fowlerdrew

FCA Call for Input:
The Consumer Investments Market

December 2020

About Fowler Drew

Our experience developing a business format with disruptive potential colours our perspective on public policy in the area of taxation, pensions, regulation and investing. Applying these insights, we have responded to past consultations by the Treasury and the FCA. This Call for Input particularly interests us but we have decided to keep our remarks general and high-level, in the belief that what is most required to reset the course of public policy is an overarching intelligence, not detailed prescriptions.

Where do our insights come from? We are a quantitative firm applying the same stochastic modelling to both planning individual goals and managing goal-based portfolios with quantified, date-specific outcomes. Client involvement in collaborative planning is via web tools that interact with the engine. Iterative feedback, with game-playing characteristics, is used to design the best possible plan. A high degree of quantification contrasts with traditional abstract methods of describing objectives and risk tolerance. (A test drive of the planning tool is on the home page of our website.) The portfolio management process is as systematic as we can make it, to obtain the available benefits of objectivity, consistency and low costs. Via the same interfaces, management becomes a continuous process of replanning the goal, as a response to either changes in the client's situation or the progress of the investments. With the emphasis on value at the strategic level, dynamic asset allocations are implemented using low-cost trackers spread across the world's equity markets and regions. Risk is controlled by 'portfolio separation' (equities plus cash/ILGs) rather than multi-asset class diversification. Thus high levels of customisation are achieved using a narrow range of essential building blocks.

As a small firm we have focused on attracting high-end clients (AUM £300m is split between just 70 clients). However, the initial concept and modelling was developed for a mass-affluent offering and the methods are scalable. They are also adaptable to different formats: face-to-face; remote but adviser-guided; remote and fully digital. Clearly, the more digital, the more disruptive, as it can effectively replace the advice role. The dynamics of a goal-based portfolio with defined outcomes and defined dates can also be delivered within a product, further disintermediating the adviser.

The questions

Yes: the FCA is asking the right questions. We have numbered them and grouped them thematically for easier reference when commenting:

1 What more can we do to help the market offer a range of products and services that meet straightforward investment needs?
2 What more can we do to facilitate effective competition and encourage firms to develop innovative products and services which help consumers to invest?
3 How can we better ensure that those who have the financial resources to accept higher investment risk can do so if they choose, but in a way that ensures they understand the risk they are taking?
4 How can we make it easier for people to understand the risks of investment and the level of regulatory protection afforded to them when they invest?

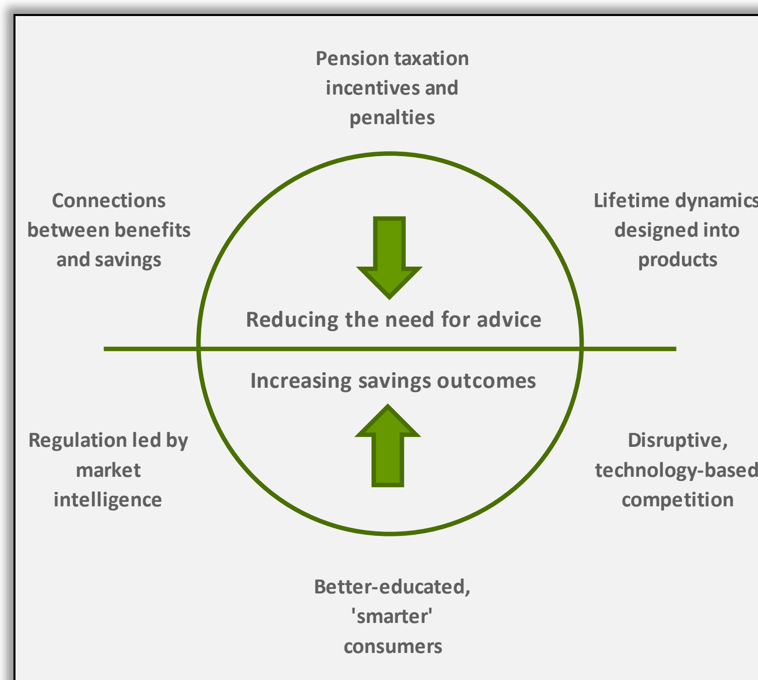
5 How can people be better protected from scams?
6 What more can we do to ensure that when people lose money because of an act or omission of a regulated firm, they are appropriately compensated and that it is paid for fairly by those who cause the loss?

All but Q6, which is more to do with institutional frameworks, are questions that would not be so prominent or topical if consumers were 'smarter'. We don't think that means having a better grasp of technical aspects of investing. 'Smarter' describes being more savvy and more engaged. To the extent it involves any underpin of technical knowledge, it mainly refers to a higher level of general numeracy and a specific awareness of statistics and probability – but not beyond the level a game player needs. In the context of behavioural science, smarter thinking should be thought of as countering common cognitive errors with better reasoning. We are where we are primarily because of a general weakness processing problems using reasoning with numbers. We might also note that having smarter consumers would benefit society in many areas other than investment or personal finance generally.

That weakness has two effects. First, it leaves consumers vulnerable to exploitation by people with an advantage of superior reasoning, either in capital markets (wherever the rules of a zero-sum gain apply) or when dealing with well-informed firms, whether they be agents or principals. Questions 3, 4 and 5 call to be asked because of this vulnerability. Second, it minimises the consumer discernment that good agents and providers rely on if their attempts to deal with the first problem, as envisaged by questions 1 and 2, are to be rewarded with market share. Disruptors need to be valued.

Public policy

In the diagram below we have placed smarter consumers as the central policy objective of one of a two-pronged attack on market deficiencies: reducing the need for intermediation by agents and increasing the 'net product' of their savings.



The policy initiatives that central government, rather than the FCA, has to address involve removing the complexity and penalties for mistakes that generate a need for advice even for smart consumers. A simpler, flatter tax code with few or no allowances would make the single most important contribution. This has to include the complexity of pension legislation, something that has cumulated over many years of tinkering.

The third factor contributing to a reduction in the need for advice is relevant to the FCA but overlaps with the Pensions Regulator: product design that builds in some of the life-stage decision making, following preferences determined at the outcome or at a necessary planning stage. A simple example has been target-date funds or 'lifestyle funds'. However, these dealt with a glide path culminating in a planned annuity purchase. Future consumption-supporting funds will need to integrate the delivery of cash flows as a risk-consistent draw strategy. The Government has seen the appeal of this and has therefore supported the initiative of Collective Defined Contribution plans. Many of the same principles apply to individual DC drawdown, such that capital does not retire when its owner does but keeps working, subject to constraints. It is worth noting that these are product developments that require sophisticated modelling as well as good product regulation. In a holistic accumulation and decumulation plan, a planned drawdown is not restricted to pension accounts.

The two other initiatives in the bottom half of our diagram, increasing the product of investment, with or without advice, are central to the FCA's policy making: regulations that rely on market intelligence and changes to the regulatory framework where it impedes disruption.

Market intelligence

We know we are not alone in feeling frustrated that almost every scandal that breaks in financial services was identified as a problem very early by other professionals, whereas the FCA seems to be the last to know. How can that be? We don't have an answer but assume it is a matter of culture.

A specific example, combining both a good initiative and bad timing, was the clever jet-ski ad. To those of us paying the bill for scams, we thought 'brilliant'. But we also wondered 'why so long coming'. Why not spend more of the FCA budget on preventative education instead of enforcement after the act?

Rule changes to foster disruption

a) Informed self-selection

Rules require that personal advice includes a suitable recommendation. This dates from the first Financial Service Act and is mirrored in EU law. The alternative that this rule negates is well-informed self-selection, where the information is made personal. The impacts of the rule are to diminish the consumer's agency, discourage personal responsibility (and therefore engagement) and create dependency on advisers as proxy decision-makers.

In one area there is already a form of self-selection: the options in a DC plan. Arguably, defaults will tend to water down the engagement being sought but it is still a striking difference in the assumption about how decisions are made and it applies to many more individuals than invest in ISAs and unwrapped accounts. Why this difference? Advice or direct-sale models should be able to include decision logic leading to designated investments without a recommendation, as long as the requirements for unbiased and complete information are met and the logic is defensible. This alternative is readily deliverable digitally, which we know from online regulated business formats which end up 'validating' a rational selection by treating it as the recommendation, but with the extra risk-based cost of it being advised rather than self-selection.

b) Interaction with engines

Direct consumer interaction with financial 'engines', ie sophisticated customisable calculators, offers a number of possibilities for encouraging greater consumer agency:

- Using probabilities (or the language of odds) to make it easier to differentiate between options and to help make better trade-offs, enabling consumers to reveal directly, rather than by inference, their 'true' preferences, notably including risk tolerance

- Forcing internal consistency between the different parameters involved in an investment goal (such as resources required, risk approach, time horizons and projected outcomes) that will ensure the information is realistic and accurately frames expectations
- Requiring any biases against the best interests of the consumer to be designed into the logic itself where it is easier to identify and prevent it
- Shifting the focus from growth rates and general measures of risk, which individuals struggle to relate to, to outcomes relevant to their objective, such as £x of spending in year y
- Creating an audit trail for the logic that led to the decision.

There have been two notable contexts where traditional suitability approaches (even where prescribed in some detail by the FSA/FCA) have failed in their purpose, both involving specified outcomes with significant impacts of falling short: mortgage endowment policies and DB transfers. Both were failures of design rather than simply application.

Regulation prevents the use of specific (personal) projection engines in the context of a retail investment product sale if it would cut across the rule requiring FCA-prescribed investment rates to be used. It is about 20 years since the FSA consulted on the use of stochastic models, which are the main alternative to deterministic rates as presribed by the FCA. Its conclusion in principle was to prevent effective competition between 'models' by requiring the mean of the stochastic distribution to be no greater than the appropriate FCA rate. This completely defeats the purpose of stochastics to model more accurately. The FCA will have to bite this bullet if it wants to improve the reliability and appropriateness of the quantitative information consumers are allowed to see, unless the context is generic and unregulated and therefore less useful.

Interaction with financial engines is the best way to inform self-selection so is the likely basis of disruptive business models that either disintermediate the advice role or perform it at much lower cost. A particular interpretation of the perimeter rules, that this is both personal and takes on the character of 'evaluation', prevents this as a non-advised route unless separated from any retail investment product as its end point. What constitutes evaluation is not clear but as interpreted by the FCA the perimeter guidance is perverse.

An attempt to clarify the guidance has been made recently as a consequence of the large number (vast majority?) of DB pension transfer cases where advisers' internal calculations were relied on to identify prima facie cases where a transfer might, simply on investment outcomes, be in the member's best interests. Surely it should not be surprising or bad that this quantitative triage led to a high proportion of actual recommendations being to transfer. The same calculation (the chance and size of any shortfall in income and the potential upside, both dependent on a particular risk approach and assumed matching draw to a given possible longevity) would be best practice if performed as an exercise in financial planning or risk-tolerance discovery. Restricting access to the same calculations, even when an adviser wants to perform them as triage, is clearly open to question. DB transfers may look like an extreme case to use as an illustration of the principle but is a relevant one if, for example, the same sort of tool (to the standard we are envisaging) had been available to members of BSPS and would have prevented a lot of panicked and ill-advised decisions.

c) Excluding the wealthy

We believe the FCA should consider bringing back a test of financial competence and economic capacity that could be used to restrict the sale of particular high-risk products. We further suggest access to the FSCS should be withdrawn for the eligible investors, so product risk is effectively trumped by risk from exposure to the sponsor.

Initiatives to help consumers act smarter

d) Too little or too much trust?

It is not easy for regulators conditioned to trying to foster trust in their regulated industry to go with the message that consumers are too trusting for their own good. But the FCA needs to. There are just too many myths that keep 'expertise' on an imaginary pedestal and are in fact forms of exploited information advantage.

In the late 90's the FSA was perfectly happy backing a counter-intuitive and controversial position where it was sure the facts supported it. Examples were its proposal to ban the publication of past performance in promotions and its well-publicised attacks on active management. It is hard to imagine today's FCA going that far. But where it is sure of its ground, why not? The old FSA seemed to have deeper analytical skills that equipped it to do this. Or maybe it's less the depth as understanding of the explanatory theories that sit above the detail. To take a case in point, the FCA regularly interprets pricing in the advice market as evidence of a market failure. This turns on its head the FSA's more telling insight that lack of price competition and clustering were precisely what you should expect to see in a market for credence goods where buyers were focusing on expectations of future investment performance. If there is a failure it is the dominance of performance expectations as the driver of competition. So address that, not pricing itself.

e) Value for money
This is one area the FCA is focusing on that we think could be fruitful as a platform for educating consumers to think smarter. That would certainly address the irrationality of 'paying to play' in a zero-sum performance game. The FCA should also promote the benefits of financial planning at key life stages. We agree with the FCA's recent argument that many customers of the industry do not need ongoing services. This is so even without the innovation, referred to above, of products that integrate some of the dynamics that ongoing services aim to address.

Like many of our ideas, this has a side benefit of encouraging a marketing reward for disruptors. The main agents of change will be competitive innovators. It would be a total failure of regulation if lack of imagination makes the perfect the enemy of the good, hence the radical changes in the advice definitions we propose. It is time to make the rules fit the real world and real consumer intuitions, instead of trying to impose artificial constructs that are confusing and counter-productive. We all need the humility to admit that this well-intentioned endeavour has not produced significant benefits in terms of either materially higher standards where access is economically possible or improving access where it wasn't.