INSURANCE COMPLIANCE SERVICES LTD

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The FCA’s Consumer Duty assessment of product value frameworks

For insurance firms, the requirement to apply a ‘fair value for a reasonably foreseeable period’ test to insurance products has been in place since October 2021. This is reinforced by the Consumer Duty (“the Duty”), under which firms need to deliver and assess four outcomes, including a price and value outcome. A robust price and value assessment framework is a key element in ensuring that firms can carry out individual value assessments.

This Hot TopICS explores what such a framework could include. Our February Hot TopICS also set out how firms can deliver their Consumer Duty implementation plans, and provides further suggestions about what firms can do in relation to the price and value outcome.

Background

To help firms better understand the FCA’s expectations in relation to the Consumer Duty price and value outcome, it has reviewed a small sample of 14 mainly large firms’ fair value assessment frameworks and has published its findings. The 14 firms represented four financial services sectors; insurance was not represented, however. The FCA believes that many of its observations will be relevant to the wider population of regulated firms. The review looked at the firms’ overall assessment frameworks, but did not cover more detailed documents such as the assessments of individual products and services.

These findings:

- can provide guidance and assistance to insurance firms, not just about meeting the requirements of this outcome under the Duty, but also under the existing product oversight and governance requirements in relation to fair value; and
- reiterate the rules and guidance on fair value. The FCA’s examples of good practice and areas for improvement refer to the FCA’s rules and guidance on price and value in PRIN 2A.4 and Chapter 7 of the FCA's non-Handbook Guidance for firms on the Duty.

Remember, if insurance product manufacturers and distributors are meeting the fair value assessment requirements under PROD 4.2 and PROD 4.3 respectively, they will be deemed to be meeting the new PRIN 2A price and value outcome requirements under the Consumer Duty. Firms should consider the output of the assessments and where appropriate adapt their existing processes to apply proportionally to their businesses.

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What does the FCA require?

Firms must undertake fair value assessments as a way of demonstrating that the price a consumer pays for a product or service is reasonable compared to the nature and quality of the overall benefits they can expect to receive.

To do this, firms must consider:

- the nature of the product or service, including the benefits that will be provided or may reasonably be expected, and their qualities;
- any limitations that are part of the product or service (e.g., limitations on scope of cover for insurance products); and
- the expected total price customers will pay, including all applicable fees and charges over the lifetime of the relationship between customers and firms.

Firms may also consider a range of additional factors in demonstrating that the price paid is reasonable compared to the benefits, including:

- the costs firms incur to manufacture and / or distribute the products or services;
- the market rates and charges for comparable products or services (although, for insurance, this is increasingly likely to come under greater regulatory scrutiny);
- the price and benefit of other products in their portfolio; and
- a profit margin.

The FCA's assessment

The FCA used five criteria for its review; our key observation is the continued focus on evidence to support fair value assessments, particularly:

1. understanding of fair value rules – how clearly the fair value assessment defines fair value and how it applies to firms' products;
2. assessing value – how costs and benefits to consumers, including non-financial costs and benefits, have been considered;
3. considering contextual factors – how the firm has considered broader contextual factors relevant to value (examples set out below);
4. assessing differential outcomes – approaches to assessing the range of consumer outcomes, and outcomes for vulnerable consumers; and
5. data and governance – the approach to measuring and monitoring fair value using data, and how firms' governance arrangements operate.

The FCA's findings and recommended areas of focus

The FCA found evidence of:

- good progress in implementing the Duty;
- firms carefully considering both the price and value requirements and the shift in focus to consumer outcomes; and
- considerable differences in firms' approaches, which is perhaps understandable given that the rules are outcomes-focussed rather than prescriptive.

In some cases, the FCA questioned how effective some firms' frameworks would prove to be in practice. If a price and value assessment framework is not practical, the likely outcome is that individual price and value assessments will not support and evidence fair value.

The FCA recommended four areas of focus following the review, again focussed on evidence to demonstrate and support fair value assessments:

1. collecting and monitoring evidence that demonstrates that products and services represent fair value;
2. clear oversight and accountability of the necessary remedial actions if products and services do not provide fair value;
3. where relevant, ensuring sufficient analysis of the distribution of outcomes across groups of consumers in the target market, beyond broad averages, to demonstrate how each group receives fair value; and
4. summarising and presenting fair value assessments in a way that enables decision-makers to robustly discuss whether the product or service represents fair value, such as by being clear on any limitations in the analysis of evidence.

What can firms do?

The FCA's observations against each of the five assessment criteria set out examples of good practice and areas for improvement. These observations, and suggestions for what your firm could do (and should perhaps not do) are summarised under the below headings.

Understanding value

- make sure you have a good understanding of what fair value is, and the requirements of the fair value outcome, by understanding the FCA's requirements as set out above;
- clearly set out, at a high level, how you will apply the concept of fair value;
- apply a critical analysis to ensure you deliver fair value for customers; and
- avoid high-level or unevidenced arguments that your business model or your culture or ethos are inherently 'fair value', without providing evidence for this view.

Assessing value

- set out a reasonable view of how to assess the benefits consumers can expect to receive, to include a broad view of the overall costs to the customer;
- consider your service delivery and product distribution costs and profit margins for different products and services, benchmarked against each other;
- if you sell products as a package, clearly set out how to price products sold as a package or bundle and assess them for value (e.g., that a bundle should not be priced higher than its constituent parts unless there is value to the consumer from the convenience of products being bundled together);
- ensure your assessment framework can allow a differentiation between products with very different characteristics – so a flexibility of approach to include different factors where appropriate;
- consider the types of non-financial costs* and benefits that retail consumers may reasonably expect to pay or receive, for example, the quality of the product or service and level of consumer service.
- *Non-financial costs might include factors such as the time and effort it takes the customer to make a decision about a product, such as a decision to amend it or the action of cancelling it.

Considering textualisation factors

Broader contextual factors can be seen as wider changes in the market that can affect your fair value assessments. They can affect the costs and benefits that consumers get from a product or service, and so may affect fair value, and can include market prices for similar products and services, or consumer characteristics in the target market.

- consider the interaction between fair value and other elements of the Duty such as the products and services, consumer support and consumer understanding outcomes;
- consider and analyse how customers make their choices, and the choices they make, especially how factors like 'sludge practices' could lead to poor value;

- consider other products and services that consumers already hold with the firm (even if not sold as part of a bundle) and how this evidence could change your conclusions around fair value for different customer groups;
- consider consumers' behavioural biases, such as instant gratification or overweighting potential losses, how these may affect the way consumers buy and use products and services and how poor value may result;
- do not seek to exploit customers' behavioural biases, lack of knowledge or characteristics of vulnerability;
- don't just consider whether the financial value customers receive is positive; make sure that you carry out a critical assessment of the fairness of your pricing structure;
- consider whether you need other information from other firms in the distribution chain.

Assessing differential outcomes

Although differential pricing is not banned under the Consumer Duty, insurance firms need to be aware of the ICOBS 6B requirements in relation to core consumer home and motor insurances and the requirement to ensure that a renewal price is no higher than an equivalent new business price. Also, the FCA expressed the view in its Finalised Guidance, and in its findings from this review, that "…differential pricing for different groups of consumers, is likely to create additional considerations for firms' fair value assessments".

- Make sure you have a focus on, and set out how you plan to look at, differential outcomes for differing customer segments by considering the value received by:
  - back-book customers versus new customers;
  - customers using different buying or communication channels;
  - subsets of consumers paying disproportionately high margins given the benefits they receive;
  - subsets of consumers at risk of paying higher fees and charges than other subsets;
  - customers with characteristics of vulnerability – analysing how the needs and objectives are likely to differ and thus how costs and benefits may vary.
- Consider, where appropriate, service-level cross-subsidies, whereby some customers pay higher prices or generate higher profit margins for the firm, and the factors to consider when reviewing whether these products or services offer fair value.
- Considered how product-level cross-subsidies may affect fair value and discuss the circumstances under which this could result in harm for some customers.
- Avoid using average outcomes which could disguise outliers or pockets of poor value.
- Where you identify differential pricing between groups of customers, demonstrate how each group of customers receives fair value.

Data and Governance

Data, MI, and how they are used will underpin how firms will monitor and review the outcomes that their customers receive.

- Use data and MI to lead your plans for monitoring and reviewing customer outcomes, and to facilitate sufficient challenge and discussion in the firm's decision-making.
- Set out clear milestones for when you will conduct your value assessments, including the frequency of reviews.
- Have clear and documented 'rectification processes' and triggers which may require a new assessment, such as movements in a certain data indicator. Assign named owners to rectification processes, which must be followed if you identify that a product no longer provides fair value, and allow for discussion and challenge at a senior level.

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- Consider how you will analyse and grade your data – for example, consider a points-based / risk-based / RAG rating approach – but make sure that you give sufficient weight to analysis of the ratings, how thresholds between points/ratings are drawn, and whether decision-makers have sufficiently detailed information to review and challenge the assessment of fair value.
- Ensure you understand any limitations of any evidence used to support and assess fair value, so decision-makers can critically review this evidence. If you are using market-level benchmarks or information on competitors within your assessments, you should consider how they are delivering fair value for their customers in absolute rather than just relative terms. Relative comparisons can hide fair value issues that are prevalent within a wider market and are just one factor in the consideration of fair value.

What next?

The FCA will continue to monitor firms' approach to ensuring customers receive fair value and this will include future reviews of firms' fair value assessments of specific products and services.

You should consider the FCA's findings, and whether you need to improve your fair value assessment processes to meet the fair value requirements of PROD 4.2 and PROD 4.3, and therefore the requirements of the Consumer Duty price and value outcome rules. Where changes are required, these should be applied proportionately.

If you would like any help or Information in relation to this update or any FCA-related compliance issues or ICS Services, please contact your usual ICS representative or Head Office on 01892 539600 or admin@insurancecompliance.co.uk and we will be happy to discuss further.

The above information is a summary of certain matters which will affect the majority of firms conducting Insurance Distribution and reflects ICS's views at the date of publication. Each firms' requirements are individual, and rules are regularly changing; it is therefore important that you always seek specific advice from ICS before acting on anything contained in this publication.

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