Association of British Insurers

FCA AND COMPETITION

a new direction for financial regulation?

Introduction

This paper discusses the importance and potential implications of the Financial Conduct Authority's (FCA) new remit to promote competition. It notes the FCA has already launched a series of market studies and thematic reviews in insurance markets where it considers there may be issues with the operation of competition. We consider the impact of these studies and offer some challenges and recommendations to both the FCA and the industry to ensure that the new regulatory objectives can be pursued in a manner which delivers on the common goal of making competition work in the interests of consumers.

Summary

Recommendations for the FCA

1. Multiple regulatory reviews of the same markets create unnecessary burdens, and may lead to overlapping or contradictory action. We recommend a joined-up approach within FCA to market analysis and interventions;
2. Other bodies continue to regulate the same markets as FCA. We recommend close coordination with the new Competition and Markets Authority and Government departments;
3. The FCA has highlighted the potential value of Behavioural Economics as a tool in understanding how consumers make decisions. We recommend that FCA should provide more insight on how Behavioural Economics analysis will influence competition policy;
4. There is some uncertainty as to whether the FCA's competition remit extends to regulating prices. We recommend caution when conducting profitability analysis and pricing interventions;
5. Regulatory interventions grounded in analysis of one market should not be simply read across to other markets. We recommend that the FCA should operate on the basis that neither different markets nor consumer interests are homogenous.

Recommendations for the industry

1. Insurers should be prepared for a different type of regulation focused on markets and overall consumer outcomes, not just individual firms' compliance with conduct rules;
2. Market studies will gather large amounts of data about how insurance markets work. Insurers should take the time to explain to regulators how each of our insurance product markets work in practice, which should also improve the effectiveness of the data requests;
3. Competition analysis looks broadly at market dynamics and outcomes. Insurers should therefore engage the whole business in responding to FCA, not just compliance;
4. Insurers should be aware of political interest in our markets, and the risks of quick fix solutions, and recognise the advantages of interventions which are evidence-based and firmly set within the FCA's regulatory framework;
5. Regulatory change represents a challenge to business models, but insurers should also recognise the potential for strategic opportunities for growth as a result of changing regulation and market dynamics.

The FCA's competition remit

The creation of the FCA has brought with it a set of new objectives for financial services conduct regulation in the UK. The FCA has been tasked with undertaking work that will encompass three operational regulatory pillars:

- To secure an appropriate degree of protection for consumers;
- To protect and enhance the integrity of the UK financial system;
- To promote effective competition in the interests of consumers.

In addition, the FCA has a new overarching strategic objective:

- To ensure the relevant markets function well.

While much of the subject matter under the first two operational objectives was covered under the scope of the old regime, the introduction of a competition objective marks a step-change between the FSA and its successor. Indeed, at an ABI conference in October 2013, Chris Woolard, FCA Director of Policy, Risk and Research described it as a 'quiet revolution', partly because ensuring effective competition in the market was previously only a by-product of the FSA's focus on protecting the consumer.

Furthermore, the Government has already granted additional competition powers to the FCA. It will have powers under the Competition Act 1998 to combat anti-competitive agreements and abuse of dominance. It will also have a statutory basis for the conduct of market studies and rights to refer markets to the new Competition and Markets Authority (CMA) under the Enterprise Act 2002, when the concurrent powers come into effect, which is anticipated to be in April 2015.

Expanding on the pillar of promoting effective competition in the interests of consumers, the FCA[1] has stated it will promote a competitive market outcome no matter which of its objectives it is pursuing, as this benefits both the consumer and the economy as a whole. In pursuing this objective, it will look to take a holistic approach including an assessment of market power, information provision, the extent of innovation and switching rates, as well as assessing whether the current level of market regulation itself presents a barrier to new entry. The FCA has made clear that it is the process of competition that needs to be protected and promoted, but it does not equate that with the protection of specific competitors.

Consequently, the FCA is building a specialist division with competition expertise and training its wider staff on the implications of the competition objective. Instead of focusing only on the compliance of individual firms with the rulebook, the FCA is placing greater emphasis upon understanding and influencing the dynamics of markets as a whole. The FCA has also turned to Behavioural Economics to help it analyse the dynamics of financial services markets, which will be discussed in more detail below.

The FCA's competition agenda may be influenced by other bodies. The FCA intends to gather information for its investigations from a variety of different sources such as FCA panels and market intelligence. In addition, designated consumer bodies such as Which? and the Federation of Small Businesses will be able to submit 'super-complaints' regarding the operation of financial services markets. The FCA will have 90 days to respond and will be required to explain the action it intends to take to resolve the issue. It can make wider requests for information, carry out internal research and conduct a review of the regulated firms involved in the grievance.

Competition and insurance markets – recent regulatory developments

Since its inception in April 2013, the FCA has been quick to launch new market studies under its competition remit, including some that impact upon insurance markets. The competition authorities have also continued to pursue reviews in the insurance field.

In July 2013, the FCA confirmed it was undertaking a study looking at **'add-ons' in the general insurance sector**. Martin Wheatley, Chief Executive of the FCA noted the importance of the work as 'the first study that we are undertaking specifically to examine the state of competition in a market.'

In fact, the study looks at five different insurance product markets (travel, gadget, guaranteed asset protection (GAP), home emergency and personal accident insurance). Each of these products is sometimes sold as an add-on to the sales of other insurance products (e.g. property insurance) or to non-insurance products (e.g. cars, holidays). The ABI responded to the FCA's call for evidence in September 2013. Our response outlined the need for the FCA to take into account the differences between the different markets, including in terms of product features, market size, market

[1] The FCA's approach to advancing its objectives, Financial Conduct Authority, July 2013

dynamics, the size of the 'standalone' markets and distribution channels. It would be distortive to try to assess each market in the same way and to reach generic conclusions about the case for, and content of, regulatory interventions.

The FCA published[2] its provisional findings and proposed remedies in March 2014. The FCA stated a lack of competition for add-ons can lead to consumers receiving poor value for money for many add-on products. The remedies proposed include requiring a 'deferred opt-in' for add-on sales of GAP insurance, improving the information available on add-ons when purchased through a price comparison website and banning opt-out pre-ticked boxes when add-on products are introduced to the consumer. The report also proposes a new requirement on insurers to publish claims ratios – this remedy appears to apply to all insurance products not just the add-ons products within the scope of the study. The ABI remains concerned that different markets require bespoke remedies. The FCA will consult further on their proposed remedies.

Meanwhile, the FCA launched a thematic review of **price comparison websites (PCW)**, a key distribution channel for general insurance products. This overlaps somewhat with the Competition Commission's (CC) investigation into impediments to competition in the **private motor insurance (PMI)** market (see discussion on 'MFN' pricing restrictions below). The press release for the FCA review appears to focus on the PCW channel from a consumer protection perspective rather than a competition one which could miss important issues. We suggest the FCA should consider the impact/implications of the CCs findings on its own review, given it has a remit which extends beyond motor insurance.

The provisional findings of the CC investigation of the PMI market, published in December 2013[3], identified five theories of harm, two of which concern conduct risk and overlap with the FCA's remit. Of these two, one addresses motor insurance add-ons and whether there is a lack of transparency in this aspect of the market. The other considers the **Most Favoured Nation (MFN)** clauses that some PCWs use to ensure that an insurer cannot offer a more favourable price on its own website (or through all other sales channels) than is offered on the PCW.

In relation to add-ons, the CC identified two areas that have an adverse effect on competition:

i. Information asymmetries between the insurer and the consumer in relation to the sale of add-ons – the prices of motor insurance 'add-ons' (e.g. Motor Legal Expenses Insurance (MLEI), breakdown cover) are not always clearly displayed by the PCW so it is difficult for the consumer to compare the total prices of the full package. The CC proposed a solution whereby the prices for add-ons are displayed on PCWs upfront in order to make it easier for consumers to compare the final prices that they will need to pay.

ii. Product descriptions – consumers have a limited understanding of add-ons because the quality and quantity of information supplied by insurers/PCWs can be variable. The CC proposed that product definitions are made clearer and standardised and that the information supplied is not unnecessarily complex.

In our response to the CC, the ABI agreed that add-ons should be more clearly priced on PCWs to allow consumers to make an informed decision about the total cost of their policy. However, we highlighted the need for consumer research and joint work to agree a consistent description of add-ons, as it can be difficult to display them in a meaningful and clear manner on a PCW, due to the variety of products available. Furthermore, we stressed that FCA and the CC should work together and with insurers and PCWs to ensure that the remedies are implemented successfully. Any broader learning points should be applied appropriately to add-on sales of other product lines. We are pleased to see that the FCA's proposed remedy on the information provided by PCWs on add-ons is broadly complementary with the CC's remedy in this area. The FCA's 2013 **thematic review on MLEI** is also relevant here so it is important for the FCA to ensure clear linkages between these multiple reviews of the motor insurance market.

In relation to MFNs, the CC identified that 'wide' MFNs had an adverse effect on the PMI market because they protect the power of incumbent PCWs and restrict price competition across different channels. The ABI agrees with this analysis. However, we question whether any MFN clauses should still be permitted, as 'narrow' MFNs also restrict competition and are protecting a channel with a share of around 60% of all new business. We are seeking a joined up approach leading to a consistent policy on MFNs in the PCW channel and have called on the FCA to include this issue within its thematic review of PCWs.

Meanwhile, the FCA is carrying out research into **consumer engagement in the insurance renewal process** on an annual basis and consumer behaviour/insurer practices at

[2] See http://www.fca.org.uk/your-fca/documents/market-studies/ms14-01
[3] See http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/provisional_findings_report.pdf

renewal stage, for example by testing reactions to displaying last year's premium on renewal letters. There is also political level interest in this topic. For example, the Government's UK Insurance Growth Action Plan[4] states that it may ask the insurance industry to take further steps to improve the renewals process, in order to avoid penalising customers who are less able or willing to shop around. This work has potential overlap with the PCW review because price differentials appear in relation to what is offered by the insurer at the point of renewal and what is available on PCWs.

There are also live reviews of competition dynamics in life insurance markets. For example, the FCA released the findings of its **thematic review of the annuity market** in February 2014. The review was split into two phases – the first phase looked at the level of detriment consumers faced through not shopping around and the second would look at whether firms' processes for providing annuities create barriers to shopping around. During the thematic review the FCA also commissioned a literature review of demand-side issues in the annuity market and indicated that it was exploring profitability in the market. The review found that annuities sold to internal pension customers were more profitable than those sold to external customers, although it has recognised that it is not straightforward to measure and assess profitability, particularly of a product with the inherent complexities associated with annuities.

The FCA found that of those consumers who do not switch, eight out of ten people could get a higher income through shopping around, that there was unequal access to medically underwritten annuities offering potentially higher rates, and that people with small pension pots (less than £5,000) have little choice when shopping around as very few providers offer them an annuity. The FCA has now launched a full **market study** – including further supervisory work in line with the second phase planned in the thematic review – which will assess competition in the retirement income market more generally, including annuities.

In September 2013, the Office of Fair Trading (OFT) published the findings of its **market study on defined contribution workplace pension schemes**[5]. The market study considered whether competition between market providers is working sufficiently well to ensure that existing and future customers would benefit from high-quality, low-charging schemes. The study concluded that two areas of the contract-based market were a cause for potential concern and reached an agreement with the industry, via the ABI, on a programme of action to address this. This involved:

- An industry-led audit of pre-2001 workplace pension products, and post-2001 workplace pension products with charges over an equivalent of 1% AMC, overseen by an Independent Project Board (IPB). The audit will assess the level of charges applied to a scheme and the benefits associated with being a member of that scheme.
- The establishment of Independent Governance Committees (IGCs) within providers to ensure workplace DC schemes offer ongoing value for money. The scope of these IGCs will include default funds and funds with significant usage in all DC workplace pension products in respect of all members of the scheme, whether active, deferred, or future leavers.

Additionally, the OFT proposed that investment managers should transparently report investment transaction costs to IGCs who will be best placed to make an informed decision on whether the level of these costs represents value for money. The OFT further recommended that the FCA should agree a consistent methodology for reporting comparable information on investment management transaction costs and portfolio turnover rate as part of its planned **competition review of wholesale markets**. This will ensure that IGCs receive consistent and comparable information on transaction costs to aid them in their value for money assessment duties. The ABI strongly supports these recommendations and looks forward to working with FCA to achieve their implementation.

The OFT decided not to refer the defined contribution market to the Competition Commission, citing these proposed remedies and other recommendations as sufficient to address the concerns identified in the market study.

Subsequently, the DWP consulted on ways to improve the disclosure of information about charges and whether a cap on pension scheme charges should be introduced. In its response to the consultation, the ABI stressed the significant practical and operational risk to the delivery of the auto-enrolment programme of schemes having to be re-negotiated in light of the introduction of a charge cap, particularly when provider capacity is already strained. The Government has recently announced that a charge cap will not be introduced in 2014, and is expected to shortly release a Command Paper outlining its response and recommendations to both its Charges consultation, as well as the key features of the contract-based Governance recommendation outlined above.

[4] See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263148/the_UK_insurance_growth_action_plan.pdf
[5] See http://www.oft.gov.uk/shared_oft/market-studies/oft1505

Competition and insurance markets – early learnings

At the time of writing, the FCA has published provisional findings and proposed remedies from its first market study into the add-ons market. So it is still early days in assessing how its new objective will impact upon its overall approach to regulation. The calls for evidence issued in relation to this and other initial market studies – cash savings and retirement income products – were very high level and gave only a limited indication of the FCA's concerns and theories about how those markets were operating.

However, it is clear that the FCA's new competition remit means an increased focus on market dynamics such as the benefits of innovation in the market, market entry/exit, the prevalence and ease of consumer switching and the extent to which consumers can access products that meet their needs. In addition, the FCA is placing a greater scrutiny on pricing, value for money and profitability.

While the FCA is now exploring competition issues, it recognises that its ultimate objective is to improve consumer outcomes. Increasing the number of competitors in a market is often just one facet of this. For example, the motor insurance market is highly competitive with many providers; however, the CC found that higher costs for at-fault insurers going through the other insurer's preferred repair shop have distorted the market and led to poorer consumer outcomes.

In line with its stated intention to use Behavioural Economics as a key tool, closely linked to the pillar of promoting effective competition in the interests of consumers, the FCA used a behavioural experiment in the add-ons study alongside more conventional qualitative and quantitative research. The aim was to better understand how consumers react to different aspects of the add-on sales process.

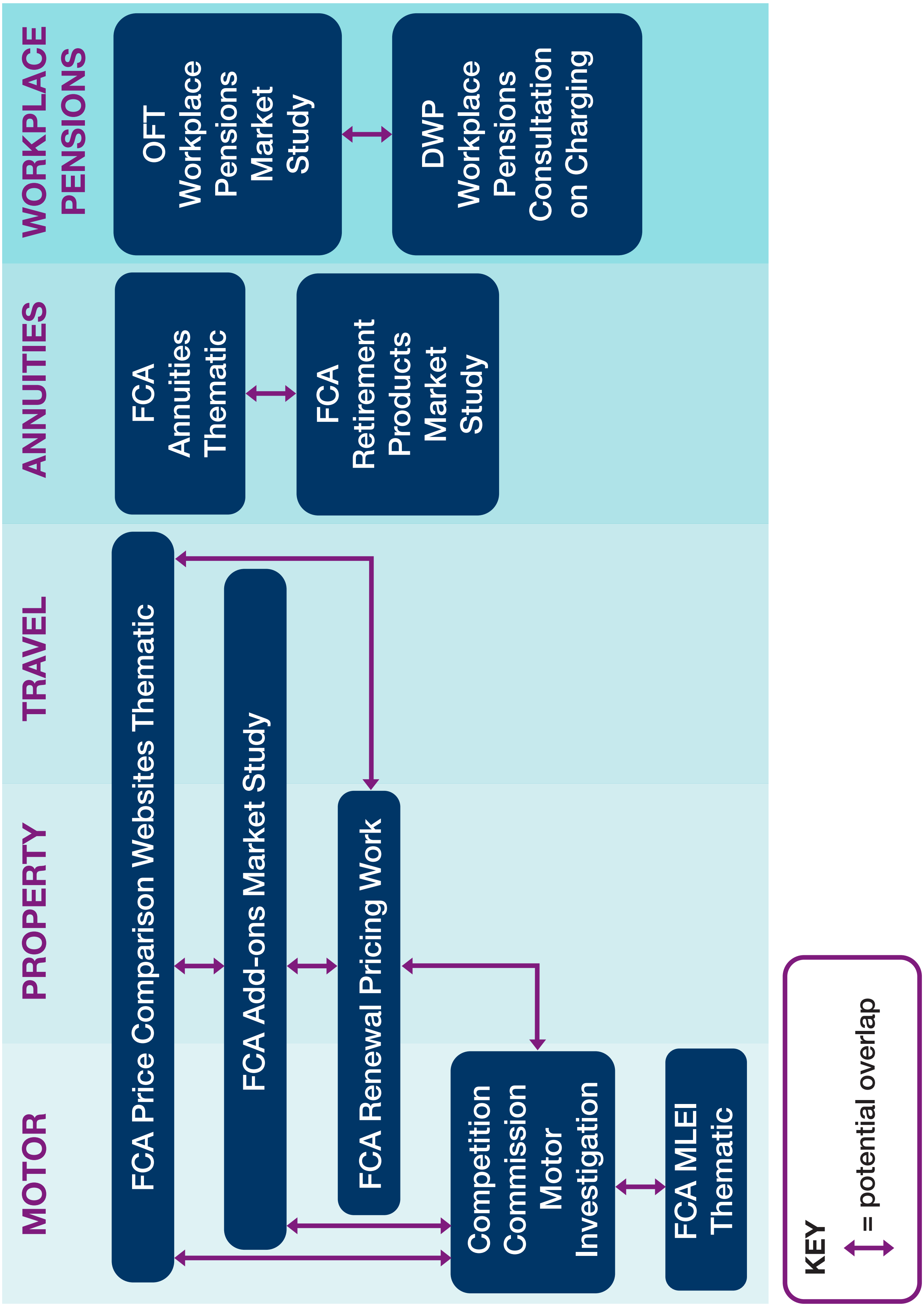
Behavioural Economics could be an important and welcome addition to the FCA's competition toolkit. It provides an insight into the demand-side of markets, including the extent to which consumer preferences and beliefs can bias their decision-making and interprets the biases in a way that allows for comprehension and for a solution to be found. There are biases within financial services due in part to the complexity of financial products, the risk and uncertainty involved in financial decisions, emotions, frequency of purchase and trade-offs between the present and the future. For example, consumers tend to place a bias on short-term payoffs and exhibit a degree of inertia that prevents them from switching to a cheaper or more appropriate product.

Behavioural Economics paints a more realistic picture of the consumer, relaxing the traditional assumption in economic textbooks of the full rationality of consumers. The FCA has said it will develop behavioural 'nudges' as part of the regulatory toolkit it can use to intervene should it judge there to be a problem in the market, such as vulnerable consumers who require additional guidance. Policymakers can use behavioural 'nudges' to influence consumers to act in a way that can be deemed to be more beneficial to their wellbeing (e.g. auto-enrolment into workplace pensions).

Meanwhile, a growing concern for the industry is that multiple, overlapping FCA studies focus on specific pockets of insurance markets and are not sufficiently joined up to ensure that a remedy in one area does not lead to consumer detriment and/or unnecessary costs due to market distortions in another part of the market. There is also the concern that issues might fall between the gaps or work could be duplicated unnecessarily when two bodies (e.g. the FCA and the OFT/CC (or their successor the CMA)) have regulatory crossover. Close coordination is required to ensure that the different reviews do not cause more problems than they solve and to provide certainty for the industry about findings and interventions.

Figure 1 illustrates multiple market studies and thematic reviews in relation to five key insurance product markets and how they overlap. (N.B. The diagram excludes additional FCA thematic reviews that impact on insurance products/sales but which do not directly relate to competition concerns e.g. claims-handling thematic).

FIGURE 1



Source: Association of British Insurers

Recommendations for the FCA

The extension of the FCA's remit to include a new competition objective presents a fresh challenge for the regulator. The ABI is encouraged that the FCA is investing in providing its staff with competition training. In this section we have outlined some key areas for consideration by the regulator to ensure that it is as effective as possible when undertaking market studies/ reviews from a competition perspective.

RECOMMENDATION 1

We recommend a joined-up approach within FCA to market analysis and interventions.

The FCA has proactively launched a series of thematic reviews and market studies since its inception. The ABI appreciates that the new regulatory environment places extra expectation on the FCA to take a more 'hands on' approach. However, in an effort to be seen to be keeping on top of multiple conduct/competition issues, it is important that the FCA does not introduce too much regulatory burden and uncertainty by launching numerous – and potentially overlapping – reviews at the same time. Insurers need to spend time and resource on responding to these reviews which would otherwise be directed at improving their businesses.

Therefore, it is critical that FCA internal communications and coordination are effective in the framing, delivery and conclusions of market reviews. Fewer, more intensive studies focused on all aspects of competition in the relevant market would permit the FCA to prioritise quality over quantity. For example, Figure 1 illustrates that there are currently five studies into different aspects of competition in the motor insurance market. To avoid potential overlap, these multiple reviews could be rationalised, preferably with a clear delineation of one investigation per market. While some studies need to cover multiple product lines, the conclusions reached in one market need to be read across to a different one with care. Furthermore, the boundaries between thematic reviews and market studies also need to be made clearer – this has not been obvious in relation to annuities, for example. The FCA should also follow the competition authorities' lead and provide a clear timetable for when they will bring a market study to a close.

It is worth noting that since October 2001, the OFT has launched 46 market studies across all markets, which averages out at fewer than four a year. Each study takes an average duration of just over a year from beginning to end. The OFT prioritises its work through four principles:

- Impact – the impact on consumers and wider economic benefits;
- Strategic significance – does the work tie in with the OFT's strategy and objectives, and is it best placed to act;
- Risks – the likelihood of success;
- Resources – the resource implications of doing the work.

We urge the FCA to adopt a similar model in prioritising its competition activities and limiting the number of live market studies/reviews.

We also urge the FCA to provide more insight on the market issues under consideration, the theories of market failure/detriment and possible policy interventions, when it seeks input from stakeholders. We were surprised that the terms of reference for the retirement income market study only asked a single general question about the obstacles to effective competition in the market with a short four week deadline for responses. We suggest that more granular analysis and questions are more likely to trigger useful input and analysis, and a longer time period is needed if the FCA wants to receive considered responses.

The industry is keen to establish a strong relationship with the regulator and is looking for straightforward and ongoing dialogue between the FCA and industry throughout the course of a market study. We regret that the FCA did not engage with the industry about the development of its thinking in relation to the general insurance add-ons market study for several months ahead of publication of the report.

Finally, we urge FCA to provide more insight for stakeholders on the implications of it taking on Competition Act responsibilities from 2015 and how that will interact with the FCA's broader regulatory remit.

RECOMMENDATION 2

We recommend close coordination with the new Competition and Markets Authority and Government departments.

The need for good coordination also applies to external work undertaken by the OFT/CC (and their successor body the CMA) and with Government departments, which also sometimes pursue interventions in insurance markets. There is always a risk that two different market reviews take place concurrently with an overlap which sees duplicated effort. Furthermore, by investigating two different issues within the same market the prescribed remedies for one review may not take account of the other review, and instead distort competition through their impact on the other issue under investigation. Therefore, it is imperative that a good relationship exists where there is regulatory overlap. For example, it is important for the FCA and the CC to be clear on the boundaries of their reviews of motor insurance, particularly in relation to add-ons and PCWs.

The FCA and the competition authorities should also work together to consider issues in related non-financial markets. For example, in the private motor market, while the FCA can regulate motor insurers, it cannot directly use its powers to affect the motor repairs market, while in private healthcare, the FCA can regulate health insurers but not the hospitals. So it makes sense for the competition bodies to have taken the lead role in conducting market studies/ investigations in these two cases. In markets such as these, all regulators/competition bodies need to build good working and transparent relationships with each other, in order for regulatory measures to be as effective as possible.

RECOMMENDATION 3

We recommend that FCA should provide more insight on how Behavioural Economics analysis will influence competition policy.

Behavioural Economics (BE) may yet become an important tool in shaping the FCA's approach to competition regulation. However, while it can offer useful insights in understanding consumer behaviour and influencing it, the FCA has so far provided limited direction on the policy implications of its commitment to better understanding consumer behaviour. The nudges that regulators implement compete against existing nudges in the marketplace, both through insurers' individual marketing campaigns and more general market/ cultural level ones. This may mean that the regulatory nudges do not succeed in the manner that was expected. BE may shed further light on why consumers are more likely to take out short-term insurance products to protect their valuables than they are to consider longer-term products that are beneficial for their future well-being and that of their loved ones, and how this can be overcome. The framing of information that makes up consumers' emotional filters encourages them to respond to an event in a particular way, but regulators might be uncomfortable with the framing of certain products if they do not recognise the value of consumers accessing products, which poses a challenge to insurers.

The FCA also needs to be alert to the reality that consumers do not all behave in the same way – so a policy intervention designed to meet the needs of one group of consumers (e.g. standardised products) might not suit the interests of other consumers who want maximum choice. The question is then how the FCA should weigh the costs and benefits of any intervention. If there is a market distortion where more confident or active consumers are better off than less active ones, should the FCA act to help remove the distortion in the market if it then makes the active consumers worse off? If so, does this mean that the welfare of some is more important than others? Any such trade-offs can be challenging, but they should be transparently analysed and surfaced by the FCA.

Similarly, there may be concern that a proliferation of products is making it difficult for consumers to find the optimal one for their needs. However, a regulatory intervention that leads to a reduction in the number of products available may adversely impact those consumers who are willing to spend more time looking for the best deal for their needs as they have fewer options from which to choose.

The FCA now needs to set out some of the policy options arising from its analytical work in this area. While there has been plenty of theoretical discussion on how BE can be used as a tool within the FCA's new competition remit, there is currently little in the way of practical implications. For example, the FCA and the industry could work together to explore improvements in disclosure documents with the aim of better engaging consumers in their finances and encourage them to think about their options, such as shopping around. The ABI has taken a proactive approach to this in the form of our Retirement Choices Code in the annuities market. We understand that the FCA is interested in testing the consumer response to alternative approaches to renewal documents for motor/property insurance but it has so far been slow to progress research in this area.
We urge the FCA to explain how it intends to use BE within its policy framework as it is now almost a year since the FCA published its paper on the importance of BE in competition regulation.

RECOMMENDATION 4

We recommend caution when conducting profitability analysis and pricing interventions.

The FCA has started to make profitability analysis a new part of its considerations when identifying perceived competition weaknesses. We appreciate the FCA will want to understand profitability trends as part of a more rounded understanding of business models and markets. However, looking at short-term profitability levels in isolation will not provide a sound understanding of whether there is a competition problem and, if so, how to address it. For example, a 'fair profit' is a difficult concept to define and assess. Profit levels can be dynamic and variable across the market and time, so the FCA should be wary of reaching hasty conclusions on the basis of snapshot analysis. It is certainly not advisable to set a maximum threshold level for 'good' profit in a single year and then determine that anything greater than this is 'bad' profit. Furthermore, an FCA thematic such as the annuities review, focuses only on some aspects of the market, so we would not expect thematic reviews to seek to reach conclusions in the complex and specialist area of profitability analysis.

The role of different firms in the supply chain can also be complex and needs to be properly understood. For example, the market study on general insurance add-ons found that insurers were not earning high profits from the underwriting of the relevant products, but it did find evidence of high distributor profitability. Good market analysis will sometimes need to take account of situations where there is cross-subsidisation from a more profitable market to a related market that is loss-making, and this may be a reflection of the overall market dynamics. The CC have explored this in the motor insurance market investigation, finding that core motor policies are often unprofitable because the motor market is highly competitive; however, the CC found that some markets for add-ons are quite profitable. When looking at profitability, the FCA should make sure that it combines its analysis with due consideration of the incentives in the market – trying to understand the prevailing incentives for both firms and consumers.

We note that the competition bodies have traditionally been cautious about making market judgements based on snapshot assessments of profitability. For example, the OFT[6] has stated that analysing performance indicators – such as price and profit – in isolation yields little information about the state of competition in a market. We recommend the FCA should heed the caution of its fellow regulators and proceed with care in this area and that it lays out clear guidance on its approach. Ultimately, the profit incentive is critical if firms are to enter or stay in any market, and for consumers to benefit from a dynamic competitive market place. It is also essential to encourage investment in new products and service propositions to meet changing customer needs.

The FCA is also giving some attention to pricing structures and levels within financial services markets. Economists are usually reluctant to advocate regulatory interventions to set prices. This is because they tend to introduce distortions into the market that can produce undesirable outcomes. For example, a price cap can lead to a shortage of a product as suppliers adjust their output to compensate, while there is evidence that prices also tend to shift towards the proposed ceiling. A reduction in price leads to an increase in demand, which is unlikely to be met as fewer firms are willing to supply at the proposed price due to cost constraints etc.

The introduction of stakeholder products with a charge cap following the Sandler Review[7] of the retail investments products market a few years ago illustrates the difficulties associated with price regulation. A flat price-cap was imposed by the Government on stakeholder products, but since the costs were incurred up front, the break-even point for providers of the product was not reached for many years. This restricted the number of distributors selling the product and gave providers little incentive to promote it. The stakeholder brand did not take-off and the exercise is now widely seen as having failed. This experience shows that it is difficult to set appropriate price caps, and attempts to do so can have unintended consequences.

We also note that the Government recently introduced specific legislation requiring the FCA to develop a price cap for high-cost short-term credit. We suggest this indicates that the FCA should only pursue this type of market intervention in exceptional circumstances where there is an explicit political mandate.

[6] See http://www.oft.gov.uk/shared_oft/business_leaflets/enterprise_act/oft511.pdf
[7] R. Sandler, Medium and Long-term Savings in the UK: A Review, HM Treasury, 2002.

The FCA has made clear that it is not an economic regulator, and we hope it will avoid using blunt tools in seeking to address competition issues. Heavy-handed interventions can do more harm than good. Changes to the prevailing incentives in the market can be more effective in making competition work better than a price cap.

RECOMMENDATION 5

We recommend that the FCA should operate on the basis that neither different markets nor consumer interests are homogenous.

The FCA should recognise that the insurance sector covers a wide-range of products and markets. It should avoid a 'one-size-fits-all' approach when regulating a particular insurance market. While there are certain issues that transfer across to different markets, care needs to be taken not to assume a perfect fit. Not only are long-term products considerably different to their general insurance counterparts, but there are also big differences within these sub-sectors – the motor insurance market is very different to the pet insurance market, for example. In addition, risk pricing is fundamental to the operation of most insurance markets, and needs to be properly understood and appreciated by regulators.

When the FCA conducts market studies and thematic reviews it should clearly define the markets it is scrutinising and should recognise the differences in the relevant markets (e.g. distribution channels, number of providers) when drawing conclusions and devising interventions. We were surprised that the scope of one of the main proposed remedies in the general insurance add-ons market study – a requirement on insurers to publish claims ratios – extends beyond the scope of the add-ons products within the study.

We recognise that sometimes a market review may raise issues which are potentially relevant across other insurance markets beyond the scope of the initial study. As discussed above, some of the proposed remedies from the CC investigation into the motor insurance market may also be appropriate in other markets, particularly where consumers are served by PCWs. However, the scope of the CC work only covered the motor market so a broader analysis of the implications for other general insurance markets would need to be carried out by the FCA, while taking into account the differences between the markets.

As mentioned above, the FCA has made it clear that it intends to use Behavioural Economics within its regulatory framework. This needs to take into account the non-homogeneity of consumer needs and preferences. While for some consumers it may be important to spend lots of time shopping around for the best deals, for others the opportunity cost of spending time looking for a deal that might save them £20 over a year might be to spend some more time with family and friends. For many, the lowest price may be a key driver of behaviour but for others the peace of mind that comes from an all-inclusive 'expensive' policy may be the most important factor in their decision. It is important that the FCA recognises these important differences in consumer preferences, behaviour and interests.

Recommendations for the industry

The FCA's new competition remit also provides a challenge for the insurance industry. However, by accepting the challenge of a different style of regulation the industry will be better placed to ensure that regulatory interventions are justified and beneficial for both consumers and firms.

RECOMMENDATION 1

Insurers should be prepared for a different type of regulation focused on markets and overall consumer outcomes, not just individual firms' compliance with conduct rules.

The insurance industry should be prepared for change and engage fully with the FCA's new competition agenda, rather than waiting to hear from the regulator. A proactive and cooperative approach will allow the industry to have a greater impact on the FCA's analysis and any decisions made, which can lead to more favourable outcomes for insurers as well as consumers. By being transparent and recognising that the FCA now has a new focus and objective, insurers can make it easier to build a positive relationship with the regulator. Insurers are likely to understand the finer nuances that exist within different product lines and markets.

The industry should see partnership with the FCA as a standard approach where market/regulatory changes may be industry-led. This is effectively an extension to the ABI's previous self-regulatory work, which has established some consumer-focussed industry norms. There may be new opportunities arising from the change in regulatory approach of the FCA – for example, the 'non-advised' thematic review suggests the FCA now recognises the consumer interest in accessing services that meet their needs, to a much greater extent than the FSA. The FCA has welcomed the ABI's Code of Conduct on Retirement Choices[8] and is keen to see other similar initiatives. The ABI is already actively engaging with the regulator, and this will be aided by an industry that shows it is committed to making markets work well.

RECOMMENDATION 2

Market studies will gather large amounts of data about how insurance markets work. Insurers should take the time to explain to regulators how each of our insurance product market works in practice, which should also improve the effectiveness of the data requests.

As the competition remit is new to the FCA, many of its staff will be new to this type of analysis and regulation, particularly in the context of general insurance markets that were not a high priority for the FSA. As mentioned above, insurance companies should work with the regulator to explain some of the nuances and complexities that exist across different insurance lines, as well as listening to their concerns and acting on them where appropriate to address or prevent a market failure. For example, the FCA will restrict the non-advised, face-to-face channel in the mortgage market from April 2014, but by explaining differences in insurance markets, the industry can ensure that the FCA does not simply transfer this remedy from the mortgage market to its thematic review of non-advised sales of retail investments. Insurers know what they sell, how they do it, how consumers engage with their products and what specific market features might mean for successful regulation. As a result they can offer support and insights to establish a good working relationship with the FCA.

RECOMMENDATION 3

Competition analysis looks broadly at market dynamics and outcomes. Insurers should therefore engage the whole business in responding to FCA, not just compliance.

The FCA remit is different to that of its predecessor. Where the FSA focused on the role of the individual firm and ensuring compliance with the existing rulebook, the FCA has a broader remit to monitor whole market dynamics. As such, effective engagement with competition issues should involve every level and division of the business, not just compliance. It is important that insurers develop new skills or source the specialist expertise required to understand, influence and adhere to competition-focused regulation. Proactive thinking about competition at an early stage across product development teams and distribution strategies can ensure that the insurer understands the FCA's broader perspective and is not faced with costly regulatory intervention further down the road. The industry can expect to be challenged by the FCA on the extent to which it makes use of Behavioural Economics and whether this is being used to deliver positive or negative consumer outcomes. Individual firms and trade associations will also need to be alert to the implications of the FCA taking on Competition Act powers. Compliance with the existing rulebook is now only a part of the overall interaction with the regulator.

[6] See https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/The%20ABI%20Code%20of%20Conduct%20on%20Retirement%20Choices.ashx

RECOMMENDATION 4

Insurers should be aware of political interest in our markets, and the risks of quick fix solutions, and recognise the advantages of interventions which are evidence-based and firmly set within the FCA's regulatory framework.

Some insurance markets interact with public provision or raise matters of concern to politicians, so we need to anticipate ongoing political interest in our sector. In particular, the recent economic downturn and the focus on 'cost of living' issues are increasing political scrutiny of mass-market insurance products such as motor insurance and pensions. There is a risk of rushed political interventions without proper economic analysis, which can be costly and distortive to the market. Insurers may see advantage in working constructively with the FCA and political stakeholders with the aim of agreeing evidence-based, regulator-led market interventions.

RECOMMENDATION 5

Regulatory change represents a challenge to business models, but insurers should also recognise the potential for strategic opportunities for growth as a result of changing regulation and market dynamics.

New regulatory measures to improve the competitive environment are likely to bring with them some shifts in market dynamics. This is because the regulator will be looking more broadly at the dynamics in the market and business models rather than just individual firms' compliance with detailed rules. These shifts in the regulatory environment may destabilise existing business models, but they are not necessarily a zero-sum game. Insurers should also be prepared to embrace these shifts as they can represent new opportunities to grow market share, to open up new product niches to be explored or to address problematic market dynamics – and this in turn can lead to opportunities for market expansion and growth. For example, regulation that seeks to reduce barriers to entry could encourage firms to enter new insurance markets, or could grow the whole market. Furthermore, the FCA focus on encouraging competition provides a different dynamic for insurers in their interactions with regulators, and so will reward those insurers that look to engage in fair competitive practices. Regulation should be more rounded now as the FCA is considering the way markets work for consumers, and so firms who feel that there are distortions in the market that prevent more effective competition (e.g. the use of MFN clauses) should have their concerns heard more easily.

Conclusion

In summary, the FCA's new competition remit presents some challenges to the financial services industry. However, insurers should not be afraid of competition regulation as it can also be viewed as an opportunity to improve the operation of markets. More competitive markets reward efficient firms that offer consumers better choices, while reduced barriers to entry can allow firms to expand their offering to new markets. For its part, the regulator should ensure that it conducts high quality market analysis and pursues well-considered interventions. It should also approach its new remit openly and be receptive to the nuances that exist across different insurance lines. While some insurance markets may require some regulatory intervention to function more effectively, there is plenty that already works well within the highly competitive insurance sector.

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