School of Politics, Philosophy, Economics, Development, Geography

Consumers and competition:

Delivering more effective consumer power in retail financial markets

By Jonquil Lowe, Senior Lecturer in Economics and Personal Finance,
The Open University
On behalf of the Financial Services Consumer Panel

6 March 2017

This ‘think-piece’ was commissioned by the Financial Services Consumer Panel to inform and stimulate debate around consumers’ role in driving competition in retail financial services markets. The research was managed for the Panel by Sharon Chapman. The author thanks Sharon for her support, along with Caroline Barr, Mark Chidley, Sharon Collard, Jennifer Genevieve, Sue Lewis, Dominic Lindley, Pam Meadows and Faith Reynolds for their valuable input and suggestions.

About the author:

Jonquil Lowe is an economist specialising in personal finance, particularly financial capability, pensions, tax, investments and the role of consumers in financial services markets. She started her working life in stockbroking, is a former head of the Money Research Team at Which? and, as a freelance researcher and author, worked extensively with consumer, regulatory and charitable organisations before joining the Economics Department at The Open University. This background gives Jonquil a multi-dimensional view of personal finance and financial markets. She is author of over 25 consumer financial books and has edited or co-authored many more, including several personal finance textbooks, as well as contributing to the consumer research literature.

jonquil.lowe@open.ac.uk

Contents

1: Summary

1.1 The Financial Services Consumer Panel (the Panel) represents the interests of consumers in advising and challenging the Financial Conduct Authority (FCA) on its policy and practices from a consumer perspective. One of the projects the Panel began focusing on in 2016 is examining the role that consumers can be reasonably expected to play in driving competition in retail financial services and the implications of this for the general principle of consumer responsibility in the FCA's objectives.

Background and aims of the project

1.2 The project originates from a growing concern across the consumer-facing community that most regulatory market studies and reviews of retail financial services recommend that consumers must become more engaged if competition is to function effectively. Typically, recommendations include: more and better information for consumers; greater use of price comparison websites; and faster and more efficient switching services. While the FCA is at the forefront of modifying competition policy to take account of findings from behavioural economics, its policy recommendations are nevertheless still typically oriented towards improving active consumer engagement. This underplays other possible approaches and overlooks the possibility that some barriers to engagement may be the result of rational consumer choice.

1.3 This research project seeks to generate a consumer-centred model (or models) of competition in retail finance services, based on what is already known about how people think and behave and taking into account what it is reasonable to expect people to do. The aims of this project are to: consider possibilities to deliver more effective 'consumer power'; generate a set of real-world metrics that can measure how well markets work for consumers; and influence FCA thinking on competition and consumer responsibility. There are two strands to the research in this phase of the project: a consumer survey to enhance our understanding of consumers' attitudes and behaviours in retail financial markets; and a literature review that looks widely across the economic, behavioural and competition work done by regulators, academics, consumer-representation organisations, firms and industry-representation bodies. The outputs are the current report and a 'straw-man proposal' that emerges from the research on a way forward for delivering more effective consumer power and measuring how well markets work for consumers. You can find the straw-man proposal in the Appendix at the end of this report.

The interests of consumers and firms

1.4 The FCA has a specific competition objective, which is to promote: *'effective competition in the interests of consumers'*. Since 1 April 2015, the FCA has additionally been given competition investigation and enforcement powers, concurrent with the Competition and Markets Authority (CMA). This does not change the competition laws by which financial firms must abide, but newly makes the FCA one of the competition regulators overseeing those laws. The FCA (2016b, p.5) defines competition as follows:

> *'Competition in the commercial world means firms striving to win customers, with innovative firms bringing ideas to market, successful firms thriving, and unsuccessful ones making an exit. When markets are competitive, consumers will be offered variety and choice, with firms striving to win custom on the basis of service, quality, price and innovation.'*

1.5 This definition and the rationale for competition policy are underpinned by the ideal of 'perfect competition'. Sections 3 and 4 of the report start with a brief look at this ideal, which economic theory suggests will deliver the best results for consumers, the most efficient use of resources across the economy and the best outcomes for society as a whole. In practice, though, perfect competition seldom if ever exists and profit-maximising firms have strong incentives to pull away from this ideal. The result is financial services markets where many firms try to carve out market power for themselves using a wide range of strategies that obfuscate prices and complicate product features. The intention is to confuse, enabling firms to charge higher prices than perfect competition would allow and build market share.

1.6 Consumers are ill-equipped to deal with these opaque and confusing markets. Individuals have numerous behavioural traits that incline them towards making decisions based on short-cuts and rules of thumb, such as focusing on headline price or sticking to brands they know. These behaviours are a gift from firms, making it easier to pursue their market-power strategies and harder for new firms to get a foothold in the market.

Consumers in the market

1.7 Consumers are not all alike. Section 5 builds on a model of consumer types first proposed by Beckett et al (2000) and enriched by insights from the consumer survey carried out for this project. Four types of consumer are identified:

- **No Purchase**. Consumers who have low involvement with financial services and lack confidence making decisions about them. Being disengaged from the market does little or nothing to drive competition. The overarching issue here is the barriers that are preventing this group from accessing and engaging with the market.
- **Repeat-Passive**. These consumers are confident opening a current account but, beyond that, tend to stick with the same providers, regardless of any change in their needs or circumstances. They see switching as a hassle and perceive little difference between providers. This group is also doing little to drive competition and the overarching issue is that they use heuristics, such as brand, rather than shopping around.
- **Rational-Active**. This type of behaviour is associated with consumers purchasing basic insurance products, such as car and house cover. Consumers are confident and switch provider often, mainly driven by price. These consumers have the potential to drive competition but, as discussed in Sections 3 and 4, how effectively they can do this will depend on the nature and extent of their behavioural traits and how the choice environment they must navigate is shaped.
- **Rational-Dependent**. These consumers perceive differences between competing products but find choosing complex. A key contention in this report is that these consumers may best be served by delegating choice to new types of service that would not just provide better outcomes but drive competition more efficiently.

1.8 The behaviour of these different types of consumer is shaped by a range of different barriers to competition. A lot of regulators' energy focuses on changing consumers from being Repeat-Passive to Rational-Active. However, this may be a tough challenge, because consumers' sticking with their current provider might not be the result of behavioural biases leading them astray, but a rational decision once the full range of potential switching costs is taken into account. Using a categorisation developed by Burnham et al (2003), important costs include: economic risk costs (such as uncertain outcomes given that many financial products and services are by nature ‘credence products’); mental effort; and opportunity cost of time (in other words, the alternative ways that consumers would prefer to spend their time rather than shopping around).

Alternative ways of enhancing consumer power

1.9 Section 6 follows the path from different consumers facing different barriers to the types of policies that might enhance consumer power. Although the starting point is different, the destination turns out to be the same as other studies, such as research for Consumer Futures in 2014 (CtrlShift, 2014; Bates, 2014) and recent work by Reynolds (2017) on open banking. Given the asymmetry of power between firms and consumers and the behavioural traits that we all share as humans, a more efficient way to drive competition would be to delegate shopping around to computer algorithms and automated switching for consumers who want it. Throughout history, people have welcomed labour-saving devices that replace onerous tasks freeing them to spend their time and effort on other activities. The time has come to accept that, for many consumers, shopping around for financial services in complex markets is a stressful, unpleasant and effortful task that can be automated and replaced, just as washing machines replaced Monday washdays, spreadsheets replaced the mental toil of manual calculation, and driverless cars may replace driving. Financial technology and innovation are already moving this way and the question is not so much ‘will this happen?’ but ‘when will it become the norm?’.

1.10 The bare bones of an automated shopping-and-switching service are as follows and summarised in Figure 1.1:

- Consumer chooses to use an automated shopping-and-switching service.
- The consumer provides required personal and usage data and/or gives permission for transfer of data from their previous provider or a centralised data store. Data from the consumer includes relevant information about their particular needs and preferences.
- The automated service identifies a best match to product and firm, using an algorithm to compare on the basis of pricing, product features and, where available, quality metrics, weighted according to the consumers’ stated needs and preferences and matched to their personal details and circumstances.
- The consumer is notified of the recommendation and may opt out within a specified time; otherwise the service automatically completes the purchase.
- The automated service re-runs the search at specified times – for example, as the end of a fixed-term deal approaches or annually.
- If a better deal is identified, the consumer is notified of the new recommendation and may opt out within a specified time; otherwise, the service automatically completes the switch.

1.11 As with all innovation, there are issues to be addressed, such as access and engagement, status and conflicts of interest, trust including data security and liability, regulation, and how to deal with changing consumer preferences. None are insurmountable, but they will require regulators across different sectors to collaborate.

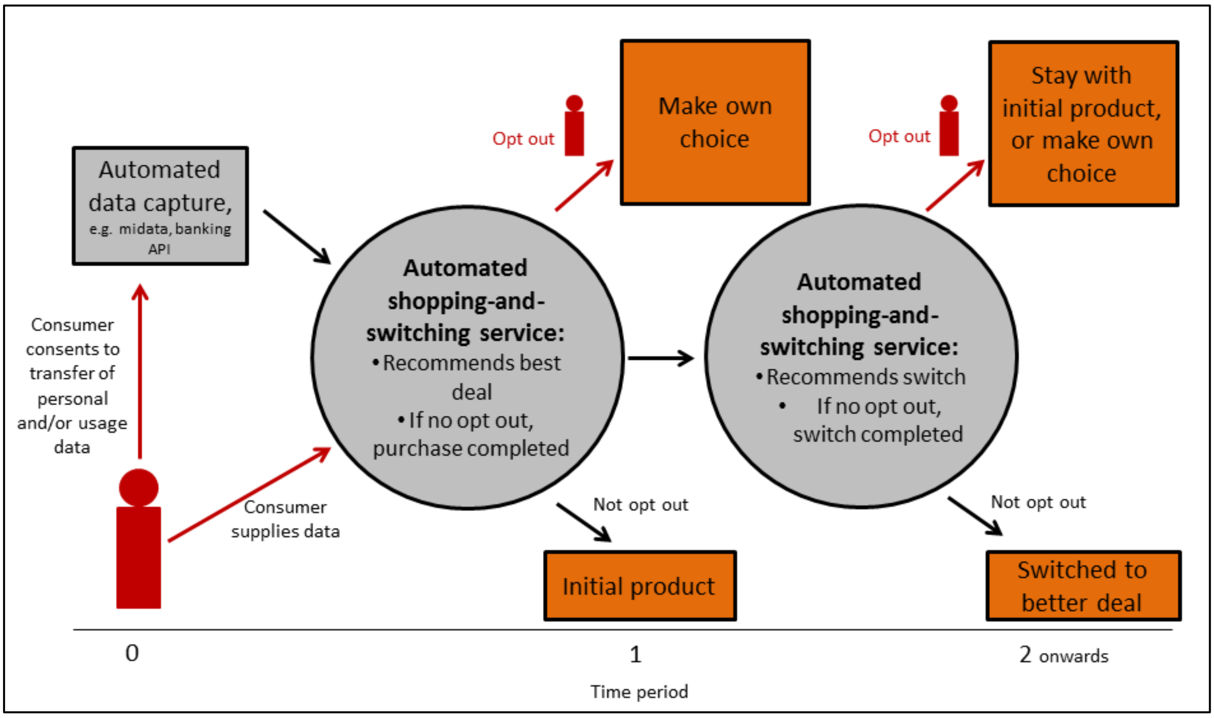


Figure 1.1: Consumers using automated shopping around and switching

1.12 Section 6 also considers some other policies that might enhance consumer power, in particular collective purchasing. This enables consumers to turn tables on firms: in conventional individual purchasing, consumers sift through the market to find products that suit their needs; with collective purchasing, they form groups who go to market with their needs and ask firms to make them an offer. So far, such schemes have been small scale. However, automated shopping-and-switching services would have the potential to match consumers to form groups, further enhancing consumer power.

Meaningful metrics

1.13 If competition is working well for consumers, a market should be characterised by low and fairly consistent prices, good quality across the whole market and high levels of satisfaction. If firms have limited opportunities to create and use market power, then pricing should normally be simple and transparent and products fairly straightforward and similar. A good metric should aim to capture these outcomes and also provide feedback that incentivises firms to behave in ways that reinforce competition.

1.14 With a focus on these requirements, Section 7 suggests a range of metrics that focus on product similarities, price differentials, price levels, claims frequency and pay-out ratios in the case of insurance products, and reputational measures. The metrics would be published and available both direct to consumers and for incorporation in the type of automated shopping-and-switching services described in Section 6 and other forms of information and advice services.

1.15 The metrics as described might not have precisely the format and detail that proves feasible in practice, but they aim to demonstrate an approach that relates metrics directly to desirable outcomes for consumers. In this way they would be indicators not just of competitive conditions in a general sense but evidence of whether competition is working well *in the interests of consumers*.

2: Background and research methods

2.1 The Financial Services Consumer Panel (the Panel) represents the interests of consumers in advising and challenging the Financial Conduct Authority (FCA) on its policy and practices from a consumer perspective. One of the projects the Panel began focusing on in 2016 is examining the role that consumers can be reasonably expected to play in driving competition in retail financial services and the implications of this for the general principle of consumer responsibility in the FCA's objectives.

2.2 The project originates from a growing concern across the consumer-facing community (see, for example, Ogunye, 2016; Lowe, 2015) that a key recommendation from most regulatory market studies and reviews of retail financial services is that consumers must become more engaged if competition is to function effectively. Typically, recommendations include:

- more and better information for consumers (for example, general insurance, general insurance add-ons, guaranteed asset protection (GAP) insurance[1], packaged bank accounts, annuities, savings accounts, payment protection insurance)
- greater use of price comparison websites (payday lending, annuities), and
- requirements that firms operate faster and more efficient switching services (current accounts, cash Individual Savings Accounts (ISAs)) [2].

2.3 In other words, competition policy focuses heavily on how to make consumers more engaged and closer to the rational decision-makers that traditional economic theory suggests are a prerequisite for well-functioning markets. While the FCA is at the forefront of modifying competition policy to take into account that actual consumer behaviour often is not rational, its policy recommendations are nevertheless still typically oriented towards creating consumer engagement, for example, by:

- framing information better (annuities, packaged bank accounts, savings accounts), or
- addressing the timing of information (either delaying it to avoid point-of-sale pressure, as with general insurance add-ons, or requiring more timely prompts, as with savings accounts)[3].

2.4 This focus on driving active consumer engagement underplays other potential policy options and overlooks the possibility that some seemingly irrational lack of engagement might in fact be rational once a wider range of factors is taken into account.

Aims of the project

2.5 This research project seeks to generate a consumer-centred model (or models) of competition in retail finance services, based on what is already known about how people think and behave and taking into account what it is reasonable to expect people to do.

2.6 The aims of this project are to:

- Consider possibilities to deliver more effective 'consumer power'
- Generate a set of real-world metrics that can measure how well markets work for consumers, based at least in part on the features and attributes that are valued by consumers, and

[1] GAP insurance pays out if the car is stolen or written off and the car insurance falls short of the outstanding car finance or other defined value.

[2] For information about the examples mentioned in paragraphs 2.2 and 2.3, see: Competition Commission (2009); Competition and Markets Authority (2016a and 2015a); FCA (2017, 2016a, 2015a, 2015b, 2015c and 2015d).

[3] Ibid.

- Influence FCA thinking on competition and consumer responsibility.

2.7 The project entails considering what it is reasonable or realistic to expect of consumers in retail financial services, particularly given the expectation on consumers also to actively participate in other markets (such as, telecoms and energy). It asks whether current levels of shopping around and switching are as good as they are likely to get, in which case alternative approaches may be required to ensure retail financial markets function well in the interests of consumers and also raises further questions about the value in using 'switching rates' as standard metrics in competition and market studies.

Research methods

2.8 Two strands of research have informed this phase of the project:

- **A consumer survey** to get a whole-person view of product holdings, attitudes and behaviours in retail financial markets and, for comparison, those for some other household services (such as, telecoms and energy). Throughout this report, this strand of the research is referred to as the 'Panel survey'.
- **A literature review** of research, findings, theories and policy relating to competition in retail financial services markets and to consumer behaviour. With limited resources, the review could not be comprehensive, but is wide-ranging and encompasses publications and working papers from regulators, academics, consumer-representation organisations, firms and industry-representation bodies.

2.9 The outputs are the current report and a 'straw-man proposal' that emerges from the research on a way forward for delivering more effective consumer power and measuring how well markets work for consumers. The intention is that the straw-man proposal, which is reproduced in the Appendix, can be used as a stimulus for discussion and feedback from interest parties.

The consumer survey

2.10 Fieldwork for the Panel survey was undertaken by Populus in December 2016 using its online omnibus survey. Results were obtained for 2,084 consumers and weighted to be representative of the UK population.

2.11 The survey gathered information about a variety of aspects relevant to the project:

- Holdings of bank accounts, savings and investments, mortgages and credit products.
- Taking out or renewing general, life and health insurance products in the last 12 months.
- Loyalty to their main bank, by asking respondents about the number of products (other than their current account) taken out with their bank and the reason for this choice.
- Attitudes towards shopping around for different products, in particular whether this seems worthwhile and time respondents would be willing to spend on the task.
- Types of information that would help respondents choose between providers and where they would expect to find this type of information.
- How often respondents review their finances, whether they considered themselves to be time-poor and a wide range of demographic factors.

2.12 The results were analysed (FSCP, 2017) using SPSS and are presented throughout this paper to support the discussion and proposals. Using cluster analysis, respondents were also segmented into four types as described in Section 5 below.

3: The interests of consumers and firms

3.1 The UK financial regulator's role in competition policy has been evolving and increasing during this century. It started with a requirement to minimise any adverse effect on competition of regulatory actions and to have regard to the desirability of innovation[4]. Since 2013, this has been replaced by a more specific competition objective. It sits within an overarching strategic objective of ensuring that regulated financial markets function well and must be pursued in a way that is compatible with the Financial Conduct Authority's (FCA) other objects of protecting consumers and ensuring the integrity of the UK financial system. Under the competition objective, the FCA must promote: *'effective competition in the interests of consumers'*. [5]

3.2 Since 1 April 2015, the FCA has additionally been given competition investigation and enforcement powers, concurrent with the Competition and Markets Authority (CMA)[6]. This does not change the competition laws by which financial firms must abide, but newly makes the FCA one of the competition regulators overseeing those laws.

3.3 The FCA (2016b, p.5) defines competition as follows:

> *'Competition in the commercial world means firms striving to win customers, with innovative firms bringing ideas to market, successful firms thriving, and unsuccessful ones making an exit. When markets are competitive, consumers will be offered variety and choice, with firms striving to win custom on the basis of service, quality, price and innovation.'*

3.4 This concept of competition and the rationale for competition regulation are underpinned by the ideal of 'perfect competition'. Economic theory shows that, in perfectly competitive markets, the economy's resources are allocated most efficiently, production is organised in the most efficient way and society's welfare is maximised.

The ideal of perfect competition

3.5 Perfect competition is characterised by markets where there are many firms producing each good or service, firms can freely enter and exit from the market and both firms and consumers freely access all relevant information on which to base their decisions. The result is markets where: consumers are sovereign - they exercise choice, knowing exactly what is on offer, and get what they want; identical goods or services are sold at the same price whoever supplies them; and firms receive just enough profit to keep them in business (economists call this 'normal profit').

3.6 In this ideal of perfect competition, consumers are active, engaged market participants who drive competition by frequently shopping around and switching providers when they find better deals. Whether knowingly or not, these engaged consumers take on a key part of the responsibility for markets working well, rewarding firms that meet their needs and helping to drive unsuccessful firms out of the market. In this ideal scenario, consumers' reward is the supply and innovation of the products they want, with the quality they want and at the lowest commensurate price.

3.7 Thus, competition authorities are concerned about:

- the structure of markets, for example, whether one or a few firms dominate and whether there are barriers that prevent new firms from joining a market
- the availability and free flow of relevant information, and
- empowering and engaging consumers.

[4] Financial Services and Markets Act 2000 s2(3)(f).
[5] Financial Services and Markets Act 2000, ss1B to 1E, as introduced by the Financial Services Act 2012.
[6] Financial Services and Markets Act 2000, ss234I to 234O, as introduced by the Financial Services (Banking Reform) Act 2013.

Firms and market power

3.8 The problem with perfect competition is that few, if any, markets conform to this ideal and do not necessarily even tend towards it because firms may be pulling in a different direction. While perfect competition would serve consumers well, firms are generally not satisfied with 'normal profit'. Profit-maximising firms would, by definition, prefer to make more (called 'supernormal profit'). In theory, a firm might try to achieve extra profits by investing to create better and more innovative products, more cost-effectively, in order to win additional customers – a win-win for firms and consumers. In practice, there is little incentive for firms to invest if perfect competition will quickly whittle away any extra rewards the firm had expected to gain. To sustain additional profits, firms need a degree of market power (defined as the ability to set prices above the level that would prevail in perfect competition). Market power can also be used to create additional profit without necessarily investing in better or more efficient products. Competition authorities have a variety of powers that they use to prevent dominant firms abusing their market power and groups of firms colluding to act like monopolists. However, many markets exhibit 'monopolistic competition' which means there are many firms and they do compete vigorously, but they nonetheless strive to develop market power which can result in information, products and prices that are complicated, messy and even misleading, inhibiting consumers ability to shop around and switch.

3.9 To gain market power and so increase profits, firms typically use the strategies described in Table 3.1. The strategies may involve increasing prices or expanding or protecting market share. They can be divided into strategies involving price and those involving product features.

Price strategies

3.10 The simplest strategy is for a firm to charge a higher price to all customers, though this can work only if something – for example, brand loyalty or the behavioural factors discussed in the next section below - stops consumers switching to cheaper competitors or deciding to consume less or none at all. The strategy will work best where the product is essential and/or all competitors are increasing prices in unison. Examples are hard to spot, since across the board price increases may be a response to rising costs or even a reduced willingness to supply the market rather than a bid to increase profit margins. Possibly, the very low interest rates[7] offering by high-street banks fit the bill, with banks' lack of interest in competing for retail deposits while cheap funds are available to them through the Bank of England's Funding for Lending Scheme (a strand of monetary policy intended to stimulate economic activity).

3.11 A more sophisticated price strategy involves charging higher prices to those consumers who are willing to pay more, while offering lower prices to other more price-sensitive consumers. There are three forms of price discrimination (Varian, 2010), though 'first-degree' (charging every customer a different price equal in each case to the absolute maximum they would be willing to part with) is theoretical rather than practical. The problem for the firm is how to identify and segregate the consumers who are willing to pay more. There are two approaches. With second-degree price discrimination, the firm offers a choice of differently priced options and leaves consumers to match to them themselves. A non-financial example is different classes of rail travel where first and second class are offered and those consumers who are willing to pay more opt to pay extra for the same journey albeit in greater comfort. A financial example may be firms offering higher interest rates on internet- rather than branch-based or phone-based savings accounts. However, as with the train example, there are some cost differences involved, so it can be hard to distinguish pure price discrimination and more often it is likely to be combined with a degree of product differentiation.

---

[7] For savings products, price is basically the inverse of the interest rate. It can be thought of as an increase in the amount that needs to be deposited in order to maintain the same return.

Table 3.1: Firms' strategies for creating market power

Firm's action	Aim/effect on the firm	Effect on consumers	Example
Price strategies			
Raise price	Higher profit on each unit sold, but volume sold generally falls.	Consumers who stay with the firm pay more. Consumers may be able to switch to another firm or decide to buy less or none at all.	Big banks cut interest on savings accounts.
Price discrimination			
First-degree: every consumer pays the maximum they are willing to pay	Higher profit on nearly every unit sold; volume sold may be less.	Nearly all consumers pay more. Consumers may be able to switch to another firm or decide to buy less or none at all.	Rarely if ever found in real world.
Second degree: different price-quantity packages (incentivises consumers to self-select)	Higher profit from consumers willing to pay extra, while retaining customers who are only prepared to pay less.	Some consumers choose to pay more, for example, for extra features, better quality or greater convenience.	Higher interest rate on internet-based savings products compared with branch-based products.
Third degree: different price for different consumer groups (relies on identifying groups or consumers providing identification)	Higher profit from some consumers; volume sold to them may be less.	Some consumers are charged more than others. These consumers may be able to switch to another firm or decide to buy less or none at all.	Charging higher insurance premiums to loyal customers than new customers.

Firm's action	Aim/effect on the firm	Effect on consumers	Example
Price obfuscation (complex, multiple and hidden charges)	Compete on just one dimension of price, while charging extra through other ancillary charges. Refuse to supply information to price comparison websites. May aid brand loyalty. Impose switching costs.	Unaware of true cost: overlook some costs, ultimately pay more than expected. Confused, hard to make comparisons: may decide shopping around too difficult. May stay with current provider to avoid paying switching costs.	Free-if-in-credit current accounts with complex overdraft charges. Extra fees for basic administrative changes to insurance policies. Pension products with multiplicity of charges. Mortgage and insurance early redemption charges. Variable rate mortgages and loans where future price changes cannot be predicted
'Bait and switch' (prominently advertising tempting offer that soon reverts to less good terms)	Initially compete on price but quickly increase profit margin.	Consumers pays more than expected if stay with the provider. Consumers may be able to switch to another firm or decide to buy less or none at all.	Credit cards competing on length of credit-free period. Teaser rates on savings accounts.
Opportunism (taking advantage of an external event or requirement to charge higher prices)	Charge some customers extra. Refuse unprofitable customers.	Consumer pays over the odds. Consumer may be unable to switch.	Mortgage 'prisoners' trapped on high standard variable interest rates.
Product-feature strategies			
Product bundling and add-ons	Hide true price of each element, enabling higher price for some. May also create a degree of production differentiation. May aid brand loyalty.	Unaware of true cost, so pay more than realise. Confused, hard to make comparisons: may decide shopping around too difficult.	Packaged bank accounts GAP insurance Payment protection insurance
Product complexity (eg many characteristics or technically complex; many similar but slightly different products)	Hide true value for money, enabling higher price. May also create a degree of production differentiation (real or spurious). May aid brand loyalty.	Unaware of true value for money, so pay more than would otherwise. Confused, hard to make comparisons: may decide shopping around too difficult.	Structured investment products Personal pensions Variable annuities Investment funds

Firm’s action	Aim/effect on the firm	Effect on consumers	Example
Product differentiation (genuine or spurious)	Charge higher price for a distinctive product and/or create brand loyalty to increase or protect market share.	Belief that no other product is as good.	Particular brands of payday loans promoted on speed and ease of access.
Brand and advertising	Create loyal customer base. Increase or protect market share, even if price has to be lower. May enable higher price. May create barrier to entry for new firms because of cost of establishing a competing brand.	Less likely to switch to another provider.	‘Big banks’ and insurance companies that advertise their caring attitude and empathy with customers.
‘Hollowing out’ (reducing core features or services)	Can compete on low prices without reducing profit.	May be unaware of loss of product features and quality, especially if overall the products terms are complex.	General insurance sold through price comparison websites.

Sources: BIBA (2016), Fletcher (2016), Heding et al (2016), Varian (2010), Waterson (2001).

3.12 With 'third-degree' price discrimination, consumers do not self-select. Instead the firm has to be able to distinguish groups of consumers who are willing to pay more. In many ways, this is easier with financial products than non-financial, since financial products are usually personalised so cannot be bought by one consumer (at a low price) and transferred to another consumer (who would otherwise be charged a higher price). This type of price discrimination is common in the general insurance market, where customers who stay with the same insurer year after year typically pay higher premiums than new customers. Consumers may view this practice as an unfair penalty on loyalty. However, a report for the Financial Services Practitioner Panel from Clayton et al (2013) documents industry views that, given existing customers can choose to switch if they want to, this form of price discrimination amounts to consumer choice rather than consumer detriment and: *'there is an inherent value to customers to not having to shop around and transfer and this should be reflected in the price they pay (i.e they should pay more)'* (p.22)

3.13 A common price strategy is price obfuscation. It is widely accepted (for example, Laibson cited in FCA, 2015e; Grubb 2015; Waterson 2001) that firms may have an incentive to confuse consumers, since this makes assessing value-for-money more difficult and may enable the charging of higher prices. To cope with price complexity, consumers may decide to focus on just one aspect of price (discussed in Section 4 below), which encourages firms to compete on that aspect and downplay ancillary or follow-on charges. The tactics come in many forms. For example, discontinuous pricing occurs where a small change in the consumer's circumstances or behaviour triggers additional charges, such as a sudden shift from free-if-in-credit current account banking to steep charges for even a small, short-lived unauthorised overdraft. Exit charges that are triggered if a consumer wants to switch their mortgage or investment-type life insurance product may be downplayed at the time of purchase. Firms may 'game' any price disclosure rules or price comparison services by keeping down headline charges, but charging extra for product features that might normally be considered integral to the basic product, for example, some insurers charge a fee for administrative adjustments, such as change of address. Some contracts are 'incomplete' in that the terms and conditions can be altered after purchase – for example, variable rate savings accounts and mortgages, and some health insurances where the cost of cover is reviewable.

3.14 Price obfuscation may be particularly effective with 'credence products', in other words, products where some of the features cannot be known with certainty at, or even after, the time of purchase (see Box 3.1). This applies to many financial products, for example, insurance where consumers cannot be sure that a policy will pay out until they have a claim, and investments where expected returns possibly many years ahead may or may not materialise. With pension products, price obfuscation often takes the form of a multiplicity of charges, such as administration charges, platform fee, plus fund charges, such as initial charge, ongoing charges, dealing fees deducted direct from the fund, and so on. There may also be different tiers for some charges, such as lower annual management fees for larger investment holdings.

3.15 Prices may, in any case, be complex where they are risk-based, as with insurance products and most credit products. Firms typically claim that the algorithms they use to assess risk are commercially sensitive and also that disclosure would enable consumer fraud. As a result, consumers may find that the actual price they are charged turns out to be different from indicative prices found when shopping around and which formed the basis of their choice of provider.

Box 3.1 Inherent factors contributing to the complexity of financial products and services

This Section discusses how complexity can arise out of strategies used by firms to create and sustain market power. However, there are additional factors that mean the nature of many financial products is inherently complex and hard for consumers to evaluate. For example:

- **Credence qualities**. If consumers cannot evaluate some aspects of a product or service prior to buying and even after purchase, they have to trust the provider to deliver what is promised and charge what it is fair. Goods and services with these qualities are called 'credence products' (Darby and Karni, 1973). An example is insurance, where the consumer cannot know for sure whether the policy will pay out if the sort of risk they are insuring against happens or whether risk-based pricing has been accurately applied.
- **Asymmetric information**. Credence qualities are often associated with an imbalance in information between provider and customer, since the provider has superior knowledge of the product design, terms and conditions.
- **Asymmetric power**. Associated with asymmetric information, the provider typically creates a unilateral contract, where the terms and conditions are generally designed to limit liability and uncertainty for the firm, not the consumer. There is usually no means for the consumer to negotiate simpler or more beneficial terms and, if all firms offer similar contracts, the consumer will have a take-it-or-leave-it choice.
- **Risk and uncertainty**. With some products and services, neither the provider nor the consumer can know in advance whether the intended outcomes will be delivered. This applies particularly to investments (including investment 'wrappers' such as personal pensions), where returns depend not just on product design but also external forces, such as stock-market performance and macroeconomic factors, that are difficult or impossible to forecast.
- **Lack of consumer experience**. Life and health insurance and pension products are, by their nature, long-term. Other contracts, such as current and savings accounts, are open-ended, with no natural trigger (such as annual renewal) to prompt review and switching. As such, consumers tend to buy them only infrequently, which means they have only limited opportunities to build up experience and so the products remain unfamiliar and harder to understand.

3.16 A further price strategy is often referred to as 'bait and switch' which entails competing on an enticing product or aspect (the 'bait') but rapidly converting the consumer to a more profitable product (the 'switch'). In extreme examples, this entails advertising a tempting deal which turns out to be unavailable and the customer is then persuaded to buy something else. A variation is to tempt consumers with a cheap, basic deal but persuade the consumer that a more expensive option would suit them better. A further variant is to deliver the tempting cheap deal for a limited period and then revert to more expensive terms and this is the model often seen in financial services with, for example, limited interest-free periods for credit cards and retail credit and teaser rates for savings accounts. The firm relies on at least some proportion of customers failing to switch once the initial deal has expired (an example of status quo bias or inertia which is discussed in Section 4 below).

3.17 Finally, firms might use external factors inappropriately – this might be called opportunism. An example is the situation created by the Mortgage Market Review (FSA, 2012) which sought to protect consumers from poor lending practices by requiring lenders to carry out an affordability test before agreeing to a mortgage. The new rules included transitional arrangements for borrowers who already had a mortgage that they would have been ineligible for under the new rules. However, one year on, reviewing the application of the rules, the FCA (2016d) found that some lenders were failing to use the flexibility allowed in the rules, meaning that customers were trapped paying higher interest rates than available elsewhere in the market. The FCA commented: *'whether or not firms choose to apply the exceptions, firms should consider the fair treatment of customers when they want to make a change to their mortgage. In doing so, firms should ensure that customers do not face unreasonable barriers to changing product'* (p.6).

Product-feature strategies

3.18 Product bundling is another strategy that works by obfuscating true price and value for money. An example is packaged bank accounts, which bundle, for example, annual travel insurance, mobile phone insurance and preferential overdraft and loan rates with a current account. Consumers pay a fee for the bundle and are unaware of the cost of the individual components of the package. Insurance add-ons work in a similar way, as, for example, when GAP insurance is bundled into a car purchase or legal expenses cover added to house or car insurance. In addition to obscuring price, consumers who take out packaged or add-on insurance are often unaware of the quality of the additional products or whether they are a good match for their needs and circumstances. In this respect, payment protection insurance is an example: it was commonly bundled in with loans and, although the extra cost was not necessarily obscured, the cover was often sold to people for whom it was unsuitable because of their work status or pre-existing health conditions.

3.19 Similar in effect to bundling, firms may offer complicated products that have many and diverse features or terms, making it hard to compare across competitors. For example, mortgages vary in the duration of any initial rate, charges on early switching, maximum loan-to-value, type of property that is acceptable, and so on. Firms may also complicate the market by offering a diversity of similar but slightly different products, creating a confusing excess supply, as in the case of investment funds. The design of other products is inherently complex, making it hard for consumers to unravel the risks and charges involved let alone compare across providers – examples include structured products that incorporate derivatives and variable-rate annuities that aim to combine the conflicting attributes of high return but secure income. Complexity is not necessarily aimed at creating market power. It may be the result of innovation that genuinely aims to increase consumer choice or cater for consumer diversity and niche markets.

3.20 Complicated products inhibit comparison. By contrast, product differentiation is designed to make products stand out. Genuine differences may increase consumer choice by catering for consumers with particular preferences, such as, bank accounts operated only by phone or branch. They may also be the sign of valuable innovation, for example, apps developed by fintech companies that aid consumers in keeping track of their finances and managing day-to-day money. However, product differentiation may also be used spuriously to create a degree of market power provided consumers are convinced the differences have some meaning and value.

3.21 One way a firm can differentiate its products is to create and market a strong brand. The brand does not necessarily relate directly to product attributes and may be more about creating an appealing personality for the product or relationship with customers (Heding et al, 2016). As management literature makes clear, the point of a brand is to foster customer loyalty to grow or defend market share or enable a higher price to be charged (see, for example, Chaudhuri and Holbrook, 2001). Thus, branding works directly against regulators' goal of consumers frequently searching for, and switching to, alternatives. Establishing a brand is expensive, requiring extensive, advertising to create and raise awareness. The loyalty of brand customers and the high cost of brand creation and maintenance act as barriers to new firms entering the market. Overall, brands are important in strategies to create market power.

3.22 A different type of product-feature strategy is ‘hollowing out’. BIBA (2016) suggests that, for general insurance sold through price comparison websites, competition is on price alone which *‘acts as a market driver for providers to deliver stripped-back policies’* (p.4). This is akin to the ‘shrinking Mars Bar’, enabling firms to achieve the same effect as a price rise by cutting content instead.

Cross-subsidisation

3.23 Price discrimination may be (but is not necessarily) associated with cross-subsidisation. Cross-subsidies occur where the difference in prices that consumers pay is in some way inversely aligned with the cost to a firm of serving those customers. For example, generally it costs more to gain a new customer than keep existing ones (Heding et al, 2016), so the common practice in the general insurance industry of charging existing customers higher premiums at renewal than premiums for new customers is an example of cross-subsidy.

3.24 In economic terms, price discrimination always reduces society’s welfare compared with supplying all consumers at the single perfectly competitive price. However, cross-subsidies might be considered justifiable where they enable many more consumers to obtain a product at an affordable price than would otherwise be the case and/or prevent some groups from being priced out of the market – for example, the Flood Re scheme (UK. Water Act 2014) in effect means that households at low risk of flooding bear part of the cost of providing cover to homes at high-risk of flooding. Similarly the moratorium on the use of genetic test results (ABI, 2014) means that life and health insurance customers who do not have genetic conditions cross-subsidise those that do.

3.25 In other cases, cross-subsidies may seem hard to justify. For example, free-if-in-credit current account banking means that customers who never go overdrawn are, in terms of banks’ income from charges, subsidised by customers who do need to borrow and so incur overdraft charges. It is likely that many customers who go overdrawn – particularly those who have unauthorised overdrafts which carry particularly high charges - are in some degree of financial distress and so it seems hard to justify why they should subsidise better-off customers. However, the cross-subsidy is not apparent if the calculation takes account of interest foregone on credit balances with banks (CMA, 2015b, Table 5.6)[8], in which case customers in credit could be deemed to be cross-subsidising all other customers. Research for the Panel (FSCP, 2014) pointed to the difficulty in identifying and measuring the different cross-subsidies in personal current account banking, let alone determining whether such subsidies are regressive or progressive[9].

[8] The Competition and Markets Authority found, for example, in 2014, 34 per cent of banks’ revenue came from overdraft charges, but 40 per cent from the ‘net value of funds’, in other words the income earned on in-credit accounts less interest paid out.

[9] A Netherlands study (cited in FSCP, 2014) suggested that free-if-in-credit cross subsidies might be progressive since they gave access to free banking to low-income households who might not have been able to afford charges.

4. Consumers and market power

4.1 The ideal of perfect competition also falls down when we look at consumers. It assumes consumers are rational, in other words, that they know their own needs and preferences, will search out and can process information about the goods and services on offer, and so can choose the provider and product that will deliver the best outcome in terms of matching the relevant needs, quality and price criteria.

4.2 The market-power strategies employed by firms, described above, may interfere with this rational process. However, just as importantly, real consumers do not necessarily behave rationally. Instead, they have all kinds of behavioural traits that may enable or reinforce the strategies of firms. Firms may even exploit these behavioural traits (Costa et al, 2016). Some of the most relevant consumer behavioural traits are summarised in Table 4.1 and discussed below.

Types of thinking

4.3 An overarching explanation for behavioural traits is the effort required for rational thought. Stanovich and West (2000, p.658) distinguish two processes of thinking which they call 'System 1' and 'System 2': *'System 1 is characterized as automatic, largely unconscious, and relatively undemanding of computational capacity…System 2 encompasses the processes of analytic intelligence that have traditionally been studied by information processing theorists trying to uncover the computational components underlying intelligence.'*

4.4 Kahnemann (2011) applies this concept to choice decisions and argues that the 'law of least effort' applies. All types of voluntary effort, whether cognitive, emotional or physical, draw at least partly on a shared pool of mental energy that easily becomes depleted (Baumeister cited in Kahnemann, 2011). Without sufficient incentive, there is a tendency for people to rely on their System 1 (rapid, automatic, intuitive) thinking. Sometimes this is referred to as 'lazy thinking', but its origins are rooted in our evolution and aim to conserve valuable (in this case, mental) energy and aid survival. System 1 thinking uses a variety of heuristics (short-cuts) rather than slowly and effortfully analysing each option. That's essential in situations where danger threatens but, in the context of market engagement, can lead to consumers being less likely to shop around, curtailing shopping around early and basing decisions on incomplete or misinterpreted information.

4.5 Firms can turn System 1 thinking to their advantage by providing consumers with cues designed to influence heuristic-based decisions. For example, using System 1 thinking, consumers are more likely to focus on a particular aspect of a product as the basis for their decision. One possibility is that they may focus just on price (ranked as important by 79 per cent of respondents in the Panel survey – see Box 4.1), in which case firms might promote low headline prices, while reducing quality and valuable product features (a process called 'hollowing out') and/or adding on charges elsewhere (an example of price obfuscation). Another common heuristic is to select providers on the basis of brand. This is a complex area, since consumers are not necessarily using brand as a proxy for value for money. Brands may instead have symbolic meaning for consumers, for example, signalling belonging to a particular community or projecting something about their own self-identity (Heding et al, 2016). Firms' response may be to promote an appealing image for their product rather than compete on price, quality and innovation.

Box 4.1 Most important factors when choosing a provider

In the Panel survey, respondents were asked how important various factors are when choosing a provider. Nearly 4 out of 5 (79 per cent) said the cost of its products and services. Next were customer service, knowledge and professionalism of staff and the reputation of the company, all rated as important by 70 per cent of respondents.

Table 4.1: Consumer behavioural traits that contribute to firms' market power

Behavioural trait	How this trait affects consumers	How firms may respond to this trait
Anchoring (reference points) and loss aversion	Basing amounts on a reference point.	Suggest anchors eg price/donation/credit repayment level/ insurance policy excess.
Availability (law of small numbers)	Tendency to generalise from small amounts of data and/or recent data and therefore stop search too soon.	Advertising to encourage own firm to be the most 'available' to the consumer.
Choice overload	Deters shopping around at all, so tendency to stick with current provider (or not buy at all) or resort to a heuristic (eg price, brand).	Increase complexity (eg additional features to confuse comparison). Product differentiation (genuine or spurious). Complex pricing (e.g. ancillary charges, discontinuous pricing). Branding and advertising.
Framing effects	Decisions altered by way information presented	Present information in way most likely to favour its products/services. Shroud individual prices by product bundling, including add-ons and ancillary charging.
Loss aversion	More sensitive to price increases/quality loss than to price falls/quality gain.	Frame changes to price/quality e.g. emphasise teaser rate on savings rather than the subsequent fall or the discounted mortgage rate not the subsequent standard variable rate.
Overconfidence effect	Take more risk than otherwise would. Least knowledgeable often the most over-confident.	Complex products, charges and risks unclear.
Present bias (hyperbolic discounting)	Underestimate future benefits and costs or likelihood of future behaviour, so making decisions that have bad outcomes later.	Downplay future and contingent charges, offer immediate bonuses and free gifts.
Satisficing (rational inattention)	Settling for adequate products/services rather than seeking the best value. Setting a limit on the amount of information to be gathered before making decision.	Branding and advertising to increase likelihood of being among first products researched.
Scarcity mindset	Consumers worried about other things (low income, disability) may have less 'mental bandwidth' to appreciate costs and risks.	Complex products, charges and risks unclear.

Behavioural trait	How this trait affects consumers	How firms may respond to this trait
Status quo (inertia)	Tendency to stick with current product/service (i.e. a default effect). Low switching rates.	Price discrimination (higher prices for existing customers). Lower quality for existing customers. Switching charges to reinforce inertia – may be framed as loyalty bonus lost if switch.
System 1 thinking (heuristics, common frame)	Reluctance to act fully rationally, eg by gathering sufficient data and making personalised comparisons. Tendency to use short-cuts (heuristics) such as cheapest price or brand.	Compete on price but not quality (eg hollowing out). Focus on headline price but use ancillary charges. Branding and advertising.
Temporal effects	Consumers respond to prompts and warnings close to the point of decision or on meaningful dates, such as birthday.	Gathering prospective customer information (eg renewal dates, birthdates) to use in timing direct marketing.

Sources: Costa et al (2016), Fletcher (2016), Grubb (2015), Huck et al (2011), Varian (2010).

Behavioural traits that inhibit engagement

4.6 One of the most common behavioural traits that affects consumer engagement in markets is status quo bias (also called inertia) (Samuelson and Zeckhauser, 1988). This manifests as a tendency to stick with the current provider rather than switching to, or choosing additional products from, a new one. The Panel survey probed the extent to which respondents were buying additional products from their main bank and the reasons for this (see Box 4.2). Three-quarters had at least one other product from their main bank and the most common reasons for this were convenience and a perceived lack of difference between providers. Status quo bias is a gift for firms, automatically creating a degree of market power. This enables firms to charge loyal customers higher prices (third-degree price discrimination) and makes it more difficult for new firms to enter the market (since it is hard to persuade customers to switch to a new provider). Section 5 below looks further at explanations for the tendency of customers to stay with their current provider.

Box 4.2 Extent of and reasons for bank loyalty

Respondents in the Panel survey were asked whether each of 31 product types (other than any current account) were with their main bank. Three-quarters (75.3 per cent) had at least one product from their main bank. The most common number was one or two, though one respondent had 20. The types of product most commonly bought from the main bank were instant access savings accounts (63 per cent of respondents with this type of product), credit card (38 per cent) and cash ISA (34 per cent).

The most common reason for getting products from the respondents' main bank was convenience (49 per cent mentioned this as a reason and 36 per cent said it was the main reason). Next was a perceived lack of difference between providers (29 per cent mentioned; 17 per cent main reason).

4.7 Status quo bias may be exacerbated by choice overload. Iyengar and Leppar (2000) showed, using an experiment giving consumers a voucher towards buying jam after being offered free samples from either a wide or a narrow range of flavours, that, if consumers are faced with many options, they may disengage from the market altogether and buy nothing at all. In terms of shopping for financial services, an abundance of providers coupled with complex prices, complicated product information and possibly hundreds or even thousands of products to choose from, is likely to encourage existing holders of products to stick with their current provider rather than switch (and other consumers to lose interest in taking out products at all). Price obfuscation, product complexity and over-supply, which firms may use as ways to charge higher prices or increase market share, contribute to the conditions for choice overload.

4.8 The Panel survey found that consumers who are bank-loyal (buying multiple products from their main bank) are more likely than other consumers to have a view about how their bank rates on a range of performance factors and to rate their bank more highly (see Box 4.3). It could be that knowledge of these high ratings is the reason consumers have chosen to take out multiple products with the bank. However, an alternative explanation may be that, having chosen a particular bank, consumers then attempt to reduce cognitive dissonance[10] by increasing their approval of the chosen bank. This may reinforce status quo bias and increase consumers' attachment to a particular brand.

[10] Cognitive dissonance theory was developed by Festinger (see for example, Festinger, 1962) and can be applied to choice decisions. It is common to have to choose between options that each have a mix of attributes, some positive and some negative. After a consumer has made their choice, there is a tension (dissonance) in having accepted the negative attributes of the chosen option and having lost the positive attributes of the rejected options. Dissonance can be reduced either by changing behaviour or attitude. Since

Box 4.3 Bank loyalty and perception of performance

Respondents in the Panel survey who have products with their main bank consistently rated their main bank's performance on a range of indicators significantly more highly than those who do not have products there and are less likely to say that they do not know how well their bank performs (see Table 4.1). Even so, respondents are choosing additional products from their main bank despite frequently lacking information on certain attributes they say are important, such as whether the company has been fined for poor conduct and the number of complaints received.

Table 4.1 Perception of main bank's performance

	How well does main bank perform on attribute?			
	At least one product with main bank		No products with main bank	
Attribute	Very/quite well	Don't know	Very/quite well	Don't know
Customer service	87.2%	1.5%	75.8%	5.2%
UK call centre	71.4%	13.8%	56.9%	26.1%
Whether company fined	45.3%	31.1%	28.7%	50.9%
How long for calls to be answered	66.6%	14.3%	53.1%	26.5%
Knowledge and professionalism of staff	86.6%	1.7%	79.5%	5.0%
Number of complaints	43.7%	34.5%	31.9%	50.2%
Cost of products and services	67.5%	5.7%	54.2%	16.1%
Reputation of company	78.6%	2.4%	67.6%	5.6%

Base: Respondents rating the attribute as important (scored 8-10). Differences between the groups are all significant at the 99 per cent confidence level.

Behavioural traits that distort engagement

4.9 Getting consumers to engage with a market is just the first hurdle for regulators. Once active, behavioural traits may nevertheless deflect consumers from making rational decisions. For example, availability bias (Tversky and Kahneman, 1974) causes consumers to overweight information that is recent, familiar or particularly salient. When shopping around, it may cause consumers to check only a narrow range of firms – perhaps those that advertise most – or to stop searching too soon on the assumption that a small set of data is indicative of the whole market. This may be particularly prevalent if consumers are distracted by other financial pressures and so are in a 'scarcity mindset'. The effect of such traits is that consumers are unlikely to identify the best outcome for themselves and will be only partially effective as drivers of competition. Satisficing, in other words looking for an outcome that meets a minimum threshold rather than the outright best,(Simon, 2008), can have the same effect, but may have a rational as much as behavioural underpin and is discussed in Section 5 below.

---

the choice cannot easily be reversed (behaviour change), there is a tendency to change attitude by increasing approval for the selected option and finding reasons to disparage the rejected options.

4.10 Consumers are vulnerable to framing effects, in other words the way in which information is presented. Tversky and Kahneman (1981) have shown that people are roughly twice as sensitive to making losses as gains of the same size. Thus it may make sense for firms to couch price differentiation in terms of discounts for some consumers rather than increases for others. Kahneman and Tversky (1979) also found that, when making decisions under conditions of uncertainty, people tend to underestimate probable outcomes compared with certain outcomes. As a result, when choices are framed as gains, people tend to prefer a certain gain even where its value is lower than the probability-weighted gain from a risky alternative. Conversely, when the choice is framed as a loss, people prefer to gamble on a probability-weighted loss even when its expected value is higher than an alternative loss of a fixed amount. This gives firms an incentive to downplay charges and risks, for example, though price obfuscation and product complexity. The ability for complicated, risky products to persist in the market may also be aided by the overconfidence effect: this is a common tendency for consumers to overestimate outcomes in uncertain situations (Lichtenstein and Fischoff, 1977).

4.11 Framing might also be used by firms to take advantage of consumers' present bias (Loewenstein and Thaler, 1989). This is the tendency to give most attention to immediate costs and benefits, while underweighting those that occur further into the future and to underestimate the likelihood of future personal behaviour that might trigger charges or other adverse outcomes. The result may be products designed with teaser rates on savings accounts (higher rates for an initial period only) and free gifts (for example with over-50s life cover) and credit with high penalties if payments are missed or borrowing limits breached.

4.12 Consumer decisions may be framed by 'anchors' – numerical amounts that set a reference point for making estimates (Tversky and Kahneman, 1974). For, example, the amount a consumer feels willing to pay for the repeat purchase of a product might be based on what they paid last time, provided they can recall the figure or find it easily. Firms that want to increase prices may prefer to suppress previous price information. By contrast, regulators may require this information to be provided as in the case from April 2017 of general insurance renewals (FCA 2016b).

4.13 Consumers are also sensitive to temporal effects (Costa et al, 2016), so that information received at a salient time – for example, close to renewal or expiry of a fixed-term deal – is likely to have more impact than the same information a long time ahead of when it becomes relevant.

The impact of increasing engagement

4.14 In markets without price discrimination, driving competition and the best outcomes for consumers would not require all consumers to take on the role of the ideal, rational consumer, consistently shopping around and switching. The actions of a minority of active shoppers might be sufficient to keep prices low and quality high with more passive consumers sharing the benefits without the cost and hassle of searching and switching for themselves.

4.15 However, as noted in Section 3 above, many financial markets are characterised by price discrimination and this may (but not necessarily) be associated with cross-subsidies between different types of consumer. Two implications follow from this:

- **Inactive consumers cross-subsidise active consumers**. A minority of active consumers will not be sufficient to drive competition for the benefit of all consumers. Instead, active consumers are more likely to find the better deals, while less active consumers may be charged more and receive poorer quality. The less active consumers may then be cross-subsidising the better deals achieved by the active consumers.
- **All consumers could be winners**. If more consumers can be persuaded to shop around and switch, then cross-subsidies will tend to unwind, which means that some consumers may

lose while others win (sometimes called the ‘waterbed effect’). However, to the extent that cross-subsidies were from vulnerable to less vulnerable consumers, this may be a socially preferred outcome. Moreover, to the extent that improved competition reduces the opportunity for firms to gain and exercise market power, all consumers may be winners, through lower prices and/or better quality across the board, even if some gain more than others.

4.16 Research by Europe Economics (2016) suggests that, if consumers were fully rational, they might collectively be better off over a 30-year span to the tune of nearly £110 billion. The research modelled the potential gains to consumers from increasing financial capability compared with their current state as measured in the Money Advice Service financial capability survey. Financial capability was defined basically as the behaviour that would lead to the outcomes a rational consumer would achieve. However, the research notes that the full extent of the gains probably could not be achieved in practice because of the persistence of some behavioural traits and because firms would adjust their own behaviour in response to any shift in consumers’ financial capability.

5: Consumers in the market

5.1 As the previous section has shown, consumers are diverse and behaviourally complex. The Panel survey reinforces this picture with respondents clustering around four distinctive segments (see Box 5.1), two of which tend towards the active ideal that regulators want, one of which is brand loyal (identified in the survey as making repeat purchases from their main bank), while the final group is disengaged from the market.

Box 5.1 Typical consumers of retail financial services

Type 1: Active-tending younger consumer

Characteristics: Aged 25 to 44, these households may be singles or couples and a third of this group have children. Slightly more likely to be in the C1 or DE social groups, they tend to have a middling income and over half are in full-time work. They are fairly evenly split between home owners and renters, with a round a third in social rental properties.

Products: Nearly all these households a bank current account. Typically, they often have savings, usually in just one account (either an instant access account or a cash ISA), but a quarter have no savings products at all. Take up of children's products is also low. Only one in ten has investments. Around a quarter have a mortgage and take-up of other types of credit tends to be low. Nearly half have no non-mortgage credit and those that do tend to have just a single credit card. Only half have car insurance reflecting relatively low car ownership and fewer than half have contents insurance.

Behaviour: This group is not loyal to their main bank, typically have no or just one product from there besides their current account. They are very keen on shopping around, with many viewing shopping for as many ten products being worthwhile. They are also among the most dedicated when it comes to reviewing the finances, with two-fifths doing so monthly.

Type 2: Bank-loyal consumer

Characteristics: Typically aged 35 to 54, these households tend to fairly well-off and four-fifths are in full-time employment. Two-fifths are in the AB social group. Couples dominate and around half have children. Nearly two-thirds are buying their home with a mortgage and renting is low.

Products: Nearly all have at least one current account and often more. They all have some savings products, typically three or more types but often just one account of each type. After instant-access accounts and cash ISAs, Premium Bonds are popular. Over a third also have investments and a third have taken out children's savings products. Mortgage take-up is high, in line with tenure, and so too is that for buildings insurance. Nine out of ten have contents insurance and a similar proportion car insurance, reflecting the level of car ownership (often two or more). Travel insurance is also popular with four-fifths of this group taking foreign holidays. This is the group most likely to have life insurance (one-third of respondents), but even so half have no life or health insurances – perhaps relying on workplace benefits. This group makes extensive use of credit, especially credit and store cards where nearly half have multiple cards. One in 20 has a payday loan – much higher than for any other group.

Behaviour: These consumers keep a close eye on their finances, with three-quarters reviewing them monthly or quarterly. However, they are extremely loyal to their main bank with 70% having more than two products 9other than their current account) there and a fifth having six or more. There is a wide spread of views on how many products it is worth shopping around for.

Continued overleaf

Box 5.1 continued

Type 3: Active-tending older consumer

Characteristics: This group is mostly retired, with two-thirds aged 65 and over, and tend to couples without (non-adult) children. They are evenly spread across the social grades and evenly split between low and middling incomes. Nearly two-thirds own their home outright but a fifth are in social rented housing.

Products: They have the highest current account ownership of all the groups and most have savings products as well, often three or more types. Most common are instant access accounts, cash ISAs and Premium Bonds. Over a quarter have investments as well. Over half are retired with a private pension, while one-fifth are retired on a state pension only. Only one in eight still has a mortgage. Nearly two-thirds have at least one credit or store card, but otherwise credit usage is low and nearly a third have no non-mortgage credit products at all. Nine out of ten have contents insurance and take up of buildings and car insurance is also high, in line with home and car ownership, respectively. This group is also the most likely to have a service contract for their boiler and/or central heating. Over a quarter have a life or health insurance product, but 70% have none.

Behaviour: These consumers stand out for being time-rich (three-quarters of respondents). A third review their finances monthly, but others are fairly evenly spread across quarterly, half-yearly and annually. They are inclined to view shopping around for three to seven products as worthwhile, but one in eight support shopping around for more. This perhaps explains why take up of products from their main bank is low, with a fifth having no products from there other than their current account and a further third just one product.

Type 4: Less-engaged consumer

Characteristics: These consumers tend to be younger, aged 18 to 44, and are most often in the C1 and DE social groups. Many are single and three-quarters have no children. Half are in full-time work but one in 11 are unemployed or off work sick. Income tends to be low to middling. Tenure is fairly evenly split between home ownership and renting.

Products: This group has the lowest take-up of current accounts (even so 97% have an account and a quarter more than one). A third have no savings products at all. Of those that do, an instant access account is the most common (half of respondents) and most do have just one account of any type. Only one in eight have investments. With nearly half renting and a third having no car, take-up of mortgages, buildings and car insurance is low. The same applies to contents insurance with just two-fifths having this cover. Four-fifths have no life or health insurance. Over half of this group have no non-mortgage credit products and, for those that do, one or sometimes two credit cards are most likely.

Behaviour: Over a third of these consumers do not view shopping around for any products as worthwhile. Others think it would be worthwhile for four products at most (one in seven respondents). This group is the least inclined to take out products with their main bank (over a third have none and a further third just one) though this may reflect low engagement with financial products generally as much as views about their bank. One in five never check their finances and one in eight less than once a year.

Source: The Panel survey (FSCP, 2017).

Types of consumer

5.2 Beckett et al (2000) proposed a model of consumer types which they tested through small-scale qualitative research with focus groups. Drawing on a review of economics, consumer behaviour and psychology literature, the researchers identified two overarching factors associated with consumers' behaviour when shopping for financial services:

- **Involvement**: This encompasses all aspects of the buyer-seller exchange, including customer control, customer participation and the level of contact with firms.
- **Confidence**: Largely determined by the consumer's perception of risk, this is a function of the complexity of the product and the certainty of the outcomes from using the product.

5.3 Beckett et al formed a matrix of these two factors to distinguish four types of consumer as shown in Figure 5.1. The Panel survey consumer segments have been superimposed onto the matrix. However, it is important to note that the descriptions of the Panel segments in Box 5.1 sketch out the features that distinguish each group from the others in a *relative* way. For example, active-tending younger and older consumers are more likely than the other two groups to review their finances regularly and say that shopping around is worthwhile for a larger number of products. It does not mean that all the consumers in these segments have those characteristics. Moreover, the Panel survey did not seek to test whether respondents who said shopping around was worthwhile followed this through to actually shop around or whether such shopping around would be free of the behavioural influences that might undermine its effectiveness. Thus, while the active-tending segments of the Panel survey can be mapped roughly to Becket et al's Rational-Active group, it would be too much to claim that these Panel segments conform to the ideal of rational consumers.

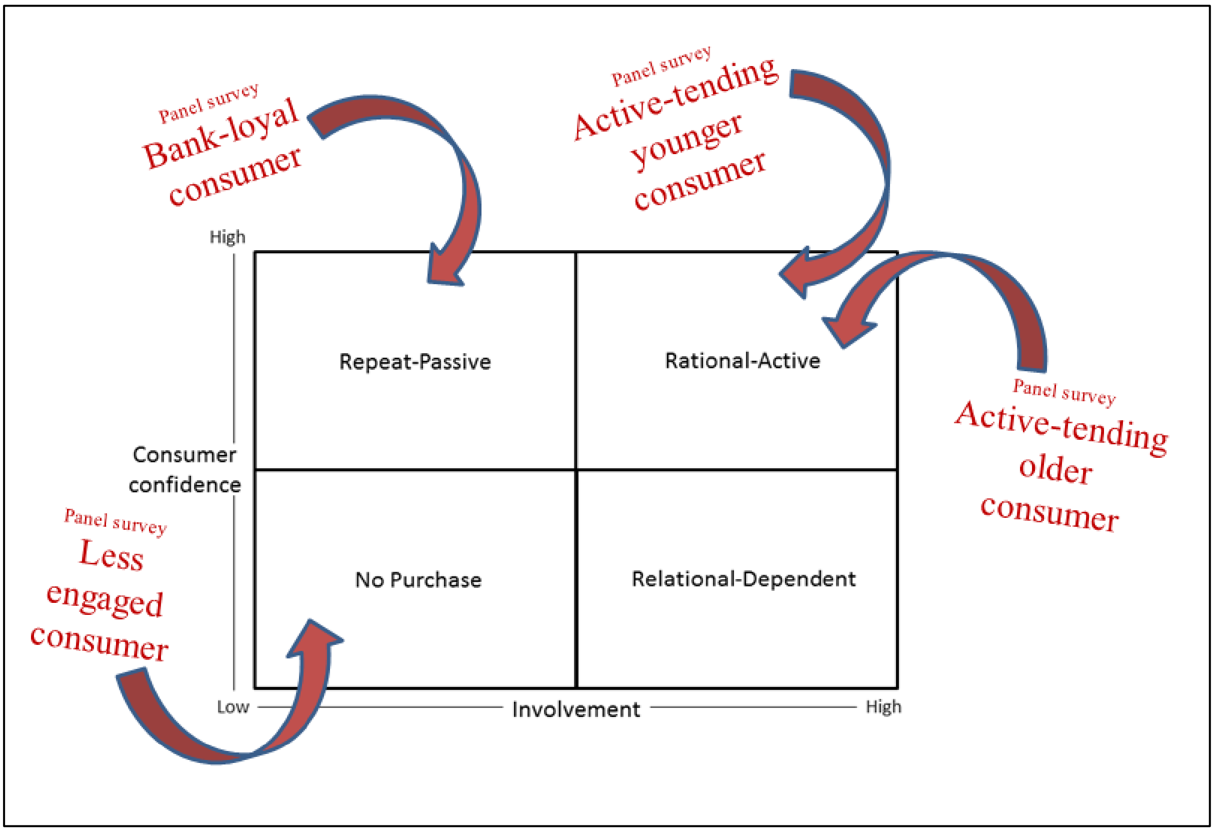


Figure 5.1: Becket et al's consumer behaviour matrix plus Panel survey segments
Sources: Beckett et al (2000, p.16); FSCP (2017).

5.4 Based on the results of their focus groups, Becket et al's four types of consumer can be described roughly as follows:

- **No Purchase**. Consumers who have low involvement with financial services and lack confidence making decisions about them. They tend to keep their money in cash at the bank, but otherwise don't make financial purchases. In the Panel survey, less-engaged consumers tended to be younger, aged 18 to 44, often single, with low to middling incomes and, while the majority work, they were more likely than other segments to be unemployed. This group, being disengaged from the market, does little or nothing to drive competition. The overarching issue here is the barriers that are preventing this group from accessing and engaging with the market.
- **Repeat-Passive**. Becket et al found that these consumers were confident opening a current account and typically chose a bank on the basis of a convenient location, recommendations from friends or family or reputation of the bank. After that, they tend to stick with the same bank, regardless of any change in their needs or circumstances. They saw switching as a hassle and perceived little difference between providers. In the Panel survey, consumers who tended to stick with their bank for multiple products were typically couples aged 35 to 54, working full-time and fairly well-off. This group is also doing little to drive competition and the overarching issue is that they use heuristics, such as brand, rather than shopping around.
- **Rational-Active**. In Beckett et al's research, this type of behaviour was associated with the purchase of basic insurance products, such as car and house cover. Consumers were confident and switched often. Although aware of brands and reputation, price was generally the most important criterion although other factors, such as any policy excess were also taken into account. The fact that consumers interacted mainly at a distance – by phone or internet – seemed to be important in fostering this active consumer engagement, turning financial products into commodities rather than transactions requiring a trust relationship. The Panel survey identified two segments of consumers tending towards this active behaviour. The younger group were typically 25 to 44, often in social groups C1 or DE, on middling incomes, and with a modest take-up of financial products. The older group tend to be retired and relatively high users of savings and general insurance products. These types of consumer have the potential to drive competition but, as discussed in Sections 3 and 4 above, how effectively they can do this will depend on the nature and extent of their behavioural traits and how the choice environment they must navigate is shaped.
- **Relational-Dependent**. In Becket et al's focus groups, consumers acted in this way when considering complex financial products, such as investments and pensions, where outcomes are uncertain but consumers perceive there were differences between competing products. Consumers were involved but lacked confidence and knowledge, so were more likely to seek advice. Becket et al (2001, p.18) note that the advice relationship *'effectively replaces the information search and processing activities…Trust plays a critical role in this relationship'*. The Panel survey did not look at use of advisers and so has no corresponding segment. A key contention in this research paper is that this section of the model has the potential to be extended and developed in new and innovative ways that can enhance consumer power, adding to the effectiveness of competition and improving consumer outcomes.

Barriers to competition

5.5 Figure 5.2 builds on the model created by Beckett et al (2000). The challenge that competition regulators have set themselves to date is how to move consumers from the No Purchase and particularly the Repeat-Passive segments into the Rational-Active behaviour space. Figure 5.2 suggests some key barriers to be overcome according to each consumer type. Traditional barriers are shown in black and behavioural barriers in red. Since the barriers in each segment differ, so too do the policy challenges and likely solutions.

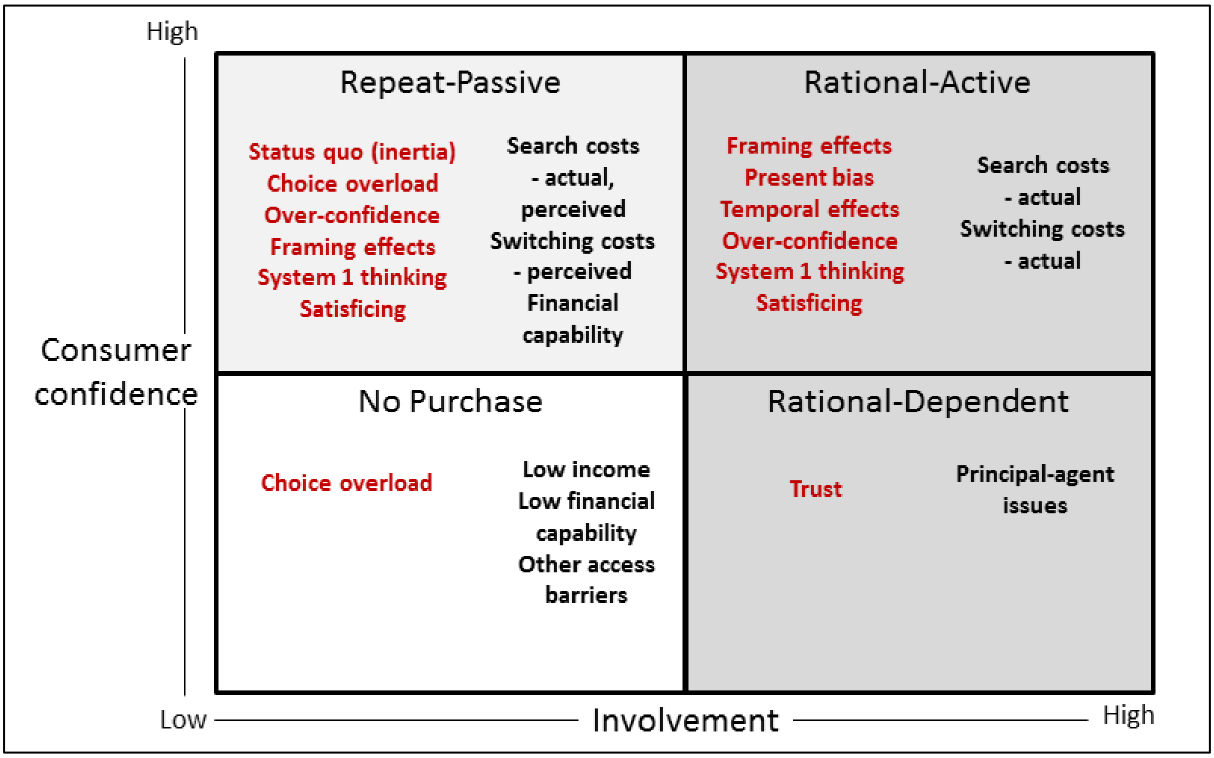


Figure 5.2: Consumer types and barriers to competition

Sources: Author's development of model from Beckett et al (2000, p.16)

Key: black denotes traditional barriers; red denotes behavioural barriers.

The challenge of No Purchase

5.6 The first challenge is consumers in the No-Purchase segment. There are many reasons why they might be there. These are consumers whose involvement is low, so they have not shopped around and actively decided not to buy; they are consumers who are missing from the shopping around process. Their confidence is also low and it is possible that, for some, this is due to perceptions that financial products are complex and choosing between many providers difficult, resulting in these consumers disengaging through choice overload. If this perception is wrong, then it might be suggested that the issue is one of low financial capability and that, for example, generic guidance and financial education might help. However, as Section 3 above has shown, the perception of complexity is highly likely to be accurate and at least partly due to firms' competitive strategies. It would take extraordinary levels of financial capability to cut through the complexity, far beyond what might reasonably be expected of financial education and generic guidance.

5.7 Apart from complexity, a large proportion of the No Purchase segment may lack engagement because they are unable to afford financial products due to low income or because there are other barriers to access, such as lacking standard identity and proof-of-address documents required to pass anti-money-laundering checks, having a poor risk rating for credit or insurance, or not being digitally enabled. These barriers are important and a reminder that consumer sovereignty in well-functioning markets reflects only those consumers who have not just the willingness, but also the opportunity, to express their preferences through buying. A full discussion of these barriers can be found in Collard et al (2016). While firms' competition strategies may be implicated – for example, through an unwillingness to serve some sections of a market deemed unprofitable - the solutions sometimes rest with social policy rather than competition policy, as in the requirement for big banks to provide basic bank accounts to all and for insurers to offer home insurance to homes at high risk of flooding.

The challenge of Repeat-Passive and effective Rational-Active

5.8 The challenge where competition regulators seem to concentrate most attention is moving consumers from the Repeat-Passive segment to Rational-Active. Fletcher (2016) describes how, around the turn of the century, competition regulators started to use demand-side remedies aimed at changing consumers' behaviour rather than just supply-side remedies focusing on the structure of markets. (However, some of the measures, such as information disclosure, have been in use much longer for other policy purposes, particularly consumer protection.) Fletcher distinguishes two types of demand-side policies, aimed at:

- **Enabling consumers:** These policies, adopted in the early years aimed to enable consumers, by providing them with information and easing costs and delays that have traditionally been recognised as barriers to searching and switching.
- **Engaging consumers:** These more recent policies focus more on engaging consumers. They recognise that there are also behavioural barriers to searching and switching and attempt to address these by, for example, changing the choice architecture (through nudges and defaults) and providing better tools (for example, framing information to work with behavioural traits).

5.9 However, competition regulators may be underestimating the extent to which consumers' decisions to occupy the Repeat-Passive space could be a rational choice rather than the result of behavioural biases that need to be changed or harnessed. There are two explanations that might justify a view that consumer's passive behaviour could be rational: the wide nature of search and switching costs; and satisficing.

5.10 It is now well recognised that searching and switching costs include time and mental effort rather than simply financial outlay, but the costs may be even more diverse. Burnham et al (2003) provide a useful classification of switching costs which is represented in Figure 5.3, in particular:

- **Economic risk costs**. This refers to the uncertainties around future outcome, convenience and quality of a new provider. Since financial services are often credence products (see Box 3.1 in Section 3), economic risk costs may be perceived as high.
- **Other procedural costs**. Evaluating options and familiarisation with new products require time and mental effort (sometimes called 'cognitive effort' or 'thinking cost').
- **Financial costs**. Benefit loss costs may include: losing any loyalty bonuses or discounts with the old provider; switching costs, such as early redemption fees; sunk costs, for example where arrangement fees have been added to a mortgage that is then transferred early. Monetary loss costs refer to one-off costs incurred with the new provider, such as deposits and arrangement fees.
- **Personal relationship costs**. Switching means losing the confidence and comfort of using familiar processes or even dealing with familiar people in the case of branch-based services.

- **Relationship loss costs**. The existing provider's brand may have some symbolic or identity value to the consumer. This is more readily understood in the context of, say, cars or supermarkets, where driving a Bentley or shopping at Waitrose may be a personal statement. Some financial service providers have distinctive brands that may work in a similar way, for example Cooperative Bank's association with ethical lending.

Procedural switching costs	Financial switching costs	Relational switching costs
• Economic risk costs • Evaluation costs • Set-up costs • Learning costs	• Benefit loss costs • Monetary loss costs	• Personal relationship loss costs • Relationship loss costs

Figure 5.3 A classification of switching costs
Source: Author's representation of Burnham et al (2003)
Key: black denotes financial costs; red denotes behavioural 'costs'.

5.11 Once the full array of financial and behavioural costs is taken into account, the cost of switching may be high and outweigh even quite substantial expected gains from switching. This may particularly be the case in markets where prices and product features are complex, increasing evaluation and economic risk costs. High total switching costs could lead quite rationally to a decision to stick with the status quo or to pursue a satisficing strategy.

5.12 Satisficing occurs when consumers set a threshold of minimum satisfaction that they are willing to accept rather than aiming to maximise their satisfaction as the ideal of perfect competition assumes. Satisficing generally results in less search activity, so less effective competition. In the Panel survey, there was some evidence of satisficing behaviour, with bank-loyal respondents commonly saying that they had searched the market but chose their bank because it had the best deal (see Box 5.1) – in reality, the products of the big banks are seldom the best available[11].

Box 5.1: Bank-loyal consumers and potentially satisficing behaviour

In the Panel survey, of the three-quarters of respondents who had at least one other product with their main bank, a quarter said a reason for doing this was that they had looked around and their main bank had the best rate. One in five said this was the main reason for choosing their main bank for the additional product(s).

[11] For example, a search of Moneyfacts (www.moneyfacts.co.uk) in February 2017 found no high street banks in the top 40 savings accounts and only one in the top 10 personal loans.

5.13 Two possible explanations for satisficing behaviour could be:

- **Switching costs** (defined widely as above) if these would be unacceptably high were shopping around to be extended further, and/or
- **Opportunity cost**, in other words, the existence of alternative ways that consumers would prefer to spend their time and energy. For example, playing a video game, doing a crossword or shopping for clothes may be a more pleasurable use of time and mental effort rather than searching for the cheapest insurance or best savings account.

5.14 The time involved in shopping around may be considerable. In research for Citizens Advice (Ogunye, 2016), consumers were coached in 'good engagement' when shopping around as opposed to 'natural engagement' (whatever consumers would normally do). Good engagement required following a structured set of steps, including reading reviews, consulting others and reading product terms and conditions. The research found that natural engagement in shopping around across a total of 12 consumer household and financial services markets (of which four were financial) would on average take a consumer 66 hours a year (76 minutes per week) but to shop around properly ('good engagement') would take 95 hours a year (107 minutes a week). In another study, Lowe (2015) asked a survey of 1,000 people about 12 common household and financial services and found that the average household shops around for fewer than half of the services it uses. On the face of it then, satisficing behaviour could simply be due to consumers having too little time to shop around across multiple markets. However, both the Panel survey and Lowe found that people generally do not consider themselves time-poor (see Box 5.2) which suggests the need for a different explanation.

Box 5.2 Time for shopping around

Only 14 per cent of respondents in the Panel survey described themselves as time poor. In general, the more worthwhile shopping around was perceived to be, the more time respondents said they were willing to spend on the task. Respondents were most likely to rate shopping for car insurance, gas and electricity, broadband and phone and home contents insurance as very worthwhile (scoring 8 to 10 on a 1 to 10 scale). Least likely to be rated very worthwhile were mortgages and personal loans.

5.15 The relevance of opportunity cost chimes with the Citizens Advice research (Ogunye, 2016). Crucially, the research found that consumers who used good engagement not only took much longer shopping around but were also less happy with the outcome than those who used natural engagement. This finding might reflect dissatisfaction on losing alternative uses of the time and effort involved. It could also reflect an increase in perceived economic risk cost if, once consumers pay more attention to a product's precise terms and conditions, they become more anxious about whether the product will actually deliver the benefits they hope it is promising.

5.16 The idea of System 1 (quick, intuitive, 'lazy') thinking and System 2 (slower, rational, effortful) thinking was introduced in Section 3 above. Kahnemann (2011) argues that, when faced with choice decisions, without sufficient incentive consumers will adopt System 1 thinking. This means consumers will be more likely to use heuristics, such as choosing products on the basis of brand and so locate in the Repeat-Passive segment of Figure 5.2. However, even if consumers do engage with the market as seemingly Rational-Active players, System 1 thinking means they may drive competition only inefficiently.

5.17 Shugan (1980) theorised that three factors increase the cost in terms of mental effort: similarity in the satisfaction a consumer would get from competing products because it's harder to identify any differences; the importance of the decision, for example, because the financial outlay is high or the contract long-term; and the extent of inconsistency in the way features of different products compare – for example, it's easy to decide where one product is better on all counts, but more difficult if different products are better on some counts but worse on others. The market-power strategies that firms may decide to use in monopolistically competitive markets (described in Section 3 above) will tend to increase the mental effort required, as will the inherent complexity of many financial products (see Box 3.1 in Section 3). This increases the likelihood of consumers resorting to heuristics that are prone to the behavioural traits described in Section 4, such as framing effects and present bias. The resulting decisions would only by chance reward 'good' firms and punish 'bad' ones.

The potential of Rational-Dependent

5.18 If consumers are rationally choosing not to shop around, it may be very difficult or impossible for regulators to find effective policies to shift consumers into the Rational-Active segment in Figure 5.2. If consumers do engage in the Rational-Active space, their ability to drive competition effectively may be limited by the combination of their behavioural traits and firms' market-power strategies.

5.19 Grubb (2015) suggests that, once behavioural barriers are taken on board, there are only three policy options available to regulators: simplify choice; provide 'advice' (which is defined to include comparison tools and guidance as well as formal advice); or make choices for consumers. The final option – choosing for consumers – sits within the final segment of Figure 5.2 which has been relabelled 'Rational-Dependent' (as opposed to Beckett et al's original 'Relational-Dependent'). Renaming this segment conveys that it may be rational for consumers to delegate their decisions and that delegation does not necessarily imply a personalised relationship with a traditional adviser.

5.20 Section 6 explores what types of policy option might shift Repeat-Passive consumers to the Rational-Dependent segment and whether these could be a viable alternative or complement to expecting consumers to be Rational-Active.

6: Enhancing consumer power

6.1 The preceding sections have explored the context in which consumers are being asked to act as drivers of competition in retail financial services markets. The discussion has revealed the obstacles in the way of this ideal: the behaviour of firms, whose interests may best be served by strategies that create and increase market power to the detriment of consumer interests; and consumers whose own behavioural traits mean they are often ill-equipped to deal with the resulting market complexity and may even aid firms in their market-power strategies.

6.2 However, consumers are not all alike. Research by Beckett et al (2000) and the Panel survey point to distinct consumer types which, in this report have been labelled: No Purchase; Repeat-Passive; Rational-Active; and Rational-Dependent. If consumer power is to be increased, each type of consumer may invite different policy responses. The challenges for competition policy are:

- **Promoting access**: How to bring No Purchase consumers into the market. Often this will be a matter for social policy and/or collaboration between multiple stakeholders.
- **Shifting consumers from Repeat-Passive to Rational**: The challenge is how to shift Repeat-Passive consumers into a Rational space. This report argues that the Rational-Dependent space needs to be given at least equal priority with Rational-Active.
- **Improving the power of Rational-Active consumers:** Given consumers' behavioural traits, firms' market-power strategies and the nature of financial products, the issue is whether consumers in the Rational-Active space are
- able to drive competition. Solutions may include shifting to the Rational-Dependent space, but could take other forms, such as collective purchasing.

6.3 For a detailed consideration of the first challenge, promoting access, see Collard et al (2016). The remaining two challenges are discussed below.

Shifting consumers from Repeat Passive to Rational

6.4 Figure 6.1 reproduces the Repeat-Passive segment from Figure 5.2, including the barriers that may be inhibiting these consumers from driving competition. Mapped onto the diagram are key policy options that might work to shift these consumers into a Rational space. Building on Grubb's (2015) policy types, the following policy options are considered:

- **Simplify choice:** This could entail policies to simplify products, information and process.
- **'Advice':** Policies that provide or facilitate expert advice to consumers, such as, comparative information from regulators and price comparison websites and requirements for firms to share customer data with these services.
- **Choose for the consumer:** Policies that involve consumers delegating choice decisions to a third party, and
- **Other policies:** These include the type of behaviourally informed measures being deployed by the FCA, such as smarter information that is better framed and more timely (see Fletcher 2016; FCA, 2016e; FCA, 2015e), as well as triggers, incentives and financial education.

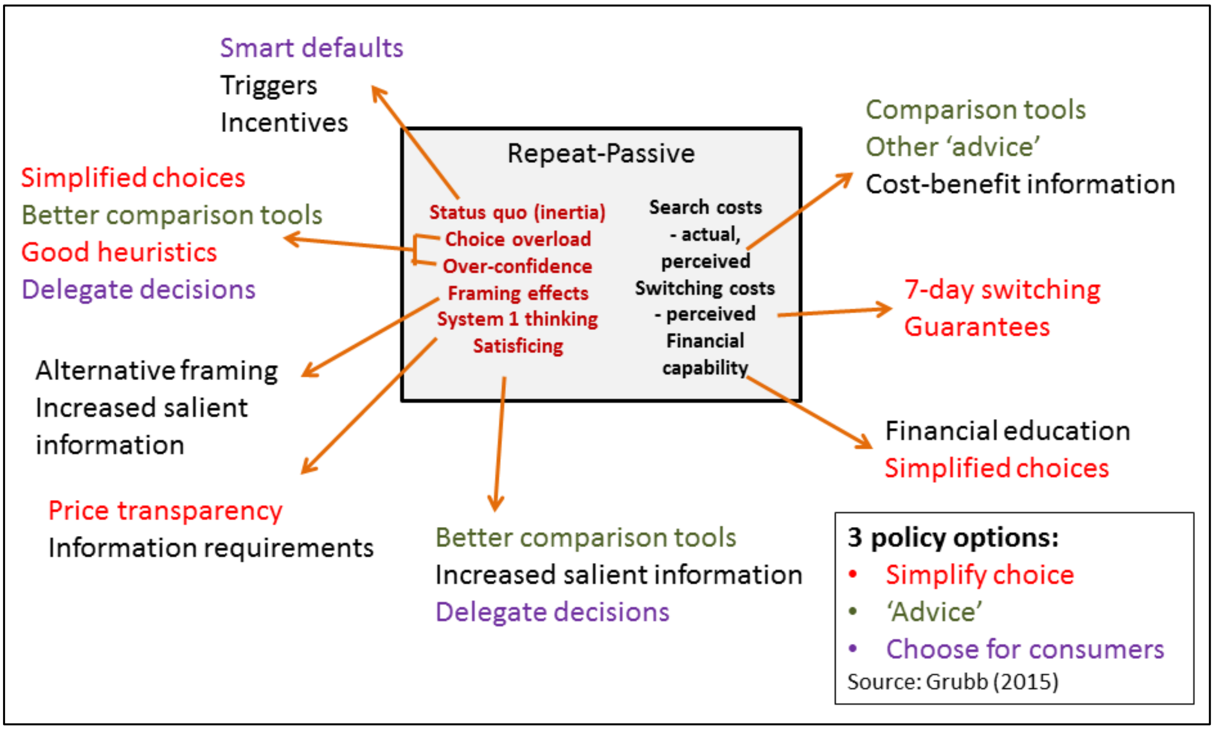


Figure 6.1: Key policy options for to shift Repeat-Passive consumers
Key: simplify choice in red; 'advice' in green; choose for consumer in purple; other in black.

Simplify choice: simple products

6.5 Consumer choice is hampered, in particular, by price obfuscation and product differentiation. An obvious solution would seem to be to make sure that at least some products are available that are straightforward, transparently priced, easily understood and suitable for basic needs. There have been several attempts to go down this route, namely:

- CAT (charges, access, terms) standards, used with cash ISAs and mortgages.
- Stakeholder products, used with pensions, Child Trust Funds and ISAs. (Proposals for investment funds and with-profits insurance did not materialise.)
- Simplified products (backed by a BSI kitemark[12]) for savings and other products.

6.6 Simple products typically have basic features, simple and transparent charges that may be capped and generally aim to offer value-for-money. However, evidence of success is mixed. Research for the Financial Services Practitioner Panel (Clayton et al, 2013) found in focus groups that, while consumers generally like the idea of simplified products, some support fell away as the problem of matching limited features to diverse needs was explored. Moreover, firms may fail to develop or market simple products if they do not expect to make sufficient profit from them[13]. It may take political pressure and ultimately legislation – as with basic bank accounts – to force the provision of simple products where a social-justice case is made. At its inception, the FCA made clear that it was not keen on endorsing products as being simple because even simple products can cause bad outcomes if mis-sold and such endorsements can inhibit innovation (Wheatley, 2012).

[12] https://www.bsigroup.com/en-GB/kitemark/services/financial-services-kitemark/
[13] For example, two years after the launch of stakeholder pension schemes, the ABI (cited in Trustnet, 2003) reported low take up for the product, partly blaming the cap on charges which made it financially difficult for firms to provide stakeholder pensions to low-income consumers.

6.7 Simple products do not necessarily have to be traded to have an impact; they can be successful if they serve as benchmarks for comparison. Arguably, one of the most successful aspects of stakeholder pensions has been an accompanying regulatory requirement (called 'RU64'[14]) which requires firms recommending personal pension plans to justify to customers why the personal pension is at least as suitable as the stakeholder product. The introduction of stakeholder pensions and RU64 was associated with a fall in the impact of pensions charges[15] over the space of three years from 1.7 per cent a year to around 1.1 per cent a year (DWP, 2006).

Simplify choice: simpler information

6.8 Choice could be simplified by a focus on the core features even when products are not simple in themselves. Regulatory requirements to produce 'Key Facts' documents and draw consumers attention to onerous terms (FCA, no date) are examples of this approach. Through its smarter communications initiative, the FCA (2016e) is championing more intelligent approaches to this type of disclosure and has highlighted exemplars, such as firms shortening and condensing their terms and conditions[16], using a range of media including video and texts, and using language in more behaviourally sensitive ways.

6.9 Nevertheless, many initiatives from firms aim to educate consumers (albeit in bite-sized, accessible ways) to understand hugely complex products and markets rather than embracing the need to simplify the supply side. There is a persistent focus on describing the product and leaving consumers to unravel how that fits with their needs. From the consumer point of view, a more useful approach would start with consumers' needs and indicate whether the product meets them. This could be achieved by consumer bodies or regulators identifying a set of basic needs for each type of product with firms' declaring whether each product as a minimum meets the core needs. Essentially this replicates the kind of consumer-centred product-characteristics-analysis that organisations such as Which? have been doing for decades. It provides consumers with a baseline from which to start comparing products and could create a disincentive for firms to 'hollow out' products (reducing core features to keep costs down where consumers are competing largely on price). Digital innovation makes it possible to develop this style of communication further, personalising the matching of information to needs through interactive tools.

6.10 Grubb (2015) discusses the possibility of constraints on pricing design, so that prices have just one dimension rather than a multiplicity of different charges, but recognises that may be impractical for some types of product and 'an uphill battle' since restrictions on some types of price may mean firms devise other forms of price obfuscation. Measures, such as the Annual Percentage Rate (APR), Reduction in Yield (RIY) and Ongoing Charges Figure (OCF) are regulatory attempts to present complex prices in a single, comparable measure. They have mixed success because, for example, in some situations they may need to be based on assumptions that differ from consumers' actual situation (APR and RIY) or they fail to capture all charges (OCF and contingent charges in the case of APR). However, these kind of simplifying devices are often useful for intermediaries who can analyse and deploy them in simpler communications, reports and tools for consumers.

---

[14] After the Personal investment Authority *Regulatory Update 64* which explained the requirement to firms. The rule is now in the FSA Handbook as rule COBS 19.2.2(1)R – see https://www.handbook.fca.org.uk/handbook/COBS/19/?view=chapter.

[15] Measured as Reduction in Yield (RIY).

[16] At the time of writing, it was expected that the spring 2017 Budget would contain measures requiring simpler terms and conditions in consumer contracts, which would reinforce this approach to simplifying choice. See, for example, http://www.telegraph.co.uk/news/2017/03/04/budget-2017-chancellor-philip-hammond-announce-ban-baffling/.

Simplify choice: simpler process

6.11 Choice may also be simplified by measures such as the Current Account Switch Service with its reassurance that, whichever banks are involved, switching will be *'simple, reliable and stress-free'*[17]. This should reduce actual and perceived switching costs (in particular, economic risk cost) and, in doing so, may also simplify by reducing the amount of information consumers need to acquire and check during the search phase of shopping around.

6.12 Finally, simplifying choice might be achievable through the use of heuristics. In areas, such as healthy eating, 'five a day' (or maybe ten!) is a very simple nudge towards eating more healthily without the need to grapple with complex dietary needs and information. The FCA's predecessor suggested that it might be possible to develop rules of thumb or 'ten key questions' that consumers should ask to prompt greater engagement (FSA, 2008).

Simplify choice: possible impact

6.13 Simplification, by definition, aims to reduce the complexity of the supply-side, but may have limited impact across the market as a whole. From the demand-side, measures designed to simplify choice could help consumers who are failing to engage with markets primarily because of choice overload, low financial capability or perceived high search and switching costs. It might also improve the outcomes for consumers who are over-confident and so liable to incur unexpected extra costs with more complex products. However, simplification measures might have little impact on consumers who are Repeat-Passive due to satisficing or brand loyalty.

'Advice' (info-mediation)

6.14 By expert advice, Grubb (2015) seems to have in mind what might be called info-mediation, presenting or repackaging product information in ways that make it easier to compare. Price comparison websites are an example, being interactive and more comprehensive versions of the 'Best buy tables' that were the mainstay of financial journalism for many decades. However, price comparison websites have been criticised where they rank on price and/or do not readily present other key information needed if consumers are to judge value for money (UKRN, 2016; FCA, 2014).

6.15 Better comparison tools would provide information and rankings based on a wide range of relevant factors. The Panel survey asked respondents for their views on the importance of a range of metrics when choosing a provider and whether the availability of such information would make a difference to their choice of provider - results are described in Box 6.1. While cost was deemed most important, information about service, quality of staff and reputation of the company were also rated highly by seven out of ten respondents. Fines and complaints were considered important by more than half of the sample. Consumer-facing organisations have used this multi-characteristic approach for many years, often producing 'star ratings' or similar composite indices that condense a large amount of information into a single metric. Investment fund info-mediaries often do the same (see Figure 6.2). In research for the Panel about the presentation of firms' conduct, consumers expressed interest in composite indices as a way of being able to rank firms (Collaborate Research, 2015).

'Advice' (info-mediation): possible impact

6.16 Better info-mediation and comparison tools could reduce search costs, help to address choice overload, might produce better consumer outcomes for the same amount of effort and so improve the effectiveness of satisficing behaviour, and might also help with over-confidence.

[17] https://www.currentaccountswitch.co.uk/Pages/Home.aspx

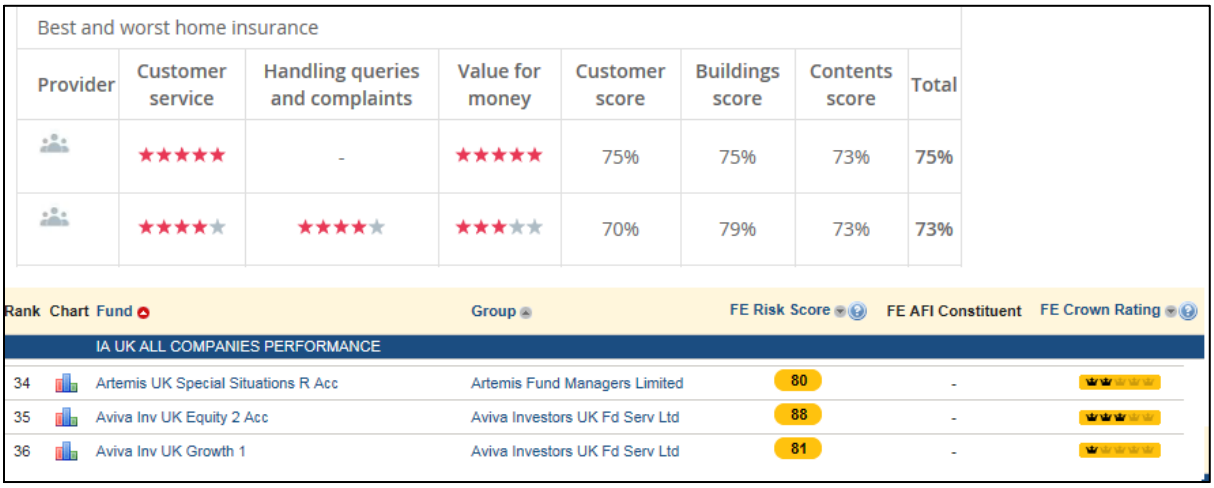
Box 6.1 Information that is important when choosing a provider

In the Panel survey, respondents were given a list of ten types of information about firms and asked how important (on a 1 to 10 scale) they thought this information was when choosing a provider. The proportion saying 'important' (score 8 to 10) is shown in Table 6.1 and also the proportion who said the information would make no difference to their choice of a particular firm. When asked where they would currently find this type of information, the most common unprompted source was the internet generally (45 per cent of respondents) followed by the provider's website/branch/call centre (22 per cent). One in ten respondents would only contact the provider without using any other source. 11 per cent would use a price comparison website. Only 3 per cent mentioned an official source of data such as the Financial Conduct Authority, an ombudsman or Companies House.

Table 6.1 Information relevant to choosing a provider

Type of information	Very important when choosing a provider % of respondents	Would make no difference to choice of provider % of respondents
Cost of products and services	79%	8%
Customer service	70%	13%
Knowledge and professionalism of staff	70%	8%
Reputation of company	70%	9%
Whether can manage services online	66%	7%
Call centre UK-based	60%	10%
Company fined for poor conduct	59%	11%
How long for calls to be answered	58%	14%
Number of complaints	53%	10%
Branch nearby	48%	10%

Base: 2084 respondents



Best and worst home insurance

Provider	Customer service	Handling queries and complaints	Value for money	Customer score	Buildings score	Contents score	Total
	★★★★★	-	★★★★★	75%	75%	73%	75%
	★★★★	★★★★	★★★	70%	79%	73%	73%

Rank	Chart	Fund	Group	FE Risk Score	FE AFI Constituent	FE Crown Rating
IA UK ALL COMPANIES PERFORMANCE						
34		Artemis UK Special Situations R Acc	Artemis Fund Managers Limited	80	-	
35		Aviva Inv UK Equity 2 Acc	Aviva Investors UK Fd Serv Ltd	88	-	
36		Aviva Inv UK Growth 1	Aviva Investors UK Fd Serv Ltd	81	-	

Figure 6.2 Examples of composite indices
Sources: which.so.uk (star ratings and percentage scores for home insurance); trustnet.com (risk scores and crown ratings for investment funds).

Choose for consumers

6.17 To the extent that Repeat-Passive decisions are rational (as suggested in Section 5 above), it may be impossible to persuade these consumers to shop around and switch unless there are considerable savings in time and mental effort. Such savings could materialise if the choice decision were delegated to a third party.

6.18 Product simplification and expert advice, discussed above, typically involve replacing or repackaging complex information in a way that is easier for consumers to understand – for example, excluding detail about non-core features or replacing diverse price and quality information with star ratings. While they may improve competition somewhat, there are nevertheless some drawbacks to these approaches, for example:

- They require assigning importance or a weighting to particular product features. Since consumers' needs and preferences are diverse, the resulting simplified product or holistic rating will not help everyone and could lead to many consumers still not achieving the best outcome.
- There may be no incentive for firms to promote simplification. They may fail to create and market simplified products. They might game rating systems by adjusting product features to score well on ratings while still having hidden charges and adverse features that fall outside the rating algorithm.

6.19 A better system would simplify the choice process for consumers but ensure products can still be tailored to their particular preferences, needs and circumstances. Advances in technology are offering the solution. If consumers are rationally rejecting the Rational-Active role because of the mental effort involved and the opportunity cost of their time (i.e. a preference to spend time doing something that gives greater satisfaction), then an obvious answer is to replace the Rational-Active role with an effort-saving and time-saving alternative. This is no different to using labour-saving devices, such as washing machines and central heating to save time and physical effort in the home, spreadsheets to save time and mental effort at home and work and, to take a contemporary example, replacing the complex individual and social process of driving with driverless cars.

6.20 Laboratory experiments Kalayci and Potters (2011) established that product differentiation does lead to poorer choices by consumers and also found that markets function more competitively, with lower prices and less price obfuscation, when consumer decisions are replaced by computers. Firms already use computers to replace complicated calculations with automated algorithms in all sorts of financial situations such as computing insurance premiums, calculating credit ratings and program-trading in stock markets. With only a small shift in perspective, it seems extraordinary not to do the same when it comes to consumer choice in complex markets.

6.21 A few firms are already most of the way to delivering this type of solution. For example, online mortgage intermediary, Trussle[18], already provides a post-sale service, so that it not only initially selects and arranges a suitable mortgage but also regularly updates the consumer on alternatives that could provide a better deal if the consumer decides to switch. In the energy market, Money Saving Expert coordinates an energy club[19] where again members are not only guided towards an initial deal and helped with the switching process (which, however, consumers must carry out for themselves) but are updated regularly when switching would be to their benefit. With these examples, it still remains for the consumer to make the final decision on whether or not to switch (to opt in). It would be a very small step for services like Trussle and the MSE energy club to take over the last steps of the process and automatically switch the consumer unless they opt out. Over time, this could become the norm for banking, savings, credit and general insurance products. Figure 6.3 demonstrates the process:

[18] https://trussle.com/

[19] https://www.moneysavingexpert.com/cheapenergyclub

- Consumer chooses to use an automated shopping-and-switching service.
- The consumer provides required personal and usage data and/or gives permission for transfer of data from their previous provider or a centralised data store. Data from the consumer includes relevant information about their particular needs and preferences.
- The automated service identifies a best match to product and firm, using an algorithm to compare on the basis of pricing, product features and, where available, quality metrics, weighted according to the consumers' stated needs and preferences and matched to their personal details and circumstances.
- The consumer is notified of the recommendation and may opt out within a specified time; otherwise the service automatically completes the purchase.
- The automated service re-runs the search at specified times – for example, as the end of a fixed-term deal approaches or annually.
- If a better deal is identified, the consumer is notified of the new recommendation and may opt out within a specified time; otherwise, the service automatically completes the switch.

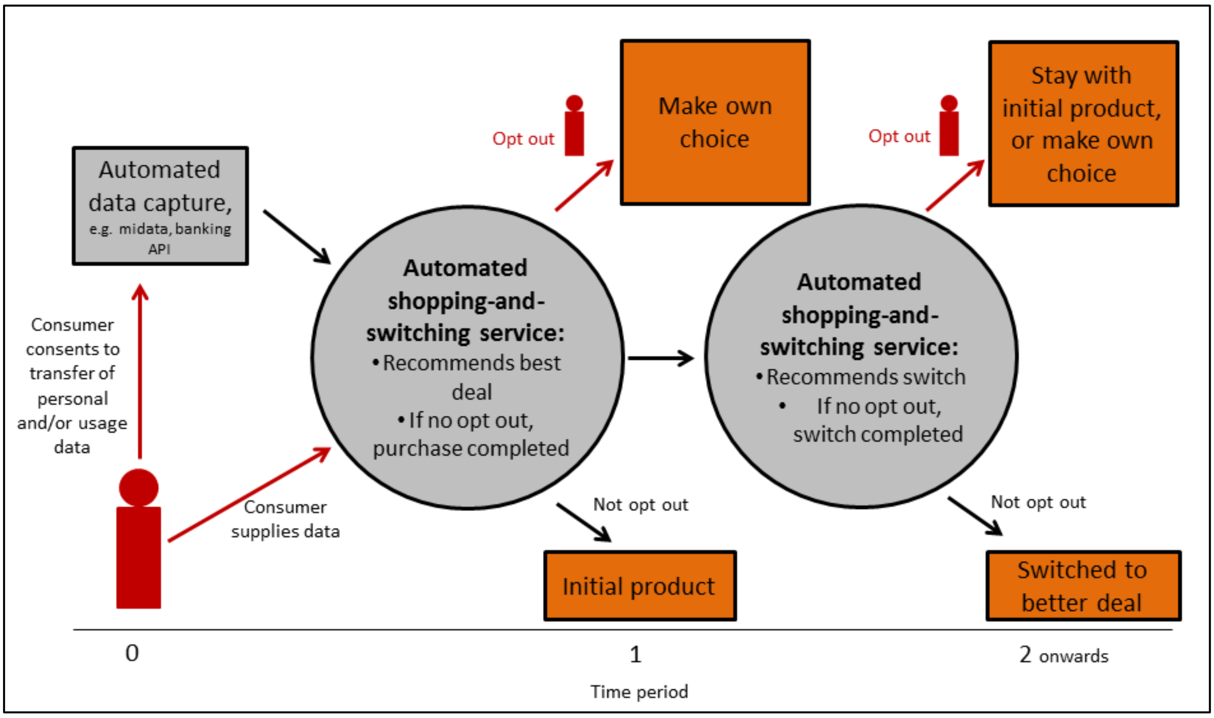


Figure 6.3: Rational-Dependent consumers using automated shopping around and switching

Choose for consumers: possible impact

6.22 An automated shopping-and-switching system focuses on the twin outcomes of delivering better deals to consumers and driving competition more efficiently than consumers are able to themselves. Provided consumers take up the system, it largely removes the need to tackle consumers' behavioural traits and works with the status quo bias by changing the default to'switch to a better deal' rather than sticking with the current provider. Since computer algorithms can cope with complex pricing and product differentiation, the incentives for firms to use these strategies is weakened and markets are more likely to tend towards the ideal of perfect competition.

6.23 An automated shopping-and-switching system with opt outs does not prevent consumers from choosing other ways to select providers, which may include managing their own shopping around and switching (in other words, occupying the Rational-Active space) or choosing other forms of delegation in the Rational-Dependent space, such as using a human broker or financial adviser. Automated shopping-and-switching simply adds a further option that allows consumers to select an effort-saving and time-saving device, just as they do in many other areas of life.

6.24 To summarise, automated shopping-and-switching has three novel aspects:

- It essentially digitises the role of a human broker or adviser, but going further than price comparison websites by taking full account of product and service features other than just price.
- It changes the default from status quo to switch if a consumer gain is identified, and
- It passively gets on with repeating the process as necessary, releasing consumers from the merry-go-round of repeated active engagement across multiple financial and household markets.

6.25 Automated shopping-and-switching can be seen as a next step in the evolution of information services into personalised services – the 'next generation intermediaries' described in research by Ctrl-Shift (2014) and Bates (2014) for Consumer Futures. The providers of automated shopping-and-switching could be diverse: information websites and price comparison websites; new fintech firms; larger established tech companies such as Google, Facebook and Amazon; big banks; consumer-facing groups, such as Which? and Money Saving Expert; and organisations with a statutory consumer education remit, such as Citizens Advice.

Choose for consumers: issues to be addressed

6.26 Of course, no system is without issues and concerns that need to be addressed. Key issues with delegation to an automated shopping-and-switching system include access and engagement, status and conflicts of interest, trust including data security and liability, regulation, and how to deal with changing consumer preferences.

Access and engagement

6.27 An automated system as described works naturally as a digital tool. Ten per cent of the population (5 million people) do not use the internet and this proportion is higher among the over-65s with over one-fifth of 65-74-year olds and over half of those aged 75 and over having never used the internet (ONS, 2016a). However, there is no reason why the 'shop-window' to such systems should not be via phone or physical branches, for example, terminals in Post Offices. Moreover, of those without digital access, a third are proxy users, having access as and when they need it through family or friends (Ofcom, 2016). Given the government's digital-by-default policy and the trend towards online financial services, digital access is a social policy issue that goes beyond just competition. In its *UK digital strategy* (DCMS, 2017), the government proposes measures to ensure access to training in digital skills, but has so far failed to address other reasons why some consumers are not adopting online ways of managing their affairs. As Table 6.2 demonstrates, well over half of those who do not use the internet simply do not think it is relevant to them. However, automating shopping around for financial and household services might be an attractive option that draws some of these households into internet usage. One household in 11 worries about the cost of equipment and the same proportion worries about the cost of connection. In considering the cost burden for low-income households, it should be borne in mind that ongoing costs need to take account of security software, not just broadband connection, and equipment typically needs to be replaced every few years.

Table 6.2 Reasons households give for not having an internet connection, 2016

Reason	Proportion of households giving this reason % of households
Don't need internet	59
Lack of skills	21
Equipment costs too high	9
Access costs too high (broadband, phone)	9
Have access to internet elsewhere	8
Privacy or security concerns	6
Physical or sensorial disability	5
Other reason	15

Source: ONS (2016b).

6.28 Just as consumers are resistant to engaging with shopping now, they will not necessarily engage with automated shopping-and-switching services. However, if consumers do want the benefits of better deals but without the effort of finding them, automation could be an attractive proposition. Take-up might be slow-burn, though over time, marketing, word-of-mouth and new norms could create momentum. Moreover, automated shopping-and-switching may be subsumed into a much larger movement towards third-party financial services being driven by the increasing availability of personalised data originating from the consumers' interaction with providers, intermediaries and social media. For example, Reynolds (2017) speculates that open API (application programming interface) banking is the floodgate to new services built specifically on the opportunities for sharing and more efficient use of personal data. New services may specialise in aggregation of data from multiple sources, analysis of transactional and other data, monitoring of personalised options, recommendation and automation including payment. Reynolds is looking towards holistic services that go far beyond just automated shopping-and-switching and could involve delegating total money management to digital intermediaries.

Status and conflicts of interest

6.29 Consumers need to understand the status of the service they are dealing with and be confident that it is working in their interests. An automated shopping-and-switching service could be viewed as a sophisticated information and search service where the consumer is still ultimately making the choice decision through the data they have input or allowed to be transferred and choosing not to opt out. On the other hand, the algorithm could be viewed as delivering personalised outcomes that equate to regulated advice. Moreover, status within one service may differ depending on the products involved. Even if the intention of the service is simply to match price and product features to the consumer's stated needs, circumstances and preferences, there may nevertheless be a 'halo effect' where consumers incorrectly assume that the product identified is not just a good match but has been vetted and approved in some way.

6.30 CtrlShift (2014) identified seven business models for new generation intermediaries, which would be likely to apply to automated shopping-and-switching services. Many have an inherent misalignment of interests between the provider and its consumers:

- **Lead generation fees and commission**. This is the business model currently used by most price comparison websites. It can distort the service because it incentivises the intermediary to recommend providers and products that pay the highest fees or commissions. Where the intermediary controls the timing and frequency of review, it also creates an incentive to switch excessively ('churn') and reject the status quo even where this would be the best outcome.

- **Revenues from connecting buyers and sellers across related markets**. This exposes consumers to related products whether or not consumers want them. For example, services that provide 'free' credit reports, sell data on consumers' credit scores to lenders who then target ads at consumers who are most likely to be eligible. This may encourage consumers to borrow when they don't need to and discourage them from shopping around when they do.
- **Revenue from traditional display advertising**. This plays to consumers' availability bias (see section 4 above) and the aim is to make consumers more likely to buy the advertised product rather than shopping around.
- **Revenues from 'reverse advertising' or intent casting services**. Rather than providers advertising their wares, consumers initiate a transaction by advertising their needs and inviting providers to pitch to supply them. The intermediary receives a payment from the successful provider and this narrows the pool of 'search' to those providers willing to pay. This technique may be combined with collective purchasing (see paragraphs 6.50 to 6.54 below).
- **Revenue from market research**. An intermediary can track consumers' use of its services, gleaning valuable insights into consumer characteristics and their search and switching habits. This information can then be sold to providers who may then adjust the way they interact with consumers, for example, to exploit their behavioural traits or target advertising more narrowly.
- **Freemium fees**. A basic service is offered for free and consumers are invited to pay extra for additional services. Provided the offer is clear and there is no automatic transfer to the paid-for services (for example, at the end of a free trial period), this need not create a conflict of interest.
- **Membership fee**. Consumers pay a fee to cover the cost of the intermediary's service. This model aligns the interests of the intermediary and consumer.

6.31 The business models outlined above are all in current usage. Consumers typically perceive the intermediary service as free because the details of the model are tucked away in small print. All too often, consumers are unaware that they are paying, for example, through the selling on of their personal data or receiving product-search results that do not represent the whole market (CMA, 2015c; FCA, 2014). The regulatory approach to these issues is generally to require greater clarity and disclosure by firms in order to inform consumers' decisions – for example, the CMA (2015c) has stated that consumers should know when and how their data is being used and be given the choice over whether to participate. This fails to take into account the reality of these markets, as described in Sections 3 and 4 above, where consumers often have little effective choice when faced with unilateral contracts for the products they need and are already grappling with huge complexity created by firms' market-power strategies. The Panel (FSCP, 2015) has proposed cutting through this by requiring all financial services providers to have a general duty of care to consumers, obliging providers *to 'avoid conflicts of interest and act with the best interests of the customer in mind'* (p.1).

Trust, data security and liability

6.32 Consumers need to be able to trust an automated shopping-and-switching service. There are a number of dimensions to trust, one of which is being confident that the service is working in the interests of the consumer, as discussed above. The previous section also touched on the issue of data, in terms of trusting intermediaries to use data fairly in their business models. This must include respecting consumers' rights to data privacy, recognising their rights to control and use data about themselves, and the right to receive fair value where their data is to be used commercially by firms

(Citizens Advice, 2015). Crucially, consumers also need to be confident that their data will be stored securely, safe from hacking and criminal use.

6.33 This current research focuses on a fairly narrow shopping-and-switching service, so the amount of data aggregated by intermediaries offering this could be limited. If the more holistic services suggested by Reynolds (2017) develop, the amount of data aggregated within one intermediary could be substantial and deliver unprecedented opportunities for intermediaries to analyse and understand individual customers at a fine granular level which might not always be in the consumers' best interests – for example, if behaviours are interpreted as indicative of risks that make some people uninsurable. Therefore, a key aspect of trust is that consumers can be sure that concentration of their data in one place will not be unfairly exploited.

6.34 More pragmatically, consumers must be able to trust that the algorithms underpinning automated services are accurate, delivering the promised outcomes.

6.35 If there are failures of accuracy, data breaches or other problems, it must be clear where liability lies and consumers be confident that rapid, easy-to-access, no quibble compensation will be provided.

Regulation

6.36 It will be clear from the discussions above that regulators need to be involved in multiple ways, for example, clarifying the status of automated shopping-and-switching services, ensuring clarity around conflicts of interest or requiring a new duty of care, ensuring that consumers' data rights are clearly defined and enforced and making clear where liability lies when things go wrong.

6.37 Even focusing just on financial services, the regulatory responsibilities straddle the FCA, the CMA and the Information Commissioner's Office (which regulates data protection). If, as seems likely, individual automated shopping-and-switching services also embraced non-financial services, such as energy and communications, yet more regulators would become involved. Therefore, it is essential that regulators work collaboratively and take a joined-up approach to the development of such automated services.

6.38 Regulators also need to consider potential barriers to innovation in automated services. For example, before taking out financial products, consumers often must pass anti-money-laundering/countering the financing of terrorism (AML/CFT) checks. Automated switching would work more smoothly if checks completed with a previous provider were automatically transferred or new checks completed digitally, for example, using the GOV.UK Verify service[20].

6.39 Given the potential of these services to empower the demand-side of competition, it is to be hoped that regulators will proactively address the relevant issues ahead of automated services emerging and foster their development.

[20] https://www.gov.uk/government/publications/introducing-govuk-verify/introducing-govuk-verify

Changing consumer preferences

6.40 Consumers would need to update their profiles with the automated shopping-and-switching service whenever their needs, preferences or circumstances changed, otherwise recommendations would no longer be correctly aligned. Some data, such as usage, might be automatically updated through APIs and so would import changing usage patterns. Other changes may need to come direct from the consumer, but this assumes that consumers know their preferences ahead of any shopping around activity. Some theory (see, for example, Warren et al, 2010) suggests that, rather than revealing their preferences when they search, consumers may be constructing their preference during the process. In the context of shopping around, this might be particularly important where consumers become aware of previously unknown features and new types of product only during the search process. Thus, there is a risk that an automated system might unnecessarily restrain choice and inhibit innovation. However, algorithms could be built in such a way as to flag up related new products and the outcomes would, in any case, not be worse than Repeat-Passive consumption where consumers are also unlikely to be aware of innovative new features and products

Other policy options

6.41 In Figure 6.2, some other policy options were suggested that fall outside the categories of simplifying choice, expert advice or choosing for consumers. The FCA is a pioneer of developing behaviourally informed competition policies, such as more salient, better framed and more timely use of information and an excellent discussion is provided by Fletcher (2016). A few of the other options are briefly considered here.

Triggers

6.42 The challenge with all policy options that aim to move consumers from being Repeat-Passive to Rational is how to stimulate any engagement where the status-quo bias is dominant. The Panel survey found that the products consumers are most likely to rate shopping around for as worthwhile are motor and house insurance (see Box 6.2). However, attitudes do not necessarily translate into action. Research by Lowe (2015) found that rates of shopping around and switching were lower than the proportions in the Panel survey considering this to be worthwhile (also shown in Figure 6.2). Nevertheless, the pattern across products is similar whether looking at attitudes or actual shopping around and switching, with the incidence much higher for car and home contents insurance. An explanation commonly suggested is that the requirement to renew annually creates a natural trigger for the consumer to shop around. This raises the question: could triggers be artificially created for products that do not have a limited lifetime?

6.43 Policymakers in other areas are experimenting with creating triggers. For example, The Competition and Markets Authority (2016b) has ordered the establishment of a new database of energy consumers who have been paying their provider’s standard variable tariff for at least three years. The database will be available to rival firms so they can target these ‘disengaged’ customers. Possibly similar tactics could be applied to consumers of some types of financial products, such as those who have had low-paying savings accounts with their main bank for years or current account customers who have been with the same bank for prolonged periods. However, with some types of financial product, artificial triggering could be detrimental – for example, long-term health insurances where health conditions that have arisen since taking out the original policy would no longer be covered on switching.

Box 6.2 Attitudes towards shopping around

The Panel survey found that consumers, whether they have the product or not, are most likely to rate shopping around as worthwhile (rated 8-10 on a 10-point scale) when it is for car insurance, gas and electricity, broadband and phone and then home contents insurance. There is a tendency for younger people to be more ambivalent about shopping around and so more likely to give its worthwhileness a middle rating (score 4-7). Focusing just on consumers who have a particular financial product, they consider shopping for car and then home insurance as most worthwhile – see Figure 6.4. With the exception of personal loans, people who check their finances regularly are also more likely to shop around for the products they use.

Figure 6.4 also includes data from a survey by Lowe (2015) on the extent to which people who have different products report that they have shopped around and whether they switched to a different product. Lowe did not collect data for mortgages and personal loans. For the other products in Figure 6.4, three features stand out:

- Actual shopping around tends to be substantially lower than the proportion saying shopping around is worthwhile.
- Nevertheless, the pattern across products is maintained with actual shopping around being highest for car and home insurance and lowest for current accounts.
- The proportion switching is even lower and, with the exception of savings accounts, the pattern across products is again repeated with respondents most likely to switch car and home insurance and least likely to switch their bank account.

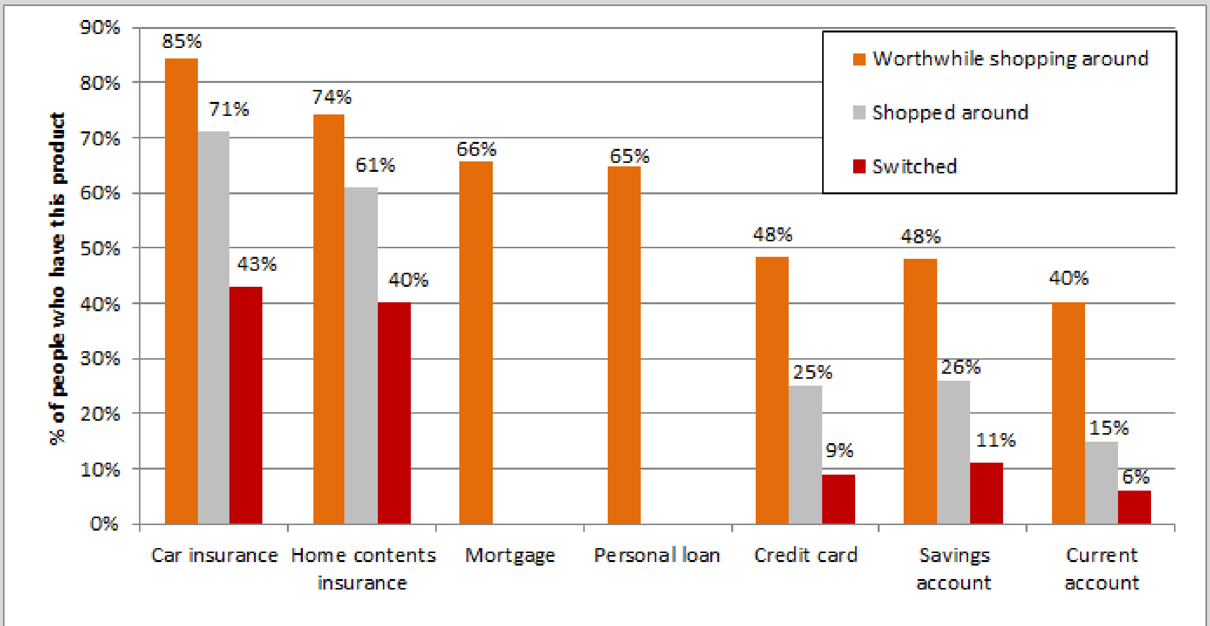


Figure 6.4 Proportions of users of each product who think shopping around for it is worthwhile, actually shopped around and switched
Sources: worthwhile (FSCP, 2016); shopped around and switched (Lowe, 2015)

6.44 Triggers, if effective, not only increase the quantity of shopping around but in doing so also increase consumers' experience of the products and so might improve the quality of shopping. Increased familiarity could improve consumers' understanding of products and this may feed through to more effective decisions even if System 1 (rapid, emotional, heuristic-driven) thinking is being used. There is a tendency to think of System 1 thinking and System 2 (rational) thinking as being mutually exclusive. However, drawing on neurological experiments, Damasio (1994|2006) shows that the two are linked. A plausible model is that, while System 1 thinking is used at the point of decision, this is often followed by a period of reflection during which an individual may question and adjust the heuristics they used, resulting in an improved rule of thumb next time the decision comes around.

Incentives

6.45 It is typically suggested that the savings from shopping around for any one service are in the region of hundreds of pounds, though this will vary with the customer's particular circumstances and the service concerned[21]. When consumers are made aware of the potential savings, this might be sufficient incentive to shop around and switch. However, it seems that many Repeat-Passive consumers are still not persuaded. More sophisticated cost-benefit information balancing the potential savings against the time required might be more effective, as could framing the potential savings as money lost rather than to be gained (and so playing to the behavioural trait whereby losses are roughly twice as significant to people as gains).

6.46 Another possible way of using incentives might be to enter consumers who shop around into a draw for a major prize. This type of approach works with consumers' present bias whereby they tend to overvalue benefits (and costs) today compared with those that will or may occur in future. Prizes and free gifts are sometimes used by firms as an inducement to engagement – examples include free gifts with over-50s life insurance, cuddly toys for users of a the Compare The Market price comparison website and, more unusually, a monthly prize draw for holders of Halifax savings accounts. However, if such a technique were intended to reward consumers for engagement in a market, it is not obvious how genuinely engaged consumers could be identified. For example, it would be easy to use a comparison website just to gain entry to the draw without conducting any genuine shopping around, while the result of genuine shopping around may be not to switch, so that switching would not be a reliable identifier (and the draw entry might create a perverse incentive to switch).

Financial education

6.47 The previous government made financial education a compulsory subject in the secondary school curriculum in England and similar requirements apply in the other UK nations. However, for personal finance teaching to be effective requires sufficient time in the curriculum and enough money to train teachers and support them with resources. It is too early to know whether this new education is working or will make a difference to consumer outcomes once these younger generations enter financial services markets.

6.48 It is generally accepted that it is important to equip young people with the skills to manage their personal finances. However, as Section 3 above has discussed, consumers are required to deploy their financial skills and knowledge in markets which lack transparency and are made overly complicated by firms' market-power strategies. It is asking too much of financial education to counterbalance the supply-side problems of the industry.

[21] For example, in a period of low interest rates, the benefit from shopping around for savers with low balances may be just a few pounds a year.

Improving the power of Rational-Active consumers

6.49 Figure 6.5 repeats the Rational-Active segment from Figure 5.2 as a reminder that, even when consumers do engage, there are still multiple reasons why they may not be able to drive competition effectively, as discussed in Sections 3 to 5 above. The key problem is that firms may create market power through strategies such as price obfuscation and unnecessary product complexity, while consumers' behavioural traits may reinforce firms' market power. Consumers seem to have little choice but to struggle through sifting the many and complicated products that firms have put onto the market in the hope of finding those that met their needs and appear to be offered at a good price. Consumer power would be strengthened considerably if they could turn the table, starting with their own needs, preferences and circumstances and requiring firms to respond with an appropriate offer. Collective purchasing aims to do just that.

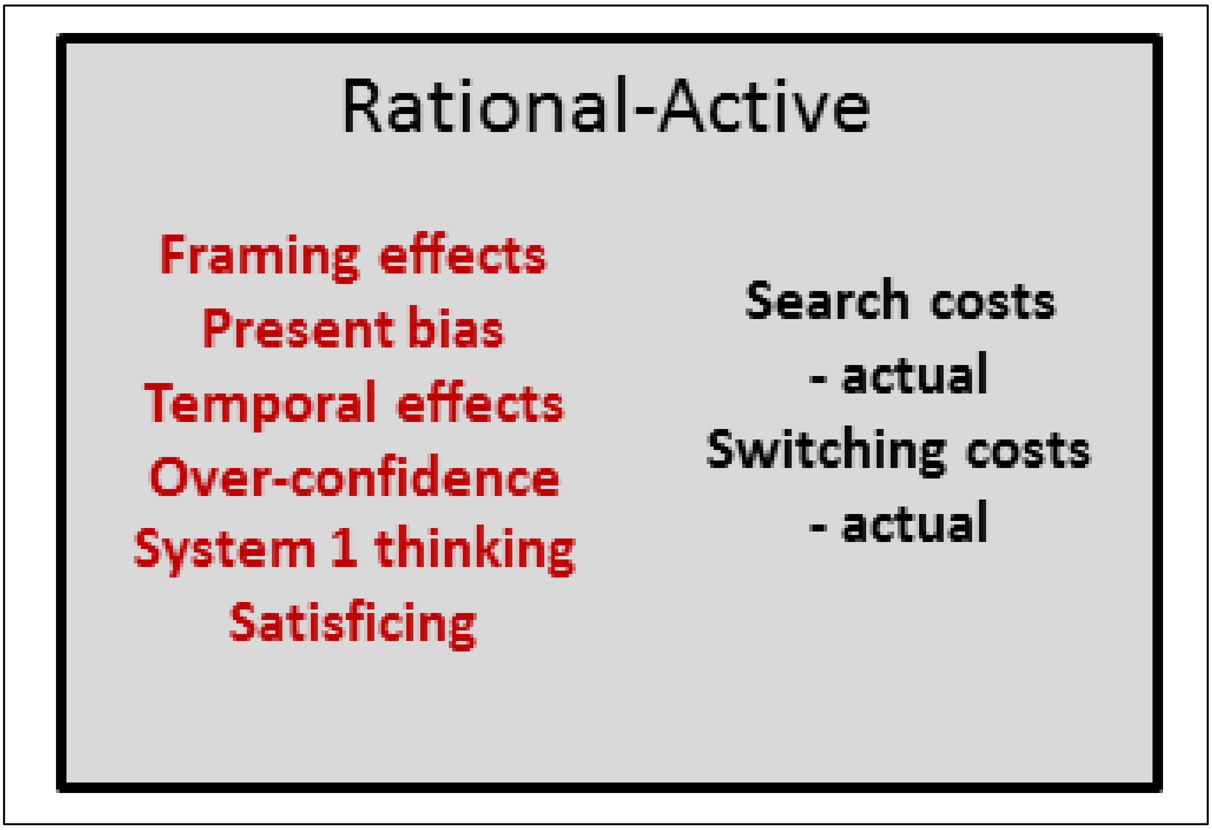


Figure 6.5: Factors that may distort Rational-Active behaviour

Collective purchasing

6.50 Collective purchasing (also called group purchasing initiatives) started in China, where consumers would form groups using the internet and then physically visit a store en masse to use their collective buying power to get a superior deal on the target product for everyone in the group (Wei et al, 2011). In the UK, similar but wholly online schemes have been used to negotiate group deals for energy, insurance and other products. There are basically four ways in which collective purchasing schemes work:

- An intermediary firm initiates the process by negotiating deals with suppliers then seeks out consumers to form a group. This is the model used by, for example, MoneySavingExpert Big

Switch and the website Groupon). The numbers of consumers involved can be huge – for example 140,000 in the case of the last MSE Big Switch (MSE, 2016). A reduced price applies to all consumers in the group, provided a pre-set volume threshold is met – and there could be tiers of thresholds. The deal might include special product and service features not just a price reduction.

- An intermediary firm gathers consumers together and then negotiated deals with suppliers. An example is the website BoughtByMany which helps consumers with particular needs find reasonably priced insurance. Typically, this model might require a minimum of, say, 100 consumers.
- A group forms, for example, by signing up on a website or through social media. The group collectively researches and chooses the target product and negotiates with a chosen supplier for a discount and possibly other preferential terms. This type of model is suitable for fairly small groups and, to be manageable, someone in the group is usually appointed to lead the venture (Wei et al, 2011).
- A group forms as above and then reverse advertising (see paragraph 6.30 above) is used to invite providers to supply the whole group. This model underpins a typical community energy scheme.

6.51 For collective purchasing to work, there must be some economies of scale for providers in supplying the whole group. This suggests there needs to be some homogeneity across the consumers in terms of their needs or at least a dominant feature that they all share. Collective purchasing might be difficult for products that are individually tailored, such as loans where rates and terms are dependent on individual credit score or health insurance if individually underwritten. Consumers may need to compromise, paying less, but not getting exactly the product they would have chosen if shopping on their own or having to wait longer than they wanted while the deal is negotiated. In some cases, the negotiated price may be lower for most consumers, but higher than some would have paid buying on their own. Where an intermediary firm is involved, it will take a cut of the price savings[22], which may create a focus on price rather than quality. It is essential that consumers in the group can trust the intermediary firm or any individual who acts as leader and safer if each consumer pays the provider direct.

6.52 Collective purchasing does not have to be organised through the internet. A common alternative example is where employers negotiate benefits, such as pension schemes and health insurance for their workforce.

6.53 Collective purchasing can increase consumer negotiating power and so drive competition more effectively. It may also reduce search costs, including mental effort, because search is either delegated to an intermediary or others in the group, or consumers can pool their efforts by sharing information. Perversely, collective purchasing could reduce competition if providers use it as an opportunity to cross-sell other products or foster a long-term relationship with the group to encourage brand loyalty.

6.54 Collective purchasing could possibly be combined with the type of automated services described in paragraphs 6.19 to 6.21 above. The algorithm underpinning the automated service could identify and match consumers with similar needs, circumstances and preferences and then use reverse advertising (see paragraph 6.30 above) to invite providers to bid for supplying the group.

[22] For example, with BoughtByMany (Digital Insurance Agenda, 2016) one-third of the savings goes to each of the website, the supplier and the consumer. With MSE (2016), BigSwitch suppliers pay MSE £60 per dual fuel switch, of which half went to the customer, £19 to data and switch partners and £11 to MSE.

7: Meaningful metrics

7.1 The challenges in measuring competition start with defining a market. In the ideal of perfect competition (discussed in Section 3), all firms produce the same homogeneous product. In the more common reality of monopolistically competitive markets, product differentiation (genuine and spurious) is widespread, begging the question of when is a product difference a variation on existing products in the same market and when does it signal a separate market? The FCA (2016c) reports that it is responsible for over 100 separate markets across the activities it regulates.

7.2 Having identified the market, there is no way to measure directly whether competition is working well. Instead, it is necessary to look at the characteristics and outcomes of the market. Traditionally, competition authorities have focused on market structure, with measures such as concentration indices and the number of new entrants. These are still important, but sit alongside a very wide range of other metrics, particularly since the integration of behavioural economics into competition regulation. Metrics include firms' price, cost and profitability data (the last two of which are usually considered to be commercially sensitive and so not publicly disclosed) and consumer shopping around and switching behaviour (FCA, 2016c). Switching data is a particularly contentious measure because the rational outcome of shopping around might be not to switch if expected benefits do not outweigh costs. Moreover, as a market approaches the ideal of perfect competition, the necessity for, and pay-off from, switching would decline. (Paradoxically, this would also reduce the incentive for consumers to shop around even though continued shopping around would be required to maintain perfect competition.)

Outcomes and incentives

7.3 If competition is working well for consumers, a market should be characterised by low and fairly consistent prices, good quality across the whole market and high levels of satisfaction. If firms have limited opportunities to create and use market power, then pricing should normally be simple and transparent and products fairly straightforward and similar. A good metric should aim to capture these outcomes and also provide feedback that incentivises firms to behave in ways that reinforce competition. With a focus on these requirements, the following metrics (summarised in Figure 7.1) might be indicators of whether competition is working well for consumers:

- **Product similarities.** A measure of whether products, as a minimum, match a set of core features (as referred to in paragraph 6.8 above). At a product or firm level, this metric indicates to consumers that their basic needs will be met by this product and so firms may be incentivised meet this threshold and avoid 'hollowing out'. At the market level, it provides a measure of basic product homogeneity and could help regulators and customers to see through spurious product differentiation.
- **Price differentials.** This could provide a measure of price discrimination by requiring firms to publish the average price for specified types of consumer – for example, a representative existing customer and identical new customer, the averages for groups of customers of specified types, or for groups representative of firms' actual customer base (in a similar way to the requirements for publishing indicative APRs). At the firm level, this would alert customers to the different treatment of similar customers in different groups and an incentive for firms to reduce price discrimination. At the market level, it would provide an indicator of the degree of price discrimination. However, it might be difficult to construct the measure in a way that cannot be gamed by firms.
- **Average prices.** The focus here would be on price level rather than price differentials. At a firm level, consumers would be able to compare the individual firm's average price level against the average for the market, which would alert customers to high-charging firms and incentivise those firms to reduce prices. At a market level, the data could be used to measure both the average level of charges and the dispersion around the average, both of

which would tend to be low if competition was working well. However, publishing this type of data might encourage tacit collusion between firms. In addition, the average price level used would need careful consideration. For example, a firm that was more willing to accept niche customers might justifiably have a higher average price per customer than a firm that cherry-picked mainstream consumers[23].

- **Claims frequency and pay-out ratios.** This is an indicator of quality of insurance products. At the firm level, it would alert consumers to firms offering a low quality product in terms of delivering the promised benefits and incentivise firms to improve. At the market level, it could indicate whether 'supernormal' profits are being made.
- **Reputation measures**. Composite indices of the reputation of firms, including for example, frequency of complaints as a ratio of customer base and incidence and amount of fines. At a firm level, this would alert customers to firms that do not prioritise customer service and create an incentive for firms to improve. At the market level, it would serve as an indicator of quality.

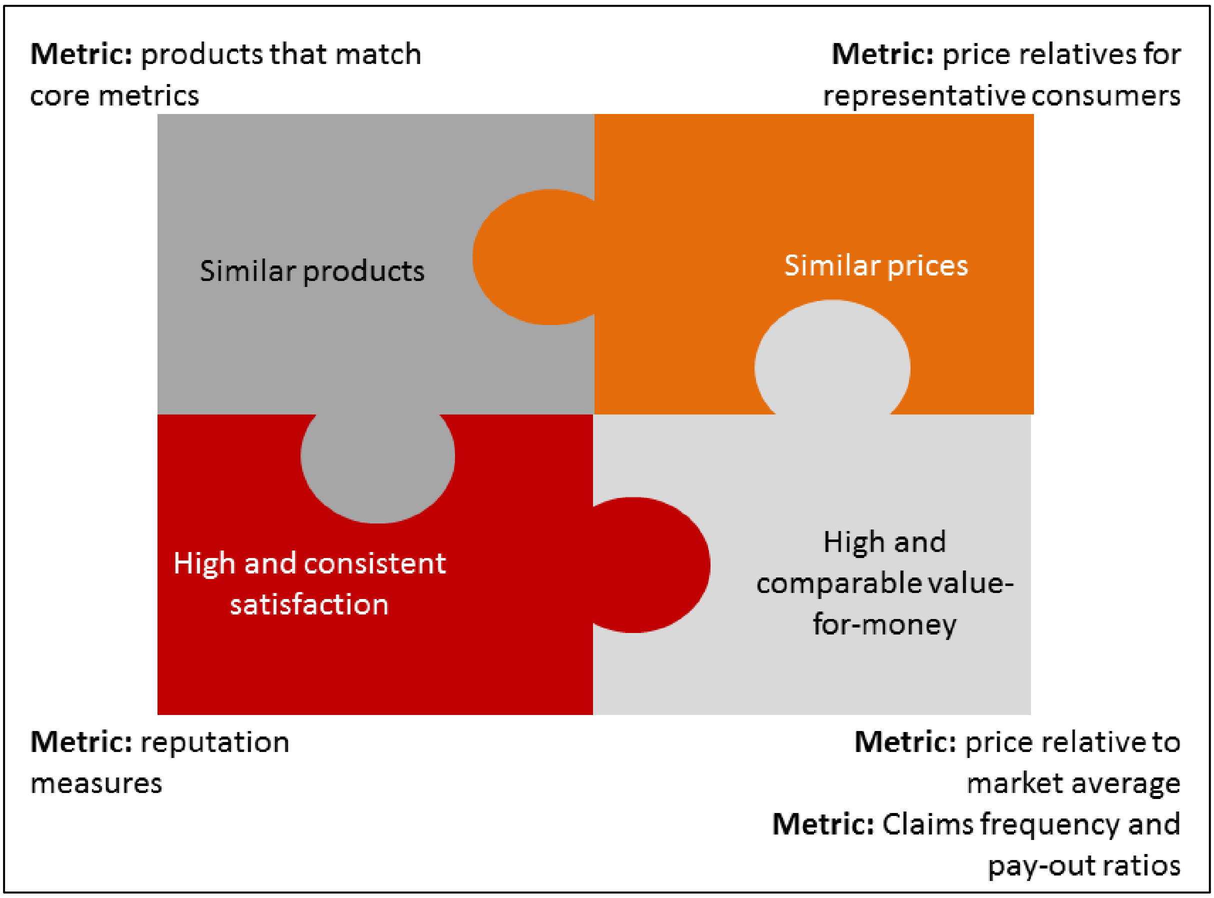


Figure 7.1 Consumer-facing features of perfect competition and related metrics

7.4 The metrics described in 7.3 would be published and available both direct to consumers and for incorporation in the type of automated shopping-and-switching services described in Section 6 and other forms of information and advice services. Since they play directly back into the assessment and publication of providers' product quality and service standards, it is to be hoped that metrics

[23] Similar to the way in which, say, a hospital might have higher death rates if it is more willing to take on difficult-to-treat patients or to offer pioneering treatments.

along these lines will play a part in, for example, the FCA (2016f) review of service quality information to consumers of retail banking.

7.5 In addition, as a measure of consumer engagement, the following metric could be used:

- **Comparison searches**. The number of unique searches on price comparison websites and similar services by consumers and the automated shopping-and-switching services described in Section 6, relative to holders of the product. This would provide a market-level indicator of shopping around activity.

7.6 The metrics as described might not have precisely the format and detail that proves feasible in practice, but they aim to demonstrate an approach that relates metrics directly to desirable outcomes for consumers. In this way they would be indicators not just of competitive conditions in a general sense but evidence of whether competition is working well *in the interests of consumers*.

8: Conclusions

8.1 Regulators currently place heavy reliance on consumers to drive competition by shopping around in multiple markets for financial services and other services, such as energy and communications. This ideal of the rational, active consumer stems from the ideal of perfect competition, which economic theory shows delivers the most efficient allocation of resources in an economy, the most efficient means of production and the greatest welfare for society.

8.2 However, the expectations placed on consumers look unrealistic because:

- Perfect competition seldom, if ever, exists in reality. In most retail financial services markets, it is in firms' interests to create and maintain market power. They do this through strategies, such as price discrimination, price obfuscation, product bundling and complexity and promotion of brands. The result is markets that are overly complicated and products that are difficult or impossible to compare. Even the most financially capable consumers face a battle to find value-for-money in markets like these.
- Price comparison websites are designed to help consumers make product comparisons, but often focus too heavily on headline price, ignoring other essential factors, such as product features and quality of service. Firms can 'game' price comparison sites by 'hollowing out' products and using a variety of ancillary charges.
- Consumers are prone to behavioural traits that get in the way of their ability to drive competition and may be deliberately exploited by firms. Competition regulators have a growing understanding of these traits, treating them as a new type of barrier to competition, and seeking either to alter consumer behaviour or adopt policies that work with the grain of consumers' actual behaviour. However, the aim of these policies is still to foster more active shopping around and switching.
- Competition regulators may be misinterpreting widespread consumer decisions not to engage with shopping around as behavioural barriers, when in reality they may be rational choices based on consumers' preferences about how they wish to spend their time and mental effort.

8.3 Throughout history, people have welcomed labour-saving devices that replace onerous tasks freeing them to spend their time and effort on other activities. The time has come to accept that, for many consumers, shopping around for financial services in complex markets is a stressful, unpleasant and effortful task that can be automated and replaced, just as washing machines replaced Monday washdays, spreadsheets replaced the mental toil of manual calculation, and driverless cars may replace driving. Computerised algorithms are widely used in financial services by firms to handle complex calculations, for example, to calculate insurance risks and credit scores. It is time that consumers had similar tools to replace the burden of shopping around and switching in complex markets.

8.4 Experiments show that computers are better than consumers at selecting optimal outcomes in complex financial markets. Therefore, in addition to delivering better consumer outcomes, automated shopping-and-switching services will enhance consumer power, reducing or eliminating the pay-off to firms from price obfuscation and product complexity, thus reducing or removing the incentive to use market-power strategies.

8.5 Digital innovation is already moving in this direction. There is a convergence between initiatives, such as open API banking, that will enable greater and more efficient sharing of data, and innovation from new and existing service providers interested in creating greater personalisation and functionality from information services. As with all innovation, there are issues to be addressed, especially around access, trust and data security. Regulators will need to collaborate to address these issues and foster the emergence of these new services. An analogy may be drawn with driverless cars, where there are questions to be answered over, for example, insurance and liability if a driverless car is involved in an accident. While the problem is knotty, no one seriously doubts that driverless cars will happen. In the same way, the question is not whether automated services will replace shopping around and switching, but how soon this will become the norm.

8.6 If competition is working well for consumers, a market should be characterised by low and fairly consistent prices, good quality across the whole market and high levels of satisfaction. If firms have limited opportunities to create and use market power, then pricing should normally be simple and transparent and products fairly straightforward and similar. A good metric should aim to capture these outcomes and also provide feedback that incentivises firms to behave in ways that reinforce competition. By relating metrics directly to desirable outcomes for consumers, they would be indicators not just of competitive conditions in a general sense but evidence of whether competition is working well in the interests of consumers.

References

Association of British Insurers (ABI) (2014) *Concordat and moratorium on genetics and insurance* [online] https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2014/Genetics/Concordat%20and%20Moratorium%20on%20Genetics%20and%20Insurance.pdf (accessed 3 February 2016).

Bates (2014) *Next generation intermediaries. Examiniming a new approach to engagement that offers consumers better outcomes for less effort* [online] http://webarchive.nationalarchives.gov.uk/20140326151011/http://www.consumerfutures.org.uk/reports/next-generation-intermediaries-examining-a-new-approach-to-market-engagement-that-offers-consumers-better-outcomes-for-less-effort (accessed 27 February 2017).

Beckett, A., Hewer, P. and Howcroft, B. (2000) 'An exposition of consumer behaviour in the financial services industry' in *International Journal of Bank Marketing*, Vol 18, issue 1, pp.15-26.

British Insurance Brokers Association (2016) 'Response to statement of scope' in CMA (2016) *Digital comparison tools market study* [online] https://www.gov.uk/cma-cases/digital-comparison-tools-market-study (accessed 2 March 2017).

Burnham, A.B., Frels, J.K. and Mahajan, V. (2003) 'Consumer switching costs: a typology, antecedents, and consequences' in *Academy of Marketing Science Journal*, Spring, 31,2, pp.109-126.

Chaudhuri, A. and Holbrook, M.B. (2001) 'The chain effect from brand trust and brand affect to brand performance: the role of brand loyalty' in *Journal of Marketing*, April, Vol. 65, pp.81-93.

Citizens Advice (2015) *Personal data empowerment. Time for a fairer deal?* [online] https://www.citizensadvice.org.uk/Global/Public/Corporate%20content/Publications/Personal%20data%20empowerment%20report.pdf (accessed 28 February 2017).

Clayton, M., Davidson, G., Leston, J., Lyon, A. and Wells, J. (2013) *Consumer responsibility. Identifying and closing the gap. Report prepared for the FCA Practitioner Panel* [online] https://www.fca-pp.org.uk/sites/default/files/fca_practitioner_panel_consumer_responsibility_report_september_2013.pdf (accessed 3 October 2016).

Collaborate Research (2015) Empowering Consumers as Coregulators: Firm conduct information for consumers. Final report [online] https://www.fs-cp.org.uk/sites/default/files/**consumers-coregulators**-research-2015.pdf

Collard, S., Coppack, M., Lowe, J. and Sarkar, S. (2016) *Access to financial services in the UK* FCA Occasional Paper 17 [online] https://www.fca.org.uk/publication/occasional-papers/occasional-paper-17.pdf (accessed 30 January 2017).

Competition and Markets Authority (CMA) (2016a) *Retail banking market investigation. Final report* [online] https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf (accessed 1 March 2017).

Competition and markets Authority (CMA) (2016b) *Energy Market investigation. Explanatory note. The Energy Market Investigation (Database) Order 2016* [online] https://assets.publishing.service.gov.uk/media/585bf999ed915d0b120000ed/database-order-explanatory-note-energy-market.pdf (accessed 6 March 2017).

Competition and Markets Authority (CMA) (2015a) *Payday lending market investigation. Final report* [online] https://assets.publishing.service.gov.uk/media/54ebb03bed915d0cf7000014/Payday_investigation_Final_report.pdf (accessed 1 March 2017).

Competition and Markets Authority (CMA) (2015b) *Retail banking market investigation. Provisional findings report* [online] https://assets.publishing.service.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf (accessed 11 January 2017).

Competition and Markets Authority (CMA) (2015c) *Commercial use of consumer data. Report on the Commissions call for information* [online] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/435817/The_commercial_use_of_consumer_data.pdf (accessed 28 February 2017).

Competition Commission (2009) Payment protection insurance market investigation [online] http://webarchive.nationalarchives.gov.uk/20140402141250/http:/www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/542.pdf (accessed 11 January 2017)

Costa, E., King, K., Dutta, R. and Algate, F. (2016) *Applying behavioural insights to regulated markets* [online] https://www.citizensadvice.org.uk/Global/CitizensAdvice/Consumer%20publications/Applying-behavioural-insights-to-regulated-markets.pdf (accessed 10 January 2017).

Ctrl-Shift (2014) *The rise of the consumer empowering intermediary* [online] http://webarchive.nationalarchives.gov.uk/20140326151011/http://www.consumerfutures.org.uk/files/2014/01/The-Rise-of-the-Consumer-Empowering-Intermediary-Ctrl-Shift.pdf (accessed 28 February 2017).

Damasio, A. (1994|2006) *Descartes' Error*, London, Vintage.

Darby, M.R. and Karni, E. (1973) 'Free competition and the optimal amount of fraud' in *The Journal of Law and Economics*, Vol 16, No 1 (April), pp.67-88.

Department for Culture, Media & Sport (DCMS) (2017) *UK digital strategy* Policy paper [online] https://www.gov.uk/government/publications/uk-digital-strategy (accessed 1 March 2017).

Department for Work and Pensions (2006) *Personal accounts: a new way to save* [online] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/272383/6975.pdf (accessed 3 March 2017).

Digital Insurance Agenda (2016) *Bought By Many: the next generation insurance intermediary* [online] http://www.diabarcelona.com/bought-by-many-the-next-generation-insurance-intermediary/ (accessed 31 January 2017).

Europe Economics (2016) *The economic impact of improved financial capability. Final report* [online] http://www.europe-economics.com/publications/15/2/00000/publications.htm (accessed 28 February 2017).

Festinger, L. (1962) 'Cognitive dissonance' in *Scientific American* , October, Volume 207 No 4 pp.93-106.

Financial Conduct Authority (FCA) (no date) *FCA Handbook* [online] https://www.handbook.fca.org.uk/handbook (accessed 4 January 2017).

Financial Conduct Authority (FCA) (2017) *General insurance values measures pilot* [online] https://www.fca.org.uk/publications/data/gi-value-measures-pilot (accessed 1 March 2017).

Financial Conduct Authority (FCA) (2016a) *Packaged bank accounts* TR16/8 [online] https://www.fca.org.uk/publication/thematic-reviews/tr16-8.pdf (accessed 1 March 2017).

Financial Conduct Authority (FCA) (2016b) *Increasing transparency and engagement at renewal in general insurance markets – feedback on CP15/41 and final rules and guidance* PS16/21 [online] https://www.fca.org.uk/sites/default/files/ps16-21.pdf (accessed 14 February 2017).

Financial Conduct Authority (FCA) (2016c) *Competition Report 2013-16* [online] https://www.fca.org.uk/publication/corporate/competition-report-2013-16.pdf (accessed 4 January 2017).

Financial Conduct Authority (FCA) (2016d) *Embedding the Mortgage Market review: Responsible lending review* TR16/4 [online] https://www.fca.org.uk/publication/thematic-reviews/tr16-04.pdf (accessed 2 March 2017).

Financial Conduct Authority (FCA) (2016e) *Smarter consumer communications* FS16/10 [online] https://www.fca.org.uk/publication/feedback/fs16-10.pdf (accessed 3 March 2017).

Financial Conduct Authority (FCA) (2016f) *Our response to the CMA's final report on its investigation into competition in the retail banking market* [online] https://www.fca.org.uk/publication/corporate/response-cma-final-report-competition-retail-banking-market.pdf (accessed 5 March 2017).

Financial Conduct Authority (FCA) (2015a) *Cash savings market study report. Part I: Final findings. Part II: Proposed remedies* [online] https://www.fca.org.uk/publication/market-studies/cash-savings-market-study-final-findings.pdf (accessed 1 March 2017).

Financial Conduct Authority (2015b) *Retirement income market study: Final report – confirmed findings and remedies* MS14/3.3 [online] https://www.fca.org.uk/publication/market-studies/ms14-03-3.pdf (accessed 1 March 2017).

Financial Conduct Authority (FCA) (2015c) *General insurance add-ons market study – Remedies: banning opt-out selling across financial services and supporting informed decision-making for add-on buyers* PS15/22 [online] https://www.fca.org.uk/publication/policy/policy-statement-15-22-general-insurance-add-ons.pdf (accessed 1 March 2017).

Financial Conduct Authority (FCA) (2015d) *Guaranteed asset protection insurance: competition remedy* PS5/13 [online] https://www.fca.org.uk/publication/policy/ps15-13.pdf (accessed 1 March 2017).

Financial Conduct Authority (FCA) (2015e) *FCA symposium: competition analysis with real behaviour* [online] http://londoneconomics.co.uk/blog/publication/fca-symposium-competition-analysis-with-realistic-behaviour-december-2015/ (accessed 22 January 2017).

Financial Conduct Authority (FCA) (2014) *Price comparison websites in the general insurance sector* TR14/11 [online] https://www.fca.org.uk/publication/thematic-reviews/tr14-11.pdf (accessed 28 February 2017).

Financial Services Authority (FSA) (2012) *Mortgage Market Review. Feedback on CP11/31 and final rules* [online] https://www.fca.org.uk/publication/policy/fsa-ps12-16.pdf (accessed 2 March 2017).

Financial Services Authority (FSA) (2008) *Consumer responsibility* DP08/5 [online] http://www.fsa.gov.uk/pubs/discussion/dp08_05.pdf (accessed 4 October 2016).

Financial Services Consumer Panel (FSCP) (2017) *Consumer and competition survey: analysis* [unpublished].

Financial Services Consumer Panel (FSCP) (2015*) Incorporating a duty of care into the Financial Services and Markets Act* [online] https://www.fs-cp.org.uk/sites/default/files/fscp_position_paper_on_duty_of_care_2015.pdf (accessed 9 May 2016).

Financial Services Consumer Panel (FSCP) (2014) *Cross-subsidisation in the personal current account market Discussion Paper* [online] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/370876/Financial_Services_Consumer_Panel_discussion_paper.pdf (accessed 25 February 2017).

Fletcher, A. (2016) *The role of demand-side remedies in driving effective competition. A review for Which?* [online] http://www.staticwhich.co.uk/documents/pdf/the-role-of-demand-side-remedies-in-driving-effective-competition-456067.pdf (accessed 8 January 2017).

Grubb, M.D. (2015) 'Failing to choose the best price: theory, evidence and policy' in *Review of Industrial Organization*, November 2015, Vol. 47 Issue 3, pp.303-340.

Heding, T., Knudtzen, C.F. and Bjerre, M. (2016) *Brand Management. Research, Theory and Practice*, Abingdon, Routledge.

Huck, S., Zhou, J. and Duke, C. (2011) *Consumer behavioural biases in competition* Report for the Office of Fair Trading [online] http://londoneconomics.co.uk/wp-content/uploads/2012/06/Consumer-behavioural-biases-in-competition-OFT1.pdf (accessed 13 May 2015).

Iyengar, S.S. and Lepper, M.R. (2000) When choice is demotivating: can one desire too much of a good thing?' in *Journal of Personality and Social Psychology*, Vol 79, No 6, pp.995-1006.

Kalayci, K. and Potters, J. (2011) 'Buyer confusion and markets prices' in *International Journal of Industrial Organisation*, Vol 29, Issue 1, January, pp.14-22.

Kahneman, D. (2011) *Thinking fast and slow*, London, Penguin.

Kahneman, D. and Tversky, A. (1979) 'Prospect theory: an analysis of decision under risk' in *Econometrica* (1979) Vol 47, No 2, March, Princeton, The Econometric Society, pp.263-292.

Lichtenstein, S. and Fischoff, B. (1977) 'Do those who know more also know more about how much they know?' in *Organizational Behavior and Human Performance*, Vol.20(2), pp.159-183.

Lowe, J. (2015) *Consumer behaviour and attitudes when shopping around for multiple financial and household services* Working paper [online] http://www.open.ac.uk/business-school-research/pufin/resources-events (accessed 30 January 2017).

Loewenstein, G. & Thaler, R.H. (1989) 'Anomalies: intertemporal choice' in *The Journal of Economic Perspectives*, Vol 3, No 4 (Autumn 1989), pp.181-193.

MoneySavingExpert.com (2016) *MSE Big Energy Switch Event 5: British gas £300/yr saving for new and existing customers* [online] http://www.moneysavingexpert.com/news/energy/2016/09/new-mse-big-energy-switch-event-5--british-gas-300yr-saving-for-new--existing-customers (accessed 31 January 2017).

Ofcom (2016). *Adults' media use and attitudes 2016* [online] https://www.ofcom.org.uk/research-and-data/media-literacy-research/adults-media-use-and-attitudes (accessed 18 February 2017).

Office for National Statistics (ONS) (2016a) 'Table 1b' in *Internet users* [online] https://www.ons.gov.uk/businessindustryandtrade/itandinternetindustry/bulletins/internetusers/2016/relateddata (accessed 18 February 2017).

Office for National Statistics (ONS) (2016b) 'Table 29' in *Internet access – households and individuals* [online] https://www.ons.gov.uk/peoplepopulationandcommunity/householdcharacteristics/homeinternetandsocialmediausage/datasets/internetaccesshouseholdsandindividualsreferencetables (accessed 5 March 2017).

Oyunge, T (2016) *Against the clock. Why more time isn't the answer for consumers* [online] https://www.citizensadvice.org.uk/Global/CitizensAdvice/Consumer%20publications/Finalreport-Againsttheclock.pdf (accessed 9 January 2017).

Reynolds, F. (2017) *Open banking: a consumer perspective* [online] http://newcityagenda.co.uk/wp-content/uploads/2017/01/Open-Banking-Print-Ready-A4.pdf (accessed 28 February 2017).

Samuelson, W. and Zeckhauser, R. (1988) ‘Status quo bias in decision making’ in *Journal of Risk and Uncertainty*, 1: pp.7-59.

Shugan, S.M. (1980) ‘The cost of thinking’ in *Journal of Consumer Research*, Vol 7, No 2 (Sep):, pp.99-111.

Simon, Herbert A. ‘satisficing’ in *The New Palgrave Dictionary of Economics*. Second Edition. Eds. Steven N. Durlauf and Lawrence E. Blume. Palgrave Macmillan, 2008. The New Palgrave Dictionary of Economics Online. Palgrave Macmillan. 14 February 2017 <http://www.dictionaryofeconomics.com.libezproxy.open.ac.uk/article?id=pde2008_S000013> doi:10.1057/9780230226203.1471

Stanovich, K.E. and West, R.F (2000) ‘Individual differences in reasoning: implications for the rationality debate’ in *Behavioural and Brain Sciences* 23, pp.645-726. Available online at http://psy2.ucsd.edu/~mckenzie/StanovichBBS.pdf (accessed 10 September 2015).

Trustnet (2003) *Stakeholder pensions ‘doomed to be a failure’ – ABI* [online] https://www.trustnet.com/News/DisplayStory.aspx?id=25204 (accessed 17 February 2017).

Tversky, A. and Kahneman, D. (1974) 'Judgment under uncertainty: heuristics and bias' in *Science* 185 (1974), pp.1124-31.

Tversky, A. and Kahneman, D. (1981) 'The framing of decisions and the psychology of choice' in *Science* 211 (1981), pp.453-58.

UK. *Financial Services and Markets Act 2000* : Elizabeth II. Chapter 8 (2000) London, The Stationery Office. Available online at www.legislation.gov.uk.

UK. *Water Act 2014*: Elizabeth II. Chapter xx (2014) London, The Stationery Office. Available online at www.legislation.gov.uk.

UK Regulators Network (UKRN) (2016) *Price comparison websites. Final report* [online] http://www.ukrn.org.uk/wp-content/uploads/2016/09/201609027-UKRN-PCWs-Report.pdf (accessed 17 February 2017).

Varian, H.R. (2010) *Intermediate microeconomics* 8th edition, New York, W.W. Norton & Co.

Warren, C., McGraw, A.P. and Van Boven, L. (2010) *Values and preferences: defining preference construction* [online] http://leeds-faculty.colorado.edu/mcgrawp/pdf/warren.mcgraw.vanboven.inpress.pdf (accessed 5 March 2017).

Waterson, M. (2001) *The role of consumers in competition and competition policy* Working paper [online] http://www2.warwick.ac.uk/fac/soc/economics/research/workingpapers/2008/twerp607.pdf (accessed 29 December 2016).

Wei, Y., Straub, D.W. and Poddar, A. (2011) ‘The power of many: an assessment of managing internet group purchasing’ in *Journal of Electronic Commerce Research*, Vol 12 No. 1. Also available online at http://www.jecr.org/node/334.

Wheatley, M. (2012) in Parliamentary Commission on Banking Standards (2012) *Minutes of Evidence* HL Paper 27-III/HC 175-III [online] https://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/121025.htm (accessed 17 February 2017).

Appendix: Straw-man proposal

This Appendix summarises the core proposal in this research for automated shopping-and-search services as a way of increasing the power of consumers in driving competition and improving consumer outcomes. It can be used as a stimulus for discussion and feedback.

Consumers and Competition

Delivering more effective consumer power in retail financial markets

Aim:

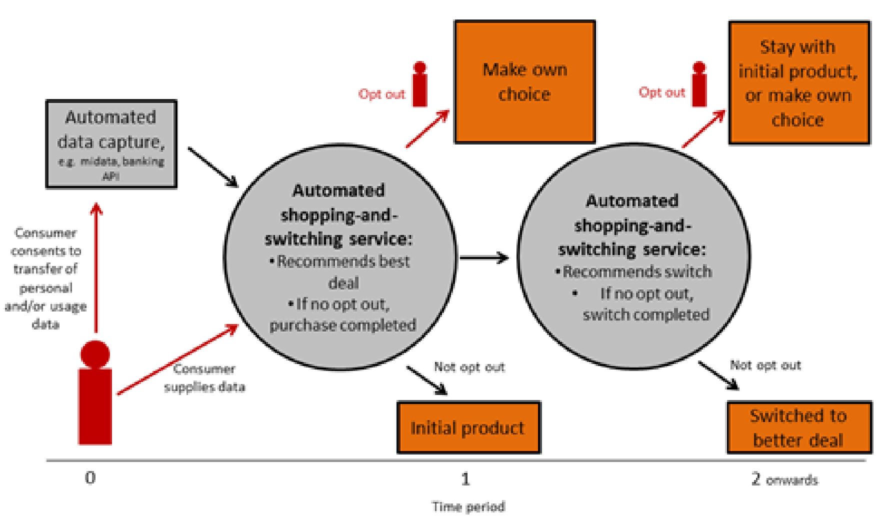
- Retail financial services markets that function well for consumers:
  - more effective competition in the interests of consumers;
  - better outcomes for consumers.

The problem:

- Firms' drive to make profits can mean competing for customers by offering the best products at the lowest prices. It can also mean using strategies to gain market power, including: price discrimination, price obfuscation and excessive product complexity.
- For markets to work well, consumers need to balance firms' market power, but are ill-equipped to do this because they have behavioural traits that work against their ability to shop effectively and can increase firms' market power.
- In addition, consumers may rationally choose not to engage with complex markets because they prefer to spend their time and mental effort in other ways.

Current regulatory focus:

- The FCA is building behavioural factors into its competition thinking. It aims to change consumer behaviour or work with their behavioural traits. The desired result is more consumers shopping around and switching providers.



How it could work

- Consumer chooses to use an automated shopping-and-switching service.
- The consumer provides required personal and usage data and/or gives permission for transfer of data from their previous provider or a centralised data store. Data from the consumer includes relevant information about their particular needs and preferences.
- The automated service identifies a best match to product and firm, using an algorithm to compare on the basis of pricing, product features and, where available, quality metrics, weighted according to the consumers' stated needs and preferences and matched to their personal details and circumstances.
- The consumer is notified of the recommendation and may opt out within a specified time; otherwise the service automatically completes the purchase.
- The automated service re-runs the search at specified times – for example, as the end of a fixed-term deal approaches or annually.
- If a better deal is identified, the consumer is notified of the new recommendation and may opt out within a specified time; otherwise, the service automatically completes the switch.

A different solution:

- The FCA should give equal priority to encouraging the development of automated shopping-and-switching services.
- Research shows computers are better than consumers at identifying the best options in complex markets.
- Labour-saving devices have been used throughout history. Why not the time-saving and cognitive-effort-saving device of automated shopping around?
- New services already include post-sale shopping around and prompts to consumers to switch. It would be a small step to change the default to automated switching to better deals unless the consumer opts out.

What regulators need to do:

- Work in collaboration, for example FCA and Information Commissioner's Office.
- Address issues, for example: clarifying the advice status of automated shopping-and-switching services, establishing a new duty of care to override conflicts of interest, ensuring that consumers' data rights are clearly defined and enforced, making clear where liability lies when things go wrong, ensuring complaints and redress systems exist.

Some issues to be addressed:

- **Access**. An automated shopping-and-switching system works naturally as a digital tool. Government data show that 10 per cent of the population (5 million people have never used the internet but more than half of those aged 75 and over have never used the internet. However, there is no reason why the 'shop-window' to an automated system could not also be via phone or physical branches – for example, terminals in Post Offices. In its 2017 *UK digital strategy*, the government proposes measures to ensure access to training in digital skills, but has so far failed to address other reasons why some consumers are not adopting online ways of managing their affairs, such as cost of equipment and connections. Given the government's digital-by-default policy and trend towards online financial services, digital access is an issue that goes beyond just competition policy.
- **Status and conflicts of interest**. Would automated shopping-and-switching services be providing regulated advice? Is there a risk of 'halo effects' where consumers may assume that a recommendation is not just a good match but that the recommended provider has been vetted and approved in some way? Price comparison websites are free for consumers to use and rely for revenue on lead fees and commissions, connecting buyers and sellers in related markets, adverting, market research and up-selling premium services. If automated shopping-and-switching followed a similar model, firms interests are misaligned with those of consumers. A better alignment might be achieved if consumers were willing to pay a membership fee.
- **Trust, data security and liability**. Consumers need to be able to trust the service to act in their interest, use their data fairly, respect their data privacy, keep their data secure and provide accurate search outcomes. If there are failures of accuracy, data breaches or other problems, it must be clear where liability lies and consumers be confident that rapid, easy-to-access, no quibble compensation will be provided.
- **Security checks**. Before opening many financial products, consumers must pass anti-money-laundering/countering the financing of terrorism (AML/CFT) checks. Automated switching would work more smoothly if checks completed with a previous provider were automatically transferred or new checks completed digitally, for example, using the GOV.UK Verify service.
- **Changing needs, preferences and circumstances**. Consumers would need to update their profiles with the comparison firm or tool whenever their needs, preferences or circumstances change, otherwise recommendations would no longer be correctly aligned. Some data, such as usage data, might be automatically updated. Some theories suggest that consumers do not reveal their preferences in the act of shopping around, but instead construct their preferences through the process. This might particularly apply where consumers become aware of a new type of product during the search process. Thus, there is a risk that an automated system might inhibit innovation. However, algorithms could be built in such a way as to flag up related new products and the outcomes would, in any case, not be worse than the situation where consumers simply stick with their current provider and so are also unlikely to be aware of innovative new products.

Meaningful metrics – measuring whether competition is working well in the interests of consumers:

- **Product similarities.** A measure of whether products, as a minimum, match a set of core features.
- **Price differentials.** A measure of price discrimination that requires firms to publish the average price for specified types of consumer – for example, a representative existing customer and identical new customer, the averages for groups of customers of specified types, or for groups representative of firms' actual customer base (in a similar way to the requirements for publishing indicative APRs).
- **Average prices.** Compare individual firm's average price level against the average for the market as a whole to alert customers to high-charging firms and incentivise those firms to reduce prices.
- **Claims frequency and pay-out ratios.** An indicator of quality of insurance products.
- **Reputation measures**. Composite indices of the reputation of firms, including for example, frequency of complaints as a ratio of customer base and incidence and amount of fines.
- **Comparison searches**. The number of unique searches on price comparison websites and similar services by consumers and automated shopping-and-switching services.

The Financial Services Consumer Panel would welcome your feedback on this proposal.