The Money Charity Response – FCA MS18/1.2 Interim Report on General Insurance Pricing Practices (November 2019)

The Money Charity is a financial capability charity whose vision is to empower people across the UK to build the skills, knowledge, attitudes and behaviours to make the most of their money throughout their lives.[1]

We approach financial regulation from a financial capability perspective:

> "Financial regulation has a vital role to play in promoting financial capability, by creating rules, guidelines and choice architectures that help consumers behave in financially capable ways. Financial regulation should take account of the varying levels of financial capability in society, ensuring that financial products and services are safe to consumers at all capability levels. Regulation should avoid adding to complexity in a way that goes beyond the financial capability of most people."[2]

[1] See box on back page.
[2] The Money Charity July 2019, Policy Paper: Financial Regulation. Available at: https://themoneycharity.org.uk/work/policy/policy-papers/

We welcome the opportunity to respond to MS18/1.2, which follows our responses to the Terms of Reference for the General Insurance Pricing Practices Study (November 2018) and to the Discussion Paper on Fair Pricing in Financial Services (January 2019).

In this response, we set out our Key Points then answer the questions posed in the Consultation Paper.

Key Points

1. The FCA's market study MS18/1.2 reveals the scale of price discrimination in motor and home insurance, the negative impact on certain groups of consumers and the scale of the unnecessary costs caused by continuous switching ("churn").

2. We agree that new regulation is called for, as well as better enforcement of the FCA's existing rules on Treating Customers Fairly (TCF).

3. We favour a general ban on demand-based price discrimination, but with the possibility of a first year only switching bonus to encourage consumers to switch to more efficient firms.

4. We agree with the proposals for improving communication with consumers about prices, terms and switching options. We see these as supplementary to a general ban on demand-based price discrimination, not as an alternative.

5. We do not favour a ban on auto-renewal, but we agree with the FCA there should be safeguards to enable consumers to exercise control over the auto-renewal option.

Answers to consultation questions

Q1: Do you have views on the interim findings set out in this report?

We welcome the detailed empirical work carried out by the FCA on the home and motor insurance markets and note the following findings:

- The prevalence of price discrimination in insurance pricing, including new customer discounts, different offers to consumers with the same risk profiles and "price walking" as policies are renewed.
- The tendency for higher prices and higher margins to fall on older customers, those with longer insurance tenures, those with lower access to the Internet, those with lower incomes, those who prefer a known brand and those with less awareness of how insurance pricing works.

- A slight tendency for customers assessed as being vulnerable to pay higher margins for home insurance.
- The cross-subsidy from customers with longer tenures and higher margins to new and switching customers.
- The wide difference in margins paid by different customers, with margins for most customers varying from zero or negative to around 90%.[3]
- The switching process ("churn") creating high costs for consumers and the industry. The study finds that for consumers of home insurance search and switching costs are equivalent to 21% of the insurance premium.[4] For firms, acquisition costs for home insurance come to 29% of premiums.[5]
- Insurance firms earn high revenues from premium financing and policy add-ons such as legal expenses cover. Non-core revenue is particularly high (53% of the total) for intermediaries in motor insurance.[6]
- Price comparison websites earn significant revenues from insurance: an average of £45 per policy for home insurance and £51 per policy for motor insurance.[7]
- Widespread misunderstanding among consumers of how insurance pricing works, with over a third of consumers of home insurance thinking that prices rise because of an increase in costs (rather than price walking).[8]
- A lack of transparency in pricing by insurance firms, particularly in relation to the loyalty penalty and price walking.[9]
- When asked, consumers say that price walking is wrong.[10]

In light of these findings, which reflect long-standing concerns about insurance pricing expressed by charity and consumer groups and by the Citizens Advice super-complaint to the Competition and Markets Authority, we think the industry is ripe for intervention and we encourage the FCA to introduce new and effective rules to make insurance pricing fair and to negate practices widely seen as unfair, such as the loyalty penalty, price walking and systematic price discrimination.

There is also a question to be answered about the behaviour of insurance firms and senior managers in relation to the FCA's current rules. The Senior Manager and Certification Regime (SM&CR) and the rules on Treating Customers Fairly (TCF) are

[3] MS18/1.2, page 44. The FCA margin distribution charts do not show the top and bottom few percentiles, so the full range is likely to be wider than this.
[4] MS18/1.2, page 32.
[5] MS18/1.2, page 33.
[6] MS18/1.2, page 36.
[7] MS18/1.2, page 37.
[8] MS18/1.2, page 41.
[9] MS18/1.2, page 56.
[10] MS18/1.2, page 57.

supposed to ensure that practices such as those revealed in MS18/1.2 do not occur. Yet, they have occurred, apparently without sanction.

Furthermore, insurance is specifically covered by the EU Insurance Distribution Directive (IDD) with its requirement that firms "act honestly, fairly and professionally in accordance with the best interests of their customers." The IDD applies to everyone in the insurance value chain including intermediaries and price comparison websites. It has been transposed into UK law and into the FCA Handbook in ICOBS 2.5, which requires a firm to "act honestly, fairly and professionally in accordance with the best interests of its customer."[11]

This rule appears to have been broken in relation to large numbers of customers paying high and very high insurance margins. Sanctions should follow from such rule breaches, but we are not aware of any significant enforcement action at the firm or individual manager level. It is one thing to change rules after the fact, but until senior managers in mainstream firms in the financial services industry are penalised or face other legal action for breaking TCF, there is not going to be a fundamental change in the culture of the industry.

We made the same point in our response to CP19/25 on pension transfer advice, which revealed widespread inappropriate advice for Defined Benefit pension transfers, motivated by the desire to earn adviser and fund manager fees.[12] In response to HMT's Review of Financial Regulation (October 2019) we argued that three changes are required:

- Amend the Financial Services and Markets Act 2000 (FSMA) so that avoidance of consumer harm becomes the central and fundamental duty of financial service firms.
- Introduce a Duty of Care requiring firms to avoid reasonably foreseeable consumer harm and to act in customers' best interests.
- Amend the SM&CR so that individual senior managers who make decisions leading to consumer harm face sanction and penalty.

Each of these changes should be supported by enhanced FCA enforcement action, affecting not just rogues and outliers, but mainstream financial service firms and their managers who breach FCA rules and principles on the scale revealed in recent FCA market studies.

Consumer protection is important in all markets, but particularly in financial services because of their complexity and lack of transparency. Few consumers have the

[11] Insurance Conduct of Business Sourcebook (ICOBS), paragraph 2.5.
[12] https://themoneycharity.org.uk/work/policy/consultation-responses/ (October 2019)

knowledge and experience to understand exactly what they are buying, and firms often hide or downplay terms that are to the consumer's disadvantage. To use a supermarket analogy, food vendors are required to make sure the food they sell is not contaminated by harmful bacteria. They have established strict control regimes to make sure food reaches the consumer in a safe condition. But, as FCA studies regularly reveal, we still lack effective protection against the toxic contamination of many financial products and services.

Q2: Do you have views on the potential remedies we propose to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?

The remedy we favour, as set out in our response to DP18/9 on Fair Pricing in Financial Services, is (a) to ban demand-based price discrimination (including price walking, elasticity measures, likelihood of switching etc), but (b) to allow a first year switching bonus.

The effect of this would be to introduce (or re-introduce) insurance pricing that is standard for people with the same risk profiles, regardless of how long they stay with an insurer. Any increases in premium should reflect claims costs for that category of risk,[13] rather than personalised demand factors. Price increases should generally be in low single digits, not out of line with general inflation in the economy. This approach will save consumers money in aggregate and create a more convenient and comfortable customer journey without a financial penalty for being loyal to a particular provider.

Our rationale for accepting a first year switching bonus is that there are search costs for the consumer. A given insurance policy may be cheaper, but its price advantage may not be enough to cause a consumer to shift, given the scale of consumer switching costs, which MS18/1.2 estimates to be equivalent to 21% of the premium in the case of home insurance.[14] To encourage competition and innovation it is desirable that consumers shift to providers who are better and cheaper, and a first year switching bonus will help this happen. After the first year, pricing should be standard.

These rules should be applied retroactively, so that customers currently on high-margin policies are switched to the new (lower) standard price for their category of risk.

We do not support a ban on auto-renewal, which we think is often convenient for the consumer. However, we agree with the safeguards proposed on page 60 of MS18/1.2, i.e. that consumers should be notified in advance, be informed of any changes in price or cover and explicitly agree to auto-renewal. It should also be easy to decline auto-

[13] Fair by Design has questioned whether risk profiling itself contains unfairness, for example by imposing higher premiums on low income people, and we would support continued investigation into this.
[14] MS18/1.2, page 32

renewal if this is what the consumer decides to do (MS18/1.2, paragraph 7.26, page 60).

We agree with the proposals for improved communication to the consumer about pricing, terms and switching options (particularly those set out in paragraph 7.29, page 61 of MS18/1.2). However, we see improved communication as supplementary to the ban on price discrimination not as an alternative to it.

Q3: Do you have views on the potential remedies that we propose not to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?

We agree with the FCA's decision not to pursue the remedies set out in paragraph 7.36 of MS18/1.2, i.e. a requirement for multi-year contracts or a single switching and renewal period. We do not think these would be effective.

Q4: Do you think there are other remedies that we should be considering? If so, what remedies and how do you think they would address the harm we have identified?

As explained in our response to Question 1, we think that demand-based price discrimination in insurance breaches existing FCA rules on Treating Customers Fairly, including those in the SM&CR. FCA needs to be more pro-active in enforcing its existing rules on fairness, as well as supporting changes to the regulatory regime as set out in our answer to Question 1.

We welcome the increased FCA interest in the concept of fair pricing and we encourage the FCA to move forward swiftly with the necessary regulatory changes and accompanying enforcement.

Q5: Are you aware of potential changes or innovations in the home and motor insurance markets that may address the harm we have identified? If so, what are these and how will they address the harm and are there any potential unintended consequences?

Innovation seems to have assisted price discrimination, through the availability of Big Data and sophisticated price discrimination software. The latter turns each customer interaction into a live test of price elasticity of demand, constantly refining the models that lead to varying price offers for individual consumers.[15] We do not see this trend abating. Rather it may intensify as the scale of Big Data grows. Without labouring the

[15] Krikler S, Dolberger D and Eckel J 2004, 'Method and tools for insurance price and revenue optimisation', Journal of Financial Services Marketing, Vol 9 1 68-79.

point, it is part of the wider challenge about privacy, confidentiality and control in a society that is becoming increasingly data driven.

This being the case, we think that industry needs help in the form of new regulation to move away from the arms race in price discrimination towards a regime of standard, fair pricing, where premiums are based on sharing risk, rather than on personal elasticities, add-ons and financing costs. The consumer should be able to stay with their preferred provider for a number of years, perhaps even a lifetime, without facing the price penalty that presently occurs.

The Money Charity is the UK's financial capability charity providing education, information, advice and guidance to all.

We believe that everyone achieves financial wellbeing by managing money well. We empower people across the UK to build the skills, knowledge, attitudes and behaviours to make the most of their money throughout their lives, helping them achieve their goals and live a happier, more positive life as a result.

We do this by developing and delivering products and services which provide education, information and advice on money matters for those in the workplace, in our communities, and in education, as well as through influencing and supporting others to promote financial capability and financial wellbeing through consultancy, policy, research and media work.

We have a 'can-do' attitude, finding solutions to meet the needs of our clients, partners, funders and stakeholders.

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