Rethinking COMPETITION

With the efficacy of switching – and other customer-focused initiatives – in question, PROFESSOR JOHN ASHTON asks whether we have seen the end of consumer-driven competition.

In July 2017, the UK Financial Services Consumer Panel (the Panel) issued a position paper on the role of the consumer in driving competition within retail financial services markets. This independent body, which advises the Financial Conduct Authority on how its strategy and policies affect UK consumers, reported that previous guidance about enhancing competition by encouraging customers to switch providers had been misplaced.

POLICY SHIFT ON SWITCHING

This shift in policy acknowledges what has been known for many years: that consumer-focused initiatives such as encouraging switching and enhancing information provision have in fact had a limited impact in fostering competition.

The decision also marks a sea change as to how competition authorities in the UK and internationally have sought to encourage further competition. Competition in financial services markets was viewed to be a consumer-driven process, where customers discipline firms by moving between suppliers based on the price and quality of the financial services on offer. To engender greater competition, appropriate government authorities have persistently advocated that customers must become active market participants, researching the market and switching their financial services supplier accordingly.

By questioning this consensus, the Panel has challenged many years of policy argument and practice, not just in financial services but in a variety of utility markets, and clearly shifted focus of competition policy from the customer to the firm.

THE WHOLE PICTURE

In light of these developments it is important to ask how was this decision reached and are these claims justified? Also what form will future regulation and policy take to encourage and develop competition in retail financial services?

The Panel's paper was based on a number of sources including reviews of past literature and customer surveys. These contributions suggest that the prevailing focus on customer switching overlooks major challenges for competition. These impediments to competition include the inertia of customers, when people prefer inaction over finding new suppliers, and the fact that firms may make switching more complex and less attractive to the customer.

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INVESTIGATING INERTIA

Of central concern is that when a high proportion of customers decide not to switch supplier, competition is driven by the small number of customers who do. It also suggests that the proportion of non-switching customers may be increased by firms' actions.

For instance, product complexity may constrain consumers' ability to research, seek out alternative products and ultimately switch provider. Therefore the behaviour of financial firms in designing, presenting and selling financial services, how contracts are written and forms of pricing adopted can all be used to limit consumers' comprehension of financial services and discourage switching. Critically, if a customer does not understand the quality and attributes of a complex financial service, they are less able to judge the value of the service and poor purchase decisions become likely.

Through this process, consumer decision-making failures arise and allow some firms the opportunity to sell lower quality and higher cost services to unknowing customers. In the face of such a challenging decision-making environment it is easier for many customers to do nothing, not switch and remain with their current supplier. Implicit within these ideas is the viewpoint that customers do not always act in their own interests and price competition is diminished by the actions of firms.

PRODUCT COMPLEXITY

By encouraging switching, competition authorities and regulators were therefore drawn into a contest with firms' marketing managers. One side of this tournament desired to encourage product simplicity, easier decision making and ultimately switching; the other side attempting to retain customers, obfuscating and increasing the complexity of financial services. Clearly, this was never a competition regulators would ever win.

Within this environment, customers were not only expected to cope with the demands of acting within a competitive market, they also had to navigate the complexity designed by firms to limit decision making and switching.

Many of these assumptions as to how competition operates in financial services markets are not new and reflect a growing body of theory within economics and finance. Since the 1950s, there has been an awareness that competition and market power has multiple sources and that customers play a critical role in defining competitive conditions, be this through making poor decisions or even not making decisions at all. More recently, it has been increasingly accepted that less sophisticated individuals may be better off when presented with less choice and complexity. For example, a smaller rather than a larger choice set, simpler rather than complex decisions and products with less frequent changes to prices and product attributes can all aid decision making. Concurrent with these insights is a longstanding concern that firms familiar with failings of customer decision making abilities trade on these weaknesses for profit.

NEW AREAS OF FOCUS

As the requirement to encourage customer switching is lifted, other policy recommendations and regulations are predicted. These new initiatives could be numerous, including the simplification of choice sets presented to customers, reduction of noise in decision-making situations and even the withdrawal of certain problematic products. In particular, when common product standards do not appear spontaneously we might imagine regulators to nudge or encourage firms towards establishing markets to operate using mutually agreed approaches. In particular, it is expected, more focus will be placed on the pricing and product design of financial services, beyond what has been observed to date.

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Clearly, time will tell if this policy change will take hold and alter how we consider the competitiveness of financial services markets. The move away from switching and the role of consumers driving competition is significant and challenges a long-held consensus as to how we assess and consider competition. Indeed, many policy makers will not fully embrace this change and continue to promote customer switching. This said, we should expect to see greater focus on possible anti-competitive behaviours of firms, particularly in the areas of developing complexity or otherwise restraining the comprehension and sovereignty of customers. CB

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