

What price is right?

Nathan Willmott considers the emerging regulatory approach to fair pricing

The remit and approach of the UK's financial regulators has evolved and expanded in the two decades since the Financial Services & Markets Act 2000 received royal assent. In its twin guises as the Financial Services Authority (FSA) and subsequently the Financial Conduct Authority (FCA), the UK conduct risk regulator has been subject to a series of major expansions in scope, taking on the regulation of mortgages, general insurance sales, consumer credit and payment services. It has also taken on wider responsibilities, such as becoming a concurrent competition regulator from 2015. The FCA is now responsible for regulating 58,000 financial services firms.

Alongside this expansion in scope, the UK regulators have significantly evolved their approach to regulating firms, in particular the sale of products and services to consumers. The FSA was principally focused on what happened at the point of sale – namely whether the consumer was given appropriate information about a product to enable him or her to make an informed decision about whether or not to buy it. If appropriate information had been provided, and the consumer chose to make a bad purchase, then it was not for the regulator to intervene. Under the leadership of Sir Howard Davies, the FSA repeatedly stated that it had not been set up to be a price regulator and so it steered well clear of interfering with the way in which firms set their prices.

Changing expectations

Expectations have certainly changed since the move to dual regulation by the Prudential Regulation Authority (PRA) and FCA in 2013, when the expression 'conduct risk' was added to our lexicon. The FCA's revised approach – based largely on the lessons from PPI misselling – was to place much greater focus on product providers rather than customer-facing distributors, requiring them to have in place effective oversight and governance to ensure that their products served a useful purpose for the specific target market that they were aimed at. If they did not, or were being sold to those outside the target market, then product providers were expected to intervene to stop further sales. This has undoubtedly resulted in better outcomes for consumers.

More recently, however, the FCA's view of its own remit has expanded yet further and it has become heavily focused on the fairness of pricing practices for consumer products. Over the last 18 months it has published a series of papers on fair pricing in financial services, and it now sees fairness in pricing of financial products as a key element in its role.

This is a complete reversal of the historic approach in relation to price regulation. This article considers the causes behind this change of approach, what specific concerns the FCA has about the way that firms are pricing their products, whether the FCA currently has the necessary powers to operate as a price regulator, and what steps firms should be taking to manage these new regulatory risks.

What has caused this change of approach?

There are several reasons why the FCA has moved into this new sphere of price regulation. One positive aspect is that firms' selling standards in retail markets have improved significantly over the last two decades, and therefore the regulator is looking to new areas where it may be able to deliver 'better' outcomes for consumers. The FCA is likely to view fair pricing as a natural next step in its oversight of whether product providers are designing products that provide a valuable service to the target market.

Equally, fair pricing is a core issue for competition authorities, and the FCA's new responsibilities from 2015 as a concurrent competition regulator for financial services has led it to examine much more closely pricing practices across the sector. This new competition responsibility and mindset has caused the FCA to think afresh about its overarching duties as a regulator. As it stated in its July 2019 feedback paper FS19/04¹, fair pricing is "directly relevant to our strategic objective to make the markets we regulate work for consumers, cutting across our consumer protection, competition, and market integrity operational objectives."

In addition, retail markets have changed very significantly over the last 20 years. Now that consumers routinely purchase financial products over the internet or through mobile apps, firms have the ability to call on huge datasets as well as artificial intelligence (AI) to utilise a much wider range of factors ▶



in the ultimate pricing of a financial product. The FCA recognises that this means that issues of fairness in pricing are likely to become increasingly prevalent and complex in the future.

Finally, the FCA has pointed to the fact that, over recent years, there is much greater public interest in fair pricing and that the Government and other regulators such as the Competition and Markets Authority (CMA) are taking actions to ensure that pricing practices are fair – one example being the Citizens Advice response to the super-complaint to the CMA on loyalty pricing.

What concerns does the FCA have?

In a series of publications, the FCA has outlined its areas of concern in relation to fair pricing. These include:

- **Loyalty pricing** – The practice of charging new customers less for financial products than established customers are charged. Firms wish to attract new customers through offering attractive rates and then take advantage of their propensity to stick with the same product provider when products are auto-renewed rather than switching to a different firm offering better prices. As the FCA's October 2019 interim report on general insurance pricing practices (MS 18/1.2)² observed with concern, “firms use complex pricing practices that allow them to raise prices for consumers that renew with them year on year [referred to as ‘price walking’]”.
- **Use of AI and Big Data** – The regulator is concerned that firms are using AI and Big Data in ways that could be viewed as unfair to consumers. Pricing of products may be based not just on traditional factors (such as the risk of making a claim in the context of an insurance product) but also take into account factors such as the extent to which the consumer is likely to be price-sensitive. Such factors may be based on the use of Big Data, potentially coupled with assessments based on the speed with which a consumer answers questions when providing information as part of the online purchase process. The use of such factors would result in some consumers being charged more than others with the same risk profile, simply because of the firm's assessment of how willing the consumer would be to pay a higher price. These are not isolated cases: the FCA's October 2019 report noted that “most firms, when setting a price, include their expectations of whether a customer will switch or pay an increased price”.
- **Price discrimination based on protected characteristics** – Where firms are improperly pricing their products based on characteristics that are protected by law, such as race, religion, gender, disability, or sexual orientation, the FCA will be keen to ensure that the approach followed by the firm is consistent with firms' legal obligations.

While there are pre-existing legal boundaries on price discrimination based on protected characteristics, the question of how far the FCA should properly be restricting the freedom of firms to price products based on Big Data and AI, and more broadly on an assessment of the consumer's price sensitivity, is a difficult one.

While high level principles on fair pricing may suit the FCA, they will not deliver the necessary level of clarity to firms on exactly what they are (and are not) permitted to incorporate into their pricing methodologies. As a result, firms facing the risk of punitive supervisory measures or even enforcement action may well prefer these more specific requirements which would provide greater certainty and more of a level playing field among competitors

Does the FCA have the powers to operate as a price regulator?

This new focus on fair pricing raises the question of whether the FCA has the powers it needs to pursue this agenda, not least given that its predecessor organisation regularly asserted that price regulation fell squarely outside its remit.

The FCA has been given discrete statutory powers to impose price caps in relation to certain products where Parliament has identified specific risk of harm. These impose restrictions on high-cost short-term credit from 2014, on workplace personal pension schemes from 2015, and on early exit pension charges from 2016. However, there is no general power to impose price caps on other types of financial products.

The FCA does have a statutory objective to promote effective competition in the interests of consumers and has been given competition powers under the Enterprise Act 2002 as a concurrent competition authority. As a result, it can investigate whether any market for financial services is working well and can make a market investigation reference to the CMA to investigate a particular market or sector in more depth. It can also make new rules under FSMA in order to promote effective competition.

To date it has relied principally on its pre-existing rulebook to pursue its agenda on fair pricing. Firms' duty under Principle 6 of the FCA's Principles for Businesses – to pay due regard to the interests of customers and treat them fairly – has been cited as a basis for requiring firms to have in place fair pricing practices. Similarly, since October 2018 the FCA has also pointed to insurance firms' duties under the Insurance Distribution Directive to act honestly, fairly and professionally in the best interests of consumers, as a basis for imposing a duty of fair pricing.

However, the FCA does not feel comfortable relying on these rules in order to require firms to have in place ►

effective processes for ensuring that the way in which consumers are charged is ‘fair’ in the eyes of the regulator. If the FCA needed to pursue a disciplinary case against a firm for ‘failing’ to have in place a fair approach to pricing (for example, by including in the price formation process an assessment of the consumer’s tolerance for paying a higher price) then it would face the prospect of having the case struck out by the FCA’s own Regulatory Decisions Committee or the Upper Tribunal.

As a result, the FCA is looking at new rules on which to ensure that firms are subject to binding duties to apply fair pricing processes. It is currently undertaking a review of its Principles for Businesses, and a discussion paper is expected by the end of the first quarter of 2020. This is very likely to include new comprehensive principles explicitly requiring firms to adopt fair pricing practices. As the issue of what is ‘fair’ is rather subjective and is likely to evolve over time, the FCA favours a higher-level obligation which it is free to interpret as such views develop.

What does ‘fair’ pricing look like?

The FCA’s July 2019 paper revealed its thinking in this area: “Assessing whether a particular pricing practice is unfair can be complex and the issues can vary from market to market. So, there is no simple formula that determines whether a practice is unfair and we will use our judgment to balance the considerations in specific context. This implies that prescriptive rules are unlikely to be sufficient to incorporate our thinking into a regulatory approach.”³

The FCA’s thinking as to what ‘fair’ pricing looks like is still at a developing stage, and so imposing vaguer, higher level, duties would meet its need to have flexibility in the future. As a result, the FCA has taken the view that “at this stage ... a principles-based approach may be more effective in driving appropriate outcomes, so we will incorporate our work on fair pricing into the review of our principles, which will be the first strand of our Handbook Review.”

In parallel, Lloyd’s of London has described fair value in consumer products as a ‘priority focus’, and its 2020 Market Oversight Plan identified that it will be introducing changes to its oversight framework that are designed “to provide the market with more certainty regarding Lloyd’s approach, our stated appetite and expectations surrounding [the pricing of] consumer products”. New high-level obligations are being considered, including to require firms to ensure that products are reasonably priced reflecting the level of cover provided.

Also in the field of general insurance, the FCA’s October 2019 interim report, following its market study on general insurance pricing practices (MS 18/1.2)⁴, suggested that more specific measures might be needed to deal with certain areas of concern. These included:

- Limiting pricing practices that allow firms to charge higher prices to consumers who do not switch. This may include restricting or banning margin optimisation based on consumers’ likelihood of renewing.
- Requiring firms to engage with customers to give them information about alternative deals and identify those who may need help in moving to better priced products with equivalent cover.
- Automatic switching of consumers paying high prices to

lower priced products that provide equivalent cover.

Consultation on the proposals set out in the FCA’s interim report has now closed and final measures are due to be published by the end of March 2020.

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How should firms manage the relevant risks?

First, product providers should already have in place effective governance arrangements to assess the value of their products to the target market. In part, this would have involved an assessment of historic performance of the product and whether the purposes for which consumers have bought the product have been properly served. It should have also included analysis of the profitability of the product and the proportionality of the level of commission paid to intermediaries.

Second, it is important that those forming part of the product governance and oversight forum within product providers understand how prices are reached on each of the firm’s products. Being able to demonstrate to the FCA that the governance forum has a full understanding of the inputs to the pricing process and the impact that different factors have on the final price – including on renewals or repurchases for existing customers – will be important in demonstrating that the governance forum is properly informed to assess the position.

Third, pending more specific rules from the FCA, firms will need to reach their own view on which elements of the pricing process they are comfortable with. This will need to consider the reputational / brand risk as well as the regulatory risk of adopting practices that are deemed by some to be ‘unfair’. These issues of principle will need to be escalated to the Board for a decision on appropriate pricing methodologies, taking into account the FCA’s emerging views on pricing practices.

Finally, firms will need to monitor closely the draft new Principles for Businesses and final rules on general insurance pricing practices that the FCA will soon be publishing and provide feedback to the regulator on unintended consequences that such new rules might lead to. Given that this is such an uncertain area for the FCA, it is likely to pay careful attention to the responses it receives from the industry and mould its new rules accordingly. ●



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1. <https://compassoc.org/fca-fair-pricing>
 2. <https://compassoc.org/fca-insurance-pricing>
 3. Ibid. note 1
 4. Ibid. note 2