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Agenda

Advancing economics in business

Financial regulation: protecting consumers from poor value?

Financial regulation is topical, partly due to what it could or perhaps should have done to stop banks feeding asset price bubbles. Peter Andrews, Head of Research and Economic Analysis, Financial Services Authority, does not discuss these controversies, but describes the government's plan for better protecting financial consumers. He shows that successive statutes have imposed progressively greater requirements for economic analysis, argues that these improve financial regulation, and outlines how the latest requirements can help make the new Financial Conduct Authority successful

Current legislative reform: overview

The government's plan for enhancing the protection of financial consumers is an important part of its agenda for reforming UK financial regulation. The current regime is set out in the Financial Services and Markets Act 2000 (FSMA). The Financial Services Bill (FSB) 2012 proposes significant changes to the FSMA. For example, responsibility for financial regulation is to be transferred from the UK Financial Services Authority (FSA) to the Financial Conduct Authority (FCA) and the Prudential Regulation Authority, which is to be a subsidiary of the Bank of England. A Financial Policy Committee (FPC) is being established at the Bank of England to monitor and mitigate systemic risk. New arrangements are being made for the management of financial crises.[1]

Separate legislation will carry forward the proposals of the Independent Commission on Banking (ICB), which aims to address the structural problem in banking, whereby the corporate link between investment banking activities that may or may not be socially useful, and banking services that are crucial to the smooth operation of the real economy, obliges the taxpayer to bail out both. This article is not about the social value of investment banking, although it is worth sharing an interesting statistic—namely, that the FSA's database of transaction reports contains about 8,500,000 'different' instruments. It may be that few of these instruments, which include over-the-counter contracts, and the plethora of retail asset management products, absorbed a great deal of society's resources for innovation (although collectively they might have done), and product differentiation might, of course, create welfare gains by better matching demand.[2]

There are, however, at least two reasons to question the social value of extensive product differentiation. One is its role in preventing the entry of new competitors;[3] and the other is in creating complexity that interacts with information asymmetry in favour of suppliers and against the interests of consumers.[4]

The ICB's proposals also seek to improve competition in the markets for banking services. In doing this, they draw in part on the materially unfulfilled recommendations in the Cruickshank Report 2000, to which the then government's initial response was positive.[5]

Current legislative reform: financial consumers

Several reforms are progressing specifically on the protection of financial consumers. The FCA has been given a clear focus on consumer detriment. While it will need to consider the solvency of firms, it is mostly spared the problem of *internalised* conflicts between objectives that can make life tougher for a single financial regulator such as the FSA. For present purposes, the FCA's proposed competition objective and duty are highlighted. These make the FCA more of an 'economic regulator' than its predecessor, the FSA, or the Prudential Regulation Authority. The implications of this will be examined below.

The ICB's proposals referred to above are another important element of the agenda, as are the Money Advice Service and initiatives to promote simple financial products and certain forms of lending.[6]

Financial regulators with limited incentives to perform economic analysis

When UK financial services started to expand rapidly in the 1980s, there were important consumer protections in the general law, such as fiduciary duty. There was also specific legislation in the form of the Prevention of Fraud (Investments) Act 1958, which restricted who could deal in securities, established penalties for fraudulent inducement to invest, and gave enforcement powers to the Board of Trade.[7] This piece of legislation now seems remarkable in several respects: it is brief and fairly easy to understand; it has a narrow scope; and it does not establish an 'independent' regulator. (Self-regulation played a significant role in the ensuing decades.) Importantly, it also does not set any requirements about the economics of regulation, and searches indicate that the Board of Trade never felt it necessary to justify the costs imposed by the Act or to establish whether it had economic benefits. There appears to be no proof that evidence-based, cost–benefit trade-offs informed decisions made under this Act.

Some of the financial scandals of the late 1970s and early 1980s led to calls for independent regulation—in particular, the Norton Warburg affair of 1981, whose vocal and high-profile victims included members of the band, Pink Floyd, who lost the money they made from their album, 'The Dark Side of the Moon'. Consequently, the Gower Report was requisitioned and included the first, albeit very brief, references to the economics of financial regulation.[8] The report was based on the principle that, while the government cannot stop fools doing foolish things, it can—and should—stop honest people being made fools of.

This principle was regarded as sound common sense. Developments in behavioural economics, though, call into question whether the distinction underpinning the principle is as clear-cut as first appeared. For example, if, like most of us, an individual is subject to systematic behavioural errors, such as not appreciating framing effects, and therefore makes a poor choice, is this a case of a fool doing a foolish thing? And if a firm sees consumers making decisions in ways that are profitable for the firm and then chooses to pursue shareholder value by designing products that use this information, is it *making* a fool of anyone? Firms do talk openly about exploiting behaviour in developing their business models.[9]

The references to the economics of regulation in the Gower Report were less sound—the author remarking that he was unfamiliar with notions about assessing impacts of regulation, but doubting that they would be useful. It contained, however, some important ideas. The case for legislative reform was partly based on the way in which a 'fringe elite' of investment bankers and others had used exemptions in the 1958 legislation to trade outside the law. This is a neat example of the regulatory game in which the legislator makes a move that is offset by industry's subsequent moves and then has to wait a long time to make a further move. The case of shadow banking is a topical example, albeit with other features too.[10]

Moreover, Gower made the case against taking a caveat emptor approach to investor protection on the basis of investors' limited understanding of risk, and noted the important limitations of an approach based solely on disclosure of information. Much of regulators' subsequent experience supports this, as does economic analysis of how information problems may interact with other market failures.[11] These interactions are a crucial fact of life that the FCA needs to address and we shall return to them below.

The White Paper that led to the Financial Services Act 1986 did not fully reflect Gower's proposals.
It introduced 'self-regulating organisations' (SROs), although these had to set requirements consistent with those of a statutory body, the Securities and Investments Board (SIB). The Act made no reference to the economics of regulation. The idea was presumably that SROs would make rules determining which suppliers could enter a market, and tell them (their 'member firms') how to conduct their business, while firms would comply, consumers would be better off, and little or nothing else would change.
In retrospect, this is surprising. The Department of Trade and Industry wrote the Act while introducing competition regulation for the newly privatised utility companies. It was, and is, obvious that intervening in financial markets—determining which firms supply services and how they must do this—will materially affect competition, and therefore the extent to which consumers get the quality and variety of products and services that they truly demand at the lowest possible prices consistent with remunerating capital and labour at market rates.[12]

The 1986 Act was not universally considered successful. There were some pervasive scandals. Thus in 1992, 'the then Chairman of the SIB, Andrew Large, was asked by the Chancellor…to carry out a review of the effectiveness of SIB's regulatory role. The review was prompted by the theft of assets from Maxwell company pension funds, and the subsequent criticism of the way that IMRO, the SRO for the investment management sector, had discharged its regulatory responsibilities. Large…published his conclusions in Financial Services Regulation: Making the two tier system work.'[13] This report picked up on the brief references to economics in the Gower Report. There was great concern about the costs and possible inefficiency of financial regulation. Large proposed that regulators should pay attention to the costs of proposals. This resulted in an economically asymmetric

amendment to the 1986 Act. Broadly, it required regulators to have satisfactory arrangements for assessing the costs to firms of complying with rules. This focus on costs, a deterrent to regulatory action, did not incentivise the use of rigorous economic analysis to find out whether rules would be likely to correct market failures and so produce social benefits. The SIB therefore worked extensively on narrow compliance cost assessments. This meant that it was well regarded by those concerned to lower or keep down the costs of regulation, such as the government's Deregulation Unit, one of the predecessors to today's Better Regulation Executive. Costs are usually borne by (possibly vulnerable) consumers since, in most realistic states of competition, firms' costs are reflected in prices. However, the SIB published little material on the benefits of its proposals, so, as with the 1958 Act and only a few notable exceptions, there is little proof that evidence-based, cost–benefit trade-offs informed the decisions. In effect, the question of whether financial regulation was socially useful was again, empirically, left unanswered.

The results of the FSA's and FCA's 'cost–benefit' requirement

The FCA's supposed obligation to carry out cost–benefit analysis (CBA), as set out in the draft FSB 2012, is the same as that applied to the FSA in the FSMA 2000. It is far from being a requirement for true CBA. Misunderstanding of this point is likely to have distorted assessment of the FSA's activity in this area, although it is an area in which the FSA has clearly surpassed its predecessors and overseas equivalents. It is argued below that the FCA's much-enhanced obligations with respect to competition will offset the weaknesses in the FSMA's requirements for economic analysis and will improve regulatory performance.

The FSMA 2000 materially developed the economic requirements in the 1986 Act, requiring publication, with proposed rules, of an estimate of the costs and an analysis of the benefits that would arise as a result of the rules being made. There is still an important asymmetry here: estimates are likely to attract more resources than analyses, but there is no restriction to compliance costs and benefits are to be considered explicitly. Moreover, the FSMA requires the FSA, in fulfilling its general functions, to have regard to various aspects of competition and competitiveness. While a duty to 'have regard to' is in general a weak duty—lawyers might debate how much real substance it adds to the proportionality test in general Administrative Law—any explicit obligation in this area was a step forward.

Under these incentives, the FSA has been able to allocate slightly more of its scarce resources to economic analysis (approximately 1%) than did the SIB, and overall has made far greater efforts to understand the likely economic consequences of its interventions than did its predecessors or other regulators that lack these incentives. It is important to note, however, that the FSA is not, *and the FCA will not be*, required to prepare a full CBA of its proposals in the sense understood by economists. The requirement to publish 'an analysis of benefits', which need not include any numbers and may be *any* (reasonable) analysis, falls way short of this. Moreover, it follows that there is no need to establish that economic benefits are likely to exceed economic costs, and the Act requires transfers that are not social costs (eg, compensation payments) to be included within the costs to be considered. Furthermore, the FSA is not obliged to follow the implications of the required economic analysis in its decisions.

The amount of CBA done by the FSA on individual proposals is highly variable, and is mostly *undertaken by policy generalists* who have a wide range of responsibilities, not by economic specialists. This reflects limits to the practical scope for economic analysis to influence policy choices (for example, the FSMA requires the FSA to publish an estimate of costs and analysis of benefits even when it is implementing a European Directive or government priority) and resource allocation decisions, which are materially driven by very substantial European obligations: there is a trade-off between the amount of policy that is made and how thoroughly it is analysed economically, and the FSA has allocated about 10% of its resources to policy generalists. Nevertheless, the FSA's 'CBA' has won several plaudits from those who have looked carefully at it, such as in the National Audit Office's Hampton Report and publications by some trade associations.[14]

Extensive web searches and direct discussions suggest that financial regulators in other countries have not put together any comparable set of materials.

Some of the results of the present requirements can be seen in FSA consultation papers.[15] Other (indirect) results can be seen in the FSA's Occasional Paper series.[16] Occasional Paper 42 is an interesting example of the difficulty of analysing the impacts of financial regulation.[17] A substantial list of positive differences made to policy by the FSA's economic analysis was submitted to the House of Lords.

Competition and behavioural economics: improved economic analysis at the FCA

The requirement for economic analysis in the FSMA, which in effect is copied in the draft FSB 2012, produced clear advantages over the 1958 and 1986 legislation. However, the materially limited incentives for economic analysis in the FSMA give somewhat mixed results because sometimes it does not make

sense to allocate valuable resources to CBA. A stronger requirement to produce a social CBA of proposed rules (and perhaps of 'guidance', to which no statutory requirement for economic analysis applies, following its removal in an amendment to the FSMA) would have led to more thorough and consistent analyses, especially in relation to welfare considerations; at the same time, in practice, it would have been a barrier to needed intervention in some cases. So, since the FCA's 'cost–benefit' obligation is the same as the FSA's, an important question is whether the FSB's requirements about competition create materially better incentives for the FCA to identify the likely consequences of its actions in UK financial markets. The argument here is that they do, and that staff allocated to the FCA have started to make substantial improvements reflecting this. It is further argued that the focus on behavioural economics of the FCA's CEO-elect, Martin Wheatley, will materially assist in this.[18]

The FSB's objectives for the FCA include 'promoting effective competition in the interests of consumers'. The direction implied by this is reinforced by its context: the FSB amends the strategic objective of the FCA to ensuring that the relevant markets function well for consumers. This is a shift from the FSMA's requirement to promote confidence in markets. It aligns the FCA's position closely with that of the current first-tier competition authority, the Office of Fair Trading, whose mission is to make markets work for consumers.[19] Moreover, when designing rules or guidance to meet the consumer protection or market integrity objective, the FCA's competition duty will specifically require it to take account of competition problems, and how they will be affected, alongside other market problems that may be driving the proposed intervention. One might therefore expect the FCA to materially increase the competition analysis undertaken by the FSA, which itself was non-trivial.[20]

The FCA's competition objective and duty, the ambition to intervene earlier, and its recognition of the need to achieve greater understanding of how 'biases' in consumer behaviour can drive persistent poor outcomes all mean that it will need a fuller analytical framework than the FSA's for identifying and correcting market failures. The framework must recognise that financial markets are complex, often with multiple problems—information, competition and behavioural biases—which interact with each other.[21]

Regulation of any market that ignores a core part of a problem will be ineffective and may make matters worse.[22] Put simply, giving consumers better information has unpredictable effects, and creating a perfectly competitive market structure may achieve little if consumer decision-making is not wholly 'rational'.

Similarly, consumers with perfect information and perfect decision-making capacity will not achieve the best possible outcomes if they face a monopolist or colluding suppliers. Again, the outcomes of a market with a perfectly competitive structure and consumers with perfect decision-making capacity may, in principle, be suboptimal if consumers somehow face severe information problems. Aside from these simplifications, the economics literature shows how, in the presence of informational problems and behavioural biases, removing barriers to entry can lead to worse outcomes, as firms 'exploit' consumers more intensively. This literature is an increasingly rich, essential source for retail financial regulators wanting to understand how the markets they regulate really work.[23]

The Integrated Analysis Framework

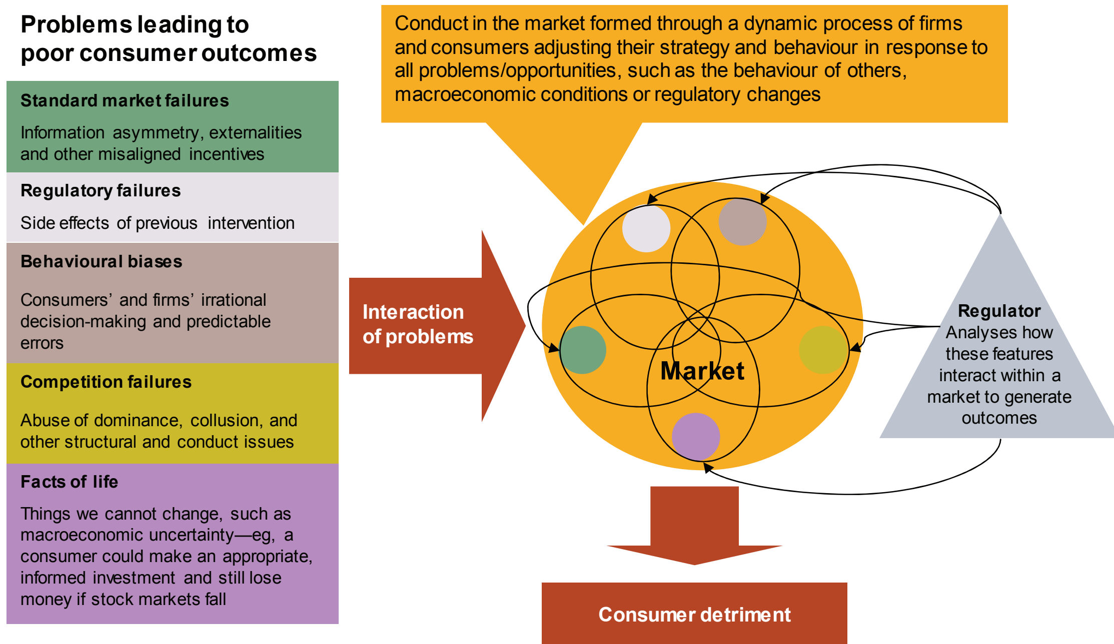
Economists allocated to the FCA have therefore been developing an integrated approach to impact assessment that will enable the FCA to analyse complex financial markets and diagnose the core problems *and interactions* that are harming consumers. The causes of market problems that lead to persistent and recurring consumer detriment (externalities, information, competition, and behavioural problems) are complex and often interact. If we focus on each part individually, or assume that only one problem is responsible for a poor outcome, we will miss these interactions and may misdiagnose the causes of detriment. Important practical examples include the following.

- PPI (payment protection insurance) sales caused detriment not just because consumers lacked information, but also because competition at the point of sale was weak (as the FSA acknowledged), and consumer biases made it easy to persuade consumers to believe that buying PPI was a good idea. This highlights how thinking about consumer protection and competition goals cannot feasibly be separated.

- The same principle—that behavioural biases and competition problems exist alongside and interact with information and incentive problems—explains why, with the benefit of hindsight, most of the disclosure requirements introduced by the FSA in retail markets failed to meet their objectives.

The current draft of the Integrated Analysis Framework, designed to help the FCA meet its statutory CBA obligations and the proposed competition remit, and provide the information the FCA needs to make effective policy interventions, is shown in Figure 1 overleaf.

Figure 1 Integrated Analysis Framework: the market process



Source: FSA (FCA).

Clearly, such analysis will pose significant challenges for remedy design.

Competition obligations and FCA strategy

Lastly, the FSA with its very limited obligations with respect to competition has tended to intervene in markets only in response to gross unsuitability, not bad value. The FCA's competition remit implies much more intervention on value grounds. It therefore sets a strategic challenge for the FCA to determine where to set its risk appetite—ie, the level of consumer detriment below which intervention will not usually occur. In the extreme, a case might be made for intervening wherever consumer contracts are not those that would be signed under perfectly efficient competition—but this is not realistic, since nearly all contracts will fail this test. The practical choice is about what degree of poor value warrants intervention, and the right choice will not always be obvious. For example, many retail financial services markets are unusual in penalising rather than rewarding loyalty: customers who do not switch get progressively worse deals and subsidise new customers. So the FCA will need to decide whether to intervene in markets where some consumers get poor value while others do well out of the way the market works.[24] While many decisions of this kind will not be straightforward, economists allocated to the FCA are well aware of the challenges and are developing the analytical tools the FCA needs to deal with them successfully.

Peter Andrews

[1] See HM Treasury (2012), 'Government publishes Financial Services Bill', press notice 08/12, January 27th.
[2] See the bracing debate in Bresnahan, T.F. (c1997), 'The Apple-Cinnamon Cheerios War: Valuing New Goods, Identifying Market Power, and Economic Measurement', available at http://www.stanford.edu/~tbres/Unpublished_Papers/hausman%20recomment.pdf.
[3] See p. 245 of Caves, R.E. and Porter, M.E. (1977), 'From Entry Barriers to Mobility Barriers: Conjectural Decisions and Contrived Deterrence to New Competition', *Quarterly Journal of Economics*, **91**:2, May, pp. 241–62.
[4] See Competition Commission of South Africa (2008), 'Banking Enquiry Report to the Competition Commissioner', chapter 2, pp. 31–2.
[5] HM Treasury (2000), 'Banking Competition to Deliver Benefits to Consumers: Government Responds to Cruickshank Report', news release 98/00, August 4th. A wide range of material about the overall agenda for reforming UK financial regulation is available on the HM Treasury website: http://www.hm-treasury.gov.uk/fin_policy_agenda_index.htm.
[6] Again, much information on the planned enhanced protection of financial consumers is on HM Treasury's website: http://www.hm-treasury.gov.uk/fin_consumer_index.htm
[7] UK Government, Prevention of Fraud (Investments) Act, 1958, 6&7 ELIZ.2 CH. 45, available at http://www.legislation.gov.uk/ukpga/1958/45/pdfs/ukpga_19580045_en.pdf.
[8] In 1981, the government mandated a distinguished lawyer, Professor L.C.B. Gower, to make a report on statutory investor protection and how this could be improved. Gower, L.C.B. (1984), 'Review of Investor Protection: Report Part I', January, Cmnd 9125. See Pimlott's authoritative review of this report and the related White Paper: Pimlott, G.F. (1985), 'The Reform of Investor Protection in the U.K.—an Examination of the Proposals of the Gower Report and the U.K. Government's White Paper of January, 1985', *Journal of Comparative Business and Capital Market Law*, **7**:2, pp. 141–72.
[9] See Fuller, R.J. (1998), 'Behavioral Finance and the Sources of Alpha', *Journal of Pension Plan Investing*, **2**:3, winter, p. 7.
[10] See Kane, E.J. (2012), 'The Inevitability of Shadow Banking', presented at the Federal Reserve Bank of Atlanta 2012 Financial Markets Conference, Financial Reform: The Devil's in the Details, Atlanta, Georgia, April 10th.
[11] Baltzer, K. (2010), 'Standards vs. Labels with Imperfect Competition and Asymmetric Information', December 6th, available at: http://www.foi.life.ku.dk/English/seminars/~/media/Foi/docs/English/docs_eng/Activities/Standard_vs%20_Label_ver2_Economics_Letters.ashx.
[12] Concerns then raised about the impacts of regulation on competition are summarised in Veljanovski, C. (2006), *The Economics of Law*, second edition, The Institute of Economic Affairs.
[13] House of Commons Library (1999), 'Financial Services and Markets Bill', Bill 121 of 1998–99, June 24th. Large, A. (1993), 'Financial Services Regulation: Making the two tier system work', Securities and Investments Board, May.
[14] See, for example, Better Regulation Executive and National Audit Office (2008), 'Effective inspection and enforcement: implementing the Hampton vision in the Financial Services Authority'; and Association of British Insurers (2004), 'Cost–Benefit Analysis: Making a Reality of Better Regulation', May.
[15] For example, Financial Services Authority (2011), 'Mortgage Market Review: Proposed Package of Reforms', Consultation Paper CP11/31.
[16] See http://www.fsa.gov.uk/pages/library/research/economic/occasional/index.shtml.
[17] de-Ramon, S., Iscenko, Z., Osborne, M., Straughan, M. and Andrews, P. (2012), 'Measuring the Impact of Prudential Policy on the Macroeconomy: a Practical Application to Basel III and other Responses to the Financial Crisis', FSA Occasional Paper Series, 42, May.
[18] See Financial Services Authority (2012), 'Rebuilding Trust and Confidence in Banks and Bankers', speech by Martin Wheatley at the Chartered Institute of Bankers, May 4th.
[19] See http://www.oft.gov.uk/.
[20] The FSA's own analytical framework was based on correcting market failures, meaning deviations from the economists' notion of perfectly efficient competition. See Financial Services Authority (2006), 'A Guide to Market Failure Analysis and High Level Cost Benefit Analysis', November.
[21] See Gabaix, X. and Laibson, D. (2006), 'Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets', *The Quarterly Journal of Economics*, **121**:2, pp. 505–40, May.
[22] Again, see Baltzer (2010), op. cit.
[23] A paper demonstrating that the welfare impacts of information in the context of a retail financial market affected by inattentiveness and adverse selection depend on the price response is: Handel, B. (2011), 'Adverse selection and switching costs in health insurance markets: when nudging hurts', NBER 17459. An especially interesting paper for financial regulators is one which establishes that firms' incentives to unshroud additional prices are weak—a profitable deceptive equilibrium always exists—where products are socially wasteful: Heidhues, P., Köszegi, B. and Murooka, T. (2012), 'The market for deceptive products', at http://elsa.berkeley.edu/~botond/deception.pdf. Much relevant literature is captured in Office of Fair Trading (2010), 'What does behavioural economics mean for competition policy?'.
[24] For an interesting discussion of this issue, see Armstrong, M. (2008), 'Interactions between competition and consumer policy', Office of Fair Trading, p. 57 ff.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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