Metrics for conduct regulation and strategy

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Overview

1. **Why metrics matter**
2. A history lesson from seventy years of UK experiments
3. The FCA's current initiatives on metrics
4. How to measure conduct regulation

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Metrics matter because…

- they tell regulators what interventions work (and what does not work)

- collectively, they inform allocation of scarce resources to pursue strategic choices e.g. enforcement-led v reliance on private sector governance v empowering consumers

- they enable regulators credibly to demonstrate success and therefore operate a stable regime (instead of fighting endless battles with critics when a single bad thing happens)

- consider the example of cricket…

The case of cricket – the problem

- there have been roughly 40,000 international 5-day matches and these gave scope for up to 800,000 (40,000x10x2) dismissals

- most dismissals are objective facts but one category, the LBW, was historically determined entirely at the discretion of the on-field supervisor of rules (the umpire)

- across all dismissals the average proportion of ‘LBW’ has been c0.15

- in England’s seven match series against Australia in 1970/71 the expected number of LBW awards from the Australian umpires to England and against Australia was therefore 21 (7x10x2x0.15)

- the number awarded over the 35 days was an incredible… ZERO

The case of cricket – the solution

- the credibility of cricket was in fact under threat for two reasons
  - evident bias in the supervisors
  - the technical difficulty faced by supervisors in implementing the rules (which meant that appointing genuinely independent supervisors was not the best solution)
- the solution to both problems was the introduction of new technology
- roughly speaking, this technology obviated malleable and behavioural opinions (regulatory ‘judgement’), replacing them with scientific facts
- again, roughly speaking, this is what clever use of new data and new analytical techniques can do for regulation…
- leading to credible and independent regulation

Metrics also matter because…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
  - critical for checking statutory objective 'ensuring…markets…function well'

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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70 years of UK experiments in approaches to regulating investment business (and still nobody knows what worked)

1950s

- protection under law of contract
- protection under law of tort
- Stock Exchange Rule Book (since 1812!)
- Prevention of Fraud (Investments) Act, 1939

1958

- Prevention of Fraud (Investments) Act updated
- registration of securities dealers
- simple and short

1960s, 1970s, 1980s

- some self-regulation e.g. NASDIM
- Stock Exchange rules imposed some restrictive practices which dampened competition)

1986

- Financial Services Act
- very complex
- specialist 'self-regulating organisations' (SROs) operating under a statutory framework
- Policing/enforcement led approach in IMRO not in other SROs

2000

- Financial Services and Markets Act
- even more complex
- single peak structure
- practical approach based on market failure, risk analysis and audit model of supervision of firms

2013

- Financial Services Act
- more complex again: new competition objective and twin peak structure
- practical approach: behavioural economics and consumer-led plus policing/enforcement led; then Business Model Analysis; then more policing…

But always something goes wrong…

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

The observed Regulatory Cycle (it's on repeat)

What may we infer from this?

- bad outcomes in retail FS have been common, costly and hard to stop albeit the UK has some well-working, competitive retail FS markets
  - mis-selling scandals have happened under all the varied FS regulatory regimes to date
  - survivor firms pay vast amounts to counteract these events
  - large numbers of naturally behavioural consumers are willing to buy terrible products
  - disclosure and suitability rules have not stopped this altogether nor has competition
- yet, equally, the FCA has been proactive in improving the situation, though nobody knows by how much or what interventions work best
- so the Treasury's Review and better data/analysis are needed

Views from the February 2021 Oxera/LSE – Systemic Risk Centre event on UK Treasury's consultation on the framework for future financial regulation

- the FCA's regime may prove to be unstable and needlessly costly as it lacks credible measures of its benefits to set against the costs of bad events that lead to irresistible demands for big changes to generally fair regulation, imposing heavy costs on firms
- whereas… a regulator with meaningful performance metrics could be praised when praise is due, appropriately boosting confidence in regulation and markets all round
- this would help consumers to engage more with FS and FS firms
- and a more confident regulator would be less inclined to regulate defensively, a benefit as defensive regulation can often be over-regulation (e.g. addressing smallish ''risks'')
- meaningful metrics must relate to the rationale for regulation i.e. reveal whether consumers are getting better prices/quality/suitability under regulation
- the FCA has data about consumers and their purchases to produce such metrics only in the markets for mortgages and credit (and in wholesale markets – not discussed here)

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FCA initiatives subsequent to Treasury Consultation

- have been very positive
  - 'outcomes-focussed regulation: a measure of success?' – a speech by FCA Chair, Charles Randell, May 2021 – included the following:
    - 'by defining the right outcomes, **measuring them even more** and acting on the results even faster with **an enhanced data capacity**, we will be able to target our interventions more effectively'
    - 'being transparent about outcomes drives us to act and increases our accountability'
  - FCA Annual Plan 2021/2022 includes some important new emphases, such as:
    - measurement/metrics
    - accountability e.g. Enhanced Impact Evaluation Programme
    - detection/punishment of fraud and misconduct (compliance incentives matter!)
  - and continues to build on important themes like firms assessing the value of their outcomes (e.g. in Asset Management), fairness and the Consumer Duty

What metrics does the FCA envisage in its Plan?

- the ‘perennial top-line outcomes/metrics including the sum of benefits’ in the FCA plan
    - so far, not defined, I believe
- strategic over-arching outcomes/metrics (set for multi-year periods and reviewed each year in line with HM Treasury’s Remit Letter and Strategic Business Priorities)
    - the sum of consumer benefits (‘sustainable innovation’)
    - market cleanliness statistic
    - more rejected authorisation requests/fewer customer complaints
    - reduced FSCS claims (as fraud found faster)
    - more permissions removed (as FCA proactive on misconduct)
    - more use of ScamSmart and fewer ‘wrong’ calls to Helpline (as consumers better informed about regulation)
    - FCA and industry targets on diversity met

Some observations (1)

- on the ‘perennial top-line outcomes/metrics including the sum of benefits’ in the FCA plan:
  - HM Treasury should consider setting these and their monitoring in the accountability reforms being developed to conclude the Future Regulatory Framework Review
  - these metrics and the ‘consumer benefits’ metric are likely to determine whether the UK can escape the Repeat Regulatory Cycle outlined above
  - the relationship of these ‘top line’ metrics with the ‘seven overarching’ metrics, especially in the area of ‘benefits’, needs to be clear
  - the FCA is right to say in its Annual Plan that measuring benefits is hard
  - as the FCA’s approach is yet to be determined, I will make some suggestions about this in the context of ‘consumer benefits’ below
  - as markets are complex and overall outcomes matter, a suite of metrics about each market is needed (regulators address market failure, so consider Lipsey/ Lancaster’s General Theory of Second Best - if one market optimality condition is not met the second best values of variables will change relative to their optimal setting)

Some observations (2)

- of the seven overarching metrics listed in the FCA plan…
  - two are beyond my scope here (diversity and wholesale market cleanliness)
  - two (FSCS claims and ScamSmart/Helpline) might or might not indicate changes in the level of fraud and of consumer awareness and neither is solely attributable to the FCA
  - two (rejected authorisation requests and permissions removed) are activity measures, which are useful as compliance incentives and likely beneficial if levels of non-compliance are high…but strictly cannot be counted as a cost or a benefit as the incidence of false positives cannot be known, as is the value of mis-selling stopped relative to the value of innovation lost
  - the final metric – the sum of consumer benefits – bears directly on the FCA's strategic objective of ensuring that the relevant markets function well, if it can be estimated realistically and if causal identification (beyond my scope today) can be established: this metric matters for confidence, regime stability and knowing what intervention works

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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...
- 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
- 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
- and here advances in experimental techniques, in particular field trials, could reveal what everyone wants to know: what works, the invaluable aid to policymaking

Techniques of causal identification

- On causation, I became more depressed the longer we talked! My original 'insight' was that economists are using so-called causal identification methods and, as I had seen little of this in ornithology, a transplant seemed potentially valuable. As I mentioned, though, these methods generally do not lead to 'objective truths' in the philosophical sense. And my sense of unease grew as it became clearer to me that the methods are less suited to ecosystems than they are even to complex economic markets, partly because there is so much to capture in ecosystems. Hence my reference to Martin Nowak's work, which is more abstract, though, as mentioned, did not prove especially useful when we tried to deploy his insights in a game-theoretic approach to a specific economic market.
- https://royalsocietypublishing.org/doi/10.1098/rstb.2009.0215
- Anyway, FWIW, causal identification methods in economics fall into a number of broad categories that give varying degrees of assurance and typically seek to exploit some extraneous phenomenon to explain

Exploit India's structure to benefit from causal techniques

- numerous stock exchanges
- numerous states (geographical units within the country)
- stagger timing of initiatives across these units
- unchanged units at any given point of time are the control group

Examples of potential to exploit timing differences by region or exchange

- scaling up initiative to grow small firms through public markets
  - Oxera EU report for types of measure [link]
- using cultural change and governance to change market outcomes
  - BTBL material [link]

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

Turning then to ‘the sum of consumer benefits’ i.e. to improvements in suitability and price/quality due to FCA

- for this, the FCA has to monitor who is buying what—and how this changes when regulation changes and over time
- this means combining product sales data, product characteristics, with personal data
- 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?
- the former is hard and beyond today’s scope while SDPR understates mis-buying BUT:
  - a time series of SDPR is a powerful indicator of the extent to which market function is improving and the FCA has already produced its first SDPR (for mortgages)
  - at firm level, SDPR provides strong evidence for Supervisory/Enforcement action
  - SDPR can drive an Early Warning System
  - SDPR can underpin credible Ex Post CBAs
- the FCA needs product and personal data beyond mortgage/other credit markets

Wholesale conduct

- market cleanliness stat
  - two are beyond my scope here (diversity and wholesale market cleanliness)
- quality of markets dashboard

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

Final thoughts - on metrics/regulatory strategy for the FCA and for firms

Absent proper measurement of outcomes, switch to product standards?

Using strong legal powers requires also use of innovation metrics to check for unintended costs

Realistic Business Model Analysis needs metrics on/ analysis of relevant economic markets

What matters in remedies is what metrics show to work: use (Behavioural) Field Trials

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