The Financial Inclusion Centre

Financial markets that work for society

FCA MISSION: OUR APPROACH TO COMPETITION

SUBMISSION BY THE FINANCAL INCLUSION CENTRE

INTRODUCTION

We are pleased to submit a response to this important paper. The reliance the FCA places on competition (rather than direct regulatory interventions) to make financial markets work will have a major impact on the financial welfare of consumers and real economy firms. Therefore, it is critical that the FCA has an open and full debate about the limits of competition and its approach to using competition to advance its statutory objectives.

Before we answer the specific questions, we would like to make some preliminary remarks.

How do we make markets work?

There are three forces[1] which determine how markets behave and how well markets produce the right outcomes for consumers, real economy firms and the rest of society:

- Effective public policy and regulation;
- Good governance, culture, ethical standards and integrity[2]; and
- Effective market forces.

The degree to which policymakers and regulators need to rely on each of those three forces to make markets work very much depends on:

- the importance of the product or service provided by the market[3];
- the extent of market failure, detriment/ harm evident in the market;
- how embedded the structural causes of market failure and detriment/ harm are and how likely improvement is without major policy and regulatory intervention; and
- the values set by society – for example, society may determine that certain groups of citizens are more vulnerable than others and are deserving of much higher levels of protection.

It is not possible to determine with precision, *ex ante,* the appropriate balance of interventions needed to make markets work. Making markets work is as much an art as a

[1] These are explained in more detail in the response to Q1 and in Annex I.
[2] These cultural factors can be determined by statutory or self-regulation.
[3] For example, pensions are more critical to the fundamental wellbeing of more consumers than pet insurance. Certain products, services or activities are critical to the functioning of the real economy.

science. But, we can use judgment, and draw on experience and evidence of what has and hasn't worked in the past in similar conditions.

It is taken as read that effective competition is a prerequisite for making markets work and should be a priority for the FCA. In key sectors, there has been the illusion of competition[4] and choice, while effective competition[5] has been absent.

There have been many attempts in the UK over the years to introduce the 'right sort' of competition into financial markets and services. But, the previous attempts which relied on demand side interventions and self-regulated governance standards have not been successful in dealing with market failures or consumer detriment in the main financial sectors (including retail banking, pensions, asset management, mortgages and consumer credit)[6].

Indeed, the continued experimentation with demand side interventions has actually been harmful for consumers – that is, more effective, direct regulatory interventions were forestalled as regulatory authorities kept on trying demand side interventions in face of the evidence.

Whereas, there are plenty of examples of robust policy and regulatory interventions having a major positive impact on markets. For example, the price cap and RU64 in the stakeholder pensions market, reform of the with-profits sector, the Retail Distribution Review, the Mortgage Market Review, the price cap and tougher conduct of business regulations in the payday lending market, have all radically transformed markets for the better.

More generally, the FCA's much tougher approach to conduct of business regulation has produced noticeable improvements in the culture and behaviours in much of the financial services industry – particularly towards vulnerable consumers (although there is clearly more to do, and we must guard against complacency given some of the emerging threats facing market participants and growth in fintech[7]).

Moreover, it is important to understand the sequence in which improvements in markets take place. Failure to ensure markets operate to consistently high standards of conduct means that firms that behave badly can take advantage of firms which try to behave in a consumer-centric way – a race to the bottom. In other words, good conduct is a prerequisite for real competition. But, we also know from experience that good conduct has not provided firms with a competitive advantage. Therefore, if we want to see real competition,

[4] In many sectors, the classic conditions for competition have been evident – numerous providers, a proliferation of products, low barriers to entry, a high degree of product development/ innovation, a great deal of competition activity, consumers provided with information etc – but competition has not produced the right outcomes.
[5] Competition that produces the right outcomes for consumers.
[6] To be fair, there are some exceptions – demand side interventions can work in simple, commoditised markets such as motor insurance.
[7] See our discussion paper 'Fintech – beware of geeks bearing gifts?' for an analysis of the major risks emerging as a result of the growth in fintech, open banking and big data http://inclusioncentre.co.uk/wordpress29/our-work/publications/fintech-beware-of-geeks-bearing-gifts .

tough regulation is needed to embed the right conduct and cultures across the market – only then is the platform created for effective competition to take place.

An overreliance on competition interventions

With this in mind, our main concern about the FCA's approach is that the regulator seems to now place too much emphasis on the potential for competition interventions (particularly demand side interventions) to fix harm and improve markets. It may be a misreading of the FCA's approach, but there seems to be a worrying 'dialing down' of the determination to use robust, effective regulatory interventions, and the emergence of a competition mindset.

The use of market studies is a particular concern. These can be very slow – in terms of the time taken from inception to actual interventions and changes in market behaviour taking place. Moreover, by their very nature, market studies:

- further inculcate a competition mindset in the regulator;
- rely on theories of harm derived from competition theory to explain market failure and detriment[8]; and
- lead the FCA towards interventions to *create the conditions*[9] for competition rather than robust, direct regulatory interventions proven to *make* markets work.

Indeed, we would conclude that the emergence of this competition mindset, and emphasis on competition and demand side interventions, is a retrograde step and could be threat to the effectiveness of the FCA.

It would be helpful if the FCA reassured consumer advocates that it is not relying on competition interventions to make markets work. In particular, we would urge the FCA to review its use of market studies as opposed to more direct regulatory interventions. We would also urge the FCA to take the lead on promoting a wider debate on how to make markets work, taking into account the full set of interventions available to the FCA, rather than just competition interventions.

We now turn to the specific questions.

[8] The attitude of proponents of this approach seems to be: 'competition hasn't worked up to now because we didn't have the right conditions for competition', or 'what we have had up to now hasn't been real competition and competition is sure to work given the right conditions'.

[9] For example, measures to tackle information asymmetries or increasingly nowadays the use of behavioural economics to try to encourage consumers to become more active.

RESPONSE TO SPECIFIC QUESTIONS

Q1. Do you have a clear understanding of the FCA's statutory remit, competition powers and aims in advancing its competition objective? If no, what more could we do to explain our competition remit and powers?

As mentioned, it is taken as read that effective competition is a prerequisite for making markets work. But, competition is one of the three 'forces' which determine how markets behave and, therefore, how well markets can meet the desired outcomes (this is explained in more detail in Annex I which sets out our theory of markets and theory of change for making markets work):

- **Effective public policy and regulation:** policy and regulation determine the framework within which markets and firms operate, the standards expected by society of markets and firms (by codifying what is expected of well-run firms), and the terms on which firms can provide products and services to consumers[10].
- **Good governance, culture, ethical standards and integrity:** these cultural factors (which can be determined by statutory or self-regulation) are intrinsic to the market and firms operating in the market, and along with effective regulation determine the prevailing market culture and attitude of firms and other market actors towards customers.
- **Effective market forces:** this includes *effective*[11] competition in the market between providers and in the supply chain, consumers exerting pressure on the market, shareholders disciplining behaviour of boards and senior management in firms, and public pressure and reputational constraints.

In answer to the specific question, we have a very clear understanding of the FCA's interpretation of its statutory remit, competition powers and aims. However, we are very concerned about the emphasis now placed by the FCA on competition interventions – particularly demand side interventions and market studies.

The FCA appears to be too focused on *creating the conditions* for competition and too reluctant to use more effective, proven regulatory interventions to *make* markets work such as product governance and product intervention powers.

[10] Remember, financial services are not like other consumer products and services. Financial services often meet core welfare needs (pensions, social security replacement products, funding of housing) rather than consumer preferences. The decision to use market solutions for these core welfare needs is often a political one. Similarly, retail banking and payments is a utility function. This means that society has a right to expect that financial markets operate to much higher standards. With other consumer sectors, society can afford the creative destruction and risks associated with competition – firm failure, product obsolescence, resources being wasted on 'innovation' etc. This creative destruction and these risks are worth it because the market ends up improving the welfare of consumers. In contrast, core financial markets have to be bounded by robust policy and regulation and guided to the right outcomes and market behaviours. Within this framework, effective competition can be promoted. We call this approach *managed markets* or *bounded competition*.

[11] It is very important to recognise the distinction between theoretical or text book competition (where the focus is on creating the *conditions for competition* such as ensuring multiple providers, low barriers to entry, tackling information asymmetries etc) and *effective* competition which produces the right outcomes for consumers and other stakeholders

The FCA may be running the risk of falling foul of a version of the *fallacy of composition* problem where, if the right *conditions* for competition are thought to be established, then the presumption is the market will deliver the desired outcomes.

A simple thought experiment illustrates why it can be more effective to deploy direct regulatory interventions rather than competition/ demand side interventions. Let us assume there are X million consumers adversely affected by a certain market practice eg. unfair overdraft or credit card charges. There are two main ways to address this detriment/ harm. The FCA can either:

i. use demand side interventions to try to get consumers to change their behaviours and/ or switch – and, in turn, exert influence on the firms' behaviours so that they stop harming the consumers affected; or
ii. directly intervene to cap charges.

We know from experience that previous attempts at using demand side interventions have not been very effective at changing consumer behaviour and, more importantly, changing *market* behaviour. The time and resource required to change the behaviours of sufficient numbers of consumers to then influence market behaviour in a meaningful way is prohibitive.

But, directly intervening to cap charges directly benefits those X million affected by the harmful practice. In other words, a direct regulatory intervention produces a much greater *return on intervention*.

Those who favour competition interventions argue that direct regulation such as price caps can have unintended consequences that harm consumers. This is a specious argument. If demand side interventions were as effective as direct regulation then the market would be affected in the same way and to the same extent – that is, the same consequences would be observed. But, of course, demand side interventions do not have the same consequences precisely because in many cases they are not as effective as direct regulation. The result is large numbers of consumers are left unprotected, unnecessarily, from the harmful market behaviour.

Moreover, what does not come through strongly enough in this paper is the important link between conduct of business and genuine competition. Failure to intervene using tough conduct of business regulation (to ensure the market generally is engaging in good conduct) means that firms that behave badly can take advantage of those who initially set out to treat consumers fairly. The result is that there is still competition in the market, but the effect of that competition is to drive down standards – a race to the bottom.

Indeed, it is difficult to find many examples of competition in critical financial markets that have been driven by good conduct – that is, good conduct being a point of differentiation

for firms and providing a competitive advantage. Competition tends to be for distribution rather than for the end user, or based on brand.

In summary, rather than hoping that the act of competition will lead to improved standards of conduct, the FCA should focus on first ensuring the market is operating to the highest possible standards of conduct. This should then provide the platform for real competition and innovation.

Q2. Are there other indicators of potential harm that we should consider in our preliminary assessments of competition?

We prefer to use an analytical approach based on *outcomes*. If markets are working for consumers, the following outcomes or conditions must be met[12]:

Access: consumers should have access to the market

Fairness: once in the market, consumers are treated fairly by firms that operate with integrity

Responsible behaviours: firms (and markets at the aggregate level) should behave responsibly and promote positive financial behaviours amongst consumers

Efficiency, value for money, and innovation: markets should be efficient, provide optimally priced, simple, easy-to-understand products and services, and truly innovative[13]

Meaningful choice: consumers should have *sufficient*[14] choice of suitable, socially useful products and services that meet their needs

Transparency: markets should be transparent and consumers are given the appropriate level of information to make effective decisions and choices

Safety and reliability: markets, firms and products and services should be safe, consumers can rely on contracts being honoured, and are protected from fraud and abuse

[12] These are based primarily on the established consumer principles which consumer experts use to judge how well markets are meeting consumers' needs

[13] Socially useful innovation improves the financial welfare of consumers. Much of what is termed 'innovative' in financial services does not meet that test. 'New' does not equal innovative. Much innovation in financial services are really just products that are variations on existing themes, existing products and services repackaged, or designed to deal with the risks created by a previous set of innovations. For example, on-line payday lending was considered by many to be innovative at the time. It clearly wasn't, if judged by the consumer welfare test. The same mistakes are being made with fintech/ big data. Structured investment products and 'dynamic' asset allocation strategies are considered to be innovative forms of managing investment risk. Yet they have failed to deliver and are usually more costly than simpler investment products/ strategies.

[14] An emphasis on choice *per se* is a distraction. Having multiple providers and plentiful choice of products does not guarantee effective outcomes. Too much choice can be as detrimental as too little choice. What matters is whether the market produces the right outcomes and consumers' needs are met.

Confidence and trust: the level of confidence and trust in markets and providers should be such that consumers are willing to engage with and use financial services

Consumer effectiveness: consumers should be able to make effective decisions and choices to meet their needs (for example, identifying the right product, building financial resilience and financial security), and exert pressure on the market

Redress and accountability: consumers should find it easy to get redress if things go wrong and/ or harm is caused, and firms and individuals are held to account

If a market does not produce the right outcomes then by definition harm or detriment is occurring. Therefore, we would suggest that, rather than look for indicators that might suggest that the conditions for competition are not there in a market, the FCA should measure whether these outcomes are being delivered. This allows the regulator to then understand the root causes of that market failure and, where relevant, identify the causes of specific harms.

The specific factors outlined on page 12 in the section *Identifying Potential Harm* are for the most part *input* measures (relating to the conditions for competition to work) with only one *outcome* measure included (price discrimination). There is no mention of the other outcomes which, if not being met by the market, indicate harm/ detriment is occurring.

In other words, the FCA uses an *input* model rather than an *outcomes* model. Even then, the factors listed on page 12 are a limited input list and appear to be based on conventional competition theory. We would doubt that relying on looking for those indicators would help the FCA determine whether a market is producing the right outcomes or understand the root causes of market failure.

Therefore, we would add the following input measures:

Oversupply: the FCA understandably includes market concentration – this is a classic competition theory indicator. Concentration, of course, can present a barrier to effective markets. But, it is also important to include oversupply, whether of suppliers or products. Oversupply can harm consumers just as much as concentration. Search costs and advice costs are higher, consumers find it more difficult to make effective decisions and choices, and additional costs are extracted from supply chains and so on. Competition theory holds that market forces should remedy this oversupply and drive down costs towards an equilibrium level. However, in the real world, we often don't see the type of competition that underpins competition theory. As explained below, embedded structural flaws and conduct of business problems means the act of competition cannot have the impact assumed in the theoretical models[15]. As a more general point, it is very important to recognise that the number of suppliers or degree of choice *per se* in a market is not the

[15] Remember, the reliance on competition theory held back much needed direct regulatory interventions in the payday lending market – at a huge cost to those consumers harmed.

issue. It may well be easier to ensure that a market produces the right outcomes for consumers if there are a limited number of well-run and well-regulated firms operating within a consumer-centric system.

Sales volumes/ aggressive competition: the FCA mentions excessive profitability. But, it has not included sales volumes. Considering the evidence from previous large scale misselling scandals, one of the main predictors of harm was a rapid growth in sales of the particular product involved. Firms found themselves having to compete fiercely to match the success of rivals. This is the 'follow the money' principle. In other words, the act of competition itself can create a harm[16].

Conflicts of interest/ incentives: linked to the above, the use of incentives in the supply chain can create conflicts of interest and block genuine competition. Distributors and intermediaries can end up selling products that benefit them rather than recommend products that represent genuine value for consumers.

Poor skills and competence: if intermediaries are poorly trained or poorly informed they can inadvertently recommend poor value, underperforming products and thereby maintain support for badly-run, inefficient firms. This distorts real competition (a prime example is the number of financial advisers who continue to recommend high cost, actively managed investment products).

Low barriers to entry: the FCA understandably mentions barriers to entry and growth. Conventional competition theory holds that barriers to entry should not be high to encourage more choice and competition – which, in theory, should then deliver the right outcomes for consumers. But, again, this condition cannot be assumed to hold across financial services. Low barriers to entry can harm consumer outcomes even when assessed from a narrow competition perspective. Low barriers to entry can lead to oversupply (see above). Low barriers to entry can allow firms operating to lower standards into the market which then causes established firms to respond by lowering their standards – the race to the bottom.

Poor conduct/ corporate cultures: linked to the above point, poor corporate cultures can distort competition. The FCA does not bring out the link between poor conduct and competition. Firms that care little about consumers will be willing to compete on terms that disadvantage consumer-centric firms. Remember, competition as a force is not very effective in key financial sectors - consumers do not reward firms who operate to higher standards. With the exception of a few simple, commoditised product sectors, financial services is a supply side driven market, not a demand led market.

Complex, fragmented supply chains: the FCA mentions integrated supply chains. This can be an issue. But, complex, fragmented supply chains with numerous intermediaries standing

[16] Of course, competition regulators would say that it wasn't the 'right sort' of competition.

between a provider and consumer can also cause harm. This can result in greater value extraction and higher costs. It can also make it more difficult for consumers to identify where fault lies and obtain redress (the growth in fintech/ Open Banking will exacerbate this problem).

Information overload: the FCA mentions lack of access to information. It is the case that consumers need a degree of appropriate information to make effective decisions and choices. But, too much information can also be harmful as it can deter consumers from making active choices and cause them to default to brands they know.

Confusion marketing/ exploitation of behavioural biases: confusion marketing and exploiting consumers' embedded behavioural biased can distort consumer decision making and choices and, therefore, genuine competition (again, the growth in fintech/ Open Banking will exacerbate this).

Q3. Are there other tools we could consider when designing remedy packages?

It is not so much a question of needing other tools, but the FCA's approach to making markets work and how effectively it is using the current set of tools it has its disposal.

Our main concern here is that the FCA relies too much on tools to try to create the conditions for competition (particularly by using demand side interventions including behavioural interventions). It seems reluctant to make greater use of its potentially very effective direct regulatory powers and tools to *make* markets work and prevent detriment/ harm. The best examples are product governance, product intervention powers, and price capping.

If the evidence of history is anything to go by, creating the conditions for competition is unlikely to be that effective. Markets such as financial services (which are supply side driven, complex, and where the cost of failure for consumers and society is very high) must be *made* to work. The FCA must not be afraid of intervening to i. constrain negative behaviours and ii. actively shape positive behaviours and outcomes.

This should extend to the FCA being bold enough to recognise that in key markets the problem is oversupply of products and providers, and be willing to target its interventions to reduce supply. The FCA should judge its effectiveness on whether its interventions cause the market to produce the right outcomes, not whether the conditions for competition exist.

As we explain above, the FCA does not seem to have explored fully the link between poor conduct/ corporate cultures and negative competition. Firms with a poor corporate culture are able to take advantage of firms that operate to higher standards. Therefore, when considering how to promote real competition, it is important that the FCA uses tougher

enforcement and sanctions to drive out bad practice. This is needed to clear the way for firms who want to compete fairly.

We have a specific point to make about the use of data as a remedy. We very much support the publishing of market-indicator data. But data has to be used in the right way. As we explain elsewhere, disclosing information to encourage more positive demand side behaviours on the part of consumers (and therefore, influence firm and market behaviours) has had limited impact previously. There is little to suggest that this will change in future.

However, data can be very effective when used by trusted intermediaries such as consumer advocates, and independent information providers and media. Rather than think of publishing data as a remedy in response to a problem identified during a market study, the FCA should publish comprehensive market data on all market sectors as a matter of course. This should include data on charges and fees, key product terms, measures of quality (eg claims data), and complaints at firm level. The FCA should also publish data on market share and sales volumes (see the point about following the money, above).

Q4. Has this document set out the FCA's approach to competition clearly? Are there other issues relating to our approach to competition that could benefit from further clarification?

Yes. As mentioned, the FCA has set out its approach to compettion clearly. To reiterate, our main concern relates to the emphasis the FCA places on compeition to make markets work (particualrly demand side interventions), and the utility of market studies. Experience shows that robust regulatory interventions are more effective at making markets work than demand side interventions.

This marks the end of our responses to the specific questions. As mentioned, Annex I explains in more detail our theory of change to set in context our responses to the questions.

Financial Inclusion Centre

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For any further information please contact: Mick.mcateer@inclusioncentre.org.uk

ANNEX I: MAKING FINANCIAL MARKETS WORK FOR CONSUMERS AND SOCIETY – FIC THEORY OF MARKETS AND THEORY OF CHANGE

Below, we set out our theory of markets and theory of change for making financial markets work including:

- What 'good' looks like in financial markets and services;
- What determines the experience of consumers in a market (the outcomes); and
- Which interventions are needed to produce the desired outcomes.

WHAT DOES 'GOOD' LOOK LIKE IN FINANCIAL MARKETS AND SERVICES?

We want to see financial markets and services that work for consumers, real economy firms and wider society. To be judged a success, there are three primary tests:

- Markets should produce financial products and services that meet the needs of consumers[17], fairly and efficiently;
- Market behaviours and practices should create positive financial behaviours amongst consumers, consumers should be able to make effective decisions and choices; and
- Markets should not create externalities or costs that are borne by other consumers or the rest of society[18].

But for that to happen, the following outcomes or conditions must be evident[19]:

Access: consumers should have access to the market

Fairness: once in the market, consumers should be treated fairly by firms that operate with integrity

Responsible behaviours: firms (and markets at the aggregate level) should behave responsibly and promote positive financial behaviours amongst consumers

[17] When we refer to 'consumer' we include micro-enterprises, SMEs, and institutional investors such as pension fund trustees. The historical distinction between retail consumers and these other categories is arbitrary and not helpful.
[18] Although not a direct consumer outcome, it is important not to ignore the risk of externalities (for example, poor lending standards creating housing bubbles, too-easy access to consumer credit creating barriers to saving, or low levels of confidence and trust deterring consumers from saving for a pension)
[19] These are based primarily on the established consumer principles which consumer experts use to judge how well markets are meeting consumers' needs

Efficiency, value for money, and innovation: markets should be efficient, provide optimally priced[20], simple, easy-to-understand products and services, and are truly innovative[21]

Meaningful choice: consumers should have a *sufficient*[22] choice of suitable, socially useful products and services that meet their needs

Transparency: markets should be transparent and consumers given the appropriate level of information to make effective decisions and choices

Safety and reliability: markets, firms and products and services should be safe, consumers can rely on contracts being honoured, and are protected from fraud and abuse

Confidence and trust: the level of confidence and trust in markets and providers should be such that consumers are willing to engage with and use financial services

Consumer effectiveness: consumers should be able to make effective decisions and choices to meet their needs (for example, identifying the right product, building financial resilience and financial security), and exert pressure on the market

Redress and accountability: consumers should find it easy to get redress if, and when, things go wrong and harm is caused, firms and individuals are held to account

WHAT DETERMINES THE OUTCOMES EXPERIENCED BY CONSUMERS?

In a market, the outcomes (good and bad) experienced by consumers (or groups of consumers) is a function of:

- Their income/ wealth;
- Their ability to function well in a market situation (level of empowerment, financial capability, confidence, ability to make choices and so on); and
- Market characteristics - this includes how truly efficient and innovative the market is, the structure of the market, the complexity of products and services, the existence of conflicts of interest, the behaviours and cultures of the firms and individuals, and

[20] This is a more complex issue than first appears. It is perfectly possible for all the firms in a market to be making a fair and reasonable profit when selling their products (that is they are not overcharging – on their terms) but for this to still ***not*** represent a good deal for consumers. How can this be? Well, a good example is provided by personal pensions. Firms selling personal pensions were not necessarily generating unacceptably high margins but there was no doubt that personal pensions were very poor value for consumers. This apparent contradiction was down to the structure of the market (high acquisition costs, intermediary incentives and so on) and fact that the individual personal pension model was inappropriate for the mass market (which is why we needed the collectively organised NEST). The same applied with payday lending.

[21] Socially useful innovation improves the financial welfare of consumers. Much of what is termed 'innovative' in financial services does not meet that test. 'New' does not equal innovative. Much 'innovation' in financial services are really just products that are variations on existing themes, existing products and services repackaged, or designed to deal with the risks created by a previous set of 'innovations'. For example, on-line payday lending was considered by many to be innovative at the time. It clearly wasn't if judged by the consumer welfare test. The same mistakes are being made with fintech/ big data (see Fintech – beware of geeks bearing gifts?). Structured investment products and 'dynamic' asset allocation strategies are considered to be innovative forms of managing investment risk. Yet they have failed to deliver and are usually more costly than simpler investment products/ strategies.

[22] An emphasis on choice *per se* is a distraction. Having multiple providers and plentiful choice of products does not guarantee effective outcomes. Too much choice can be as detrimental as too little choice. What matters is whether the market produces the right outcomes and consumers' needs are met.

the organising principle of the market (ie. is it organised according to principles of mutuality/ use of cross-subsidies or individualism/ discrimination?).

Markets are 'amoral' and allocate value according to economic power or influence, not needs or rights. So, for example, absent effective policy and regulation, a consumer:

- with a low disposable income,
- considered to be a high risk,
- with a low level of financial capability, and
- forced to buy a financial product in a complex, oversupplied market organised along individualistic principles,

is very likely to end up with a poor deal or be treated unfairly. Trying to encourage more competition is unlikely to be of much help to consumers in this position.

HOW DO WE MAKE MARKETS WORK, ENSURE THE RIGHT OUTCOMES HAPPEN?

Good policymaking and regulation is just systems analysis inside a values framework. That is, policymakers need to:

- be clear about what they want the system (financial markets and services) to achieve (the outcomes);
- understand how well financial markets and services are performing against those outcomes (measurement and evaluation to identify degree of market failure and consumer detriment/ harm);
- understand the root cause of market failure and detriment/ harm (structures, behaviours, market dynamics, quality of products, weak governance, conflicts of interest, basic fitness for purpose of market provision);
- identify and implement the most effective interventions (or set of interventions) to address market failures and detriment/ harm; and
- monitor (and supervise) markets to gauge the impact of interventions and how well markets are performing against those outcomes, report against outcomes.

The values framework determines the priorities for intervention (there are finite resources) and which groups of consumers deserve priority levels of protection or greater rights.

There are three 'forces' which determine how markets behave and, therefore, how well markets can meet the desired outcomes:

- **Effective public policy and regulation:** policy and regulation determine the framework within which markets and firms operate, the standards expected by society of markets and firms (by codifying what is expected of well-run firms), the terms on which firms can provide products and services to consumers.

- **Good governance, ethical standards and integrity:** these are intrinsic to the market and firms operating in the market (and can be determined by statutory and/ or self-regulation), and along with effective regulation determine the prevailing market culture and attitude of firms and other market actors towards customers.
- **Effective market forces:** this includes *effective*[23] competition in the market between providers and in the supply chain, consumers exerting pressure on the market, shareholders disciplining behaviour of boards and senior management in firms, and public pressure and reputational constraints.

The degree to which policymakers and regulators need to rely on each of those three forces to make markets work and produce the right outcomes very much depends on:

- how important the product or service provided by market is[24];
- the extent of market failure, detriment/ harm evident in the market;
- how embedded the structural causes of market failure and detriment/ harm are and how likely improvement is without major policy and regulatory intervention; and
- as mentioned, the values set by society – for example, society may determine that certain groups of citizens are more vulnerable than others and are deserving of much higher levels of protection.

Making markets work is as much an art as a science. It is not possible to determine with precision *ex ante* the appropriate balance of interventions needed to make markets work. But, we can draw on experience and evidence of what has and hasn't worked in the past in similar conditions.

We know from experience that relying on market forces (competition and demand side interventions), and self-regulated governance/ ethical standards, have not been very successful in dealing with market failures or consumer detriment in key sectors. There are some exceptions – demand side interventions can work in simple, commoditised markets such as motor insurance.

As mentioned, our main concern about the FCA's approach is that the regulator seems to now place too much emphasis on the potential for market forces (competition and demand side behaviours) to deal with harm and improve markets. It may be a misreading of the FCA's approach but there seems to be a worrying 'dialing down' of the use of robust, effective regulatory interventions and the emergence of a competition mindset.

[23] It is very important to recognise the distinction between theoretical or text book competition (where the focus is on creating the *conditions for competition* such as ensuring multiple providers, low barriers to entry, tackling information asymmetries etc) and *effective* competition which produces the right outcomes for consumers and other stakeholders

[24] This is based on how important the product, service or activity is. For example, pensions are more critical to the fundamental wellbeing of more consumers than pet insurance. Certain products, services or activities are critical to the functioning of the real economy.

The use of market studies is a particular concern. These can be very slow – in terms of the time taken from inception to actual interventions taking place. Moreover, by their very nature, market studies:

- further inculcate a competition mindset;
- rely on theories of harm derived from competition theory to explaining market failure and detriment[25]; and
- lead the FCA towards interventions to *create the conditions* for competition rather than robust direct regulatory interventions to *make* markets work.

Indeed, we think that the emergence of this competition mindset and emphasis on competition and demand side interventions is a retrograde step and is a threat to the effectiveness of the FCA.

[25] The attitude of proponents of this approach seems to be: 'competition hasn't worked up to now because we didn't have the right conditions for competition', or 'what we have had up to now hasn't been real competition and competition is sure to work given the right conditions'