The Money Charity response to the FCA Consultation on Price Discrimination in the Cash Savings Market (Oct 2018)

The Money Charity is the UK's leading financial capability charity.

We believe that being on top of your money means you are more in control of your life, your finances and your debts, reducing stress and hardship. And that being on top of your money increases your wellbeing, helps you achieve your goals and live a happier more positive life as a result.

Our vision is for everyone to be on top of their money as a part of everyday life. So, we empower people across the UK to build the skills, knowledge, attitudes and behaviours, to make the most of their money throughout their lives.

We believe financially capable people are on top of and make the most of their money in five key areas:

- Planning (including budgeting)
- Saving
- Debt
- Financial services products
- Everyday money (including wages, cash, bank accounts)

Introduction

The Money Charity is pleased to have the opportunity to respond to the FCA discussion paper on price discrimination in the cash savings market (DP 18/6, July 2018). We believe this discussion provides an opportunity to improve regulation of the cash savings market, address longstanding consumer harm and help improve financial capability. We support the idea of introducing a Basic Savings Rate (BSR) as proposed in the discussion paper. Once a BSR has been introduced, we think there should be a further review to see how a BSR performs and whether or not the gap between the first year rate and the BSR is socially acceptable and economically efficient. The idea of a complete ban on demand-based price discrimination should remain on the table, but be approached in the light of the evidence.

What this response does

First, as a charity focused on financial education, we set out some general considerations about price discrimination and its relationship to financial capability. Second, we address the questions posed by the discussion paper.

1 General considerations

1.1 Price discrimination based on consumer demand – is it fair?

As pointed out in the discussion paper and in the accompanying Occasional Paper 41[1] there is a large literature on price discrimination. One of the issues discussed in this literature is whether demand-based price discrimination is, in an ethical sense, fair. Scholars of the subject report that consumers tend to find price discrimination underhand rather than fair.[2] This is because demand-based price discrimination is often implemented in a surreptitious manner: the consumer simply notices one day, perhaps months or years after the change, that his or her savings rate has gone down or insurance premium has gone up by far more than seems explicable by economic events such as the rate of inflation or the general movement of interest rates. Because the technique takes advantage of consumer inertia, it is hard for firms engaging in demand-based price discrimination to shake off this feeling of unfairness. When consumers realise what is happening, they tend to feel ambushed and/or exploited.

[1] Gaber Burnik and Tommaso Majer, *Price discrimination in the cash savings market: One rate, one solution?* FCA, Occasional Paper 41, July 2018.
[2] See, for example, Office of Fair Trading (OFT) 2013,*The economics of online personalised pricing*, May 2013.

This sense of unfairness is reinforced by the demographics of consumers who tend to be caught by it: the discussion paper notes that a large number of 'inert' consumers are those showing indicators of vulnerability.[3]

A feature of the literature on demand-based price discrimination is the coyness of companies about admitting they use this pricing technique. Thomas 2012 reports that:

> '…vendors of banking and insurance price optimisation[4] software report that "most of our customers have kept their investment in pricing optimisation technology quiet". According to another banking industry analyst, "there is a consistent belief that if word gets out to the press, users of price-optimisation software will be deemed users of price-gouging software.'[5]

Schwartz & Harrington 2015 report the banning of demand-based price discrimination in insurance in various US states on the grounds of 'unfair price discrimination' and Minty 2016 suggests that:

> '… entering a cycle of discounting new business premiums and inflating renewal premiums will exacerbate even further the low levels of trust in the insurance sector. Many consumers find it an alienating practice.'[6]

In relation to the insurance market, OFT 2013 notes there is empirical evidence that consumers dislike price discrimination (even when they benefit from it) and that the damage to consumer trust may have negative effects on the market as a whole.[7]

Minty 2016 asks the rhetorical question:

> 'Which insurance firm Chief Executive will be prepared to stand up and defend the practice on, say, BBC Radio 4's Today programme?'

In relation to cash savings, there is something inherently uncomfortable about a bank saying, 'we shall pay our loyal, long-standing customers a lower interest rate than the rate we pay to our new customers.' Because of this sense of unfairness, we believe that the option of a complete ban on demand-based price discrimination should be kept on the table.

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[3] FCA Discussion Paper, p 7.
[4] 'Price optimisation' is an alternative term for demand based price discrimination. The price is optimised from the point of view of the firm, not the consumer.
[5] Thomas RG 2012, 'Non-Risk Price Discrimination in Insurance: Market Outcomes and Public Policy', *The Geneva Papers* 37, 27-46, p 33.
[6] Minty D 2016, 'Price optimisation for Insurance. Optimising price; Destroying Value?', *Thinkpiece*, CII, March 2016, p 4.
[7] OFT 2013, p 84.

1.2 Is there a pragmatic case for a first year bonus interest rate?

Notwithstanding the sense that demand-based price discrimination is unfair, there is a pragmatic argument that firms should be able to pay a first year bonus to encourage switching. This enables new entrants to compete more effectively with established players, makes switching (slightly) more likely and, from a consumer point of view, compensates people for their search and switching costs.

The more competitive a market, the less should be the difference in interest rates offered by competing suppliers. But if there is only a small difference in interest rates, the incentive to switch is low. This is compounded by the effect of the time value of money: a switcher does not receive their bonus the day they switch but gains it gradually, month by month, from the higher interest rate. But money received in a year's time has much less value to the average consumer than money received now, so a small difference in interest rates may not be enough to provoke the switch.

For this reason, we think that the BSR in the form proposed by the FCA strikes a balance. It will raise interest rates for loyal savers while allowing a premium to be paid for switching. We think this regime should be introduced and observed for a period of time. If consumer harm in the form of excessively low interest rates on savings balances for a significant proportion of savers persists, the discussion on remedies should be reopened.

1.3 Price discrimination undermines key aspects of financial capability

As we argued in our 2014 response to the FCA's earlier consultation on this issue,[8] we believe that restricting demand-based price discrimination will improve financial capability in the UK. This view arises from our experience of running financial capability workshops where every week we interact with school age students and adults and hear what they are struggling with in terms of understanding the financial system and making decisions in their best interests.

First, the establishment of good savings habits is one of the cornerstones of financial capability. The Money Charity encourages the idea of goal setting, with regular savings to achieve goals. Policy and financial market practice should support this approach. It is not helpful when interest rates on savings are lower than the inflation rate and when banks penalise long-term savings by reducing interest rates for loyal customers. This behaviour sets off the counter-message that the preferred approach is 'short-termism' or that 'since the banks manipulate us, we should try to manipulate them' (for example, by gaming the system to pick up as many bonuses as possible). These messages damage trust in the financial sector and complicate attempts to build financial capability.

[8] Available at: https://themoneycharity.org.uk/media/Response-to-the-FCAs-cash-market-study.pdf

Second, the proliferation of ‘products’ in the financial marketplace creates confusion. In the discussion paper, the FCA correctly calls this ‘price obfuscation’.[9] In our financial capability work, we strive for simplification and clarity, and these should be the watchwords of the financial sector as well. Money is fungible and the only real variable in savings decisions should be that arising from liquidity preference: ‘for how long do I want to tie up my money, at what interest rate?’ Instant access accounts naturally have a lower interest rate than term deposits. It is hard to rationalise any difference in retail savings products beyond time and interest rate. Indeed, having a simple range of products differentiated only by time and interest rate would help improve financial capability by getting to the heart of what it means to save.

Third, the surreptitious nature of interest rate reductions for loyal savers is damaging to financial capability. It places people in a situation where their money is somewhere they didn’t intend it to be (in a near-zero interest rate account) and frustrates what originally may have been a financially sound decision. Under current policy the only remedy is constant vigilance, but many people, young and old, are not in a position to be constantly vigilant, either because they have more important things to do in their lives, or because they are in a situation of vulnerability.

1.4 The economic cost of churn

One of the side-effects of price discrimination is churn. A proportion of consumers are aware of demand-based price discrimination and take evasive action by moving their accounts when the adverse price change occurs. This applies to savings accounts, insurance policies and utility charges. Across the economy, there are millions of people moving their accounts each year, hundreds of thousands of staff dealing with the resulting transfers and enquiries and a whole industry of ‘compare the market’ websites and apps. These are overhead or ‘deadweight’ costs to the economy, which can only be justified if there is a substantial productivity-boosting effect from competition. Given the wide gap between interest rates on savings and lending, and between the Bank of England base rate and lending rates (this gap has grown substantially since the 2008 crash)[10], it is hard to see evidence for such productivity. It would be timely to have a full cost-benefit analysis of the churn associated with demand-based price discrimination.[11]

[9] DP 18/6, p 12.
[10] The Money Charity, *The Money Statistics*, October 2018, p 14.
[11] The economic cost of churn features prominently in the literature on price discrimination. See, for example, Thomas RG 2012, ‘Non-Risk Price Discrimination in Insurance: Market Outcomes and Public Policy’, *The Geneva Papers* 37, 27-46 and Taylor CR 2003, ‘Supplier surfing: competition and consumer behaviour in subscription markets’, *RAND Journal of Economics*, Vol. 34, No. 2, Summer 2003, pp 223-246.

We note that the FCA has identified the potential positive economic effects from introducing a BSR[12] and encourage the FCA to take the analysis of these effects further.

1.5 Low household savings and high household borrowing

We note also the wider economic context: the UK's 'lost decade' of pay and productivity growth[13] accompanied by high household borrowing and, currently, a very low household savings rate. Credit card borrowing is growing at a rate of nearly 9% per year, while the household savings rate is only 4.4%. In 2016/17, only 45% of working age adults actively participated in a pension, even with the relative success of auto-enrolment.[14] In these circumstances, it is not helpful for UK banks and building societies to reduce interest rates on savings for long-term savers at the same time as they take a permissive approach to credit card and mortgage debt. One of the side effects is the excessive level of house prices, especially in London and the South East, combined with a low rate of return on savings, making saving for a house deposit even harder than it normally is and prompting the Government to step in with supplementary savings subsidies such as Help to Buy. The low savings/high borrowing environment leans against the responsible financial practices we try to encourage in our workshops, complicating the task of improving the UK's financial capability.

2. The Money Charity's responses to the Discussion Paper questions

Q1: What are your view on the nature and scale of harm outlined above? Does it merit some form of intervention in the cash savings market?

As indicated in our general remarks above, the harm in our view is significant enough to warrant intervention. The harm involves:

- Significant financial losses for a large number of people, including people who are less able to interact actively with the market and/or are in situations of vulnerability.
- Damage to financial capability by creating confusion and sending the wrong messages ('save less, borrow more').
- Damage to the reputation of the financial services industry, complicating the industry's attempts to recover from the reputational damage done by the 2008 crash and its aftermath.

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12 Occasional Paper 41, p 6.
13 See, for example, Stephen Clarke and Paul Gregg, *Count the Pennies: Explaining a Decade of Lost Pay Growth*, Resolution Foundation, October 2018.
14 The Money Charity, *The Money Statistics*, October 2018, pp 12 and 13.

We agree with the FCA's proposal to introduce a Basic Savings Rate. We think the effect of this should be observed in practice for a period of time, then a further review undertaken. If interest rates for loyal savers remain too low, the idea of a complete ban on price discrimination should be revisited.

Q2: Do you agree with our analysis of the demand side remedies? Are there any further considerations we should make?

We agree with the FCA's conclusions on the limited effectiveness of demand side remedies. Attempts to improve clarity of information and offers to switch should continue, but experience shows that these cannot be relied on to remedy the problem of price discrimination.

Q3: Do you think we should require the publication of any service metrics that relate specifically to cash savings? If so, please suggest metrics that you think we should consider.

Service metrics that address the clarity of information about cash savings interest rates, and the convenience and speed of moving to a higher interest rate account would be useful. In relation to service metrics in general, it is important that metrics get to the heart of the issues that bother consumers. For Internet banking, availability, user-friendly design, speed of response and speed of execution would be key metrics. Because of the UK's variable Internet infrastructure, the performance of Internet banking over lower speed lines should be measured separately. For telephone-accessed services, phone waiting times and menu systems are often problematic. What consumers want is the effect of a live person[15] picking up the phone as soon as it rings, understanding what they are calling about and steering them to the right solution. Service metrics that focus on speed of pick-up, speed of menu navigation and speed of solution would be useful. As well as being of interest to consumers and the FCA, such metrics could spur innovation by financial firms and their technology suppliers.

Q4: Do you agree with our analysis of the supply-side options considered in this chapter? We welcome views on the impact of these options and any risks and benefits that we have not captured.

We generally agree with the analysis of the supply-side options.

Neither a 'superseded accounts rule' nor 'ratio-based price regulation' look attractive, for the reasons set out in the discussion paper. Both would be complex to explain and likely to lead to consumer confusion and inaction. Many consumers would feel bewildered by

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[15] If this can be achieved by an automatic system, all well and good. It is the effect of a live response that consumers wish to achieve.

a stream of bank communications saying something along the lines of, ‘your super gold plus account has been superseded so we have shifted you to our new gold saver plus account which has the same interest rate as your superseded account.’ Similarly, an attempted explanation of ratio-based price setting would immediately exclude a significant part of the consumer population, for whom financial mathematics is challenging. For those who understand it, the thought that ‘life is too short’ is likely to arise.

For simplicity, clarity and efficiency, the BSR looks like the best option. The modelling of the effects looks sound, but the test will be what happens in practice. Should the industry find a profit-maximising way of keeping the BSR at an excessively low rate, we think the option of a complete ban on price discrimination should be revisited. A complete ban on price discrimination does have some potential downsides, but these would need to be weighed against the policy goal of protecting long-term savers.

Q5: Do you have any views on our analysis that a BSR should apply after 12 months of an account being opened?

Yes, as indicated in our general remarks, this makes sense in terms of offering a switcher a first year bonus, in order to encourage switching and defray some of the consumer’s switching costs.

Should the BSR prove less effective in practice than the modelling indicates, one option would be to reduce the maximum term of the bonus rate, for example to nine or six months. We suggest that this option be kept on the table, pending assessment of the behaviour in practice of a BSR.

Q6: Do you have any views on our analysis that there should be a maximum of 2 BSRs per provider (ie limiting providers to 1 BSR for easy access savings accounts and 1 for easy access cash ISAs)? What impact would this have on the provision of particular products (for example, loyalty, tiered, branch etc) and how would this affect providers offering such accounts?

Yes, we agree with this. It is important that all existing savings products (off sale and on sale) should be transferred to the new BSRs on a ‘most favourable interest rate’ basis, ie the BSR should be equal to or greater than the best existing interest rate for savings of similar duration. FCA rules should prevent the industry from inventing new savings products that have the effect of circumventing the new rules and steering savers onto ultra-low interest rates.

From a financial capability point of view, a small and simple structure of products is preferable to a large and complex one. In the past there has been too much artificial product differentiation. We believe consolidation onto a smaller range of core products with easy to understand terms would be a good thing.

Q7: Should a BSR apply equally to all providers? We are particularly interested in the views of building societies and small deposit takers.

Yes, in our view the rule should be clear and apply to all providers. This is the best way of improving consumer awareness and financial capability. Complexity is the enemy of consumer engagement.

Q8: What are your views on the impact a BSR would have on firms' liquidity requirements and funding models? We are particularly interested in the views of building societies and small deposit takers.

No comment. This is outside our field of expertise.

Q9: What are your views on the impact a BSR would have on lending rates? Are there any other markets that providers may seek to pass costs to?

We agree that the FCA should be alert to cost shifting by the industry. Financial institutions charge high rates of interest on some forms of lending, including credit card lending and overdrafts. The FCA needs to keep scrutinising these interest rates. It is interesting to note, for example, that since the 2008 crash the gap between the Bank of England base rate and the average overdraft and credit card lending rates has widened significantly, from around 10% to 18-19%. It is not clear what this reflects, other than the market power of lenders.

Q10: What is your view of the likely costs of compliance with a BSR, in terms of both one-off and ongoing costs? We will carry out a detailed cost survey as we take forward this work, but we would be interested in any initial views you may have on the costs of a BSR.

If this question refers to administration and overhead costs, rather than the cost of paying a higher interest rate to loyal customers, the BSR should be cheaper than the current regime, as it implies a much simpler product structure. It should improve the productivity of the banking industry by reducing the costs of churn and of excessive product differentiation.

Q11: Are there any additional impacts and unintended consequences on providers that we have not covered in this section?

The reputation of the industry would be improved by having a pricing structure that is clear to explain, feels honest and does not rely on the surreptitious exploitation of consumer inertia. The first year bonus interest rate can be explained in terms of recompensing consumers for switching costs, so is less likely to be seen as exploitative than is incremental, longer term demand based price discrimination.

Q12: What are your views of the impact that a reduced product offering may have on consumers? Please provide views on the impact on specific products (for example, loyalty, tiered, branch etc), where applicable.

We do not see any disadvantages from a ‘reduced product offering’. Rather we see this as a positive thing, establishing a simpler and clearer offering. For example, it would come as a surprise to many consumers to learn that their savings account was an ‘off sale product’. The language of this description would not make sense to many consumers, who would think ‘how can my savings account be ‘off-sale’? This type of language only makes sense to industry insiders. For most people, money is placed in a savings account, and this is expected to be the standard savings account offered by the bank. Even the idea that putting money into a savings account is a ‘sale’ would be an alien concept.

Q13: Do you agree with our initial view on how a BSR could be communicated to consumers and the market?

We like the idea of greater clarity in communicating interest rates. In particular, encouraging consumers to compare both the bonus first year rate and the long-term rate is a good idea, as this is the package the consumer is actually opting for. The two rates should be given similar prominence, in similar-sized type (or the equivalent mobile or web-based imagery). The fact that the rate will drop after a year should be clear at the outset, plus the gain from switching to get the higher rate.

We agree that communications should not use only percentages, but should also express things in actual money, for example the £1000 balance mentioned in paragraph 5.55 of the discussion paper.

We agree that BSRs and first year rates should be published regularly on the FCA website, though in practice it is likely to be from having these rates published in the media and on financial advice websites that most consumers are likely to see them. This wider dissemination should be encouraged by the FCA.

Q14: Are there any additional effects and unintended consequences on consumers that we have not covered in this section?

Easy saver accounts and ISAs are not the only options for people holding significant cash balances. It would be useful to consider how improved communication about the BSR could be accompanied by signalling other options. For example, someone who has accumulated a significant sum in cash savings (or received a lump sum, eg a pension lump sum, a gambling win or a bequest) might wish to consider term deposits of varying lengths of term, alongside ready money in an easy saver or ISA. These are relatively simple choices that do not require a financial adviser, but some consumers leave even large sums of cash in near-zero interest rate accounts, either through inertia or through not understanding the options. Improved communication about the BSR might help them make better decisions. Richard Thaler's approach to choice architecture is relevant in this context, the objective being to 'help people make good decisions, *as they would judge themselves*.'[16]

Q15: In light of the above, do you think we should take forward a BSR?

Yes.

(end)

[16] Richard Thaler & Cass Sunstein, *Nudge - improving decisions about health, wealth and happiness*, Penguin, 2009, p 12.