Improving decision-making in financial regulation

Peter Andrews
Head of Research and Economic Analysis
Financial Services Authority

Overview

- How might decision-making go wrong?
- What evidence is there for this?
- A somewhat behavioural perspective (Behavioural Economics may be the new black but…)
- What improvements could be made?
- All views here strictly personal/technical – not the views or position of the FCA

How might decision-making go wrong?

- Psychological/behavioural biases of politicians and regulators
- Perverse effects of legislation
- Political economy (rational public choice)
- Hard choices at the knowledge frontier (e.g. behavioural economics)
- A profession without a curriculum?
- I will look briefly at the evidence for each area in turn

Psychological/behavioural biases

- Interesting overview by Hirshleifer in European Financial Management, 2008, 856-874: Psychological Bias as a Driver of Financial Regulation
- Sets out ‘psychological attraction approach to regulation’
- Shows how beliefs about regulation exploit biases to attract support for irrational approaches

Psychological/behavioural errors: examples from Hirshleifer

- Salience/vividness: WorldCom + lost pension pots → Sarbox (= 'Dangerous Dogs Act')
- Charity norm → Usury law → poor cannot borrow
- Loss salience → VAR (on which see Haldane's new paper 'The Dog and the Frisbee': http://www.bankofengland.co.uk/publications/Pages/news/2012/075.aspx

and Danielsson et al: Model Risk of Systemic Risk Models - http://www.riskresearch.org/files/sysrisk-paper-models.pdf)

Psychological/behavioural errors: one more example from Hirshleifer

- Overconfidence helps explain excessive activism in regulatory strategies
- Overconfident policy analysts may not see how markets have already addressed failures and may be too sure of their own remedies
- This drives the great length of financial rule-books (e.g. European Directives)?

Effects of faulty legislation

- Recent legislation possibly longer than is ideal - see Haldane op cit and my short paper for Oxera: http://www.oxera.com/Oxera/media/Oxera/downloads/Agenda/Financial-regulation-protecting-consumers.pdf?ext=.pdf
- Detailed points on FSMA 2000:
  - No proper CBA requirement (consequence: e.g. welfare ignored - no incentive hence no resources to address it)
  - No proper competition obligation (consequence: price ignored)
  - Hence no clear power to get price/cost data (so consumers often buy ?needlessly expensive products e.g. crypto-trackers)
  - No clear power to require participation in RCTs or protection from differential treatment of consumers (benefits predicted and errors not detected until after the fact e.g. the Menu)
- Some of this also applicable to FS Bill 2012, although it <u>is</u> an improvement: see my paper above

Political economy

- Rational public choice, meaning the well-known ideas in: "**A Theory of Competition among Pressure Groups for Political Influence**." Gary S. Becker; *Quarterly Journal of Economics*, 1983, *98*(3), pp. 371-400. http://links.jstor.org/sici?sici=0033-5533%28198308%2998%3A3%3C371%3AATOCAP%3E2.0.CO%3B2-I
  Applied here in financial services: Randall S. Kroszner & Thomas Stratmann, 1998. "**Interest Group Competition and the Organization of Congress: Theory and Evidence from Financial Services' Political Action Committees**," CRSP working papers 349
- Not posed as an alternative to regulators' behavioural errors (Hirshleifer above)
- Both can be true
- Example: more than one possible cause of hostility by firms' representatives to welfare analysis in financial regulation

Hard choices (Behavioural Economics)

- Insights from behavioural economics raise serious issues in demand side modelling: clearly foolish to ignore
- Widespread consumer ‘errors’ in financial markets e.g. regarding credence services
- Which errors are systematic enough to model? And where do we rely on experiments?
- What is stated preference or stated well-being in the presence of errors?
- Can we infer true preferences and thus whether regulation is welfare-enhancing?
- Some suggestions on identifying true – normative – preferences in Beshears et al: How are preferences revealed? http://www.nber.org/papers/w13976

A profession without a curriculum?

- Financial regulators have very diverse backgrounds and views
- The great majority rightly not economists, despite economics giving the ?only rationale/ design for welfare-enhancing regulation
- Do conflicting views on regulation matter?
- FSA's Guide to Market Failure addresses only two (information asymmetry and externality) of the four failures listed in the OFT's 'What does behavioural economics mean for competition policy?'
- The others (market power and behavioural errors) are mentioned but not pursued as they were considered by many not to be a true part of financial regulation: http://www.fsa.gov.uk/pubs/other/mfa_guide.pdf
- Thus, for example, interactions between in-scope and out-of-scope failures cannot be explored in the Guide
- This may matter: for example, Handel, B (2011), 'Adverse selection and switching costs in health insurance markets: when nudging hurts' NBER 17459, which shows that the welfare impacts of <u>information</u> in the context of a retail financial market affected by inattentiveness and adverse selection depend on the price response

Possible improvements

- Legislation more attuned to regulators' incentives
- Common curriculum for financial regulators?
- Cutting edge research on knowledge gaps
- Wider range of tools (experiments, possibly neurological work as per Green Book)
- Taking proper account of Behavioural Economics as an overlay/complement to much existing financial regulation
- Use of insights from new FSA/FCA Occasional Paper: What does behavioural economics mean for regulation of conduct in retail financial markets? (in draft)
- Which is based on Della Vigna's classification of biases and our 'Behavioural drivers in retail financial markets'

Possible improvements – integrated analysis

- Refers to the need to look at the OFT's four market failures in the round and consider their interaction