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Session 2. Market governance: competition policies and business conduct regulation

Speaking notes

Bringing competition to FCA

George has spoken about the difficulty of answering the question "what will be the specific outcome?" of measures to promote competition. This resonates strongly with me - it is a real challenge for a public body.

I can (and do) say "There is a wide body of theoretical and empirical literature demonstrating that competition increases productivity by disciplining management, by having more efficient firms displace less efficient ones, and by opening markets to innovation."

I say "This not only increases productivity and growth but it is also great for consumers, who benefit from more choice, lower prices and better quality goods and services."

If I'm still getting blank stares at this point I resort to "It's in the statute, we have to do this."

And someone will, inevitably, come back with "But what, specifically, are we trying to achieve here?" Variants on this include, "What would good look like?", or "How will you know if you've been successful?" Perfectly reasonable questions for, say, a Non-Executive Board member to ask, say, FCA's Director of Competition.

We operate in a public policy climate where there is – rightly – a desire to focus on outcomes rather than on outputs, a desire to be disciplined about regulatory impacts, and a desire for a compelling narrative around interventions. And that sits pretty badly with the ideologically sound answer to all of the above questions, which is "A process of rigorous competition will deliver better outcomes in the long run, I just don't know what they are or when we'll see them. Have faith."

This inability to specify precisely how competition will make the world a better place was a real challenge in introducing the competition mandate to FCA in the aftermath of the crisis. There were other challenges too. At that point "competition" was not universally or even widely regarded as a good thing in financial regulation circles – for many people the chain of association went "competition – free market – financial crisis" – it did not end in a happy place. The experience of bank bailouts, PPI misselling, and Libor manipulation was vivid, recent and painful and the idea of putting more rather than less trust in markets was for many people deeply counterintuitive.

The FCA also had a large volume of very immediate challenges to deal with. The scandals kept coming (Libor rigging was followed by forex rigging…); the remedial action on conduct and culture was intense (eg the complete overhaul of the regime for regulating senior individuals); FCA took on regulation of consumer credit, which more than doubled the number of regulated firms; the pension reforms were announced out of the blue and had to be implemented very quickly.

Not to mention the operational challenges of forming a new organisation, mistakes of our own making and the resulting defenestration of our chief executive. Getting senior bandwidth to focus on competition – a long term game with uncertain payoffs - has been tough.

Happily, a number of things have played in our favour. First, the more than doubling of the number of firms we regulate forced a fundamental rethink of how FCA goes about its business. Regulating primarily through relationship management is simply unfeasible and FCA has had to shift from a predominantly firm-by-firm view of the world towards a more horizontal, markets-based view.

And the competition world supplied the perfect vehicle: the market study. A holistic, transparent and evidence-based inquiry into how markets work, and how they could work better. They focus attention on the workings of the market, rather than the workings of the firm.

Crucially proper analysis of markets forces the regulator to look beyond the experience of incumbent firms. It is certainly arguable that that viewpoint had dominated since the days when the industry was largely self-regulated (before the creation of FSA). As well as understanding the experience of incumbent firms, a regulator seeking to understand markets must be able to do two other things.

First, stand in the shoes of new entrants and innovators – suppliers who are on the outside, whose business models do not necessarily fit neatly with regulation shaped by and to fit the last generation.

And second, understand the consumer perspective – and that means not simply listening to consumer advocates (though that is important) but also bringing real rigour to analysing the demand-side of the markets we oversee.

And oddly, having to do both those things helped. FCA, it turned out, may have had its reservations about competition and markets, but it was keen as mustard on consumers and up for innovation. We pushed on those doors and found them perhaps not fully open but at least ajar.

I'll talk about consumers first. What do I mean when I say FCA is really serious about consumers? I mean serious about coming to work to serve them as a constituency – this comes through very strongly in our staff survey. Interestingly, over time the constituency of consumers served by FSA and now FCA has broadened. Crudely, it used to be about protecting the well-off - about stopping the unscrupulous but charismatic from making off with people's savings. Now, it is just as much about protecting the poor from unscrupulous lenders.

But as well as wanting to serve consumers, FCA is also serious about understanding consumers. And is helped in this, perhaps, by not being overly burdened with the intellectual baggage of neoclassical economics. Among regulators we've been relatively quick to move away from viewing consumers as a homogenous lump of rational economic agents, and are getting increasingly sophisticated at painting a more detailed and accurate picture.

We've used two broad types of analytical approach here – consumer segmentation/market research, and behavioural science. These are both fields that are very well used by marketing departments in the commercial world; regulators have been a little slower on the uptake.

To give an example of how we've used consumer segmentation, we did some research into the victims of investment fraud. We found that the victims of investment fraud are not necessarily those you first think of as being the most vulnerable in the market – little old ladies, if you will – but people who have a track record of successful investing, who are confident in their ability to invest their own money, and who are tempted by the prospect of higher returns. What did we do with that insight? We ran a consumer campaign – ScamSmart – we tailored it to that audience, advertised it in the kind of publications they read etc.

Since launching in October 2014, over 130,000 people have visited the ScamSmart website, over 31,000 have visited the Warning List, with over 14,000 checking an investment on the list.

Our evaluation shows that our targeting approach is working: through our marketing we have reached over half of the 'Retired with Resources' group of approximately 3m people. There has been a 67% increase in visits to our website from the retired with resources segment since the campaign started.

I'll talk a bit now about behavioural science. The key insight here is from Daniel Kahneman's Thinking Fast and Slow – the idea that our brains work most of the time reacting quickly and intuitively (thinking fast) and have limited capacity for logical or computational processing (thinking slow) – the latter is difficult and effortful and our brains can handle only a limited amount of such thinking each day.

This insight has a range of implications for financial regulation, but I'll spell out two in particular.

First, regulators need to be alive to the ways in which unscrupulous providers of financial services can trick consumers into making choices that are not in their best interest. I'm probably not the only person in this room who's bought travel insurance I didn't need because of a pre-ticked box. Our research into the sale of insurance sold as an add-on to a main purchase (car, holiday, gadget) showed that both bundling and drip-pricing had significant effects on both consumers' ability to choose the cheapest deal from a selection and on their willingness to shop around.

Buying insurance separately, only 1 in 20 consumers failed to identify the cheapest deal, and only 3 in 20 did not shop around. Buying insurance as an add-on to another purchase, with the price revealed only after the main product had been selected, 5 in 20 failed to identify the cheapest deal and a whopping 13 in 20 did not shop around.

For the big ticket, long-term choices – mortgages, pensions – the potential for harm is really significant. And while it's easy to take a line on pre-ticked boxes, many of the issues around framing and choice architecture are far from black and white. Our research into the retirement income market for example showed that when consumers were presented with a choice between buying an annuity or taking income draw-down, they made very different choices depending on whether the conversation was framed in terms of consumption or investment. This tells us that choice architecture really matters; it does not tell us which is the right frame. It does, however, suggest the next set of questions around whether profit margins and sales incentives differ between annuities and drawdown – which product would the sales person prefer you to choose?

The second implication of the fact that slow thinking is effortful – cognitively expensive if you like – is that regulators need to recognise the limitations of disclosure as a means to make markets work well. The idea that if consumers had all the facts before them they'd make great choices is terribly flawed.

This is not to say that informing consumers has no place in financial regulation – but we have to be realistic about what disclosure can and can't achieve, and we have to be smart about how we deploy it.

Our research into what helps customers avoid unauthorised overdraft charges, showed that giving consumers annual summaries of charges incurred had no discernable effect on overdraft charges, balance levels or switching. By contrast, signing up to text alerts or mobile banking apps reduced the amount of unarranged overdraft charges incurred by 5-8% and signing up to both reduced charges by 24%. This demonstrates the benefit of receiving information automatically, rather than having to acquire it, and the importance of being able to act quickly.

In doing these kinds of research we've used a range of methods including lab trials, field trials and ex post analysis. Each method has pros and cons, and I won't go into the details. On the whole I am a big believer that such approaches can help us do our job better. However, there are some important caveats:

- It takes time and money – need to be judicious about when the evidential standard we are aiming for makes it appropriate to run fresh trials vs reading across from existing results (eg from other markets or other jurisdictions)
- At the moment we rely on firms to volunteer to work with us on field trials – and given the time and expense, not to mention the ethical issues around running live experiments on real customers, this is probably appropriate. But as a regulator we cannot limit ourselves to considering only those remedies that firms are willing to step forward and help design.
- Trialling generally shows only first order effects. Which means it can be really useful for testing the impact of disclosure designed to prompt or nudge consumers in some way. But it is much less useful for testing those remedies where what you're really interested in is second order effects, for example the impact of sunlight remedies designed to facilitate scrutiny of some aspect of performance (eg broadband speed) rather than change behaviour at point of sale.

More generally it is important that we not only think beyond but also explain beyond first order effects. Too much focus on first order effects can leave stakeholders with the impression that to us good looks like consumers spending their evenings and weekends shopping around. We need to tell the rest of the story: good looks like firms knowing it wouldn't cost their customers much of an evening or a weekend to look elsewhere, and raising their game as a result. Good looks like a new entrant reckoning that with a compelling proposition it could get a foothold in this market because enough people could be tempted to switch.

Which sort of comes back to where I started. We may not know what good looks like specifically, but a public body has to be able to tell a convincing story not only about first order effects which modern research methods may render predictable, but also about second order effects which are much harder to predict or evidence, but which are arguably much more important. It's a challenge.

With that segue into the impossibility of confidently predicting the fruits of competition, let me turn now to talk about innovation.

I will confess I have been pleasantly surprised by how FCA has taken to innovation. Again, not obviously a good word – the repackaging of mortgage-backed securities was innovative and look where that got us. In the UK we've just about got ourselves into a position where we don't think we hate high frequency trading, but there's not much to love about it either – it is zero-sum innovation at best.

On the other hand, post-crisis there was also little to love about the status quo. And it is not hard to embrace the idea that if we want to effect genuine change – to transform financial services from the mess it was in at the time of the crisis – this is unlikely to be a question solely of existing players mending their ways, it will also require new players and new approaches.

When we arrived at FCA one of our first observations related to what might be termed "honest" regulatory capture - the capture that comes simply from listening to and understanding the worldview of those you regulate. From a competition perspective this was particularly acute at FCA which – for excellent operational reasons - allocated more resource to supervising big players. The views of large incumbents were well understood; the views of smaller players rather less so; the views of potential new entrants all but inaudible.

To counter this we launched what started as an outreach programme to potential new entrants, in particular the financial technology (FinTech) community. We went on to establish the Innovation Hub, a dedicated unit which provides support to firms trying to bring new or innovative business models to market. For example there's a company called Aire, one of several start-ups whose motivating observation is that traditional banking deals incredibly badly with people newly arrived in the UK, even self-evidently respectable people from respectable jurisdictions – French doctors, say. Aire draws on a range of data to build up a proxy credit file to speed up the process of getting established financially in the UK. But building proxy credit records was not something anyone had tried to do before. What kind of permissions would they need? Which rules affect their business? The Innovation Hub provides help to firms like Aire to navigate the regulatory framework and get to market quicker.

Most recently we launched something called The Sandbox. The idea is that a firm – new entrant or established player – that wants to try a different way of doing something (a different approach to customer communications, say) can approach us for permission to try the new approach out without incurring full regulatory consequences if the approach proves unsuccessful. Very early days for the sandbox – we've had a lot of interest but it will be a few months before we know if it's getting good results.

The innovation hub and sandbox are important initiatives. But they are a bit initiative-y. They are resource-intensive and, at least directly, they can only help a fairly small number of firms. There is almost certainly more FCA needs to do to make innovation less of a special project and embed it deeper in the organisation's DNA. This means asking some fundamental questions about our risk appetite.

Estimates vary, but FSB figures suggest that 20% of new start-ups fail within the first year, and 50% last less than three years. In financial services, I exaggerate only slightly when I say the failure of a single firm used to be enough to get its supervisor fired. Are we really fine with half the firms we authorise failing within 3 years?

Maybe we never will be. But the financial crisis did teach us a thing or two about firm failure. On the prudential side, much work has been done to develop the resolution regime to make it easier for banks to fail in an orderly fashion. On the conduct side, following the collapse of Lehman (whose clients' money was nowhere to be found) there's been a lot of work on the client assets regime to ensure that if an investment firm goes down, the cash, stocks and shares it holds on customers' behalf can be returned to them.

This regime has been tested. In January 2015, Alpari – a retail forex trading firm and erstwhile sponsor of West Ham FC – went into administration. Alpari had segregated client funds according to CASS rules, and this allowed the administrators to return money to customers.

The client asset regime may not sound like it has much to do with competition; and yet it is absolutely essential. Until we can handle exit, we'll never properly be able to handle entry or innovation.

So, finally - let me come back to the title and exam question for the session: are competition policies and business conduct regulation in conflict?

Unsurprisingly my answer is: quite the opposite. Competition and business conduct regulation can and should be mutually supportive. In financial services, without conduct regulation there would be no market. We would all keep our savings under our mattresses and sleep with shotguns under our pillows. To make the same point in less wild west terms, I'll talk about peer-to-peer lending.

Before the FCA started regulating P2P in April 2014, the Consumer Credit Act gave some protection to borrowers as consumers, but there were no protections for investors or specific requirements for firms running P2P platforms. And the industry was lobbying the government to regulate, to create the conditions of confidence in which the market could grow. Rather than trying to shoe-horn P2P into existing rules for banks or credit firms, we designed a purpose-built regime for P2P. And we tried very hard to strike the right balance by protecting consumers without creating disproportionate barriers to entry or regulatory burdens.

Which brings me to the other question in the notes: how well are current arrangements doing in addressing the relevant trade-offs? On peer-to-peer it's a bit early to say. We're keeping an eye on it and will conduct a full post-implementation review later this year. But the feedback so far is good: 90% of platforms think regulation is adequate and appropriate.

More generally how well is FCA doing at addressing the trade-offs? My view is, unsurprisingly, that we are doing much better as a result of having a competition mandate. But I'm interested in views from the floor…