Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

Telephone: 020 7066 9346
Email: enquiries@fs-cp.org.uk

loyaltypenalty@cma.org.uk

15 October 2018

Dear Sir / Madam,

'Loyalty penalty' super-complaint

This is the Financial Services Consumer Panel's response to the Competition and Markets Authority (CMA) call for evidence and views on the Citizens Advice (CitA) super-complaint. We only comment on financial services, as we do not have expertise in the other markets cited in the complaint.

The Panel shares CitA's concerns about the widespread poor treatment of long-standing customers. We have repeatedly questioned whether treating one group of customers differently from another is consistent with the FCA's principles for business 6 and 8.[1] However, the super-complaint places too much emphasis on consumers switching products and services to ensure they get the best price. Relying on consumers to drive competition has had only limited effectiveness in markets such as energy, and in financial services markets such as cash savings and current accounts.[2] Moreover, there is growing evidence that 'information' remedies are ineffective in improving consumer engagement.[3]

It is simply not sufficient to give consumers masses of information and expect them to be constantly trying to find the best deal. Nor should they have to. Our research shows that consumers want their existing provider to treat them fairly, rather than spend their precious time searching an often complex market place.[4] Consumers should not be penalised for loyalty or for lacking the time or capacity to shop around; the result of staying put should be neutral at worst.

Research we carried out in 2017[5] found that, although there are many firms and they appear to compete vigorously, they strive to inhibit consumers' ability to shop around by developing products, prices and information that are complicated and sometimes misleading. So even if consumers do want to switch, they face barriers to doing so. There are also costs to searching at switching; regulators and competition authorities fail to take these into account.

Not switching often carries a price penalty. However, price is not the only factor when selecting a product or service. Switching will only help drive competition if consumers move away from high prices and poor service to better value products. Competition authorities should look at consumer outcomes from switching, not just whether people are 'happy' with their new product.

Research suggests that markets can function more competitively, with lower prices and less price obfuscation, when computers replace consumer decisions.[6] This is already happening in financial services, and the Panel has set out how consumers could delegate choice to new types

---

[1] Principle 6: Customers' interests: A firm must pay due regard to the interest of its customers and treat them fairly. Principle 8: Conflicts of interest: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and a client.
[2] https://www.regulation.org.uk/library/2016-CCP-Demand_Side_Remedies.pdf
[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/744521/UKCN_consumer_remedies_project_-_lessons_learned_report.pdf
[4] http://www.open.ac.uk/business-school-research/pufin/sites/www.open.ac.uk.business-school-research.pufin/files/files/WORKING-PAPER-Shopping-around-in-multiple-markets-Lowe-Nov15.pdf
[5] https://www.fs-cp.org.uk/sites/default/files/fscp_consumers_and_competition_position_paper.pdf
[6] Kalayci, K. and Potters, J. (2011) 'Buyer confusion and markets prices' in *International Journal of IndustrialOrganisation*, Vol 29, Issue 1, January, pp.14-22

of services that automate decision-making based on consumers' own profiles and preferences.[7] This has the potential to provide better consumer outcomes, and to improve competition.

However, we are concerned about the reliance on algorithms to decide whether a firm offers a customer access to a product, and the terms on which it does so. This can give the impression that a decision has been reached based upon robust analysis of relevant data, which may not be the case. The use of algorithms also enables firms to use non-relevant information about a consumer (e.g. their online search history) to identify their propensity to pay an inflated price.

Finally, the CMA should consider the needs of small businesses. Microbusinesses in particular share many of the same characteristics as individual consumers, but their barriers to switching are, if anything, higher.[8] They will stay with their main bank out of fear of disrupting the business if they move, or in the mistaken belief it will be easier to get finance if they stay put.

Q1. What are your views on the existence, impact and root causes of a 'loyalty penalty' for consumers across markets; including the five identified by Citizens Advice (mobile, broadband, savings accounts, home insurance and mortgages) and any others?

It is very clear there is a loyalty penalty across financial services markets. This is most acute in general insurance. In 2015, the FCA found that customers who had been with their home insurance provider for 5 years paid 70% higher premiums than new customers despite evidence suggesting that they posed no higher risk than new customers.[9] Auto-renewal plays a part in the loyalty penalty. Insurers encourage this facility so that people are not left uninsured through an oversight, but it means prices can creep up unnoticed. Telling people what they paid last year – which insurers are now required to do – is of little help to people who have been paying over the odds for many years. The use of data enables firms to 'price optimise' more effectively, that is to charge customers more if they are unlikely to switch. This systematises the loyalty penalty.

We also see consumers stuck on tiny interest rates in 'obsolete' savings accounts and mortgage 'prisoners'.

There is also a heavy penalty for pension savers in 'legacy' schemes. Legacy workplace pension schemes are not required to comply with the 0.75% charge cap on the default option for qualifying schemes used for auto-enrolment.

The Independent Project Board (IPB) found that "Between £23.2bn and £25.8bn of assets under management are potentially exposed to charges of above 1%. Around half of this is potentially exposed to charges above 1.5%; between £5.6bn and £8.0bn to charges above 2%; and around £0.9bn to charges above 3%".[10]

The Department for Work and Pensions (DWP) pension charges survey found that 2.7 million consumers in non-qualifying contract-based schemes are paying an average charge of 0.86% (against the average in qualifying schemes of 0.54%). 79% of these consumers are paying more than the 0.75% charge cap.[11]

The role of PCWs

In recent market investigations, the CMA has asserted that PCWs increase competition and allow consumers to make better choices. However, in a 2014 thematic review into general insurance, the FCA found that PCWs encourage consumers to focus on headline price and brand, distracting from crucial product features such as policy coverage and terms, and resulting in choices that were not always appropriate for consumers' needs.[12] In its report '*Misbuying Insurance*', Fairer Finance concluded that "the pressure to reduce headline prices on online comparison sites

7 https://fscp.org.uk/sites/default/files/fscp_consumers_and_competition_thinkpiece_finalpp_jtl_20170306.pdf
8 https://www.fs-cp.org.uk/sites/default/files/bank_culture_position_paper_final.pdf
9 https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-12-encouraging-consumers-act-renewal-evidence
10 https://www.fca.org.uk/news/press-releases/defined-contribution-workplace-pensions-audit-charges-and-benefits-legacy
11 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/652086/pension-charges-survey-2016-charges-in-defined-contribution-pension-schemes.pdf
12 https://www.fca.org.uk/publications/thematic-reviews/tr14-11-price-comparison-websites-general-insurance-sector

appears to have led to companies 'hollowing out' the underlying product, whether by reducing cover, upping fees for amendment or cancellation or raising excesses to levels where vast numbers of claims are simply not worth pursuing".[13]

Fierce price competition means that general insurance products for new customers are often sold at cost price, or even at a loss. Firms have to make profits elsewhere, which may mean penalising loyal customers.

Payment of commission from product providers to PCWs and other intermediaries can lead to choices being presented to consumers that generate the most commission, rather than those that are in their best interests.[14] Providers may need to raise prices, particularly those for inert/captive consumers to fund commission payments. Although marketing costs may be reduced for product providers there may be an increase in marketing costs for intermediaries, particularly for the new generation of PCWs that will help consumers interpret data and compare products. This is reflected, for example, in the amount of PCW television advertising, which far exceeds that of insurance providers.

Research suggests that an increasing number of price comparison intermediaries can increase costs for consumers.[15] It is clear that PCWs are not the solution to the loyalty penalty and, in the absence of effective supply-side interventions, the promotion of PCWs could actually make it worse.

Q2. Are there circumstances in which you think a 'loyalty penalty' is not problematic at all or where it is particularly problematic, and if so why?

Loyalty penalties are always problematic: consumers should not have to switch if they don't want to. They are arguably most problematic where consumers have severe difficulty switching products. This may be because the rules don't allow them to (e.g. mortgage prisoners), or they lack the capacity to do so.

Mortgages

Nearly half of borrowers on standard variable rates (SVRs) are on low legacy SVRs, close to the end of their term or have a low outstanding balance where switching would make them worse off.[16] However, the FCA's interim report on the Mortgage Market study also found that there are 800,000 mortgage holders paying SVRs or other default rates for more than six months who would be eligible for a better rate loan from their existing lender.

Our main concern is with mortgage prisoners, and in particular with borrowers who are trapped in mortgages with lenders who are no longer active, or who have never been active and only purchase mortgages on the secondary market.

Consumers who can't switch at the end of fixed-rate deals will see significant rises in payments. For example, a consumer taking out a deal with a two-year fixed rate of 1.7% now could see their rate increase to between 4% and 5% if they are unable to switch at the end of the deal. The absolute gap between base rates and SVRs has increased significantly and in the future customers stuck paying the SVR will be unlikely to benefit from cuts in interest rates as base rates are already much lower than prior to the financial crisis.

The FCA refers to mortgage prisoners as a 'legacy issue'. However, large numbers of mortgage prisoners will re-emerge the next time there is a change in the economic environment, house prices or lending standards. Withdrawal of the help-to-buy mortgage guarantee and Government equity loan could also cause new generations of mortgage prisoners to emerge. Lenders may be unable or unwilling to offer good value mortgages once consumers begin to pay interest on equity loans, which happens after five years. There are already reports that few lenders are willing to offer remortgages to Help to Buy borrowers unless they redeem their government loan

[13] https://www.fairerfinance.com/assets/uploads/documents/Fairer-Finance-Misbuying-Insurance-Research-Report.pdf

[14] OFT (2007), Competition in markets with commission rates, http://www.dotecon.com/assets/images/crmain.pdf

[15] Ronanye (2018), Price Comparison Website, https://warwick.ac.uk/fac/soc/economics/research/workingpapers/2015/twerp_1056b_ronayne.pdf

[16] https://www.fca.org.uk/publication/market-studies/ms16-2-2-interim-report.pdf

first.[17] There is no clear evidence that any of the policies put forward by the FCA or PRA will prevent the re-emergence of mortgage prisoners – indeed, regulators appear to be overconfident in their own ability to prevent risks from occurring.

Those that don't switch their mortgage tend to be older and poorer consumers. Some are unable to switch to a better deal with their existing lender because they have taken a repayment holiday due to ill health or a temporary drop in income. Those in arrears for other reasons, or whose income does not meet current lending criteria, are unable to move to other lenders. This is particularly problematic for those whose lender is not currently offering any new loans. The FCA's initiatives to help mortgage prisoners do not cover these groups. Older and low-income consumers are also more likely to have an interest-only mortgage. Switching away from interest-only will inevitably involve moving to a repayment mortgage which would increase total outgoings even if the interest element was lower.

Q3. What specific additional challenges do vulnerable consumers experience and should there be additional protections?

All consumers are vulnerable to harm in financial services because of the way the market operates. Even those consumers who may not fit a definition of vulnerable are paying over the odds because their 'trusted' provider does not tell them it offers better prices. Essentially providers are gaining market power by exploiting asymmetries of information. So, arguably, anyone paying a loyalty penalty is vulnerable because they have been unable to avoid the penalty.

Additional protections for a defined set of consumers would not solve the problem. Defining and identifying vulnerability can be virtually impossible, and what would different protection for different groups look like? To take an example, 15% of the UK population is functionally illiterate, so is vulnerable to misunderstanding terms and conditions that often require tertiary level education to understand.[18] The solution is not to try to identify the 15%, but to design information that can be understood by a 9 year old. This would benefit *all* consumers, as well as being inclusive to those who are vulnerable.

Although labelling people as 'vulnerable' or 'not vulnerable' is not generally helpful, there are some groups of consumers who need additional help. For example, FCA research has identified that those with cancer and other critical illnesses pay multiples more than average for travel insurance.[19] There is no obligation on providers to signpost consumers to specialist providers or to tell them that the price they have been quoted is multiples more than is the standard. PCWs are of no use to consumers with non-standard needs in general. They are unlikely to find insurance online, and be unsure of where to go.

Q4. What measures to tackle any 'loyalty penalty' should be considered, including those suggested by Citizens Advice and any others? Please explain how these measures would effectively address the problem.

Robust supply-side regulation is required to ensure minimum standards for products and services, and to ensure firms do not exploit consumers' behavioural biases. Regulators should do more to ensure that loyal customers who choose not to search for and switch to new deals are not penalised, and that those who are less able to access better deals are protected.

Savings accounts

For savings accounts the CMA and the FCA could consider limiting the number of accounts which one bank can offer. The Modern Savings policy in the Netherlands[20] required banks to simplify their range of savings accounts. This was seen as having improved outcomes for loyal customers. Another option would be a rule on superseded savings accounts. The 2001 version of the Banking Code contained provisions which obliged participating savings providers either to keep interest rates on superseded accounts at the same level as accounts with similar features in their current

[17] Daily Telegraph 16 September 2018.
[18] https://literacytrust.org.uk/parents-and-families/adult-literacy/
[19] https://www.fca.org.uk/publication/feedback/fs18-01.pdf
[20] PWC (2014), Savings Accounts, An International Comparison, https://www.fca.org.uk/publication/research/pwc-cash-savings-international-comparison-study.pdf

range, or to switch consumers automatically to new accounts if they offered one with similar features and better terms.

General insurance

Insurance firms should offer their best price automatically (without any need for action) to existing customers. That they don't, suggests they are exploiting the inertia of loyal customers who do not shop around, or who trust their provider to treat them fairly.

The CMA/FCA should look more closely at the impact of PCWs on the loyalty penalty and the FCA should also consider whether price optimisation is consistent with the principle of 'Treating Customers Fairly'.

Mortgages

Any consumer for whom there is a cheaper deal available with the same lender should be able to switch, whether or not they are in arrears. Denying customers in arrears the ability to switch is deeply unfair: some consumers are only in arrears because they are currently being charged an excessive rate and could afford a cheaper deal, while others are technically in arrears because they have negotiated a repayment holiday (e.g. due to illness or job loss).

The protections that allow existing customers of active lenders to switch to a better deal with the same lender without a full affordability test only apply to loans that originated pre- financial crisis. It is not clear why people who took out loans post-crisis – even if these make up only a relatively small proportion of the total number of those with active lenders who are unable to switch – are treated worse than people in similar circumstances who took out their loans earlier.

For customers with firms that are no longer lending, or where a mortgage book has been sold to a company that is not authorised for mortgage lending, we recognise that the FCA's ability to act is limited. It is not right that consumers can find themselves with a lower level of protection, and unable to switch to a better mortgage deal, because of decisions made by a firm to sell on or move a mortgage book outside of the regulatory perimeter. While the FCA's regulatory remit is for Parliament, the FCA should press for changes, given the harm consumers suffer because of the current regulatory framework.

We would also expect the FCA to evaluate whether to use its powers to limit the 'go-to' or 'follow-on' rate which mortgage lenders can charge after the initial period expires. This would help ensure that mortgage prisoners are not exploited, even if their loan is sold on to a company not authorised for mortgage lending.

The CMA should learn the lesson from the very successful CAT standard mortgage initiative. CAT standard mortgages included a term which required the variable rate of the mortgage to be no more than 2% above the Bank of England base rate. Two major mortgage providers (Nationwide and Lloyds TSB) continued to include this term in their mortgage agreements in the run-up to the financial crisis. The result has been that these two lenders were required to pass on in full the cuts in Bank of England base rates. Other lenders have used cuts in the base rate to widen their margins at the expense of their customers. Nationwide estimated that the benefit of the CAT standard had been £300 million in the six months to November 2010. Assuming that borrowers at Lloyds TSB have enjoyed a commensurate benefit in line with their market share means that consumers with those mortgages benefited from the CAT standard mortgage initiative by over £1 billion each year in the aftermath of the financial crisis.

Price comparison websites

For PCWs to lead to better outcomes for consumers it should be possible to compare products, including key features, easily. Consumers should be able to trust that the top ranked product or service, based on their specific search criteria, is the best one for their needs. The CMA's principles for PCWs do not go far enough to remedy this, as they rely on the PCW giving the user reams of information on e.g. commission and conflicts of interest, rather than eliminating these.[21]

---

[21] https://assets.publishing.service.gov.uk/media/59c93546e5274a77468120d6/digital-comparison-tools-market-study-final-report.pdf

Automated switching

Regulators need to ensure that the increased use of automated switching and AI serves the interests of all consumers. While automated processes rely on technology, the 'shop window' to such services could be via phone or branch terminals in supermarkets or post offices, making the services available to 'offline' as well as 'online' consumers.

New tools for searching and switching based on the use of consumers' personal data require changes to regulation if they are to improve consumer outcomes. These include: an overhaul of terms and conditions (Ts&Cs) so that consent to share data is properly informed; protection from the use of 'Big Data' to market expensive and unnecessary add-on products and services; regulation of third party providers of comparison and other services to ensure they present information fairly and in a way that helps consumers find a good deal, and do not distort markets.

Given the considerable increase in the complexity of algorithms, consumers could end up completely outsourcing their purchasing decision.[22] Therefore, algorithms should be transparent, and firms must explain to consumers in clear and simple language how they reach a decision, as is required by the GDPR.

There is a risk that automated switching could magnify the loyalty penalty for those who are digitally excluded or do not want to share their data. Regulators should ensure firms do not discriminate against these consumers.

A duty of care

The differences of treatment often seen between existing loyal customers and switchers, could be addressed by a general duty of care on firms. This would force them to put their customers' interests first in designing and delivering products and services. Firms should have an affirmative obligation to make better prices available without consumers having to take any action (e.g., an automatic upgrade) where the provider's prices have changed for comparable services.

Yours faithfully

Sue Lewis
Chair, Financial Services Consumer Panel

---

[22] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/746353/Algorithms_econ_report.pdf