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Can a leopard change its spots? 'Repurposing' UK conduct regulation

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Summary

- In many respects, the advent of the Financial Conduct Authority (FCA) is nothing new. Financial regulation has been reformed a number of times over the past quarter of a century. However, there are signs of a fresh approach to conduct regulation by the FCA.
- There has been change in the objectives of conduct regulation. The FCA has been given an overall strategic objective (to ensure that markets function well) and supplementary objectives – including the new 'promotion of effective competition in the interests of consumers'.
- The FCA is setting a lot of store in behavioural economics – in contrast to its predecessor, the Financial Services Authority (FSA). Such an approach suggests an organisation open to, and willing to embrace, change.
- Although there has been little immediate staff turnover between the FSA and FCA, the latter's recruitment priorities, including hiring competition economists and former practitioners, highlights another shift in regulatory direction.
- Despite being a 'new organisation', the reality is that the FCA remains a political football, as the FSA was before it – providing Ministers with protection when things go wrong.
- As the FCA tries to shake off the past and create its own, innovative path, it will need the help of firms. The industry should be prepared to put its best foot forward, ensuring that the good of the consumer is at the forefront of their mind.
- The jury is out on whether conduct risk regulation will change in the UK – but the initial noises coming out of the FCA regarding a different approach are positive. The question is whether politics and the industry will enable this to happen.

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CII Introduction: Much of the debate around the splitting of the old FSA into two had focused on the structural implications of regulation, but only know is the potential implications of the culture of regulation, particularly under the FCA as conduct regulator becoming clearer. Richard Hobbs runs his an expert eye over some of the new emergence themes – the new competition powers, the focus on behavioural economics, the challenge for firms to understand and engage with the new culture rather than merely don compliance helmets. Above all, can the regulators escape from their current vulnerable political position and risk a more adult relationship with its regulated community amidst the glare of public scrutiny over financial services?

"New Regulator for the New Millennium", "Journey to the FCA", slogans come and slogans go but the reality is that since 1988 we have seen a quarter of a century of apparent regulatory failure and four clear-cut attempts to reform the way we regulate financial services. The somewhat odd reality is that the crisis of 2008 was a relatively narrow failure of prudential regulation in the banking sector, primarily in the USA and the UK but with profound impacts in the EU and the Eurozone in particular.

Under the veneer of changing the prudential regulatory arrangements for banks George Osborne announced immediately after the 2010 general election the break-up of the FSA just as Gordon Brown had announced its creation immediately after the 1997 election. The break-up was not just aimed at the prudential failure but at reform of conduct regulation: a tacit admission that 25 years of conduct regulation had not been particularly successful.

Perhaps changing regulation is just fashionable. MPs have had their own travails to cope with; the expenses scandal required new rules and the media that uncovered it became quickly embroiled in the phone tapping scandal where Parliament and the media remain at loggerheads on what sort of regulation is appropriate. It was certainly a febrile environment into which to introduce a complex Financial Services Bill. However, banking and banking regulatory reform was quickly hived off into the Independent Commission on Banking and the subsequent Parliamentary Committee on Banking Standards. Banking reform and its regulation is unfinished business. The Financial Services Bill largely concentrated changing regulatory structures and on conduct risk. The Financial Conduct Authority is the finished article so far as we can see.

The ill this new body is trying to address is not widely acknowledged but by giving the new regulator different and more nuanced objectives Parliament appears to believe that regardless of whether the FSA was doing the job right, it has the view that it was not doing the right job. The sub-text of Parliament's consideration of the objectives appears to have been that whilst the regulator was focussed, some might say fixated, on the misdeeds of the industry it was ignoring the other consequences of consumers not engaging with the industry successfully.

Can re-purposing a regulator with new objectives change it?

It would be easy to dismiss the FCA's statutory objectives as being remote from day-to-day supervision of firms and a mere rearranging of the words on the page. The high command of the FCA certainly doesn't see it that way. The early indications are that they believe they must address market failure in a quite different way. Parliament has given them a number of grounds for that belief. The first of these is that their objectives have been recast to reflect an overall priority. FSMA gave the FSA four objectives all of apparently equal weight. Thus, protecting consumers was as important as maintaining confidence in the financial system, reducing financial crime and protecting and enhancing the UK financial system. There was little clue as to how the FSA might go about these abstract concepts.

The FCA's new single strategic objective is to ensure that markets function well (surely the key purpose of any economic regulation) but until now unstated. Beneath that strategic aim are the previous objectives of consumer protection and integrity of the financial system. But added to those is a new objective of promoting effective competition in the interests of consumers.

Section 6 of the Financial Services Act 2012 provides important clues about how the FCA should view its competition objective. It contains matters the FCA "may" have regard to in meeting the competition objective:

- The needs of different consumers who use or may use those services, including their need for information that enables them to make informed choices;
- The ease with which consumers who may wish to use those services, including consumers in areas affected by social or economic deprivation, can access them;
- The ease with which consumers who obtain those services can change the person from whom they obtain them;
- The ease with which new entrants can enter the market;
- How far competition is encouraging innovation.

No regulator has been asked to think about these matters before. Quite how it will think about social and economic deprivation, barriers to market entry and innovation is not yet clear but it will have to explain itself in due course before the Treasury Select Committee.

We might reasonably assume that behind closed doors FCA and Treasury officials are thinking quite hard about what these new legislative requirements mean. They were hard fought in Parliament, in part by members of the Treasury Select Committee, and Parliament will be looking for some return on its investment. The political dynamics are that the new regulator will have to demonstrate how it had addressed these factors or else have a compelling reason why it considered Parliament to be in the wrong in setting these tasks.

It would be a controversial outcome if the FCA paid these new objectives no more than lip service and the better view of it is surely that they will develop new ways of thinking about their responsibilities.

The attraction of behavioural economics

The earliest indication of new thinking at the FCA is its emphasis on behavioural economics. It is not a new science. A quick literature search will show (mainly US) research papers going back to the 1950s. They show the extent of apparently irrational behaviour in a world where public policy has been built up around a presumption of rational economic people operating in free and open markets. The FSA knew about behavioural economics and published occasional papers about it without ever drawing any conclusions from it which might be inconvenient for its core consumer protection strategies.

Experienced bureaucrats know how disruptive an inconvenient truth can be. For the FSA behavioural economics implied that years of reliance on strategies such as ever greater disclosure and transparency as an antidote to information asymmetries was so much barking up the wrong tree. So the FCA's willingness to embrace publicly a body of evidence not consonant with the policies and rules it inherited from the FSA suggests an organisation intent on changing its policy prescription in an open manner and not without reputational risk.

In practice, the lessons of behavioural economics go much wider than the FCA. Its implications for the DWP on pensions and welfare policies and the Treasury and Number 10 on public spending are profound. There is some evidence of that thinking permeating those policies. NEST has auto-enrolment, a classic behavioural economics prescription, and Number 10 likes to emphasise the utility of "nudge theory" across a variety of issues. But these are just the dipping of a toe. Any substantial recasting of policy by one agency to embrace the lessons of behavioural economics would expose the others and a breaking down of the Whitehall, Canary Wharf and Threadneedle Street silos is implicit even though some of them have just been set up. It would be interesting to know whether Whitehall is driving Canary Wharf on this agenda or vice versa.

People

A few years ago a global brand professional services firm produced a hard back book (how times change) entitled “Making Change Happen”. Its central aphorism was that to change, organisations had either to “change the people or change the people”. It went on to argue that if an organisation wanted to change quickly it needed to do more firing and hiring rather than redeveloping its people. The exact balance between the two would, of course, require consultants to do a project.

The FCA employed the same 3,000 people after 1 April 2013 as before so the organisation is not in a position to change on day one. In practice, even in a recession, the FSA experienced relatively high staff turnover so the opportunity to replace and renew is ever present. The regulator has always needed a multi-disciplinary approach to populating its ranks. But added to the ranks of lawyers, former civil servants and former practitioners are likely to be competition economists and psychologists. They will take time to hire and their influence will take time to show through as their effectiveness builds up. However, the FCA’s recruitment priorities are a further indication that regulation is heading in a new direction.

Political realities

The key question is whether the FCA can achieve escape velocity from the gravitational pull of its political reality. Jettisoning established policy prescriptions even if they are seen to have failed incurs reputational risk. Underpaid and angry politicians will not be slow to jump on any failure of the regulator when it attempts to innovate because that deflects criticism from them. When the FSA was set up in 1997 Ministers could not get rid quickly enough of their remaining responsibilities for financial services regulation to an arm’s length body. The FSA, and now the FCA, are carefully specified in statute as not acting on behalf of the Crown and their employees are not Crown servants. In effect they are Ministers’ heat shield when things go wrong as the abolition of the FSA so amply demonstrates.

The implication of this is that the FCA will always have one eye on its back. It is a political football exposed to facile criticism. If it embarks on a different sort of conversation with the industry – a more grown up one – it risks being accused of cosying up. For example, a council of elders approach could have forewarned the FSA of the PPI mis-selling scandal. The RDR, which took six years to complete might have used expert groups for more than just six weeks of those six years. The Practitioner Panel might be used in a more informal way. But all of these risk the cosying up accusation.

The FCA could also ask itself whether ever greater fines handed down to firms and individuals doesn’t destroy consumers’ confidence in financial services rather than raise it. They could also consider whether there is any parallel with the socialising of children where it might be thought that a diet of pure punishment without any reward could produce a troubled adolescent. But if the regulator attempted a new deal innovation it would be panned when the next scandal occurred. In a non-zero failure regime that should be allowed to happen but the febrile political climate is a significant risk.

Some commentators may argue that the dead hand of EU Law will increasingly strangle any UK attempt at innovation. It was a common FSA claim that their hands were tied by Europe. Inevitably there is some truth in the claim; just ask any insurer labouring under Solvency 2. But any examination of EU draft legislation will reveal the extent of UK influence upon it. Even after London’s apparent fall from grace following the 2008 crisis, its intellectual input to the EU remains largely undiminished so the argument about the EU effect is rather circular. New thinking in London will soon be new thinking in other capitals on many occasions. Moreover, even fleeting visits to other Member States will reveal substantial variation in implementation of single market laws and just how incomplete the suite of harmonising measures is. There is plenty of wriggle room for distinctive UK policy innovation.

What should firms do?

This is no time for donning steel helmets. A new regulator trying to achieve escape velocity needs all the help it can get. Educating politicians, journalists and regulators is not easy against the backdrop created by the banking industry and the regulator. But it is a time for investing in engagement not giving up or lying low. If the regulator is prepared to run risks from innovating, so should the industry.

It would help greatly if all of the industry put its best foot forward. The culture of firms needs to be one of being farmers rather than hunters. Whether they are large or small, firms need to think about the life time value of customers rather than where the next sale is coming from. Ethics need to be lived every day rather than documented and filed away safely. Professional standards need to be achieved and lived every day rather than hanging a certificate on a wall or adding more letters to a business card. Above all they should ask the question whether what they propose to do is good for them or good for their customer.

Conclusion

Inevitably, the jury must be out on the question whether conduct risk regulation will change materially in the UK. But a regulator intent on not changing would not make many of the statements of this new one. Whether it will be allowed to change depends critically on two factors: whether its attempts to change are not sunk by political headwinds and whether the industry can help it sufficiently by resisting short-term economic gain.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk, or by telephone: +44 (0)20 7417 4783.

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Learning Objectives

Having read this Thinkpiece, readers will be able to:

- To identify the compnonets of the FCA's competition objective, and consider what it might mean in practice.
- To understand the increasing role that behavioural economics is playing in financial regulation in the UK.
- To consider the political climate that the FCA finds itself operating in and the impact this might have on its ability to achieve its objectives.

Reflective Questions

1. One of the FCA's new objectives concerns "promoting effective competition in the interests of consumers". What you think the regulator's approach will be to this? Do you believe it will be a priority? What possible outcomes do you envisage over the shorter and longer term?

2. Given the political nature behind the creation of the FCA, and the potential for Westminster and Treasury involvement in the future, do you believe that the FCA will be able to achieve its objectives as a regulator? And do you see these changing over time?

3. The author considers the role that firms play in the reformed regulatory landscape and suggests that the industry should "*put its best foot forward*". How do you think this can be achieved? Do you believe this already happening, and if so, in what way?

4. As well as changing its culture, the FCA has been vocal in changing the way in which firms behave and operate – consider the implications this has for you and your firm. What changes might you need to make and how would you evidence this if the FCA were to ask?