



Europe Economics

## Automatic Upgrades

## Final Report

June 2019

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# Executive Summary

Europe Economics was appointed by the Financial Services Consumer Panel (the Panel) to investigate the potential value of a policy of automatic upgrades for consumers holding poorly performing financial products. The context for this research is the Panel’s call for financial services firms to have a new duty of care in order to bring about the better treatment of financial services consumers.

An automatic upgrade policy would require firms to move consumers who were in these products onto a better, comparable product within the company’s suite of products. There are different methods to estimating the costs associated with remaining with poorly performing products. At a basic level, they all entail comparing the current charges or returns of the poorly performing product (the “status quo” rate) with the charges or returns of the “best” alternative. The status quo rates could either reflect those that a product reverts to from an introductory rate, or be the continuing, legacy rates of a product where newer products exist with more favourable rates. What constitutes the “best alternative” is influenced by how the concept of a “loyalty penalty” is interpreted, i.e. whether it is the mark-up on what a “fair” rate might be, or whether it is the difference between what a loyal customer and an active customer pays or receives, or some combination of the two.

In our view, both interpretations of a loyalty penalty are valid, and our approach to estimating the ‘status quo’ and ‘best’ rates is driven largely by data availability and the nature of the various products under investigation. We estimate the costs of remaining in poorly performing products for eight products, namely cash ISAs, mortgages, accumulation pensions, credit cards, current accounts, investment products, home insurance, and income protection insurance. These products, suggested by the Panel, were chosen to reflect a range of products that might appear in a consumer’s financial portfolio.

## Consumer profiles

To assess the costs of being trapped in poorly performing products in a meaningful way, we developed six consumer profiles covering a number of demographic dimensions recorded in the FCA’s Financial Lives Survey (2017).<sup>1</sup> Gender, age and personal income were the three main dimensions used in all profiles, with other dimensions such as marital, employment and home-owner status included in different combinations. The goal was to develop profiles that represent a range of consumers, to help understand how a policy of automatic upgrades might affect different segments of the population.

The table below presents the six consumer profiles and the products held by each.

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<sup>1</sup> FCA Financial Lives survey [\[online\]](#)

**Table 1: Summary of profiles by characteristics, products held and average (mean) amount held in products**

	Profile 1	Profile 2	Profile 3	Profile 4	Profile 5	Profile 6
<b>Gender</b>	Female	Male	Female	Female	Male	Male
<b>Personal income</b>	Low	Low	Average	Average	Average	High
<b>Age</b>	18-34	25-44	40s	60+	60+	35-60
<b>Other</b>	Out of work	In financial difficulties	Not married	Retired, financially resilient	Owns home, no Internet	Owns home
<b>Cash ISA</b>				£100,000		£30,000
<b>Residential mortgage</b>			£80,000			£100,000
<b>Credit card</b>		£6,000	£8,000	£3,000	£3,000	£7,000
<b>Current account</b>	n/a	n/a	n/a	n/a	n/a	n/a
<b>Investment product</b>				£80,000		£40,000
<b>Private pension (acc.)</b>		£8,000	£50,000			£200,000
<b>Home insurance</b>			n/a	n/a	n/a	n/a
<b>Income protection</b>			n/a			

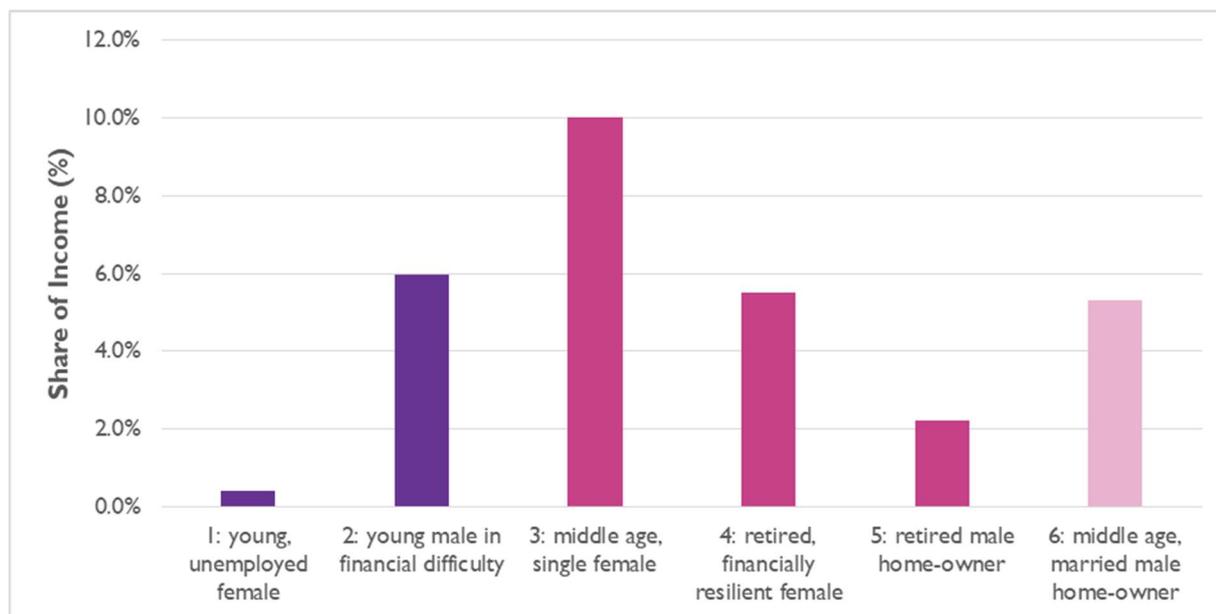
Note: Columns left blank represent profiles that do not hold that particular product. 'N/a' refers to products which do not entail an initial product amount.

Source: Europe Economics' analysis of Financial Lives survey data; \* Amounts for pensions estimated by in-house Europe Economics' analysis.

## Results

Our results show that the costs of remaining in poorly performing products can represent a notable proportion of consumers' annual incomes. It is conceivable that some consumers are incurring loyalty penalties in excess of five per cent of annual income, and not impossible to imagine that there are some consumers for whom these costs are as high as 10 per cent of their income. Based on our profiles, these are likely to be consumers with an average income and a range of standard financial products, with relatively large amounts of debt (e.g. upwards of £3,000 in a credit card balance and a mortgage of at least £80,000).

The relative costs of remaining in poorly performing products are in part – but not entirely – associated with consumers' income levels. The different colours in the figure below represent different income levels, and the range of costs within each income band. Factors such as employment status, household characteristics and homeownership also influence the number and value of financial products held, and thus the associated costs of remaining in poorly performing products.

**Figure 1: Cost of remaining with poorly performing products as share of income, by profile**

Note: • Low income, • Average income; • High income

Source: Europe Economics' analysis of publicly available data from a range of sources.

Mortgages and credit cards are the two largest drivers of loyalty penalties for those that hold these products. In the case of credit cards, our focus is on identifying the possible loyalty penalty for those who fail to pay off the balance each month. The evidence suggests this loyalty penalty can be large.

The results show that consumers with low incomes, because they may not hold many financial products, are unlikely to be particularly affected by the costs of remaining in poorly performing products – either in absolute terms or as a proportion of personal (gross) income. The relative costs for those with the lowest incomes would rise if the estimates were based on disposable income after essentials (accommodation, food) are netted off. However, the Financial Lives data show that low-income consumers simply do not hold many financial products, thus placing an upper bound on even the relative impact of loyalty penalties on these consumers. This finding may suggest that issues associated with a lack of access to financial products, rather than loyalty penalties, may be a greater problem for those on very low incomes.

## Policy implications

There are two key motivations for intervening to reduce the costs associated with remaining in poorly performing products (i.e. loyalty penalties). The first is based on the view that firms are making excessive profits by charging a mark-up over a “fair” rate, and that a policy such as automatic upgrades would effectively transfer welfare from firms (shareholders) to customers. The second is the view that loyalty penalties are used to cross-subsidise other products, such that intervention is justified for distributional reasons.

The latter motivation entails a value judgement on which group of consumers deserves protection. If a policy removes the ability of firms to cross-subsidise products such that there is price convergence for products and consumer groups, it would benefit consumers at risk of being trapped in poorly performing products, but penalise other consumers by raising the prices of previously (potentially) loss-leading products. If ‘trapped’ consumers are considered to be those who are more financially vulnerable (e.g. using credit cards as a primary means of borrowing) or unable to engage in switching for other reasons (other vulnerabilities or behavioural biases) then the distributional impacts of such a policy may be considered appropriate. However,

different views about 'trapped' consumers could reduce the perceived benefit of such a policy. For example, maybe they are perceived to be time constrained or not to engage in switching for rational reasons. Additionally, consumers who might lose out from the cessation in cross-subsidisation may also be vulnerable and face exclusion, such as those currently accessing below-cost products for whom a "fair" price would be prohibitively high.

There are a number of potential policy responses that could help avoid consumers becoming trapped in poorly performing financial products and reduce the extent to which firms can cross-subsidise between product and consumer groups. These include restricting product ranges, price benchmarking, information provision initiatives and technological solutions such as automatic switching.

# 1 Introduction

Europe Economics was appointed by the Financial Services Consumer Panel (the Panel) to investigate the potential value of a policy of automatic upgrades for consumers holding poorly performing financial products. The context for this research is the Panel's call for financial services firms to have a new duty of care in order to bring about the better treatment of financial services consumers. The FCA's business plan includes a cross-sector priority concerning the treatment of existing customers where the "aim is to ensure that existing customers enjoy the benefits of increased competition and innovation." The regulator has stated that "firms should not give longstanding customers less attention than new customers or treat them in a way which results in poorer outcomes."<sup>2</sup>

An automatic upgrade policy would require firms to move consumers who were in these products onto a better, comparable product within the company's suite of products. This policy would focus on consumers who are "trapped" in poorly performing products (e.g. those with high costs and charges and/or low returns compared to similar alternatives). The motivation is the concern that firms may profit excessively from consumers' apparent loyalty by imposing high or increasing costs on them, or otherwise rely on their profitability to subsidise the provision of products to other consumers. 'Loyal' consumers can be those who are too busy to search for and switch to better products, those who do not switch due to behavioural biases, and those who are not aware that better alternatives exist. There is a concern that in many cases it may be the financially most vulnerable who face the higher charges that allow firms either to make excessive profits or to recoup losses made elsewhere.<sup>3</sup>

This study seeks to estimate the potential detriment faced by consumers trapped in poorly performing products and the value of being automatically upgraded to better performing products, in order to inform the development of the policy. Nine product examples are investigated, namely cash ISAs, mortgages, accumulation pensions, credit cards, current accounts, investment products, home insurance, income protection insurance and motor finance.

This report sets out our research approach and results as follows:

- Section 2 sets out the development of six consumer profiles to demonstrate the potential detriment of being trapped in poorly performing products for some 'average' consumers from different demographics.
- Section 2 also describes our approach to estimating the costs per product for consumers who stay in a poorly performing product and the benefits of being upgraded to better, comparable products.
- Section 3 presents the results of the cost estimates, both per product and for each profile across all their products. It also discusses the impacts of the policy on consumers' time.
- Section 4 presents a review of the evidence on other policy approaches that could help trapped financial consumers, and on the impacts of preventing cross-subsidisation.
- Section 5 concludes, and additional charts from our analysis are included in the Appendix.

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<sup>2</sup> FCA Business Plan 2018/19, page 28

<sup>3</sup> Ogunye et al. (2018): 'The cost of loyalty', Citizens Advice [[online](#)]

## 2 Methodology

We set out here the approach we have used to estimate the costs of remaining in poorly performing products for different consumer profiles and across different financial products. In particular, we explain:

- How we estimate ‘status quo’ and ‘best’ rates for different financial products and
- How we developed the consumer profiles, including their product ownership and amounts held.

### 2.1 Approaches to estimating ‘status quo’ and ‘best’ rates across products

There are different methods to estimating the costs associated with remaining with poorly performing products. At a basic level, they all entail comparing the current charges or returns of the poorly performing product (the “status quo” rate) with the charges or returns of the “best” alternative. The status quo rates could either reflect those that a product reverts to from an introductory rate, or be the continuing, legacy rates of a product where newer products exist with more favourable rates.

What constitutes the “best alternative” is influenced by how the concept of a “loyalty penalty” is interpreted, i.e. whether it is the mark-up on what a “fair” rate might be, or whether it is the difference between what a loyal customer and an active customer pays or receives, or some combination of the two. Under the first interpretation, the concern is that the firm is earning excessive profits from the consumer. The “fair” rate entails the charge that the firm could levy while earning normal profits. The best alternative to a poorly performing product would be a product (potentially a newer one) with a price that more accurately reflects fair rates. For example, it might be argued that charges associated with an qualifying auto-enrolment pension (compared to a legacy personal pension), or the charges and returns associated with a passive tracker investment fund (compared to a more expensive, but only partly active fund) represent rates that generate sustainable but not excessive profits for the firm and are therefore “fair” rates. Similarly, the increasing insurance premiums associated with auto-renewals could reflect a situation in which firms are simply charging an increasing mark-up on a fair price (which is available to new customers or to those who challenge the auto-renewal price).

Under the latter interpretation, the best alternative to a poorly performing product would be the best rate that a new (active) customer would get, such as an introductory or teaser offer. This “best” rate may well be below-cost and unsustainable in the absence of other consumers paying higher rates and cross-subsidising the product. The interest in the loyalty penalty in this scenario reflects distributional concerns about how “loyal” and “not loyal” consumers are treated, rather than a belief that the firm is necessarily earning excessive profits.

Both interpretations of a loyalty penalty have validity. For this study, we have not specifically sought to estimate one version. Instead, our approach to estimating the ‘status quo’ and ‘best’ rates is driven largely by data availability and the nature of the various products under investigation.

We applied the following general rules in developing these approaches:

- Comparing status quo and best rates for the *same* provider, rather than across providers. This captures the intention of the policy of requiring providers to upgrade consumers to their own best products.
- Comparing, as far as practically possible, the same product, such that the difference between the best and status quo rate reflects the costs of remaining in a poorly performing product and is not driven by differences in the underlying financial product. For example, this means comparing the best variable

mortgage rate with the status quo variable mortgage rate, rather than the best fixed mortgage rate with a status quo variable mortgage rate.

- Similarly, given that the updates would be automatic, we assume that the provider would not assess whether a different combination of fees/excess/interest rate would be better for the consumer.
- Comparing, where possible, status quo and best rates of products that are concurrently available from the same provider, and for which either product can be accessed by a given consumer. We therefore aim to exclude best rates that are only available to new consumers upon first switching.
- Where necessary, include transfer or switching fees that would be incurred in being upgraded to a better product.

We set out below our approach for each of the products under investigation, with the exception of motor finance. On closer investigation, we found that motor finance loans are not subject to either interpretation of a loyalty penalty. Loans are generally fixed term until fully repaid, so the concept of a ‘better alternative’ to which a customer could be upgraded does not apply.

### 2.1.1 Cash ISAs

Our approach for cash ISAs compares the interest rate a consumer would receive remaining in an easy access cash ISA for more than 5 years, with the rate they would get if upgraded to a newer product (open for less than 2 years). In other words, we compare the rate received on the same product but held for different lengths of time. This approach is consistent with the concept of automatic upgrades (i.e. an existing consumer upgraded to a better rate for the same product).

This approach draws on 2013 data taken from the FCA’s “Cash Savings Market Study”.<sup>4</sup> At that time, the average interest rate for cash ISA opened up to two years ago was 1.5 per cent. The average rate for a cash ISA held for more than five years was 0.7 per cent. The difference between these two rates implies a 0.8 per cent cost per year of remaining on the poorly performing ISA compared to the newer ISA. The current leading easy access variable rate on the market is 1.5 per cent,<sup>5</sup> broadly in line with the best rates available in 2013.

In the absence of more up-to-date data on the rates paid for cash ISAs opened more than five years ago, we assume a cost of **0.8 per cent per year** in remaining with the status quo ISA compared to being upgraded to a newer product.

### 2.1.2 Mortgages

We estimate the cost of poor performance associated with mortgages by comparing the interest rate a consumer would pay on a standard variable rate (SVR) mortgage, with a new variable rate mortgage. By doing so, we are comparing the rate received by an inactive consumer (the SVR) with the rate achieved by a new consumer searching for a similar product (the new variable rate).

We have compared rates from a major lender for which information on mortgage rates by different products and for different loan-to-value ratios was accessible online. Specifically, we compared the current rate of the SVR of 4.19 per cent, with the new variable rate achieved on a variable two-year Bank of England tracker of 1.69 per cent plus £1,029 in booking fees. We assumed a loan-to-value (LTV) ratio of 60 per cent, the lowest LTV ratio for which mortgage rates are reported online. This would be a high LTV ratio for our two profiles who hold a mortgage (based on Financial Lives data, the sample of people according with Profile 3 and Profile 6 with mortgages had average LTV ratios of 29 per cent and 16 per cent respectively). Nevertheless, a

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<sup>4</sup> Financial Conduct Authority (2015), “Cash savings market study report”.

<sup>5</sup> Based on <https://www.moneysavingexpert.com/savings/best-cash-isa/#best> search of 19 March 2019.

decrease in the LTV below 60 per cent should not have a material impact on the mortgage rate as the lender is already well protected against the risk of negative equity.

Comparing the rates gives a difference of **2.7 per cent less the annual pro-rated booking fee**.

### 2.1.3 Credit cards

Different consumers use credit cards for different purposes. For some it is used as a source of credit (specifically where the balance is not paid off in full at the end of each month), while for others it may principally be used as a source of rewards (cashback, air miles etc., with any short-term credit paid off in full at the end of each month) or simply as a means of payment. Other consumers may use it for a mix of these reasons.

The size of the loyalty penalty will depend on how consumers use their credit cards. We have assumed that the profiles in our study with credit cards use them as a source of credit, not paying off the balance in full at the end of each month. Consequently, we focus on the differences in rates on the agreed line of credit between products. Under this approach we explicitly consider a loyalty penalty arising from unsecured borrowing (we adopt the other focus, of using an account for rewards, when assessing the loyalty penalties associated with current accounts).

To estimate the cost of remaining with a poorly performing credit card, we compare the annual percentage rate (APR) charged on the agreed line of credit for a standard credit card, with the APR that is charged on a low interest (or 'rate-for-life') credit card. The latter are cards which offer lower APRs for the full lifetime of the card, providing consumers with a better chance of paying off their credit balance (by reducing interest charges). Thus, it compares the standard rate a consumer would end up on as a result of inactivity (e.g. after any interest-free period), with the rate a consumer could get from the same provider if switching onto their low interest card.

Specifically, we have compared the APR on the standard credit card at a major lender (19.9 per cent APR), with the APR on its low interest card (6.4 per cent) which also charges no balance transfer fee.

The implied cost of remaining on a poorly performing credit card is an interest rate of **13.5 per cent per year**.

### 2.1.4 Current accounts

Traditionally, current accounts have been 'free' products provided to consumers at no expense; a means of storing and easily accessing money, receiving and making payments and accessing cash (through ATMs).

More recently, banks and other providers have offered reward current accounts which include certain benefits to consumers (cashback, interest on amount held, insurance and other products), in exchange for a fixed monthly fee and/or providing certain conditions are met by the consumer.

There is a broad range of reward accounts on offer, each possessing a combination of monthly fees, eligibility criteria and benefits. As such, the articulation and measurement of the costs to a consumer of remaining on a 'poorly performing' current account will differ depending on the type of account held.

For example, some accounts have clear and objective eligibility criteria – e.g. a minimum monthly amount deposited or a minimum number of direct debits set up. If such criteria are not met, all benefits are foregone and the customer incurs a net cost of holding the account equal to the monthly fee. The possibility that the eligibility requirements are no longer met is plausible (e.g. a customer's direct debits being paid through a new partner's account). In such circumstances, there would be a clear rationale for the provider to upgrade

the customer to a classic – non fee-paying – account, with the associated benefit to the customer easily quantifiable.

In other cases, the net benefits to the customer of the account are less clear and are not reliant on objective eligibility thresholds. This is the case with some accounts that offer cashback on general spending, spending at certain ‘partner providers’, or spending on household bills. In these circumstances how much the customer benefits from the cashback provision may vary from month to month, and as such, there may be no clear ‘trigger’ for when the account is no longer suitable.

The picture is further complicated for those accounts offering other ‘associated product’ benefits, such as free mobile phone or travel insurance, leisure and dining deals, or improved foreign transaction rates or fees. Identifying the value of these products to customers and thus whether the consumer would be better off on a different account would be very subjective.

For the purpose of this study, we focus on an account with rewards associated with clear eligibility requirements. This allows us to assess the cost of remaining on a poorly performing current account, by comparing the annual cost of a reward current account assuming the consumer is no longer eligible for any of the rewards it offers, with the annual cost of a standard, zero fee account. In other words, we look at the potential benefit to a consumer of being switched to a more suitable standard account when no longer eligible for the benefits offered by this type of reward account. We believe this approach is the most straightforward and quantifiable in assessing the potential value of automatic upgrades, and does not necessitate extensive assumptions about spending levels and preferences for associated products. We adopt the same approach across all of our profiles, although we recognise that some profiles may be more likely to hold a reward account than others.

We compare a standard, free account of a major bank with the reward account which costs £60 per year (assuming the consumer was no longer eligible for the rewards, the £60 would reflect a net cost).<sup>6</sup> The two products are not identical and therefore consumer characteristics and needs may drive the preference for one product over another. For example, a consumer may at a specific point in time be ineligible for rewards but still value having the reward account if in the future they expect to become eligible for rewards once more; as such, some consumers may not want to be automatically moved into a standard account if they become temporarily ineligible for rewards. That said, we consider this to be a more conservative approach than automatically upgrading someone to a fee-paying reward account from a standard account, if their provider judged that they met the relevant criteria and would be financially better off as a result of the rewards.

The product comparison implies a fixed loyalty penalty of **£60 per year**.

### 2.1.5 Investment products

Providers of investment products charge consumers a fee for managing the funds they have invested. This management fee is typically a percentage of the total amount invested in the product, i.e. the assets under management (AUM). Investment products can attract different fees depending on how actively managed they are, with active funds requiring more management and thus higher fees than passive funds.

The FCA’s (2017) “Asset Management Market Study” identifies ‘partly active’ funds as those funds which have active fees but which closely track the performance of passive funds. As such, consumers may be better off being moved to a passive fund. Although passive and partly active funds are different products, we

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<sup>6</sup> All the rewards in this account (including cash back and interest on the available balance) are dependent on the customer meeting the conditions of a minimum monthly deposit and monthly direct debits.

consider them to be reasonably comparable – a consumer may well have chosen a passive fund as best suited to his needs, but missed out due to the lack of marketing etc. Therefore, moving consumers from a ‘partly active’ fund to a passive fund can still be considered within the concept of an automatic upgrade policy, although it is possible that some consumers would prefer an active fund even when the return/fee trade-off appears unfavourable.

Specifically, we have compared the average ongoing fund charge (OFC) for a passive clean equity share class of 0.15 per cent of AUM, with the lower-bound OFC for a partly active clean equity share class of 0.5 per cent of AUM.<sup>7</sup> Our approach should be considered a conservative estimate of the potential costs, as the OFC for a partly active clean equity share class could be as high as 1.5 per cent of AUM.

The rates above imply a cost of remaining in a poor investment product of **0.35 per cent of AUM per year**.

### 2.1.6 Pensions (accumulation)

Like investment products, pensions are also subject to management fees charged as a percentage share of the pension’s value. In 2012, the UK Government introduced pension auto-enrolment along with caps on the management fees that can be charged to individuals with these new qualifying auto-enrolment pensions. This means that individuals in new auto-enrolment schemes are likely to benefit from lower fees than many with ‘legacy’ pensions (i.e. pensions started before the auto-enrolment scheme was introduced).

We adopt a methodology which quantifies the benefits of upgrading from a legacy pension to a qualifying auto-enrolment pension with capped fees. This is simply done by comparing the average annual charges for consumers on legacy contract-based pension schemes,<sup>8</sup> with average annual charges under auto-enrolment qualifying schemes. These average charges are estimated in the Department for Work and Pensions’ (DWP’s) “Pension charges survey 2016”.<sup>9</sup>

According to the DWP’s study, the average annual charge for members of auto-enrolment qualifying contract-based schemes is 0.54 per cent, while the average charge paid by non-qualifying contract-based scheme members was 0.86 per cent.

The implied cost of remaining on a poorly performing pension is therefore **0.32 per cent per annum**.

### 2.1.7 Home insurance

Insurance products (for travel, car, home etc.) are typically sold as annual policies that renew automatically on a yearly basis. The insurance provider makes contact with a consumer when their current policy is about to expire, setting out the terms and price of the new policy for the forthcoming year. If the consumer does not respond, then the default position is for the insurance to renew as a new annual policy with the new terms and price quoted. This means that, through inertia, a consumer could see their insurance premium rise year-on-year.

There are existing studies which have quantified the size of the average loyalty penalty as a percentage year-on-year increase for consumers remaining on the same policy at the same provider. Citizens Advice estimated the average increase in home insurance premiums from auto-renewal after one year to be 8 per cent.<sup>10</sup> To

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<sup>7</sup> FCA (2017) “Asset Management Market Study”.

<sup>8</sup> Contract-based schemes were chosen, as opposed to master trust, trust-based or unbundled schemes, as according to the DWP’s 2017 study these are the most common types of scheme in the market.

<sup>9</sup> Department for Work and Pensions (2017), “Pension Charges Survey 2016: Charges in defined contribution pension schemes”.

<sup>10</sup> Citizens Advice (2017), “The insurance loyalty penalty: Unfair pricing in the home insurance market”.

estimate the size of the loyalty penalty for a given consumer profile, we apply this 8 per cent increase in premiums on a year-on-year compounded basis (along with the estimated number of years for which the product has been held, as described in Section 2.3 below).<sup>11</sup>

To identify the best current premiums we used price comparison website MoneyFacts. For each consumer profile holding home insurance, we identified the best current premium by tailoring two key elements of the quote: first, whether the product covered contents only, or buildings and contents; and, secondly, the estimated value of the house (our choices informed by data from the FCA's Financial Lives survey). In generating the home insurance premium quotes, we used the same excesses (i.e. the amount the consumer is liable to pay when making an insurance claim) to ensure comparability.

The cost of remaining in a poorly performing insurance policy (i.e. with annual auto renewals) is an **8 per cent increase in premiums per year**.

### 2.1.8 Income protection

Income protection insurance is a long-term insurance policy designed to help people if they cannot work due to illness or injury, by ensuring a stream of income until one is able to return to work. It is most likely to be needed by persons who are self-employed, or employed but do not have any sick pay to fall back on. Evidence from the FCA's Financial Lives Survey data suggests that only around 4 per cent of the UK adult population holds such a product.

Individuals with income protection insurance could see their premiums rise year-on-year as a result of inertia (i.e. remaining on the same product at the same provider), in the same manner described for home insurance above. We are, however, unaware of any studies that have specifically looked to estimate the average year-on-year increase in premiums from auto-renewal specifically in the income protection insurance market. As such, until such a study is undertaken, we believe the best approach is to apply the loyalty premium estimated in the home insurance market.

The best rate, as for home insurance, was found using the price comparison website MoneyFacts, with inputs to generate the quote tailored to the consumer profile which holds this product.

The cost of remaining in a poorly performing insurance policy (i.e. with annual auto renewals) is an **8 per cent increase in premiums per year**.

## 2.2 Summary of 'penalty' rates

Table 2.1 below summarises the penalty rates for each financial product, reflecting the costs of remaining in a poorly performing product compared to a better alternative.

**Table 2.1: Summary of 'penalty' rates**

	% of amount held
Cash ISA	0.80
Mortgage	2.70 (less fee)
Credit Card	13.5

<sup>11</sup> Citizens Advice estimate the average increase as a result of auto-enrolment after five years to be 70 per cent. This is higher than an annual 8 per cent uplift compounded over five years (47 per cent), and thus our approach can be considered a more conservative estimate of the loyalty penalty.

<b>Current Account</b>	[£60]
<b>Investment Products</b>	0.35
<b>Pensions</b>	0.32
<b>Home Insurance</b>	[8% increase per year]
<b>Protection Insurance</b>	[8% increase per year]

Square brackets denote a 'penalty' rate that is not a percentage of the amount held, but rather either a fixed fee in the case of a current account, or an expected increase year-on-year in the case of home insurance and protection insurance.

Source: publicly available data from a range of sources (see precise sources for each product above).

## 2.3 Developing the profiles

To assess the costs of being trapped in poorly performing products in a meaningful way, we developed six consumer profiles covering a number of demographic dimensions recorded in the FCA's Financial Lives Survey (2017). The goal was to develop profiles that represent a range of consumers, to help understand how a policy of automatic upgrades might affect different segments of the population. Different people will hold a different range of financial products, and within each product class the level of assets or debt will vary by person.

The six profiles we chose are intended to reflect a wide cross-section of the UK population. Inevitably, six profiles cannot be statistically representative of the entire UK population, but we believe that the profiles are illustrative and grounded in reality. We assigned a limited number of profile characteristics and then referred to Financial Lives data to develop each profile. By design, we chose profile characteristics for which there was a reasonable sample size of people in the Financial Lives data. Our profiles' financial portfolios are informed by the situation of a number of people with the assumed characteristics, rather than a single person.

The table below presents the six consumer profiles.

**Table 2.2: Consumer profiles**

Profile #	Gender	Age	Income (£ p.a.)	Other characteristics
1	Female	25	15,000	Unemployed
2	Male	35	15,000	In financial difficulties, Wales
3	Female	45	30,000	Urban area, not married, England
4	Female	65	30,000	Retired, financially resilient, Scotland
5	Male	70	30,000	No internet, owns home
6	Male	55	80,000	Owens home, married, NI

Notes: To generate samples for each profile in the Financial Lives data, we used the relevant age and income ranges that matched our six profiles. Income refers to pension income, from all sources before tax and other deductions

### 2.3.1 Allocation of product holdings

The financial portfolios of the profiles were developed using the Financial Lives survey data. Each profile generated a sample of between 12 and 27 people, with a range of products held. As a starting point, we allocated a product to a profile where more than 50 per cent of the profile sample held that product. The percentage shares holding each product for each consumer profile are shown in Table 2.3. For example,

Profile 1 was not allocated a mortgage because none of the surveyed population in that profile held a mortgage, while Profile 2 was allocated a mortgage because 67 per cent of surveyed persons in that profile held a mortgage.

This mapping process gives results which are broadly consistent with the share of the total survey population holding that product. Continuing with the mortgage example, we see that two out of six profiles (33 per cent) have a mortgage, while the percentage share holding a mortgage in the total population is 31 per cent.

**Table 2.3: Percentage shares holding each financial product by profile**

Product	Profile 1	Profile 2	Profile 3	Profile 4	Profile 5	Profile 6	Total Population
Cash ISA	13%	18%	37%	74%	31%	51%	37%
Mortgage	0%	8%	67%	0%	11%	84%	31%
Credit Card	25%	49%	81%	73%	52%	97%	62%
Current Account	78%	100%	100%	100%	100%	100%	96%
Investment Products	5%	0%	19%	88%	32%	47%	29%
Pensions	26%	58%	94%	84%	74%	81%	66%
Home Insurance	6%	0%	64%	75%	74%	100%	49%
Protection Insurance	0%	0%	19%	0%	0%	6%	4%

Source: Financial Lives survey data.

The final allocation of products to each profile, as well as the key characteristics of each profile, are summarised in Table 2.4. In generating this final allocation, a small number of exceptions were made to the rule of allocating a product to a profile where more than 50 per cent of surveyed persons in that profile held the product.

- **Inclusion of credit card for Profile 2.** This decision meant that one of our low-income profiles held a credit card. Moreover, it is close to the 50 per cent threshold (49 per cent of surveyed persons in this profile held a credit card) and the Financial Lives survey data show a very high proportion (94 per cent) of individuals who fit this profile have some sort of overdraft facility.
- **Inclusion of income protection insurance for Profile 3.** As seen in Table 2.3 above, income protection insurance is very rare with only 4 per cent of the total surveyed population holding such a product. We include it in Profile 3, as this is the profile for which the largest share of individuals hold protection insurance (19 per cent).
- **Exclusion of pension for Profile 4 and Profile 5.** These profiles represent pensioners drawing down their pension, rather than accumulating. The Financial Lives survey data does not make this distinction, instead recording whether participants hold any kind of pension. For the purposes of estimating the loyalty penalty, our approach focussed on the loyalty premium that consumers might incur if they do not switch plan while they are saving. There is the possibility that people in income drawdown could go on paying investment charges after retirement and be subject to the same scale of loyalty penalty as those pre-retirement. In developing our profiles, we assume that these consumers would have bought an annuity prior to the introduction of pension freedoms, but in future the loyalty penalty may continue into retirement for many consumers.
- **Inclusion of investment products for Profile 6.** The relevant considerations for this exception are that it is close to the 50 per cent threshold (47 per cent of surveyed persons in this profile hold investment products), it means that one-third of our profiles hold investment products (29 per cent of the overall

surveyed population hold investment products), and it seems appropriate to look at how loyalty premiums associated with investment products might affect high-income individuals.

We also note that for Profile 4 we assumed a contents only home insurance product (as opposed to joint buildings and contents cover for each of Profiles 3, 5 and 6). This is because Profile 4 does not own their home.

### 2.3.2 Estimating amounts held in financial products

For profiles holding certain financial products, we determine the amount held in these financial products as this will drive the size of the overall loyalty penalty. This is applicable in the case of: cash ISAs; mortgages; credit cards (the size of the agreed credit balance); investment products; and pensions.

To determine the amounts of money held in each of these financial products across our consumer profiles, we make use of the FCA's Financial Lives survey data and calculate the mean holdings for a given financial product and consumer profile. In some cases, the Financial Lives data reports amounts held for broader categories of product than are included in our product sample. For example, it collects data on the amount held across savings products as a whole (including current accounts, savings accounts, NS&I bonds, credit union savings accounts, e-money accounts, post office card accounts, and cash ISAs) rather than specifically in cash ISAs. In such cases we assume that the full amount represented by the broader category is held in the specific product in our sample. For example, if the Financial Lives data reports an average of £30,000 in savings products for a given profile, we assume that the profile in question has £30,000 saved specifically in a cash ISA. Whilst this may over-state the loyalty penalty associated particularly with cash ISAs, it is possible that similar loyalty penalties exist with other savings forms such that the results generated in this report are not a significant overestimate of the savings loyalty penalty in reality.

In the case of pension pot size no data are available from the Financial Lives survey, so we developed our own estimates for each profile based on assumptions on annual income, annual contributions and number of years held.

Since we assess the loyalty penalty for current accounts based on the fees paid, the amount of money actually in the current account does not affect the estimated penalty.

In the case of insurance (i.e. home insurance and income protection), clearly no money is held in these products. Instead, what is of interest to estimating the total penalty is the length of time for which these products have been held and what is being insured (e.g. the assumed value of the house). Again, we have made use of the FCA's Financial Lives survey data to estimate the average time held for each profile that holds the insurance product in question.

### 2.3.3 Summary of profiles

Table 2.3 summarises the six profiles for whom we attempted to estimate a loyalty penalty. It details the assumed portfolio of products and, where appropriate, amounts held in each, as well the demographic characteristics on which the profile was developed.

Table 2.4: Summary of profiles by characteristics, products held and average (mean) amount held in products

	Profile 1	Profile 2	Profile 3	Profile 4	Profile 5	Profile 6
<b>Gender</b>	Female	Male	Female	Female	Male	Male
<b>Personal income</b>	Low	Low	Average	Average	Average	High
<b>Age</b>	18-34	25-44	40s	60+	60+	35-60
<b>Other</b>	Out of work	In financial difficulties	Not married	Retired, financially resilient	Owns home, no Internet	Owns home
<b>Cash ISA</b>				£100,000		£30,000
<b>Residential mortgage</b>			£80,000			£100,000
<b>Credit card</b>		£6,000	£8,000	£3,000	£3,000	£7,000
<b>Current account</b>	n/a	n/a	n/a	n/a	n/a	n/a
<b>Investment product</b>				£80,000		£40,000
<b>Private pension (acc.)</b>		£8,000	£50,000			£200,000
<b>Home insurance</b>			n/a	n/a	n/a	n/a
<b>Income protection</b>			n/a			

Note: Columns left blank represent profiles that do not hold that particular product. 'N/a' refers to products which do not entail an initial product amount.

Source: Europe Economics' analysis of Financial Lives survey data; \* Amounts for pensions estimated by in-house Europe Economics' analysis.

## 2.4 Application of our approach

The approach to estimating the loyalty penalty varies by product.

Firstly, for those financial products in which money is held (i.e. cash ISAs, mortgages, credit cards, investment products and pensions), the loyalty penalty is calculated as:

$$\text{Loyalty Penalty Product A} = \text{Loyalty Penalty Rate Product A} * \text{Amount held in Product A}$$

Secondly, for current accounts, the total loyalty penalty is simply equal to the loyalty penalty rate and does not vary across profiles.

Thirdly, for insurance products (i.e. home insurance and income protection), the loyalty penalty is given by:

$$\begin{aligned} \text{Loyalty Penalty Product B} \\ = \text{Current Best Rate} * (\text{Annual Premium Increase} * \text{Number of years held} - 1) \end{aligned}$$

In the Results chapter we present total loyalty penalties for each profile, which simply sums together the loyalty penalty for each product that the given consumer profile holds. The total loyalty penalty as a share of income is then calculated by dividing the total loyalty penalty by the assumed average income of the profile in question.



## 3 Results

In this section we set out the results of our analysis, for the eight different financial products under investigation and for our six consumer profiles. Specifically, we present the following:

- Overall detriment (cost) of remaining in poorly performing products per profile.
- Cost breakdown by product for each profile.
- Cost breakdown by profile for each product.

We conclude this section by summarising our findings, as well as setting out key caveats to our analysis.

The costs associated with remaining in a poorly performing product can simultaneously be considered as potential benefits of an automatic upgrade policy – a consumer who is upgraded to the better product would forgo the costs associated with the poorly performing product.

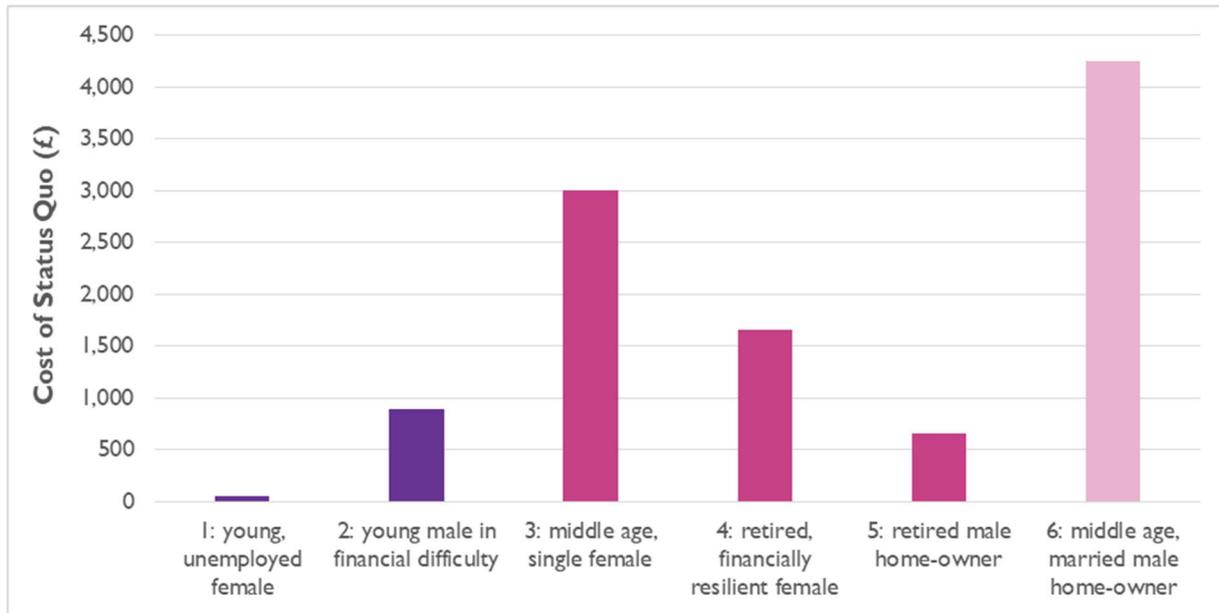
### 3.1 Costs per profile

We have assessed the total cost of remaining with poorly performing products per profile, summing the costs associated with all the products within each profile's financial portfolio. The results are presented in Figure 3.1. This shows that the total cost of remaining in poorly performing products varies significantly depending on which financial products are held, and subsequently on the amount held in those financial products (where relevant).

The most affected profile, in absolute terms, is that of the high income, middle age and married male homeowner (Profile 6), who could experience an annual cost in excess of £4,000. The next highest cost is incurred by the middle age, average income, single female (Profile 3), which we estimate to be in the region of £3,000 a year. The least affected profile is the young unemployed female (Profile 2), with a cost of around £60, by virtue of only holding a current account out of the set of financial products.

Whilst it is clear that not all consumers fitting the characteristics of our profiles would necessarily be trapped in poorly performing products, because our profiles are developed using real data on UK consumers this exercise does suggest that there will be some consumers in the UK incurring potentially sizeable costs from remaining with poorly performing products.

**Figure 3.1: Absolute cost of remaining with poorly performing products, by profile**

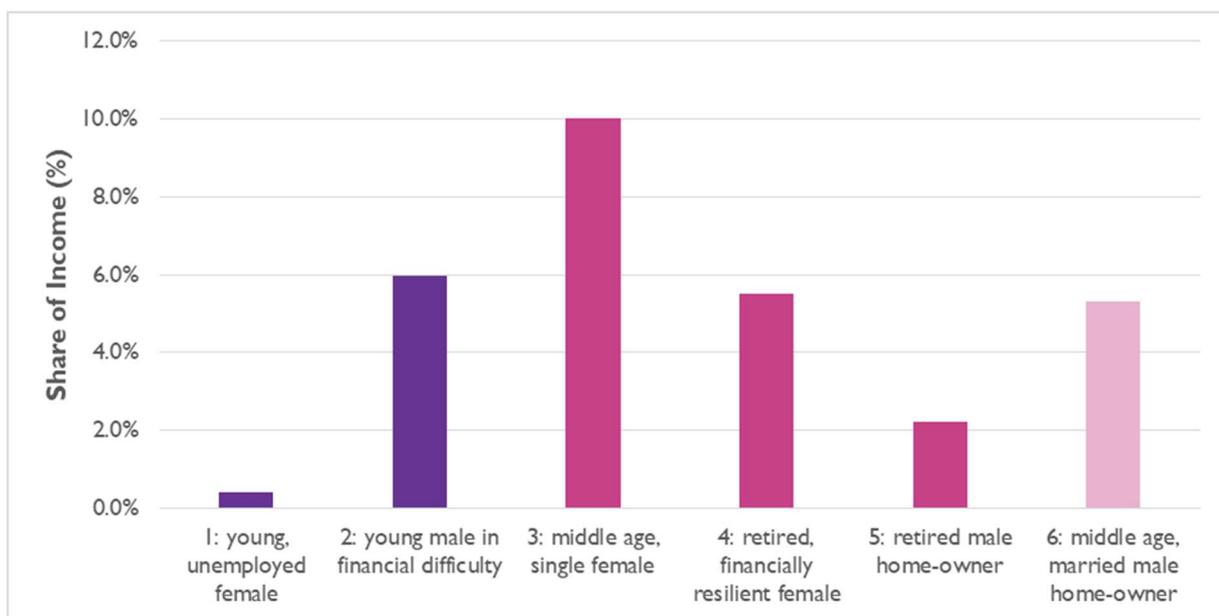


Note: • Low income, • Average income; • High income

Source: Europe Economics' analysis of publicly available data from a range of sources.

The results change when the cost of remaining with poorly performing products is expressed as a percentage of annual income. The worst affected profile is now the middle age, average income single female, for whom the costs are 10 per cent of annual income. The relative impact on Profile 6 is much lower, at 5.3 per cent. Four out of the six profiles have a total annual cost in excess of 5 per cent of their annual income. As before, the least affected profile is the young, unemployed female, with the cost of remaining in a poorly performing product constituting 0.4 per cent of annual income.

**Figure 3.2: Cost of remaining with poorly performing products as share of income, by profile**



NB: • Low income, • Average income; • High income

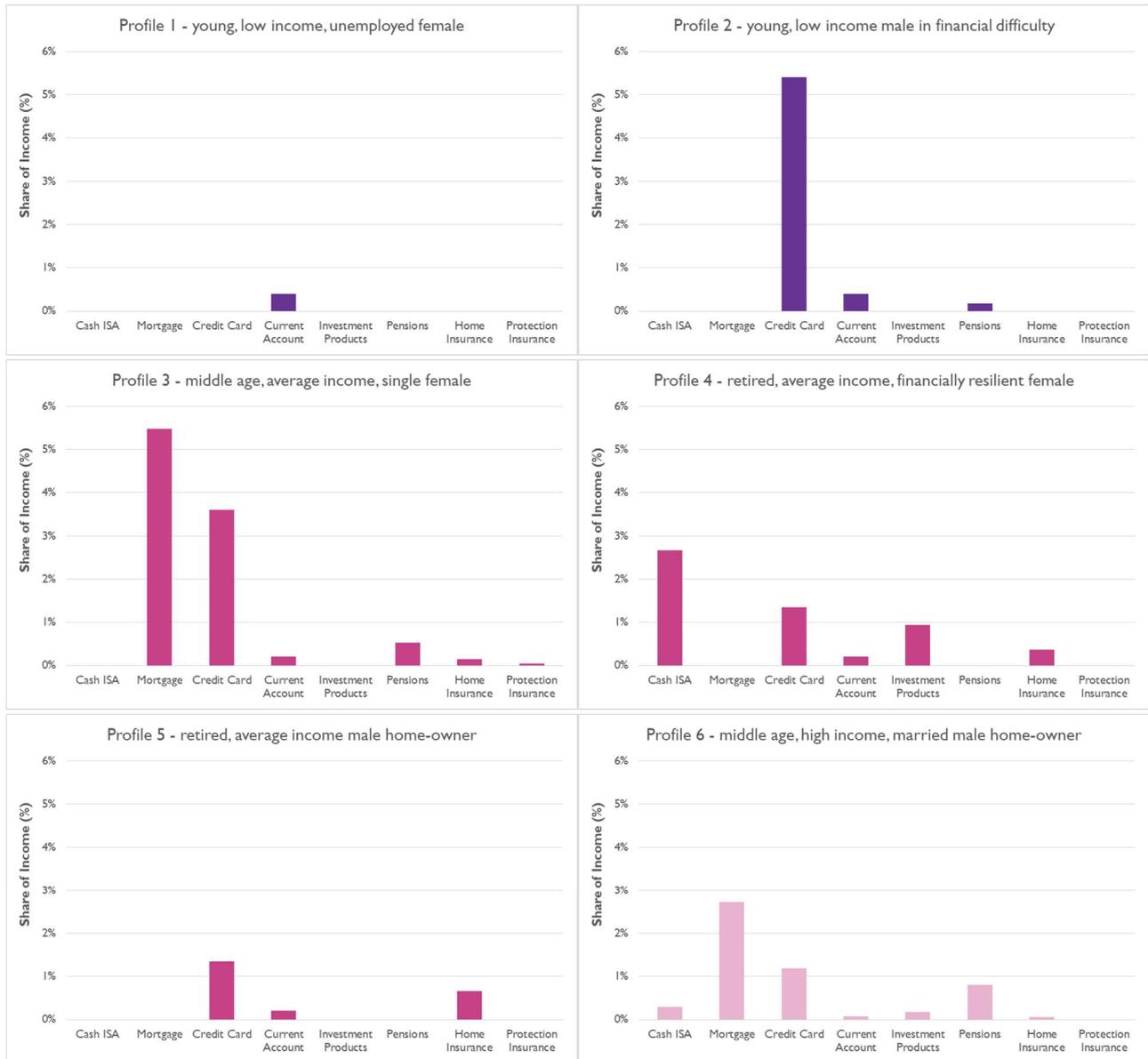
Source: Europe Economics' analysis of publicly available data from a range of sources.

## 3.2 Cost breakdown by profile

We now present the costs of remaining in poorly performing products for each profile. The results are presented in Figure 3.3. The following key observations can be made:

- There is variation across consumer profiles depending on which products are held, the amount held in these products (if relevant), and the length of time for which the product has been held (again, if relevant).
- For those profiles with a mortgage (Profiles 3 and 6), this is the key driver of the overall cost. This is a combination of the relatively high loyalty penalty rate (around four per cent per year) and the material size of the mortgage balances.
- Credit cards are another major driver of cost – out of our five consumer profiles that hold a credit card, it is the largest component of the overall cost in three cases and the second largest in the other two cases. This is driven by the high loyalty penalty rate applicable to the credit card balance, of around 13 per cent.
- Current accounts, insurance products, investment products and pensions represent relatively small shares of the overall costs for each consumer profile.
- Based on share of income, the two most significant costs identified (by some margin) are for the mortgage held by Profile 3 – our middle age, average income, single female, and for the credit card held by Profile 2 – our young, low income male in financial difficulty.

**Figure 3.3: Breakdown of costs as a share of income by profile**



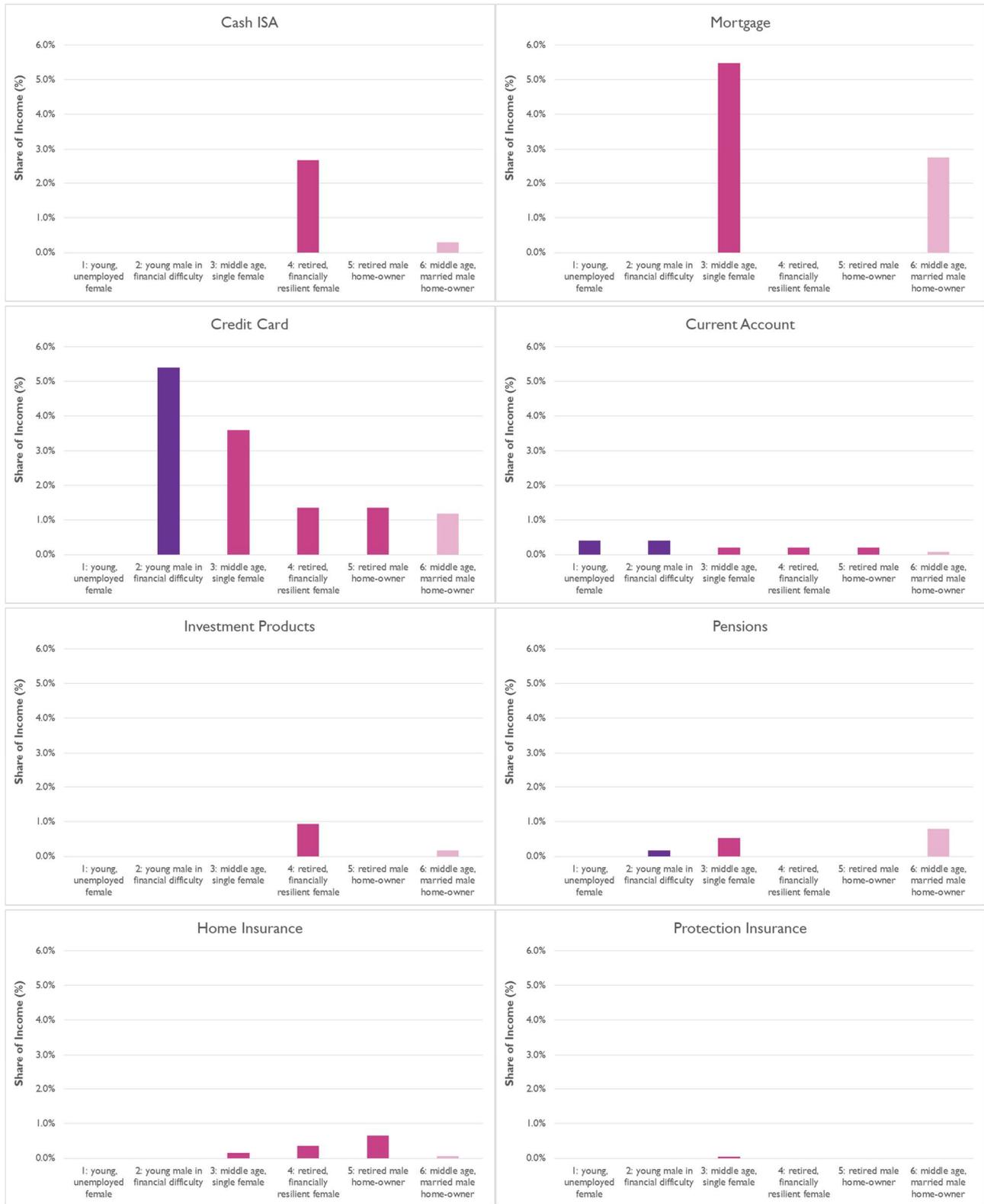
NB. • Low income, • Average income; • High income  
 Source: Europe Economics’ analysis of publicly available data from a range of sources.

### 3.3 Cost breakdown by product

In this section, we compare the costs of remaining in poorly performing products for a given financial product across the different profiles. This can help identify for which profiles the costs associated with a particular product may be felt most acutely. The following key observations can be made:

- With the exception of pensions and insurance products, we generally see a pattern whereby lower income individuals suffer a higher cost of remaining in a poorly performing product as a share of income (with columns getting shorter from left to right in Figure 3.4).
- This is exemplified by credit cards, for which one of our low income profiles sees a loyalty penalty in excess of 5 per cent of income, while our high income profile sees a loyalty penalty of just over 1 per cent.

Figure 3.4: Breakdown of loyalty penalties as a share of income by product



NB. • Low income, • Average income; • High income

Source: Europe Economics' analysis of publicly available data from a range of sources.

### 3.4 Summary of key findings

The costs of remaining in poorly performing products – and hence the potential benefits of a policy of automatic upgrades – represent a notable proportion of consumers’ annual incomes. Four out of our six profiles face a total cost in excess of five per cent of their annual personal income. Our middle age, average income, single female (Profile 3) is by a large margin the most affected, with costs amounting to 10 per cent of annual income.

In terms of absolute monetary value, the estimated costs in this study vary significantly from our young, low income, unemployed female (Profile 1) of £60 per year to our high income (Profile 6) of over £4,000 per year.

Consumers with the lowest incomes, who may not hold many financial products, are unlikely to be particularly affected by the costs of remaining in poorly performing products either in absolute terms or as a proportion of personal (gross) income. The relative costs for those with the lowest incomes may well rise if the estimates were based on disposable income after essentials (accommodation, food) are netted off. However, the Financial Lives data do show that low-income consumers simply do not hold many financial products, thus placing an upper bound on even the relative impact of loyalty penalties on these consumers. For them, a lack of access to financial markets rather than loyalty penalties appears to be the key problem.

Mortgages and credit cards are the two largest drivers of costs for those that hold these products. Credit cards in particular are widely held across our profiles (and the UK population according to the Financial Lives data). Our analysis for credit cards is focussed on those who fail to pay off the balance each month which, judging from the Financial Lives data, could be a significant number of people.

#### 3.4.1 Summary of key assumptions

The variation in results across the six consumer profiles is driven by a combination of the products held in each financial portfolio, the amount held in each product, and the length of time for products have been held. These results are influenced by a number of key assumptions made to undertake the analysis, including the product- and profile-specific assumptions already set out in detail in Chapter 2.

A key driver of the results is the assumed products held and amounts held in these products across the profiles. We think that the approach we adopted to determine the portfolios for our six profiles is reasonable, generating profiles that bear some relationship with the situation facing some segments of the population.

Our approach to measuring the cost of remaining with the status quo differs across the products under investigation. This is because of both data availability and the nature of the products. In some cases, our product approach compares the rates of two broadly similar products of a given provider that are concurrently available to the same customer (e.g. comparing the rates on a standard credit card with that on a low interest card). In other cases, our approach compares the rate available to a loyal customer to that available to a new customer switching into a product (e.g. in the case of home insurance, comparing the premium after multiple auto-renewals with the best available rate on a price comparison website). We think both approaches are viable methods of measuring the cost of status quo, albeit the precise interpretation of the result may differ slightly.

Because our profiles are not statistically representative of the entire UK population, we cannot, based on this analysis alone, draw inferences as to the potential costs of remaining in poorly performing products for the UK as a whole. Our analysis provides insight into which consumer types may suffer more acutely relative to others, the potential magnitude of costs faced by each, and the products likely to give rise to the largest loyalty penalties.

### 3.5 Switching costs

An important intended benefit of an automatic upgrade policy would be the impact on consumers' time. Many policy solutions, for example to enhance competition or consumer outcomes, require consumers to be more engaged in the market. However, there are arguments that searching and switching take up a large proportion of consumers' time and represent a cost burden that is not always reflected in these policy discussions.<sup>12</sup>

If consumers are automatically upgraded to a better performing product by their providers, this would save them the costs of searching among the providers' suite of products and the costs of the switching process (in reality *some* time would need to be spent engaging with the provider during the switching process, but this would be less than with a consumer-instigated switch). Time spent searching and switching will have different values for different consumers, and it is not practical to estimate here the savings that might stem from a policy of automatic upgrades across the range of products we have considered. Estimates from Citizens Advice suggest that time spent 'engaging well' with switching decisions can be as much as 95 hours a year for a consumer. This applies across a range of product areas not just financial services, but reflects the fact that this time burden is not immaterial.<sup>13</sup>

The total time required for a product switch can be significant. Estimates vary across the various products we have considered, for example 15 working days to switch a cash ISA,<sup>14</sup> 4-8 weeks for a mortgage,<sup>15</sup> 7 days for a credit card and current account,<sup>16</sup> and 15 days for a pension (this can increase to 12 weeks if not done electronically).<sup>17</sup> Under an automatic upgrade policy the product switch would be done within the same provider, most likely saving on this time due to reduced paperwork and inter-bank communication. Consumers would therefore be likely to enjoy the benefits of better performing products earlier than if they undertook the switching process themselves.

The actual savings that this policy might generate would depend on its impact on consumer behaviour.

- Consumers most likely to benefit from a policy of automatic upgrades are unlikely to be searching/switching at all, and thus the policy would not provide many time savings to them.
- If there are time savings to be had, they would accrue to consumers who previously searched and switched regularly (and who therefore would not suffer from the costs of remaining in poorly performing products). However, these consumers would most likely be searching between *different* providers to find the best product (rather than restricting themselves to searching within the same provider), and thus this policy would not address those time costs. However, with a policy of automatic upgrades the benefits of searching and switching (even across providers) would now be less – the alternative of not doing so would no longer result in a poorly performing product, and providers would also be less willing to offer low introductory rates. Therefore consumers' searching and switching costs may still decline as an indirect result of this policy, with the potential detrimental impact on competition if switching *between* providers reduces.

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<sup>12</sup> See for example the discussion by Citizens Advice (2016) "Against the clock Why more time isn't the answer for consumers" [\[online\]](#)

<sup>13</sup> Citizens Advice (2016) "Against the clock Why more time isn't the answer for consumers" [\[online\]](#)

<sup>14</sup> FCA, *Switching your bank account* (8 December 2017) [\[online\]](#).

<sup>15</sup> Money, *How to get a remortgage* (20 December 2018) [\[online\]](#).

<sup>16</sup> MoneySavingExpert.com, *7-day bank switching era begins: Full Q&A on what it means for you* (16 September 2013) [\[online\]](#).

<sup>17</sup> Out-Law.com, *Changing a pension scheme* (August 2011) [\[online\]](#).

## 4 Evidence Review

This evidence review complements the empirical work of this study in providing an evidence base for the Panel’s consideration of an automatic upgrade policy for consumers “trapped” in poorly performing financial products. Financial services consumers may be trapped for a number of reasons. Some may consciously choose to remain with a product and may consider the costs to be balanced or outweighed by the benefits they attach to that particular product and/or the expected costs of shopping around for a better deal. There may be those who know they would benefit from a different product but do not switch because of excessive switching costs, behavioural biases (such as choice overload, inertia, or regret aversion) or a combination thereof. Finally, some consumers may not even be aware that there might be better alternative products available for them. It might be argued that not all of these consumers are “trapped”, as some take a conscious decision not to shop around. However, consumers’ trade-offs may be affected by relatively high switching costs due to a number of reasons (life stage, family/employment situations, or an inability to adequately weigh the long-term benefits of shopping around with the short-term costs), such that firms’ behaviour could still be considered exploitative.

A policy of automatic upgrades is one way in which to prevent consumers from being trapped in poorly performing financial products. In this first section of this evidence review we explore alternative policy propositions for achieving this, such as RU64-style rules, restricting product ranges, and price benchmarking, as well as more novel approaches raised in the literature. We set out their advantages and drawbacks, and provide evidence of their efficacy in other sectors where this exists.

A policy of automatic upgrades may limit the ability of firms to cross-subsidise between consumers and products. If firms are obliged to upgrade consumers on expensive products to newer, better value products, they would not have the incentive to cross-subsidise (or otherwise offer below-cost introductory offers) since there would no longer be any prospect of customers subsequently reverting to expensive products and generating large revenues. In the second section of this review we examine the impacts of preventing cross-subsidisation on consumers, firms, and markets.

The tables below summarise the impacts of the alternative policy approaches, and examples of the impacts of stopping cross-subsidisation.

**Table 4.1: Summary of impacts of policy approaches**

Policy approach	Stakeholder	Benefits	Drawbacks
<b>Restricting Product Ranges</b>  Reducing number of products, simplifying products, and standardisation.	Consumers	Ease of product comparison if standardised products are introduced, leading to more switching and lower charges/better rates.	Consumers may still need to switch regularly to benefit from the best rates. Consumers on non-standardised products may be even more exposed to loyalty penalties.
	Market	Lower unit costs to firms for providing standardised / simple products.	Firms may choose to not sell the simple products. Innovation may be stifled.
	Regulator		Burden of setting boundaries of restricted products and / or determining the information to be standardised.

		New firms providing standardised products could increase competition and reduce regulator concerns about exploitative incumbent firms.	
<p><b>RU64-style Rules</b></p> <p>Providing a statement to customers that provider's product is at least as good as an alternative, either at time-of-sale or periodically.</p>	<p>Consumers</p> <p>Market</p> <p>Regulator</p>	<p>Reduced information asymmetry, and consumers would not need to weigh the benefits of many products to know which is most suitable.</p> <p>Competition may improve between providers, as keeping consumers in poorly performing products would be less viable.</p> <p>Embodies an element of self-regulation in that firms would internally assess the suitability of products for consumers.</p>	<p>The physical switching process remains unchanged (unless accompanied by easy-switching options). Potentially reduced incentives to seek financial advice.</p> <p>Providers may raise prices across all products to reduce the differences between alternatives.</p> <p>Regulatory risks may emerge from statements that are intended as advice being provided by firms not authorised to do so.</p>
<p><b>Price Benchmarking</b></p> <p>Setting upper-limits for reversion rates and / limiting below-cost introductory pricing.</p>	<p>Consumers</p> <p>Market</p> <p>Regulator</p>	<p>Restricting reversion rates could reduce the extent to which consumers become trapped over time. Limiting below-cost pricing removes the potential for consumers to be attracted to headline figures which then deteriorate.</p> <p>Limiting below-cost pricing may encourage market entry, as firms compete on a similar cost basis per product.</p> <p>Encouraged innovation may benefit poorest consumers the most if firms compete to provide basic products for lowest cost.</p>	<p>Financial inclusion could suffer if prices/fees rise across all products.</p> <p>New firms would not be able to gain market share (e.g. compete with more efficient incumbents) through any below-cost pricing strategies.</p> <p>Below-cost pricing would be difficult to monitor, and the regulator's definition of a product's cost may differ to that of industry.</p>
<p><b>Technological innovation</b></p> <p>For example, automatic switching services</p>	<p>Consumers</p> <p>Market</p>	<p>Switching is delegated to an automated process, overcoming consumers' inertia and improving access to better products.</p>	<p>Automatic programmes may not take into account consumers' non-monetary preferences for remaining with a particular product. May entrench consumer complacency and reduce incentives to seek financial advice.</p>

	Regulator	<p>Increased competition driven by higher switching rates.</p> <p>May reduce the ability of provider to tie in consumers and reduce the need for regulatory intervention to prevent this.</p>	<p>Regulatory risks in operating in this sector may increase firms' costs and deter entry.</p> <p>Implications for data-sharing could be significant and would require a considered regulatory response. Potential risks to consumers of sub-optimal outcomes would need to be monitored and measured.</p>
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Table 4.2: Summary of impacts of stopping cross-subsidisation

Examples of stopping cross-subsidisation	Winners	Losers
1. Free if in credit current accounts	<b>Consumers</b> with other products may win through lower prices / better returns, if they were previously cross-subsidising the FIC accounts.	<b>Firms</b> may need to rethink the funding strategies in place that allow them to reach poorer consumers and meet their regulatory requirements to provide basic current accounts free of charge (UK Payment Accounts Regulation 2015).
2. UK Flood Re Scheme	<b>Low-risk households</b> may no longer subsidise high-risk households, reducing their premiums. Society in general benefits from accurately pricing risk of climate-based events.	<b>High-risk households</b> may become priced out of insurance market.
3. USA general insurance pricing laws	<b>Consumers with low propensities to switch</b> would be shielded from exploitation.	<b>Regulators</b> would struggle to monitor providers' adherence to laws banning pricing based on consumer switching propensity.

## 4.1 Policy approaches to help trapped financial consumers

In this section we consider a number of policy responses that may reduce the risks to consumers of becoming trapped in poorly performing products.

### 4.1.1 Restricting product ranges

Confronted by a multitude of different products, consumers are likely to be unable and / or unwilling to trawl through all possible options to select the best one in terms of price and/or quality. Such choice overload has been associated with decision fatigue, going with the default option, as well as choice deferral (avoiding making a decision altogether and not switching to a more suitable product).<sup>18</sup> Choice overload can be counteracted by reducing the number of available options or simplifying the information with which

<sup>18</sup> Iyengar, S., & Lepper, M. (2000). 'When choice is demotivating: Can one desire too much of a good thing?' *Journal of Personality and Social Psychology*, 79, 995-1006.

consumption choices are made.<sup>19</sup> By reducing the extent of choice overload, comparing and finding the right product will become a less onerous task for consumers, thus potentially increasing the likelihood that trapped consumers will be willing and able to switch products.

Restricting product ranges would require financial services providers to standardise the products they offer. One option here could involve the introduction of a range of simpler products with identical features either to replace existing product lines or, more likely, in addition to them. The FCA has recently begun to debate the introduction of a basic savings rate that would apply to all consumers who have been on easy-access savings products for more than a set period of time, such as one year.<sup>20</sup> Another option which has been introduced in some countries, such as Belgium (discussed below), requires products to be accompanied by information provided to consumers in a standard format that allows for ease of comparison between multiple products on the market. Relatedly, tax incentives could even direct consumers towards more 'favourable' products in a form of 'libertarian paternalism', where existing choices remain unchanged (the libertarian aspect) but a regulator identifies particularly suitable products for the typical consumer (the paternal aspect). Fundamentally, this policy response would seek to limit the detrimental impact that choice overload has on the capacity for decision-making of the typical consumer.

In this section we focus mainly on the policy response of introducing a simplified, standardised product (or product range) into the market in addition to existing product lines. The literature and policy discussions have tended to focus on this type of product range restriction.

## Benefits

### *For consumers*

Simplified products would be clear and transparent.<sup>21</sup> Consumers would need to compare fewer characteristics, which could reduce switching costs associated with the search for better products. That firms would compete on fewer characteristics could encourage cost-reducing strategies within firms as they compete for a greater share of the market, thus resulting in lower prices faced by consumers.

With the choice of available products simplified, those consumers who are trapped because of high switching costs or choice overload should find it easier to shop around for better deals. Additionally, information provided in a standardised format would enable consumers to directly compare across a variety of products, further reducing switching costs.

For example, the FCA's proposed basic savings rate (BSR) would entail an interest rate, set by individual providers, to which the savings rates of loyal consumers would revert after a set period of time. The ease of comparing the basic savings rates across providers should increase competition for this product. Providers would thus set the rate at a reasonably high level to gain market share, and the introduction of the BSR should automatically increase rates for those consumers who are trapped in accounts currently paying the very lowest rates.<sup>22</sup>

### *For the market*

Simple financial products could reduce the unit costs of distribution for firms. In theory, a reduction in the costs of providing firms' products could enable them to extend their reach to greater numbers of consumers

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<sup>19</sup> Johnson, E. J., Shu, S. B., Dellaert, B. G.C., Fox, C. R., Goldstein, D. G., Häubl, G., Larrick, R. P., Payne, J. W., Peters, E., Schkade, D., Wansink, B., & Weber, E. U. (2012), 'Beyond nudges: Tools of a choice architecture', *Marketing Letters*, 23, 487-504.

<sup>20</sup> FCA (2018a): 'FCA opens a discussion on introducing a basic savings rate in the cash savings market' [\[online\]](#).

<sup>21</sup> ACM (2015): 'Financial standard products: Study into the effects of standard products on competition in the financial sector' [\[online\]](#).

<sup>22</sup> Fairer Finance (2018): 'Full disclosure: fixing the UK savings market' [\[online\]](#).

who were hitherto considered economically unviable.<sup>23</sup> A simple product range would have lower product design and development costs than the cohort of current and sometimes bespoke products offered. These lower costs could be passed on to consumers through lower fees/charges. Furthermore, if the increased comparability enhances competition this could place further downward pressure on prices. This could make financial products more affordable and attractive for excluded or underserved consumers. Consequently, the need for providers to engage in cross-subsidisation to reach underserved consumers could be reduced (simplified products could therefore also partially offset the potential negative impact of stopping cross-subsidisation on financial inclusion).

Benefits for the market as a whole stem from competition and innovation. The Financial Services User Group (FSUG) has alluded to the potential for 'socially useful financial innovation' resulting from a standardised product range.<sup>24</sup> By this, FSUG refers to the reduction of costs and risks faced by the consumer in exploring alternative financial products, given that firms would be competing for the sale of standardised products solely on price.

The market could benefit from the introduction of new firms that intend to specialise in providing the standardised products. Supposing that the characteristics of simple products were designed by the regulator, new firms would not face the costs of designing revolutionary products in order to enter the market. Alternatively, if information becomes more standardised and easier to digest, consumers may be more willing to switch to smaller providers. This has happened recently in the UK domestic energy sector, in which increased switching rates have been driven by consumers switching to smaller energy providers.<sup>25</sup> However, although the entry of smaller firms in the energy sector continues, Ofgem has noted in its annual 'State of the energy market' that smaller suppliers typically struggle to expand after initial entry. None of the new entrants have managed to reach a five per cent market share. And recent mishaps amongst new entrants, such as Outfox the Market systematically overcharging its customers by 25 per cent, may reinforce the tendency of consumers to remain with established providers.<sup>26</sup> Nevertheless, redistribution of market shares away from large incumbent providers may motivate them to find cost efficiencies and innovation in other areas (although a potential result of innovation is the creation of new products, which may defeat the simplifying aims of the policy).

### Drawbacks

If product ranges were restricted, or if legislation were to force the introduction of a certain range of simple products, the onus of deciding what types of products should be restricted / designed would fall on the regulator. Any restriction of product ranges would need to ensure that consumers' preferences are accurately captured, and that innovation is not unduly restricted. This task would need to be carefully considered by the regulator.

There may also be push-back from industry regarding the introduction of a range of simple products, which would need to be managed. Evidence from the attempted introduction of 'vanilla' financial service products in the US provides an example of the difficulty of championing initiatives that do not have the backing of the industry sector.<sup>27</sup>

### *For consumers*

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<sup>23</sup> FSUG (2014): 'FSUG Discussion Paper: A Simple Financial Products Regime' [\[online\]](#).

<sup>24</sup> FSUG (2014): 'FSUG Discussion Paper: A Simple Financial Products Regime' [\[online\]](#), p15.

<sup>25</sup> Ofgem (2018): 'State of the energy market: 2018 report' [\[online\]](#), p22.

<sup>26</sup> BBC (2018): 'Energy company apologises for bill mix up' [\[online\]](#).

<sup>27</sup> Devlin (2010): 'Literature Review on Lessons Learned from Previous "Simple Products" Initiatives' [\[online\]](#).

Legislation to *replace* existing product lines with a standardised product range may be considered too extreme to be practical, whereas introducing simplified products alongside existing product lines may add to the problem of choice overload, making it even more difficult for consumers to engage in searching for a switching to better products.

The introduction of simplified products alongside existing product lines may not adequately combat cross-subsidisation practices. To provide the simplified products at accessible prices, firms may continue to subsidise their provision with the revenue gained from consumers who choose to remain on the existing (more expensive) product lines. This could therefore simply shift the burden of cross-subsidisation from one group of consumers to another.

Further, as firms would not be compelled to sell simplified products there is a risk that firms will decide to minimise the rollout and associated marketing of a simplified product range.<sup>28</sup> Consumers therefore may not be aware of the simplified products available to choose from.

A key drawback of this policy would be the potential impacts on innovation, whereby firms are reluctant to invest in developing new products if there is a risk that these will be overridden by a set of standardised products. In the US, debate over introducing ‘vanilla’ consumer finance products has been stalled by concerns over the prospect of giving government too much control in the market and the potential hazard of restricting innovation.<sup>29</sup> Consumers may miss out on new products that would otherwise have been developed and offered in the market, products which might have been more suitable for them.

#### *For the market*

Legislation requiring firms to have a simplified product range may increase their operating costs, with little offsetting revenue from the new products (in extremis, it may be to no avail if consumers do not purchase them).

If firms were to minimise the sale of the simple, standardised products there would be little change in the level of competition in the market. Firms may not engage in the fierce price competition on the simplified product as hypothesised by proponents of this policy. Second, consumers would need to compare additional product lines when making their decisions, and the problem of inertia keeping consumers trapped in their current products would likely remain. The overall effect of simplified product ranges on competition in the market would depend on the relative strength of these two effects: firms competing on price with the simplified product and consumers being faced with a greater choice of products.<sup>30</sup>

In addition, standardised products may not go far enough to encourage consumers to engage more in switching so as not to be trapped in poorly performing products (i.e. consumers may still be deterred if they do not fully understand the products on offer). This may be addressed if the standardisation of information provision is included as part of this policy response. For this reason, a number of regulators have taken steps to introduce simplified and standardised information to help consumers navigate the existing range of products on offer, as highlighted in the following examples.

#### **Efficacy in Practice**

There are some examples of legislation requiring the standardisation of certain features of consumer finance products – namely standardised information provided for products. In 2013 in Belgium, legislation was

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<sup>28</sup> ACM (2015): ‘Financial standard products: Study into the effects of standard products on competition in the financial sector’ [\[online\]](#).

<sup>29</sup> Devlin (2010): ‘Literature Review on Lessons Learned from Previous “Simple Products” Initiatives’, page 31 [\[online\]](#).

<sup>30</sup> ACM (2015): ‘Financial standard products: Study into the effects of standard products on competition in the financial sector’ [\[online\]](#).

passed that sought to standardise many characteristics of savings accounts without imposing a 'single standard model'.<sup>31</sup> For instance, the law states that there be a maximum of six different saving account 'formulas' per bank. This standardisation legislation is complemented by: 1) laws stating that banks must not reduce interest rates on savings accounts for three months after raising them; and 2) an online simulator for consumers to calculate the interest they would be paid under different conditions. The former curtails the ability of providers to 'revert' products to lower returns. An analysis of the provision of standardised information is provided by Willamaers (2014a).<sup>32</sup> This suggests that the requirement for a key information document is an ineffective response given the 'lack of competence, time, and will to read' of consumers. It is likely that it would be only those with the prior inclination to switch products would do so, and that trapped consumers would not be helped. Furthermore, complementary financial education provided by the Belgian Financial Services and Markets Authority to assist with the understanding of a key information document has been deemed unlikely to change this situation. Willamaers (2014b) shares the view of the European financial markets' supervisor with respect to products restrictions and bans, which should be considered as 'measures of last resort'.<sup>33</sup>

The FCA is currently deliberating on the possible introduction of a 'Basic Saving Rate' (BSR) in the UK cash savings market to encourage switching and protect inert customers. It would require firms to have a single interest rate onto which a cash savings account reverts after a certain period of time, such as a year.<sup>34</sup> This would prevent firms from paying different interest rates to different consumers based on the age of accounts. Providers would be free to set this rate at whichever level they choose, and could vary it at any time. Given the rigid threshold required for the Rate to set in – one year – it is possible that consumers would still have to switch each year to obtain the best rate in the market. Although encouraging this type of product simplification could lead to more switching, it could also be exploited by providers by increasing the divergence between introductory rates and the BSR, thus penalising loyal customers further.<sup>35</sup> Ideally, a policy such as this would need to be complemented by legislation limiting the difference between the introductory and Basic Savings rates.

In the Netherlands, the Modern Savings Policy was introduced to end the use of teaser rates, limit the number of accounts offered, and limit price differences between products offered in the cash savings market. It also required open communication of interest rate changes to all customers (both existing as well as new customers). The intervention was carefully considered by the AFM (Dutch financial conduct authority) because it recognised the value of teaser rates to some customers whilst acknowledging their potential detriment to less vigilant customers. In response to this requirement, several banks started periodically emailing their customers their current interest rates. The FCA has acknowledged the feedback from savings providers in the UK that warn of this possibility.<sup>36</sup> By limiting the number of savings products offered by banks, and requiring them to be open about if and when they change interest rates, the number of accounts offered in the Netherlands has declined. The PwC report argues that customer outcomes are perceived to have improved,<sup>37</sup> but it is unclear what the drivers of these outcomes are.

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<sup>31</sup> FSUG (2014): 'FSUG Discussion Paper: A Simple Financial Products Regime' [online], p25.

<sup>32</sup> Willemaers, G. (2014a): 'Client protection under Belgian financial law: recent developments in information duties, product intervention and beyond' [online].

<sup>33</sup> Willemaers, G. (2014b): 'Client Protection on European Financial Markets – From Inform Your Client to Know Your Product and Beyond: An Assessment of the PRIIPs Regulation, MiFID II/MiFIR and IMD 2'.

<sup>34</sup> FCA (2018b): 'Price discrimination in the cash savings market: One rate, one solution?' [online].

<sup>35</sup> Fairer Finance (2018): 'Full disclosure: fixing the UK savings market' [online].

<sup>36</sup> FCA (2015): 'Cash savings market study report' [online].

<sup>37</sup> PwC (2014): 'Cash Savings – An International Comparison' [online].

Looking to another sector, the UK consumer energy sector has had reforms in effect since 2014 that limit the number of gas and electricity tariffs that providers can offer consumers to four (four for gas, and four for electricity) with the express intention of reducing choice overload and stimulating switching (CMA 2016, para 170).<sup>38</sup> A 2016 report into the effect of the ‘simpler choices’ component by the CMA argues that the benefits of simplification have not readily emerged.<sup>39</sup> Its analysis concluded that there were ‘few, if any, signs that consumer engagement [was] improving materially, either in terms of direct consumer activity (e.g. switching, shopping around) or their experience and perception’ (page 41, paragraph 172). Those who were previously disengaged from switching appeared to remain so, which may be the result of the variable-rate tariffs being replaced by an equal range of fixed-rate tariffs.<sup>40</sup>

The CMA’s report may not have captured preferable price effects in the long run due to its relatively short data period after the 2014 policy introduction (data only until 2016). However, Ioannidou (2018) suggests that Ofgem’s tariff simplification revealed the limits of relying too heavily on behavioural economics to inform remedial policy solutions to consumer vulnerabilities.<sup>41</sup> She argues that if the remedy for vulnerable consumers is encouraging switching through product simplification, whilst not addressing the *ability* of consumers to assess products, this will have an adverse impact on the competitive process and negatively affect the very consumers the remedy sought to protect.<sup>42</sup>

#### 4.1.2 RU64-style Rules

The RU64 (2004: FSA Handbook rule COBS 19.2.2(1)R) is a rule requiring firms providing advice to consumers to explain in the suitability report why they consider a personal pension to be at least as suitable as a stakeholder pension.<sup>43</sup> Its stated aim was to prevent consumers being locked into high-charging pension contracts once it had become clear that a cheaper, more flexible alternative was soon to be available. Applied more generally to consumer financial services, this policy response could require that consumer finance providers and / or brokers explain in writing why a consumer’s product is at least as good as a standard alternative. By doing so, firms would be obliged to consider whether it would be better for the consumer to have an alternative product, thus limiting the risk that consumers are trapped in poorly performing products.

The policy could either require providers/brokers to compare the consumer’s product against other products offered by the same provider, or against some standard alternative. The feasibility of the latter may be limited, and we focus on the former scenario. (We also do not consider the application of this policy for financial advisers. Advisers will have different business models, some of which will compare a broader range of products than others.)

This kind of rule could stipulate either that 1) providers explain in writing why a consumer’s product is right for them *in the first instance* (i.e. upon making the purchase / signing the contract); or 2) providers explain in writing why a consumer’s product is right for them *at regular intervals* (i.e. in monthly statements). The former would benefit consumers because they would be provided with the most suitable product of a

<sup>38</sup> Aside from other reforms brought in simultaneously, such as: 1) showing the potential savings from switching to a provider’s cheapest tariff; 2) showing Tariff Comparison Rate as a ‘common currency’ to help consumers compare tariffs; and 3) switching consumers on ‘dead tariffs’ to the cheapest variable rate.

<sup>39</sup> CMA (2016): ‘Energy market investigation: summary of final report’ [\[online\]](#), p41.

<sup>40</sup> CMA (2016): ‘Energy market investigation: summary of final report’ [\[online\]](#), Figure 2 on page 25.

<sup>41</sup> Ioannidou, M. (2018): ‘Effective Paths for Consumer Empowerment and Protection in Retail Energy Markets’ [\[online\]](#), p149.

<sup>42</sup> Ioannidou, M. (2018): ‘Effective Paths for Consumer Empowerment and Protection in Retail Energy Markets’ [\[online\]](#), p137 and 153.

<sup>43</sup> FSA (2004): ‘A basic advice regime for the sale of stakeholder products’ [\[online\]](#). The rule is now in the FCA Handbook as rule COBS 19.2.2(1)R [\[online\]](#).

provider from the outset, and would prevent them purchasing a product where there is a better alternative. However, this approach is unlikely to prevent consumers from becoming trapped in that product in cases where a better alternative becomes available later one. The latter approach could encourage switching/upgrading if the time comes that a product is no longer suitable (because of product developments, or the consumer's situation changes, for example).

## Benefits

### *For consumers*

Such rules would provide the consumer with a transparent justification of the charges and fees associated with the products currently being consumed, reducing a possible asymmetry of information between firms and consumers. The provider would formally consider the recommendation it gives and ensure that it is the best product for the consumer. In this way, such legislation may nudge firms away from designing a range of products intended to take advantage of its ability to segment the market and only sell certain products to informed consumers actively searching the market.

There would be less onus on consumers to consider a range of alternative products and decide which one was most suitable.

### *For the market*

The new legislation on information transparency could enhance competition between firms seeking to realise cost efficiencies or product innovations, as the incentives to finding ways to segment their consumer base and offer inferior products to loyal customers would be reduced.

## Drawbacks

### *For consumers*

Whilst the policy may increase the likelihood of consumers being provided with the most suitable product from the outset, providers may introduce new products or update existing ones, or a consumer's position may change, resulting in the product *no longer* being the most suitable.

Digesting regular communications from the provider as to the ongoing suitability of the product may be difficult unless such information is provided in a clear, jargon-free format. The problems that keep some consumers trapped, such as insufficient time or resources to make a product switch, may remain unless this policy response is accompanied by the option to respond to the information given in a way that speedily sets in motion a switching process.

Such a policy would need to be carefully considered with regards to the role of financial advice. Any consideration by a provider of the suitability of a product for a consumer could be construed as formal advice. This risks removing consumers' incentive to seek the formal advice in situations where this may be necessary.

### *For the market*

Regulation that requires firms to justify why the product currently consumed by a consumer is at least as good as an alternative necessarily places an upper limit on the charges associated with a product. This is because there will be a threshold charge above which the current product becomes less suitable for a consumer to continue to consume relative to the available alternative. In this way, an RU64-style rule may have the same effect as placing a cap on the prices charged to consumers. Firms may respond to this effective price cap by uniformly raising all product prices to ensure that existing revenues are maintained, which comes as a detriment to all consumers.

Key drawbacks of a policy such as this are the associated regulatory risks and compliance costs. As mentioned, the consideration by a provider of the suitability of a product for a consumer could be construed as providing advice, which would go beyond the remit of providers that are not authorised to provide financial advice. Providing the information letters would impose costs on firms which could be transferred to consumers as higher prices, or reduce the profitability and competitiveness of firms. Firms that are authorised to provide advice and provide independent advice would presumably be undertaking this comparison anyway and as such a policy would be unlikely to add value for customers of these firms.

### Efficacy in Practice

The introduction of the RU64 and its adjoining introduction of price-capped stakeholder pensions were together credited with a fall in the impact of pensions charges (measured as the Reduction In Yield) over the space of three years from 1.7 per cent a year to around 1.1 per cent a year.<sup>44</sup> The introduction of RU64 brought costs on personal pensions down to the level of price-capped stakeholder pensions.<sup>45</sup> DWP argued that the benefits of this package of regulation in reducing charges paid by consumers appear to be far greater than the potential costs of stifled competition.<sup>46</sup> However, feedback on the rule from insurance providers suggested that it effectively placed a price cap on personal pension plans<sup>47</sup>. This in turn allegedly made personal pensions uneconomic to distribute and contributed to a decline in their sales. The Pensions Commission noted “fundamentally, however, if the industry does require a 1.5% Annual Management Charge to sell to low income customers or employees of small firms, that cost is itself a major disincentive to saving and has implications for the level of saving required to deliver adequate pensions.”<sup>48</sup> Other industry bodies suggested that they could distribute pensions to consumers within the charge cap, and that it was the smaller, less cost-efficient providers that may be unable to distribute products to mass market consumers within the charge cap.<sup>49</sup> At the time of the introduction of the Rules (before commissions for retail investment products were banned), the prevailing industry business model was based on paying commission to financial advisers, which could arguably have limited the pressure on providers to keep costs down (providers could gain extra business by increasing prices and increasing the level of commission).<sup>50</sup>

In 2009, the Australian Securities and Investment Commission made a number of recommendations for improvements to household term deposit advertising, the disclosure of interest rates and the disclosure of the risk of dual pricing and ‘grace periods’ (teaser rates offered at first, reverted to a lower level after a period).<sup>51</sup> Because term deposits can ‘roll over’ on a default basis (unless the consumer intervenes), the dual-pricing practice was thought to create a risk that consumers could roll over automatically from a higher interest rate to a lower interest rate once a term deposit matured, without the consumer being conscious of the change. The legislation did not stop the dual-pricing practice, but firms improved their disclosure of the existence and risk of teaser rates.<sup>52</sup> Moreover, although firms did seem to compensate for this change with larger differences between introductory and default interest rates on deposits, the disclosure prompted more consumers to change their term deposit before their rates reverted to lower levels. Of the eight

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<sup>44</sup> DWP (2006): ‘Personal accounts: a new way to save’ [\[online\]](#).

<sup>45</sup> FSUG (2017): ‘Distribution systems of retail investment products across the EU – FSUG response to the study commissioned by the European Commission’ [\[online\]](#).

<sup>46</sup> *Ibid*, p75.

<sup>47</sup> FSA (February 2007): ‘Suitability Standards for advice on Personal Pensions: Feedback on CP05/8’ [\[online\]](#)

<sup>48</sup> Pensions Commission (2004): Pensions: Challenges and Choices - The First Report of the Pensions Commission Page 222.

<sup>49</sup> For example, see the evidence provided to the Treasury Committee by the Building and Civil Engineering Benefit Schemes (B&CE) [\[online\]](#).

<sup>50</sup> Study of intermediary remuneration, CRA, ABI, page 55, February 2005

<sup>51</sup> Australian Securities & Investment Commission (2010): ‘Review of term deposits’ [\[online\]](#).

<sup>52</sup> Australian Securities & Investment Commission (2013): ‘Further review of term deposits’ [\[online\]](#).

authorised deposit-taking institutions studied that have dual-price strategies, term deposits automatically reverted to lower rates an average of 3.5 times per customer in 2011, whereas in 2008-9 they had done so five times.<sup>53</sup>

An example of an analogous policy is the US CARD Act of February 2010. The Act has been credited with helping consumers escape debt traps. Besides limiting credit card fees, the Act entailed a behavioural 'nudge' in the form of providing consumer credit card holders with repayment disclosures in monthly credit statements. These disclosures provide information on the consequences of making only the minimum repayment, and on the reductions in interest rates possible if a consumer were to eliminate the debt in 36 months. Following the implementation of the Act, there was a small but significant 0.5 percentage-point increase in the share of consumer credit card holders paying the 36-month repayment amount (albeit from a low base of 5.7 percent of consumers making payments around the 36-month mark).<sup>54</sup> Importantly, borrowing costs were reduced for the most vulnerable credit card users. However, there are warnings that a longer-term analysis of the Act could see a negative effect on firm entry into the market as credit-card provision becomes less lucrative. This could entrench the dominance of a small number of credit-card providers who have the scale and resources to meet the fee limit and legislative requirement.

### 4.1.3 Price Benchmarking

Price benchmarking involves setting restrictions on the prices that firms can offer or the pricing strategies they follow. This can involve stipulating, for example, that firms do not set product prices at a level that yields a loss in the provision of a product to a consumer in isolation (i.e. below economic cost), thus effectively reducing the ability of firms to engage in cross-subsidisation across products.

Alternatively, price benchmarking can be considered as a policy to limit the offering of teaser / introductory rates and the detrimental impact these can have on a consumer's long-term welfare when the rates revert to a poorer level after a period of time (e.g. higher interest rates on debt products and lower rates on investment products). In this scenario providers may make a loss on the initial rate, but recoup this from the reversion rates. Price benchmarking strategies can either stipulate a floor/cap for the introductory offers, or a cap/floor on the reversion rate, depending on whether dealing with debt or investment products. Both approaches could be justified as a means of restricting consumer price increases.<sup>55</sup>

#### Benefits

##### *For consumers*

With a price floor explicitly banning below-cost pricing, consumers may be less likely to be baited into signing up to a product that then reverts to a poorer rate to recoup the prior losses absorbed by the provider. This would reduce the likelihood that they became trapped over time (assuming that the consumers do not regularly switch products).

Similarly, limiting reversion rates on debt products could reduce the extent to which consumers eventually face more burdensome costs at the end of the teaser rate period. It is not necessarily the case that consumers may face a lower total cost over the lifetime use of a product, as we explain further in this section.

##### *For the market*

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<sup>53</sup> Ibid, page 7.

<sup>54</sup> Agarwal et al. (2013): 'Regulating consumer financial products: evidence from credit cards' [\[online\]](#).

<sup>55</sup> Bar-Gill & Bubb (2012): 'Credit Card Pricing: The CARD Act and Beyond' [\[online\]](#), p1010.

Banning below-cost pricing could encourage market entry into specific product markets as new firms would be better able to compete with incumbents on an efficient cost basis, without needing a range of other product areas with which to cross-subsidise, or to convince shareholders to endure losses for some time whilst building up a customer base. This could enhance competition in the market, leading to better quality and/or lower costs.

Price floors on introductory rates will encourage competition on the ability to offer a better product (i.e. to innovate) or on lower costs.

### Drawbacks

#### *For consumers*

An OECD (2007) report argues that retail below-cost (RBC) laws are likely to lead to higher prices overall and thus harm consumers.<sup>56</sup> The reduction in consumer welfare resulting from higher prices may exceed the increase in firm revenues and thus lead to a reduction in *overall* welfare. Price floors in the form of RBC bans could also reduce the ability of firms to offer products to financially excluded people which they could do previously with below-cost pricing subsidised by others. This would come as a detriment to policy goals of increasing financial inclusion, and presents a more general issue with preventing cross-subsidisation which we discuss in the following section.

Limited reversion rates may not mean that consumers face a lower total cost over the lifetime use of a product. Consider the case that providers were previously able to recoup losses made from the teaser rate of a product with higher rates charged over time during the reversion phase such that the total cost of a product's provision equalled the revenue received from its consumer, i.e. the provider breaks-even on this product. In response to this policy, providers may raise the price of all products that it had hitherto offered at teaser rates, as they are less able to increase prices at a later stage to recoup lost revenue.

It is also possible that total product switching rates decline in response to price benchmarking in both of the aforementioned forms. Teaser rates and RBC strategies offer visually-appealing headline prices to those consumers who have a higher propensity to switch. Removing them, or limiting the extent to which these low prices can be offered, may reduce the attractiveness of switching for these consumers, and may also do little to help those trapped consumers who were unlikely to switch anyway.

#### *For the market*

Structuring and enforcing such price benchmarking would incur costs for the regulator, particularly in assessing what constituted 'below-cost' pricing. In addition, firms would face regulatory costs from having to demonstrate that they are adhering to the legislation. This cost may be passed onto consumers in the form of higher prices, further reducing consumer welfare.

There are a number of general regulatory issues with price caps, such as a burden on the regulator in setting the caps, and potential distortions and inefficiencies resulting if regulators are not able to 'perfectly' set the cap. Banning RBC prices would not necessarily involve a single price floor, as the cost of providing consumer finance products will vary across firms. It would make an onerous task for a regulator to assess the individual costs of product provision of each firm, and then to determine whether prices paid by consumers are actually below the cost of provision.

Assuming that an RBC ban could be adequately enforced, the between-firm reallocation of market share may come at the expense of higher barriers to entry, since new firms would need to ensure that they can price

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<sup>56</sup> OECD (2007): 'Resale Below Cost Laws and Regulations' [[online](#)].

their products above cost, yet at a level that would make them competitive with the larger incumbent firms (which may well have a lower cost-per-unit of product provision).

Price benchmarking could inhibit competition if it reduces consumer switching rates. Lower switching rates could reduce the pressure on providers to capture those who do switch with enticing deals and quality products. Price caps could also introduce distortions in the market by limiting innovation and responses to market signals.

### Efficacy in Practice

Few interventions on pricing practices in the consumer finance market have been subject to assessments of their impact, therefore making it more difficult to argue whether they have been beneficial or not in practice.<sup>57</sup> Comparisons with other regulated sectors (e.g. utilities) is less helpful given the different market structures which necessitate price benchmarking and caps.

The US CARD Act provides an example of placing a temporal cap on additional charges on consumer finance products that often go unnoticed by the typical consumer looking for headline prices (in some cases these are teaser prices). The Act has curtailed the extent to which providers can increase interest rates on credit by stipulating that teaser rates must be in place for at least six months before the rate reverts to higher levels.<sup>58</sup> Bar-Gill & Bubb (2012) find that the restriction of interest rate reversion in credit card contracts had little effect on the proportion of providers offering teaser rates between 2001 and 2011. This implies that consumers were not made better off by not being enticed towards introductory offers that eventually reverted to high levels.

Importantly, the Act does not specifically target teaser rates for being too low, rather it aims to tackle the extent to which rates can *change* from their initial levels. Some have argued that, although effectively capping charges is a step in the right direction, from a behavioural perspective a stronger case can be made for regulating interest rates that are *too low*.<sup>59</sup> This is because teaser rates warp the perceived price of a product and lead consumers to underestimate the probability that they will suffer the consequences of staying with the product long after the deal period ends (i.e. the probability of becoming trapped). The lack of change in teaser rates being offered by US credit card providers could arguably be helped by stronger legislation that specifically targets low rates. The Act's softer attitude to teaser rate limitation may actually be reinforcing the behavioural bias emanating from low introductory rates, as longer introductory periods enforced by the Act have been found to have made APR terms higher.<sup>60</sup>

In the UK energy sector, price caps in the form of safeguard tariffs have been used to protect the most vulnerable consumers from "runaway" prepayment meter (PPM) annual charges. PPM gas and electricity contracts require consumers to pay for their energy before using it, and legislation was implemented to ensure that the annual bills paid by PPM consumers do not exceed a specified cap for a period until the end of 2020. Since the introduction of these tariffs in April 2017, a broad impact of the cap has been to reduce the average price of energy across providers.<sup>61</sup> This was mainly due to providers reducing higher prices to comply with the cap, while the market's cheapest tariffs remained roughly at the same level as in April 2017. But switching rates of PPM consumers have appeared to decline in this short period. Levels of overall engagement among PPM consumers have traditionally been lower than those observed for consumers on other payment methods. 2018 survey data indicates that the proportion of PPM consumers who have

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<sup>57</sup> FCA (2016): 'Price discrimination and cross-subsidy in financial services' [\[online\]](#).

<sup>58</sup> Bar-Gill & Bubb (2012): 'Credit Card Pricing: The CARD Act and Beyond' [\[online\]](#).

<sup>59</sup> Bar-Gill & Bubb (2012): 'Credit Card Pricing: The CARD Act and Beyond' [\[online\]](#).

<sup>60</sup> Davidson, A. (2011): 'The Supply of Credit in the Card Market', [\[online\]](#).

<sup>61</sup> Ofgem (2018): 'State of the energy market: 2018 report' [\[online\]](#).

switched supplier, tariff or just compared deals remained largely unchanged at 32 per cent, below the average for all consumers (41per cent).<sup>62</sup>

Also in the UK, there has been movement towards reducing the extent to which mortgage go-to rates (often variable rates) revert after introductory periods expire. HM Treasury introduced voluntary benchmark standards, referred to as CAT (Charges, Access, Terms) standards, in 1999, applying to ISAs and later to residential mortgage products. For mortgages these limited the variable rate to no more than 2 per cent above the Bank of England base rate. As providers were free to offer non-capped products, they often made the decision not to offer CAT standard or stakeholder products.<sup>63</sup> Although the adoption of CAT standards was small, the Panel has previously reported that two major mortgage providers (Nationwide and Lloyds TSB) included the CAT standards in their mortgage agreements in the run-up to the financial crisis. These two lenders were therefore required to pass on to consumers in full the cuts in Bank of England base rates to their Standard Variable Rates.<sup>64</sup> This would suggest that, after the financial crisis, customers with CAT standard mortgages would have found that they were paying significantly lower rates than those on non-CAT rates. Nationwide estimated that the benefit of the CAT standard for its customers had been £300 million in the six months to November 2010.<sup>65</sup> The Panel has estimated that if borrowers at Lloyds TSB have enjoyed a proportionately similar benefit in line with the provider's market share, customers with CAT-standard mortgages might have saved £1 billion each year following the crisis.<sup>66</sup> On the other hand, although the Treasury had deemed the CAT standards initiative successful in relation to ISAs by reducing choice overload, only 30 loans offered by 12 firms were CAT compliant, out of the hundreds on offer, in May 2003.<sup>67</sup>

#### 4.1.4 Further policy options: empowering consumers with technological innovation

The literature has recently begun to explore the concept of empowering consumers with time-saving technological innovation. One potential innovation is to delegate shopping around for more suitable consumer finance products to computer algorithms and automated switching for consumers who want it.<sup>68</sup> Potential online switching services, such as that sketched by Lowe (2017),<sup>69</sup> offer consumers a clear reduction in this switching cost. However, there is the problem of data protection and security. Switching current accounts within the same provider may be relatively straightforward; switching credit providers is a more complicated task and requires a number of security checks to be carried out by the provider. Switching consumers seamlessly from one provider to another would likely require the construction of a substantial data-sharing network between providers that allows a consumer's credit history, for example, to be transferred from the old provider to be assessed by the new provider. There would be considerable consumer, industry, and governmental implications of this. Even switching within the same provider raises risks and complications, for example if consumers have reasons other than simply cost for choosing a particular product.

<sup>62</sup> Ofgem (2018): 'State of the energy market: 2018 report' [\[online\]](#). p 34.

<sup>63</sup> HM Treasury (2010): 'Simple financial products: a consultation' [\[online\]](#).

<sup>64</sup> Uncited at source: FSCP (2018): 'Mortgages Market Study – Interim Report note' [\[online\]](#).

<sup>65</sup> Nationwide (2010: 'Half-Yearly Financial Report For the period ended 30 September 2010', page 4 [\[online\]](#)). The quoted £300 million in consumer savings is referred to as an 'opportunity cost of maintaining BMR at this level, relative to other rates charged in the market' and is understood to mean what Nationwide could have earned if it has allowed rates similar to its competitors who do not adopt the cap.

<sup>66</sup> FSCP (2018): 'Mortgages Market Study – Interim Report note', page 5 [\[online\]](#).

<sup>67</sup> Devlin (2010): 'Literature Review on Lessons Learned from Previous "Simple Products" Initiatives', page 12 [\[online\]](#).

<sup>68</sup> Lowe, J. (2017). 'Consumers and competition: Delivering more effective consumer power in retail financial markets' [\[online\]](#).

<sup>69</sup> See 'Appendix: Straw-Man Proposal' p 59-61 of Lowe (2017).

There is also the potential for ‘halo effects’ of government-certified switching services in causing consumer complacency regarding the products they consume. An automatic switching service may appear to some consumers as a form financial advice, thus reducing their perceived need to consult experts on the most suitable products for them.

The UK energy sector offers examples of an online switching service. *Weflip.com*, operated by the price comparison firm Gocompare, is an online service that uses algorithms to track and identify potential energy savings based on a consumer’s energy usage meter type, and current tariff.<sup>70</sup> Tracking 67 energy providers, if it identifies a potential savings of £50 per year on projected costs, after paying applicable exit fees from the current tariff, it will automatically initiate a switch and notify the consumer via email.<sup>71</sup> The apparent problem with this website’s methods is that it bases potential savings (and therefore any automatic switch) on projected costs, rather than the rates actually paid by consumers, so it could potentially switch consumers from a cheaper to a more expensive tariff. Similarly, *flipper.community* calculates potential savings based on data collected from a consumer’s previous billing history and initiates a switching process if the expected savings exceeds £50 per year.<sup>72</sup> As of 15 March 2019, neither *weflip.com* nor *flipper.community* were listed by Ofgem as accredited price comparison tools.<sup>73</sup>

In the mobile telecommunication sector, in 2017 Ofcom published a decision to include an automatic switching service in a package of reforms.<sup>74</sup> The proposal involves removing some of the hoops through which consumers must jump to switch from one provider to another. For example, the need to have a telephone conversation with the current provider would be replaced by a code received by a consumer from a new provider that can be sent to the old provider by text message. In this way it increases the likelihood that consumers with low switching propensities (who may be considered trapped) eventually switch. Industry bodies have expressed concern for the potential of fraud in the auto-switching process, as it makes authentication of consumers a less secure process.<sup>75</sup> Currently, the ‘losing’ provider completes authentication checks over the phone before releasing the code that is needed to make a phone number switch from one provider to another (the PAC code). As of 4 January 2019, the mobile telecommunications industry has begun implementing the reforms.<sup>76</sup>

## 4.2 Implications of a cessation in cross-subsidisation

Given the potential implications of a policy such as automatic upgrades on firms’ incentive to cross-subsidise, this evidence review considers cross-subsidisation, its forms, and what could happen to the consumer finance market were cross-subsidisation to cease. The rationale for cross-subsidisation could be to attract consumers who may not be immediately profitable (e.g. through introductory teaser rates), but with the view that they – or at least some of them – become profitable in the future. Another rationale for cross-subsidisation could be to fund one product line with another, for example to gain entry into a particular market sector.<sup>77</sup> In

<sup>70</sup> See <https://www.weflip.com/>.

<sup>71</sup> Money Savings Expert (2018): ‘New automatic energy switching service launches’ [[online](#)].

<sup>72</sup> See <https://flipper.community/>.

<sup>73</sup> See Ofgem’s information on ‘How to switch energy supplier and shop for a better deal’ [[online](#)].

<sup>74</sup> Ofcom (2017): ‘Consumer Switching: Decision on reforming the switching of mobile communication services’ [[online](#)].

<sup>75</sup> BT (2017): ‘BT’s response to Ofcom’s consultation document’ [[online](#)], p 13.

<sup>76</sup> See Ofcom (2017): ‘Statement: Decision on reforming the switching of mobile communication services’ [[online](#)]: ‘Update 4 January 2019: Multi-SIM contracts and Multi-SIM accounts’.

<sup>77</sup> This strategy need not only be funded by cross-subsidisation, but this is one way in which providers (and their shareholders) can avoid sustaining losses while waiting for consumers to become profitable.

addition, providers may have fixed or common costs which may be recovered through differential pricing, which could be viewed as cross-subsidisation between different consumer groups.

The Office of Fair Trading (OFT) defined cross-subsidisation as ‘funding the loss or low return from one line of goods or services from another more profitable activity’.<sup>78</sup> This can involve ‘bait-and-switch’ policies aimed to attract new consumers with offers that soon revert to less favourable terms, thus making (some of) these new customers eventually profitable. Alternatively, firms may group consumers and use higher profits gained from loyal consumers to subsidise new consumers simultaneously (although these new consumers would need to become profitable eventually, e.g. through purchasing other products).<sup>79</sup>

One potential impact of cross-subsidisation is price differentiation amongst consumers. Price differentiation can be considered to improve overall market efficiency by allowing companies to supply products at lower prices (i.e. at below average cost) to consumers with low willingness to pay. This can result in greater output, a wider range of consumers being served, and greater overall welfare from a more competitive market. However, there are also arguments against price differentiation and cross-subsidisation, particularly when those consumers charged the higher prices are not those with a higher willingness to pay, but are for some other reasons unable to switch to cheaper products (e.g. the concept of the “trapped” consumers).

A policy of automatic upgrades would limit firms’ ability to cross-subsidise between products and consumers. Providers would be required to upgrade consumers to better (most likely cheaper) alternatives as soon as these became available. Firms would no longer have the incentive to cross-subsidise (or otherwise offer below-cost introductory offers) since there would no longer be any prospect of customers subsequently reverting to expensive products and generating large revenues.

#### 4.2.1 What are potential forms of cross-subsidisation?

Generally, it costs more to gain a new consumer than to retain an existing one,<sup>80</sup> so subsidising newcomers with the revenue from loyal consumers may be regarded as profitable behaviour by providers. In the personal current account market, for example, the Panel has previously hypothesised that cross-subsidisation may be in the form of:

1. Overdraft fees subsidy – those who become overdrawn subsidise everyone else.
2. ‘Money to the middle’ subsidy – those with low but always in credit balances are subsidised by everyone else.
3. Diligence subsidy – consumers who understand the costs and shop around for the best deal are subsidised by those who do not. Loyalty thus incurs a cost.<sup>81</sup>

The debate has largely moved away from 1 due to regulatory limits on overdraft charges, whilst forms 2 and 3 are more prominent and capture the consumer behavioural factors that make cross-subsidisation a worthwhile activity for firms.

The FCA Practitioner Panel (2013) suggested that since consumers are usually not actually prohibited from switching products, the exploitation of loyal consumers can amount to consumer choice rather than exploitation per se.<sup>82</sup> The inherent value to consumers of staying with a firm or product for a long time should

<sup>78</sup> Ussher, et al. (2014). ‘Literature review on cross-subsidisation in the personal current accounts market. A report for the Financial Services Consumer Panel’ [\[online\]](#).

<sup>79</sup> Lowe, J. (2017). ‘Consumers and competition: Delivering more effective consumer power in retail financial markets’ [\[online\]](#).

<sup>80</sup> Heding, T., C. F. Knudtzen, and M. Bjerre (2016): ‘Brand Management. Research, Theory and Practice’.

<sup>81</sup> FSCP (2014): ‘Consumer Panel Position Paper: Cross-subsidisation in the Personal Current Account Market’ [\[online\]](#).

<sup>82</sup> FCA Practitioner Panel (2013). ‘Practitioner Panel Financial Services Industry Survey 2013’ [\[online\]](#).

be priced into the charges and prices they pay, resulting in higher prices for loyal consumers on a rational basis. This argument stands in contrast to the view that consumers who remain with a certain product for a long time whilst cheaper products become available are ‘trapped’ or exploited, especially if it is difficult to determine the inherent value of remaining with the same provider (i.e. consumers may feel that there *ought* to be benefits of staying with the same provider but this may not be borne out in practice).

#### 4.2.2 Impacts of stopping cross-subsidisation

It could be argued that economic analyses of pricing strategies such as price differentiation and cross-subsidisation cannot begin by presuming that they are either harmful or beneficial.<sup>83</sup> Consideration on a case-by-case basis is required. Cross-subsidisation can offer lower prices to some consumers, whilst expanding the market to those who would otherwise be priced-out of the market. Limiting cross-subsidisation could therefore have a negative distributional effect by reducing the level of financial inclusion.

When confronted with the subject of cross-subsidisation, personal current account providers have cited the large costs of providing payments infrastructure, branch and ATM estates, IT systems (etc.) that render cross-subsidisation a necessary phenomenon when products such as free-if-in-credit-current accounts exist.<sup>84</sup> An alternative argument is that more streamlined production processes and adhering to principles that firms do not over-stretch themselves could enable consumer finance firms to meet these costs. In addition, cross-subsidisation in this example may hinder market entry from providers who do not have the wider customer base to subsidise the costs of the account infrastructure, which further limits the incentives on incumbent firms to achieve cost efficiencies.

##### **Example 1: Free if in credit current accounts**

The provision of free if in credit (FIIC) current accounts suggests that never-overdrawn consumers, who do not pay overdraft fees or interest, are subsidised by those who are overdrawn. (Another argument could be that overdrawn customers, in addition to subsidising others, also contribute to excessive profit-making by firms.) If overdrawn consumers are likely to be those in financial trouble, the arguments for regulatory intervention may be greater.

However, regulating against cross-subsidisation could destabilise the mechanisms in place that allow the provision of basic current accounts for free, as is required by EU law and the UK’s Payment Accounts Regulations 2015.<sup>85</sup> On the one hand, vulnerable consumers might be paying high fees/interest for being overdrawn, providing revenue to subsidise the FIIC current accounts of others; on the other hand, it may be another group of financially vulnerable consumers who benefit from this form of cross-subsidisation by having access to those FIIC current accounts subsidised by the borrowing activity of others.

##### **Example 2: The Flood Re scheme (UK Water Act 2014)**

Another sector in which cross-subsidisation has long been the norm is insurance. The claims of the most risky consumers are met with the revenue generated from a large group of consumers. For example in the flood insurance market, consumers in flood risk areas are more likely than in the past to be charged a premium that reflects their risk of making a claim because premium-setting strategies take more account of long-term climate-based risks. While in the long-term this will help build greater awareness of flood risk, and encourage appropriate steps to be taken to reduce the risk of flooding, in the shorter term many households

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<sup>83</sup> FCA (2016): ‘Price discrimination and cross-subsidy in financial services’ [\[online\]](#).

<sup>84</sup> FSCP (2014): ‘Consumer Panel Position Paper: Cross-subsidisation in the Personal Current Account Market’ [\[online\]](#).

<sup>85</sup> UK Government (2015): ‘The Payment Accounts Regulations 2015’ [\[online\]](#). Page 8: ‘a credit institution must not charge any fee for the services set out in regulation 19(1) when those services are provided as part of a payment account with basic features’.

might have struggled to afford ongoing cover.<sup>86</sup> Thus, the reduced level of cross-subsidisation experienced in this market arising from the more accurately-priced insurance premiums was expected by regulators to have inequitable effects on consumers.<sup>87</sup>

Although pricing in risk fits with competitive market theory and encourages greater awareness of climate risks, regulators opted for assisting households maintain access to welfare-enhancing insurance. The UK Water Act (2014)<sup>88</sup> involved formalising the cross-subsidisation that was already present in the flood insurance market: that low-risk households were subsidising the premiums of high-risk households. The 'Flood Re' scheme effectively places a limit on the cost of providing flood insurance for high-risk households, to ensure that risky households are not priced-out of the insurance market if cross-subsidisation were stopped. This demonstrates that cross-subsidisation is expected to exist in multiple sectors of the economy and that, in the case of flood insurance, limiting cross-subsidisation may damage the ability of consumers to hedge against significant risks.

However, this example of formalised cross-subsidisation interferes with market signals which would otherwise be expected to yield a more efficient allocation of flood insurance. If high-risk households were forced to face higher insurance premiums, as was beginning to be the case, over time it would be only those consumers willing to pay these premiums and endure the associated risks who would choose to live in risky areas. It would also encourage greater efforts to implement flood-prevention measures. The extent to which this kind of legislation may affect market signals depends on the proportion of the market affected by the non-competitive pricing strategy, and in the case of Flood Re it is estimated that only 1-2 per cent of UK households would benefit from the Flood Re scheme.

### **Example 3: USA general insurance**

The laws governing the sale of general insurance in the US that began to be introduced in 2014 offer an example of legislation that attempts to regulate pricing strategies followed by consumer finance providers.

They state that 'rates shall not be excessive, inadequate, or unfairly discriminatory',<sup>89</sup> for example by prohibiting differences in prices charged unless they reflect genuine differences in consumer risk.<sup>90</sup> These laws were implemented precisely because regulators believed that the lack of ability or propensity for product switching of some consumers was being exploited by insurance providers, and that the growth of 'big data' to analyse consumer habits was playing a key role in this exploitation.<sup>91</sup> US states have taken different approaches to implementing the law concerning pricing, but some, such as Maryland and California, have specifically banned firms from using price elasticity and consumers' propensity to shop for insurance in pricing.

A major issue of a policy response such as banning pricing strategies based on consumer behaviour is monitoring whether providers are genuinely not exploiting differences in consumers' switching propensities. Price elasticities and consumers' propensities to switch products cannot be observed directly and are only estimated. Providers are more likely to have the means (and perhaps the data) to estimate these characteristics more accurately than regulators.

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<sup>86</sup> Defra (n.d.): 'A short guide to Flood Re' [\[online\]](#).

<sup>87</sup> Defra (n.d.): 'A short guide to Flood Re' [\[online\]](#).

<sup>88</sup> UK Government (2014): 'Water Act 2014' [\[online\]](#).

<sup>89</sup> National Association of Insurance Commissioners (2015): Price Optimization White Paper [\[online\]](#).

<sup>90</sup> FCA (2016): 'Price discrimination and cross-subsidy in financial services' [\[online\]](#).

<sup>91</sup> Chartered Insurance Institute (2016): 'Price Optimisation for Insurance Optimising Price; Destroying Value?' [\[online\]](#)

### 4.2.3 Summary

The impacts of limiting cross-subsidisation between 'loyal' and 'active' consumers will depend on the factors that influence whether a consumer remains in an expensive product. Some have a high willingness to pay and value the product for reasons such as convenience, whilst others may be considered trapped in the product because of unfavourable circumstances and ideally should switch but do not. Limiting cross-subsidisation will have distributional effects, and it will be a policy judgement whether these are justified.

## 5 Conclusions

This study estimates the costs of remaining in poorly performing products for a range of consumer types across different demographics and with different financial portfolios. These costs are estimated by comparing the 'status quo' charges or rates for poorly performing products with the charges or rates that consumer would pay/receive from better alternative products.

Our results show that the costs of remaining in poorly performing products could represent a notable proportion of consumers' annual incomes. It is conceivable that some consumers are incurring costs of as much as five per cent of annual income, and not impossible to imagine that there are some consumers for whom these costs are as high as 10 per cent of their income. Based on our profiles, these are likely to be consumers with an average income and a range of standard financial products, with relatively large amounts of debt.

Mortgages and credit cards are the two largest drivers of loyalty penalties for those that hold these products. In the case of credit cards, our focus is on identifying the possible loyalty penalty for those that fail to pay off the balance each month. The evidence suggests this loyalty penalty can be large.

The results suggest that consumers with the lowest incomes, because they may not hold many financial products, are unlikely to be particularly affected by the costs of remaining in poorly performing products (either in absolute terms or as a percentage of income). This finding may suggest that problems associated with a lack of access to financial products, rather than loyalty penalties, may be a greater problem for those on very low incomes.

We identify two distinct reasons that might motivate intervening to reduce the costs associated with remaining in poorly performing products (i.e. loyalty penalties). The first is based on the view that firms are making excessive profits by charging a mark-up over a "fair" rate, and that a policy such as automatic upgrades would effectively transfer welfare from firms (shareholders) to customers. The second is the view that loyalty penalties are used to cross-subsidise other products, such that intervention is justified for distributional reasons.

The latter motivation entails a value judgement on which group of consumers deserves protection. If a policy removes the ability of firms to cross-subsidise products such that there is price convergence between products and consumer groups, it would benefit consumers at risk of being trapped in poorly performing products, but penalise other consumers by raising the prices of previously (potentially) loss-leading products. If 'trapped' consumers are considered to be those who are more financially vulnerable (e.g. using credit cards as a primary means of borrowing) or unable to engage in switching for other reasons (other vulnerabilities or behavioural biases) then the distributional impacts of such a policy could be appropriate. However, different views about 'trapped' consumers could reduce the perceived attraction of such a policy, e.g. if they were perceived to be 'time-constrained or not to engage in switching for rational reasons. Additionally, consumers who might lose out from the cessation in cross-subsidisation may also be vulnerable and face exclusion, such as those currently accessing below-cost products for whom a "fair" price would be prohibitively high.

### 5.1.1 Potential challenges to the study

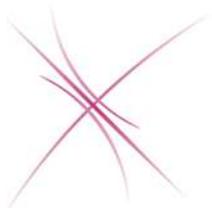
The results presented depend on a number of assumptions, detailed in Section 3.4.1, which could be challenged. We recognise that there may be alternative methods for estimating the costs associated with remaining with poorly performing products. However, we think that our approach makes the best use of the data available to us and is most consistent with the intuition of a policy of automatic upgrades.

Further, the profiles we have developed and their financial portfolios are intended to be illustrative rather than representative. It would have been possible to develop different profiles, with different assumed product portfolios, for whom the measured loyalty penalty would have been very different. However, the profiles we have generated are grounded in actual data and provide insights into the types of consumer and products most likely affected by loyalty penalties. The finding that credit cards can give rise to large loyalty penalties is potentially driven by the focus on the costs to people who roll-over the balance each month.

A further challenge may arise as to the value of a policy of automatic upgrades given its potential unintended consequences resulting from a reduction in cross-subsidisation (based on arguments about the nature of ‘trapped’ consumers, and that such a policy merely penalises other types of consumers). This does not detract from the reported loyalty penalties, but instead is an important consideration when deciding on whether the distributional outcome would be better if these loyalty penalties were reduced or eliminated. Is there a case for a policy that re-distributes to “loyal” consumers? Further, it is possible that loyalty penalties are not simply a signal of cross-subsidisation, but of firms making excess profits, in which case removing the ability of firms to make significant mark-ups on trapped consumers would not necessarily lead to a rise in prices elsewhere, such that all consumers benefit.



## Appendix



Europe Economics

# Additional Analysis

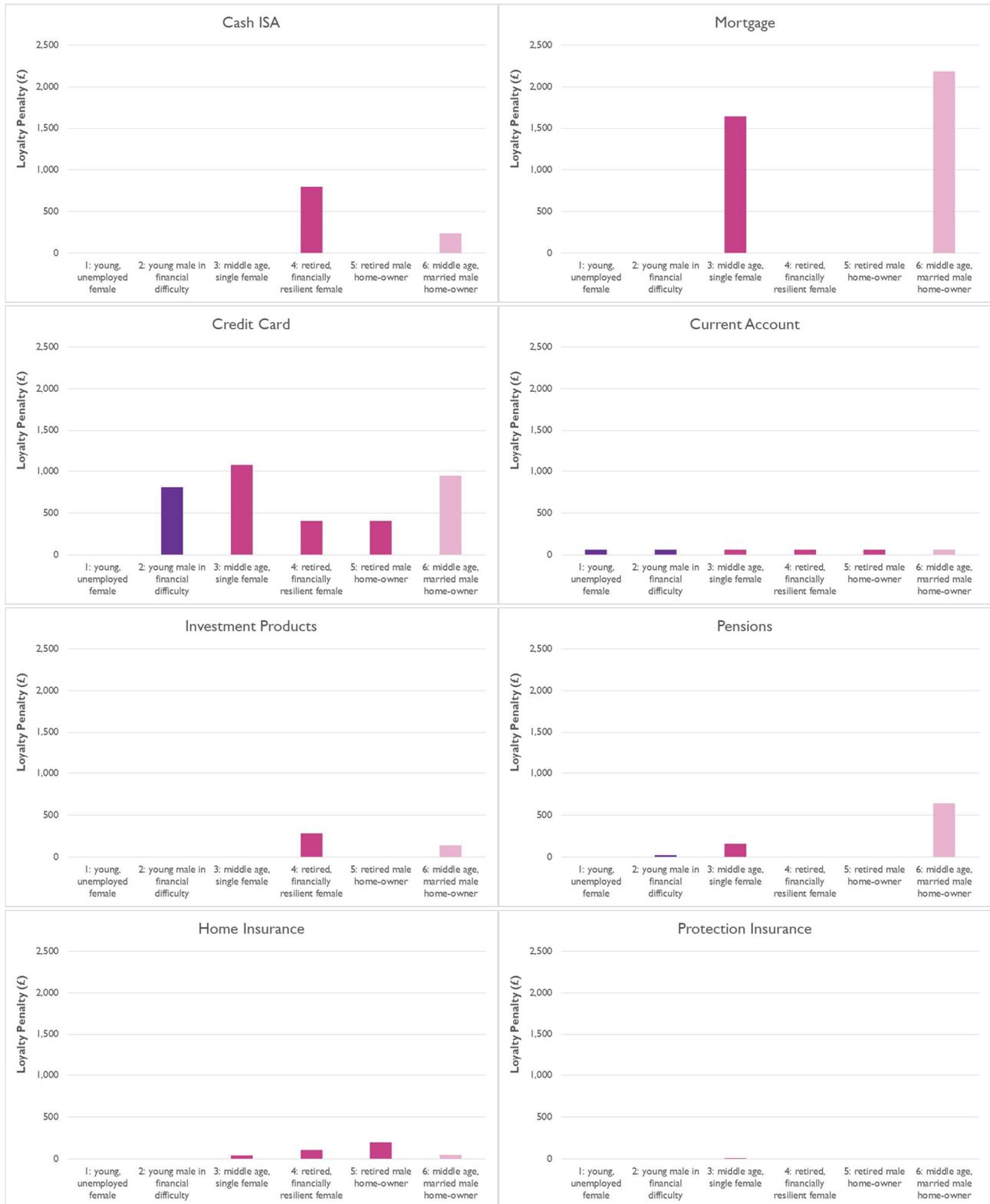
## Breakdown of absolute costs by profile



NB. • Low income, • Average income; • High income

Source: Europe Economics' analysis of publicly available data from a range of sources.

**Breakdown of absolute costs by product**



NB. • Low income, • Average income; • High income

Source: Europe Economics' analysis of publicly available data from a range of sources.

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