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FCA Leaning on Behavioural Economics In Competition Reviews

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Martin Wheatley, the chief executive of the U.K. Financial Conduct Authority, has observed that the FCA's mandate to promote effective competition is "the single most significant change in our objectives as a regulator".

How the FCA will carry out this objective in pursuing consumer protection and market integrity is only beginning to emerge, but it has already committed to an extensive programme of reviews examining whether market sectors are sufficiently operating in the interest of consumers — and it is clear that findings drawn from behavioural economics will inform these reviews.

It is also apparent that the new regime will have teeth; starting in April 2015, the FCA will enforce competition law alongside the new Competition and Markets Authority, giving it parity with competition regulators in other U.K. markets and a significant role in EU-level competition policy and enforcement.

The implications for firms are significant, affecting business-model development as well as relationships with the regulator. As Wheatley recently noted, "Competition will be king as we move forward. And that means tomorrow is unlikely to look like today".

The Importance of Behavioural Economics

The FCA's efforts to develop as a competition regulator include a clear and increasing emphasis on the use of behavioural economics to assess competition and intervene in markets more effectively.

The FCA has noted its interest in the lack of consumer mobility in some financial services sectors — Wheatley, for instance, noted in a recent speech that the British are more likely to seek a divorce than a new bank account.[1] The authority has set out to understand how consumers make decisions about financial products, including why they frequently choose not to shop around for the best rates.

In February, the FCA's Thematic Review of Annuities pointed to a lack of competition in the traditional annuities market, finding that 80% of consumers who purchased their annuity from their pension-plan provider could get a better deal in the open market.[2] It found that many consumers in the traditional

1 http://www.fca.org.uk/news/making-competition-king
2 http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-02

annuities market were losing out by more than 6% (in terms of premiums per annum) if they did not shop around.

The authority — not convinced that lack of competition is due to inadequate disclosures — is turning to behavioural economics to answer its questions. The field contemplates a model of economic behaviour in which humans are influenced by biases or heuristics to make what appear to be irrational financial decisions, and explores the factors that lead to errors in decision-making by customers.

The FCA has published three occasional papers that outline its use of behavioural economics to guide regulation and present results from its own commissioned studies. The second paper, whilst not related to competition issues, examined how the presentation of materials in a letter influenced customer responses — including, for instance, boosting the response rate. The FCA has already begun to assess and revise the formatting of firms' consumer-targeted communications based on these findings.

A study forming the basis for the third occasional paper (and its first market study) directly addressed the FCA's substantive competition concerns.[3] It found that companies offering general insurance products as add-ons — for instance, travel insurance offered alongside a holiday package — took advantage of common customer behaviour to charge higher prices than achievable if the product had been sold separately. The FCA rejected the notion that the incremental differences were offset by lower prices on core products. The paper also examined the incremental effects of different sales and presentation methods, such as framing price quotes in yearly versus monthly terms, or presenting add-on products upfront versus at the point of sale.

The FCA concluded that "the structure of the transaction has very strong, and generalizable, effects on consumers' ability to drive effective competition" and "highlights the importance of considering how and when information is presented to consumers in designing regulatory interventions, as well as thinking about its content". The FCA is developing proposals that are intended to change the way products are sold, including potentially requiring firms to publish claims ratios to illuminate the difference between what consumers pay and the amount they can expect to claim.

This study, as well as highlighting concerns around the sale of secondary products, suggests that the FCA may look unfavourably on cross-subsidies between products.

It is clear the use of behavioural economics will be a key driver in determining the remedies the FCA deems appropriate when it identifies competition issues.

Competition Is King

The FCA's competition mandate, however, also extends past issues related to consumer error, and it is worth examining these other areas in which the agency has indicated it will focus. These include expected issues, such as supplier market power and limited information flows between market participants. A series of publications and announcements from the FCA continues to illuminate its approach to competition.

3 http://www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-3

Assessing Potential Interventions

The FCA's use of behavioural economics in competition interventions invites scrutiny in three areas:

Market

- Is the market insufficiently competitive?
- What is the product's rate of return?

Customer

- Is the customer vulnerable?
- Are outcomes positive?
- Are marketing and disclosures clear?

Distribution

- Does the firm provide advice?
- Is the product sold through intermediaries?

The FCA's 2014/5 Business Plan[4] set out a programme of further work related to its competition mandate, including:

- Market studies into the effectiveness of competition in the credit card market, account switching and overdrafts for cash savings accounts, and competition in the wholesale sector
- The imposition of a price cap on payday lending
- Further developing consumer profiling to enhance supervision of financial promotions

The FCA's latest call for inputs (by 9 October) indicates that its interest in competition goes beyond the retail sector. The review, launched in July, is an exploratory exercise that will enable the FCA to determine where competition in the wholesale sector may be weak or not working effectively. The review is potentially wide ranging.

4 http://www.fca.org.uk/static/documents/corporate/business-plan-2014-2015.pdf

It is clear from these goals the FCA is equipping itself with the intellectual and analytical resources necessary to intervene in markets where it sees cases of consumer detriment that may result from a lack of effective competition.

Implications for Firms

The range of the FCA's potential interventions will be wider than that of the former Financial Services Authority, with the most significant changes influencing the ways in which firms and consumers interact. Existing business models may face pressure from competition interventions, and firms that are highly reliant on potentially anticompetitive products or markets may be more affected, no matter how compliant those firms are with the letter of existing FCA conduct-of-business requirements. The proactive firm will benefit from asking:

- Is it active in markets with targeted anticompetitive market features, such as supplier market power or disincentives to switching?

- Which products are earning high rates of return that may attract regulatory attention, and to what extent are anticompetitive practices highlighted by the FCA's behavioural economics studies causing the high returns?

- Where is the company applying cross-subsidies across products? Is there a convincing argument that the overall outcome for customers is positive?

- Is the firm certain that marketing efforts clearly explain to customers what they are buying? Does the approach differentiate customers who might be perceived as vulnerable, or could it be accused of relying on consumer biases?

- Does the distribution method of a product affect customer outcomes in situations where the firm itself is not providing advice? How does responsibility for outcomes change depending on the type of product, whether it is sold through intermediaries, or aimed at vulnerable customers? What should a firm do if it concludes distribution methods are limiting the likelihood of good customer outcomes?

- How does a firm articulate its responsibilities for identifying and dealing with customers who are unlikely to achieve a good outcome from the product, either through change of circumstances or the product not performing as intended?

Firms who understand where the FCA is heading with its competition agenda, and prepare earlier for potential change, will have a significant advantage. In some cases, the FCA will look to better disclosure as a remedy, but it is likely also to utilise a wide range of other potential interventions — including sanctions — for breach of competition law. Firms can take important steps to avoid these circumstances by thinking through what behavioural economics mean for their operating models, with particular attention to product development and distribution.

Contact Promontory

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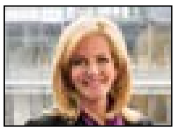

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