Measurement tools for enhancing accountability in conduct regulation

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Overview

1. **Is there a problem, sir?**
2. Measure the right things and regulators will do the right things
3. New tech and data tools can help make regulators accountable as much as help regulators regulate
4. Legislative implications

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Is there a problem, sir?

1970s

- Norton Warburg investment fraud
- the catalyst for regulation

1980s

- endowment mortgage mis-selling

Late 1980s–mid 1990s

- personal pensions mis-selling

1990–2010

- PPI mis-selling
- the hidden problem of the hidden cost of investing?

Recent years

- pension transfers, pay day loans, swaps for SMEs…
- over-priced mortgages sales: an iceberg?

2021

- FSCS needs £1bn for redress...
- personal pensions mis-selling cost c. £13.5bn

So, yes, there is a problem?

- what may we infer from the facts?
  - the FCA may well be making things better than they otherwise would be
  - there are plenty of unscrupulous people working in FS
  - they have succeeded under all FS regulatory regimes to date
  - honest firms pay vast amounts to counteract the unscrupulous
  - large numbers of consumers are willing to buy terrible products
  - disclosure and suitability rules have worked poorly in retail

What else might we infer from the facts?

- it has taken a long time to identify and stop malpractice (poor data?)
- honest firms and consumers deserve better protection
- competition has not coalesced around price, quality and genuine innovation (in many retail FS markets—weak demand side?)
- past regulatory approaches need to be changed (more experiments and lessons from ex post CBA?)
- tools to provide EARLY WARNING of problems in markets need to be introduced
- early warnings need to be acted upon (who prompts the regulator?)

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Measure the right things and regulators will do the right things

- what is this about?
  - what's measured influences what's done
  - some things done now are measured mostly in activity reports, e.g. Supervision, so their substantive contribution is unclear

- what should be measured?
  - the things that are the rationale for conduct regulation and how they manifest in the real world
  - rationale—information asymmetry (principal/agent problems), weaknesses in the process of competition and restorative justice
  - manifestation: individual suitability of purchases, price/quality relationship
  - <u>critical</u> for checking statutory objective 'ensuring…markets…function well'

But isn't this all quite hard?

- yes and no
  - restorative justice has simple metrics such as the ratio of awards by FOS and FSCS relative to their operating costs
  - wholesale markets have great trade data
  - the Market Cleanliness stat should be supplemented by other stats from Australia's Quality of Markets Dashboard and international comparators (as in Luis's slides)

- retail suitability and price/quality metrics are harder
- but they are <u>central</u> to the FCA's protection and competition regime <u>and</u> where the biggest problems have been
- so they <u>must</u> be measured, and luckily extra data and new analytical techniques can really help one explore how markets are functioning

Scope for a virtuous circle further justifies change

- as it stands, regulators mostly don’t measure their goal—to make markets work well—through price, value, suitability, and instead look at proxies like ‘risks’, compliance infractions, systems and controls...
- but if regulators were required to report on suitability (the match between the product and the person who bought it) and price/quality, they would be motivated to explore whether these metrics could be improved
- thus, while evidence of ‘behavioural’ consumers has mounted, calling into question disclosure and competition, regulators don’t know whether, say, product regulation would deliver better market outcomes
- and here advances in experimental techniques, in particular field trials, could reveal what everyone wants to know: what works, the invaluable aid to policymaking

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Using 'Big Data' to make regulators accountable

- if the regulator wants to know about suitability and price/quality, it has to monitor who is buying what—and how this changes when regulation changes and over time
- suitability analysis means combining product sales data with personal data
- GDPR allows authorities to do this

- two approaches can work:
  - full suitability analysis, ideally at household portfolio level
  - strictly dominated purchases ratio (SDPR): what % of people buy a product which has zero advantages over a cheaper rival product?

- some good news: the FCA has already used advanced analytics to perform SDPR for mortgages

What about price/quality?

- more good news
  - law and economics scholars in the USA have worked extensively on the evolution of contracts in E-commerce
  - law firms are making increasing use of AI to parse contracts
- is it practical?
  - data on price, product characteristics and buyers should be included in FCA Product Sales Data (e.g. regulator to use XBRL to take firms' management information)
  - a simplifying device might be the re-introduction of pro-competitive CAT standards (e.g. where transaction size cannot sensibly fund proper advice, possible cut-off point being where properly remunerating advisor would absorb all or most of equity risk premium)
  - anyway, can regulators of conduct of sales really not know the true nature of what is being sold and to whom?

Can ‘Big Data’ approaches solve the early warning problem?

- yes—this is another huge advantage
  - consider how large digital firms operate through real-time experiments and the increasing shift of FS toward being digital businesses
  - firms can provide data quickly and product providers can supply data for Appointed Representatives and IFAs
  - this will cost money but it will also save honest firms lots of money—see above—and allow removal of most prescriptive regulation, saving costs and freeing innovation, because firms will quickly be judged by results: principles-based regulation (TCF) with substance

- but this would also require the FCA to be urgently on the case?
  - yes, but the FCA is rightly boosting its capability in Data Science—and governance needs to ensure this capability is quickly deployed on the right things
  - the suitability and SDPR approaches advocated here play to the FCA’s strengths:
    - economic data scientists can design the models that show how markets are functioning
    - Business Intelligence Data Scientists in Supervision can monitor the outputs of these models, using the outputs to intervene immediately when inflection points in sales mix, prices, buyer characteristics, etc. are observed at market or individual firm level

Are further metrics needed?

- yes
  - conduct regulation is a very hard job
  - behavioural decision-making and the scale of mis-buying say that consumer surveys, etc. give little reliable information on the strategic objective to ensure markets function well, nor do most of the FCA's 'Consumer Outcomes' relate directly to market functioning
  - so the FCA's hard information on the strategic objective is only some ex ante CBAs, the few ex post CBAs that are done, some research papers, and great but ad hoc market studies

- what then would help?
  - at market level, and in aggregate for the regime as a whole, time series of metrics like suitability and SDPR provide an excellent ex post CBA of regulation so long as, to check proportionality, they are supplemented by cost data in ex post CBAs, which should anyway be routine to ensure the FCA knows what works and what is a waste of money
  - the same metrics in cross-sectional form (firm-level) would provide excellent intelligence for Supervision and Enforcement, and probably do not need a supplement
  - quick-fire, tech-style field trials, especially in E-commerce settings, would give substance to ex ante CBAs and reduce policy errors (unjustified regulations)/ the need for policy changes

Regarding accountability

- the status quo makes the FCA look bad
  - in well-functioning markets, consumer detriment is limited: the level of suitable sales is high and higher priced products are justified by innovation or quality or both
  - but current opaque metrics about consumer outcomes reveal little about detriment
  - so the status quo is like a game of football in which the crowd (and the regulator) cannot see the goal posts and therefore does not know how often the regulator scores goals (by reducing detriment and thereby ensuring that markets function well)
  - the only things that register are the occasional own goals – big, bad events like LCF

- prompt, meaningful metrics about how well markets are functioning would transform the situation
  - the regulator could be praised when praise is due, appropriately boosting confidence
  - a more confident regulator would be less inclined to regulate defensively, and defensive regulation can often be over-regulation (e.g. addressing smallish ''risks'')
  - early warnings of problems could be identified and acted upon
  - an independent scrutiny body could use the metrics to reinforce what works and challenge appropriately where markets are not performing well

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Areas for legislative consideration

FCA indemnity for field trials	FCA oversight and public policy coordination body
Mandatory metrics	Field trial and ex post CBA obligations

Indemnity for field trials

- the FCA needs to know what works, and so do its stakeholders
- government therefore needs to ensure that there are no impediments to proper field trials
- lab experiments are a poor substitute, for obvious reasons

FCA oversight and public policy coordination

- why needed?
  - FCA is almost certain to cut across social policy, given the markets it regulates
  - in the era of Big Data, accountability can be improved (as already described)
  - but this requires an independent institution that can invest in understanding and monitoring data, which implies something about its resources (Secretariat needed)

- would could it be?
  - FPC
  - RPC
  - NAO
  - a new body – more than Judicial Review but well short of Competition Appeals Tribunal
  - [TSC]

what would it do?
  - specify the metrics to be provided (some mandatory in statute?)
  - obviously to include suitability and SPDR data!
  - check responses to data and public policy coordination

Field trial and ex post CBA obligations

- field trials of proposed remedies/policies can materially improve regulation
- but for some measures, they are hard to design and get reliable results
- rebuttable presumption not obligation?

- ex post CBA is critical for understanding whether interventions made relevant markets function well and, if not, whether the interventions should be removed for failing the test of proportionality
- ex post CBA provides invaluable lessons for improving future policy
- ex post CBA should be an obligation for any regulator with more than 3,000 staff

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