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The FCA’s focus on competition and behavioural economics

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FCA: new focus and toolkit

"Competition will be king as we [the FCA] move forward.

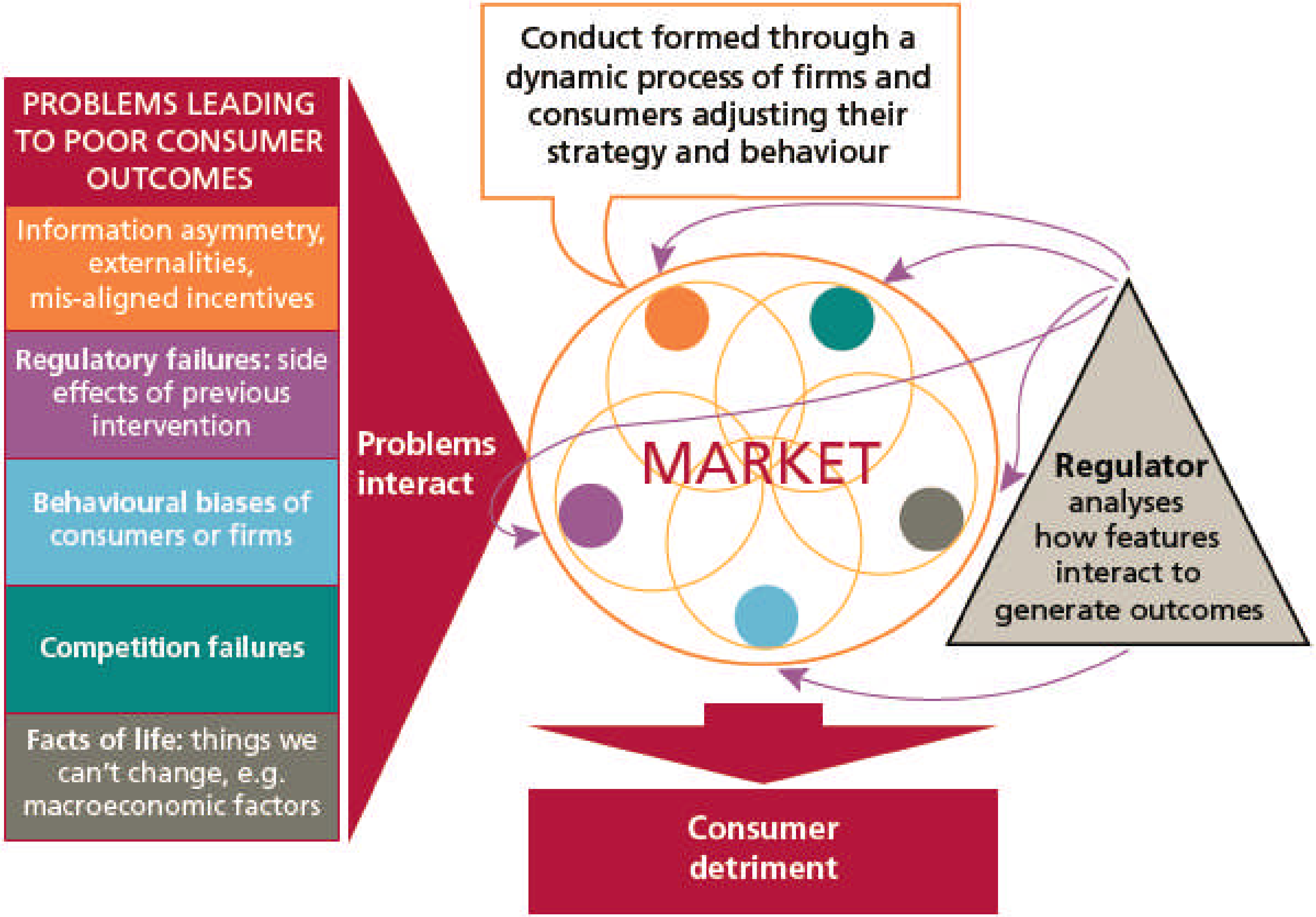
And that means tomorrow is unlikely to look like today"

Martin Wheatley,
CEO, FCA
March 2014

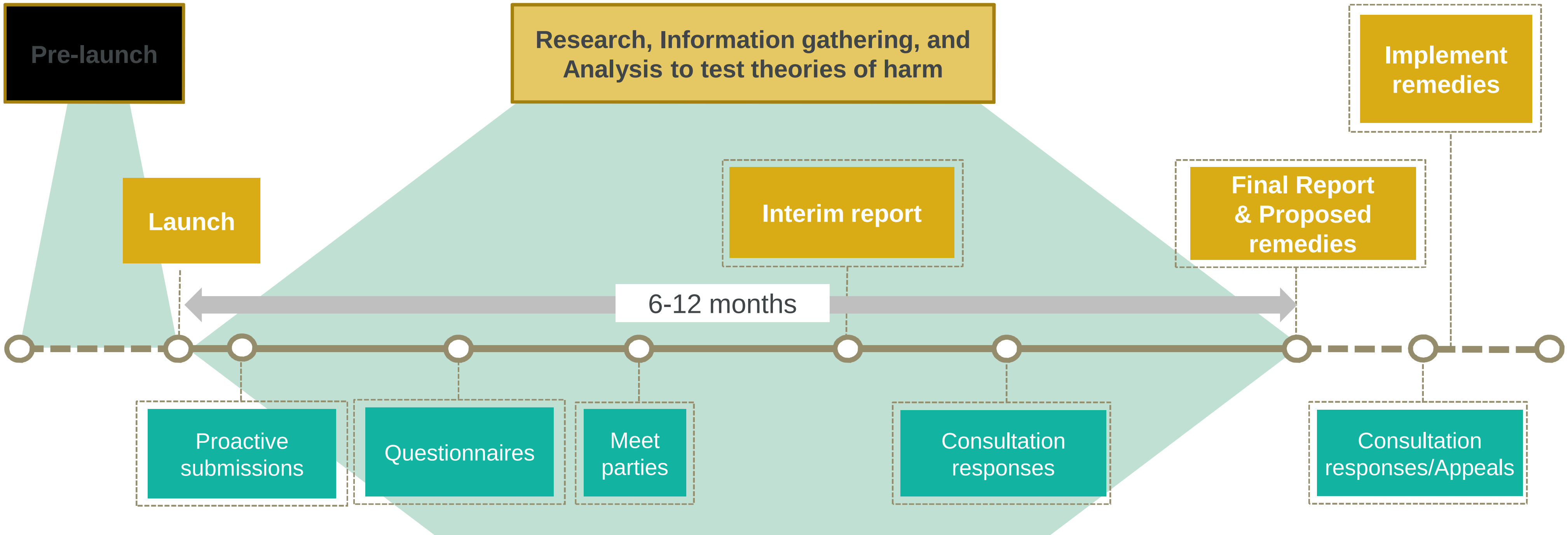
- Strategic objective is to **ensure markets function well**; achieved through:
  - securing an appropriate degree of **protection for consumers**
  - protecting and enhancing the integrity of the UK financial system
  - **promoting effective competition** in the interests of consumers
- **Early intervention** to deliver speedy and proactive consumer protection
- **Market studies** to investigate and remedy market-wide issues
- Concurrent Competition Act powers from April 2015

FCA proposes an integrated analysis of market-wide problems

- Effective competition needs both the demand and supply sides of market to work well
- Consumers should have information they can access, assess and act on
- Firms should compete on price, quality, service and innovation



The typical anatomy of a market study



Key analysis

- Market definition and customer segmentation
- Review of information flows
- Customer surveys, mystery shopping and experiments
- Analysis of product/segment profitability and fairness of prices
- Customer detriment calculations

Make the most of market studies

- Begin with the end in mind
- Engage early and as often as possible
- Plan, and practice, your communications so that critical strategic points and evidence are clear (particularly if a later legal appeal may be likely)
- Educate non-industry specialists in the FCA team on the complexity and history of your market/product
- Help the FCA design appropriate customer surveys and experiments; participate, don’t sit back
- Think about how best to measure product and customer segment profitability e.g. attributing shared costs, accounting for intangible assets and economic capital
- Dedicate sufficient internal resource to manage *ad hoc* information requests and consultation responses

Behavioural economics ("BE")

- Economics and psychology combining to better explain real customer (or firm) choices
- People exhibit "**bounded rationality**" and "**bounded willpower**"
- Some **persistent and predictable** biases in decision making
- But choices are highly context specific

- Framing matters:

  8x7x6x5x4x3x2x1 > 1x2x3x4x5x6x7x8

  "Gandhi was younger than 140 when he died, how old was he?" > *"Gandhi was older than 9 when he died, how old was he?"*

- People hate losses: Loss ~ 2 x equivalent gain
- Rules of thumb to shortcut complex questions:

  "Is this a good financial adviser?" → *"Is this financial adviser likeable?"*

- Relativity matters:

  "Would you drive 15 minutes to save 50% on a £20 toaster?" > *"Would you drive 15 minutes to save 2.5% on a £400 TV?"*

- Overconfidence:

  In a Swedish survey of car drivers, 68% rated themselves as being better than the average driver, and no one rated themselves as being below average

BE may be particularly important in improving retail financial markets

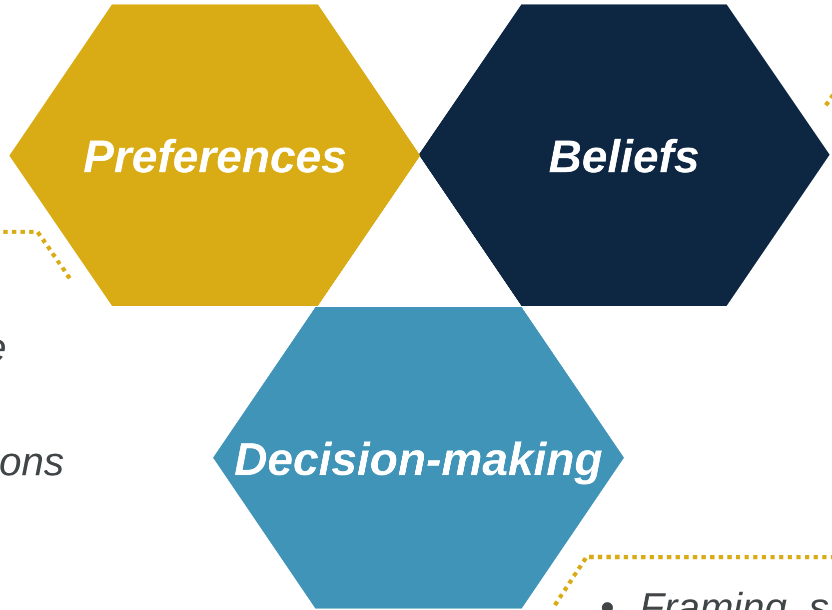
The FCA thinks that retail financial markets are prone to biases:

- Most customers find financial products complex
- Many financial decisions require assessing risk and uncertainty
- Decisions often require trade-offs between the present and the future
- Financial decisions can be emotional
- It can be difficult to learn about financial products

"Behavioural economics enables regulators to intervene in markets more effectively, and in new ways, to counter business models [that do not compete on price and quality] and secure better outcomes for consumers"

Martin Wheatley, FCA CEO, April 2013

Biases affect many parts of making a choice



- *Overconfidence*
- *Over-extrapolation*
- *Projection bias*

- *Present bias*
- *Reference dependence and loss aversion*
- *Regret and other emotions*

- *Framing, salience and limited attention*
- *Mental accounting and narrow bracketing*
- *Decision-making rules of thumb*
- *Persuasion and social influence*

Biases affect competition and market function

- **Market may not correct biases itself**
- **Biases could lead to negative distributional effects** – less sophisticated consumers cross-subsidise the more sophisticated
- **Biases could create or strengthen firm market power**. Biases may mean consumers don't search enough, search on the wrong basis, and don't switch to better offers
- **Biases could dampen effects of entry or incentives to innovate**. Excellence is not rewarded by customers switching
- **Biases may lead to spurious pricing/product differentiation and complexity**
- **Firms decisions may be distorted by biases**
- **Biases may render remedies of other market failures ineffective** (even harmful) e.g. information remedies.

All financial products will tick some of the FCA's indicators of concern, but FCA will focus on those ticking most of them

	Signs	Potential indicators
Firms	**Rip-offs** – uncompetitively high margins	1. Persistent excess profits
		2. Price dispersion unrelated to cost
	Suckers – concentrated profits from a small group of customers	3. High penetration rate for high-margin unessential add-ons
		4. Cross-subsidies between consumer groups or products
		5. Very different financial sophistication across customers
Product	**Bargains** – innovations that appear very cheap	6. "To good to be true" headline prices or returns
		7. Material charges or exclusions hidden or under-emphasised
	Traps – contract features that target behavioural biases	8. Teaser rates, especially with automatic renewal
		9. Cancellation charges or hurdles
		10. "Default" options for some key contract elements
Consumers	**Regret** – reported or potential regret	11. Widespread reports of consumer complaint
		12. Product purchased rarely – little scope to learn
	Folly – choices out of line with common sense	13. Product inconsistent with other products owned or with stated goals
		14. Product clearly provides poor value for some customers
	Confusion – observed or likely confusion	15. Consumers unable to describe key product features/prices after purchase
		16. Product complicated by structure or number of options

Techniques to identify biases

- Reviewing internal strategy, product and governance documents
- Crunching through actual consumer consumption data to find patterns and specific customer segments
- Stated and revealed preference surveys (e.g. conjoint)
- Random controlled trials – experiments, simulations and field trials
- Academic BE literature

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How the FCA might use BE in remedies

- **Provide information** in a specific way (prohibit ways of displaying information)
- **Change the choice environment** e.g. change the default
- **Control product distribution**. Require products to be sold or promoted only through certain channels or to certain customer groups
- **Control products**. Ban specific product features designed to exploit

Preference for remedies that do **not** restrict choice

A tension between paternalism and individual consumer responsibility/freedom

Remedies need to be necessary, trialled and proportionate

Performance of remedies must be monitored and possibly amended in future

But the FCA faces a high standard of proof

- Rigorous cost-benefit analysis is needed before any intervention to avoid **policy errors**, **unintended consequences** and **legal challenge**
- E.g.
  - Federal Trade Commission and mortgage brokers
  - CAT judgment in *Barclays Bank Plc v. Competition Commission*
- The FCA itself notes: "*If the FCA mistakenly intervenes to 'correct' reasonable consumer choices, our interventions could impose costs for no real benefit, or even make people worse off*".

"One of the key messages to come from the behavioural economics literature is that ***consumer behaviour is highly contextual and multi-dimensioned*** *and that, before we can be confident that intervening will actually enhance the position of consumers taken as a whole, it is necessary to have robust evidence. This usually comes at a significant cost".*

UAE, CCP, 2013

What matters for actuaries?

- Insurance products will be in the spotlight – e.g. complexity, emotions, cross-subsidy, uncertainty
- Actuaries' role in product design and pricing make them a critical first line defence in terms of governance, strategy and marketing
- Actuaries need to communicate the complexity of their work to the FCA during market studies
- Actuaries have comfort with crunching through key datasets to identify consumer consumption patterns – quantification matters

There's plenty of opportunity …

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Questions

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Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

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