



Incoherent consumer preferences in markets – What do we learn from the work of the regulators?

NIBS Conference 2016:
*Assessing well-being when
preferences are incoherent*

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Introduction

- ❖ Competition authorities and regulators interested in incoherent consumer preferences and their implications for how well markets function.
- ❖ Focus today on two example areas of bias:
 - Biases relating to customer search and switching behaviour
 - Biases relating to point-of-sale (POS) selling of ‘add-ons’
- ❖ In each, there is clear evidence of incoherent preferences, and clear consequences for market pricing.
 - There have also been regulatory interventions designed to solve the problem.
- ❖ Key question for today: Can we learn anything from such regulatory work in terms of assessing well-being when preferences are incoherent?

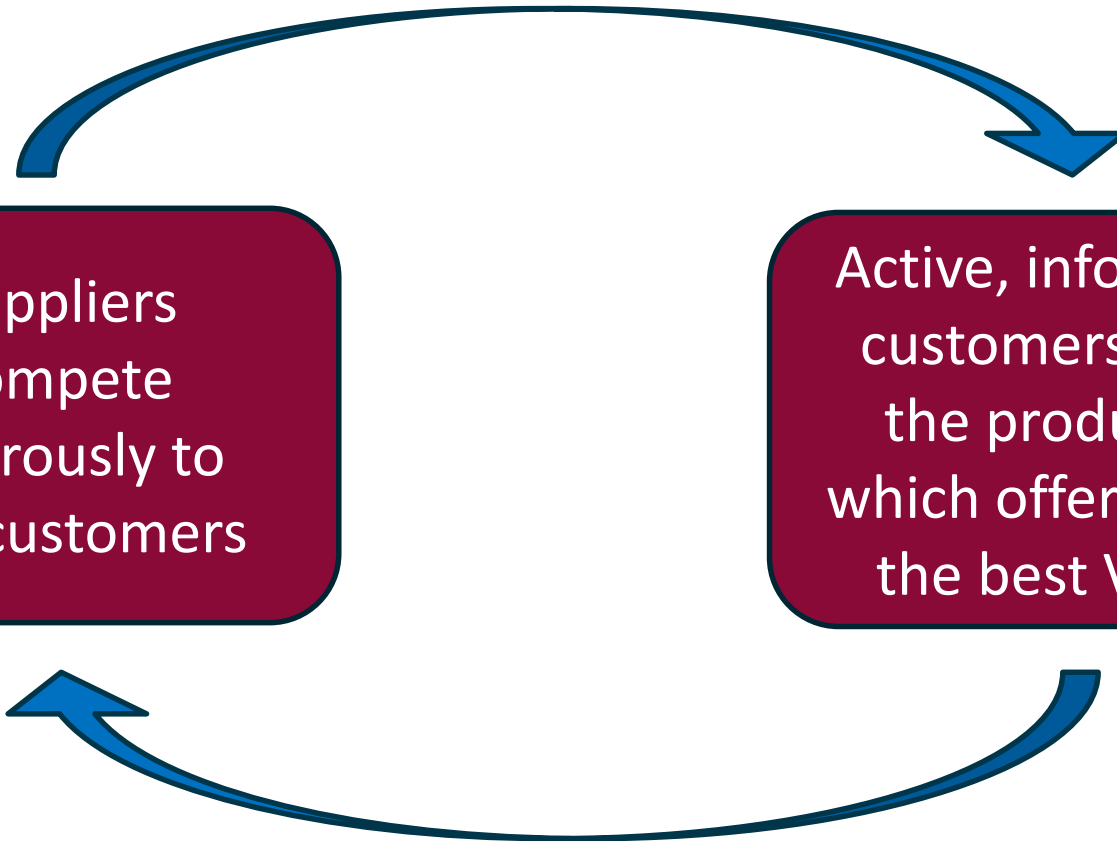
The D-side and S-side in competitive markets – A virtuous circle for consumer well-being?

SUPPLY SIDE

Suppliers
compete
vigorously to
win customers

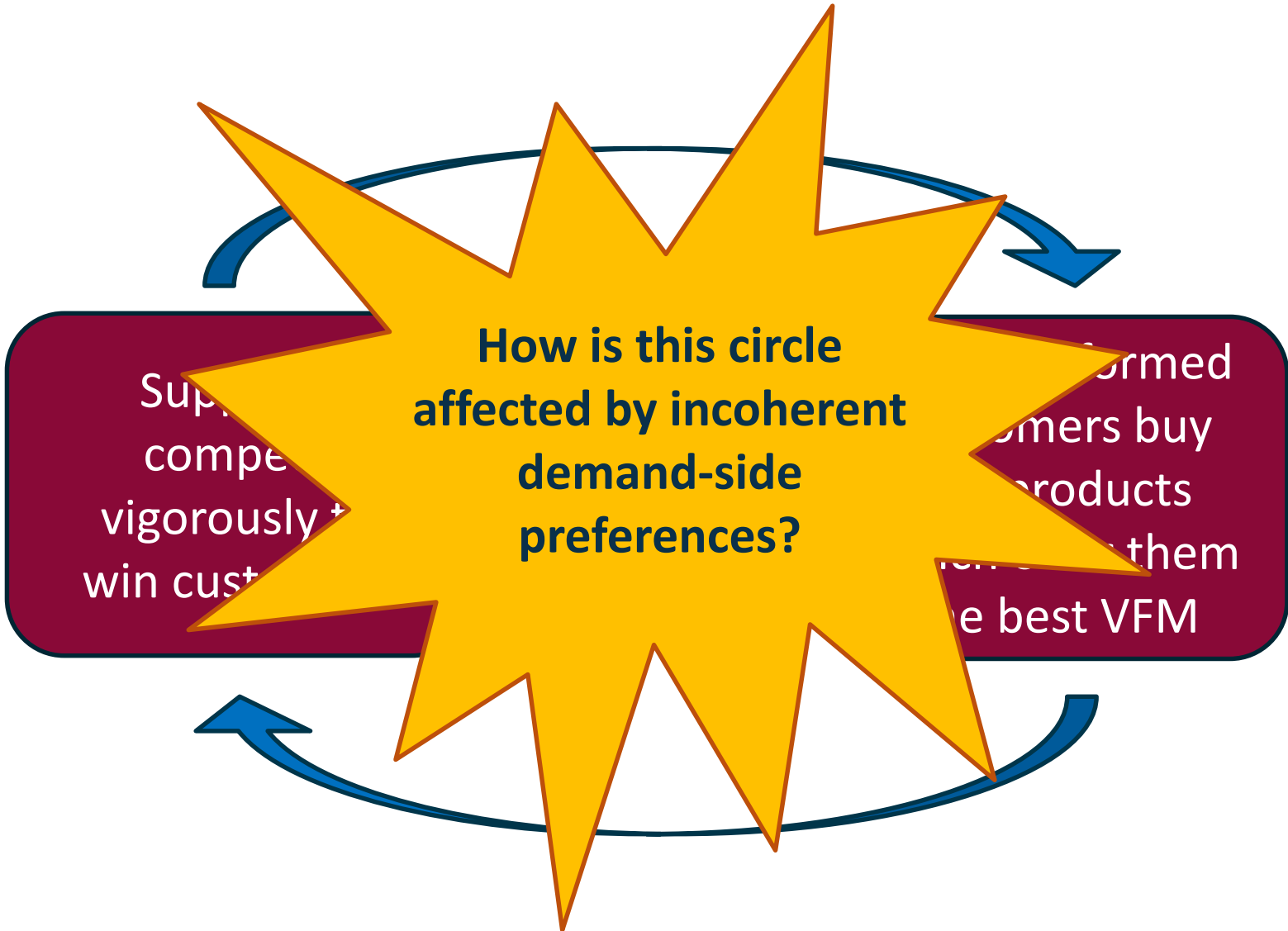
Active, informed
customers buy
the products
which offer them
the best VFM

DEMAND SIDE



The D-side and S-side in competitive markets – A virtuous circle for consumer well-being?

SUPPLY SIDE



DEMAND SIDE

Assessing implications for consumer well-being

- ❖ (At least) four elements of potential harm:
 - *Direct*: Customers buy too much, too little, or differently than they would absent incoherent preferences. Customer well-being is less than expected.
 - *Indirect*: Competition occurs on ‘wrong’ dimensions or may be lessened. Firms worsen their product offering (and may well increase their profits)
 - *Strategic*: Firms deliberately act to worsen biases, eg by obfuscation, misleading sales practices or hiding unfair contract terms.
 - *Emotional*: Consumers suffer regret or distress, eg due to feeling ‘ripped off’ or unfairly treated

- ❖ NB “Waterbed” effects may act to limit harm. That is, competition amongst firms may lead to any excessive profits being given away in other parts of the market
 - But the waterbed effect may be imperfect, may anyway create allocative inefficiency and may have distributional implications which create additional harm to emotional well-being.

Issue 1:

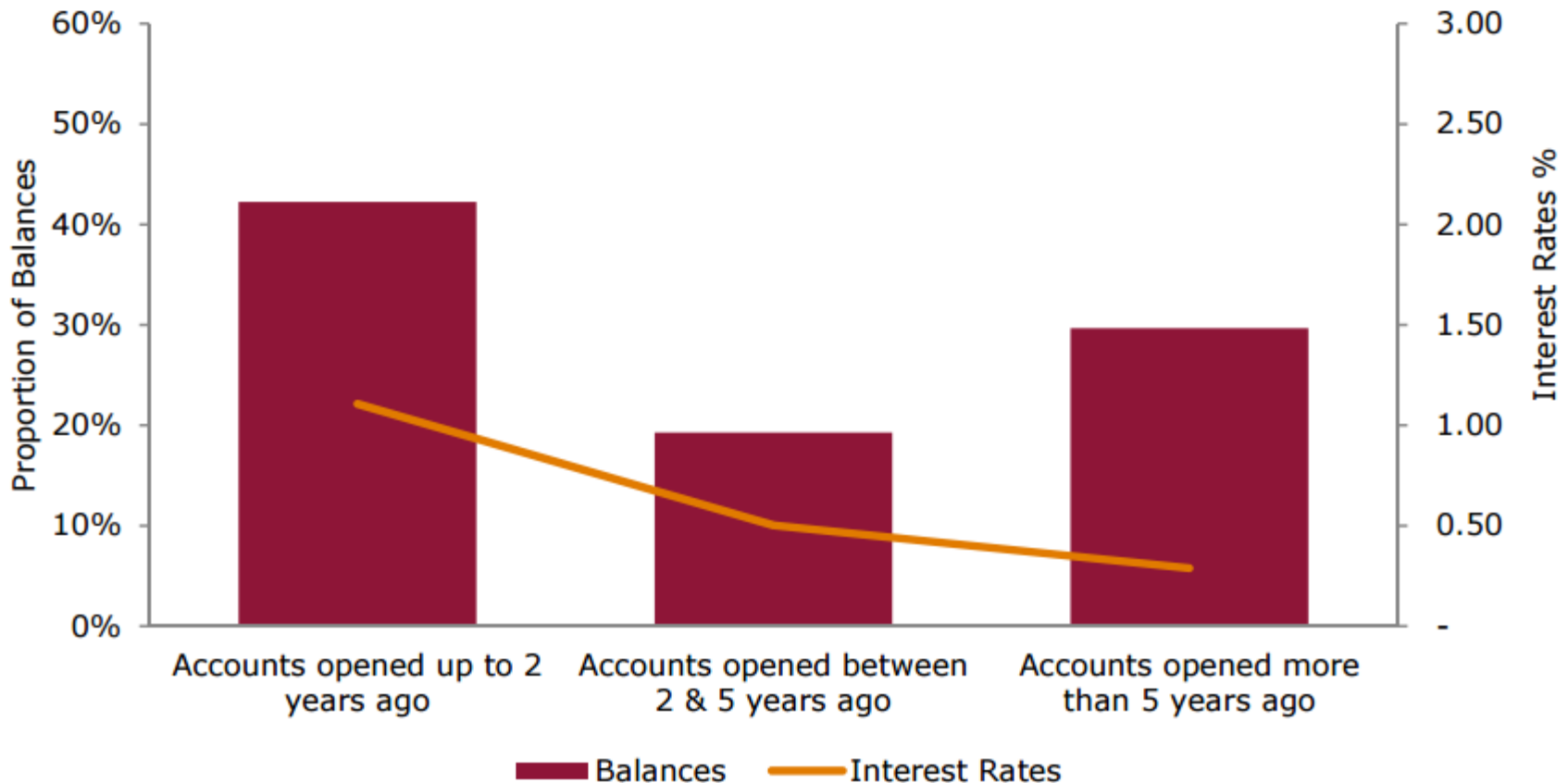
Biases in search and switching behaviour

- ❖ In general (and there are exceptions) more search and switching drives more effective competition, which in turn delivers benefits to consumers
- ❖ As such, regulators have tended to try and promote search and switching
- ❖ But the way in which this is done has been changing:
 - Until around 2010-12, focus was on reducing search and switching costs. E.g. Improved speed/reliability of switching, reduced exit costs, transparency remedies, support for Price Comparison Websites.
 - These remedies were not as effective as expected. Insights from BE led to realisation that these old-style remedies may be necessary, but are often not sufficient, for changing consumer behaviour.
 - Focus has changed to remedies that ‘nudge’ search and switching or otherwise overcome psychological barriers to switching. Eg cash savings, ban on auto-rolover contracts in telecoms

Biases in search and switching behaviour

Eg: Cash savings

Figure 21: Proportion of balances and average interest rates for easy access products by age of account, 2013



Source FCA (2015). NB £354 bn held in easy access accounts

Biases in search and switching behaviour

Eg: Cash savings

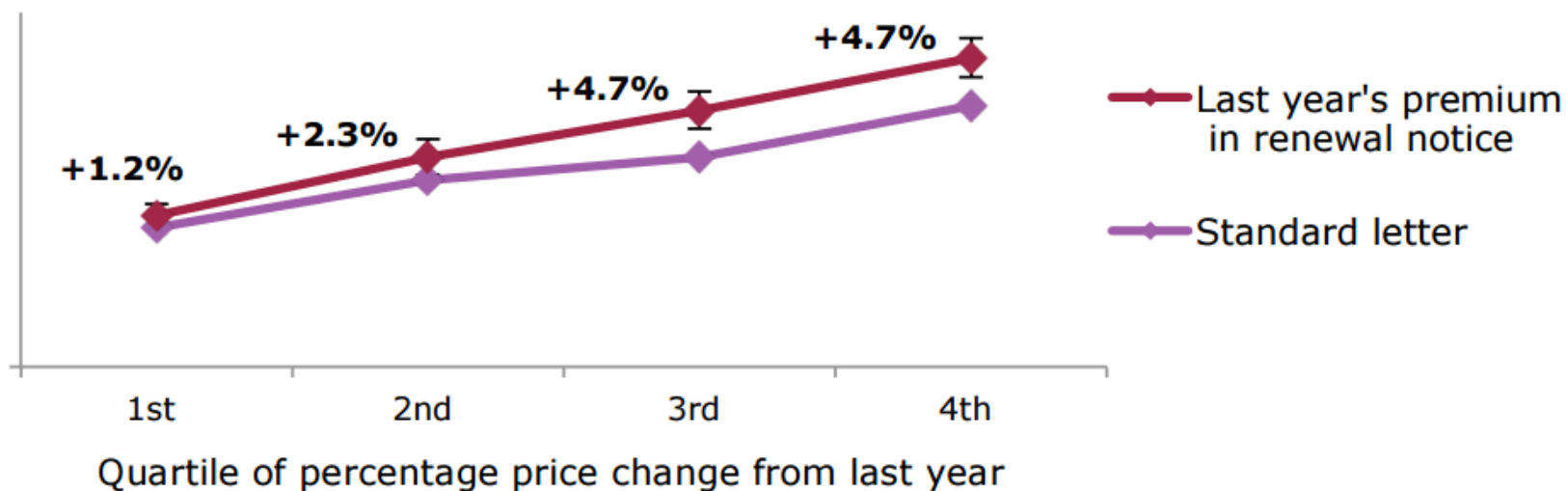
- ❖ OFT market study on cash ISAs (2010)
 - Switching process should be shorter and reliable
- ❖ Ex post evaluation (2014) of OFT intervention found improvements in ease, speed and reliability of switching, but no evidence of improved consumer awareness or of actual switching!
- ❖ FCA cash savings market study (2015) proposes even quicker switching (for cash ISAs) but also a small nudge:
 - Firms to send reminder letters around rate changes.
 - Randomised Control Trial found that reminders increase switching by 5.6 to 7.9 percentage points
 - Importantly, timing matters! Reminders sent before the rate change primarily led to switching to other firms. But reminders sent after the rate change largely led to within-firm switching.

Biases in search and switching behaviour

Eg: Home insurance renewal

- ❖ RCT (2015) considered impact of stating last year's premium on the renewal letter for home insurance.
- ❖ Found that impact of intervention on switching (or negotiating) increased as with the extent of premium rise.

Rate of switching
or negotiating



Issue 2: Biases relating to point-of-sale selling

Eg: Guaranteed Asset Protection insurance



**CAR INSURANCE
PAYOUT**

**GAP
PAYOUT**

Biases relating to point-of-sale selling

Eg: Guaranteed Asset Protection insurance

- ❖ FCA findings (2015)
 - GAP insurance not generally a planned purchase. 59% of add-on customers hadn't considered buying it until the day they did.
 - Almost half of add-on customers were unaware they could have bought GAP insurance other than at the point of sale and only 19% shop around. This is despite shopping around affording up to 50% savings. The stand-alone share of the market is very small in comparison with add-on GAP.
 - GAP add-on customers have a significantly worse understanding of the product than those who had bought GAP on a stand alone basis.
 - S-side impact: GAP sold as an add-on is poor value for customers. The claims ratio is only 10% (c.f. motor insurance claims ratio of 80%, meaning a profit margin for GAP insurance 4.5 times higher!)

- ❖ *Is buying GAP as an add-on an example of incoherent consumer behaviour? Which biases? Can we clearly calculate resulting harm to well-being?*

Which behavioural biases are at play here?

- ❖ FCA survey findings – Add-on customers only
 - 78% agreed with the statement “I felt helped by the salesperson and trusted them that this was an insurance I should buy”
 - 96% agreed with the statement “I don’t want something to happen and then regret not having the insurance”
 - 41% agreed with “It was part of a special deal / offer”
 - 27% agreed with “ I didn’t have much time to think about it, I just bought it”
 - 8% agreed with “I felt pressured by the salesperson”
- ❖ NB Price of GAP insurance low relative to cost of car.
 - Evidence elsewhere of framing effects whereby prices of add-ons viewed as more attractive, for a given price, if bought alongside a higher price item.

Can we roughly estimate the harm to consumer well-being?

- ❖ Total annual premiums paid for GAP insurance, 2012: £120m. (99% of sold as an add-on.)
- ❖ Around 10% of add-on GAP customers would not be likely to buy the product again.
 - If we assume that these would prefer not to have bought the product this time either then = £12m of detriment. Even excluding regret.
- ❖ Price of add-on GAP insurance are around twice as high as for stand-alone insurance (and even that is high relative to motor insurance)
 - If those 90% of GAP customers who would buy GAP again were to have shopped around, then they could have saved around £54m.
- ❖ Suggests total harm to consumer well-being of at least £66m per year
 - NB This is not the same as saying that intervention could remove all this detriment. [FCA CBA estimates consumer benefit from delayed purchase remedy = £31-54m per year, given that not all will now shop around]

To conclude

- ❖ Considering the change in market outcomes associated with incoherent preferences can provide at least one route to evaluating their impact on well-being. And these impacts can be significant, cf:
 - £66m per year in case of GAP insurance
 - £1.4bn per year for instant access cash savings
 - This doesn't allow for emotional impacts
- ❖ But there is still a big debate ongoing around the pros and cons of different types of interventions
 - Partly about their effectiveness (and thus proportionality)
 - Partly about whether it is right – or over-paternalistic - to 'wake up' consumers who are keen to stay asleep!
 - Partly about winners and losers arising from waterbed effects.



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Questions/Discussion

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