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Good value?

A suggested framework for financial services firms to assess the value for money of their products

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Contents

Overview: this paper's purpose and for whom it is intended

Against a background of rising regulatory scrutiny of value for money, this paper sets out a comprehensive economic framework that **firms across all financial services** sectors can use to assess and demonstrate the value for money of their products and services.

The paper sets out the core principles underpinning this framework and explains how it can be used to think about different aspects of value, as well as a number of practical questions firms across different financial sectors can put to themselves to ensure they are considering an appropriate range of value perspectives. Accordingly, this framework will provide **an extensive toolkit for board members and senior executives, including CROs and heads of product,** to use in assessing and demonstrating value from both an internal governance and a regulatory perspective. The framework can also be used as **an effective tool with which to construct management information and board and risk governance reporting.**


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Executive summary

Firms are facing increasing regulatory scrutiny relating to the "value for money" of their products and services.

As a result of this scrutiny, firms will increasingly be asked to justify the pricing and wider value of their products and services to the regulator.

In the UK, the FCA has already undertaken a number of market studies across the asset management and general insurance sectors, looking at the pricing and value of these markets.

UK based asset managers are now obligated to produce value assessments for their funds, while insurers have seen regulatory pressure on their use of differential pricing.

The FCA is beginning to apply the lens of value and the approach taken in these markets to other retail financial products.

"Value" can first appear to be a nebulous and debateable concept, and regulators will, understandably, be unwilling to provide firms with template answers for what good or fair value looks like.

However, this report illustrates and explores an economic framework that boards can use to assess and demonstrate the value for money of their products and services.

Introduction: why and how FS regulators are focussing on value for money

Over the past decade, the financial services industry has been subject to an intensive programme of regulatory change. Much of this change was driven by the financial crisis, and the need to make the global financial system more stable and secure. However, a "second financial crisis" relating to poor conduct by financial firms[1], has also driven major change. This "second crisis" has included the mis-selling of PPI, LIBOR and FX benchmark manipulation and mis-selling of interest rate hedging products, all of which have damaged consumers' trust in financial services firms. It is against this backdrop, that conduct regulation has undergone a gradual but radical evolution.

Where good conduct would once be demonstrated by a focus on systems, processes and controls, regulators are increasingly assessing the economic outcomes products are delivering for consumers whilst expecting firms to put good customer outcomes at the heart of their conduct frameworks.

This growing emphasis on the economic outcomes consumers receive from financial products has been accompanied with a sharper focus on firms' business models and overall purpose, with particular focus on whether the business model and product strategy is driven by unfair consumer treatment and/or consumer misunderstanding or inertia; on pricing practices; and on the use and fairness of cross-subsidies and price discrimination.

Where regulators have identified concerns relating to these areas they have become more willing to intervene, including, as a last resort, and where other interventions have proved ineffective, directly on the prices firms charge.

These developments in conduct regulation have culminated in regulators turning their attention to the value for money provided by financial products and services.

In the UK, where the regulatory emphasis on value assessment has been most marked, the FCA has introduced new rules, requiring the UK authorised fund managers (AFMs) to assess the overall value that their funds deliver to investors, and to publish a summary of these assessments annually. These rules are driven by concerns that retail investors may be getting poor value for money, as there is evidence that retail investors can often pay twice as much as institutional investors for similar products, and may unwittingly invest in poor value products such as 'closet index-tracking funds'.[2]

This will be the first time AFMs have had to justify their pricing and the wider value of their funds publically, and it will be highly important from a reputational, as well as regulatory, perspective for firms to produce credible assessments. Importantly, and as a possible harbinger for other financial services sectors, this is also the first time that the FCA has made an individual accountable under the Senior Managers and Certification Regime (SM&CR) for a firm assessing value for money.

The general insurance sector has seen the value it provides to its customers come under similar regulatory scrutiny. The FCA's general insurance pricing market study looked at the practice of 'price walking' in the markets for home and motor insurance. The study found that consumers who continually renewed their insurance policies with their existing insurance provider paid rising premiums each year they continued to renew, meaning they paid ever higher prices and became steadily more profitable than newer customers. The FCA said that these pricing practices meant that around 6 million UK consumers paid "*unnecessarily high prices*" for their insurance.

In order to address these issues, the FCA's study's final report proposed a series of remedies, including a ban on firms' ability to use differential pricing or 'price walking', further restrictions on the firms use of auto-renewal, and a direct responsibility under the Senior Managers Regime for a senior manager to attest that the firm's pricing practices comply with these pricing rules. This

1 The FCA's CEO Andrew Bailey referred to this "second financial crisis" in a speech in 2016: The rationale for the FCA's Mission and the context which the FCA operates in, 26 October 2016

2 ESMA found in its 2019 report on costs and past performance in retail investment products that retail investors in UCITS funds pay twice as much as institutional investors on average. The FCA also continues to review potential closet tracker funds and closet constrained funds as part of its ongoing supervision.

shows that the FCA is willing to introduce strong pricing and oversight related remedies where it thinks a market is delivering poor value for consumers.

While the FCA's study focuses on price, it is clear that the FCA is concerned about the overall value of the general insurance market, with the FCA stating in the study's final review that its goals for the general insurance market include that *"consumers can trust that firms are offering long term fair value"* and that firms *"deliver fair value in their insurance products' pricing and design throughout their lifetime."*[3]

This concept of "fair value" is central to how they FCA will consider value for money across other financial services markets. The FCA has set out its thinking on the pricing side of firms' value propositions its discussion paper and feedback statement on fair pricing.

The FCA's paper does not focus on the prices charged for particular goods or services, but instead sets out the FCA's thinking on whether certain pricing strategies or practices employed by firms are likely to be fair. The paper sets out the FCA's "6 question framework" (see the table below) which it will deploy in order to assess the fairness of a given pricing practice, and consequently whether it will be minded to intervene.

The FCA says that it will look to apply the framework on a case by case basis, and that certain questions may carry more weight than others depending upon the pricing practice in question.

However, in most cases no single question will determine whether a pricing practice is viewed as fair, with the FCA stressing that the framework needs to be considered in the round, and that it hinges upon judgement in each case.

The FCA has used this framework to inform its general insurance pricing market study and has committed to incorporating its work on fair pricing into its forthcoming review of its Principles for Business. The FCA also says that "*issues of fairness in pricing are likely to become increasingly prevalent and complex in the future*" [4] suggesting its focus on fair pricing will grow still more significant in the years ahead.

Beyond its focus on the asset management and general insurance markets, the FCA has also been concerned about value for money in a number of other markets. The high cost credit market has been an area of particular concern, and the FCA's high cost credit review has led to changes to overdrafts, buy now pay later offers, and to a price cap on rent-to-own-policies (in addition to its existing high cost credit price cap). The FCA has also looked at the value longer term savers receive in the cash savings market, and has proposed that firms will have to offer customers a single rate of interest across all of their easy access savings accounts open for longer than 12 months with this interest rate being set by the firm. This interest rate will be called a Single Easy Access Rate (SEAR).

In the coming years the FCA is likely to turn its attention to the value for money of a growing number of financial services markets, with a particular focus on mass market retail products. Firms will consequently need to prepare to justify the pricing and value that their products provide

	Lesser desire to act	Greater desire to act
Who is harmed by price discrimination ?	Wealthier consumers - e.g.time poor, cash rich	Consumers with charectistics which might be deemed vulnerable (e.g. low income, old age etc.)
How much are these individuals harmed?	Profitability difference between consumer segments is minimal and is immaterial to the harmed segment	Significant profitability differences and the harm has a significant adverse effect on the segment affected
How significant is the pool of people harmed?	Very small minority	Significant group of consumers
How are firms price discriminating?	Transparent and based on behaviour which consumers can easily change (e.g. switching)	Hidden and based on intrinsic charecteristics which consumers cannot easily change (e.g. personal characteristics)
Is the product/service essential?	Product/service is considered non-essential but desired by some consumers	Essential product/service (e.g. current account or motor insurance)
Does society view the price discrimination as egregious/socially unfair?	Little concern expressed about practices and firm behaviour widely accepted	Persistent and broad-based concern expressed and firm behaviour seen as poor conduct

3 FCA, General Insurance pricing market study final report, September 2020, p5
4 The FCA, Fair pricing in financial services feedback statement, July 2019, p3

Thinking about value

Normally, when we think about whether a product or service provides value for money, we tend consider what benefit or utility we derive from it, weighed against its cost. We also tend to think about value for money in a narrow sense and whether the product/service provides value to us, the consumer. However, whilst focusing on value to the consumer is important, any assessment of value should also take into account wider perspectives relating to the sustainability of a product/service, or the value delivered to society more generally.

These different perspectives form the core part of our suggested approach to assessing value for money, the details of which we set out below:

Consumer value

At its most simple, value for money is about minimising the total cost the consumer pays for a product or service, whilst maximising the benefit or utility they receive from a product. It is also important to consider how the product may compare to other options available to the consumer, typically in the form of competitor products.

With financial products, which ultimately deliver financial outcomes (e.g. an insurance payment given a certain insured event, or a return on an investment), there can be ways to quantify 'value'. Insurance, for example, is often considered in terms of the claims ratio, which is the cost of claims (to the insurer) divided by the premiums paid. An insurance product might also be compared against the cost of self-insuring; how much would it cost the consumer to make good the impact of the insurable event?

However, the value that the consumer receives from insurance can be greater than this. If a driver crashes into the back of a Bugatti Veyron, they may simply be unable to afford the cost of the damage or face financial ruin in doing so (putting aside the legal requirement for motor insurance, of course). This means that the value of insurance that covers potentially high cost (and

typically low probability) events is likely to be relatively higher than the value of insurance that only covers events that the consumer could, in principle at least, afford to self-pay.

Alternatively, value for money can be considered from a cost plus perspective, which compares the cost of providing the service to the consumer with its price. For asset managers this can involve allocating a significant chunk of common costs (e.g. research costs) across different investors and different investment funds. These common costs are usually considered relative to assets under management, as that is how costs are normally considered within investment funds. But from an economic perspective, there is no a single answer to how common costs might be allocated. One theory of optimal allocation, known as "Ramsey Pricing", posits that allocating a greater share of common costs to consumers with lower price elasticity (meaning they have a greater willingness to pay) can be socially efficient, as the lower price thereby provided to more price sensitive consumers maximises consumption. This could, at least partially, justify allocating proportionally more common costs to retail investors than institutional investors (assuming the latter are more price sensitive), although this needs to be tempered by considerations of equitably and consumer vulnerability, as explained further below.

Sustainability

Value-for-money metrics may also reflect utility and costs associated with the long term sustainability of products and the producer of those products, to reflect the wider needs of the economy, and the long term needs of consumers. Consumers require products that can be sustained not just for the current year, but for many years, and therefore sustainability is often crucial.

There are numerous examples of this in the insurance industry, ultimately due to the need to ensure that there is a sustainable risk pool and products that deliver over the long run. For example, with health insurance or lifelong pet insurance, there is an implicit long term relationship between the customer and the insurer. While they could do so, given typical twelve month contracts, insurers do not price fully to risk, as this would likely mean charging very high prices to customers (or their pets) with ongoing health conditions, which in turn would undermine the long term sustainability of the product. This means, inevitably, that healthy customers pay more, to subsidise the unhealthy, although this is considered equitable as all customers may (although hopefully will not) be unwell themselves in the future. Value-for-money in this case therefore needs to look beyond the current policy, and consider value over a longer period – for example, over a customer lifetime.

There is also a question around long term investment costs. Many new products are not immediately profitable and involve significant investment to develop, trial and fine tune before they are sold. Even after the product is launched, costs may remain high until sufficient economies of scale are achieved to bring down costs. In order to ensure these new products are not poor value or uncompetitive, there may be a need for successful products to cross subsidise the development of new products which may face high start-up costs and risk not being successful; for example the launch of a new investment fund.

However, while cross subsidies may be acceptable in some circumstances, they can often lead to some groups of consumers paying higher prices and receiving less value than others. This is a practice to which regulators may object, especially when this leads to poorer value for more vulnerable customers. Firms will consequently need to balance the value they provide to longstanding customers with their desire to deliver good value products sold to new customers.

Social value

Financial products can, like other products, produce what are known as positive or negative "externalities", where the consumption of the product creates costs or benefits for others, which may or may not be factored in by the product manufacturer or understood by the consumer of the product.

For example, investment funds that aim to deliver on environmental, social and governance (ESG) criteria are arguably delivering wider benefits. These may be considered by the investor, but this also has implications for how one might define value for money. Value is not just driven by the investment returns, but also needs to reflect the degree to which the fund is delivering on

its ESG objectives, balanced against the costs of fund management. This may require some measure of the willingness of ESG investors to pay for differing levels of ESG criteria, but other approaches may also be relevant.

With insurance, there may also be implications for behaviour. Being insured could encourage risk-taking behaviour, which could impact on others, although this should usually be tempered through risk-based pricing, which penalises risk takers with higher prices. There may be a limit, however, to the extent to which society wishes to place the cost of risk on the policyholder, for example in the case of flood insurance. This in turn has implications for how one might consider value for money.

The pricing structure or business models of certain products can also create winners and losers, raising wider distributional issues and concerns whether these outcomes are socially just. The FCA's work on fair pricing shows the regulator is interested in who might be harmed by price discrimination, and how well placed they might be to respond (e.g. by shopping around for a better offer). This focus is broader than on a strict definition of 'vulnerable consumers' (although it will be important for firms to consider the impact on vulnerable consumers as well) and includes consumers who are persistently unengaged, renewing products without assessing their value.

This may suggest to firms that they should measure value for money for particular groups of consumers. For example, in general insurance this might be consumers that have renewed for a number of years without discussing the premium (as an indicator of lack of engagement). With credit products, regularly extending credit facilities might be an indicator of financial distress, which could also define a potentially vulnerable group. Ensuring value for money for these groups may require changes to pricing policies.

Ex-ante vs Ex-post

Considering how the product performs over the product lifecycle is also important to assessing value. A distinction can be made between the value of a product when it is being bought and how the product may perform over time.

Consequently, it is also important that value is considered from both an ex-ante and an ex-post perspective:

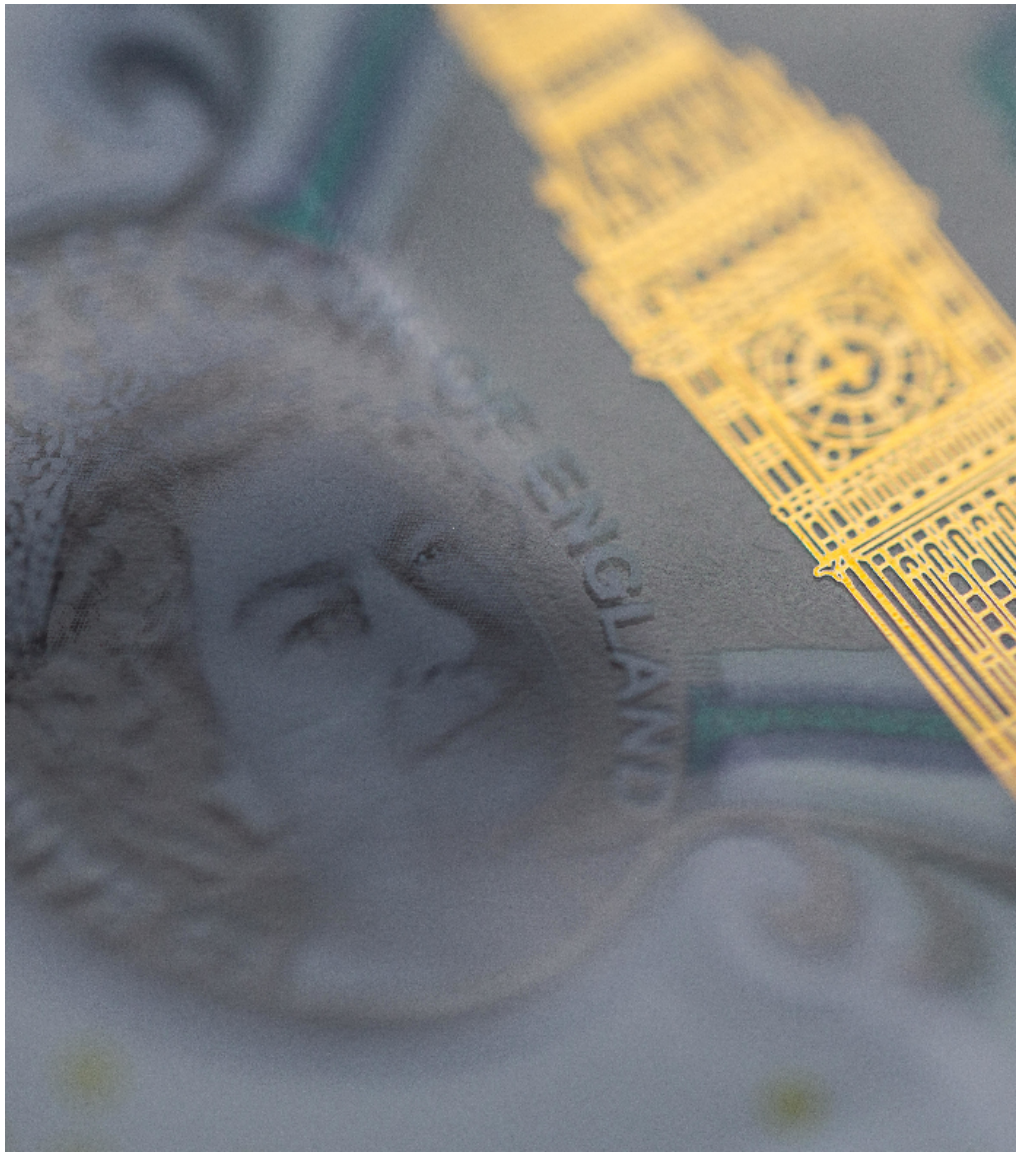
- **At purchase (ex-ante)** – what value would the product be reasonably expected to provide when it is being purchased?
- **Over time (ex-post)** – does the product actually deliver value in line with what could reasonably have been expected?

This is especially true of risk based products such as investment funds and insurance. We cannot say today whether an investment fund will actually deliver on its objectives over the investment horizon in the future, but value-for-money can still be considered on an ex-ante basis as to whether asset management services being provided have the potential to justify the costs.

Value for money in practice:

Whether an outcome can be considered to deliver value for money depends on the perspective being taken in terms of the value. This can be considered in terms of the perspective described above, which can be summarised as: consumer, sustainability, and society. In addition, each of these perspectives can be considered from an ex-ante or ex-post perspective, distinguishing between whether a service can reasonably be expected to deliver value, and whether it actually delivers value.

To show how this may be put into practice, we provide below a series of examples, utilising the above perspectives, which set out useful questions around which boards in all sectors might ask for assessments of the value that their products deliver to be constructed. These questions can also help inform and structure the management information firms seek to collect and monitor to assess value, which should in turn be regularly reviewed and challenged by senior managers and board members.



Protection products

	Ex-ante	Ex-post
Consumer	How much does the consumer pay for the product (premiums + other costs)? How much of this is taken up by commission/ distribution costs? How does the cost of the premium compare to competitors for the same level of cover? What is the expected pay out for the product? Is this guaranteed or variable? Is there additional non-financial value to the consumer (e.g. peace of mind)? Is the product FSCS protected? How does the product compare to the consumer saving and investing money to provide a similar style benefit (e.g. self-insuring)?	Does the product reliably deliver the expected pay out? What is the product's claims ratio? Does the level of commission/distribution costs remain competitive over the life time of the policy (for example, is there trail commission)? How do these costs compare to a consumer taking out a similar policy today? How many/what proportion of customers have complained about the product? How quickly are claims assessed and paid? Is there flexibility to be understanding in paying out against claims? What requirements are placed on the policyholder or their family when they come to file a claim? Are any requests for documentation reasonable?
Sustainability	Is there a risk of adverse selection affecting the viability of the insurance pool? How is this risk managed? Are returns on investing consumer premiums likely to be high enough to cover expected pay outs? Are levels of investment risk appropriate for the level of cover being offered?	Is the product viable over a 30+ year lifecycle? What scale does the product have to reach to become viable? Does the profile of investments match the likely maturity of the product?
Social	Is the product available to a broad number of consumers or are T&Cs likely to make it exclusionary? Does the product unfairly exclude vulnerable consumers? Are any evidence requirements (e.g. for medical evidence) likely to unfairly exclude certain consumers? Does the product produce any negative change in consumer behaviour (e.g. recklessness due to moral hazard)? Are there any exclusions that could contribute to treating the consumer poorly, and is there flexibility to override them?	Do the product's T&Cs unfairly penalise changes in consumers' circumstances? Does the product allow consumers to adapt the policy to account for changing needs/demands? Can the consumer easily exit the product without facing adverse costs if they need to?

Asset management

	Ex-ante	Ex-post
Consumer	What will the consumer pay for the product (initial charges, ongoing charges, and performance fees?) and how does this compare to the long run expected rate of return? Is the product and its charging structure easy to understand? How does the cost of the product compare to competitors? Does the product promise a suitable rate of return for the associated investment risk? Is the investor implicitly paying for an active strategy? Does the potential outperformance of the investment strategy justify additional costs relative to a tracker fund? What are retail investors charged vs institutional investors? Is any difference justifiable?	What transaction costs does the consumer pay? Do these transactions help deliver alpha? Does the fund meet its stated investment objectives? Does the fund outperform its benchmark? If so over what period (1 year, 3 years, 5 years?) Does the fund deliver a better rate of return than funds with similar investment objectives? Does the fund closely track an index? How does this compare to the stated objectives and the relative cost of the fund? Are economies of scale (for example, once the fund reaches a certain AUM) passed on to the end consumer?Could consumers benefit from being in a different share class?
Sustainability	Does the fund invest in assets which match its stated redemption period? Where the fund is invested in illiquid assets, are there appropriate strategies in place to manage liquidity risks? Is the fund commercially viable below a certain level of AUM?	Does an economic downturn or other external risk event have the potential to affect the long term viability of the fund? Are appropriate provisions put in place to reduce this risk, and the fund managed accordingly? Are investors successfully able to withdraw their investments from the fund in line with stated redemption periods?
Social	Does the fund have wider environmental, social or governance objectives that provide positive externalities? Does the firm's stewardship of investments in the fund contribute to socially beneficial outcomes? What value might investors place on the expectation of funds delivering on these additional benefits?	Are any promised environmental, social or governance objectives met? Does the firm use its powers as a shareholder to act in line with investors wishes? What might be the value of these benefits to society, relative to the costs of asset management?

Consumer credit

	Ex-ante	Ex-post
Consumer	What will the consumer pay for the product (interest, fees and other costs)? How much of this is taken up by commission/ distribution costs? What is the total amount to be repaid vs the principle? Is the product and its charging structure easy to understand? Can the consumer reliably estimate what they will end up paying in pounds and pence? How does the cost of the product (including any fees) compare to competitors? Can the consumer afford to repay the credit, or just service the interest on the debt? Does the provision of credit allow the consumer to purchase essential goods/services, the loss of access to which, or failure to pay for, would otherwise cause serious detriment?	Does the consumer receive the borrowed monies in a timely manner? Is it easy and hassle free for the consumer to borrow? Does monitoring indicate that having borrowed once, customers tend to take out repeated loans (indicating dependency on credit)? What would the outcome be for the consumer if they did not take the credit? Would they ultimately be better or worse off financially? For example, is the consumer trapped with persistent debt? Where the credit line is directly linked to the purchase of a product, does the consumer lose any equity built up in the product should they fail to meet later repayments?
Sustainability	Is there a risk of adverse selection affecting the provision of credit? How is this risk managed? Does an economic downturn or other external risk event have the potential to affect the long term viability of the loan? Are appropriate provisions put in place to reduce this risk, and is the loan priced accordingly? Does the credit's interest and payment terms appropriately match the risk profile of the borrower?	Was the pricing of the product (interest rate) appropriate given the realised rate of return (default)? Where loans affordable in practice? Are impairments/defaults at risk of affecting the long term viability of the product/firm? Is the firm's wider business model/viability contingent upon the success of the product?
Social	Does the credit help meet the needs of vulnerable consumers who would struggle to borrow elsewhere? Would an alternative form of credit provide a lower cost way of borrowing the same money (e.g. using a personal loan vs an overdraft)?	Is appropriate forbearance/flexibility available should the consumer have trouble repaying the loan? Do the lender's collection practices consider the interests of the consumer and ensure they are treated fairly?

Conclusion: Implications for firms

In the years ahead, firms are likely to face increasing regulatory and supervisory scrutiny of the value for money that their products provide. Given this, firms will want to consider incorporating a framework to review the value that their products provide, both as part of their product design and overall governance processes, and to inform the management information received by the board and executives. Firms can use this framework and information to respond to what is likely to be a central and increasingly frequent regulatory challenge question, namely: "how do you know your products deliver good value for money?"

Whilst value to consumers should be at the forefront of firms' minds when considering value, firms will also need to consider how both the long term sustainability and wider social impact of their products weigh upon the value that they deliver. Firms will thus need monitoring and oversight arrangements to ensure that their products not only deliver value at the point of sale (ex-ante) but over the entire product lifecycle (ex-post). Accordingly, they will need to consider value holistically, rather than from a 'snapshot', point in time perspective. Firms will also need to be mindful of how equitable their products value may be to different groups of consumers, as the FCA is likely to be particularly concerned about vulnerable consumers receiving poor value products and to any cross-subsidisation between different consumer groups that creates potential unfairness.

Where firms find that their products are not delivering good value, a variety of options are available. These can range from cutting fees and charges, to improving the quality of service and changing how the product is managed. Where poor value is sustained and consistent, firms will need to consider either re-designing or even closing the product to new customers and, where possible and appropriate, moving existing customers to a similar but better value product, in line with their obligation to treat customers fairly.

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