



# **COSTS OF COMPLIANCE**

**A Report by Europe Economics**

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**June 2003**



## TABLE OF CONTENTS

|   |               |
|---|---------------|
| <b>SUMMARY AND CONCLUSIONS .....</b>  | <b>I</b>      |
| Objectives .....  | i             |
| Identifying Incremental Compliance Costs .....  | i             |
| Sample Selection .....  | ii            |
| The Range within which Firms Believe that their Incremental Compliance Costs<br>Generally Lie .....             | iii           |
| Changes since N2 in Incremental Compliance Costs .....  | v             |
| How Firms Can Reduce Incremental Compliance Costs: Compliance Arrangements .....                                | vii           |
| How Firms Can Reduce Incremental Compliance Costs: Business Approach .....                                      | viii          |
| <br><b>1 INTRODUCTION.....</b>  | <br><b>1</b>  |
| <br><b>2 CONTEXT .....</b>  | <br><b>2</b>  |
| 2.1 The Costs of Complying with Regulation.....   | 2             |
| 2.2 Financial Services Markets and the Rationale for Regulation.....  | 4             |
| 2.3 The FSA and N2.....   | 8             |
| 2.4 The FSA and Changes in the Cost of Compliance: Recent Surveys.....  | 9             |
| <br><b>3 SURVEY METHODOLOGY AND SAMPLE .....</b>  | <br><b>13</b> |
| 3.1 Sources of Evidence.....  | 13            |
| 3.2 Specification of Questions .....  | 13            |
| 3.3 Sample.....   | 17            |
| <br><b>4 INCREMENTAL COSTS OF FSA REGULATION: SURVEY<br/>EVIDENCE .....</b>                                     | <br><b>21</b> |
| 4.1 Incremental Compliance Costs .....  | 21            |
| 4.2 Incremental Compliance Costs by Firm Size .....   | 22            |
| 4.3 Incremental Compliance Costs by Whether the Firm is Subject to Overseas<br>Regulation .....                 | 22            |
| 4.4 Incremental Compliance Costs by Activity Grouping .....   | 23            |
| 4.5 Elements of Incremental Cost .....  | 24            |
| 4.6 Prudential Regulation and Firms' Balance Sheets.....  | 26            |
| 4.7 FSA Regulation and Market Behaviour.....  | 28            |
| 4.8 Summary .....   | 29            |
| <br><b>5 CHANGES IN INCREMENTAL COST OF COMPLYING WITH FSA<br/>REGULATION: SURVEY EVIDENCE .....</b>            | <br><b>31</b> |
| 5.1 Market Drivers of Changes in Incremental Costs of Compliance .....  | 31            |
| 5.2 Regulatory Changes: One-off Impacts of Changes in FSA Regulation .....                                      | 33            |
| 5.3 Regulatory Changes: Impact of Changes in FSA Regulation on Continuing<br>Incremental Compliance Costs ..... | 34            |
| 5.4 Regulatory Drivers of Change in Incremental Compliance Costs .....  | 37            |
| 5.5 Summary .....   | 41            |



|  |  |           |
|--|--|-----------|
| <b>6</b>   | <b>HOW FIRMS CAN REDUCE THEIR COSTS OF COMPLIANCE.....</b>   | <b>43</b> |
| <b>6.1</b>   | <b>Compliance Quality, Compliance Arrangements, Business Approaches, and Incremental Costs .....</b> | <b>43</b> |
| <b>6.2</b>   | <b>How Effective are “Cost-reducing” Compliance Arrangements at Reducing Costs?.....</b>             | <b>43</b> |
| <b>6.3</b>   | <b>Would Changing Business Approach Reduce a Firm’s Compliance Costs? .....</b>                      | <b>50</b> |
| <b>6.4</b>   | <b>Summary of Section .....</b>  | <b>55</b> |
| <b>APPENDIX 1: FSA PRINCIPLES FOR BUSINESSES.....</b>                                    |  | <b>56</b> |
| <b>APPENDIX 2: ADDITIONAL TABLES.....</b>  |  | <b>57</b> |
| <b>APPENDIX 3: THE FSA’S SUPERVISORY RELATIONSHIP WITH FIRMS.....</b>                    |  | <b>60</b> |
| <b>APPENDIX 4: HOW TO REDUCE COMPLIANCE COSTS — FURTHER IDEAS OFFERED BY FIRMS .....</b> |  | <b>62</b> |



## SUMMARY AND CONCLUSIONS

### Objectives

Europe Economics, an independent economics consultancy, was commissioned by the FSA to assess:

- the range within which firms believe that their incremental compliance costs generally lie;
- how those costs have changed since N2;
- the specific causes of those changes;
- the relationship between the levels of compliance costs and the quality of compliance; and
- the lessons arising for regulated firms on how they might reduce compliance costs.

This report sets out the methodology and findings of the study, which was conducted in a period of three months from January to April 2003.

### Identifying Incremental Compliance Costs

Regulation obliges firms to do various things — monitoring, keeping certain kinds of records, having certain kinds of procedures, etc. When asked about the costs of complying with regulation it is natural to consider these costs. However, simply taking the sum of such costs would not capture properly the costs of compliance, for three main reasons:

- 1 **Firms may adjust their businesses in many indirect ways in response to regulation.** Costs arising include profits foregone on products never launched, markets never entered, and re-structuring of the company in response to regulation.
- 2 **Firms would do many of the things that regulation obliges them to do, even in the absence of regulation.** For example, many firms would monitor sales staff even in the absence of regulation, if only to calculate their commissions. The *nature* and *degree* of monitoring might be different in the absence of regulation, but the *fact* of monitoring is not, typically, the result of regulation. The self-selected intensity of monitoring might be higher or lower than the regulator-imposed intensity.
- 3 **Firms might have to do additional things in the absence of regulation.** For example, being FSA regulated gives firms a “badge” they may be able to use to reassure customers of the quality of their internal procedures. In the absence of regulation firms might have to engage in *additional* expenditure on quality systems or brand positioning advertising to sustain the same portfolio of products, or to hold additional capital.

For this exercise, it is necessary to compare the current position with a counterfactual position describing what would have happened in the absence of FSA regulation. The path financial



services markets would have taken in the absence of regulation is of course inherently unobservable.

It should be noted that this study was set up to measure only the compliance costs borne by firms remaining in the market after the changes in regulation to be studied. Furthermore, it does not seek to measure effects on consumers or the costs incurred by the FSA. It was however, designed to distinguish between the costs firms face from regulation of the financial services sector implemented by the FSA and costs arising from general UK legislation or from participation in industry codes of conduct.

A number of published reports have suggested significant market failures in certain financial services markets. It is not the purpose of this study to try to reach definitive conclusions, or to undertake new analysis, of how far different financial services markets operated in a competitive manner. Evidence about suggested market failures was, however, taken into account in assessing the findings on incremental compliance costs in different kinds of markets and the relationship between incremental compliance costs and other spending related to quality.

The FSA's objectives and principles mean that the priorities of the FSA will not always be aligned with those of financial services firms. The FSA can be expected to try to require firms to behave differently from the way they would behave in the absence of regulation, and to generate incremental compliance costs in doing so. These costs might be expected to be greatest where the FSA judges that consumers need to be protected; there are systemic risks and externalities that are not taken account of by firms in their balance sheet or other risk management; or the risk of financial crime is greatest.

## **Sample Selection**

Central to the study was the collection of data from regulated firms. It was agreed from the outset that the study should not aim to produce estimates of the total incremental compliance costs faced by the entire population of regulated firms. This agreement allowed the sample selection process to focus on other priorities. The FSA wished the firms in the sample to cover the whole range of regulated firms and selected the firms to approach on that basis. For example, the sample included large and smaller firms within each category of business activity.

Ultimately, 60 regulated firms were interviewed between 12 February and 14 March 2003. Fifty-two of those firms returned partially or wholly completed questionnaires used for the statistical analysis reported below. Firms that agreed to take part in the survey were assured that their responses would be treated with strict confidentiality.

Returns were grouped into six categories: banking and credit; managed investments (both fund management and managing CISs); retail (sales, advice, and broking); insurance and pensions; capital market operations; and exchanges, counterparties and others.

Many of the questions in the questionnaire (reproduced as an Annex to this Report) were known to have been different from any firms would have faced before, and asked for breakdowns or for comparison against alternative states of the world. Such information could not be extracted from standard financial reporting information, and required judgements on how the firm would have



behaved in the absence of sectoral regulation. Firms were asked to provide answers they thought were *roughly right* — there was no intention to audit the answers, and in many places there would be no document that a firm's answers could be audited against. Face-to-face interviews where questions and responses could be clarified were used to minimise the risk of misunderstanding or errors, as were consistency checks on each firm's responses.

Some firms interviewed were branches or subsidiaries of overseas firms. Where this was so, the relationship was noted, and the incremental effect of FSA regulation *given* overseas regulation explored through the questionnaire and discussion.

## **The Range within which Firms Believe that their Incremental Compliance Costs Generally Lie**

When assessing the costs of policy it is important to define a baseline (a “counterfactual”) against which to make comparisons. This counterfactual is normally the situation that would be expected to pertain had the regulation not been implemented. Firms were first asked to estimate the total of all the costs they currently incurred related to risk management and client confidence, and then asked how those would change if there were no FSA rules or oversight. The questions relating to the incremental cost of complying with FSA regulation asked firms to consider the following counterfactual:

“Suppose that there were no FSA rules or oversight, and that you and your current competitors in your main markets competed for custom subject only to the general legal framework common to all UK firms. Please assume you would **continue to trade in your current portfolio of products.**”

Firms were then asked to consider how the total costs they faced of risk management and of maintaining client confidence would differ from their current levels under this scenario: the change provided a measure of the incremental costs of compliance.

Incremental costs as defined in the report therefore rely on the particular counterfactual used. The counterfactual is based on a partial equilibrium concept i.e. allowing only a partial market adjustment to the change in the regulatory framework. Markets would change if there were no FSA rules and oversight, and the mix of products and nature of competition may well be different, but firms were specifically asked to assume the mix of products was held constant in answering questions.

All but two of the 42 firms that returned usable responses on this point indicated some increased cost arising from FSA regulation. Half estimated that incremental compliance costs of FSA regulation added between 0 and 2 per cent to operating costs, with 14 reporting values between 2 and 10 per cent and 5 indicating values between 10 and 20 per cent. **The sample median of incremental compliance costs was of 1.6 per cent of non-regulatory operating costs.**

(Note that the denominator used in summarising these findings is the operating costs firms think they would have incurred without FSA regulation (“non-regulatory operating costs”), so that the measure shows the additional costs due to regulation as a proportion of what costs would have



been without the regulation. This gives ratios slightly higher than dividing by operating costs. As incremental compliance costs diminish relative to total operating costs, the two ratios converge.)

The sample means and medians reported in the study are presented as summary statistics of the wide range of individual observations offered by firms in the sample. It would not be valid to try to scale them up to whole populations of firms, or, at the other extreme, to use them as the basis for predicting the values for particular firms.

Larger firms reported smaller proportional values for incremental compliance cost, as did firms whose behaviour was also materially influenced by overseas regulators. After allowing for the influences of size and of overseas regulatory impact, firms engaged in retail sales and advice and in capital market operations still typically reported higher incremental costs than firms in the other categories.

More than half of the firms in the sample indicated that expenditure on risk monitoring would be reduced in the absence of FSA oversight, suggesting that the FSA's objectives to maintain market confidence, prevent financial crime, and protect consumers may lead the FSA to be more averse to certain risks in respect of firms than the firms themselves are.

A significant proportion of firms indicated they would reduce their level of training in the absence of FSA oversight, while only a small number would reduce the level of expenditure on brand and reputation-building.

A minority of firms indicated they would reduce the level of capital held: the proportion doing so was broadly similar across the different kinds of regulated financial services firms included in the sample. Whether or not firms needed to hold additional capital for regulatory purposes had a major impact on their estimated incremental compliance costs. For firms that indicated they would hold less capital in the absence of FSA regulation, the median ratio of incremental compliance cost to non-regulatory operating costs was 2.6 per cent. For firms that indicated they would hold the same or more capital in the absence of FSA regulation, the median ratio of incremental compliance cost to non-regulatory operating costs was 0.8 per cent.

This does not mean that the difference is the cost of holding additional capital, but is consistent with the answers given to another question in showing that for the minority of firms that held more capital because of regulatory requirements, the cost of holding that additional capital was typically the most important element of incremental compliance costs.

Where firms have included in their estimate of incremental costs the costs of additional capital holdings but have not included the costs of holding capital in their reported operating costs, there will an upward bias to the measured ratio for those firms.

These findings should not be interpreted as showing that firms considered they would reduce quality if FSA oversight were withdrawn. Only a small minority of firms regarded FSA regulation as the key constraint preventing firms in their market reducing service quality. Most regarded customer expectations as the key constraint, followed by competitor response. Of course, the notion of service quality used by firms may not be closely correlated with the notion of quality used by the FSA (assessed partly in terms of suitability), a point explored further below.



## Changes Since N2 in Incremental Compliance Costs

Firms were asked to compare their incremental compliance costs in the reporting year ending in 2002 with the incremental costs of compliance in the financial year ending in 1998. The initial period corresponds broadly to the period before the FSA's programme of change. Costs from this period are compared to those for the most recent period for which cost data were available.

These costs would include those resulting from all regulatory change implemented by the FSA, not just of that over which it had discretion. During this period the FSA was required to introduce changes as a result of the Financial Services and Markets Act 2000 and the EU Financial Services Action Plan.

Most firms thought that the effect of drivers other than regulatory change on the costs of maintaining risk management and client confidence had been neutral or had led to a small increase. This included comments by several wholesale firms that clients expected more sophisticated risk management techniques to be applied. Most firms considered that the net effect of these market changes on the incremental costs of compliance with financial services regulation as it was in 1998 would have been zero or of a small increase.

From firms that provided estimates for one-off costs from regulatory change over 1998-2002, the median for their main one-off costs (a lower bound for their total one-off costs) was 0.8 per cent of their operating costs over the period. Most of these costs were incurred towards the end of the period, in 2001 and 2002 i.e. around the period of the FSA assuming its full powers (N2). N2 preparation was the most commonly cited driver of one-off costs, cited by 30 firms.

It was reported above that firms' median estimate of their incremental compliance costs was of an addition to their operating costs of around 1.6 per cent. Most firms interviewed considered that changes in FSA regulation since 1998 had increased the continuing annual incremental compliance costs they faced. The median increase was of 0.5 per cent of a firm's non-regulatory operating costs.

Firms in the managed investments and banking and credit categories typically considered they faced more limited increases in compliance costs than firms in the other categories — the median increases are smaller for these groups. The largest increases in annual incremental costs as a proportion of operating costs were in the retail and capital market operations categories.

If firms mis-classified one-off costs as continuing, the reported estimate of increase in continuing incremental compliance costs would be an overestimate (and the reported estimate of one-off costs an underestimate). For example, many firms cited aspects of the process of regulatory change as a driver both of one-off costs and of continuing increases in incremental compliance costs. If the increase in regulatory change associated with FSMA and FSAP is viewed as a transitional period of exceptional regulatory change rather than as a permanent increase in the level of change, then some of these costs might better have been categorised as one-off costs. It is not possible to measure the effects of different boundaries between one-off and continuing costs other than those used by firms in answering the questions.





Any change in regulation can be expected to increase incremental compliance costs until firms have adjusted their portfolios and behaviour to be optimal given the new regulation. The long-term increase in annual incremental compliance costs from a given episode of regulatory change would therefore be expected to be lower than the short-term increase.

Changes to the regulation on money laundering were seen as having had an important impact on businesses' cost of compliance: 21 firms perceived this as having had a significant impact on their compliance costs. Interview discussions showed that these additional costs were mainly driven by close FSA monitoring of the 1993 Money Laundering Regulations since the FSA became responsible for monitoring compliance with these Regulations rather than by the new rules imposed by the FSA. Previous regulators did not have this responsibility.

Thirteen firms, mainly in the retail sales and advice, and insurance and pension firms categories, identified the new regime on approved persons as having led to higher incremental compliance costs. Many of the compliance officers interviewed volunteered that this regime has led directors and senior managers to attach higher importance to regulatory compliance.

Close to a third of the respondents believed a change in the quality of advice and of supervision received was a significant factor driving up their compliance costs. Within this broad heading, firms offered various more specific views on how the quality of FSA advice and supervision had contributed to their incremental compliance costs having risen. Some firms considered that their having had relatively inexperienced supervisory staff, and a high rate of supervisor turnover, had increased their costs, although other firms considered that the quality of supervision had improved compared to their previous regulator.

A recurring theme of firms interviewed was that the individual guidance regime was not working well, so that in their view it was not possible to obtain individual guidance on carefully considered requests in a reasonable timeframe. Some firms believed their business had been adversely affected by the inability to obtain such advice when it was necessary. Such firms were not always familiar with the procedures for giving individual guidance set out by the FSA, with some wrongly believing that giving such advice had been prohibited. It may be that this effect perceived by firms partly reflects procedures developed by the FSA to ensure the cost-effectiveness of its supervisory regime.

It may be that what is being picked up here is partly the effect of the FSA's risk-based approach to supervision, which means less frequent visits or monitoring for many firms not assessed as high risk (something which should reduce both firms' and the FSA's costs), but which may also increase uncertainty about regulatory behaviour.

As a general point, it should be noted that firms may be subject to some self-deception in their views of the enforcement of some general legislation (e.g. on money laundering), or on complaints and redress. There may be a natural tendency to blame the FSA because the FSA happens to be the responsible regulator at the time of enforcement ("shoot the messenger"), when in fact even in the absence of a financial regulator (and ombudsman) the courts may order that firms pay redress — in some cases this might be at considerably greater cost (e.g. for legal fees) than firms may bear in the presence of a regulator. It is also possible, however, that firms



may under-estimate their incremental compliance costs from other sources, such as the knock-on effects on their businesses from regulation.

Lastly, we note that only two of the 45 firms that answered these questions identified changes in FSA fees as having had an important impact on their incremental compliance costs.

## **How Firms Can Reduce Incremental Compliance Costs: Compliance Arrangements**

Analysis of the relationship between aspects of firms' organisation, their assessed compliance quality and their incremental compliance costs led to a number of conclusions, some surprising and some less so. Firms can do better or worse at complying with FSA regulation and there is evidence from the study that certain approaches to compliance can help firms keep down their incremental compliance costs.

At a broad level the exercise showed the advantages of *keeping it simple*. Prominence and profile are not necessarily the same thing as compliance efficiency. Efficient compliance arrangements help to ensure that compliance resources are not deflected from carrying out the traditional core tasks of the compliance function. The most cost-efficient priorities for the compliance function seem to be implementing regulatory change and monitoring, and risk-based monitoring seems to increase compliance-efficiency. Heavily occupying the compliance function with other duties is not efficient. More detailed points included:

1. Open and proactive contact with FSA supervisors may reduce compliance costs and increase compliance quality. Firm supervisors will better be able to offer guidance and give feedback on whether processes meet the regulations or need changing if they understand a firm's business and if the firm works with them rather than against them. However, the FSA's risk-based approach to monitoring will have reduced the regularity of contact with supervisors for many smaller firms: this finding suggests that this reduction may be generating costs to firms as well as benefits.
2. The most cost-efficient priorities for the compliance function are monitoring compliance and, possibly, implementing regulatory change. Heavily occupying the compliance function with other duties is not efficient. Compliance may need some involvement in other activities, but is most efficient if a balance is struck such that the core compliance tasks have the principal focus.
3. Using risk-based monitoring may be compliance-efficient, in that it helps focus effort and keep down costs.
4. The compliance function will be more compliance-efficient if it is accountable to well-defined individual(s), rather than simply to the board as a whole. And the efficient procedure appears to be the compliance function to be accountable to a defined member of senior management (though this should not be interpreted as suggesting that senior management attempt to micro-manage the compliance function).



5. Compliance may be more efficient when operating in close conjunction with a legal function, rather than being integrated with risk or other functions. It is possible that facilitating the transfer of legal expertise on compliance issues may be relatively efficient (though this should not be interpreted as implying that it is most efficient for compliance staff to be formally trained lawyers).
6. When responding to compliance failures, it is most cost-effective to ensure that resolution of an issue is brought to completion, that appropriate changes to procedures etc. are actually implemented, and follow-up monitoring is conducted.

The study did not find that any of the following made any significant difference to compliance efficiency: the proportion of staff in compliance; the integration of the compliance and risk functions within one overall department; the head of compliance having a seat on the Board; or the use of external lawyers or compliance consultants. .

## **How Firms Can Reduce Incremental Compliance Costs: Business Approach**

If all firms operated in the same business environment, and if expenditure on quality were realised in practice in higher quality outputs, then a measure of firms' quality-related expenditure would be a good proxy for product quality. Of course, different kinds of firm operate in different categories of business, and the evidence from published studies summarised in the report suggests that different financial services markets may operate differently, with some quite far removed from economists' standard models of competitive markets.

A measure of expenditure on quality was constructed from the amount firms reported they spend on risk management and client confidence, *after* deducting from those totals the incremental costs incurred as a result of regulation. This notion of risk management and client confidence should in principle be broad enough to encompass the firm's monitoring of its financial position as well as investment in the quality of the products supplied, two useful dimensions in assessing the quality of a firm's products.

Except in the category "Exchanges, counterparties and others", the firms that reported the highest expenditure on risk management and client confidence also reported greater incremental compliance costs than other firms in relation to their size.

One interpretation is that much of this expenditure is on differentiation that does not relate to any index of objective quality as measured by the regulator. If so, this would suggest that incremental compliance costs could be reduced — perhaps significantly — if firms did not attempt to differentiate their products as being of higher quality unless this differentiation could be shown to the regulator to be based on objective criteria.



# 1 INTRODUCTION

Statements relating to the compliance cost the Financial Services Authority (FSA) imposes on firms it regulates, and to how these have changed since the FSA assumed its full powers, are frequently reported in the Press. However, measurement is difficult, and there are no publicly available data collected on a consistent basis to evaluate these statements.

The FSA commissioned Europe Economics to assess:

- the range within which firms believe that their incremental compliance costs generally lie;
- how those costs have changed since N2;
- the specific causes of those changes;
- the relationship between the levels of compliance costs and the quality of compliance; and
- the lessons arising for regulated firms on how they might reduce compliance costs.

Europe Economics is an independent economics consultancy specialising in the application of microeconomic analysis and industrial organisation theory to economic regulation, competition policy, and business and policy decisions. Europe Economics is grateful for assistance and advice throughout this study from Marilyn Bassett, an experienced financial services compliance officer engaged as a consultant by the FSA.

This report sets out the methodology and findings of the study, which was conducted in a period of three months from January to April 2003.

The remainder of this report is organised as follows:

- Section 2 explains further the context for the study and some initial hypotheses;
- Section 3 describes the methodology and sample of the survey;
- Section 4 discusses the survey findings related to firms' incremental costs of compliance;
- Section 5 reports the survey findings related to the change in those costs and the regulatory and non-regulatory drivers of change; and
- Section 6 sets out the conclusions relating to how firms might reduce their compliance costs.

The letter and questionnaire sent to firms in advance of the survey interviews are reproduced in the Annex.



## 2 CONTEXT

### 2.1 The Costs of Complying with Regulation

Regulation obliges firms to do various things — monitoring, keeping certain kinds of records, having certain kinds of procedures, etc. When asked about the costs of complying with regulation it is natural to consider these costs. However, simply taking the sum of such costs would not capture properly the costs of complying with regulation, for three main reasons:

1. **Firms may adjust their businesses in many indirect ways in response to regulation.** Costs arising include profits foregone on products never launched, markets never entered, and re-structuring of the company in response to regulation.
2. **Firms would do many of the things that regulation obliges them to do, even in the absence of regulation.** For example, firms would monitor sales staff even in the absence of regulation, if only to calculate their commissions. The *nature* and *degree* of monitoring might be different in the absence of regulation (for example, the self-selected intensity of monitoring might be higher or lower than the regulator-imposed intensity), but the *fact* of monitoring is not, typically, the result of regulation. .
3. **Firms might have to do additional things in the absence of regulation.** For example, being FSA regulated gives firms a “badge” they may be able to use to reassure customers of the quality of their internal procedures. In the absence of regulation firms might have to engage in *additional* expenditure on quality systems or brand positioning advertising to sustain the same portfolio of products. Another example is that in the absence of financial regulation capital markets may require firms to hold additional capital.

The notion of incremental compliance costs is set out in Alfon and Andrews (1999) as follows:<sup>1</sup>

“Compliance costs are the costs to firms and individuals of those activities required by regulators that would not have been undertaken in the absence of regulation. Thus the term ‘compliance costs’ as used here refers to the incremental costs of compliance caused by regulation, not to the total cost of activities that happen to contribute to regulatory compliance. Examples of compliance costs include the costs of any additional systems, training, management time and capital required by the regulator.”

As Alfon and Andrews explain, a crucial requirement in estimating incremental compliance costs is forming a judgement about how the world would look in the absence of regulation — what firms would do, how the market would evolve, and so on.

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<sup>1</sup> Alfon, I., and Andrews, P., 1999, “Cost-benefit analysis in financial regulation — how to do it and how it adds value”, *FSA Occasional Paper Series 3*.



“One of the features of incremental compliance costs is that they depend on views about the activities that would be undertaken in the absence of regulation. Changes made on the introduction of regulations are not necessarily a wholly reliable guide to this because regulated firms often use the opportunity provided by a consultation on regulatory proposals to review procedures in broad business areas. Moreover, even for an individual regulatory measure, it is unlikely that only a single view about its incremental impacts would exist because many firms, competing in service characteristics, may be affected in different ways by the measure.”

Thus when assessing the costs of policy it is important to define a baseline (a “counterfactual”) against which to make comparisons. This counterfactual is normally the situation that would be expected to pertain had the regulation not been implemented. The challenge it presents is that the path financial services markets would have taken in the absence of regulation is inherently unobservable.

It should also be noted at this point that this study was set up to measure only the compliance costs borne by firms remaining in the market after the changes in regulation to be studied. Furthermore, it does not seek to measure effects on consumers or the costs incurred by the FSA. It was, however, designed to distinguish between the costs firms face from FSA regulation and costs arising from general UK legislation or from participation in industry codes of conduct.

‘Efficiency’ in compliance is an important issue. Compliance costs will depend on the extent to which businesses comply with regulatory requirements in the most cost-effective manner. It is sometimes questioned whether compliance costs should be measured on the basis of what businesses actually do, given prevailing market forces and imperfect information, or on the basis of the most efficient method of complying, whether any businesses apply this or not? This question is not trivial. Compliance costs will reflect the previous investment decisions of businesses in the market. Relatively inefficient suppliers, perhaps due to lower levels of investment in management systems, will tend to have higher compliance costs than suppliers that have more advanced systems. Such companies may be about to exit the market, but their costs of compliance are real nonetheless.

Where a market is not competitive, there may be productive inefficiency, and firms may incur higher compliance costs than would be strictly necessary. While it may be desirable to capture the ‘true’ or ‘minimal’ incremental costs of compliance for a standard firm in the marketplace that can be regarded as ‘efficient’, this will typically be hard to measure. This study tries to identify the costs that firms have actually incurred as a result of regulation. Section 6 then examines how firms might comply more efficiently.



## 2.2 Financial Services Markets and the Rationale for Regulation

### 2.2.1 Market failures in financial services markets

Despite the drawbacks of regulating any industry<sup>2</sup> there is extensive regulation of financial services markets in the EU and elsewhere. This is because it is considered that the benefits of regulation outweigh the costs. That is mainly because there is considered to be the potential for significant market failures in unregulated financial markets.

Potential areas of market failure commonly analysed in financial markets include:

- The problem that firms may know more about the value of their products than consumers. Firms (or their salesmen) may have incentives to exploit their informational advantages to the detriment of consumers. Markets may have mechanisms to address these problems. However, market punishment mechanisms are not always effective, and even where they are may operate over a sufficiently long-run timescale that failures can arise. For example, in the long-term companies that do not exploit their customers may gain a good reputation. But a company that already has a good reputation may exploit that reputation in the short-term, and while in the long-term that will lead to its losing its reputation, in the short-term its customers may suffer.
- Many financial products are highly complex, and their value cannot easily be observed by consumers. This gives rise to problems of the value of information — one cannot, by definition, know precisely how much information is worth until one knows what it is. This may mean that proper markets for information are difficult to sustain. Hence instead of direct information consumers may rely on the reputation of a financial firm, in general, for the quality of its products. However, some financial service products are experienced only once (e.g. pensions), sometimes long after purchase (and even then consumers may rely on experts to tell them how much products are worth — such products are known as “credence” goods). Hence reputational disciplining mechanisms may be weak.
- The managers of depositing institutions face limited liability (even bankruptcy is a limited form of punishment). Therefore they have incentives to engage in risky activities that might return high rewards but also might lead to large losses — or alternatively to engage in many different very risky activities, each of which has only a relatively small chance of success. This means that such managers need monitoring by those whose money they invest. However, many depositors are small (in fact a major function of banks is to collect relatively small deposits to use for relatively larger loans) so each depositor faces incentives to free-ride on the monitoring of other depositors. Hence markets may under-

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<sup>2</sup> Regulation of any industry generates direct and indirect costs of compliance. It also creates risks of:

- Regulatory capture and rent seeking: companies or other vested interested may seek to capture the regulatory process and use it to obtain advantage over rivals with less privileged access.
- Undermining of market punishments (which may be more credible and effective than the regulation).





monitor banks to the detriment of some depositors. Hence it is argued that there is a need for private or public “representatives” of depositors. This necessitates regulation.<sup>3</sup>

- Externalities: failure by one firm might harm not only its depositors, but also other firms by affecting the confidence of investors more widely. For example, because banks operate on the basis of fractional reserves, bank runs can sometimes cause the failure of even the soundest banks.<sup>4</sup> Mis-selling also generates externalities: the fact that mis-selling occurs at one firm — or a group of firms — can lead to a lack of consumer confidence in the market as a whole.

Some of these potential market failures have motivated financial regulation for many years. (For example, significant financial regulation was introduced in the US following widespread banking failures in the early 1930s, and frequent bank runs during the nineteenth century.<sup>5</sup>) There have also been several recent studies widely interpreted as suggesting significant market failures in several key areas of financial services:

The Cruickshank Report (2000) on Competition in UK Banking Report found:

1. The market for money transmission systems lacked competition largely due to network effects. The report said that this resulted in persistent inefficiencies, and the systems were run in the interests of those that control them rather than the public interest. Sustained intervention was the report’s recommendation for resolving this issue.
2. The market for supplying banking services to personal consumers although still not perfect was showing encouraging signs of increased competition and new entry. In this area the market itself was working towards a solution and would require very limited intervention.
3. In the market for supplying banking services to SMEs there were significant problems found to be preventing competition. The report commented that effective competition was not possible on its own because of, “the concentrated market structures that have resulted from successive mergers, combined with high barriers to entry and expansion”. The report recommended a one-off structural solution for this problem.

The Myners review (2001) of institutional investment found a number of “distortions to effective decision-making”. These included:

1. pension fund trustees relying heavily on a narrow group of investment consulting firms for advice, whose performance is not usually assessed or measured;
2. fund managers being set objectives which gave them incentives to herd, such as “peer group” benchmarks, directly incentivising funds to copy other funds, and risk controls for

<sup>3</sup> This is the famous Dewatripont and Tirole “representation hypothesis”. See Dewatripont, M. and Tirole, J. *The prudential regulation of banks*.

<sup>4</sup> For example, during the US bank runs 1930-32, the Bank of the United States failed, but paid over 92 cents in the dollar to its creditors.

<sup>5</sup> Prior to the bank runs of 1930-32, there had been major runs on US banks in 1819, 1837, 1857, 1873, 1884, 1893, and 1907.





- active managers being set such that there was little choice but to cling closely to stock market indices, making meaningful active management near-impossible;
3. vagueness about the timescales over which fund managers' performance is to be judged creating incentives for short-termism;
  4. fund managers being reluctant to intervene in companies where they own substantial shareholdings, even where this would be in the interests of their clients;
  5. broking commission being subject to insufficient scrutiny; and
  6. competition in the life insurance industry, though intense, tending not to focus directly on investment performance.

The Sandler Review (2002) of the retail savings industry made several important comments about competition within the industry. Key features of the retail savings industry identified by the review included:

- “there are very large numbers of almost identical products. These products are typically complex and opaque;
- price and performance are generally hard to compare and in many cases are not even identifiable at all. There are wide ranges in the prices of identical products; and
- there are persistent concerns about the effects of commission-driven selling.”

The natural interpretation of the Sandler findings is that consumers find it difficult to assess both investment performance and price, making the rewards to an adviser for providing superior advice quite limited. The report concluded that advisers were better placed than consumers to assess the price-performance trade-off, “but they have only weak incentives to seek out keenly priced products, since their clients will tend not to value the fact that they are doing so.” This may possibly give providers little incentive to compete strongly on price. The Review found that in its place, competition in distribution “tends to focus on maximising sales to higher-income consumers, with products that can be differentiated by their tax benefits or because of minor additional features”. This may result in only limited incentives for providers to make their products simpler or to improve efficiency. In such a market, an increase in compliance costs may not carry through into higher prices.

The FSA's own published research also found significant price dispersion in the market-place for retail products, with the greatest potential monetary losses facing individuals being on long term products such as pensions and endowments.<sup>6</sup> This study also found that price differences between providers tended to persist over time, which may be an indicator of weak competition.

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<sup>6</sup> “Losing interest: How much can consumers save by shopping around for financial products?” by Cook, Earley, Ketteringham and Smith (2002)



It is not the purpose of this study to undertake new analysis or to try to reach definitive conclusions on how far different financial services markets operate in a competitive manner. This evidence is summarised here to provide a basis for framing hypotheses about what might determine incremental compliance costs in different kinds of markets.

The picture emerging from these studies is one in which financial markets differ in important ways. Capital markets involve many highly informed agents, often operating in a highly competitive and transparent environment that is usually considered to approximate closely to perfect competition. Retail investment, by contrast, is thought to involve many relatively ill-informed consumers, facing firms and sales staff with incentives not well aligned with those of consumers, depending on expert opinion to work out the value of products even after they have been experienced (but unwilling to pay enough for such information). Between these two extremes, the market for fund management may have information asymmetry problems, but perhaps not as severe as those for retail savings products.

### 2.2.2 Objective quality versus perceived quality

Notions of quality, as well as of price, are central to competition. One relevant notion of *product* quality is of *vertical differentiation*. Economists define products as “vertically differentiated” when at the same price all customers would prefer one over the other. Another notion of quality is *horizontal differentiation*. Economists define products as “horizontally differentiated” when at the same price some customers would prefer one over the other, but other customers would prefer the other over the first. Crudely, products are vertically differentiated when some are simply *better* than others, and horizontally differentiated when some are simply *different* from others.

If some products are better than others, one might expect that to be reflected in objectively measurable aspects of the product — e.g. its risk-return profile, or the level of customer service. Where products simply differ, however, it may be that some are less suitable for particular customers than others, but firms may have incentives to advertise or otherwise portray themselves so as to attract customers to these less suitable products. For example, this might be the case if financial services products are *credence goods*, in which the customer is unable to distinguish product quality (expected returns, suitability of risk profile) in advance and relies on indications of company quality such as the familiarity of its brand. In such a case, consumers may be willing to pay more for products of firms with more reputational spend (i.e. products with a higher *perceived* quality), but these products may not be of higher quality in terms of a *regulatory* notion of quality, with an emphasis on suitability.

This seems most likely where customers have no way of finding out even in the longer term about product quality. Where there is some quality discovery mechanism — i.e. financial service products are to some extent experience goods rather than credence goods — repeat purchases and reputational effects from word of mouth can be expected to provide some incentive to maintain product quality, depending on the incremental cost of quality. Indeed, one plausible justification for financial services regulation would be altering this trade-off for firms so that the costs of not providing quality become higher, through incremental compliance costs and the risk of enforcement action publicising low suitability to customers.



A possible measure of firm quality is of the level of risk management and reputation-building activity undertaken by a firm, which it may be possible to measure directly. If the kinds of expenditures firms engage in to manage risks and build reputation are measures that also help satisfy the regulator's requirements (in terms of some objectively measurable quality increases), or that create stronger incentives within the firm to maintain quality, then firms that engage in more such activity may have lower incremental compliance costs (i.e. that "higher quality" firms will have *lower* incremental compliance costs).

On the other hand, in a world of credence goods reputation-building activity may not be correlated with any objective measure of product quality. The less the degree to which consumers are able to assess product quality, the more likely that the regulator's incremental compliance cost imposed will instead be *inversely* correlated with measures of spending on reputation building or with other measures of vertical differentiation (i.e. that "higher quality" firms will have *higher* incremental compliance costs). As will be seen in Section 6, for most categories of financial services firms this latter state is precisely what the study found.

## 2.3 The FSA and N2

The FSA oversees and enforces UK financial regulation, including that derived from the EU Financial Services Action Plan implemented in the UK by regulatory order.

Under its governing legislation, the FSA has four key objectives:

- market confidence: maintaining confidence in the financial system;
- public awareness: promoting public understanding of the financial system;
- consumer protection: securing the appropriate degree of protection for consumers; and
- reduction of financial crime: reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime.

The FSA was, in corporate and legal terms, the Securities and Investments Board (SIB) renamed. The Bank of England Act (1998) transferred from the Bank to the FSA responsibility for supervising banks, listed money market institutions and related clearing houses (as defined in section 43 of the Financial Services Act 1986, Part 1). The date the FSA acquired its new powers to supervise banks (1 June 1998) was referred to as 'N1'.

The Financial Services and Markets Act 2000 (FSMA) created a new statutory regime under which the FSA acquired the regulatory and registration functions previously exercised by the Self-Regulating Organisations (SROs) — the Investment Management Regulatory Organisation (IMRO), the Personal Investment Authority (PIA) the Securities and Futures Authority (SFA)), the DTI Insurance Directorate, the Building Societies Commission, the Friendly Societies Commission, and the Registry of Friendly Societies — as well as the SIB. The date the FSA acquired its full range of powers under the FSMA to regulate this wider constituency (1 December 2001) is referred to as 'N2'.



The FSA began to develop its approach and programme of regulation in 1998. Changes since then have included:

- consolidating several regulatory and supervisory regimes into one FSA regime;
- changes in supervision arrangements, and the development of a risk-based approach to regulation (the term regulation here covers rules, guidance, evidential provisions, and the practice of regulation. Appendix 3 sets out the FSA's new approach to its supervisory relationship);
- tighter regulatory requirements for senior management arrangements and systems and controls;
- the FSA adopting a new role in regulating the prevention of money laundering;
- introducing provisions on market abuse and of the Code of Market Conduct;
- introducing the approved-persons regime, and the concept of controlled functions;
- consolidating existing conduct of business rules and developing new rules; and
- extending prudential rules to different kinds of business.

Firms will at any one point be incurring costs in anticipation of future expected regulatory changes. Current examples of future expected changes that may be affecting behaviour now include the ending of polarisation; the extension of statutory regulation to mortgage and general insurance business; and the Integrated Prudential Sourcebook.

The FSA has formulated a set of high-level principles (reproduced in Appendix 1 of this report) stating the fundamental obligations of regulated businesses, to provide a basic yardstick for firms to order their behaviour by and provide a basis for supervisory and enforcement activity by the FSA itself. These objectives and principles mean that the priorities of the FSA will not always be aligned with those of financial services firms. The FSA can be expected to try to require firms to behave differently from the way they would behave in the absence of regulation, and to generate incremental compliance costs in doing so.

These costs might be expected to be greatest where the FSA judges:

- consumers need to be protected;
- there are systemic risks and externalities that are not taken account of by firms in their balance sheet or other risk management; and
- the risk of financial crime is greatest.

## **2.4 The FSA and Changes in the Cost of Compliance: Recent Surveys**

A number of published survey reports have reported on the incremental costs of compliance and of the changes in FSA regulation that have led to changes in these costs. This sub-section



reports their main findings and indicates the key ways in which the current project differed from these earlier surveys.

#### **2.4.1 British Banking Association (BBA) survey**

The BBA questionnaire was sent to the 173 members of the BBA's Post-N2 Monitoring Contact Group in June 2002. Responses were received from 123 firms, of which 61 were UK incorporated institutions, 25 were firms incorporated elsewhere in the EU and 37 were incorporated in the rest of the world. Splitting the sample by FSA division, 30 were monitored by Major Financial Groups Division (MFGD), 72 by Deposit Takers Division (DTD) and 21 by Investment Firms Division (IFD).

The survey found that 45 per cent of firms reported a 'moderate increase' (less than 10 per cent) in incremental compliance costs and 37 per cent reported a 'larger increase' post N2. Nine out of ten respondents described FSA supervision staff's understanding of firms' business as 'good' or 'moderate'. Six out of ten firms considered the application of FSA rules was 'highly rigid' or 'fairly rigid', and 40 per cent believed the application of rules had become 'more rigid' since N2. Regarding applications for individual guidance, 20 per cent of respondents indicated response times had a 'moderate business impact', and 6 per cent a 'greater business impact'. Eight out of ten respondents with experience described guidance received post N2 as either 'generally good' or 'moderate' in terms of clarity, however almost a third of those with experience considered post N2 guidance to show less clarity than before. The report noted that the most commonly cited high level concerns with the post N2 arrangements were the volume and complexity of regulatory material and the perception that the regime was being applied over-rigidly.

#### **2.4.2 Practitioner Panel**

The Practitioner Panel carried out its second survey of the FSA's regulatory performance in July–August 2002. The results were obtained from a survey of 3,890 senior executives in regulated financial services firms. The survey was carried out using postal questionnaires. There was a response rate of 42 percent for individuals and 50 per cent for firms contacted. All regulated firms were included in the survey, except for IFAs with fewer than 10 registered persons, and accountancy and legal firms. One in three firms in these categories were included. In most cases a questionnaire was sent to both the chief executive and the senior person with specific compliance responsibility for each firm. This survey built upon the similar 1999 Practitioner Panel survey, which highlighted firms' expectations of N2 and the impact the FSA would have upon their business.

About half of respondents believed their costs of compliance as a percentage of total costs to lie between 2 and 10 per cent.<sup>7</sup> Two out of three practitioners expected costs of compliance to be higher after the end of the N2 transition period and almost none expected them to be lower. Of those who expected an increase, a little over a third expected the increase in compliance costs to be 10 per cent or less and another third to be 11 – 20 per cent, leaving one in four believing ongoing compliance costs would rise by over 20 per cent.

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<sup>7</sup> The median lay in the "5% -less than 10%" range.



The practitioner panel found that fewer than half of firms believed the regulator has a good understanding of their business. The survey also reported respondents' view that rules were being applied in a checklist manner with little flexibility, rather than regulation being principles-based. It also found that there were many complaints concerning the FSA's apparent inability or unwillingness to provide guidance promptly, and also to provide informal guidance without involving legal advisors. It also highlighted firms' views that the handbook was difficult to navigate and understand, and that the FSA had misjudged the appropriate level of detail.

### **2.4.3 Association of Foreign Banks (AFB, formerly FBSA)**

The AFB study in 2002, carried out in conjunction with Deloitte & Touche, surveyed non-UK banks operating in London. The aim was to find out whether there have been changes to the regulatory costs of operating in London since N2. In total 154 forms were sent out to the former membership of both the Foreign Banks and Security Houses Association (FBSA) and the American Financial Services Association (ASFA). At the time a report was made available was published there had been 49 responses to the survey, of which 35 were from corporate / wholesale banks, 11 from retail banks and three from securities and derivatives firms. By FSA division the respondents included 22 Deposit Takers (DTD), 19 Investment Firms (IFD) and eight from Major Financial Groups (MFGD). The firms divide into 22 branches of EU companies, 15 branches of non-EU firms and 12 UK incorporated firms. This survey focussed on the cost aspects of regulation whereas the others looked at all aspects of regulation.

The survey reported "total regulatory costs" of about 1.6 per cent of operating costs, and that since N2 compliance costs have risen by around 3 per cent (i.e. about 0.05 per cent of total operating costs) whereas over the same period operating costs have actually fallen 3.5 per cent. The survey found that the ratio of regulatory staff to registered / approved persons pre-N2 was 1:7 whereas post-N2 this ratio is now 1:5.5 which shows "a surprising 27% increase in the burden on compliance staff". Nearly 40 per cent of respondents believed the FSA does not provide an appropriate level of service, and a similar proportion also felt the FSA is less responsive than their previous regulator. The survey revealed that 61 per cent of respondents believed that the creation of the single regulator has increased their costs, with only 19 per cent experiencing a fall and 20 per cent not noticing any change.

### **2.4.4 Key findings**

These surveys had broadly similar findings.

- Compliance costs have risen since N2.
- FSA supervisory staff tend to apply rules more rigidly rather than based upon broad principles and this approach varies depending on the individual.
- Guidance received post N2 has less clarity and consistency or in certain instances is not provided at all.
- Regulatory material post N2 is both voluminous and complex.



### **2.4.5 Europe Economics survey**

In meeting the remit set out in Section 1 above, this Europe Economics report explores or tests many of the themes in these surveys. Its main distinguishing features are:

1. the framing of incremental compliance costs as a response to a clearly stated counterfactual within the context of a wider notion of a firm's expenditure to manage risks and maintain client confidence;
2. the collection of detailed data on the levels of these incremental compliance costs, on changes in those costs, and on the drivers of those changes, and analysing these data for firms engaged in different regulated activities; and
3. the testing of a number of specific hypotheses on how the incremental costs of a firm's compliance might be reduced for a given assessed quality of that compliance, using an analysis based on economists' concepts of quality and of vertical differentiation and drawing on recent published evidence on how different financial services markets operate.

The next section of this report explains the methodology of Europe Economics' survey.





## 3 SURVEY METHODOLOGY AND SAMPLE

### 3.1 Sources of Evidence

Survey data were collected from a sample of 60 firms subject to FSA regulation. Each firm was asked to complete a questionnaire in advance of an interview. Copies of the letter and questionnaire sent to firms are attached as an **Annex**. Firms that agreed to take part in the survey were assured that their responses would be treated with strict confidentiality: at some points the need to preserve anonymity limits the level of detail in the analysis that can be presented.

The questionnaire asked for some general background information on the regulated entities and for information on scale of operations, and then asked detailed questions on costs. The information sought was intended to allow answers to the specific remit posed by the FSA, notably:

- the range within which firms believe that their incremental compliance costs generally lie;
- how those costs have changed since N2; and
- the specific causes of those changes.

Data were then analysed for the sample as a whole and for a number of groupings of firms within the sample engaged in similar business activities. The data collected also had to allow testing of different hypotheses of how firms might reduce incremental compliance costs.

### 3.2 Specification of Questions

#### 3.2.1 Incremental costs of FSA regulation

As noted in Section 2, firms would have to incur costs to manage risks and maintain client confidence in the absence of FSA regulation.

A two-stage process was used in the questionnaire. Firms were first asked to estimate the total of all the costs they currently incurred related to risk management and client confidence, and then asked how those would change if FSA rules and oversight were withdrawn.

Firms were given the following guidance:

“The **total costs of risk management and client confidence** as used here is a very broad notion capturing all of the costs associated with all of the firm’s activities designed to promote the firm’s reputation, manage risks and ensure quality.

This includes, but runs much wider than, the costs related to meeting all relevant legal and regulatory requirements, including those deriving from the FSA. For example, this should include all costs related to management systems and controls and to managing risks, training for quality; costs of building your firm’s reputation such as brand-building advertising campaigns, and costs of internal and external quality programmes.”





The questions relating to the incremental cost of complying with FSA regulation (Questions 12-19) then asked firms to consider the following counterfactual:

“Suppose that there were no FSA rules or oversight, and that you and your current competitors in your main markets competed for custom subject only to the general legal framework common to all UK firms. Please assume you would **continue to trade in your current portfolio of products.**”

Firms were then asked to consider how their behaviour, and their costs associated with risk management and client confidence, would differ from their current levels under this scenario. That difference in costs was taken as the measure of incremental costs of FSA regulation.

Incremental costs as defined here therefore rely on the particular counterfactual used. The counterfactual is based on a partial equilibrium concept: markets would change if there were no FSA rules and oversight, and the mix of products and nature of competition may well be different, but firms were specifically asked to assume the mix of products was held constant in answering questions. For example, if there were markets that relied particularly on regulatory oversight, such that they would close in its absence, the partial equilibrium responses would not give a full picture of incremental compliance costs. There is no single right counterfactual. The questions were intended to help obtain answers that could be interpreted and compared, and to avoid extensive discussions with firms exploring how individual markets would work in the absence of FSA regulatory oversight.

Depending on the demands of customers and the degree of comfort they take from the badge of regulatory approval, it is of course possible that the costs of risk management and client confidence costs could be *higher* without FSA regulation, in which case the incremental costs of FSA regulation would be negative, and the questions were carefully worded so as not to exclude such responses.

### 3.2.2 Change in incremental costs around N2

Defining the notion of costs changing around N2 was not straightforward. N2 is just one step on a process of change, and even where rules or other changes took effect from that date, firms may have incurred costs in anticipation of those changes.

The approach taken in this part of the questionnaire (Questions 20-29) was to ask firms to compare the incremental costs of compliance in the reporting year ending in 2002 with the incremental costs of compliance in the financial year ending in 1998. The initial period corresponds broadly to the period before the FSA's programme of change. Costs from this period are compared to those for the most recent period for which costs are available.

For many firms, the financial year ending in 2002 will have included the date of N2 (1 December 2001). If there were a one-off peak in costs arising from FSA regulation around N2 due to the nature of change, then the estimates of costs may be upper bounds to the underlying costs of change. Note also that any change in regulation would be expected to increase incremental compliance costs until firms have adjusted their portfolios and behaviour to be optimal given the new regulation. To put it a different way, before a regulation has become fully reflected in the



market, firms are experiencing its incremental costs but not all of its benefits (such as increased consumer confidence or the ability to sell a different portfolio of products). But once portfolios have adjusted, the incremental costs of well-directed regulation for sustaining that *new* portfolio should be lower (or even negative). Thus incremental costs of very recent legislation can give a misleading account of the longer-term burden of that regulation.<sup>8</sup>

### 3.2.3 Drivers of change in compliance costs

FSA regulation is not the only likely cause of change in firm's incremental compliance costs since 1998. Firms were asked to assess the effects of drivers of change in the total costs of risk management and client confidence other than changes in financial sector regulation. Such drivers might include changes in technology, or in risk-appetite, or the effects of legislation. Firms were also asked to identify how the incremental costs of complying with FSA regulation had changed between 1998 and 2002 as a result of drivers other than FSA regulation (see Questions 20-22).

Firms taking part in the survey were then asked to specify the main drivers from FSA regulation of one-off costs and of continuing changes in cost levels, and asked to estimate the total effect on one-off and continuing incremental compliance costs of changes in FSA regulation (rules and practice) between 1998 and 2002 (see Questions 24-29). There are a number of reasons why such comparisons might be difficult for particular firms. Many of the interviewees had not been in post in 1998; in other cases the firm had grown and the nature of its regulated activity had changed.

Cost estimates derived from responses to questions 24-29 will include both the costs of regulation the FSA was required to introduce, and of any that was super-equivalent. Of course, different elements of regulatory change interact with each other in complex ways, making such a distinction a difficult one for firms to make — and probably one that is of limited interest to them.

External influences on the FSA in this period include the Financial Services and Markets Act (2000) and the EU Financial Services Action Plan, which aims to create a single market in financial services within the European Union. As EU leaders have set an ambitious deadline for achieving this by 2005, there has recently been a corresponding rise in the amount of legislation originating from the EU. It is possible that once this initial programme is complete the rate of regulatory change will diminish. Alternatively, firms responding to the questionnaire might consider that there had been a permanent shift to a model of more intense regulation or more frequent regulatory change.

Data on firms' assessments of the drivers of change are provided in Section 5 below. The evidence assembled from firms' reports on the regulatory drivers of change in incremental compliance costs was discussed with relevant FSA officials in preparing this report. This does not mean that the FSA accepts the cost estimates or views presented in this report

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<sup>8</sup> This issue is explored in more detail in Section 5.2 below.



### 3.2.4 Validity of responses: a cautionary note

Many of the questions were known to have been different from any firms had faced before, and asked for breakdowns or for comparison against hypothetical states of the world. Such information could not be extracted from standard financial reporting information.

Firms were asked to provide the answers they thought were *roughly right*. There was no intention to audit the answers, and in many places there would be no document that a firm's answers could be audited against. Conducting interviews face-to-face allowed interviewers to clarify what was intended and helped firms provide responses that could then be compared with those of other firms.

Even so, the length and complexity of the questionnaires, and the limited time firms were able to devote to answering, meant that some of the questionnaires returned had blanks. Although guidance was given to firms in a discussion of terms, and by suggesting categories of costs to be included, many firms found the questions on total costs of maintaining risk management and client confidence (Questions 10 and 11) particularly difficult to answer. It is possible that two firms in the same circumstances could give different answers to Q11, reflecting different interpretations. This caveat should be borne in mind when considering the analysis of answers to Q11.

The same point applies, perhaps slightly less strongly, to the questions on incremental costs of compliance (Q12-19) and on change in those incremental costs (Q20-29). Many respondents found it hard to envisage a world without FSA rules or oversight, and, despite the guidance given, firms may not have responded in the same way. Staff turnover, which reduces institutional memory, and organisational and market change all make comparisons with the past harder.

Nevertheless, the experience of interviewers was that firms tried to answer the questions as intended. For example, firms were not measuring incremental costs by the numbers of compliance staff, but were thinking through the adjustments they would make, helped by the sequence of questions designed to help them assess incremental compliance costs. Inconsistencies between a firm's responses revealed by consistency checks on the database were put back to interviewers to be resolved. In some cases responses to individual questions were judged to have been based on a misunderstanding, and those that could not be clarified with the firm concerned, were rejected.

It is possible that firms may have over-estimated the incremental costs of compliance, attributing to the effects of regulation costs that they would in reality have had to incur without it. It is genuinely difficult for firms to envisage the nature of the demands they would face from clients and capital markets in the absence of sectoral regulation.

It is also possible, however, that firms may have under-estimated the incremental compliance costs of regulation, due to the difficulty of taking full account of the knock-on effects on their businesses from regulation. As noted above, it is natural for firms to focus initially on the costs of the compliance function, and some respondents may have found difficulty in identifying just how different their businesses would be in the absence of financial regulation.



While acknowledging that there are error margins around the estimates, Europe Economics considers the responses analysed below as having been broadly successful in capturing firms' perceptions of the compliance costs they faced and of how these have changed.

### **3.3 Sample**

#### **3.3.1 Sample selection**

It was agreed to seek information from interviews with 70 firms.

The first objective of the project was to identify the range within which firms believe that their incremental compliance costs generally lie, not to produce an estimate of the incremental costs of regulation for the entire population of regulated firms. Given that objective, and the other constraints on the project, it was agreed from the outset that the study should not produce estimates of the total incremental compliance costs faced by the entire population of regulated firms. This agreement allowed the sample selection process to focus on other priorities.

The FSA wished the firms in the sample to cover the whole range of regulated firms and selected which firms to approach on that basis. Supervisors selecting firms for the sample were asked to make it as representative of the population as they could. Thus the sample included large and small firms within each category of business activity, and firms of different assessed compliance quality. However, the intention of the sample selection process was to include sufficient firms subject to each of the following kinds of FSA regulation:

- 1 Prudential supervision of credit institutions (including Credit Unions).
- 2 Prudential supervision of insurance companies (life and non-life).
- 3 Prudential supervision of securities firms.
- 4 Conduct of business regulation for capital markets.
- 5 Prudential and conduct of business regulation of advice on or sale of retail products.

Of course, the third and fourth categories of regulation are closely related, and it was hoped to obtain some multiple responses from firms subject to both.

The intention was also to include smaller numbers of firms subject to the following further categories of regulation:

- 6 Supervision of and standards for exchanges, clearing and settlement systems and serviced providers.
- 7 The regulation of collective investment schemes and fund management.

A number of firms declined to participate in the study when approached by the FSA. Six firms that did initially agree to participate subsequently pulled out of the study, mainly on the grounds that they would not be able to complete the questionnaire in the time available. There is therefore



some possibility of bias in the sample other than any unintended bias from the initial selection by the FSA, although there is no evidence that the firms that withdrew on seeing the questionnaire were different in any material way. The FSA did not select firms on the basis of perceptions of their relative levels of compliance costs, and there is no reason to think the sample is not broadly representative in that respect.

Ultimately, 60 firms were interviewed between 12 February and 14 March 2003. Fifty-two firms returned partially- or wholly-completed questionnaires used for the statistical analysis reported below.

Europe Economics accepted the FSA's advice that each firm answer questions for the set of regulated activities that the firm found most natural. Firms were invited to offer to complete additional questionnaires for other regulated activities, but only one firm did (hence 53 questionnaires were returned). Question 1 of the questionnaire invited firms to explain which of the following regulated activities were included in their questionnaire response:

- Banking or other credit.
- Fund management.
- Managing collective investment schemes.
- Sales of or advice on retail-financial products.
- Long term insurance business and pensions.
- General-insurance business.
- Securities or capital-market operations.
- Operating as an exchange or market.
- Other (please specify).

Some firms answered the questionnaire in respect of one of these activities; others in respect of more than one (this point is discussed further below).

### **3.3.2 Final sample**

Following the interviews, Europe Economics then needed to group the 60 firms for further analysis. The groupings needed to:

- be large enough to allow analysis;
- be reasonably homogeneous to make analysis within them appropriate;
- capture as far as possible the different streams of regulated activity specified by the FSA; and



- reflect the different activities firms had recorded as being covered by their questionnaire.

Where firms indicated that the response to the questionnaire covered more than one activity, firms were allocated to one group if one activity was clearly dominating their responses, or to more than one if not. This allocation to more than one group assumes that the costs of regulation are incurred equally across the different activities covered in the questionnaire.

From the eight categories, plus “other”, specified on the questionnaire, firms were grouped into six categories for analysis. These are shown in Table 3.1 below along with the corresponding streams of FSA regulatory activity and the number of firms in the sample in each category. Note that some firms’ entries are counted in more than one group, so the number of observations exceeds 60, even though the eight firms interviewed that did not return a questionnaire are not included in the table.

**Table 3.1: Firm Groupings**

| Europe Economics Groupings                                      | Categories of FSA Regulatory Activity  | Number of questionnaire responses |
|---|--|-----------------------------------|
| A. Banking and credit   | Prudential supervision of credit institutions (including Credit Unions)                            | 13                                |
| B. Managed investments (both Fund Management and Managing CISs) | The regulation of collective investment schemes and fund management.                               | 13                                |
| C. Retail (sales, advice, and broking)                          | Prudential and conduct of business regulation of advice on or sale of retail products              | 11                                |
| D. Insurance and pensions                                       | Prudential supervision of insurance companies (life and non-life)                                  | 14                                |
| E. Capital Market Operations                                    | Prudential supervision of securities firms<br>Conduct of business regulation for capital markets   | 5                                 |
| F. Exchanges, counterparties and others <sup>9</sup>            | Supervision of and standards for exchanges, clearing and settlement systems and serviced providers | 6                                 |

Of the five principal groups identified by the FSA for the study, it can be seen that there was a limited response from firms in the capital market operations group. Some firms interviewed in this category stated that the task of analysing their activities in the way requested was unmanageable. Others answered for other parts of their business only.

Some firms interviewed were branches or subsidiaries of overseas firms. Where this was so, the relationship was noted, and the incremental effect of FSA regulation, *given overseas regulation*,

<sup>9</sup> Counterparties includes firms that guarantee transactions for a fee.



explored through the questionnaire and discussion. Here, the statistics are intended to capture the incremental costs of FSA regulation over and above that of overseas regulation.

All of the means shown in the tables below are unweighted arithmetic means of the statistics for the different groups of firms. Responses from small firms in the sample are given the same weight as those from large firms.

In providing summaries, medians are used rather than means. These sample medians can be thought of as representing the experience of a typical or middling firm. Unlike sample means, medians are not affected by the shape of the underlying distribution. Medians are not affected by outliers that might arise if one firm has had a quite atypical experience or has misunderstood the question, a property useful when summarising distributions from small samples.

These sample means and medians are presented as summary statistics of the wide range of individual observations offered by firms in the sample. It would not be valid to try to scale them up to whole populations of firms, or, at the other extreme, to use them as the basis for predicting the values for particular firms.





## 4 INCREMENTAL COSTS OF FSA REGULATION: SURVEY EVIDENCE

### 4.1 Incremental Compliance Costs

Table 4.1 shows the distribution of the additional costs firms believe FSA regulation imposes on them, from usable data in 42 questionnaires. It does this by using firms' answers to Q19, the reduction in cost if FSA rules and oversight were withdrawn but the firm faced the same competitors as currently and provided the same products. The denominator is the operating costs firms think they would have incurred without FSA regulation, hereafter described as "non-regulatory operating costs". This measure shows the additional costs due to regulation as a proportion of what costs would have been without that regulation. This gives ratios slightly higher than dividing by operating costs. As incremental compliance costs diminish relative to total operating costs, the two ratios converge.

**Table 4.1: Incremental Costs of FSA Compliance as Percentage of Non-regulatory Operating Costs: Whole Sample**

| Percentage     | Number of responses |
|----------------|---------------------|
| Negative or 0  | 2                   |
| 0-2 per cent   | 21                  |
| 2-5 per cent   | 9                   |
| 5-10 per cent  | 5                   |
| 11-20 per cent | 5                   |
| <b>Total</b>   | <b>42</b>           |

Source: Firms' responses to Q19/(Q5-Q19).

Half of the respondents answering this question estimated that incremental compliance costs of FSA regulation added in the range 0-2 per cent to what operating costs would have been without regulation, with almost half providing a higher estimate. For the sample as a whole **the (unweighted) mean of firms' estimated change to operating costs in respect of FSA regulation is an increase of 3.3 per cent, and the median an increase of 1.6 per cent.**

The distribution shown in Table 4.1 can be compared with that from the *2002 Survey of the FSA's Regulatory Performance* prepared for the FSA Practitioner Panel in November 2002. Chart 9.2 of that report shows that of the CEOs that answered the question, more than 50 per cent considered the incremental cost of complying with FSA regulation to lie between 2 and 10 per cent of operating costs, with the remainder fairly evenly divided between those who considered incremental costs to be below that range and those who considered incremental costs to be above that range.<sup>10</sup> The median increase of 1.6 per cent from the Europe Economics sample is significantly lower than the median from the Practitioner Panel Survey of between 5 and 10 per cent. This cannot be because of the slightly different denominator used, which would have

<sup>10</sup> "Smaller organisations" tended to consider that incremental compliance costs were higher than this, with 35 per cent considering that they constituted 10 per cent or more of total costs.





increased the difference. However, the Practitioner Panel survey did not include a clearly defined counterfactual, and respondents may have envisaged a range of counterfactuals different from that specified in the Europe Economics survey.

## 4.2 Incremental Compliance Costs by Firm Size

The forty-two usable responses to this question on incremental compliance costs were split evenly into three by firm size, as measured by operating costs.

**Table 4.2: Incremental Compliance Costs as Percentage of Non-regulatory Operating Costs: by Firm Size**

|        | Number of firms | Mean (per cent) | Median (per cent) |
|--------|-----------------|-----------------|-------------------|
| Small  | 14              | 5               | 3                 |
| Medium | 14              | 3               | 2                 |
| Large  | 14              | 2               | 1                 |

Source: Firms' responses to Q19, Q5.

This suggests that smaller firms face proportionately higher incremental costs, which would be consistent with some incremental costs, such as those of firm registration and approved persons, being fixed (not directly related to output). The finding applies also within the activity groupings shown in Table 3.1 above — the finding is not because small firms in our sample are disproportionately engaged in particular activities that entail higher incremental compliance costs.<sup>11</sup>

These sample means, as with the sample medians, are presented as summary statistics of the wide range of individual observations offered by firms in the sample. It would not be valid to try to scale them up to whole populations of firms, or, at the other extreme, to use them as the basis for predicting the values for particular firms.

## 4.3 Incremental Compliance Costs by Whether the Firm is Subject to Overseas Regulation

Incremental compliance costs were analysed separately according to whether firms are regulated by one or more overseas regulators “such that the management and operation of the UK business is heavily influenced by the requirements of one or more overseas regulators?” (Question 3).

<sup>11</sup> This finding is also consistent with the 2002 Financial Services Practitioner Panel report, Chart 9.2 (p.104), in which smaller organisations report materially higher “total internal and external identifiable current costs of compliance, as percentage of total costs”.



**Table 4.3 Incremental Compliance Costs as Percentage of Non-regulatory Operating Costs: by Overseas Regulatory Position**

|  | Number of firms | Mean (per cent) | Median (per cent) |
|--|-----------------|-----------------|-------------------|
| Significantly affected by overseas regulator | 10              | 2               | 1                 |
| Not so affected                              | 32              | 4               | 2                 |

Source: Firms' responses to Q3, Q19, Q5.

The provisional conclusion from this is that firms materially affected by overseas regulators report lower incremental compliance costs. This is not surprising: several of these firms indicated that their policies were determined at group level, partly in response to overseas regulation. US and Japanese, as well as other EU regulators, were amongst those whose influence was cited. It is worth noting that the Association of Foreign Banks study reported "total regulatory costs" at 1.5 per cent of total operating costs — lower than the whole sample mean and median from the current study of 3.3 per cent and 1.6 per cent; and broadly in line with the mean of 2 per cent and median of 1 per cent in the current study for institutions significantly affected by a foreign regulator.

A small number of international firms reported regulatory arbitrage, in that they undertook particular kinds of transactions in jurisdictions where these were more lightly regulated. Very few firms reported the FSA regulatory regime as giving an unfair disadvantage in competing in EU markets. Those who did make comparisons mainly indicated they preferred the UK regulatory model of principles and rules to needing to gain permission in advance for transactions.

#### 4.4 Incremental Compliance Costs by Activity Grouping

Table 4.4 shows the means and medians of firms' estimated incremental compliance costs for different groupings of firms in the sample.

**Table 4.4: Incremental Costs of FSA Compliance as Percentage of Non-regulatory Operating Costs: Means and Median by Group**

| Europe Economics Groupings                                      | Number of usable responses | Sample mean (per cent) | Sample median (per cent) |
|---|----------------------------|------------------------|--------------------------|
| A. Banking and credit   | 8                          | 2.6                    | 0.9                      |
| B. Managed investments (both Fund Management and Managing CISs) | 12                         | 3.4                    | 1.1                      |
| C. Retail (sales, advice, and broking)                          | 7                          | 5.6                    | 2.6                      |
| D. Insurance and pensions                                       | 11                         | 2.4                    | 0.8                      |
| E. Capital Market Operations                                    | 5                          | 4.7                    | 2.0                      |
| F. Exchanges, counterparties and others                         | 6                          | 2.1                    | 1.5                      |

Source: Firms' responses to Q19/(Q5-Q19).

On both the mean and median measures, retail firms reported the highest incremental compliance costs, and insurance and pensions and retail and banking firms amongst the lowest.



Sample sizes for these categories are small, but these differences may still be significant. However, it is important to consider whether the differences between activity groupings can be wholly explained by the results relating to firm size and overseas regulation noted above. The predicted values for these experiments are shown in Table 4.5 below. (Note that for this purpose the population was divided into six size groups rather than the three broad size groups shown in Table 4.2 above. The mean incremental cost was 7 per cent of non-regulatory operating costs for the smallest size group, and only 1 per cent for the largest.)

**Table 4.5: Incremental Costs of FSA Compliance as Percentage of Non-regulatory Operating Costs: Means by Group**

| Europe Economics Groupings                                      | Number of usable responses | Sample mean (per cent) | Expected mean if only size determined Incremental costs (per cent) | Expected mean if only overseas regulation determined Incremental costs (per cent) |
|---|----------------------------|------------------------|--|---|
| A. Banking and credit   | 8                          | 3                      | 4  | 2   |
| B. Managed investments (both Fund Management and Managing CISs) | 12                         | 3                      | 3  | 3   |
| C. Retail (sales, advice, and broking)                          | 7                          | 6                      | 4  | 4   |
| D. Insurance and pensions                                       | 11                         | 2                      | 4  | 3   |
| E. Capital Market Operations                                    | 5                          | 5                      | 2  | 2   |
| F. Exchanges, counterparties and others                         | 6                          | 2                      | 3  | 4   |

Source: *Firms' responses to Q19/(Q5-Q19).*

Adjustments for size and overseas status help explain why retail sales and advice firms report higher incremental costs, but not why capital market operations firms do so. In both cases, there looks to be some remaining effect from being in these sectors to explain. Perhaps retail firms face higher costs because of retail conduct of business rules and customer reviews, although some insurance and pension firms also face such regulations and they do not report higher incremental compliance costs than other groups.

## 4.5 Elements of Incremental Cost

Firms were asked to indicate in more detail how their business would change in the absence of FSA rules and oversight, and which costs would be reduced (Questions 12-18).

Responses of the firms that answered some of these questions are shown in Table 4.6 below.



**Table 4.6: Effects on Different Categories of Expenditure if FSA Rules and Oversight were Withdrawn: Numbers of Responses**

| Category of Expenditure | Expenditure would fall | Expenditure would be unchanged | Expenditure would rise | Total number of responses |
|-------------------------|------------------------|--------------------------------|------------------------|---------------------------|
| Training (Q13)          | 22                     | 29*                            | 1                      | 52                        |
| Risk-monitoring (Q14)   | 34                     | 19                             | 0                      | 53                        |
| Reputational (Q16)      | 3                      | 41                             | 6                      | 50                        |

\* Firms that indicated that training to meet specific FSA requirements would decline but training would otherwise be unchanged were included in this category.

From Table 4.6, it is clear that the majority of firms expected expenditure on training to be unchanged in the absence of FSA oversight, but that a sizeable minority expected it to be reduced.

In contrast, most firms that responded to the question on risk-monitoring said that expenditure on risk-monitoring would fall. The implication is that these firms believe the FSA requires them to undertake more risk monitoring than they would otherwise undertake. In terms of commercial risks, the reverse might be expected: the costs to a firm's shareholders of a major loss or business failure by the firm would be greater than the costs to the FSA of that loss or failure. On the other hand, the FSA also seeks to maintain market confidence, prevent financial crime, and protect consumers. These objectives may lead the FSA to be more averse to certain risks in respect of firms than the firms themselves are. For example, firms whose failures would represent a systemic risk can expect close prudential regulation. Consistent with this, firms' written and interview responses included attributing additional risk monitoring to regulation related to FSA reporting requirements or to monitoring of compliance with conduct of business or money laundering rules monitored by the FSA.

Most firms expected other expenditure on brand and reputation building to be unchanged, with minorities expecting a reduction or an increase in expenditure. Of the firms that suggested there would be an increase, two thought that the "FSA-approved" badge was useful in non-EU markets. The other four presumably believe that the FSA badge is a useful indicator of quality in the EU. Some of the firms indicating "no response" specifically indicated that they did not consider this to be so. Of the firms that expected a reduction, those that specified where this would fall indicated that advertising would be cheaper without FSA rules on financial promotions.

Question 17 asked firms to provide cost data for the different elements of incremental compliance costs, in order of importance. While not enough provided cost figures for these to be analysed, 36 firms provided some listing of the elements of incremental compliance costs in order of importance. Table 4.7 below summarises those listings, grouping into categories firms' responses to this open-ended question.

From Table 4.7, more firms cited holding additional capital as the most important source of incremental compliance costs than any other source. While only a minority of firms indicated that



they were required to hold more capital because of regulation that they otherwise would have done, it was clearly the most important incremental cost of regulation for many of those firms.

Savings in compliance staff; in fees and through using less complex transactions or systems were also cited by significant numbers of firms as important potential sources of savings in the absence of FSA regulation.

**Table 4.7: Sources of Incremental Compliance Costs: Areas in which Savings would be made if FSA Rules and Oversight were Withdrawn**

| Areas in which savings would be made                 | Number of firms specifying as |                       |                      |
|--|-------------------------------|-----------------------|----------------------|
|  | Most important                | Second most important | Third most important |
| Hold less capital*                                   | 12                            | 2                     | 0                    |
| Less compliance staff resources                      | 6                             | 6                     | 1                    |
| Reduction in fees                                    | 5                             | 2                     | 0                    |
| Less complex method of transactions or systems*      | 4                             | 6                     | 1                    |
| Less staff training*                                 | 3                             | 1                     | 5                    |
| Reduced cost of FSA reporting and dialogue           | 3                             | 3                     | 2                    |
| Less monitoring*                                     | 2                             | 2                     | 2                    |
| Less resources devoted towards anti-money laundering | 1                             | 1                     | 0                    |

Source: Firms' responses to Q17.

Groups of responses where firms may have been prompted or reminded by preceding questions are shown with an asterisk.

## 4.6 Prudential Regulation and Firms' Balance Sheets

One area of great interest for the FSA is of the effect of its regulation on firms' balance sheets. Different kinds of firms will have been affected differently by FSA capital requirements, with life insurance firms thought most likely to have been affected by action taken since 1998. The responses to this question are shown in Table 4.8 below, by category of firms.



**Table 4.8: Firms' Expected Changes in their Holdings of Capital Expenditure if FSA Rules and Oversight were Withdrawn: Numbers of Firms**

| Category of firms   | Reduction | No effect or increase | Question not answered | Number of questionnaires |
|---|-----------|-----------------------|-----------------------|--------------------------|
| A. Banking and credit   | 5         | 6                     | 2                     | 13                       |
| B. Managed investments (both Fund Management and Managing CISs) | 5         | 6                     | 2                     | 13                       |
| C. Retail (sales, advice, and broking)                          | 3         | 4                     | 4                     | 11                       |
| D. Insurance and pensions                                       | 4         | 8                     | 2                     | 14                       |
| E. Capital Market Operations                                    | 2         | 4                     | 0                     | 6                        |
| F. Exchanges, counterparties and others                         | 2         | 4                     | 0                     | 6                        |

Source: Firms' responses to Q15.

It can be seen from Table 4.8 that within each broad activity grouping, a minority of firms that answered the question indicated that they would hold less capital on their balance sheet in the absence of FSA regulation.

But in each category, a majority of firms that answered the question expected that in the absence of FSA regulation there would be no change in the capital they would hold, such that the FSA requirements do not constitute a binding constraint. Within the sample as a whole, only three firms anticipated an increase in the capital they would need to hold in the absence of FSA regulation. Some of these firms indicated that credit ratings or client or counterparty expectation required capital levels substantially above those required by prudential regulation. Of firms that anticipated a reduction, only six provided sufficient information to derive a percentage change in their balance sheet or an annual cost, so these data are not reported directly.

However, it is possible to calculate separately the means and medians of incremental compliance cost (as a proportion of non-regulatory operating costs) for two groups of firms:

- those that indicated they would hold less capital in the absence of FSA regulation (15 firms provided the necessary data); and
- those that indicated they would hold the same or more capital (23 firms provided the necessary data).

For firms that indicated they would hold less capital in the absence of FSA regulation, the mean ratio of incremental compliance cost to non-regulatory operating costs was 4.3 per cent and the median ratio 2.6 per cent.

For firms that indicated they would hold the same or more capital in the absence of FSA regulation, the mean ratio of incremental compliance cost to non-regulatory operating costs was 2.5 per cent and the median ratio 0.8 per cent.



Note that this does **not** mean that the costs of holding additional capital accounted for the difference between the two sets of results. Firms that would hold less capital in the absence of regulation may also be the firms that would reduce monitoring or training.

But if this comparison is taken along with the finding from Table 4.7 above that holding additional capital were most frequently cited as the most important of additional costs of regulation, this further comparison shows how important the costs of holding additional capital were to the minority of firms that were required to do so because of regulation.

It is possible that for some firms in the first category the costs of holding additional capital are included in their estimate of incremental compliance costs, but the costs of holding “non-regulatory” capital are typically not included in their reported operating costs. This would give an upward bias to incremental compliance costs expressed as a proportion of operating costs.

## **4.7 FSA Regulation and Market Behaviour**

The questionnaire was designed to establish compliance costs and did not include questions specifically on pricing. While a few firms operated in specialist niches with limited direct competition, most firms interviewed considered themselves to be operating in competitive and price-sensitive markets. In such markets, compliance costs that are a function of sales and that affected all firms equally would be passed on in higher prices. However, the evidence reported in Section 2 suggests that some financial services markets may be subject to significant market failures, and for those markets there is no such obvious presumption about how prices will be affected.

Regulatory costs that affect firms, or competitive models, differently, will of course change the nature of markets. Some costs are largely fixed in nature in that they do not vary directly with output. Such costs, such as of the approved persons regime, may have proportionately larger effects on small firms, intensifying concentration. Many of these fixed costs are also sunk costs in that they are irrecoverable once incurred. Such costs might have less impact on pricing but increase barriers to entry. Where markets are concentrated, the effect on pricing of an across-the-board cost increase will depend on the nature and intensity of competition.

However, it was not part of this study to assess the net effects on consumer welfare of any market exits or changes in the nature of competition arising from changes in financial services regulation. Such an exercise would require a major analysis of data on developments in financial services markets.

One interesting example of how regulation can affect a market, cited by more than one firm, was of the effects of requirements for “best execution” on “over-the counter” foreign exchange transactions on behalf of retail customers. By the time firms had obtained the necessary three quotes, prices had changed. Firms considered it impossible to demonstrate best execution in this market as required by the FSA, and the market had therefore collapsed.

To achieve a further understanding of firms’ responses, it is useful to consider them alongside firms’ responses to Q44:





“What prevents a firm in the market from trying to increase its margins by reducing the quality of service it provides?”

Firms were asked to indicate an order of priority amongst several possible constraints. The results from 48 firms that provided some response to this question are shown in Table 4.9.

**Table 4.9: Constraints on Reducing Service Quality**

| Constraints on reducing service quality | Number of firms specifying as |                       |                      |
|---|-------------------------------|-----------------------|----------------------|
|   | Most important                | Second most important | Third most important |
| UK Regulation                           | 8                             | 6                     | 19                   |
| Overseas regulation                     | 0                             | 2                     | 4                    |
| Loss of industry kite-marks             | 0                             | 1                     | 3                    |
| Loss of customers                       | 35                            | 7                     | 4                    |
| Response of competitors                 | 3                             | 25                    | 4                    |
| Something else. Please specify          | 2                             | 0                     | 1                    |

Source: Firms' responses to Q44.

While FSA regulation is considered an important constraint on reducing service quality, it comes well behind loss of customers and, for most firms, competitor response. This is consistent with the tenor of responses to questions 13, 14 and 16 as summarised above, and shows that most firms see customer expectation, not FSA regulation as the principal driver of service quality. Tables A2.1 and A2.2 in Appendix 2 report this evidence separately for firms dealing principally with retail investment products and for other firms: the first group are slightly more likely to see FSA regulation as the most important constraint on reducing service quality, but customer response remains more important. However, the FSA and firms may have quite different *notions* of service quality. The FSA may assess service quality partly in terms of suitability of the product for the particular customer, while firms may assess service quality in terms of whether clients are made to feel important. So such a response from firms does not tell us whether the level or nature of regulation is appropriate. As already noted, there may be good reasons, given the FSA's objectives, for requiring some, or even all, firms to do things they would not otherwise have chosen to do. The relationship between different measures of quality and incremental compliance costs is explored in Section 6.

## 4.8 Summary

Incremental costs as defined in the report rely on the particular counterfactual used. That used here was considered the most suitable for assessing the incremental costs of FSA regulation. The counterfactual is based on a partial equilibrium concept: markets would change if there were no FSA rules and oversight, and the mix of products and nature of competition may well be different, but firms were asked to assume in answering questions that the mix of products would be unchanged.





All but two of the 42 firms that returned usable responses on this point indicated some increased cost arising from FSA regulation. Half estimated that incremental compliance costs of FSA regulation added between 0 and 2 per cent to operating costs, with 14 reporting values between 2 and 10 per cent and 5 indicating values between 10 and 20 per cent. The sample median of incremental compliance costs was of 1.6 per cent of non-regulatory operating costs.

Larger firms reported smaller proportional values for incremental compliance cost, as did firms whose behaviour was also materially influenced by overseas regulators. After allowing for the influences of size and of overseas regulatory impact, firms engaged in retail sales and advice and in capital market operations still typically reported higher incremental costs than firms in the other categories. More than half of the firms in the sample indicated that expenditure on risk monitoring would be reduced in the absence of FSA oversight, suggesting that the FSA's objectives to maintain market confidence, prevent financial crime, and protect consumers may lead the FSA to be more averse to certain risks in respect of firms than the firms themselves are.

A significant proportion of firms indicated they would reduce their level of training in the absence of FSA oversight, while only a small number would reduce the level of expenditure on brand and reputation-building.

A minority of firms indicated they would reduce the level of capital held: the proportion doing so was broadly similar across the different kinds of regulated financial services firms included in the sample. Whether or not firms needed to hold additional capital for regulatory purposes had a major impact on their estimated incremental compliance costs. For firms that indicated they would hold less capital in the absence of FSA regulation, the median ratio of incremental compliance cost to non-regulatory operating costs was 2.6 per cent. For firms that indicated they would hold the same or more capital in the absence of FSA regulation, the median ratio of incremental compliance cost to non-regulatory operating costs was 0.8 per cent.

This does not, however, mean that the difference is the cost of holding additional capital, but is consistent with the answers given to another question in showing that for the minority of firms held more capital because of regulatory requirements, the cost of doing so was typically the most important element of incremental compliance costs.

Where firms have included in their estimate of incremental costs the costs of additional capital holdings but have not included the costs of holding capital in their reported operating costs, there will an upward bias to the measured ratio for those firms.



## **5 CHANGES IN INCREMENTAL COST OF COMPLYING WITH FSA REGULATION: SURVEY EVIDENCE**

### **5.1 Market Drivers of Changes in Incremental Costs of Compliance**

Question 20 of the questionnaire asked firms to identify key drivers of change in the costs of maintaining risk management and client confidence other than changes in FSA regulation. Not all firms answered this question, and some specified more than one driver. In terms of the four broad categories that were given as prompts:

- 6 firms of the 52 that returned questionnaires specified growth of their firm;
- 14 firms mentioned new products, with more complex products or an expansion to product range increasing costs;
- 21 firms specified changes in the pattern of demand or expectations by customers, typically as leading to higher costs. This included comments by several firms operating in wholesale markets that their clients now expected more sophisticated risk management techniques to be applied;
- 25 firms specified changes in technology. In most cases, these were shown as driving costs up rather than down. When firms were asked, they typically responded to the effect that if there were gains, these were not reflected in actual lower operating costs. Of course, it could be that more, and more useful, information was being provided at the higher costs, as in the comment above.

Table A2.5 in Appendix 2 reports total costs of risk management and client confidence as a percentage of operating costs. In Question 21, firms were asked to estimate changes in the total costs of risk management and client confidence due to influences other than changes in FSA regulation. The responses are shown in Table 5.1 below.



**Table 5.1: Change in Total Cost of Risk Management and Client Confidence 1998-2002 due to Influences other than Changes in FSA Regulation**

| Change in total cost of risk management and client confidence 1998-2002 due to influences other than changes in FSA regulation | Number of responses |
|--|---------------------|
| Reduction since 1998 of 50 -100 per cent   | 0                   |
| Reduction since 1998 of 20-50 percent  | 1                   |
| Reduction since 1998 of 0-20 per cent  | 5                   |
| No difference i.e. the answer in 1998 would have been the same as at Q11   | 8                   |
| 0-20 per cent increase   | 20                  |
| 20 -50 per cent increase   | 6                   |
| 50- 100 per cent increase  | 2                   |
| 100-200 per cent increase  | 0                   |
| Over 200 per cent increase (i.e. more than tripled)  | 0                   |
| <b>All firms</b>   | <b>42</b>           |

Source: Firms' responses to Question 21.

The modal and median response is that changes in the total costs of risk management and client confidence due to influences other than changes in FSA regulation were within the range 0-20 per cent increase.

Firms were then asked how non-regulatory drivers of change would have affected the incremental cost of meeting the set of financial services regulatory requirements that existed in 1998.

**Table 5.2: Change in Incremental Compliance Costs 1998-2002 due to Influences other than Changes in FSA Regulation**

| Change in incremental compliance costs 1998-2002 due to influences other than changes in FSA regulation | Number of responses |
|---|---------------------|
| Reduction since 1998 of 50 -100 per cent  | 0                   |
| Reduction since 1998 of 20-50 percent   | 2                   |
| Reduction since 1998 of 0-20 per cent   | 2                   |
| No difference i.e. the answer in 1998 would have been the same as at Question 19                        | 15                  |
| 0-20 per cent increase  | 17                  |
| 20-50 per cent increase   | 2                   |
| 50-100 per cent increase  | 2                   |
| 100-200 per cent increase   | 0                   |
| Over 200 per cent increase (i.e. more than tripled)   | 0                   |
| <b>Total</b>  | <b>40</b>           |

Source: Firms' responses to Question 22.

From Table 5.2, it is clear that most firms that responded thought that given the set of financial services regulatory requirements that existed in 1998, non-regulatory drivers of change would



have left the incremental cost of meeting those regulations unchanged or led to an increase in the range 0-20 per cent.

The question did not specify whether answers were in nominal or real terms, and some of the modest increases reported above could be explained by inflation. In broad terms, firms typically perceived environmental changes other than changes in FSA regulation as having had relatively limited net effects on the costs of risk management and client confidence, and even more limited effects on the continuing incremental costs of FSA regulation.

## 5.2 Regulatory Changes: One-off Impacts of Changes in FSA Regulation

At Question 24 and Question 25 of the questionnaire, firms were asked to set out the four main regulatory drivers of one-off costs and the costs they had generated. 18 firms provided usable data. The distribution of firms' responses as a proportion of non-regulatory operating costs is shown in Table 5.3. Note that these are lower bounds – firms were asked only to specify the costs of the four most significant sources of one-off costs. (For the figures shown in this section, the increase is not materially affected by the choice of denominator. While non-regulatory costs were used throughout as the denominator for calculations, the term “percentage of operating costs”, used for simplicity in the text, is here not misleading.)

**Table 5.3: One-off Compliance Costs Arising due to Changes in Financial Services Regulation by the FSA 1998-2002, as Percentages of Annual Non-regulatory Operating Costs**

| Range (per cent) | Number of responses |
|------------------|---------------------|
| 0 – 0.5          | 6                   |
| 0.5 – 1          | 4                   |
| 1 – 2            | 3                   |
| 2 – 3            | 1                   |
| 3 – 4            | 2                   |
| 4 – 5            | 0                   |
| 5 – 6            | 2                   |

*Source: Firms' responses to Questions 24, 5 and 19.*

From the firms that provided usable data, the mean one-off costs, as a proportion of operating costs, were 1.6 per cent, and the median 0.8 per cent. Note that these are lower bounds, capturing only the costs of the most important effects identified by each firm, of costs imposed over the whole time period. Over four years, 0.8 per cent of operating costs would average 0.2 per cent of operating costs per year. However, most of the costs were shown as incurred towards the end of the period i.e. in 2001 and 2002.

These costs include those resulting from all regulatory change implemented by the FSA, not just that over which it had discretion. During this period the FSA was required to introduce changes as a result of the Financial Services and Markets Act 2000 and the EU Financial Services Action Plan.



Eleven firms provided estimates for one-off costs of N2 preparation, with a median of 0.4 per cent of operating costs (mean 0.6 per cent). Four firms provided estimates of the one-off costs of meeting new money laundering requirements, with a median of 0.5 per cent of operating costs (mean 0.5 per cent).

### **5.3 Regulatory Changes: Impact of Changes in FSA Regulation on Continuing Incremental Compliance Costs**

At Questions 26-28 of the questionnaire, firms were asked to identify the continuing increases in annual incremental compliance costs in the period between the financial year ending in 1998 and the latest financial year as a result of changes in regulation by the FSA.

These questions asked about the *continuing* costs of change in regulation, as contrasted with one-off costs on which evidence is reported above. Only 19 of the firms provided detailed breakdowns of cost drivers of continuing and one-off costs, but the distribution of their responses was similar to that of the other firms. There is no reason to think that firms did not understand the distinction.

As noted above, this measure of costs encompasses the effects of all regulatory change implemented by the FSA, not just of that over which it had discretion.

Only one firm indicated that changes in regulation since 1998 had reduced the continuing incremental compliance costs it faced, and four thought it made no difference. The other 37 reported an increase.

Table 5.4 reports results obtained from Questions 29, regarding firms' estimates of the increase in incremental compliance costs between 1998 and 2002, as a percentage of operating costs.<sup>12</sup>

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<sup>12</sup> Note that the figure used here is operating costs, rather than non-regulatory operating costs. Because in most cases incremental compliance costs are such a small percentage of operating costs there is no material difference between expressing the change in incremental compliance costs in one way rather than the other. Operating costs are used here for convenience.



**Table 5.4: Change in Annual Incremental Compliance costs 1998-2002 due to Changes in Financial Services Regulation by the FSA: by Activity Grouping as Percentage of Annual Non-regulatory Operating Costs**

| Europe Economics groupings                                      | Sample mean<br>(per cent) | Sample median<br>(per cent) | Number of usable<br>responses |
|---|---------------------------|-----------------------------|-------------------------------|
| Banking and credit  | 1.4                       | 0.4                         | 7                             |
| Managed investments (both Fund<br>Management and Managing CISs) | 1.2                       | 0.2                         | 8                             |
| Retail (sales, advice, and broking)                             | 3.7                       | 1.0                         | 3                             |
| Insurance and pensions  | 0.8                       | 0.5                         | 10                            |
| Capital Market Operations                                       | *                         | *                           | 2                             |
| Exchanges, counterparties and others                            | 1.4                       | 0.9                         | 5                             |
| All firms   | 1.4                       | 0.5                         | 32                            |

\* Too few returns to report values. The median reported change in annual incremental compliance costs attributable to changes in FSA regulation was in the range 0-20 per cent for five capital market operations firms. Source: Firms' responses to Questions 5, 19, 28 and 29.

**For the whole sample, the median increase in continuing annual incremental compliance costs as a result of regulatory change is around 0.5 per cent of operating costs, and the mean increase is of 1.4 per cent of operating costs.**

Table 5.4 suggests that typical firms in the managed investments and banking and credit categories considered they faced more limited increases in compliance costs than firms in the other categories — the median increases are smaller for these groups.

The largest increases in annual incremental costs as a proportion of operating costs were in the retail and capital market operations, with means and medians here higher than for other categories.

More detail on regulatory drivers of change by activity category is provided in Section 5.5 below.

The increase as a proportion of operating costs found in this study (median 0.5 per cent; mean 1 per cent) is of the same order as the expectation suggested by data in the FSA Practitioner Panel Survey of November 2002, although the two sets of figures are not directly comparable due to differences in methodology, timing etc.<sup>13,14</sup>

<sup>13</sup> Chart 9.4 (p.106) of the Practitioner Panel study reported an expected median increase in costs between before and after "the N2 transition period" was somewhere between 11 and 20 per cent. It should be noted that, given the Practitioner Panel median result for total incremental costs was between 5 and 10 per cent of total costs (Chart 9.2, p.104), an expected N2-related increase of between 11 and 20 per cent in costs of compliance suggests that continuing increases in compliance costs due to regulation were typically expected to constitute around 1 per cent of total costs.

<sup>14</sup> By way of comparison, the BBA survey reports a median "impact of N2 on compliance costs" somewhere between "Moderate increase <10%" and "Larger increase" — which one might interpret as approximately 10 per cent. That survey does not report an initial compliance cost, so it is unclear what a 10 per cent increase represents in terms of operating costs. The AFB study suggests a 3 per cent increase for foreign banks. The current study median proportionate increase in incremental compliance costs for institutions heavily influenced by a foreign regulator is similarly lower than the whole sample increase, lying in the 0 to 20 per cent range.



As discussed below, many firms listed the process of regulatory change (as distinct from N2 preparation) as causing both one-off continuing costs. Noting the major changes already anticipated between 2003 and 2006, and the way financial services regulation was developing in the UK and EU, many firms indicated they believed that financial services regulation had moved to a permanent state of more frequent regulatory change. If firms have wrongly allocated one-off regulatory changes as continuing changes, then the estimates shown in Table 5.4 above could be over-estimates (and the one-off costs reported in Table 5.3 underestimates).

It is important to recognise that any change in regulation would be expected to increase incremental compliance costs until firms have adjusted their portfolios and behaviour to be optimal given the new regulation. The questionnaire had earlier asked firms to consider how their costs would differ, in the absence of FSA regulation, if they were sustaining their *present* portfolio of products. But before revised regulation has become fully reflected in product portfolios (i.e. before firms have adjusted their portfolios to reflect the higher compliance costs of products and practices the regulation is attempting to discourage), firms are experiencing the incremental costs of regulation but not all of its benefits (such as increased consumer confidence or the ability to sell a different portfolio of products).

If the intention of regulation is to prevent detriment to one group, regardless of whether (in the absence of regulation) the gains to other groups might outweigh losses, then there will be positive incremental compliance costs under well-designed regulation. But for some regulations the aim will be to promote the existence of a market in a product that would be prohibitively expensive to supply in the absence of regulation (e.g. a product subject to considerable adverse selection or moral hazard problems). In such cases the regulation makes it cheaper to supply those products, and the incremental costs of regulation, based on a portfolio of the *post facto* products, will be negative. But an incremental cost calculation based on the pre-regulation product portfolio, shortly after the regulation is introduced (as has been the basis of the current study), will naturally (and properly — for it would be the intention of the regulation) show non-trivial positive incremental compliance costs.

Hence those aspects of regulation firms believe impose the greatest incremental costs should be expected to be recent, with older, fully incorporated regulations being less significant. One would expect this, not merely because of the difficulty firms may have in considering the effects of older regulations, but because well-directed older regulations *should* generate lower incremental compliance costs, other things being equal. Likewise, it may be the *intention* of new regulation to generate additional incremental compliance costs for certain pre-regulatory portfolios and practices. The proper response of firms is to change their portfolios and practices accordingly.<sup>15</sup>

Once portfolios have adjusted, the incremental costs of regulation for sustaining that *new* portfolio should, if the regulation is well-directed, be low (or even negative). Thus incremental costs of very recent legislation can give a misleading account of the longer-term burden of that regulation. These points need to be borne in mind when interpreting the change in incremental compliance costs around N2.

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<sup>15</sup> How firms might be able to adjust their portfolios to reduce compliance costs is explored further in Section 6.3.





## 5.4 Regulatory Drivers of Change in Incremental Compliance Costs

### 5.4.1 Results from questionnaire

The questionnaire (questions 24-27) asked interviewees to identify the elements of regulatory change that had had the most impact on their incremental costs of compliance in the period 1998-2002. Firms were asked to distinguish between one-off and continuing changes to their costs. Table 5.5 below summarises the responses of the 45 firms that answered either Question 24 or Question 26 or that cited particular causes of increased incremental compliance costs in the interview.

For each potential cause of change in incremental compliance costs, it shows the numbers of firms identifying that cause as a source of one-off costs, as a source of continuing increase in incremental compliance costs; and as a source of both.

**Table 5.5: Reported Drivers of Changes in Incremental Compliance Costs — One-off or Continuing Changes**

| Number of firms specifying        | Source of one-off Cost | Source of continuing increase in cost | Both | Total number of firms mentioning |
|-----------------------------------|------------------------|---------------------------------------|------|----------------------------------|
| N2 preparation                    | 29                     | 0                                     | 1    | 30                               |
| Process of regulatory change      | 2                      | 8                                     | 15   | 25                               |
| Money laundering                  | 3                      | 5                                     | 13   | 21                               |
| Quality of advice and supervision | 1                      | 13                                    | 0    | 14                               |
| Approved Persons                  | 6                      | 4                                     | 3    | 13                               |
| Systems and control (SYSC)        | 4                      | 4                                     | 5    | 13                               |
| Complaints                        | 2                      | 4                                     | 4    | 10                               |
| Documentation/stationery          | 6                      | 0                                     | 2    | 8                                |
| Training and competence (T&C)     | 3                      | 3                                     | 2    | 8                                |
| Prescriptive on detail            | 0                      | 4                                     | 1    | 5                                |
| Fees                              | 0                      | 2                                     | 0    | 2                                |

*Source: Firms' responses to questions 24 and 26 and interviews.*

Although firms were asked to identify costs associated with each of the regulatory drivers they noted (Questions 25 and 27), only a minority of interviewees provided breakdowns of their estimated change in incremental compliance costs. Further, it is at times difficult to assign an interviewee's response to one of the classes of drivers being considered. As such, it is doubtful that a meaningful average estimate of the additional incremental cost of compliance associated with each category of cause can be computed, and this exercise is not pursued.

As can be seen in Table 5.5, many of the same drivers were cited as both one-off and as on-going costs. Some respondents replied to questions 26-27 (relating to continuing changes in costs) by writing "refer to questions 24-25" (which refer to one-off costs). The exceptions to this



were costs associated with preparing for N2, almost always regarded as one-off changes, and those associated with changes in the quality of advice and supervision, generally seen as on-going costs. These are as would be expected, and show that firms responding to this question understood the distinction. Many costs genuinely have both one-off and continuing impacts. This may be the case, for example, with new requirements relating to money laundering. For some categories of cost, the distinction between the two may be difficult to make, partly because it can depend on predictions of the future.

There are, however, points at which a reader may not necessarily agree with all of the categorisations made by firms. Causes of cost increases cited under process of regulatory change include dealing with the stream of FSA CPs and proposals was most frequently specified, along with the repeated reviews of internal procedures and systems that the FSA documents entailed. If the increase in regulatory change associated with FSMA and FSAP is viewed as a transitional period of exceptional regulatory change rather than as a permanent increase in the level of change, then this classification made by firms may not be considered appropriate. Eight firms provided numbers for continuing costs attributed to these causes, with a median of 0.2 per cent of operating costs (mean 0.3 per cent). It is also puzzling that for some firms the approved persons regime, and new systems and controls requirements, can impose continuing cost implications without generating any initial one-off costs. In both cases, any mis-classification of one-off costs as continuing costs would tend to increase the estimated change in annual incremental compliance costs.

Tables A2.3 and A2.4 report detailed findings by activity grouping. There are in most cases no discernible differences between the drivers most commonly reported by firms in different sectors. There appears to be a clear exception to this. The approved persons regime is proportionately more likely to be identified as a driver of change in compliance costs by retail firms and those providing insurance and pensions (all but one of the firms who mentioned this factor belonged to one of these two sectors); perhaps suggesting that costs are more related to approved persons dealing with retail customers than with those exercising other controlled functions.

#### **5.4.2 Main drivers of change in incremental compliance costs**

Thirty of the 45 firms that responded to these questions identified changes required by N2 as drivers that have significantly increased their costs of compliance. Many firms used “N2 preparations” as an umbrella under which they included, when prodded, factors that other firms mentioned as drivers in their own right. These included factors associated with changes in requirements for systems and controls, staff training and approved persons. Other issues firms included under the heading “N2 preparation” included the costs of reviewing the new rule book, the costs of implementing new procedures and preparing new documentation relating to the regulatory change, the costs associated with the grand-fathering process and the costs of establishing good working relationships with their new supervisory team. A significant proportion of those firms that specified “N2 preparation” as a source of costs had made use of external consultants to help them with the process.

Costs associated with changes in systems and controls were mentioned by a significant proportion of firms (13 out of 45). Of those that provided an explanation of what lay behind such



changes, firms identified first and foremost the impact of regulation on the need to formalise and document procedures that firms already had in place in a form acceptable to the FSA. One firm described this as the need “to demonstrate to the FSA that this is happening”. Other firms noted that the detail of a new specification of recording or reporting requirements could seem straightforward from the outside but could still require major IT work to bring together information held on different systems.

Changes to the regulation on money laundering were seen as having had an important impact on businesses’ cost of compliance: 21 respondents perceived this as having had a significant impact on their compliance costs. Thirteen of those firms indicated that the new regime had generated both one-off and continuing costs. For the six firms that reported estimates of the increased continuing annual cost attributable to revised money laundering obligations and oversight, the mean continuing annual increase was 0.4 per cent of annual non-regulatory operating costs and the median 0.2 per cent.

The FSA’s contribution to money laundering regulation is limited to the requirements that relevant firms take reasonable steps to identify their clients, appoint a money laundering reporting officer (MLRO) and ensure staff are aware of their role in preventing money laundering and given regular (every 24 months) and appropriate training on the matter.<sup>16</sup> The appointment and duties expected of a money laundering reporting officer (MLRO) were not raised as having had a significant impact on firms’ compliance costs.

The impact of the changes to money laundering regulations on compliance costs tended to arise from keeping detailed paper audit trails (including for closed accounts), the cost of training staff and the cost of client identification. Of these elements only the training requirement is new. Other costs relate to firms’ obligations under the 1993 Money Laundering Regulations. Since the FSA has taken over responsibility for monitoring compliance with the Money Laundering Regulations, this has been specified as a priority area and systematic monitoring of compliance with the 1993 Money Laundering Regulations is now in place, for the first time. FSA staff advised us that this monitoring has shown many firms’ procedures and record-keeping to be inadequate.

In contrast to the emphasis given by firm to money laundering obligations as a source of increases in incremental compliance costs, it is perhaps surprising that money laundering was specified as an important source of incremental compliance costs by only a few firms (see Table 4.7 above).

Money laundering regulation was one of the areas where firms asked Europe Economics if the FSA had carried out any work to review the actual costs and benefits against those anticipated in the initial consultation paper (in this case CP 46). Such ex-post evaluation can provide valuable information about the actual effects of policy changes.

Several firms (13 out of 45) identified the new regime on approved persons as having led to higher incremental compliance costs. Where this was raised, firms identified completing documentation and carrying out staff training as main contributory factors. As noted above, these

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<sup>16</sup> FSA Handbook, Money Laundering, February 2003.



firms were mainly retail and insurance and pension firms. A number of firms reported they had re-organised their internal structures to better meet the requirements of this regulation. Many of the compliance officers interviewed commented that this regime has led directors and senior managers to attach higher importance to regulatory compliance.

Ten of the 45 firms identified changes in the process of dealing with customer complaints as having had an important effect on their compliance costs. From the interviews, these costs may be largely driven by the increased volume of complaints rather than by any actual change in regulation. Several firms reported that, despite the filters used by the Ombudsman, they have to meet the cost of complaints made to the Ombudsman that the firms considered unfounded and unsupported, while complainants face no cost for making such complaints.

Close to a third of the respondents believed a change in the quality or nature of guidance and of supervision they received had led to higher incremental compliance costs. Within this broad heading, firms offered various more specific views on how the quality of FSA guidance and supervision contributed to their incremental compliance costs having risen. Some firms considered that their having had relatively inexperienced supervisory staff, and a high rate of supervisor turnover, had increased their costs, although other firms considered that the quality of supervision had improved compared to their previous regulator.

A recurring theme of firms interviewed was that, in their view, the specific guidance regime was not working well, so that it was not possible to obtain individual guidance on carefully considered requests in a reasonable timeframe. Some firms believed their business had been adversely affected by the inability to obtain such advice when it was necessary. Such firms were not always familiar with the procedures for giving individual guidance set out by the FSA, with some wrongly believing that giving such advice had been prohibited. It may be that this effect perceived by firms partly reflects procedures developed by the FSA to ensure the cost-effective nature of its supervisory regime. For example, the FSA does not expect to be the first port of call for queries, and has introduced internal procedures to reduce the risk of advice being given to a particular firm that has not first been fully considered.

Perhaps what is being picked up here is partly the effect of the FSA's risk-based approach to supervision, which means less frequent visits or monitoring for many firms not assessed as generating high risk to the FSA's objectives, but which may also increase uncertainty about regulatory behaviour.

As a general point, it should be noted that in their assessment of changes to incremental compliance costs since 1998 firms may be subject to some self-deception in their views of the enforcement of some general legislation (e.g. on money laundering), or on complaints and redress. There may be a natural tendency to blame the FSA because the FSA happens to be the responsible regulator at the time of enforcement ("shoot the messenger"), when in fact even in the absence of a financial regulator (and ombudsman) the courts may order that firms pay redress — in some cases this might be at considerably greater cost (e.g. for legal fees) than firms may bear in the presence of a regulator.



It is also possible, however, that firms may under-estimate their incremental compliance costs from other sources, such as the knock-on effects on their businesses from regulation.

Lastly, we note that only two of the 45 firms that identified drivers of change listed changes in FSA fees as having had an important impact on their incremental compliance costs.

## **5.5 Summary**

Firms were asked to compare their incremental compliance costs in the reporting year ending in 2002 with the incremental costs of compliance in the financial year ending in 1998. The initial period corresponds broadly to the period before the FSA's programme of change. Costs from this period are compared to those for the most recent period for which costs are available.

Most firms thought that the effect of changes other than regulatory change on the incremental costs of compliance with financial services regulation as it was in 1998 would have been zero or of a small increase.

From firms that provided estimates for one-off costs from regulatory change over 1998-2002, the median for their main one-off costs (a lower bound for their total one-off costs) was 0.8 per cent of their operating costs over the period. Most of these costs were incurred towards the end of the period, in 2001 and 2002 i.e. around the period of the FSA assuming its full powers (N2). N2 preparation was the most commonly cited driver of one - off costs, cited by 30 firms.

Costs of changes in regulation include those resulting from all regulatory change implemented by the FSA, not just of that over which it had discretion. During this period the FSA was required to introduce changes as a result of the Financial Services and Markets Act 2000 and the EU Financial Services Action Plan.

In Section 4 it was reported that firms' median estimate of their incremental compliance costs was of an addition to their operating costs of around 1.6 per cent. Most firms interviewed considered that **changes in FSA regulation** since 1998 had increased the continuing annual incremental compliance costs they faced. The median increase was of 0.5 per cent of operating costs.

Firms in the managed investments and banking and credit categories typically considered they faced more limited increases in compliance costs than firms in the other categories – the median increases are smaller for these groups. The largest increases in annual incremental costs as a proportion of operating costs were in the retail and capital market operations categories.

If firms mis-classified one-off costs as continuing, the reported estimate of increase in continuing incremental compliance costs would be an overestimate (and the reported estimate of one-off costs an underestimate). For example, many firms cited aspects of the process of regulatory change as a driver both of one-off costs and of continuing increases in incremental compliance costs. If the increase in regulatory change associated with FSMA and FSAP is viewed as a transitional period of exceptional regulatory change rather than as a permanent increase in the level of change, then some of these costs might better have been categorised as one-off costs. It is not possible to measure the effects of making distinctions between one-off and continuing costs other than those used by firms in answering the questions.



Other regulatory sources of increased costs cited by many firms included:

- money laundering (mainly from close FSA monitoring of the 1993 Money Laundering Regulations rather than from the new rules imposed by the FSA) was frequently cited as a source of both one-off and continuing costs;
- the approved persons regime (believed by many compliance officers to have led directors and senior managers to attach higher importance to regulatory compliance);
- supervisor turnover and inexperience (although other firms reported an improvement in supervision quality compared to under their previous regulator); and
- the perceived difficulty of obtaining individual guidance from the FSA.

Any change in regulation can be expected to increase incremental compliance costs until firms have adjusted their portfolios and behaviour to be optimal given the new regulation. The long-term increase in annual incremental compliance costs from a given episode of regulatory change would therefore be expected to be lower than the short-term increase.



## **6 HOW FIRMS CAN REDUCE THEIR COSTS OF COMPLIANCE**

### **6.1 Compliance Quality, Compliance Arrangements, Business Approaches, and Incremental Costs**

The questionnaire contained a number of questions asking firms about their internal compliance arrangements. It also asked firms for ideas of how to reduce compliance costs without undermining compliance quality. Appendix 4 sets out the responses of firms on actions that tend to reduce compliance costs (Q36). Section 6.2 analyses the ideas firms offered to share, and the actual practices of firms, to attempt to draw lessons for firms about how they can more efficiently comply with FSA regulation. Then Section 6.3 moves on to consider whether the business approach of firms — in particular how much they spend on “quality” other than to meet regulatory requirements — can make a difference to their incremental compliance costs.

### **6.2 How Effective are “Cost-reducing” Compliance Arrangements at Reducing Costs?**

#### **6.2.1 Compliance quality**

Compliance quality is a complex notion. Should it be based on the number of past incidents, or on the probability of future failings? What if a firm has an excellent record in respect of some elements of FSA regulation, but less so in terms of other elements? After discussion with the FSA, it was agreed there was no ready way of compiling a well-defined and objective index of compliance quality. (This is not to say, of course, that the FSA does not have clear views on the compliance quality of individual firms.)

For the purpose of this exercise, Europe Economics grouped firms in the sample by compliance quality into roughly equal “High”, “Medium” and “Low” categories, on the basis of comments on firms’ compliance provided by FSA supervisors. Since this ranking depends on individual judgements made by supervisors, it is possible that firms of similar underlying quality could be classified differently.

The categorisation of firms’ quality of compliance was put together once the interviews had been completed and did not affect the interviews or data entry. The Europe Economics categorisations were not reported back to the FSA.





### 6.2.2 Compliance quality and incremental cost

Europe Economics ranked firms by their reported incremental compliance costs as a percentage of non-compliance operating costs ( $Q19/(Q5 - Q19)$ ), then grouping firms into Low/Medium/High incremental compliance costs (by their ranking within categories, so as to adjust for the difference in compliance costs between categories).<sup>17</sup> In this way a 3 x 3 matrix was constructed as shown in Table 6.1.

**Table 6.1: Compliance Quality versus Incremental Compliance Cost**

|                              |   | Compliance Quality |         |         |
|------------------------------|---|--------------------|---------|---------|
|                              |   | L                  | M       | H       |
| Incremental compliance costs | L | 6 firms            | 7 firms | 5 firms |
|                              | M | 2 firms            | 5 firms | 6 firms |
|                              | H | 4 firms            | 5 firms | 2 firms |

Cells along the upper-left-to-lower-right diagonals of this matrix would represent different points in a compliance quality/compliance costs trade-off (e.g. choosing between having high compliance quality at high cost and low compliance quality at low cost).

One set of valuable lessons for firms would be how to move, instead, along the lower-left-to-upper-right diagonals, the “improving trade-off diagonals”, for example from medium compliance quality at high cost to high compliance quality at medium cost.

### 6.2.3 Methodology

To identify lessons on how to improve the compliance quality/compliance costs trade-off, Europe Economics compared the compliance practices (from Section A4 of the questionnaire) and opinions (from Section A3) of firms in pairs of cells along all the improving trade-off diagonals. Referring again to Table 6.1, there are five pairs of cells along the improving trade-off diagonals:

- Low compliance quality at high compliance cost (LH) versus high compliance quality at low compliance cost (HL);
- LH versus MM;
- MM versus HL;
- MH versus HM; and

<sup>17</sup> Note that the analysis was also conducted with compliance costs ranked on an overall basis (so not adjusting for cost differences between categories), and also with an overall ranking adjusted for whether firms reported that regulation obliged them to hold additional capital (see Section 4). Neither of these alternative specifications led to substantial changes in the findings or appropriate lessons. The results of adjusting for the effects of the capital holding decision are discussed further below.



- LM versus ML.

For each of these pairs a mean response to the compliance questions was calculated for each cell of Table 6.1. In some cases a particular answer was more often obtained from firms in the favourable element of a trade-off pair (a “positive result”). In other cases a particular answer was more often obtained from firms in the unfavourable element of a trade-off pair (a “negative result”). The total number of results (positive plus negative plus no difference) always sums to five.

When the number of positive results was the same or only one more or less than the number of negative results, no significance was attached. For example, out of the five pairs in two cases a high priority given by the compliance function to remedial action generated a positive result in two cases it generated a negative result, and in one pair there was no difference — hence there was no finding that this priority was either efficient or inefficient.

When the number of positive results was at least three more than the number of negative results this was taken as an indicator that the compliance arrangement in question promoted compliance-efficiency (for example, in some cases there were three positive results and no negative results). In contrast, when the number of negative results was at least three more than the number of positive results this was taken as an indicator that the compliance arrangement in question promoted compliance-inefficiency (for example in some cases there were four negative results and one positive result).

The results below focus on the trade-off improving diagonals so as to increase robustness. Because firms are grouped, and because of the use of group averages, it is possible that a horizontal movement may, in fact, involve higher compliance quality at higher incremental cost. Similarly, a vertical movement may involve a reduction in incremental costs but also some corresponding reduction in compliance quality. By focusing on movements along the trade-off improving diagonals the analysis identifies changes in compliance practice that might lead to unambiguous improvements in compliance efficiency.

Another important issue is that the methodology adopted here focuses on *differences* between firms in the different groups. If, for example, one considered in isolation the practices adopted by the firms in the High Compliance Quality/Low Incremental Compliance Costs box in Table 6.1, it would be impossible to draw lessons about which of these actually promoted compliance efficiency, and which were irrelevant (say).<sup>18</sup> For example, suppose that the average firm in this box employs 1 per cent of its staff as compliance staff. Is that efficient or merely irrelevant? As it turns out the number of compliance staff, per se, appears to be irrelevant, but that is not something it would be possible to conclude by considering one box in isolation. The methodology adopted here compares more compliance-efficient groups of firms with less compliance-efficient groups of firms, so as to draw lessons from the differences between them.

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<sup>18</sup> In addition, of course, there would be the issue that even the most efficient firms in the sample may not be as efficient as would be theoretically possible



## 6.2.4 Findings about compliance efficiency

Table 6.2 summarises various important results (with compliance-inefficient results shown in italics). Note that the figures that appear in Table 6.2 refer to numbers of groups, not to numbers of firms. This means that rather more firms are involved in a result than may be obvious at first sight. For example, the “Compliance function reports to the CEO” result has four positive results and one negative result (out of the maximum of five results possible). From all such results nine of the firms in the sample are excluded (those in the LL and HH boxes of Table 6.1), but in this case of the other 33 firms appearing in Table 6.1, all those answering Q47 are included (i.e. in this case 32 firms).

**Table 6.2: Indicators of Efficient or Inefficient Compliance Practice from Improving Trade-off: Diagonals Analysis**

| Compliance practice or priority indicated  | Question  | Number of positive results between pairs of groups | Number of negative results between pairs of groups <sup>19</sup> |
|--|-----------|--|--|
| Mention of FSA relationship  | 36 g or j | 3  | 0  |
| Mention of approach to monitoring  | 36 h      | 3  | 0  |
| Rank of implementing and influencing regulatory change   | 51        | 4  | 1  |
| <i>Rank of providing advice</i>  | <i>51</i> | <i>0</i>   | <i>5</i>   |
| <i>Compliance function reports to Board</i>  | <i>47</i> | <i>0</i>   | <i>3</i>   |
| <i>Head of compliance on Board</i>   | <i>46</i> | <i>1</i>   | <i>4</i>   |
| Compliance and legal functions in the same overall department  | 48        | 4  | 0  |
| Compliance and risk functions in the same overall department   | 48        | 1  | 3  |
| Proportion of staff in compliance  | 50/9      | 3  | 2  |
| <i>Firm uses external lawyers in compliance</i>  | <i>56</i> | <i>1</i>   | <i>3</i>   |
| <i>Firm uses compliance consultants</i>  | <i>56</i> | <i>1</i>   | <i>3</i>   |
| Company responds to compliance failings by following up the resolution of the issue and employing appropriate monitoring | 54        | 3  | 0  |

Findings illustrated in Table 6.2 include that:

1. Firms with more favourable compliance quality/cost trade-offs (i.e. lower incremental compliance cost for a given reported compliance quality) were more likely to have mentioned their relationship with the FSA, and in particular to believe that having an open and/or proactive interaction with the FSA or their supervisors reduced costs. (i.e. forming a close and proactive relationship with FSA supervisors appears to be compliance-efficient.)

<sup>19</sup> Note that there are five pairs of groups, so the number of pairs of groups for which there was no significant relationship is always five minus



2. Firms with more favourable compliance quality/cost trade-offs were more likely to have mentioned the use of risk-based monitoring. This suggests that using risk-based monitoring may be compliance-efficient. This was particularly true of firms obtaining high quality compliance at moderate incremental compliance cost.
3. It may be relatively efficient to devote a higher share of compliance resources to implementing and influencing regulatory change and (to a lesser extent) to monitoring. In contrast, it seems to be compliance-inefficient to devote a high share of compliance resources to providing advice.
4. Firms in which the head of the compliance function reported just to the board generally, tended to be less compliance-efficient than firms for which the head of the compliance function reported to some defined individual.
5. Including the head of the compliance function on the board does not appear to be compliance-efficient. This does not appear to be the result of muddying of reporting lines (see previous bullet-point). It may be simply that, *per se*, the use of expensive “hard-hitting” senior compliance personnel is over-rated.
6. Combining the compliance and legal functions within one overall department appears to increase compliance efficiency.
7. However, the analysis did not support the proposition that combining the compliance and risk functions (or compliance and internal audit functions) within one overall department increases compliance efficiency.
8. The proportion of staff involved in compliance appears to be independent of the compliance quality/cost trade-off. That is to say, it is neither more efficient nor less efficient to have many compliance staff.
9. The use of external lawyers to meet compliance goals seems not to be compliance-efficient. Use of external consultants for compliance advice may also not be very compliance-efficient.
10. In responding to compliance failures, the most compliance-efficient part of the response appears to be to follow up the resolution of the issue and employ appropriate post-event monitoring.

The first finding here (about the value of forming a good relationship with the FSA, either directly or through supervisors) gained further support from other tests. For example, over the sample as a whole, firms that mentioned having a good relationship with the FSA had incremental compliance costs of only between one third and a half of the incremental compliance costs of firms that answered Q36 but did not mention the FSA. Furthermore, firms that mentioned having a good relationship with the FSA were likely to rank financial regulation lower on average in Q44 (concerning what restricted firms from increasing margins by reducing service quality) — that is to say, firms who valued a good relationship with the FSA considered financial regulation less of a restriction in their markets. This does not rule out an element of regulatory capture in these



instances. That is to say, the FSA might not always welcome such a close relationship as is perceived beneficial by firms.

Given the importance to compliance costs of whether firms reported that regulation obliged them to hold more capital than they would otherwise choose, the analysis above was repeated by grouping firms into those that reported that regulation obliged them to hold higher capital, and those not so reporting, then ranking their compliance costs as high, medium, or low within these groups. This alternative ranking of compliance costs left most findings as above. However, compared with the above findings, adjusting the rankings of incremental compliance costs for the capital position alters the above findings slightly.

Some changes occur at the margin in how the allocation of allocation of compliance resources to different tasks is associated with compliance efficiency. An emphasis on remedial action (in responses to both questions 36 and 54) becomes positively associated with efficient compliance. High priorities for training; product/business development; and money laundering in the allocation of compliance resources become negatively correlated with compliance efficiency and the emphasis given to implementing and influencing regulatory change ceases to be material.

In addition, the positive effect on compliance efficiency of integration of compliance with the legal function declines with this categorisation of firms to become statistically less significant.

Lessons drawn below take into account this further analysis, emphasising conclusions that are robust across different ways of ranking firms.

### **6.2.5 Lessons for firms about efficient compliance arrangements**

It is important to note that with all of the results above there is a “problem of causality”. Is it that firms do the things identified above as compliance-efficient and then have low compliance costs, or is it, instead, that firms with low compliance costs do the things identified above as compliance-efficient? For example, it is suggested above that having the head of the compliance function on the board appears to be compliance-inefficient. But perhaps what happens is that certain companies are compliance-inefficient and try to address that by having the head of compliance on the board. Again, the findings suggest that having a good relationship with FSA supervisors is compliance-efficient. But perhaps firms that have low compliance costs are well-disposed to their FSA supervisors whilst, similarly, supervisors of high compliance quality firms are well-disposed to the firms.

This means that the appropriate lessons to draw from these statistical relationships are not straightforwardly a matter of recommending firms do what the more compliance-efficient firms do or say. Instead we must form a judgement about what lessons it is right to draw, based partly on these statistical results, but also on insights from compliance practice.

This section should not be taken as suggesting that there is any one do-it-all way of organising compliance. Each firm must choose from among the options available those that best serve its own requirements.



Noting the findings of Section 6.2.4 and the above caveats, there are a number of key lessons for firms Europe Economics considers it is legitimate to draw:

1. Open and pro-active contact with FSA supervisors may reduce compliance costs and increase compliance quality. Firm supervisors will better be able to offer guidance and give feedback on whether processes meet the regulations or need changing if they understand a firm's business and if the firm works with them rather than against them. However, the FSA's risk-based approach to monitoring will have reduced the regularity of contact with supervisors for many smaller firms: this finding suggests that this reduction may be generating costs to firms as well as benefits.
2. The most cost-efficient priorities for the compliance function are monitoring compliance and, possibly, implementing regulatory change. Heavily occupying the compliance function with other duties is not efficient. Compliance may need some involvement in other activities, but is most efficient if a balance is struck such that the core compliance tasks have the principal focus.
3. Using risk-based monitoring may be compliance-efficient, in that it helps focus effort and keep down costs.
4. The compliance function will be more compliance-efficient if it is accountable to well-defined individual(s), rather than simply to the board as a whole. And the efficient procedure appears to be the compliance function to be accountable to a defined member of senior management (though this should not be interpreted as suggesting that senior management attempt to micro-manage the compliance function).
5. Compliance may be more efficient when operating in close conjunction with a legal function, rather than being integrated with risk or other functions. It is possible that facilitating the transfer of legal expertise on compliance issues may be relatively efficient (though this should not be interpreted as implying that it is most efficient for compliance staff to be formally trained lawyers).
6. When responding to compliance failures, it is most cost-effective to ensure that resolution of an issue is brought to completion, that appropriate changes to procedures etc. are actually implemented, and follow-up monitoring is conducted.

In summary, though there can be no one simple set of compliance practices that will always promote compliance efficiency for all firms, and the right approach to compliance arrangements will vary depending on size, ownership, product distribution model, etc., the over-riding message of this analysis is that firms should try to avoid over-engineering their compliance arrangements. Prominence and profile are not necessarily the same thing as compliance efficiency. Firms should consider keeping it simple, and ensuring above all that compliance resources are not deflected from carrying out the traditional core tasks of the compliance function.



## 6.3 Would Changing Business Approach Reduce a Firm's Compliance Costs?

### 6.3.1 Assessed compliance quality and vertical differentiation

Question 41 of the survey was intended to understand how firms located themselves in terms of price and product offering. Table 6.3 shows which of the categories offered firms considered the most important source of any durable competitive advantage they held.

**Table 6.3: Sources of Competitive Advantage in Order of Importance: All Firms**

| Source of competitive advantage   | Number of firms specifying as |                       |                      |
|---|-------------------------------|-----------------------|----------------------|
|   | Most important                | Second most important | Third most important |
| Your costs are lower  | 9                             | 1                     | 2                    |
| Your brand is stronger  | 21                            | 2                     | 6                    |
| Your product range is more closely aligned with your customers' preferences | 13                            | 11                    | 3                    |
| Your service to your customers is of higher quality                         | 21                            | 6                     | 9                    |
| Your innovation in products or service is more regular and useful           | 7                             | 5                     | 3                    |
| Something else  | 10                            | 3                     | 0                    |

Source: Firms' responses to Question 41.

As can be seen from Table 6.3, more firms considered stronger brands and service quality to customers as durable sources of their competitive advantage than identified any other source. These might be expected to be associated with higher quality products, or at least with higher effort to convince customers that products/firms are of high quality.

In contrast, citing lower costs as a source of competitive advantage might be associated with selling products that are towards the lower end of a vertically differentiated scale, and to be more likely to be associated with lower assessed quality of compliance.

Table 6.4 reports these findings broken down according to assessed compliance quality of firms.





**Table 6.4: Most Important Source of Durable Competitive Advantage by Firm's Assessed Compliance Quality**

| Source of competitive advantage   | Number of firms specifying as most important by assessed compliance quality of firms |        |     |
|---|--|--------|-----|
|   | High   | Medium | Low |
| Your costs are lower  | 3  | 5      | 1   |
| Your brand is stronger  | 8  | 7      | 6   |
| Your product range is more closely aligned with your customers' preferences | 5  | 5      | 3   |
| Your service to your customers is of higher quality                         | 6  | 11     | 4   |
| Your innovation in products or service is more regular and useful           | 3  | 3      | 1   |
| Something else:   | 3  | 5      | 2   |

*Source: Firms' responses to Question 41, assessments of compliance quality.*

Table 6.4 suggests that the sources of competitive advantage cited by firms are independent of assessed compliance quality. In particular, a firm considering its cost advantage to flow from lower costs did not increase the probability of it being assessed a low compliance quality firm; and firms assessed as of low compliance quality were just as likely to consider that their competitive advantage lay in a strong brand or higher quality service.

Some alternative method of analysis using data collected in the survey was necessary to test the relation between vertical differentiation and quality of compliance.

### 6.3.2 "Intrinsic quality" and incremental compliance costs

One straightforward way for firms to reduce compliance costs might seem to be to stop acting in ways (or selling products) that raise compliance issues. We consider two possible changes to business approach that might be thought to affect incremental compliance costs:

- 1 One might expect that if firms were to raise their quality that would reduce compliance costs. If one important objective of financial regulation is to ensure that financial products sold do not fall below some intrinsic quality threshold, then perhaps incremental compliance costs would be lower if intrinsic quality were higher?
- 2 Alternatively, one might imagine that if regulation treats financial products as essentially commodities, with little true underlying quality difference but significant credence goods issues, then attempts to raise perceived quality would work against the objectives of financial regulation and give rise to greater compliance costs. Hence in this case incremental costs might, perhaps, be higher if customer-*perceived* intrinsic quality (though not, of course, actual quality) were higher?

As Section 2 discussed, this position may differ between financial service markets included in this study.



To test these competing hypotheses, firm quality was proxied by *the amount firms claim to spend on risk management and client confidence, after deducting from those totals the incremental costs incurred as a result of regulation*. This notion of underlying expenditure on risk management and client confidence should in principle be broad enough to encompass the firm's financial position as well as expenditure on the quality of the products supplied, two useful dimensions in assessing the quality of a firm.

If all firms operated in the same business environment, and if expenditure on quality were realised in practice in higher quality outputs, then this measure would be a good proxy for intrinsic firm quality. Of course, different kinds of firm operate in different categories of business, and it may be that different categories require different degrees of expenditure on quality in order to generate the same quality of output. Furthermore, the evidence from published studies reported in Section 2 can be interpreted as implying that different financial services markets operate differently, with some being some way away from standard models of competitive markets. In such markets, reputation-building expenditure may not be related to any underlying objective measure of product quality, for example if financial services products such as retail savings products are to a significant extent credence goods, or are experience goods with only weak pressure from repeat purchases.

The analysis in this section meets this difficulty by presenting findings at the category level (banking and credit, managed investments and so on) to test the competing hypotheses.

A dynamic market will contain firms that are inefficient and may, in due course, be eliminated. Alternatively, even in the long-run some firms may be more efficient than average at, for example, labour recruitment, but less efficient at intrinsic quality expenditure. In either of these cases higher expenditure on quality may not be realised in higher quality outputs.

Nonetheless, it may still be productive to test whether expenditure on intrinsic quality can serve as the basis for an informative, if imperfect, proxy for intrinsic quality.<sup>20</sup> To derive our measure of "Intrinsic Quality" we express expenditure on non-regulatory risk management and client confidence as a percentage of non-regulatory operating costs  $((Q11-Q19)/(Q5 - Q19))$ .

In some of the discussion below we quote "Intrinsic Quality" as High/Medium/Low. In such cases we simply ranked firms by Intrinsic Quality then divided them into thirds.

### 6.3.3 "Intrinsic quality" versus incremental compliance costs

Table 6.5 tracks expenditure on intrinsic quality versus incremental compliance costs, by group and for the whole sample.

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<sup>20</sup> That the measure of firm quality is problematic is, of course, taken into account when assessing the findings of the statistical analysis.

**Table 6.5: Intrinsic Quality versus Incremental Compliance Costs**

| Activity Groupings   | Incremental compliance costs as percentages of operating costs, by “Intrinsic Quality” grouping |        |     |
|--|---|--------|-----|
|  | High  | Medium | Low |
| Banking and credit   | 8   | 1      | 1   |
| Managed investments (both Fund Management and Managing CISs) | 8   | 2      | 1   |
| Retail (sales, advice, and broking)                          | 4   | 1      | 2   |
| Insurance and pensions                                       | 4   | 1      | 1   |
| Capital Market Operations                                    | 10  | 0      | 1   |
| Exchanges, counterparties and others                         | 0   | 3      | 3   |
| <b>All</b>   | 4   | 3      | 1   |

Source: Firms' responses to Q5, Q11, Q19.

From Table 6.5, for every category except “Exchanges, counterparties and others” the highest incremental costs, by a considerable margin, are experienced by those with the highest intrinsic quality spend. For example, for Banking and Credit, firms with High intrinsic quality report incremental compliance costs of 8 per cent of non-regulatory operating costs, some eight times those experienced by medium or low “intrinsic quality” spend firms.

Between the low and medium intrinsic quality expenditure categories the relationship is less clear. Sometimes medium “intrinsic quality” spend is associated with higher incremental compliance costs than low “intrinsic quality” spend, and sometimes with lower incremental compliance costs.<sup>21</sup>

Besides the greater heterogeneity of the “Exchanges, counterparties and others” compared with other groups, it also seems plausible that it is in the nature of Exchanges and counterparties that there are very clear objectively defensible gains to being perceived by clients as being of higher quality. In these cases the clients will tend to be highly sophisticated firms and investors, for whom the regulator will feel no need to act as a representative or monitor.

Given the evidence in Section 2 about market failures in markets for retail investment products, it is not surprising that such a result holds in those markets. The same comment may also be appropriate for fund management, where firms may have informational advantages over fund trustees, and for banking and credit activities directed at retail customers who are unlikely to switch (although this does not hold for mortgages). However, the findings are more surprising for firms engaged in capital market operations. Here firms are typically dealing with sophisticated wholesale counterparties, and markets may be expected to be much closer to economists'

<sup>21</sup> Given the importance of costs of holding additional capital for firms required to do so, the analysis above was repeated for each of two groups of firms: those that stated they would hold less capital in the absence of regulation; and those that did not. For firms that would hold less capital in the absence of regulation, high Intrinsic Quality spend firms have incremental compliance costs of 5 per cent of operating costs, medium IQ spend firms have ICC of 5 per cent, and low IQ spend firm have ICC of 1 per cent. For firms that did not state they would hold less capital in the absence of regulation, high Intrinsic Quality spend firms have incremental compliance costs of 4 per cent of operating costs, medium IQ spend firms have ICC of 1 per cent and low IQ spend firms have ICC of 1 per cent. The finding that incremental compliance costs typically increase with Intrinsic Quality spend is not a spurious result related to firms' holding of capital.



models of perfect competition. In these markets, the reverse relationship might have been expected.

The evidence suggests to us it is likely that that firms in at least some of the markets analysed perceive a significant opportunity in the market to gain a competitive advantage by being regarded as high quality by customers, and hence may engage in credibility-building activity by raising expenditure on “intrinsic quality”. In trying to recover through product differentiation the costs of such expenditure, firms may then be more likely to face costs from regulatory constraints.

On the other hand, firms with high quality and expensive risk-management systems and sophisticated customers may be highly averse to regulatory risk, on the grounds that non-compliant behaviour would damage their reputations. This could lead to high incremental compliance spending, especially if such firms have a strong preference for using their own bespoke approaches to risk-management. This could also be a factor in explaining the positive relationship. The analysis undertaken for this study was not able to distinguish between expenditure on risk management that may directly lead to objectively increased quality (for example investment in sophisticated risk-management software) and expenditure that may not (such as advertising).

There are also further possible influences that might contribute to the positive relationship observed. For example, firms that took a broad view of their risk management costs may have also been more likely to take a broad view of the adjustments they would make in the absence of regulation. Or firms that had introduced more sophisticated risk-management systems may have faced higher costs in grafting specific regulatory reporting requirements onto them.

But the strong positive relationship found between “intrinsic quality” expenditure and incremental compliance costs, taken alongside the evidence on the working of markets noted in Section 2, suggests that in at least some regulated financial services markets, “intrinsic quality” expenditure tend to increase, rather than reduce, the demands then placed on the firms by the regulator.<sup>22</sup>

Of course, this would not establish whether the regulator would be correct to treat certain markets as commoditised (which it was not part of this study to assess), only that there appears to be a major disjunction between firms’ notions of quality and the FSA’s.

It may be helpful to consider here how the discussion above relates to the emphasis on “suitability” in FSA regulatory practice. In a vertically differentiated market some products are simply better — better for everybody — so the question of “suitability” does not arise. Suitability is the characteristic of horizontally differentiated markets: in a horizontally differentiated market some products will be more suitable for some customers than other products. Where a regulatory approach does not treat financial services products as vertically differentiated, it would be expected that a notion of suitability would be central to regulatory practice, as is indeed the case with the FSA.

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<sup>22</sup> Note that this study has not collected evidence on the precise mechanisms by which this would happen.



It is possible that while attempts to differentiate vertically are perceived by the regulator as involving attempts to exploit informational advantages over consumers, and so create greater compliance costs, the gains from being perceived as higher quality by customers are such that firms choose to bear these higher compliance costs, sometimes even engaging in activities that run against the objectives of financial regulation.<sup>23</sup> In such cases, firms could reduce their compliance costs (in some cases considerably) by simply ceasing to engage in activities that run against these regulatory objectives. In practice this would mean attempting to market higher-priced products as “higher quality” only where this can be shown to the regulator to be justified on the basis of objective quality criteria.

## **6.4 Summary of Section**

On compliance arrangements:

- Compliance-efficient firms work proactively with their supervisors, rather than against them.
- Keep it simple. Prominence and profile are not necessarily the same thing as compliance efficiency. Efficient compliance arrangements ensure above all that compliance resources are not deflected from carrying out the traditional core tasks of the compliance function.

On business approach:

- Compliance costs will be significantly lower if firms do not attempt to differentiate their products as being of higher quality unless this differentiation can be shown to the regulator to be based on objective criteria. Compliance-efficient firms work with the principles of financial legislation, rather than against them.

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<sup>23</sup> The FSA's principles for regulated businesses are set out in Appendix 1. The issue arises of whether these costs should really be counted among “compliance costs”, if for example firms as bearing them voluntarily in return for greater opportunity to exploit informational advantages over consumers.



## APPENDIX 1: FSA PRINCIPLES FOR BUSINESSES

1. **Integrity.** A firm must conduct its business with integrity.
2. **Skill, care and diligence.** A firm must conduct its business with due skill, care and diligence.
3. **Management and control.** A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. **Financial prudence.** A firm must maintain adequate financial resources.
5. **Market conduct.** A firm must observe proper standards of market conduct.
6. **Customers' interests.** A firm must pay due regard to the interests of its customers and treat them fairly.
7. **Communications with clients.** A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. **Conflicts of interest.** A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. **Customers: relationships of trust.** A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. **Customers' assets.** A firm must arrange adequate protection for customers' assets when it is responsible for them.
11. **Relations with regulators.** A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

*Source: FSA Handbook of rules and guidance*



## APPENDIX 2: ADDITIONAL TABLES

**Table A2.1: Constraints on Reducing Service Quality: Providers of or Advisers on Retail Investment Products (Firms in Category C (Retail), or D (Insurance and Pensions) other than General Insurance Firms)**

| Constraints on reducing service quality | Number of firms specifying as |                       |                      |
|---|-------------------------------|-----------------------|----------------------|
|   | Most important                | second most important | third most important |
| UK Regulation                           | 4                             | 1                     | 5                    |
| Overseas regulation                     | 0                             | 1                     | 0                    |
| Loss of industry kite-marks             | 0                             | 0                     | 0                    |
| Loss of customers                       | 11                            | 3                     | 1                    |
| Response of competitors                 | 1                             | 8                     | 3                    |
| Something else. Please specify          | 1                             | 0                     | 0                    |

Source: Firms' responses to Q44

**Table A2.2: Constraints on Reducing Service Quality: All Other Firms**

| Constraints on reducing service quality | Number of firms specifying as |                       |                      |
|---|-------------------------------|-----------------------|----------------------|
|   | Most important                | second most important | third most important |
| UK Regulation                           | 4                             | 5                     | 13                   |
| Overseas regulation                     | 0                             | 1                     | 4                    |
| Loss of industry kite-marks             | 0                             | 1                     | 3                    |
| Loss of customers                       | 24                            | 4                     | 3                    |
| Response of competitors                 | 2                             | 17                    | 1                    |
| Something else. Please specify          | 1                             | 0                     | 1                    |

Source: Firms' responses to Q44





**Table A2.3: Firms' response to Questions 24 and 25 on Drivers of Change in One-Off Changes in Incremental Compliance Costs: Numbers Specifying**

| Regulatory driver                 | Banking and credit | Managed Investments | Retail sales advice and broking | Insurance and pensions | Capital market operations | Exchanges, Counterparties and Others | Total |
|-----------------------------------|--------------------|---------------------|---------------------------------|------------------------|---------------------------|--------------------------------------|-------|
| N2 preparation                    | 5                  | 8                   | 4                               | 7                      | 3                         | 3                                    | 30    |
| Process of regulatory change      | 4                  | 4                   | 2                               | 4                      | 2                         | 1                                    | 17    |
| Money laundering                  | 3                  | 3                   | 3                               | 3                      | 2                         | 2                                    | 16    |
| Quality of advice and supervision | 0                  | 0                   | 1                               | 0                      | 0                         | 0                                    | 1     |
| Approved Persons                  | 1                  | 2                   | 2                               | 4                      | 0                         | 0                                    | 9     |
| Systems and control (SYSC)        | 5                  | 1                   | 2                               | 0                      | 0                         | 1                                    | 9     |
| Complaints                        | 1                  | 3                   | 0                               | 2                      | 0                         | 0                                    | 6     |
| Documentation / stationery        | 3                  | 1                   | 1                               | 1                      | 1                         | 1                                    | 8     |
| Training and competence (T&C)     | 2                  | 1                   | 1                               | 1                      | 0                         | 0                                    | 5     |
| Prescriptive on detail            | 0                  | 1                   | 0                               | 0                      | 0                         | 0                                    | 1     |
| Fees                              | 0                  | 0                   | 0                               | 0                      | 0                         | 0                                    | 0     |
| <b>Total number of responses</b>  | <b>9</b>           | <b>9</b>            | <b>7</b>                        | <b>9</b>               | <b>5</b>                  | <b>4</b>                             |       |

Source: Firms' responses to questions 24 and 25 and interviews.



**Table A2.4: Firms' Response to Questions 26 and 27 on Drivers of Continuing Change in Incremental Compliance Costs: Numbers Specifying**

| Regulatory driver                 | Banking etc. | Managed Investments | Retail sales advice and broking | Insurance and pensions | Capital market operations | Exchanges, Counterparties and Others | Total |
|-----------------------------------|--------------|---------------------|---------------------------------|------------------------|---------------------------|--------------------------------------|-------|
| N2 preparation                    | 1            | 0                   | 0                               | 0                      | 0                         | 0                                    | 1     |
| Process of regulatory change      | 4            | 5                   | 3                               | 6                      | 3                         | 2                                    | 23    |
| Money laundering                  | 4            | 3                   | 4                               | 3                      | 1                         | 3                                    | 18    |
| Quality of advice and supervision | 2            | 4                   | 3                               | 2                      | 1                         | 1                                    | 13    |
| Approved Persons                  | 1            | 0                   | 3                               | 3                      | 0                         | 0                                    | 7     |
| Systems and control (SYSC)        | 2            | 2                   | 3                               | 2                      | 0                         | 0                                    | 9     |
| Complaints                        | 1            | 4                   | 0                               | 2                      | 1                         | 0                                    | 8     |
| Documentation / stationery        | 0            | 1                   | 0                               | 0                      | 1                         | 0                                    | 2     |
| Training and competence (T&C)     | 2            | 0                   | 1                               | 0                      | 1                         | 1                                    | 5     |
| Prescriptive on detail            | 0            | 3                   | 0                               | 2                      | 0                         | 0                                    | 5     |
| Fees                              | 0            | 0                   | 1                               | 1                      | 0                         | 0                                    | 2     |
| <b>Total number of responses</b>  | <b>7</b>     | <b>10</b>           | <b>8</b>                        | <b>9</b>               | <b>5</b>                  | <b>4</b>                             |       |

Source: Firms' responses to questions 26 and 27 and interviews.

**Table A2.5: Total Costs of Risk Management and Client Confidence as a Percentage of Operating Costs: Whole Sample**

| Percentage      | Number of responses |
|-----------------|---------------------|
| 0-5 per cent    | 16                  |
| 5-10 per cent   | 7                   |
| 10-20 per cent  | 8                   |
| 20-40 per cent  | 10                  |
| 40-60 per cent  | 0                   |
| 60-80 per cent  | 2                   |
| 80-100 per cent | 1                   |
| <b>Total</b>    | <b>44</b>           |

Source: Firms' responses to Q11/Q5.



## APPENDIX 3: THE FSA'S SUPERVISORY RELATIONSHIP WITH FIRMS

The FSA's expectations of the nature and intensity of its supervisory relationship with firms is set out in "Financial Services Authority — A new regulator for the new millennium" (January 2000), as follows (p.19):

*"The nature and intensity of the FSA's relationship with a firm will depend on its assessment of the impact of the firm on consumers and on market participants.*

*At one end of the spectrum the FSA will expect to maintain a continuous relationship with certain firms, in order to develop and sustain a detailed understanding of current and potential areas of risk in the firm. This approach will be resource-intensive and will be efficient only for firms with a high impact grading. Supervisors of firms in this category will maintain regular working relationships with the firm's senior management team in order to understand the firm's systems and controls, and to be aware of other areas of potential risk through knowledge of the firm's business, structure, key processes and systems.*

*At the other end of the spectrum the FSA expects to cover large numbers of mainly small firms, which it assesses as low-impact, using a remote monitoring approach combined with visits, as necessary, in relation to specific issues. This relies heavily on carrying out a common set of activities across large numbers of firms, in order to investigate cross-industry risks, rather than focusing resource on individual firms. Firms in this category would not have a regular relationship with the FSA, but would be expected to submit periodic returns for automated analysis, and to inform the FSA of any major strategic developments. Their selling trends and practices would be monitored, and they would be included in industry-wide sampling exercises. They would also have a nominated contact point in the FSA. The FSA will consider how best to offer guidance — including via industry Helplines — to firms with which it will not have a regular supervisory relationship.*

*Where a firm within a particular supervisory category enters a situation of heightened risk, the intensity of the supervisory relationship will be adjusted accordingly, for a temporary period until the events prompting the crisis have been addressed. If the risks are not addressed within a set period, further action is likely to be appropriate (e.g. intervention, wind-down etc).*

*The FSA will explain to firms the nature of the supervisory relationship so that they understand what to expect of the FSA. FSA supervisory staff, in turn, will have clear objectives for their activities. We will aim for a shared understanding of what information is required, when and why, and in which situations pre-notification is required (e.g. mergers and other major strategic moves). For firms engaged in more than one type of regulated business, the FSA's activities will continue to be co-ordinated through a lead supervisor.*

*The intensity of the FSA's supervisory relationship with a firm will also be influenced by our assessment of the firm's risk management procedures and practice. Well-managed firms whose own assessment of risk is sophisticated and effective will require less supervisory attention than a firm conducting similar business whose controls are not of the same quality. This approach*



*provides an incentive to senior management to manage their firm's risks effectively and so reduce in-house compliance costs."*



## **APPENDIX 4: HOW TO REDUCE COMPLIANCE COSTS — FURTHER IDEAS OFFERED BY FIRMS**

Section A3 of the questionnaire invited firms to share their ideas and suggestions for how costs of compliance can be minimised. This Appendix reports, without editorial comment or analysis, methods which some of our participating firms considered in their experience reduced compliance costs. Many of these suggestions were included in the analysis in Section 6.

### **A4.1.1 Senior management**

A number of the firms answering Section A3 highlighted visible input into or support of compliance priorities from senior management as a key to reducing costs. Active involvement and sponsorship by senior management “sets the right culture and reduces the number of issues arising in a firm”; it “helps in getting it right first time”. Other firms commented that the business is “less resistant to change when support of senior management is visible, “and greater success in obtaining business buy-in has been noted with higher levels of support from senior staff”.

There were differing views as to whether visible input or support from senior management was in itself a direct driver of cost reduction. One firm commented that its impact tended to be more on the facility with which compliance was achieved, than a driver of cost reduction, while another felt that a compliance agenda was adopted more quickly than would otherwise be the case.

Various examples of the demonstration of visible support from senior management were cited. These included active involvement in the firm’s compliance governance structure through, for example, compliance being a standing agenda item for discussion at the board, the CEO chairing the firm’s compliance committee, compliance representation at all board and senior management meetings, and a close working relationship between the head of compliance and the CEO and other senior management.

One firm had established a “controls group” with broad and senior business membership so as to promote a more integrated risk management approach than provided by a more traditional audit and compliance committee.

Two firms reported benefiting from the compliance knowledge of non-executive directors with relevant technical experience of other companies.

“Leading from the top”, with a strong compliance message from senior management to all staff, was identified by a number of firms as imperative to forming a good compliance culture and, through this, reducing the risks of non-compliance. Again there were differing views on the further impact this had on compliance costs but a number of firms believed that it did reduce compliance costs by reducing the number of issues in the firm and helping to ensure “right first time”.

### **A4.1.2 Compliance culture**

Other methods firms reported they had used to attain a successful compliance culture centred around there being a visible linkage to the commercial benefit gained from good compliance,



such as the protection of the brand, and an understanding that the regulatory impact must be considered as a first priority with every project. Some firms referred to instilling a compliance mentality in all new recruits through the induction process, and one firm reported focusing explicitly on the key behaviours that were important to avoiding risk and errors using, for example, labelled office equipment to reinforce key risk management strap lines. Another firm felt a company ethos of no blame attaching for genuine errors, with the emphasis on revising procedures to ensure mistakes were not repeated, was important to the compliance culture.

Compliance presentations and broadcasts, access to training by the compliance department, and an accessible compliance team were means used by firms to reinforce the compliance culture as well as to increase awareness of specific rules and regulations. Others cited the relationships management focus of the compliance team and the compliance officer having the appropriate status in the organisation.

#### **A4.1.3 Positioning of compliance function**

A number of firms considered that their compliance costs were reduced by the ownership of compliance being pushed back into the business. This may have been achieved through the use of self-assessment certification techniques by the business, which a number of firms reported as having found effective, or the integration of compliance processes within the business and in operational systems and controls. One firm commented that “good systems and controls with greater automation reduce the number of staff needed”, but push-back of compliance responsibility to business units was also seen to increase staff buy-in to compliance.

Some firms had found that compliance costs had been reduced through the compliance function’s proximity and visibility to the business. The alignment of compliance teams to business areas, or significant influence functions or to business projects was also considered an important method for reducing compliance costs. It ensured the compliance function did not operate remotely.

#### **A4.1.4 Compliance staff**

The quality of the compliance staff and the fact that they had the respect of the business at the highest levels to obtain senior management buy-in, were seen by some firms as important factors for reducing compliance costs. Firms identified proper management of resources, alignment of key skills of compliance staff to particular business areas, performance reviews, time management and prioritisation of tasks, as well as identification of clear and precise responsibilities, as means of reducing compliance costs. Downward delegation of more routine tasks was cited by more than one firm as contributing to a reduction in costs. The integration of compliance and operational risk teams has assisted one firm in eliminating risk gaps while improving communications and securing maximum efficiency. It has also noticed better skills transfer in an integrated team.

Opinions varied on the profile of compliance staff necessary to reduce compliance costs but a common theme was the need for good interpersonal skills: “a sell” not “tell” approach was considered fundamental by one firm. A pragmatic nature and relevant industry experience were also considered important. As one firm stated: “The ability to understand business issues and



relate them to regulatory requirements is essential.” Another firm recommended that compliance staff should always react very quickly to meet business needs, thereby encouraging the business to engage with them. Some firms believed the need for internal audit skills was growing and the existence of strong risk and internal audit functions was cited as keeping compliance costs down.

Other firms believe they have benefited through the employing of experienced ex-regulatory staff and one reported saving considerable sums through the use of specialist external compliance consultants. Another advocated the outsourcing of the compliance function for small businesses.

One firm referred to increased awareness of risks and regulation reducing the likelihood of inappropriate conduct, and many firms cited in-house compliance training as assisting in reducing compliance costs. A firm might use its local compliance teams to enhance risk awareness, or compliance staff to review training material and course content. It might make training and competence requirements a key performance indicator for all staff or use web-based training.

#### **A4.1.5 Monitoring**

Firms were also asked whether they operated any particular methods in their approach to monitoring which reduced compliance costs. Many operated a risk based monitoring programme and one firm asserted that this was the only way to approach monitoring where cost control is key: “annual compliance checks are too costly in today’s regulatory regime.”

Other approaches to monitoring considered by firms to reduce costs were:

- A proactive focus by compliance (for example, by proximity to the business or, a regular proactive review of change) to increase the likelihood of identification of issues before they arise.
- Checking operational controls in which compliant processes had been embedded, rather than monitoring actual levels of compliance.
- Use of comprehensive management information systems.
- Efficient rule breach reporting mechanisms.
- Electronic tools to improve focus and efficiency, such as dedicated analytical compliance surveillance software or risk identification tools.
- Internal audit and peer reviews.
- Concentrating on significant risk areas and not using a “tick box” approach.

#### **A4.1.6 Relationship with the FSA**

Many firms believed that the effective management of their relationship with the FSA contributed to a reduction in compliance costs. A number have invested considerable time and effort in regular and proactive contact with their supervisors to “educate” them about their business. They





considered that increased openness and cooperation had reduced the potential for investigations and costly enquiries or ensured that less onerous duties or requirements were imposed on them than might otherwise be. Others felt that obtaining advice from the regulator saved them from incurring costs on external advice.

One firm believed that high standards, demonstrating the gripping and resolution of issues quickly and ensuring confidence in the overall risk management and control functions, were important factors in its relationship with the FSA.

#### **A4.1.7 Influencing debate**

A few firms commented on the importance of influencing debates on future regulation early or at high level by, for example, contacts at policy level in the FSA or being involved in working parties or providing representatives for trade bodies, or simply by giving feedback on consultation papers.

Indeed, one firm believed that its industry relationships were the most significant method of reducing compliance costs, saving on time and research. Certainly many firms commented on the benefits to be gained from good contacts with peers, similar organisations and compliance discussion groups, as well as through effective trade body lobbying. These relationships were felt to be extremely useful for sharing experiences or as an early warning system of regulatory theme visits or of the implications of proposed rules. They provided the opportunity to plan, which in itself could help to reduce costs, and also assisted firms in benchmarking their efforts.

While the use of trade bodies to lobby was considered important by many, a few firms also believed that political lobbying to influence regulatory matters even earlier in the process reduced compliance costs.

#### **A4.1.8 Remedial action**

Finally, firms were asked whether they had identified any methods in connection with remedial action which reduced compliance costs. A number commented on the need for action to be swift, and one firm advocated a focus on the most significant issue first. Others highlighted the importance of identifying the cause of the issue, and of amending procedures and risk maps to ensure that it did not re-occur. The need to monitor the remedial action until resolution of the issue was also emphasised. One firm considered that its use of an electronic actions tracking system, with automatic e-mail escalation of points due, had improved the quality of its actions tracking and reduced the likelihood of repeat mistakes.

# **COSTS OF COMPLIANCE**

## **ANNEX: Survey Letter and Questionnaire**

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**June 2003**

## SURVEY LETTER

[Name]  
[Address]

Dear [Recipient]

### **FSA Study on the Costs of Compliance**

Thank you very much for agreeing to see [ ] [ a member of the Europe Economics team] [ ] at [ ] on [ ] [at your offices]. [We will call you nearer the time to let you know which member of the team interviewing firms will attend.]

The Financial Services Authority (FSA) has asked Europe Economics to assess

- the range of the costs to financial services firms of complying with FSA regulation;
- change in compliance costs to firms associated with the FSA taking over its full regulatory duties; and
- what underlies those changes in costs.

As well as giving the FSA better information on what drives firms' compliance costs, the goal of the project is to help the FSA help firms reduce their compliance costs by indicating how lower-cost strategies and methods might be sought. Part of this exercise is to link firms' business strategies and approaches to compliance with their reported costs.

It will make the interview shorter and more productive if you are able to complete, and ideally return to us in advance of the meeting, the attached questionnaire.

The questionnaire invites you to specify the range of activities to be covered in your answers. Where your responses would be quite distinct for different business activities, we would welcome it if your firm were willing to complete an additional questionnaire for that separate line of regulated business.

For our purposes it is not necessary to provide answers as exact as would be required for tax purposes or an audit. Indeed, in some cases this would be impossible as the questions rely on comparisons with counterfactuals that cannot be precisely known. While obviously we would appreciate your responses being as accurate as you can manage without imposing unnecessary burdens on your firm's time, we are seeking answers that are roughly right.

The meeting will be used to clarify the assumptions underlying the answers to questions in Part A of the questionnaire and to discuss the more open-ended questions in Part B. There is no need to provide written responses to the Part B questions, but any advance thought you could give to the questions would be appreciated. Given the range of firms affected by the different elements

of FSA rules, guidance and procedures, it is difficult to design a questionnaire that is appropriate for all firms; I apologise if some questions are either not relevant or difficult for you to answer.

Responses will be used to help develop explanations of differences in compliance costs between firms, but firms' individual responses will not be shared with the FSA or with third parties. Your response (both the completed questionnaire and during the interview) will be treated as strictly confidential.

One set of questions in Part A of the questionnaire (Part A3) asks for your ideas and suggestions for how costs of compliance can be minimised. Please enter in response to these *questions only views and ideas that you are willing for the FSA and other firms to see*. The reporting of these will not indicate the source. The team at Europe Economics will ensure that parties (including the FSA) cannot trace back to your firm any information that you provide.

If you have any questions, please do not hesitate to contact one of the following members of our team at the number given above: Peter Edmonds, Andrew Lilico, or Pedro Fernandes.

Yours sincerely

**[Interviewer]**  
**Europe Economics**



## QUESTIONNAIRE

### A1 ABOUT YOUR FIRM

*This section comprises questions designed to establish precisely the scope of your responses and to collect information that will allow a range of comparisons across firms, e.g, information on different measures of the scale or volume of your firm's trading.*

**Q1** For which of the regulated business activities in Table 1 below is the questionnaire being completed? Please indicate by ticking the relevant boxes in Table 1

**\*\* If the effects and compliance costs of regulation on different business activities are quite distinct and separable, please do not include them together in one questionnaire. In those circumstances, we would be grateful if you were able to complete an additional questionnaire in respect of any wholly separable business activities.**

**Table 1: Set of regulated business activities covered by this questionnaire**

| Business activity                                | Coverage of questionnaire | Relevant customer classification (if any) |
|--|---------------------------|---|
| Banking or other credit                          |                           |   |
| Fund management                                  |                           |   |
| Managing CISs                                    |                           |   |
| Sale of or advice on retail financial products   |                           |   |
| Long-term insurance business (includes pensions) |                           |   |
| General insurance business                       |                           |   |
| Securities or Capital market operations          |                           |   |
| Operating as an exchange or market               |                           |   |
| Other (please specify)                           |                           |   |

**Q2** Please give the name of the firm directly involved in the business activities indicated above, and any prominent brand names used within the business.

**Q3** Is your firm a subsidiary of an overseas firm such that the management and operation of the UK business is heavily influenced by the requirements of one or more overseas regulators? If so, please say which overseas regulators.



## Financial Information

For the last financial year for which returns are available:

**Q4** What were the firm's total operating costs?

£

**Q5** Of those total operating costs, how much were attributable to the set of regulated business activities you ticked in Table 1 as covered in your responses to this questionnaire?

£

**Q6** Please indicate in Table 2 below the broad proportions of the firm's total operating costs derived from each of the business activities covered in your responses to this questionnaire. As far as possible, please also provide figures for key **volume** measures (drawn from the list below): this is to help us compare the scale of each of your business activities covered with similar activities of other firms.

**Suggested volume measures for different business activities, for use in completing Table 2 below:**

**Banking or other credit:** number of accounts; value of mortgages and other secured loans; value of unsecured loans; number of UK customers; number of foreign customers, size of branch network.

**Fund management:** number of different funds, total value of sterling funds under management, total sterling value of foreign currency funds under management.

**Managing CISs:** number of accounts and value of funds under management, each broken down into retail and institutional.

**Sale of or advice on retail financial products:** number of sales people employed, number of appointed representatives, number of contracts sold per year, proportion of complex products such as pension transfers in the total.

**Long-term insurance business:** Numbers of sales people employed and of appointed representatives (if not covered above); Value of funds invested at end of last financial year; Number of products offered (if well-defined); number of policy-holders.

**General insurance business:** Numbers of sales people employed and of appointed representatives; Sums insured at end last financial year; number of policyholders, Number of product lines.

**Securities and capital markets:** number of individual contracts in last financial year, number of stocks in which market maker, number of authorised dealing staff, number of brokerage customers, size of asset holdings, value of transaction flows in last financial year.

**Exchange or market:** number of member firms, number of trades in last financial year, number of contract types (if well-defined), monetary value of trades in last financial year.

**Table 2: More information on the business activities covered in your responses to the questionnaire**



| Business activity (from Table 1) in order of importance | Distinct lines of business within that activity (in order of importance) | Total operating cost (£) of business activity in last financial year | Volume measures for business activity in last financial year |
|---|--|--|--|
| 1. [Please specify]                                     | 1  |  | 1  |
|   | 2  |  | 2  |
|   | 3  |  | 3  |
|   |  |  | 4  |
|   |  |  | 5  |
| 2. [Please specify]                                     | 1  |  | 1  |
|   | 2  |  | 2  |
|   | 3  |  | 3  |
|   |  |  | 4  |
|   |  |  | 5  |
| 3 [Please specify]                                      | 1  |  | 1  |
|   | 2  |  | 2  |
|   | 3  |  | 3  |
|   |  |  | 4  |
|   |  |  | 5  |

|           |  |
|-----------|--|
| <b>Q7</b> | Unless fully covered in your answer above, what were the total UK assets of the firm at the end of the financial year? |
|-----------|--|

|   |
|---|
| £ |
|---|

|           |  |
|-----------|--|
| <b>Q8</b> | Of that total, can you identify the proportion dedicated to each of the business activities (as defined in Table 1) covered in your responses to this questionnaire? |
|-----------|--|

| Business activity | Rough allocation of assets (per cent) |
|-------------------|---------------------------------------|
|                   |                                       |
|                   |                                       |
|                   |                                       |
|                   |                                       |

|           |  |
|-----------|--|
| <b>Q9</b> | How many UK employees does the firm have engaged in these business activities? |
|-----------|--|

|  |
|--|
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## A2 THE COSTS OF RISK MANAGEMENT AND CLIENT CONFIDENCE AND OF COMPLIANCE

- \*\* Please answer all of these questions in respect of the business activities you identified in Table 1 above.**
- \*\* Please use another copy of the questionnaire if you wish to provide data for another set of business activities.**
- \*\* Please remember that we are seeking roughly right numbers rather than precise or auditable answers.**

### On terminology

The questions in this Section make reference to a number of different concepts of costs. Some of these, will be familiar to you, while others may not. However, to ensure that our understanding of each of these matches yours, it might be useful to first set out what each will mean for the purpose of this questionnaire.

The **total costs of risk management and client confidence** as used here is a very broad notion capturing all of the costs associated with all of the firm's activities designed to promote the firm's reputation, manage risks and ensure quality.

This includes, but runs much wider than, the costs related to meeting all relevant legal and regulatory requirements, including those deriving from the FSA. For example, this should include all costs related to management systems and controls and to managing risks, training for quality; costs of building your firm's reputation such as brand-building advertising campaigns, and costs of internal and external quality programmes.

Examples are given in Table 3 below.

The **incremental compliance costs of FSA regulation** refer to the total costs of risk management and client confidence as above *less* what the total costs of risk management and client confidence would have been without financial services sector-specific regulation, on the assumption that the firm sells the same products and faces the same competitors. This considers the difference in total costs of risk management and client confidence with and without sector-specific regulation.

Note that the incremental compliance costs of FSA regulation could be negative if you considered that in the absence of FSA regulation you would have to spend more in total on maintaining quality and reputation. If this seems counter-intuitive, consider that if there were no prudential or conduct of business regulation, customers would still need to be persuaded of a firm's quality and probity: how would this be demonstrated?



These cost concepts for which we are asking you to estimate values are not calculated for standard financial reporting purposes, and indeed the incremental compliance cost as defined above requires a comparison with what would have happened in an alternative “counterfactual” world. Please recall that we are seeking *roughly right* answers, not precise ones.

### Total costs of risk management and client confidence

|            |   |
|------------|---|
| <b>Q10</b> | Consider the three broad categories of activities making up the costs of risk management and client confidence as set out in Table 3 below. Table 3 identifies a number of activities falling under each of these categories. Within each broad category, please rank these activities by their relative costs (1 being the relatively more costly). If there are other activities which are more relevant please specify next to ‘Other’ under the relevant category. Where there is overlap between cost sources, please allocate the costs according to your judgement on the relative importance of different cost drivers. |
|------------|---|

**Table 3: Categories of cost related to risk management and client confidence**

| Category  | Source of the costs                                   | Rank within category |
|---|---|----------------------|
| <b>Contributions to general legal requirements</b>  | Companies Act   |                      |
|   | Employment and health and safety legislation          |                      |
|   | Data protection legislation                           |                      |
|   | Fiduciary, tortious and contractual duties to clients |                      |
|   | Other (please specify)                                |                      |
| <b>Contributions to FSA regulatory requirements</b> | Retail conduct of business rules                      |                      |
|   | Wholesale conduct of business rules                   |                      |
|   | Capital and liquidity rules                           |                      |
|   | Approved persons, systems and controls etc            |                      |
|   | Money laundering                                      |                      |
|   | Other (please specify)                                |                      |
| <b>Non-regulatory driven</b>                        | Costs of management systems and controls              |                      |
|   | Risk management                                       |                      |
|   | Quality control/internal audit                        |                      |
|   | Signalling product quality to consumers               |                      |
|   | Meeting the demands of capital markets                |                      |
|   | Compliance with voluntary codes or best practice      |                      |
|   | Quality related training                              |                      |
|   | Other (please specify)                                |                      |



|            |  |
|------------|--|
| <b>Q11</b> | Please estimate the total costs associated with risk management and client confidence for the business activities being considered in this questionnaire, providing, if feasible, an indicative breakdown of the total into the various broad categories of cost-driver set out above. |
|------------|--|

|   |
|---|
| £ |
|---|

| <b>Category</b>   | <b>Estimated cost (£)</b> |
|---|---------------------------|
| General legal requirements  |                           |
| FSA regulatory requirements                                       |                           |
| Non-regulatory (brand or reputation building and risk management) |                           |



## Incremental compliance costs of FSA regulation

*For these next questions, we would like you to provide estimates of the costs to you of the net effect of rules, monitoring and guidance administered by the FSA.*

Questions 12 to 19 should be answered against the backdrop of the scenario described below.

### Scenario

Suppose that there were no FSA rules or oversight, and that you and your current competitors in your main markets competed for custom subject only to the general legal framework common to all UK firms. Please assume you would **continue to trade in your current portfolio of products**.

With reference to the above scenario:

|            |  |
|------------|--|
| <b>Q12</b> | What behavioural or organisational differences might you expect to see in your business? |
|------------|--|

|  |
|--|
|  |
|--|

|            |   |
|------------|---|
| <b>Q13</b> | Would the level of staff training be reduced, increased or remain unchanged? If you expect it would change, can you estimate how much more or less it would cost? |
|------------|---|

|  |
|--|
|  |
|--|

|            |  |
|------------|--|
| <b>Q14</b> | Would you expect the costs associated with internal monitoring or risk-management systems to be reduced, increased or remain unchanged? If you expect they would change, can you estimate how much more or less it would cost? |
|------------|--|

|  |
|--|
|  |
|--|

|            |   |
|------------|---|
| <b>Q15</b> | How would your balance sheet adjust? Can you estimate the annual savings or losses from this change? (e.g. in the absence of FSA regulation would capital markets demand that your firm hold more or less capital?) |
|------------|---|

|  |
|--|
|  |
|--|



**Q16** Would you expect your business to change the level of other reputation-building or quality-management activities to support its business sales (e.g. change in advertising, employment of international quality management standards, changes in staff salaries, increasing the role of industry bodies)?

|  |
|--|
|  |
|--|

**Q17** Can you provide an estimate of the overall effect on costs of the points at questions 12 – 16 above? If possible, can you identify in Table 4 below four of the most important kinds of costs, the changes to which will have the greatest impact on costs. (Please specify whether the impact on costs is positive i.e. leading to higher costs, or negative).

**Table 4: Change in costs in the absence of FSA regulation**

| Overall effect on costs:                         |                                  |
|--|----------------------------------|
| Way in which your business would change the most | Associated change in cost (£+/-) |
| 1  |                                  |
| 2  |                                  |
| 3  |                                  |
| 4  |                                  |

**Q18** Taking account of your answers to Questions 12-17 and to then looking back to Question 11, how are the costs associated with risk management and client confidence in the scenario defined above different from the costs associated with risk management and client confidence under the FSA regulatory framework currently in place? Please use Table 5 below to answer.

**Table 5: Incremental compliance costs of FSA regulation**



| Difference in costs of risk management and client confidence without FSA regulation   | Tick relevant box |
|---|-------------------|
| Costs of building risk management and client confidence would be greater without FSA regulation (e.g. because of the costs that would be incurred to persuade customers of quality and probity) |                   |
| No difference [i.e. FSA regulation imposes no net additional costs]   |                   |
| 0-10 per cent less than at Q 11   |                   |
| 10-25 per cent less   |                   |
| 25-50 per cent less   |                   |
| 50-75 per cent less   |                   |
| 75-100 per cent less  |                   |
| 100 per cent less<br>[i.e. all risk management and client confidence costs are a direct result of FSA regulation]   |                   |

|            |   |
|------------|---|
| <b>Q19</b> | Given your responses to Questions 17 and 18, please give an estimate of the incremental costs of FSA regulation (your answer to Q11 times the adjustment you estimated in Table 5 above). |
|------------|---|

|   |
|---|
| £ |
|---|



## Changes in incremental costs of complying with FSA regulation

*This section aims to identify the change in incremental compliance costs of FSA regulation over the last few years, and the drivers of those changes.*

The FSA began to develop its approach and programme of regulation in 1998. Changes since then have included:

- consolidation of several regulatory and supervisory regimes into one FSA regime
- changes in supervision arrangements, and the development of a risk-based approach to rules, guidance and regulation;
- tighter regulatory requirements in respect of senior management arrangements and systems and controls;
- the implications of the statutory framework for giving guidance;
- the FSA's new role in regulating the prevention of money laundering;
- a programme of proposals and consultations;
- introduction of provisions on market abuse and of the Code of Market Conduct;
- introduction of the approved persons regime, and of the concept of controlled functions;
- the consolidation of existing conduct of business rules and development of new rules; and
- the extension of prudential rules to different kinds of business.

Firms may also now be incurring costs in anticipation of future expected regulatory changes. Examples include the ending of polarisation; the extension of statutory regulation to mortgage and general insurance activity; and the Integrated Prudential Sourcebook.

These changes encompass "N2", when the FSA took its full regulatory powers. However, the questions do not refer specifically to N2. N2 is only one point in a whole process of change, and the impact of the changes associated with the FSA's assumption of powers will have affected costs before and since. Instead we are asking you to compare the change between the costs due to FSA (or predecessor) regulation in the financial year ending in 1998 and in the financial year ending in 2002.

This section distinguishes between the changes in incremental cost of complying with FSA regulation that are driven by changes in regulation from those driven by other developments in technology, market growth or introduction of new products.

### Effects of external drivers of change other than FSA regulation

|            |   |
|------------|---|
| <b>Q20</b> | Other than changes in FSA regulation, please list in Table 6 below what you see as other key drivers of change in the markets you operate in that have affected the costs associated with ensuring risk management and client confidence as defined above and illustrated in Table 3. Examples might relate to technology; demand; new product entry or growth. |
|------------|---|





Table 6: Drivers of change other than FSA regulatory change

| Driver | Impact on costs of risk management and client confidence: (increase or decrease) |
|--------|--|
|        |  |
|        |  |
|        |  |
|        |  |

**Q21** Had financial services regulation not changed since 1998, how on balance do you think the drivers you identified in Table 6 above would have affected your **total costs of risk management and client confidence** since then? Please tick Table 7 as appropriate.

Table 7: Change in total cost of risk management and client confidence 1998-2002 due to influences other than changes in FSA regulation (please tick box)

| Change in total cost of risk management and client confidence 1998-2002 due to influences other than changes in FSA regulation |  |
|--|--|
| Reduction since 1998 of 50 -100 per cent   |  |
| Reduction since 1998 of 20-50 percent  |  |
| Reduction since 1998 of 0-20 per cent  |  |
| No difference i.e. the answer in 1998 would have been the same as at Q11   |  |
| 0-20 per cent increase   |  |
| 20 -50 per cent increase   |  |
| 50- 100 per cent increase  |  |
| 100-200 per cent increase  |  |
| Over 200 per cent increase (i.e. more than tripled)  |  |

**Q22** Had regulation not changed, how on balance do you think the drivers you identified in Table 6 above would have affected the **incremental cost of meeting the set of financial services regulatory requirements that existed in 1998**. Would, for example, the changes in technology that have taken place have reduced the incremental compliance costs of meeting the 1998 regulatory framework had the latter remained in place? Did the development of more complex or more varied products make dealing with regulation intrinsically harder? Please tick Table 8 below as appropriate.



**Table 8: Change in incremental compliance costs 1998-2002 due to influences other than changes in FSA regulation**

| <b>Change in incremental compliance costs 1998-2002 due to influences other than changes in FSA regulation</b> |  |
|--|--|
| Reduction since 1998 of 50 -100 per cent   |  |
| Reduction since 1998 of 20-50 percent  |  |
| Reduction since 1998 of 0-20 per cent  |  |
| No difference i.e. the answer in 1998 would have been the same as at Question 19                               |  |
| 0-20 per cent increase   |  |
| 20 -50 per cent increase   |  |
| 50- 100 per cent increase  |  |
| 100-200 per cent increase  |  |
| Over 200 per cent increase (i.e. more than tripled)  |  |
| Other (specify):   |  |

### **Effects of changes in regulation**

*This section asks you to provide an estimate of the change in incremental compliance costs your firm has faced due to changes in financial services regulation by the FSA. Please*

- a. include at this point both one-off and recurring costs, including those preparing for changes that have not yet been introduced.*
- b. in answering, allow as best you can for the other changes since 1998 that you identified in Table 5 above i.e. focus on the component of change attributable to regulatory change as opposed to attributable to the other influences you specified above.*

|            |   |
|------------|---|
| <b>Q23</b> | Please note any major changes since 1998 in the scope of your firm's operations within the business activities covered in your responses to this questionnaire. |
|------------|---|

|  |
|--|
|  |
|--|



The next questions ask in turn about the causes of major one-off and of continuing changes in costs.

### One-off Costs

|            |   |
|------------|---|
| <b>Q24</b> | <p>Which four changes in financial services rules or regulatory practice by the FSA have driven the largest <b>one-off costs</b> of regulatory change (e.g. developing a new system solely to meet a regulatory demand, or setting up a new process for approved persons, or responding to a specific regulatory review)?</p> <p>For each, please indicate in Table 9 when the cost was incurred, and as far as possible the amount of the cost incurred (Please recall: these are one-off costs driven by regulatory rules or behaviour: for each change, please try to estimate the cost by comparing what you would have done if that change had not been introduced).</p> |
|------------|---|

**Table 9: Main drivers of one-off costs of regulatory change**

| Regulatory driver of one-off cost | Perceived aim of FSA | Nature of firm response required | Timing of cost incidence | One-off cost (£+/-) |
|-----------------------------------|----------------------|----------------------------------|--------------------------|---------------------|
| 1                                 |                      |                                  |                          |                     |
| 2                                 |                      |                                  |                          |                     |
| 3                                 |                      |                                  |                          |                     |
| 4                                 |                      |                                  |                          |                     |

|            |   |
|------------|---|
| <b>Q25</b> | <p>For each of the four main drivers of one-off compliance costs you identified in Table 9 above, please explain the nature of the costs, break down those costs and identify the feature of rules / practice that have driven them and why there was no way that the costs incurred could have been avoided.</p> |
|------------|---|

|   |  |
|---|--|
| 1 |  |
| 2 |  |
| 3 |  |
| 4 |  |

### Continuing Annual Costs



**Q26** Which four changes in financial services rules or regulatory practice by the FSA have generated the largest changes (increases or decreases) in your firm's **continuing annual incremental costs of compliance** over 1998-2002.

For each, please indicate in Table 10 below the nature of the firm's response that was required and as far as possible the annual amount of the additional cost incurred (Please recall: these are costs driven by regulatory rules or behaviour: for each change, please try to estimate the cost of each by comparing what you would have done if that particular change had not been introduced).

**Table 10: Continuing annual costs of regulatory change**

| Regulatory change that has led to change in annual incremental compliance costs | Perceived aim of FSA | Nature of firm response required | Change to annual cost in 2002 compared to in 1998 (£+/-) |
|---|----------------------|----------------------------------|--|
| 1   |                      |                                  |  |
| 2   |                      |                                  |  |
| 3   |                      |                                  |  |
| 4   |                      |                                  |  |

**Q27** For each of the four main drivers of increased annual compliance costs shown in Table 10, please explain the nature of the costs break down those costs and identify the feature of rules / practice that have driven them and why there was no way that the costs incurred could have been avoided.

|   |  |
|---|--|
| 1 |  |
| 2 |  |
| 3 |  |
| 4 |  |

*Overall effect*

**Q28** Using the answers to Questions 26 to 27 as a guide, by how much has the annual incremental cost of compliance changed as a result of changes in regulation by the FSA in the period between the financial year ending in 1998 and the latest financial year? Please tick relevant box in Table 11 below.



**Table 11: Change in annual incremental compliance costs 1998-2002 due to changes in financial services regulation by the FSA**

| <b>Change in Incremental Compliance Costs 1998-2002 due to changes in FSA regulation</b> |  |
|--|--|
| Reduction since 1998 of 50 -100 per cent   |  |
| Reduction since 1998 of 20-50 percent  |  |
| Reduction since 1998 of 0-20 per cent  |  |
| No difference i.e. the answer in 1998 would have been the same as at <b>Question 19</b>  |  |
| 0-20 per cent increase   |  |
| 20 -50 per cent increase   |  |
| 50- 100 per cent increase  |  |
| 100-200 per cent increase  |  |
| Over 200 per cent increase (i.e. more than tripled)                                      |  |

|            |   |
|------------|---|
| <b>Q29</b> | Given your entry in Table 11 and your answer to Question 19, please provide an estimate of the change in incremental compliance costs of financial services regulation between 1998 and 2002. |
|------------|---|

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| £ |
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### A3 COMPLIANCE COST-MINIMISING LESSONS TO BE SHARED WITH THE INDUSTRY

*Material from this section only may be shared with other firms, though all reporting will be anonymous. If you have no suggestions, or do not wish to record any suggestions that might be shared with other firms, please go directly to the next section (Section A4, Q37).*

**Q30** Which of the following does your firm consider itself to be at keeping compliance costs down in complying with FSA regulation?

|                             |  |
|-----------------------------|--|
| (a) very successful         |  |
| (b) acceptably successful   |  |
| (c) facing tough challenges |  |

**Q31** Has your firm changed its business model at all in response to FSA regulation? Yes/No

**Q32** If "Yes" please state in what way

**Q33** Has this proved commercially beneficial? Yes/No. If "Yes", can you estimate the annual gain in profit?

£

**Q34** Does your firm monitor regularly the cost of complying with FSA regulation? Yes/No

**Q35** What aspects of the firm's handling of the FSA regulatory programme do you consider to have been particularly successful? For each, please indicate what it was that made them successful.



|            |  |  |
|------------|--|--|
| <b>Q36</b> | Please state any methods which, in the experience of your firm (or others) you consider reduces compliance costs in the following areas: |  |
| a)         | Visible input into or support of compliance priorities from senior management  |  |
| b)         | Compliance culture within the firm   |  |
| c)         | Number and organisation of compliance staff  |  |
| d)         | Allocation of compliance responsibilities  |  |
| e)         | Particular aspects of the skills and experience of compliance staff  |  |
| f)         | Training of other staff  |  |
| g)         | Relationship with the FSA  |  |
| h)         | Approach to monitoring   |  |
| i)         | Remedial action  |  |
| j)         | Relationship with FSA supervisors  |  |
| k)         | Industry relationships   |  |
| l)         | Anything else — please specify`  |  |



## A4 FIRM'S BUSINESS MODEL AND COMPLIANCE FUNCTION

*This section sets out some further questions intended to allow the exploration of different explanations of differences in firms' reported compliance costs in terms of differences in their business strategies or in their compliance organisation and strategies.*

### Your business model

**Q37** What do you see as the main recent market trends in your line of business over the past few years?

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**Q38** Has there been any shift in the market towards a higher proportion of sales of high quality expensive products in recent years, or any shift towards more sales of lower quality but cheaper products? If so, please explain what has driven these trends and where your firm has stood in relation to this changing nature of competition?

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**Q39** Do you focus on particular market segments or customers? If so, please specify which.

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**Q40** If your firm provides retail services, please indicate the following channels in order of importance and give a rough indication of the number of outlets.

| Channel  | Order of importance by revenue (1 = most important) | Number of outlets |
|--|---|-------------------|
| Direct sales   |   |                   |
| Your employed salesforce   |   |                   |
| Internet   |   |                   |
| Call centres   |   |                   |
| IFAs and other third parties responsible to FSA for their own compliance |   |                   |
| Agents for whose compliance you are responsible                          |   |                   |



**Q41** Do you perceive yourself as having any durable competitive advantages over your main competitors in your market(s)?

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**If so, is that because (please indicate in order of importance)**

|   |  |
|---|--|
| Your costs are lower  |  |
| Your brand is stronger  |  |
| Your product range is more closely aligned with your customers' preferences |  |
| Your service to your customers is of higher quality                         |  |
| Your innovation in products or service is more regular and useful           |  |
| Something else: Please specify below:                                       |  |

**Q42** Are the price differences you observe justified by quality differences? or by other factors? (please list any that are relevant).

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**Q43** What significant activities have you undertaken in the last five years to reduce costs? Please comment briefly on whether you obtained any lasting competitive advantage from these:

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**Q44** What prevents a firm in the market from trying to increase its margins by reducing the quality of service it provides? (Please indicate in order of importance)

|                                | Order of importance (1 =most important) |
|--------------------------------|---|
| UK Regulation                  |   |
| Overseas regulation            |   |
| Loss of industry kite-marks    |   |
| Loss of customers              |   |
| Response of competitors        |   |
| Something else. Please specify |   |



**Q45** What important parts of your firm's business are now outsourced? Please indicate what has driven these decisions

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**Your compliance function**

**Q46** Is the compliance function represented on the board? If so, please list the compliance responsibilities of that board member? How (if at all) have these changed over the last five years and what has driven these changes?

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**Q47** Who does the head of the compliance function report to? How has this changed in the last five years and why?

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**Q48** Please describe briefly the organisational structure of the compliance function (e.g. centralised group function, business unit function) and how it fits into your firm's organisational structure (e.g. part of risk function, part of legal and compliance). Has this changed in the last 5 years and, why?

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**Q49** What have been the major drivers of the firm's compliance strategy over the last five years? Please specify in order of importance.

| Drivers of strategy                      | Order of importance (1 =most important) |
|--|---|
| FSA regulation                           |   |
| Perceived threat of regulatory sanctions |   |
| Overseas regulation (please specify)     |   |
| Improve quality of service to customers  |   |
| Disciplinary action against other firms  |   |
| Technological change                     |   |
| Industry best practice                   |   |
| Other (please specify)                   |   |



**Q50** Roughly how many full-time equivalent staff are there within the compliance function (if the function is dispersed, please include the dispersed staff)?

**Q51** Please indicate which of the following tasks take up most of the resources devoted to compliance within the firm.

| Task   | Relative allocation of resources<br>(Ranking: 1 = most) |
|--|---|
| Monitoring                                     |   |
| Remedial action                                |   |
| Providing advice                               |   |
| Training                                       |   |
| Implementing and influencing regulatory change |   |
| Money laundering responsibilities              |   |
| Internal reporting                             |   |
| External reporting                             |   |
| Special projects or reviews (please specify)   |   |
| Product / business developments                |   |
| Other (please specify)                         |   |

**Q52** How has the relative allocation above changed over the last five years?

**Q53** In what ways does the firm use computer software in identifying compliance risks and in monitoring compliance?

**Q54** Please describe briefly how the company responds to compliance failings.



|            |   |
|------------|---|
| <b>Q55</b> | If the business is conducted through multiple locations, please describe briefly how compliance with FSA regulatory requirements is monitored across locations. |
|------------|---|

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|------------|--|
| <b>Q56</b> | Does the firm rely significantly on external sources in meeting its compliance goals? If yes, please describe briefly what these are and how they are used, and how this has changed over the last five years. |
|------------|--|

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|------------|--|
| <b>Q57</b> | If your business activity is subject to regulation overseas, please indicate how overseas financial services sector regulation affects your compliance approach or arrangements. |
|------------|--|

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|------------|---|
| <b>Q58</b> | Please summarise any disciplinary action taken against your firm by financial services sector regulators in the last six years and your response to it. |
|------------|---|

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## **B QUESTIONS FOR DISCUSSION AT THE INTERVIEW**

*The questions in this section are for discussion at the interview. Their purpose is to help us understand further the nature of your firm and the market(s) it operates in, to allow a fuller understanding of the drivers of its compliance costs.*

### **Suggested discussion topics on your business and market**

Where do you see your market going over the next few years? Have you made any changes in the internal organisation of your business in anticipation of future market trends?  
What was the focus of your last advertising campaign? [company brand, particular characteristics of the products, ...]

### **Suggested discussion topics on the effects of regulation**

In what ways have changes in regulation in recent years contributed to change in:

- a) the range of products/services that can be offered on a profitable basis? and/or
- b) the degree and nature of competition in your UK markets?

If there were no FSA regulation at all, how do you think the range of products you offered or their prices would change?

What changes in the present regulatory approach or practices would facilitate better/cheaper offerings to customers without significantly increasing risks to customers?

In what ways might changes in regulatory approach and practice have affected you differently from your competitors?

To what extent do the FSA's Principles for Businesses influence your business strategy?

How, if at all, have regulatory requirements (including both those relating to your ways of operating and those relating to information disclosure) affected the costs of entry?

Has FSA regulation affected your ability to compete internationally? If so, in what ways?

### **Suggested discussion topics on firm's approach to compliance**

What do you regard as the prime objectives of the compliance function? Has this changed since 1998 and, if so, how and why?

How do you measure good compliance?



What is the organisational structure of the compliance function and how does it fit into the firm's organisational structure?

Would you say the compliance function is largely reactive in its approach, or largely proactive?

How would you describe the skills, backgrounds and expertise of your compliance staff?

How does your firm ensure that staff have the skills needed to meet your compliance obligations?

How does the firm encourage staff to report concerns about compliance?

What are the key elements of the firm's procedure for handling any concerns or issues that arise relating to compliance with FSA regulatory requirements?

How does senior management maintain and enhance its understanding of business and regulatory risks?

Did the company's compliance organisation make it relatively easy or difficult to respond to new requirements on money laundering?

In what ways, and at what points, does the compliance function influence business decisions or developments?

How far, and in what ways, is the compliance function's approach to its activities risk-driven?

How would you describe your firm's relationship with the regulators? How has this changed over the last 5 years?

Do you think that the cost of non-compliance has increased over the last 5 years? Please explain your answer.