The product governance approach to regulating consumer credit pricing

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Definitions

Consumer credit product

A contractual arrangement for the provision of credit (loan), entered into between a regulated private financial entity that extends loans on a professional and commercial basis (lender), and a consumer, with pre-drafted general price terms and price terms subject to variation, proposed by the lender on a take-it-or-leave it basis.

Pricing

1. Design of the general price structure for a specific product category
2. Price structure determined when selling a specific product to an individual consumer (granting)

Price structure

The totality of interest rates, fees, charges and other prices charged by the lender in connection with the product (all stages, including examination, management and enforcement)

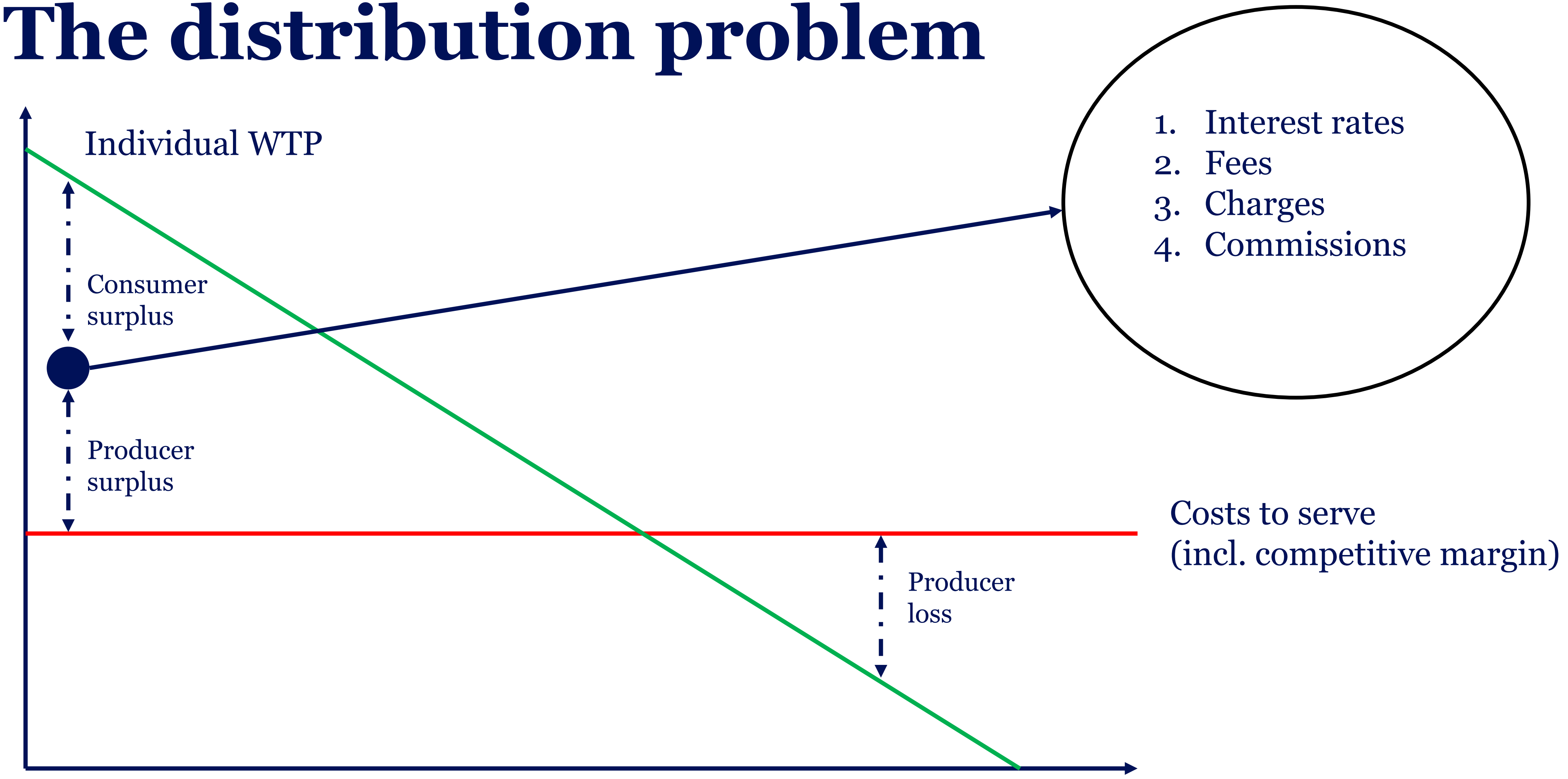
Personalised pricing

Charging different prices for the same product to different consumers, based on profiling and segmentation techniques using personal data and algorithms (both ‘first degree’ and ‘third degree’ pricing, Pigou)

Economic surplus:

The difference between the price paid by the consumer and marginal costs to serve, over loan term (<u>duration</u>)

The distribution problem

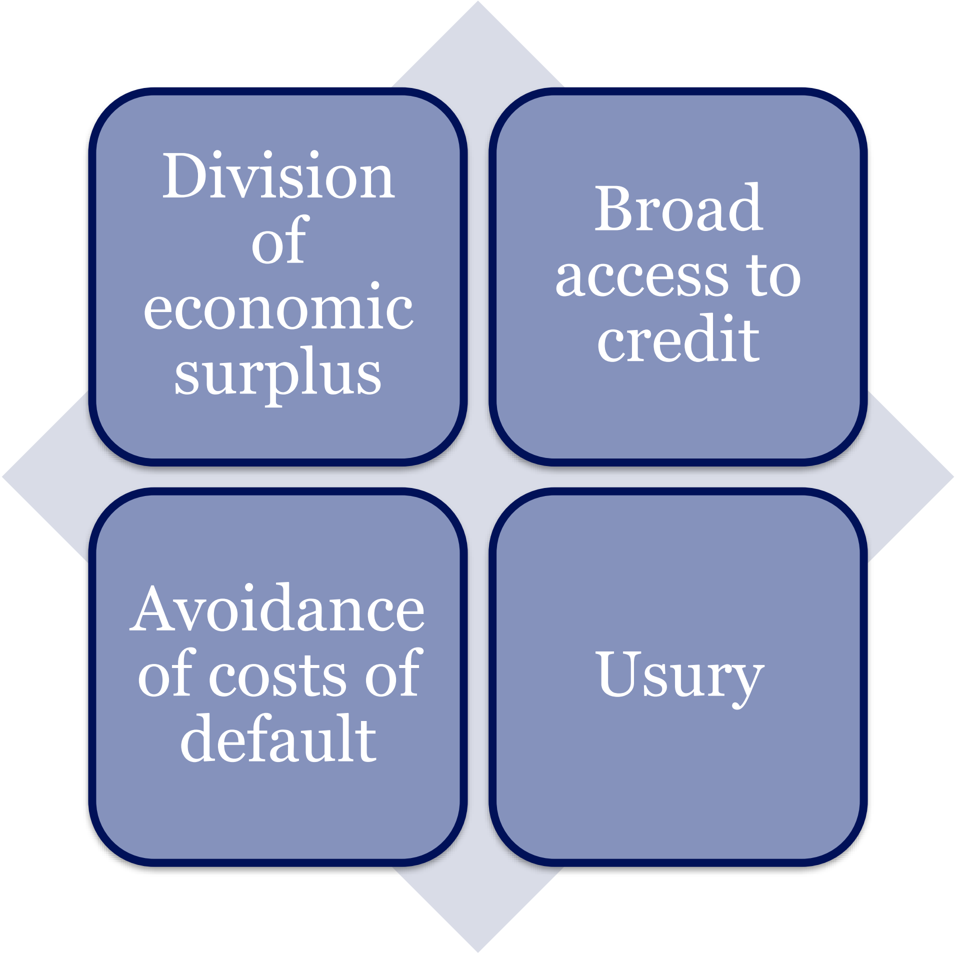


Why regulate product pricing?

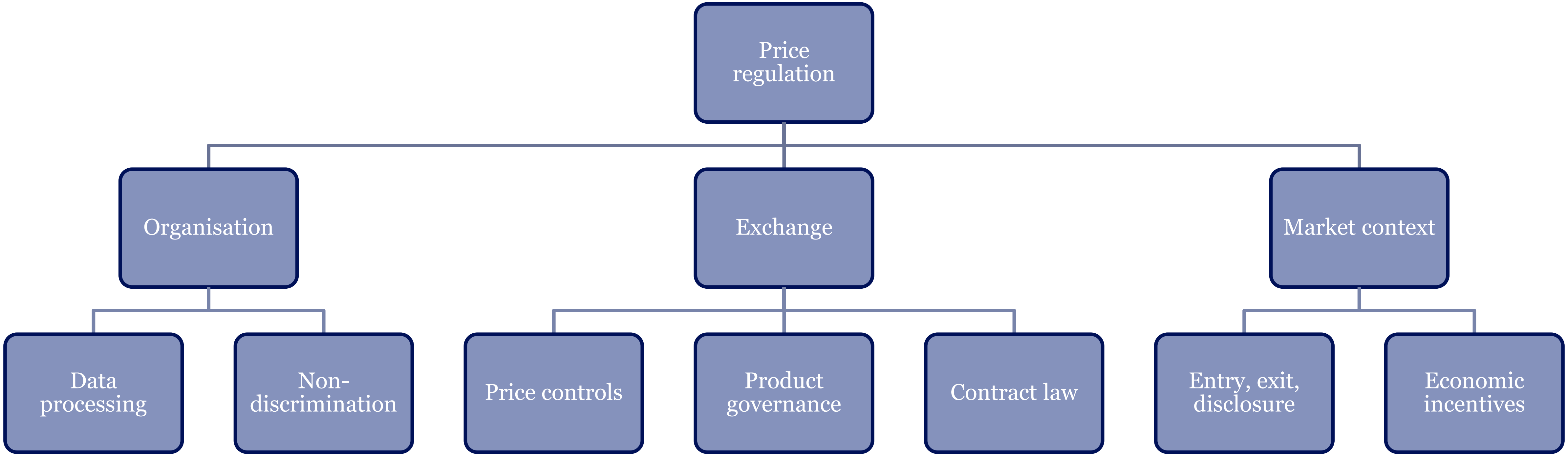
At its core, product governance regulates pricing.

Price regulation in *private, for-profit* consumer credit markets is traditionally justified by the following:

- Avoidance of personal and social costs of default
  - High personalised prices may increase those costs
- Broad access to credit by consumers
  - High personalised prices may exclude some consumers
- Desired division of economic surplus
  - High personalised prices allows lender to capture all surplus
- Traditional principle that lender cannot exploit a person in need (usury)
  - A price exceeding some (explicit) threshold is not allowed
  - Regilious, ethical origins (Aquinas)



Regulatory approaches



Regulatory approaches (2)

Product governance is only one of many ways to regulate prices.

There are a number of regulatory approaches that governments can use to (in)directly influence personalised price-setting (Baldwin et al, 2013; Ramsay, 2007), each with different economic tradeoffs and effects

1. **Exchange**
   1. ***Price controls***: a form of *command-and-control regulation* in which the government sets maximum prices applicable to individual exchanges on ex ante basis (e.g. usury rate, cost cap)
   2. ***Product governance***: a form of *meta-regulation* in which the government sets a substantive standard, allowing regulated entities discretion in design of processes to meet the standard
   3. ***Contractual balance***: contract law doctrine to assess whether the exchange meets substantive/procedural fairness
2. **Market context**
   1. ***Disclosure***: public disclosure allows consumers and competitors to compare products, stimulating price competition
   2. ***Market access***: lower barriers of entry increase number of lenders, which in turn may lead to lower prices, especially if those competitors have different costs of capital and return expectations (e.g. credit unions)
   3. ***Economic incentives***: subsidies of favourable business models, tax exemptions
3. **Internal organisation**: data use restrictions, non-discrimination obligations

Product governance and value for money

Current regulatory policies

In the UK and EU, regulators have introduced 'value for money' as the core of a product governance approach to price regulation

- FCA, Consumer Duty, Price and Value Outcome.
  - 'Fair value' and 'value for money'
- EIOPA, Product Oversight and Governance Obligations IDD
  - 'Value for money'
- ESMA, Product Oversight and Governance Obligations MiFID II, AIFM UCITS
  - 'Value for money' and 'due costs'
- EC, Retail Investment Strategy, amendments to MiFID, UCITS, AIFM
  - 'Value for money'

Product governance: law and history

Very short history in the EU through adoption as principle

- 2014 MIFID II
  - Article 24.1: ‘act honestly, fairly and professionally in accordance with the best interests of its clients’, Art 24.2: ‘compatible’ with the target market
- 2014 MCD
  - Article 7.1: ‘acts honestly, fairly, transparently and professionally, taking account of the rights and interests of the consumers’
- 2016 IDD
  - Article 17.1: ‘act honestly, fairly and professionally in accordance with the best interests of their customers’
- 2023 CCD
  - Article 32.1: ‘act honestly, fairly, transparently and professionally and take account of the rights and interests of the consumers…’

Question: should price (level) be considered a product characteristic?

Product governance: law and history (2)

Transpositions in national law

Often mix of private law and public law obligations. Take the MCD:

- Netherlands:
  - Information obligations: Book 7, Chapter 2b, Section 3, *Burgerlijk Wetboek* (contract law)
  - Conduct obligation: 4:24, 4:24a en 4:25 *Wet op het financieel toezicht* and *afdeling 8.2 Bgfo* (regulatory law)
- Luxembourg:
  - Information obligations and conduct obligation: Chapter 6, Art. L-226-36.1 *Code de la Consommation* (consumer contract law)

Key consequence of transposition choice: remedies and sanctions

- Private law: personal rights (national civil liability rules)
- Public law: administrative sanctions (fines, publication, license revocation)

Product governance: mechanics

Aspects

Product governance generally deal with two aspects

- **Product design**
  - Product must not offer ‘poor value’ to all consumers → relates to price structure
- **Product distribution**
  - Product must meet needs of ‘individual consumer’ to which product is sold → interaction between personal circumstances, price structure and price levels
  - The needs of the individual consumer dictate pre-contractual disclosure requirements, as well as the required actions/forbearabce during loan term
- As meta-regulation, it needs a specific **normative standard**, such as
  - Value for money: specific price standard using price-value proportionality
  - Other possible standards: cost basis (MiFID II CRD 2017/565), excessive
- Supervision ex ante (design) and ex post (transactions), prior approval possible

Product governance: issues

What is value in economics?

- *Objective* or *subjective* approach, Mazzucato 2019
  - Objective: labour (Marx), value-in-exchange (Smith, competitive price (Aquinas)
  - Subjective: value-in-use (Smith), utility and willingness to pay (Jevons, Marshall)
  - Credit: valuation as a service or as a stream of discounted cash flows?
- *Financial* and *non-financial* (psychological) aspects
  - Trust, brand loyalty and service matter (Izaret and Sinha)
- Risk tolerance and contingent costs
  - Different consumers have different risk tolerance (= probability of additional costs in case of non-compliance or fluctuation of referenced price)
  - Tolerance impacts valuation (financial vulnerability can tolerance)
  - No reliable method to predict default ex ante, FCA

Product governance: issues (2)

Distributive or procedural concerns?

- Objective of value characterisation is price regulation
  - ‘We are not price regulators’: correct, no price *controls*, but *standards* (FCA’s fair value: *substantive* and *procedural* fairness)
  - Greater objective: to combat high non-interest price components in certain products (application fee, default fee, roll-over), as well as high interest rates for consumers
  - At the same time, regulators scrutinize profits of lenders

  → Clear distributive objective: shift division of economic surplus
- VFM also regulates process
  - Holistic: pre-contractual disclosure and advice to consumer, post-contractual customer service, forbearance
  - But some consumers prefer less service to get a lower price (Ryanair)

  → Clear objective to ensure procedural fairness

Product governance: issues (3)

What about differential pricing?

- Clearly allowed (CCD), but subject to conditions
  - FCA: Must still provide fair value
  - EBA: silent, but generally favoring freedom of contract
- Potential normative conflict
  - Strict proportionality and an objective approach clash with differential pricing
  - Value proportionality and differential pricing can only co-exist with a subjective approach to value, or a broad notion of proportionality
- Also, cross-subsidisation is at risk
  - Mandatory proportionality obligation for all transactions
  - No exemption for progressive subsidies