FCA: Call for Evidence - Guidance for firms on the fair treatment of vulnerable customers

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Consultation response from the

Centre for Competition Policy

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This consultation response has been drafted by the named academic members of the Centre, who retain responsibility for its content.

As an academic research centre, we welcome explicit citation and sharing of this consultation response and the research cited within it. If you would like to discuss the evidence in more detail, please feel free to contact the centre or the named academics.

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Response by Lyons & Sugden, both Centre for Competition Policy (CCP), University of East Anglia (UEA) and Network for Integrated Behavioural Science (NIBS) to FCA consultation on "Guidance for firms on the fair treatment of vulnerable customers"

Response…

1. *Our understanding of how the FCA sees the context of the proposed guidance*

The FCA Principles for business include: '6. A firm must pay due regard to the interests of its customers and treat them fairly.'

> *Comment*: Paying 'due regard' and treating 'fairly' are such vague concepts that they can be interpreted in many different ways. This is unhelpful for compliance and makes enforcement difficult.

The FCA has developed a set of 'consumer outcomes that firms should strive to achieve for all consumers' (FCA, Fig.2 p.26)

> *Comment*: We agree that the properties labelled 'outcomes' 2-6 are very helpful. However, we do not see these as 'consumer outcomes' so much as necessary conditions for a fair transaction. We return to transactional fairness in the next section.

The FCA suggests (FCA, #1.1) that '50% of UK adults display one or more characteristics of being potentially vulnerable', and 'Vulnerable consumers may be more likely to experience harm.'

> *Comment*: All consumers are susceptible to making poor decisions regardless of vulnerability, so the FCA should clarify its understanding of which measures it is proposing that are specific to vulnerable consumers, and which are more general. Put another way, the FCA's definition of vulnerability is both too narrow (because firms should treat all consumers fairly) and too wide (because it dilutes a special focus on the most vulnerable).

The FCA's aim is to provide clear guidance to firms: 'Firms have sought greater clarity from us on what they need to do to ensure the fair treatment of vulnerable consumers, and our intention in proposing this guidance is to make clear what, in our view, firms should do to ensure that vulnerable consumers are treated fairly, and consistently across financial services sectors.' (FCA, #1.3)

> *Comment*: We agree with this aim, but suggest that the current approach goes straight to examples without explaining what is meant by 'fair treatment'. We return to how to achieve this in the next section.

The FCA identifies four drivers of vulnerability (Table 1, p.7): health, life events, resilience, capability.

> *Comment*: These 'drivers' cut across two types of vulnerability: A) cognitive vulnerability which affects the ability to make good decisions (e.g. poor mental health, bereavement, low emotional resilience, learning impairments); B) low income/wealth which raises the stakes of making the right decision (e.g. physical disability that limits work opportunities, income shock, over-indebtedness, lack of digital skills). These have different implications for what regulators should do. A) is crucial for regulation because it can be exploited by firms. Furthermore, interventions which make it easy for consumers to make good decisions benefit everyone – they just benefit the vulnerable more. We shouldn't encourage the idea that it's OK to exploit the non-vulnerable. B) involves wider issues of income inequality. It is certainly important and a very significant issue for public policy, but it is less obviously appropriate for a regulator to require firms to address.

The FCA argues that ‘vulnerable consumers may be significantly less able to represent their own interests. They may have non-standard needs, and may be more prone to certain behavioural biases that negatively impact their decision making.’ (FCA, #2.11)

> *Comment*: We concur with the spirit of the second sentence that vulnerable consumers may be ‘more prone to certain behavioural biases’. However, we believe that for many of the patterns of behaviour that have been identified by behavioural scientists and which contravene traditional assumptions about rational choice, the concept of ‘bias’ is misplaced, because it implies that individuals have underlying ‘true preferences’ from which they deviate by error. In many cases, the reality is that individuals simply lack stable preferences. Using the concept of ‘bias’ fosters the belief that policies can be designed to nudge people towards ‘correct’ choices. We are particularly concerned that the first sentence, which suggests vulnerable consumers may be ‘less able to represent their own interests’, appears to imply interventions of the form that someone else should represent the consumer’s interests. While the FCA must take steps to ensure that vulnerable consumers are able to understand the consequences of their choices, we believe it is important that the FCA still allows consumers to make their own decisions unless their cognitive capacity is severely impaired.

The FCA properly notes the substantial difficulty for firms in specifically identifying vulnerable consumers (FCA, Fig.2 p.11).

> *Comment*: This informational constraint is incorporated the analysis of transactional fairness discussed in section 2 below.

The FCA’s guidance on communicating with vulnerable consumers says: ‘Firms should take steps to ensure vulnerable customers are not disadvantaged in understanding products and services’ (FCA, Fig.8 p.51).

> *Comment*: We agree that the properties of appropriate communications set out as a.–d. of Fig.8 are excellent, except *we would not restrict them to vulnerable consumers*. Furthermore, the implicit comparative element may even be interpreted as it being acceptable to take vulnerable consumers up to the level of misunderstanding of non-vulnerable consumers who nonetheless pay too little attention to their financial decisions.

We next set out some of the ideas in L&S that we believe would help clarify the FCA’s approach both to vulnerable consumers and to its wider regulatory work.

2. *Transactional Fairness as a guide for both the FCA and the firms it regulates*

Our paper (L&S) explains why much of the economics literature is deficient in providing a proper understanding of what many people, including the FCA, think of as “fair treatment of customers”. This deficiency has left regulators with inadequate principles on which to base their guidance, which should not be an unsystematic collection of case-by-case ex post decisions. We argue that our concept of transactional fairness helps to fill the gap in a way that is largely consistent with the intuitions of the FCA (and other regulators such as the CMA). The concept is built on an ethical approach to market in which firms and consumers engage with each other in the spirit of mutual benefit. ***The advantage of this principled approach is that it provides a foundational framework against which new business practices can be judged as they emerge. Just as importantly, it***

provides the basis for firms to comply by understanding ex ante what innovative business models would be acceptable and which ones would not.

Our focus is on individual transactions rather than market outcomes or unequal income distribution. As such, we do not consider transactional fairness as an alternative to the normative standards of efficiency and distributional fairness, but as complementary to them. Furthermore, our approach does not require firms to fund loss-making transactions or to use information that is not available to them, or for regulators (or firms) to make choices on behalf of consumers. Transactional fairness is concerned with ethical standards that can be action-guiding for individual firms (and consumers).

> ***Definition of Transactional Fairness.*** Transactional fairness requires that a firm acts in such a way that consumers with normal expectations about pricing practices in the relevant market are able to understand the consequences of transacting with that firm (*No Deception*) and are not hindered from terminating a relationship with the firm or from transacting with alternative sellers (*No Hindrance*). It also requires that the firm is able to explain the rationale of its pricing practices, locating them as part of a business model based on mutual benefit between the firm and its customers, and is willing to provide the explanation publicly (*Public Explanation*).

Section 4 of the attached paper unpicks this definition in relation to normal expectations, no deception and no hindrance. While active deception and active hindrance may be covered by consumer law, we focus on the ***grey area of passive deception and passive hindrance***, which are tend to be addressed by ad hoc regulatory interventions. For example, we say that a firm engages in passive deception if it relies on (and does not try to correct) a customer's mistaken beliefs about its business practices.

> "Principles of non-deception and non-hindrance are already written into consumer and competition law, but generally with the emphasis on active deception and active hindrance. What we have called passive deception and passive hindrance rest in a grey area of business practices that are unfair without being clearly illegal, except insofar as they contravene specific regulations. Such regulations are often designed as remedies for existing practices that have been judged to be unfair. There is an entrepreneurial dynamic here, with an inbuilt time lag. Firms discover new strategies (perhaps made possible by advances in technology) for making profit within the constraints imposed by existing regulations; when those strategies are judged unfair, new regulations are introduced. " [L&S, p.30]

We propose that transactional fairness should be a standard part of corporate culture, and that it should apply a fortiori to financial services given the fundamental role of trust in such markets. Nevertheless, we also address the issue of ***transactional fairness in relation to vulnerable consumers***:

> "We will say that (in relation to a specific transaction) a consumer is *transactionally vulnerable* if her capacity to make considered and well-informed decisions is impaired by factors outside her or the firm's control. 'Impairment' may be due to long-lasting cognitive limitations (e.g. young children, individuals with dementia) or temporary distress (e.g. a recently bereaved person planning a funeral). Vulnerability with respect to information could also be due to inability to access commonly-used sources of information (e.g. lack of internet access). Insofar as the firm can recognise transactionally vulnerable customers, it should interpret its implicit contracts with them in accordance with what those customers can be expected to know and understand. Because the requirements that transactional fairness imposes on a firm are conditional on the firm's information, vulnerability is relevant

for transactional fairness only to the extent that the firm can recognise it. There are very substantial privacy issues in identifying vulnerable individuals. Nevertheless, some natural correlates of vulnerability are easily identified (e.g. age), and some sales situations may naturally present other evidence (e.g. severe mental impairment is likely to be revealed in person-to-person sales, bereavement is revealed in funeral planning)." [L&S, p.21]

Furthermore, ***business models*** can be transactionally unfair if they are ***targeted at the vulnerable***:

> "Take the case of an unscrupulous firm that specialises in doorstep contact with elderly householders, offering to do repair work at prices far above market levels. If these customers are known to lack the mental resources necessary for effective price search, this practice should be viewed as transactionally unfair." [L&S, p.23]

We propose two ***guiding principles for regulation***:

> "First, regulation should facilitate the formation and maintenance of trading practices that allow consumers to predict, as precisely as possible, the consequences of entering a transaction. Second, regulation should not hinder the emergence of (non-deceptive and non-hindering) business models which, by offering new opportunities to consumers, may create new expectations." [L&S, p.29]

Our aim is to contribute to the development of ***general principles that can guide regulators*** in assessing the fairness or unfairness of firms' pricing practices. If those principles use only information that is directly available to firms, firms should be able to predict whether or not particular new practices would be permitted by the regulator. This facilitates both compliance and, where necessary, enforcement.

We suggest the FCA should:

1. Be clear in ***explaining the principles of fairness*** behind its judgement that certain practices are unfair. This will facilitate the development of new, innovative business practices while lessening the need for ex post interventions to stem the damage of new ways to be unfair.
2. ***Prohibit specific types of passive deception*** in a category of markets (e.g. a firm 'hiding' prices from an eligible consumer, or 'price walking' for a consumer on auto-renewal). Similarly, certain types of passive hindrance may be prohibited in relevant markets (e.g. making it harder to leave a contract than to sign-up, or 'rolling-over' fixed-term contracts without sufficient warning).
3. Our definition of transactional unfairness includes a ***Public Explanation*** condition to address practices that may have both positive and negative justifications. Firms should be required to cooperate with regulators in the public process of ensuring that business practices are fair. Regulatory agencies are a repository for complaints of unfairness made by consumers and advocacy groups. Regulators can ask firms to explain their practices, ask for verification of questionable claims, make public comment on their findings, and potentially enforce a change in business practice. This is, of course, a standard part of regulatory activity but we suggest that this would become much more straightforward and efficient to enforce if assessment was against clearer principles of transactional fairness.
4. Because the concepts of deception and hindrance are defined in relation to normal expectations, there is a third role for regulation in ***shaping those expectations***. For example, a regulation that imposes a specific definition (e.g. requiring that headline prices are stated inclusive of taxes and standard delivery charges) can *create* a normal expectation and a corresponding category of transactional unfairness.

It is reasonable to hope that the ***regulation needed to secure transactional fairness would not be onerous***. There is currently a lack of corporate understanding about what is acceptable practice in pricing. We suggest that clear, principled guidance on transactional fairness would make it easier for firms to act fairly.