, vulnerability ought to be in the 'How are firms discriminating?' question, not the 'Who is harmed?' question. For example, consider someone who is old and well-off. Because of age, he is easily confused by difficult decisions, i.e. vulnerable. But when he is making simple decisions, he is 'harmed' by forms of price discrimination which set higher prices for higher-income people. Is vulnerability supposed to be relevant in this case?

There is also ambiguity about whether price discrimination practices that charge higher prices to consumers who search less are unfair *in so far as vulnerable* consumers are unable to avoid the high prices, or unfair *to consumers in general*, and merely more harmful to vulnerable ones. Current public debate about inertia pricing suggests that many people take the second position.

The sixth 'evidential question' ('Would society view the price discrimination as egregious/ socially unfair?') seems mis-specified. The FCA should be setting out its *criteria of fairness*. The first five questions are proposed criteria, but the sixth effectively says that something is unfair if people think it is unfair. This provides no basis for either compliance or FCA leadership. The FCA should take account of public opinion in *setting* its criteria, but public opinion should not be a criterion in itself. We conjecture that the open-ended form of this question reflects the FCA's uncertainty about how to give precise expression to non-welfarist ideas about fairness that are prominent in public debate.

Our claim in this response is that the FCA's underlying ideas can be more clearly expressed in terms of transactional unfairness, and that this provides a sound basis for compliance and enforcement. It also leads naturally on to the evidential questions and the answer to the consultation question 1.

A suggested alternative set of evidential questions in relation to transactional unfairness in price discrimination

1. Basis for price discrimination
    a. Does the firm provide misleading price information, or hide obviously relevant tariffs from some customers, including by presenting information with misleading salience that draws attention away from what is likely to be most relevant to them?
    b. Does the firm offer existing customers sufficiently updated information (at suitable intervals) and facilitate its customer's choice to revisit the purchase decision (including "entry/exit equivalence")?
    c. On what basis does the firm discriminate between its customers? Does this use a characteristic of purchase or purchaser that is likely to be associated with transactional vulnerability? Does it use a characteristic of purchase or purchaser that is likely to be associated with the mutual benefit of the transaction?
    d. Is the firm willing to explain the basis of its price discrimination to its customers and expose this explanation to regulatory scrutiny and public debate?
2. Effect of price discrimination
    a. Does the basis of price discrimination have the effect of charging higher prices to poorer people?
    b. Does the basis of price discrimination have the effect of charging higher prices to transactionally vulnerable consumers?
    c. Does the basis of price discrimination induce avoidance strategies that are disproportionately costly to consumers?
    d. Are these effects 'substantial' to the customers concerned (i.e. in terms of numbers and scale of discrimination)?
3. Pro-competitive justifications
    a. Is there an 'efficiency defence' for the basis of discrimination in terms of increased output or the provision of a mutually beneficial product that would otherwise not be provided?
    b. Is there a 'competition defence' in terms of price discrimination being required to enhance competition?

Part 2: Defining Price Discrimination and Informational Requirements for Enforcement

(by Morten Hviid and Catherine Waddams)

Rather than commenting directly on the six questions, we want to make a few general points. The first set relate to precise definition of terms while the second set relate to the information required for enforcement.

Definitions

There is an important difference between price dispersion (or the existence of a price distribution) and price discrimination. The latter refers to prices of a single form for comparable products which do not reflect costs. Typically when it comes to price discrimination, we think of different prices to different people where the cost of supplying these people do not differ to such an extent that the difference in price can be justified. However price discrimination equally arises where the price is the same to all but the cost of supply differ across consumers or consumer groups. The latter is important for many of the products supplied by the firms regulated by the FCA. More about that below.

There is also an important difference between introductory offers [sometimes referred to pejoratively as teaser rates] and prices which increase as a result of inactivity at the point of contract renewal, what is referred to in the DP as "price-walking". It would, in our view, be inappropriate to classify introductory offers as examples of inertia pricing. There may be some inertia effects, but we can equally find pro-competitive justifications for their introduction. Section 4.6 does not make this sufficiently clear. Price-walking is much harder to justify as a commercial practice than are introductory offers. The latter may be essential for competition to take place where consumers are unsure about the benefits from switching. The former exploits inertia.

Information requirements

For many of the products provided by the firms regulated by the FCA there are differences in the cost of supplying these services. Insurance is instructive. From a cost perspective, it is important to segment the customers into various risk-classes to ensure that the price reflects the cost of providing insurance to that class. Indeed inadequate segmentation could be viewed as a form of price discrimination. On the other hand, perfect segmentation [a possible future implication of Big Data and AI?] would totally undermine insurance. Hence, insurance is a case of some but not too much segmentation.

Now conduct the following thought experiment: Given the level of competition in the market, a firm provides a set of offerings which segments its customers according to costs. Imagine that the elasticity of demand differs across segments. Go a step further and assume that those with higher costs have greater desire for insurance and hence are less price sensitive. If so, on top of the price reflecting differences in costs, it may also reflect this difference is demand elasticity. How much of the price reflects price discrimination in this case? Now let us complicate matters further. Once the firm realises that different segments have different demand elasticities, might it want to redraw the boundaries of the segments? If so, now how much of the price difference reflects price discrimination?

We are not aware of any academic research, which might help to disentangle these effects, let alone how the answer might depend on the degree and nature of competition in the market. What is clear, however, is that acquiring the information necessary to convince an appeals court that the differences do not merely reflect differences in costs would be challenging. Nor is it obvious that requiring the firm to demonstrate that they are not discriminating would be fair and reasonable.

While some practices, such as price-walking, appear hard to justify[19] and a requirement placed on the firm to explain itself seems reasonable, for other practices, it is challenging for the FCA to be sufficiently sure that the price behaviour is abusive that intervention is appropriate. Banning introductory offers may reduce entry and competition among existing firms, leading to higher prices for all.[20]

Section 4.9 [the grey box] is another example where obtaining the appropriate information is problematic, either because the information is not readily available or because privacy rules would prevent the information being provided. First bullet point – who has the duty to disclose and how does this sit with privacy? Second bullet point – how can a firm assess this and what means of appeal may there be? Third bullet point – given privacy rules and lack of central register of people how can a firm learn about that? What evidence can they ask for? Fourth bullet point – are we talking mental incapacity at this point? There are very clear rules for when individuals are not able to access these markets for capability reasons. Who decides on rules?

Generally we would urge the FCA to consider the burden of proof and the standard of the evidence which is required before proposing any remedies.

[19] Theoretically we probably need to be a little bit careful – price-walking could be made to look a lot like a ratchet effect in which the side of the market with less information learns this over time. In such cases the informed (here the consumer) would be the beneficiary through lower prices early on. This effect may be inefficient but not usually thought of as unfair.

[20] Some of the analysis in Hviid, M. and Waddams Price C. ('Non-Discrimination Clauses in the Retail Energy Sector', Economic Journal, 122 (August 2012), pp. F236-F252) may be useful. Waddams Price, C and M. Zhu (2016b), 'Non-discrimination clauses: their effect on GB Retail Energy Prices 2005-2013', The Energy Journal, 37, 2, pp. 111-132 reported evidence that the introduction of non discrimination clauses did soften competition.