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On Wednesday this week the Financial Conduct Authority (FCA) announced that it was launching a market study into the general insurance industry covering motor and home insurance, with a focus on insurance pricing practices. This follows its work focusing on pricing practices in the household insurance market. In addition, the Competition and Markets Authority (CMA) are in the early stages of an investigation into Loyalty Penalties following a super-complaint from Citizens Advice. What is going on here? Identifiable groups of consumers are being charged different prices for the same product or service for reasons that are not related to the cost to serve those consumers, leaving groups of consumers being exploited. A typical example is new vs existing customers, where existing customers pay substantially higher prices as their contracts are rolled over from year to year. The price of loyalty!

This author has first-hand experience. I have what I now jokingly call my 'annual chat' with my well-known vehicle breakdown cover provider when they send me my renewal premium which is typically in the region of 40% higher than the price they offer to new customers on their own website. After a short phone call my premium is discounted to be roughly equivalent to the new customer deal. On Wednesday, after hearing of the FCAs investigation, I went onto my well-known home insurance provider's website to find that the premium I had paid only a few days before when my cover automatically renewed was some 44% higher than would be charged to a new customer. A short phone call later to enquire over the reason for this discrepancy, and the friendly chap dutifully refunded to me the difference between the two premiums.

What is basically happening here is loyal consumers are being charged higher prices than otherwise equivalent new consumers. Why does this happen? In a perfect world with perfectly rational consumers it wouldn't, and it wouldn't really matter what firms do if markets are competitive enough: consumers would see through it and seek the best deals (especially since the cost of doing so is so low). But they don't. Why not?

For most people there is only a small cost to searching around for the best deal at renewal time, and while we might all plan to search, when the time comes there are always better things to do and we procrastinate over these tedious tasks until after the point that the automatic renewal has kicked in. This idea that we plan to do things, but after the passage of time don't do them, is called time inconsistency and happens because the cost of doing a task becomes particularly salient when it comes to actually doing it. The same behavioural mechanism lies behind why people plan to go to the gym but then don't, and why people put off contributing to a pension (that recently led to the UK adopting an opt-out scheme rather than opt-in).

In pretty much any market where there is an opportunity for contracts to roll over, there is scope for firms to exploit this behavioural tendency of procrastination. Existing, loyal, customers exhibit inertia which means they are less sensitive to increases in the price. Competition for new business, however, is fierce and potential new customers are very price sensitive as they are actively making their decision and often have at their disposal such tools as price comparison websites.

What we have seen essentially boils down to what we microeconomists call 'third-degree price discrimination', where different groups of consumers are charged different prices (a typical example of which is student discounts that allow firms to get around students being more sensitive to prices than the average punter). The price that new consumers, that are highly price-sensitive, face is less than the price that existing consumers face who are less price sensitive because of inertia, either by simply offering a lower price or by offering new customer discounts.

Of course, not all existing consumers are the same. Some will not procrastinate at all and will not suffer from inertia. To some extent firms face a delicate trade-off in pricing for these consumers to extract as much as they can from those that don't engage at all with search at the point of renewal, while not inciting those that do investigate the terms of renewal to move to a different supplier. A great way for a firm to get around this is to do exactly what they did for me: if an existing customer does engage in search they simply offer the new customer price with an appropriate excuse or apology.

If none of us suffered from inertia, that would be fine. But we do, either because we procrastinate, or we don't have access to the means to undertake effective search. This leaves some consumers being exploited, and the fear is that those that are more vulnerable might me more likely to be the ones that suffer the consequences (such as the elderly). This is true in insurance markets, in energy markets, in mortgage markets, and in mobile telecoms markets, to name a few.

[An aside on the latter: as soon as you are 'out of contract' make sure you change to a sim only deal if you don't want a new phone with a new contract; your old contract (which also covers the cost of the phone) will just roll over if you don't, meaning you are paying for the phone again!]

What solutions are available? These are somewhat specific to the market in question, and I don’t propose here to present a complete solution. But I think simplicity is the key. It has struck me when thinking about energy and mortgage markets that the way to solve the issue of people rolling onto uncompetitive ‘standard’ contracts in these markets is to impose that each company can have but a single contract, which is then the only thing companies can compete with. While this is likely to be less attractive than new customer deals, it will be more attractive than the standard contract loyal consumers roll-over onto, as firms balance the incentive to lower prices to attract new consumers and keep those that actively engage with search with the incentive to raise prices to exploit those consumers that suffer from inertia. There is something of a value judgement here: should consumers with inertia be effectively subsidising those that actively engage with search? And there is also a requirement for serious consideration of the overall welfare consequences, which are not obvious.

In insurance markets the solution will be more nuanced because prices are specific to specific individuals depending on observable characteristics that are correlated with their risk. A pledge of honesty would do the trick! As would consumers being forced to make an active decision at the point of renewal.

The investigations of the FCA and CMA will hopefully provide some rigorous evidence to understand the extent of this practice, and to find some pragmatic solutions that at the same time don’t dampen the incentives for firms to compete. As we begin to understand consumers better through advances in behavioural economics, we begin to understand the ways in which those consumers can be exploited by firms and appropriate regulatory responses to shake the market up.

Shake away FCA and CMA!