Agenda
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Competition regulation and consumer protection in financial services: are they natural bedfellows?

In most countries, financial conduct regulation and competition regulation are undertaken by separate institutions. Yet there are questions about the efficacy of this arrangement, given the results seen in UK financial markets, which can sometimes favour neither consumers nor efficient and innovative firms. Peter Andrews, Oxera Senior Adviser, looks at how these and other issues were discussed at an October 2018 round-table event organised jointly by Oxera and the Centre for Competition and Regulation Policy, City University London

The event (see https://bit.ly/2ShDOAX) was held under the Chatham House Rule. This article therefore draws out themes from the event but does not record what specific individuals said.

The questions about the merits of the split between competition regulation and consumer protection that has been observed in the UK financial services sector seem to be fair in principle. Competition authorities often lack detailed sector-specific knowledge of the business models of firms, which in financial markets may differ materially from the assumptions made in competition textbooks. Moreover, in retail financial markets, demand-side discipline is often weak—as exhibited by low customer switching rates—which undermines many standard procompetitive remedies.

Financial regulators, on the other hand, have found that addressing information asymmetry when the demand side is weak does not lead to the kind of competition that protects consumers by driving price and quality to consumers' preferred levels. For example, the Final Report and Recommendations of the Independent Commission on Banking in the UK found that:

> One of the reasons for long-standing problems of competition and consumer choice in banking and financial services more generally has been that competition has not been central to financial regulation. The current reform of the financial regulatory authorities, especially the creation of the FCA, presents an opportunity to change this, which in the Commission's view should be seized.[1]

It therefore made sense in the UK to try an experiment in which a single institution, the Financial Conduct Authority (FCA), had a competition objective, a consumer protection objective, and the powers to pursue both. These include a power to investigate anticompetitive behaviour under the Competition Act 1998 (CA98) and its EU equivalent. In addition, the FCA was given its competition duty. This is important because an institution with wide powers and objectives, and substantial resources, could intervene excessively in markets rather than let markets work where they can work well. Thus the competition duty requires the FCA, as far as is compatible with acting in a way that advances the consumer protection objective or integrity objective, to discharge its general functions in a way that promotes effective competition in the interests of consumers.[2]

The core purpose of the Oxera/CCRP round table was to explore what difference this combination of objectives, powers and duties has or has not made (absent the ability to observe what would have happened if the UK had continued with arrangements for financial regulation—and regulation of competition in financial services—similar to those that remain prevalent in the rest of the world).

This led to two sets of observations.

First, in terms of the traditional institutional structures, the challenges faced by separate competition authorities and financial regulators are as discussed above. It is worth adding that coordination between separate, autonomous authorities can be challenging because the different authorities may, quite properly, have different priorities and approaches, as well as differing opinions on the major uncertainties that are bound to arise when authorities intervene in dynamic markets. Moreover, there may be legal and governance-based challenges to effective cooperation.

Second, and more importantly, there is a question about what effect the FCA's new combination of objectives, powers and duties has had on its approach—and what the consequences of these changes are.

One important point is that the broadened mandate of the FCA, relative to its predecessor, the Financial Services Authority (FSA), enables it to 'design' a market that works well by looking at **all** relevant market failures and creating a cocktail of remedies that addresses these failures in ways that improve market outcomes, including more competitive prices.[3] This seems likely to be aligned with the FCA's intention[4] of setting out a procompetitive approach to developing 'policy'—i.e. analysis of markets and design of remedies leading to the formulation of rules and guidance.

It is important to note that the FCA has gone beyond the conceptual approach just described by giving practical guidance on the formal procedures that it will adopt for conducting its market studies and making its market investigation references.[5] Moreover, as part of its 'Mission',[6] the FCA has set out its overall approach to competition, and it has listed a number of areas in which the FCA's competition interventions have made a difference, as follows.[7]

1. Creation, with the Prudential Regulation Authority, of a New Bank Authorisation Unit, which is designed to address important regulatory barriers to entry for retail banks and thereby stimulate competition and drive innovation to promote better outcomes for consumers.

2. Undertaking of a market study on 'big data', to address concerns that firms might be using big data to discriminate against 'high-risk' consumers, especially in insurance markets. The FCA found that in fact, big data is delivering a range of benefits for consumers in motor and home insurance, and that the potential concern about 'high-risk' consumers has not yet materialised in these markets. The FCA also noted the high pace of technological change in the financial sector and undertook to monitor developments in big data.

3. Undertaking the credit card market study, which found a market working well for most consumers. In this case, therefore, the FCA targeted its remedies narrowly on the area adversely affected by current market practice—namely, the scale, extent and nature of problem credit card debt, and firms' limited incentives to reduce this.

4. Prompts for customers to switch motor insurance providers at renewal, in response to firms adopting the practice of 'price walking'.[8]

A clear example of how the FCA used a distinct approach is the way it set the price cap on high-cost short-term credit.[9] While at first sight this does not seem to be a procompetitive remedy, it is in fact based partly on a competition analysis that shows that, in this case, the relevant, 'behavioural' consumers were unable to drive efficient competition, although it is also driven by notions of fairness.

Probably, however, the most important area in which the FCA has demonstrated its commitment to competition is in its adoption of supply-side and 'intermediate' remedies, the latter being remedies that are not clearly on either the supply or the demand side. The traditional approach of financial (conduct) regulators has been to approach markets as if the main relevant market failure is information asymmetry. This has resulted in lots of mandatory disclosure, but there is little evidence that it has worked well.

The FCA's first response to this problem was to try to make disclosures more behavioural, based on the reasoning that this would not be intrusive on the market process and would enable competition to flourish. These remedies were indeed, for the most part, not very intrusive on the market process.[10] Therefore, while it still makes sense to look for non-intrusive behavioural and other demand-side remedies, as they can still be useful, the FCA decided that it would also have to deploy further tools of the kind used by competition authorities.

A good example of this is the remedies deployed by the FCA in the cash savings market.[11] These comprised:

- disclosure remedies, pre-, at and post-sale;
- the sunlight remedy—i.e. publication of simple data on a provider's worst rates to raise awareness of its strategies towards long-standing customers;
- switching remedies, designed to make switching easier;
- convenience remedies, to reduce barriers to customers managing accounts in one place even if the accounts are from different providers.

This is just the kind of 'cocktail of remedies' enabled by the FCA's mix of objectives, powers and duties, and it is hard to imagine any previous financial regulator imposing such a set.

A second set of observations concerns the significant impact of the FCA's competition mandate on its models of supervision and authorisation. The authorisation case is well known and obvious. For example, the FCA's Regulatory Sandbox is a means of facilitating market entry for small, innovative firms.

The supervision case, for the great majority of UK-regulated financial firms, is far more important. The FCA's two Supervision divisions between them hold far more staff than any other FCA function, and one of their purposes is to ensure that rules and guidance, overall, amount to more than words on a page and have their broadly intended effects. Here, again, the FCA's competition mandate appears to have had a significant impact.

The historical approach of supervision in financial regulators could be oversimplified in a description such as identifying real-world risks to regulators' objectives and, in this context, checking whether firms complied with rules and were making sensible decisions. At the FCA, this would not be a fair description of supervision. In line with the competition mandate, supervisors are now concerned with business model analysis. This is based on the recognition that, on the one hand, firms need to compete to make a profit and, on the other hand, they need to pay heed to the substance of regulation. Thus the FCA has developed an approach to monitoring and addressing 'conduct risk' that emphasises the relationship between firms' individual business models and fair outcomes for consumers.[12]

It is worth spelling out some details of the 'conduct risk' approach, to show how different an approach that seeks to use principles to balance the need to compete with the need to treat customers fairly is from tick-box compliance. Rather than publishing a precise definition of 'conduct risk', the FCA has emphasised that it is for each firm to assess its own risks, taking proper account of its own circumstances.[13] It has, however, tended to emphasise a handful of key points designed to bring about fair market outcomes:

- compliance is not about ticking boxes;
- it is vital to comply with the spirit of regulations;
- commercial interests need to be balanced with consumers' interests;
- profits matter, but not more than ethics;
- fair disclosure at the point of sale is not the end of a firm's responsibility to its customers—outcomes matter too.

These points, especially the first two, can be interpreted as a strong indicator that business models—i.e. how firms compete—should not (needlessly) be distorted by regulation or the avoidance of regulation.

Based on the important changes to the FCA's approach described above, and the examples of its actions, it is reasonable to suppose that the FCA's remedies, and their impacts on financial markets, are materially different to what they would have been without the competition mandate.

Overall, the FCA is using materially different approaches from its predecessor, shares material common ground (and mutual learning opportunities) with competition authorities and utility regulators, and may well be deploying cocktails of remedies that can improve outcomes for consumers and for firms with properly competitive business models.

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[1] Independent Commission on Banking (2011), 'Final Report and Recommendations', https://bit.ly/2FLd0rv, p. 17 and para. 6.20.

[2] Financial Services and Markets Act, 2000, s 1B(4).

[3] The FSA, on the other hand, steered away from making such prices a goal of its policies.

[4] See Financial Conduct Authority (2016), 'Economics for Effective Regulation', Occasional Paper No. 13, https://bit.ly/2PZJNOe.

[5] Financial Conduct Authority (2015), 'FG15/9: Market studies and market investigation references. A guide to the FCA's powers and procedures', July, https://bit.ly/2E3vou0.

[6] Andrew Bailey, FCA Chief Executive said: 'Our Mission is to serve the public interest through the objectives given to us by Parliament. The Mission gives firms and consumers greater clarity about how and why we prioritise, protect and intervene in financial markets.' Financial Conduct Authority (2017), 'The FCA published its Mission and Business Plan', press release, 18 April, https://bit.ly/2oR9odj.

[7] Financial Conduct Authority (2017), 'FCA Mission: Our Approach to Competition', December, https://bit.ly/2SicjHG.

[8] For more information on price walking, see Oxera (2018), 'Which direction is the FCA walking on prices?', 1 November, https://bit.ly/2KF9TQy.

[9] Financial Conduct Authority (2016), 'Price cap on high-cost short-term credit', 21 June, https://bit.ly/2AxwwBS.

[10] Financial Conduct Authority (2016), 'Occasional Paper No. 23: Full disclosure: a round-up of FCA experimental research into giving information', 23 November, https://bit.ly/2gb9hCJ.

[11] Financial Conduct Authority (2015), 'Cash savings market study', 20 January, https://bit.ly/2KJR7HG.

[12] Financial Conduct Authority (2017), 'Strategic Review of Retail Banking Business Models: Purpose and Scope', October, https://bit.ly/2rd2qPL.

[13] For example, see Financial Conduct Authority (2017), 'Where next for investment and asset management regulation?', speech by Megan Butler, Executive Director of Supervision—Investment, Wholesale and Specialists at the FCA, delivered at the FT Investment Management Summit Europe 2017, https://bit.ly/2ftuQzg.