UK FINANCE

Discussion Paper Response

Fair Pricing in Financial Services

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UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

We welcome the opportunity to respond to the discussion paper (DP). The cross-cutting nature of the DP, which follows on from the FCA's Mission and Approach documents, suggests that the FCA may be looking for a whole industry solution, but we believe each market should be considered individually. We are aware that the FCA and other regulators have been undertaking a number of reviews that consider back book and front book pricing. UK Finance has made relevant submissions to:

- The FCA Mortgage Market Study
- The FCA High Cost Credit Review
- The CMA response to the Citizens Advice Super-complaint on Loyalty Penalties
- The FCA Strategic Review of Retail Banking Business Models
- The FCA Review of the Cash Savings Market and proposals for a basic savings rate.

Copies of these responses are attached to the email accompanying this paper.

We have the following general points on the discussion paper:

- The FCA principles rightly set out that financial institutions must treat customers fairly. The paper concentrates on price as a determination of what is "fair". In the absence of any guidance, lenders/product providers have difficulty in demonstrating that a price is "fair".
- We agree that issues of fairness should be treated on a market by market basis. This will ensure that if intervention is required it will be targeted and effective.
- Price is not the only consideration for customers, for example, customers may be keen to deal with firms they trust on the basis of their experience and the reputation of the firm and, where based on significant investment in their service, this could explain a higher price, or they may choose to transact in a branch rather than purely online. The importance of brand loyalty is explored in the FCA's Strategic Review of Retail Banking Business Models.
- Focussing purely on price infers that customers do not value service of proposition differentiation.

- The paper does not recognise the extent to which risk-based financing is used in retail banking, especially mortgages.
- The paper and the questions therein appear to pre-suppose that price discrimination will always give rise to some concern, despite the FCA acknowledging elsewhere that it can be pro-competitive. Differential pricing could be an indicator of competition working well.
- If regulators seek to increase/decrease the interest rate for the "worst off" they may just decrease/increase the average rate, through discouraging competitive acquisition pricing.
- How customers are treated by financial institutions has evolved in the low interest-rate environment with the focus on price diminishing. Instead the media increasingly scrutinises the non-price treatment of customers.

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? How firms set prices for existing customers

We believe that the 'evidential questions framework' appears too price-centric and does not fairly reflect non-price related reasons for why a customer would remain with their existing product. This framework does not ask why customers do not engage with their product provider or examine if there are barriers to being able to access information on products or assess and act on the information available.

In addition, the framework does not consider the "why" of pricing decisions: for example, does differentiated pricing exist to cover the cost of an additional service, feature, or infrastructure associated with a particular product? This includes consideration of whether a customer is tied in for a period.

There are some definitional issues on the terms/questions used in the evidential question framework. For example, how is 'wealthier', or 'profitability' defined'? These dimensions are not static and alter through time. This can be a particular concern for long-term products such as mortgages.

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?

In a low interest environment there is less potential for harm, but it is also more likely that the low benefit of switching results in greater inertia among customers. As interest rates rise, we are likely to see more switching by customers. We also think that there is a false assumption that default to SVR automatically equates to price discrimination. For many customers on very long-term products, the interest charged/received is at a comparable or better level than new deals.

Some financial products are not commoditised. For example, mortgages are "tailor made" to meet the needs of the customer and the property they want to purchase.

Reviewing the scale of the price differential in isolation is likely to give an incomplete picture of consumer outcomes. The scale of price differential has to be viewed in the context of other aspects of the customer's value-exchange e.g. cost of risk; unique policy; service; loyalty; convenience; flexibility; ease etc.

The Mortgage Market Study (MMS) noted that not all customers qualified for the cheapest deal. The FCA Handbook requires mortgage advisers and lenders to find the most suitable product - which may not always be the cheapest.

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?*

It is a long-held principle that Treating Customers Fairly (TCF) does not equate to treating all customers the same. We recognise that vulnerable customers need to be protected but there is also a level of customer responsibility that has to be exercised if customers are going to have freedom of choice.

It is well recognised that many customers will be considered vulnerable at some point when they hold a long-term product such as an instant access savings account or a mortgage. Many of these customers will cease being vulnerable or have a different degree of vulnerability over time. Product providers may not know if the customer is vulnerable at any point in time if there has been no interaction with the customer or someone caring for them.

There will always be some customers who think that they will not qualify for a new or better rate but who in fact would qualify. Some customers remain on low-interest savings product because they believe that all products have a low rate. Some customers may be reluctant to try to switch as they believe that mortgage lenders are not lending to for example, self-employed people, but that specialist lenders will take into account a wide range of circumstances.

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

The FCA's Interim Report on the MMS acknowledged high levels of mortgage switching within six months of a customer moving onto a reversion rate (SVR) and intermediaries have a role in assisting borrowers to switch. It also acknowledged that a "better deal" is not always a cheaper one.

There are some reasons why people will not want to move to a better rate, including needing the flexibility to port their mortgage to a new property or knowing that they will need to use their savings within a fixed period.

Inertia is more likely in the current low interest rate environment as there is less financial incentive for the consumer to move.

The FCA Strategic Review of Retail Banking Business Models notes that firms benefit from cross-selling, while the analysis indicated that customers frequently turn to their PCA provider for a loan, credit card or mortgage. This suggests that customer satisfaction, brand loyalty, trust and convenience are as important as price for some customers.

Anecdotal evidence suggests that convenience, product features (e.g. flexibility), speed and quality of service are just as important for some customers as headline prices. Consumers will go with a lenders or product provider for different reasons, including brand loyalty or not wanting to transact with a financial institution they have not heard of. Customer satisfaction with a product or firm generates loyalty, so if the customer thinks the product is good they will not move to another product.

In their response to the Citizens Advice super-complaint on loyalty penalties, the Competition and Markets Authority recommended that the FCA undertake research to explore why customers do not switch.

We would like to see more published behavioural economics research in this area. It would also be helpful to have more research to evidence suppositions around what society views as fair and balance fairness against competitiveness.

> *d) The transparency of firms' pricing practices? The characteristics of the product, including whether it is an essential service?*

The paper suggests that transparency of pricing will assist consumers to make better choices. However, pricing structures for some products may be complex and difficult to explain to consumers. For example, any do not understand that Bank of England base rate is only one element influencing retail savings and loans rates. The FCA's Strategic Review of Retail Banking Business Models provided an explanation of the different types of firms, their business models and the impact of these on pricing.

Transparency on a firm's pricing methodology as a sunlight remedy runs into commercial sensitivities. If products provided by two or more lenders are reasonably similar, e.g. a 25-year, 80 per cent, LTV repayment mortgage how they turn a profit may depend on the way that they price their products.

Mortgages are dependent on risk-based pricing. If lenders did not have the ability to price according to risk then many consumers would not have access to funds enabling them to purchase their homes. It is reasonable that where a customer presents a greater risk, e.g. they have a low deposit or have a history of arrears, the lender is able to charge a higher rate to mitigate that risk. To ensure that consumers are able to get products that are suitable for their needs there needs to be a range of prices and product characteristics.

Risk is not solely credit score or LTV – pricing will be influenced by softer policy aspects as well as individual lenders' affordability models. For example, a lender willing to offer a higher borrowing amount to a given borrower may be able to charge a higher interest rate than peers and may be more likely to retain that customer on a higher interest rate than the customer could access in the open market, due to brand loyalty created, combined with certainty / stability of access to credit.

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.

All firms will price their products in order to make a reasonable return. Introductory rates will be developed according to the cost of funding, predicted future interest rates and the likelihood of retention rates. Mortgage lenders and cash savings product providers will move customers onto a 'better' rate if requested and the terms and conditions of the product and the regulatory framework allows. Mortgage lenders proactively offer consumers new products before the end of a discounted period and around two thirds of all customers do switch as evidenced by remortgaging and product transfer data.

Promotional and acquisition costs will always be a factor for a firm and customers may be conscious of time and administrative costs in making a switch. It can therefore be rational for a firm

to offer introductory discounts or bonuses to compensate customers and this is part of the marketing mix in attracting new business.

FCA rules require firms to notify cash savers and borrowers of disadvantageous changes to the interest rate paid or charged (subject to de minimus savings levels).

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

We think it is important to make the distinction between the “cheapest” mortgage and the “right” mortgage. Mortgage lenders rely to a large extent on a wide network of whole of market mortgage brokers. Current price comparison websites may work for “standard” customers but do not provide appropriate options for anyone who has more complex circumstances.

The mortgage market is heavily intermediated, and the brokers’ role is to help the customer understand what is available for them. Around 70 per cent of customers go via a broker to get their mortgage. When the fixed rate is coming to an end brokers have a financial incentive to assist customers find a better rate.

Better distribution of lender criteria is being developed by fintech companies which should assist customers to get the most suitable mortgage. The fintech industry, along with lenders and intermediaries, should be allowed to develop products to allow the comparison of mortgage products before there is any regulatory intervention. A range of commercial solutions have already been launched and more are being developed by the fintech sector which will make it easier for intermediaries to select the most appropriate products for applicants. It is only a matter of time before consumer facing solutions are launched.

b) the amount of effort required to make their choice

There is a tension between search costs and switching costs. For cash saving products the best buy tables and PCWs provide a simple way of selecting an appropriate new deal. However, the amount that is gained may be reasonably small in comparison with the time it takes to search and transfer the funds to a new provider. For a mortgage transfer the process requires substantial customer investment at both the search and switching stages, reflective in the proportion of lending channelled through brokers. Mortgage firms are actively supporting aggregators to make it easier for customers to choose a suitable new product that they are eligible for. A number have also introduced online eligibility checkers and product selection tools.

From a switching perspective, lenders have invested significantly over recent years to make the process easier. For internal switching, where the customer does not wish to receive or need advice, most lenders offer an online option which can take just a matter of minutes. Similarly, for external remortgages, free legal and valuations are now commonly offered by lenders to reduce the cost of switching. Lenders have also invested to make the process easier and quicker through the likes of automated identity verification.

Many firms have developed digital services alongside more traditional services, which allow customers who want to operate in the virtual world to purchase and retain the products that suit them. It is important however to ensure that customers who are unable or unwilling to use digital services are not left behind.

c) not discouraging switching or shopping around

We believe that for both the cash savings market and the mortgage market, there is a high level of competition and evidence that consumers can and do shop around. See our responses to the recent market studies on this.

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

As stated previously, complete transparency on pricing may not be of assistance to customers. Pricing decisions are complex, and firms have to ensure that any changes to interest rates are fair. Firms have to demonstrate they comply with court rulings and FCA guidance on variation of terms.

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?

Barriers to switching between mortgage lenders have, to a large extent, been created by the adoption of the Mortgage Credit Directive, which means that an affordability assessment is triggered every time a new regulated mortgage contract is written. It means that lenders cannot use the transitional provisions for customers from another lender, even if they show that they are up to date with payments. We understand the FCA is revisiting the transposition of the MCD into UK regulation to see if these barriers can be reduced.

UK Finance members responded positively to the challenge set out by the FCA in the MMS Interim Report to commit to helping longstanding borrowers who are currently unable to switch to a better deal; supporting those customers who are often referred to as “mortgage prisoners”.

Sixty-seven large and small lenders covering more than 95 per cent of the market signed up to a principles based voluntary agreement to assist these customers. Lenders will contact customers once they have identified eligible borrowers. To qualify, the following standard principle-based criteria will apply:

- be first charge owner-occupiers
- be existing borrowers of an active lender
- be on a reversion rate
- be looking for a like-for-like mortgage
- have no material breaches of contract
- have a minimum remaining term of 2 years
- have a minimum outstanding loan amount of £10,000

And be able to benefit from switching.

Lenders have identified those customers who would meet these criteria and have contacted them inviting the customer to consider a new offer.

When considering savings accounts, customers are presented with a summary box that outlines how the product works, any restrictions on operating the account and what the return is over a 12-month period.

Where a variable rate is changed, customers are notified within BCOBS guidelines. All reductions in rate (subject to a de minimus £100 balance) are notified to the customers 14 days in advance of any change, demonstrating the rate before and after the change and the effective date. This should prompt customers to review whether the account still meets their needs.

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

Firms are currently required to let customers know what interest rate they are on in annual statements. This should act as a prompt to review the market. However, many firms recognise that this may not be sufficient to trigger customer action and so provide additional prompts. If a customer has opted out of receiving marketing material, then it is difficult to inform them of better options which may be contrary to GDPR requirements.

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

With a wide range of products available with different eligibility criteria and characteristics it is difficult to know how this would work in practice in a cost-effective way. As noted above the customer may not be eligible for the best available rate and risk-based pricing is the basis for some markets. For mortgages it is highly complex to define the "best available rate" – given the interplay between credit score, policy, affordability, risk and cost-based pricing, plus other customer value drivers such as service, convenience, loyalty etc.

The FCA needs to consider the longer-term impact of interventions on the competitiveness of the market and not just focus on perceived short-term pricing benefits for customers.

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.

There is a risk that supply-side pricing remedies drives homogenous business models and products whilst stifling innovation. It may also mean that customers with more complex circumstances are not served if mortgage lenders are not able to price for risk. Cost-reflective pricing of products may result in the more 'tech-savvy' customers benefiting from better pricing whereas those who have to rely on more traditional sourcing techniques may miss out on the best products creating further inequality.

There is an underlying assumption that people on lower incomes are more "time rich" and so could spend longer researching better options but this is not always the case.

Demand-side remedies are emerging with innovative products coming to market that allow brokers to match customers to eligibility criteria. We are supportive of the use of nudges and reminders to help customers make better decisions and recognise that. In both demand- and supply-side measures, proportionality is a key consideration.

If you have any questions relating to this response, please contact Sue Rossiter, Principal Mortgage Regulation (sue.rossiter@ukfinance.org.uk)

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