Financial Conduct Authority

Research Note

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Price discrimination in financial services

How should we deal with questions of fairness?

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This short paper sets out a framework for considering the fairness aspects of price discrimination and how best to balance them with economic considerations.[1]

Price discrimination is a practice that is common in many markets, both in financial services and more generally. We regularly find different consumers paying different prices for the same product in our daily life.

But the way in which firms price discriminate so that some consumers pay more (and some pay less) can lead to different public reactions. Some forms of price discrimination are widely accepted (eg student discounts). However, in recent years other forms of price discrimination have provoked strong views on how firms treat their customers. Some recent examples that have attracted negative attention include:

- Longstanding customers receiving a significantly worse deal than new customers, particularly in insurance and cash savings
- Insurance customers paying more because of their email address, gender or potentially even the ethnicity of their name
- Fears that big data will make it easier for firms to charge personalised prices based on a customer's profile

The FCA has a strategic objective to ensure that markets work well for consumers, so this issue very much fits within that objective. Moreover, it is a topic of concern to other regulators. The recent BEIS Consumer Green Paper discusses how regulators should ensure that consumers are treated fairly and pays attention to vulnerable consumers and fair use of consumer data for price discrimination (ie personalisation of price). [2]

As price discrimination affects outcomes across a range of markets that we regulate, we have to consider when it is an acceptable pricing practice and when it is potentially problematic.

To help us with this, we already have an established framework for identifying and assessing distortions of competition and market efficiency. But what this framework is missing is a consideration of whether the outcomes price discrimination produces are fair. Should we be concerned about how outcomes differ between different consumer groups? Are we uncomfortable with some types of consumers paying significantly more for the same product than others? If so, to what extent do we prioritise such concerns over potentially competing factors?

The aim of this paper is to provide a framework to address these questions. We are publishing it in order to be transparent about how we approach fairness issues when considering cases of price discrimination in retail markets. The framework we present is

[1] This note is based on the views of the authors but reflects discussions held with the FCA Executive Committee and the Board. It has also benefitted from discussions held with the UK Competition Network (UKCN) representatives.

[2] BEIS *Modernising consumer markets: green paper* (April 2018)
https://www.gov.uk/government/consultations/consumer-green-paper-modernising-consumer-markets

intended as a general approach which can be consistently applied across different markets to inform decision making. However, any conclusions we draw from applying this framework in practice may differ from market to market as the specific circumstances vary. Ultimately, we will always assess the pros and cons of price discrimination on a case by case basis.

The paper is structured as follows:

- First, we discuss what price discrimination is and why it often occurs in financial services markets.
- Second, we discuss the economic and fairness aspects of price discrimination, in particular how we consider fairness. We set out the key evidential questions that we consider when assessing fairness outcomes from price discrimination. We also provide a structure for weighing these with economic considerations.
- Third, we explain the factors we consider when weighing whether we need to intervene to address price discrimination concerns and the approaches we could take.

Price discrimination can take different forms and present complex issues

What exactly is price discrimination? While it is possible to define the term more precisely, for the purpose of this paper we treat it simply as the practice of charging different prices to different consumers that have the same costs to serve, but different willingness to pay.[3] The critical element of this definition is the underlying demand-side features – the different willingness to pay - for charging different prices. In contrast, for instance, if a consumer pays more for a product than another customer because they cost more for a firm to serve or the quality of the product is different, then this is not price discrimination.[4]

Practical examples of price discrimination exist everywhere. We show some common examples in Figure 1. They include: movie discounts for students; airline ticket pricing; and coffee loyalty cards.

Figure 1: Common examples of price discrimination

These examples are simple forms of price discrimination and they are widely accepted as uncontroversial. In fact, they may even be seen as good or fair. For example, movie

[3] In stricter terms, price discrimination also captures situations in which consumers pay the same price despite different costs to serve. An example of this is risk pooling in insurance.

[4] This would be a version of 'cost-based pricing' when costs are different, sometimes called 'price differentiation'.

discounts for students can allow people to see movies who would otherwise not have paid to do so. But society's views of what constitutes fair pricing practices can vary over time – the practice of variable airlines ticket prices was once considered unfair by many but is seen positively by most now that they understand that booking earlier can provide access to cheaper tickets.

In financial services markets, price discrimination often takes more complicated forms than in other markets. One reason for this is that the complexity of financial services products can make it difficult to identify when price discrimination is happening and to what degree. For example, in the market for general insurance it is often difficult to disentangle cost-based causes of price differences from price discrimination. To illustrate, suppose insurance premiums vary between two postcodes. How can we be sure whether that is because of differences in the actuarial risk between the postcodes (cost-based pricing) or because people have different levels of willingness to pay in the two postcodes (price discrimination)?

In addition, the basis for price discrimination is often more complex and it sometimes raises questions about the fairness of particular practices. For example, in the market for cash savings it is common for firms to lower interest rates on older accounts so that unengaged savers earn less than those who are engaged and who shop around for better rates. Similarly, in the market for general insurance many firms increase prices on renewal in an attempt to charge higher prices to more inert consumers.

Views are divided on whether price discrimination in these instances is fair. Some may consider that more active consumers are being rewarded for shopping around and finding a good deal. Others may consider that more active consumers are getting a reward at someone else's expense and that firms are penalising loyal customers or those who are less able to find a better alternative.

While price discrimination can take a variety of forms in financial services markets, in each case there are **three key conditions** that must be satisfied to make it possible:

1. **Consumers must have different levels of price sensitivity**. This might be due to the way they value a product or because they have particular costs that other consumers do not (such as real or perceived switching costs). It may also be because they are more or less savvy or engaged than other consumers in the process of seeking out alternative products and prices. Or it may be that they have more limited options because of their personal characteristics.
2. **Firms need to be able to distinguish between the less and more-price sensitive consumers, so they can charge accordingly**. Firms can over time learn consumers' behaviour and price based on certain characteristics or demographics. More information through big data and advanced algorithms of artificial intelligence will potentially enhance the ability of firms to identify different types of consumer behaviour.
3. **Firms must be able to adapt products to ensure different prices can be charged to different consumer groups**. This is usually done by designing products that match to the demand profiles of the different groups. For example, creating add-ons or multiple tariffs. Firms must also be able to prevent consumers from transferring products between themselves otherwise attempts to price discriminate

would not work. As financial services are often personalised this is rarely an issue for firms in these markets.

Without one of these conditions, firms' ability to price discriminate is constrained. In regulating these firms, regulators may well target one or more of these three conditions to achieve the desired market outcome. However, as we discuss below, this may be difficult and other indirect ways of changing market outcomes in the presence of price discrimination exist.

There are both economic and fairness aspects to consider when assessing the effects of price discrimination

How do we identify whether or not price discrimination is harmful? This is not a straightforward question as there are potentially both economic and fairness considerations at play. Considering both aspects of harm in turn helps break down the question into simpler, more manageable parts.

Economic Considerations

Our Mission[5] sets out a clear framework for identifying, assessing and scaling economic harm.[6] Applying this to price discrimination, these economic considerations can be separated into questions such as:

- **Accessibility:** Are more consumers able to access a good quality product due to price discrimination?
- **Prices:** Does price discrimination increase or decrease prices on average?
- **Competition:** Does price discrimination distort competition (for example by creating barriers to entry) or have other efficiency implications (for search costs for consumers too high)?

Answering these questions enables us to assess the economic benefits and harm from price discrimination. In a stylised way, we can think of price discrimination being clearly harmful (eg below cost pricing to stop potential entrants from entering a market), or clearly beneficial (eg by increasing market access without impacting those who are already served). In reality, the outcomes are often less clear and can be very complex.

Fairness considerations

When it comes to fairness, it helps to distinguish between **procedural fairness** – which is about a firm's conduct in how it treats consumers – and **distributive fairness** – which is the fairness of some consumers paying more than others.

As the financial services regulator, we are accustomed to assessing firms' conduct against our principles and rules, including the obligation to pay due regard to the interests of consumers and treat them fairly. It enables us to pick out and address unacceptable behaviour.

Traditionally our work has focussed less on issues relating to distributive fairness. Our approach to the economic considerations is based on established methods and regulatory best practices. In contrast, any assessment of distributive fairness issues is inherently

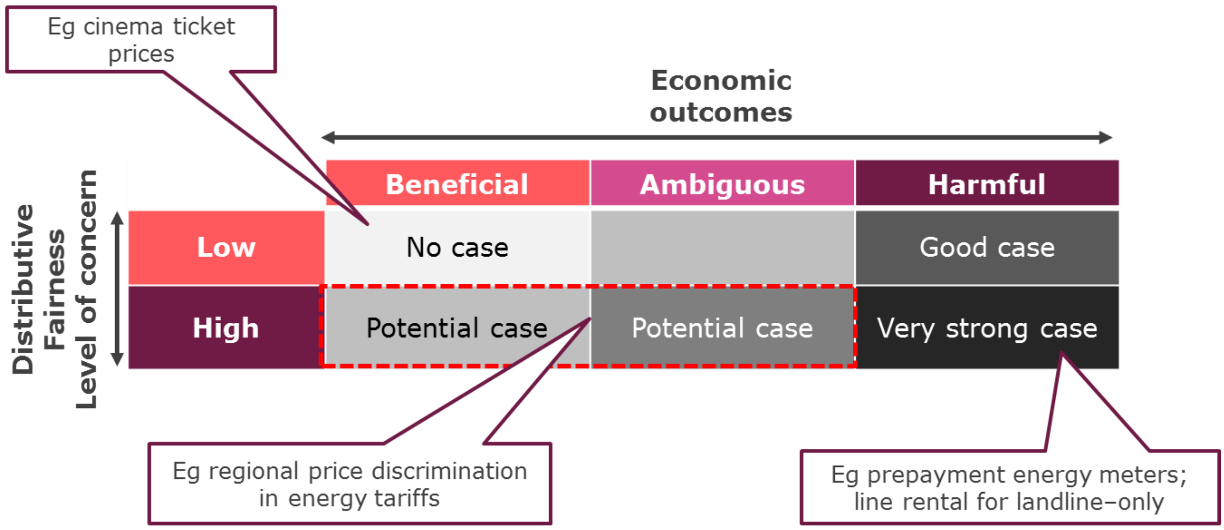
[5] Our Mission 2017: How we regulate financial services. https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf

[6] Our approach to economic regulation is formalised within the Mission and an in-depth discussion of the relevant tools can be found in Occasional Paper 13 (see www.fca.org.uk/publication/occasional-papers/occassional-paper-13.pdf).

subjective and not typically addressed by regulators. If, for example one person pays less at the expense of another paying more, when should this be considered a bad outcome? What if a wealthier person is the one paying a higher price? Does that make it fairer?

These questions become more complex when, as is often the case, the economic considerations interact with the fairness considerations and especially when there is a trade-off between the two aspects of harm. Figure 2 illustrates how the economic outcomes and distributive fairness concerns interact to create different strengths of cases for intervention.

Figure 2: Interplay of economic and fairness considerations when assessing price discrimination[7]



Where we have an economic case for intervention, the basis for intervening is clear but may be strengthened by distributive fairness concerns.[8] However, the economic and distributive fairness outcomes are not always aligned. Where there is no economic case for intervention but there is a distributive fairness concern, protecting some consumers from harm may be at the expense of others. In these circumstances, we should consider carefully the case for intervention. In particular whether we should intervene under our existing mandate or take further instruction from Parliament given the social policy considerations at stake.

Figure 2 shows some examples of scenarios where economic and distributive considerations align.

- Cinema ticket prices are not seen as an issue, as both economic and distributive outcomes are viewed positively.
- At the opposite end are scenarios with harmful economic effects and a high concern for distributive fairness. Here it is clear that this *is* an issue and there are grounds to consider an intervention. One such scenario might be prepayment energy meters, where vulnerable consumers were paying a higher price (considered unfair) and the

[7] Here we use 'case' as shorthand for a set of reasons to consider intervening. This should not be confused with a legal 'case'.

[8] Similarly, the case for intervening on procedural grounds may also be strengthened by high concern related to distributive fairness.

presence of these meters were seen as reducing suppliers ability and incentives to compete (negative economic outcome).[9]

More complex scenarios from a regulatory viewpoint (highlighted in Figure 2) are where fairness outcomes are clearly of concern, but the economic issues are not viewed as problematic. Such instances should be analysed on a case-by-case basis to decide the appropriate policy response.

This figure outlines where the most complex policy issues are likely to be. But how should we assess whether there are issues relating to distributive fairness and when should we be concerned with what we find?

We have identified six key evidential questions to assess the scale of any distributive fairness concerns

Our framework considers six key questions when weighing up distributive fairness concerns. These are laid out below in Figure 3. These are informed by a range of factors including our approach to assessing economic harm (ie scale, severity) and our Future Approach to Consumers.[10]

Figure 3: Six evidential questions on distributive fairness

	Lesser desire to act	Greater desire to act
Who is harmed by price discrimination?	Wealthier consumers – eg time poor, cash rich	Consumers with characteristics which might be deemed vulnerable (eg low income, old age, etc.)
How much are these individuals harmed?	Profitability difference between consumer segments is minimal and is immaterial to the harmed segment	Significant profitability differences and the harm has a significant adverse effect on the segment affected
How significant is the pool of people harmed?	Very small minority	Significant group of consumers
How are firms price discriminating?	Transparent and based on behaviour which consumers can easily change (eg switching)	Hidden and based on intrinsic characteristics which consumers cannot easily change (eg personal characteristics)
Is the product/service essential?	Product/service is considered non-essential but desired by some consumers	Essential product/service (eg current account or motor insurance)
Does society view the price discrimination as egregious/socially unfair?	Little concern expressed about practices and firm behaviour widely accepted	Persistent and broad-based concern expressed and firm behaviour seen as poor conduct

If we answer these questions in turn and consider where there is potential concern, we can build an overall view of the level of distributive unfairness. The answers to each question may not all point toward the same course of action, but we can and should gather evidence on them to give an indication as to whether we might have a greater need to act.

[9] See www.gov.uk/government/news/cma-puts-300m-saving-in-place-for-prepayment-energy-customers.

[10] FCA Mission: Our Future Approach to Consumers. https://www.fca.org.uk/publication/corporate/our-future-approach-consumers.pdf

When we are considering whether action is required, there is no hard rule based on our answers to the questions, and judgment is required when balancing competing points. This is a subjective issue, and the questions are designed to inform judgments rather than dictate them. Not all questions need to be satisfied to decide whether action is required. Equally there is no minimum or maximum number of questions that need to be satisfied to justify taking action or not taking action.

We have designed a structured process when deciding how to act, including where others are better placed to take action

Bringing it all together, it is clear that price discrimination can be a cause for concern. This concern can take different forms depending on the case in question.

First, there is already a framework for dealing with procedural unfairness. Where we identify a breach of rules or the law we would expect to consider supervisory or enforcement action.

Second, if there is an economic case for intervention we generally consider making rules to address the underlying drivers of the observed outcome. In this case we consider the following:

- Which remedy is likely to address the issue and harm identified? Is this remedy proportionate in terms of costs and benefits? Can the desired outcome be achieved by less intrusive measures?
- What effect does the intervention have on competition, average prices and particular groups of consumers? Does it make matters better or worse? And what effect does it have on distribution – might we make some consumers better off and others significantly worse off? What is the impact on vulnerable consumers?
- Are there any negative unintended consequences that might make matters worse? For instance, firms might withdraw a product or service for some consumers if everyone is forced to pay the same price.

Finally, if there is no economic case for intervention but we have significant concerns about distributive fairness based on our answers to the 6 key evidential questions, then we should consider whether it is appropriate to intervene within our existing remit or whether the matter requires Government or Parliamentary consideration.

The most appropriate way to intervene depends on the factors that are enabling the price discrimination

Should we conclude that it is appropriate for the FCA to intervene, then there is a range of options at our disposal. Clearly the appropriate intervention will depend on the specifics of the case. The possibilities can be categorised as follows:

1. Interventions that remove the necessary conditions for price discrimination
2. Interventions that reduce the commercial incentives for firms to price discriminate
3. Interventions that put formal constraints on prices (eg price caps, uniform pricing requirements)

Each of these three categories is discussed below. The principle of proportionality provides an important guide when we consider what remedy is most appropriate. In particular, we seek to apply the least intrusive remedy possible to achieve the desired market outcome. While it may be tempting to assume that price controls are the natural remedy to price discrimination, there may well be far less intrusive interventions to address the concerns that arise.

Interventions that prevent the necessary conditions for price discrimination

The conditions that are required for price discrimination to work were presented earlier in this paper. If one of these conditions should fail to be satisfied, then firms would no longer be able to price discriminate. Interventions targeted at changing these conditions can therefore have the effect of preventing price discrimination.

The first condition requires that consumers' observed willingness to pay differs between customer groups. In cases where consumers' willingness to pay varies according to either their intrinsic preferences (such as risk-aversion) or their financial position (such as income and household wealth) there is very little the FCA can do to affect the variation in willingness to pay between consumer groups. However, there are many cases where differences in willingness to pay are driven by asymmetries between consumers in information, understanding or costs, which can be addressed. For example, where price discrimination is based on differences in consumers' understanding of products, there may be opportunities to help consumers with their decision-making process by improving information disclosure or the provision of advice.

Motivated by the second necessary condition, other interventions could be targeted at a firm's ability to identify such variations. This may include constraints on the way certain types of data are collected or used, such as the restricted use of individual protected characteristics under the Equality Act 2010.

Finally, the third necessary condition for price discrimination requires that firms can design products that allow them to charge different prices to different consumer groups. This condition is particularly important where price discrimination is based on characteristics that are signalled through consumers' choice of product (for example, when consumers auto-renew they may indicate a higher willingness to pay than those who actively search). Interventions that constrain firms' ability to design products in this way could prevent effective price discrimination.

Interventions that reduce the incentives to price discriminate

Firms price discriminate because it allows them to increase profits relative to a uniform pricing strategy. Interventions that reduce the gains to price discrimination will reduce the incentives to pursue this pricing strategy and may put off firms from adopting it altogether. Such interventions could be most effective when fairness considerations are relevant. In some cases drawing attention to the practices, highlighting the harm and identifying the worst offenders could act as a sufficient deterrent to firms. In the past we have used sunlight remedies for similar purposes (eg drawing attention to the lowest rates on back book accounts) and we could apply a similar approach to cases where we see unacceptable forms of price discrimination. In these instances the incremental gains made from price discrimination are off-set by potential damage to the brand caused by the controversial pricing practice.

Interventions that put formal constraints on prices

Finally, the most direct type of intervention would be to prevent price discrimination by putting restrictions on the way firms set prices of their products. For simple forms of price discrimination this might be a straightforward rule (eg requiring firms to charge a single price to all consumers). But the complexity of financial services products could make direct price regulation difficult to design and enforce, particularly where it is difficult to unpick price discrimination from cost-based pricing. It is also important to consider what the likely market response would be following such an intervention.

Nonetheless price regulation is an option that is available to us and we will consider whether it is appropriate on a case by case basis. Possible interventions are not limited to simply implementing an absolute cap on prices, but rather they could take a variety of forms. For example, we could apply a relative price cap (that is, putting limits on differences in prices firms charge either between different consumer groups or over time) or limit the number of prices they can offer on similar products.

Conclusion

Price discrimination is not in itself an unfair practice. However, many questions are being raised about when and how it is fair. Traditionally, the FCA's regulatory approach has been focussed more on issues relating to economic efficiency and procedural fairness. We have set out a framework for considering both economic and distributive fairness considerations, focusing on their interaction with one another. The framework should be applied on a market-by-market basis. If harm is identified, it will be necessary to determine whether it is appropriate to intervene, and, if so, the most proportionate way of remedying the harm. The most appropriate form of any intervention will depend on the specifics of the case.

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