

The Financial Services Authority

N2 + 2 Review

of

Cost Benefit Analysis

Cultural Issues



John Howell & Co Ltd

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Foreword

This document contains a report by John Howell & Co on embedding cost-benefit analysis (CBA) more deeply in the FSA's policy making process. The FSA gave John Howell & Co full access to its staff and internal documents. It welcomes the recognition by John Howell & Co of the considerable progress that has been made in the FSA's use of CBA and is pleased to accept the main recommendations in the report.

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List of Abbreviations used in this Report

| | |
|-------------|---|
| ABI (Paper) | Association of British Insurers (Paper on CBA May 2004) |
| ARROW | Advanced Risk-Responsive Operating Framework |
| BIP | Business Improvement Process |
| CBA | Cost Benefit Analysis |
| CIW(F) | Consumer and Industry-Wide (Framework) |
| CP | Consultation Paper |
| EFR | Economics of Financial Regulation |
| EC | European Commission |
| EU | European Union |
| FSA | (The) Financial Services Authority |
| FSMA | Financial Services and Markets Act 2000 |
| GPD | Guide to Process Disciplines |
| HMT | Her Majesty's Treasury |
| HOD | Head of Department |
| IFA | Independent Financial Adviser |
| JH & Co | John Howell & Co Ltd |
| MFA | Market Failure Analysis |
| POGR | Principles of Good Regulation |
| RIA | Regulatory Impact Assessment |
| RPC | Regulatory Policy Committee |
| SBPP | Small Business Practitioner Panel |
| SPSS | Statistical Package for the Social Sciences® |

1 SUMMARY

1.1 As part of the N2 + 2 Review JH & Co were asked to report on cultural issues regarding conduct of CBA at the FSA and to make recommendations on how to optimise use of CBA in the FSA. Research was carried out by interview, questionnaire and group sessions. The study found a strong commitment to CBA from Top Management. In addition to statutory CBA activity, the FSA choses to do wider CBA to promote accountability and transparency. Over 150 analyses have been undertaken since 1999. In the process, the FSA has gained a national and international reputation for its know-how on CBA in the financial sector, and the quality of its output.

1.2 The FSA's substantial and significant achievements to date should be seen in the context of several constraints that affect the way in which CBAs are produced and highlight the importance of timing and approach in determining the effectiveness of CBA activity. The FSA must regulate markets yet have regard to a number of POGR while doing so, such as the desirability of maintaining the competitive position of the United Kingdom. A young and industry-funded organisation, it enjoys fewer resources than many peers. Only a very small proportion of the staff involved in policy making are economists. As a result, the depth to which CBA is adopted across the FSA can vary.

1.3 Despite the FSA's substantial achievements in producing CBAs, there is sometimes a gap between the firm commitment of Senior Management to CBA and the culture in Line Management of policy-making areas. CBA is not seen by all as an essential policy maker skill and few of the FSA's policy makers have direct experience of undertaking CBA. Lack of regard for CBA is strongest among Middle Management, who sometimes wish to avoid conducting CBAs. CBA is sometimes seen as something to be bolted onto, rather than built into, policy making, weakening the prime purpose of CBA – to inform decisions. Young policy-makers are at risk of taking on the wrong messages as a result.

1.4 The study has thus identified the need to build on the achievements and dedication of FSA staff in key areas by consolidating and extending the CBA capability and capacity of all policy divisions. It makes four recommendations for doing so:

- 1. CBA should be seen to enjoy full Top Management sponsorship, including endorsement and monitoring of its routine use.*
- 2. FSA should take action to embed firmly use of CBA as a means of organising and conducting analysis of issues as policy is developed.*
- 3. There should be clear lines of responsibility for the conduct of CBA, confirmed and enforced by top and senior management*
- 4. The use of CBA should be appropriately resourced to ensure there are enough well qualified staff available to conduct CBA.*

1.5 The study was designed and undertaken by Prof. Henk Elffers, John Howell, Prof. David Llewellyn and Prof. Piet van Reenen.

2. CONTEXT

2.1 POLICY MAKING AT THE FSA

2.1.1 Ambit and Competence

The FSA is the statutory regulator for UK financial institutions and for foreign financial institutions operating in the UK⁶. Those regulated by the FSA range from global investment banks to sole-trading IFAs and individual company staff in non-financial institutions. The market regulated by the FSA is believed to contribute in the region of 7% (or approximately £80 billion) to UK GDP. Under the FSMA the FSA has responsibilities for prudential and conduct of business regulation in the financial sector, including authorisation, supervision and enforcement. It develops policies:

⁶ Institutions based in other Member states of the EU may be subject to separate home/host regulator arrangements.

- In reaction to risks and opportunities (including on its own initiative)
- To implement UK government and EU regulations
- To reflect its participation in international regulatory fora and co-operation agreements.

2.1.2 Objectives and Approach

The FSA's four regulatory objectives as per Section 2(2) FSMA target:

- Market confidence
- Public awareness
- Consumer protection
- Financial crime.

These are all areas where there is an economic rationale for regulation to prevent market failure of one sort or another.

It is important to note that, notwithstanding the powers described above (2.1.1), the FSA has to work first and foremost through the market to achieve its goals. (Unlike certain other regulators, for example in central government, it generally cannot mandate the existence of a given state of affairs.) Having a good understanding of the impact of regulations on the market – that is, of how consumers, incumbent firms and potential entrants will likely change their behaviour and strategy in response to FSA interventions - is therefore of vital importance for the FSA.

2.1.3 Rationale for using CBA

Under FSMA S155, the FSA is required to publish a CBA of:

- proposed rules;
- proposed guidance on rules;
- any final rules that differ significantly from the proposed rules.

In practice the FSA has committed to undertake CBA on all significant changes of policy whether through rules, evidential provisions, codes of conduct, statements of policy or guidance.

FSA procedural documents (e.g. GPD Appendix 4, CIWF Appendix 10) set out various legal and policy considerations for the conduct of CBA. They correctly point out that, notwithstanding the legal need to estimate costs and analyse benefits, the overall purpose is to highlight the most cost-effective regulatory option open to the policy maker. They also highlight the benefits of using CBA in policy making.

2.1.4 Volume of Activity and Outlook

Transitional provisions in the FSMA meant that the obligation to publish a CBA did not apply to FSA rules that largely reflected the rules of predecessor organisations. A substantial part of the FSA's rules has thus not been analysed according to the FSA's standards for CBA. However, since its inception, the FSA has been involved in a substantial volume of changes to regulation, especially in the implementation of EU directives, and all areas subject to material change have benefited from some degree of CBA. Going forward, Top Management has committed to reducing the volume of discretionary new policy.

2.2 FSA ARRANGEMENTS FOR CBA

2.2.1 Key Organisational Elements

With respect to CBA the key actors are:

- *Regulatory Policy Committee.* Approves the initiation of a policy initiative, monitors its progress and signs off on outcome. The RPC (whose variable membership is currently identical with that of the Executive Committee, save for the absence of the Chairman) consists of senior FSA staff, at least some of whom have wide experience of CBA and are thus able to assess the quality of CBA.
- *Directors.* Directors of the policy divisions.

- *Middle Managers.* HODs and managerial staff below them with day to day responsibility for developing and delivering a policy initiative as a module owner or project manager. They may or may not be involved in detailed CBA work.
NB: In this report, Directors are also referred to as Senior Managers and Senior and Middle Managers together are referred to as "Line Management".
- *Policy makers.* Work in teams lead by module owners and projects managers. Likely to be the ones involved in detailed CBA.
- *General Counsel's Division.* Provides legal advice and drafting services, and comments on clarity.
- *Economics of Financial Regulation.* This department performs an advice and challenge role in CBA. EFR "is required to verify that CBA, Competition Analysis and Proportionality Analysis have been carried out to FSA standards throughout the process of formulating rules, guidance and similar regulating provisions. EFR also confirms that the Handbook Co-ordination Committee Chairman can sign-off the relevant sections of the Board checklist for CPs." (GPD Section 8.5.2). EFR's role includes confirming to the RPC that RPC papers include appropriate MFA and high-level CBA, and that there is a credible plan for converting the high-level CBA into a CBA that will suffice to inform the RPC's and Board's later, substantive decisions on the policy issues.

2.2.2 CBA in the Policy Making Processes

A range of documents, including the GPD, BIP output, as well as the ARROW and CIWF Guides set out the precise internal procedures to be followed by policy makers when initiating and developing policy and obtaining final approval. Under the recently introduced BIP Policy and Rules (CP) Process, policy making that involves CP production is divided into three parts, Policy Initiation, Development and Text Preparation and Publishing. All three stages provide opportunities to obtain and review evidence to support the decision to progress an initiative and, if so, the best option(s).

There are in theory three alternative models for implementing CBA: centralised (all projects undertaken by a specialised and dedicated unit), operational (only undertaken at the decision-making level with no central input), and the spectrum approach (a varying mix of both). The FSA has committed to the third approach.

2.2.3 Stage 1 Policy Making and High Level CBA

CBA and MFA both play a central role in the new BIP procedures for Stage 1 Policy Making which:

- Require an initial CBA to set out the broad nature and scale of the expected market impacts of the main policy option(s)
- In doing so recognise the importance of using CBA and involving EFR *ab initio*
- Stress the need for EFR assistance and certification of both MFA and CBA as fit for purpose
- Mandate use of CBA to optimise implementation of EU directives where they address a market failure (as identified by prior market failure analysis)
- Mandate use of CBA to identify possible relaxation of existing rules (or justify super-equivalence) where the EU directive does not address a UK market failure and minimum requirements are being implemented.

In the Guide for Policy Makers on High Level CBA (June 2004), the role of the high level CBA is defined as helping to answer three questions which relate to both content and procedure and influence the successful outcome of the CBA process:

- What are the main regulatory options (although CBA is not the only influence on the identification and design of options)?
- What are the costs and benefits of the options relative to the *status quo*?
- What is the plan for other CBA work?

2.2.4 Stage 2 Policy Making and Detailed CBA.

Stage 2 of the new BIP Policy & Rules (CP) Process calls for a detailed CBA once detailed policy options have been defined. Hereto, the full standards for CBA have been those in the FSA Guide to CBA, which uses a six part analysis (quantity, quality, variety of services offered/sold, efficiency of competition, FSA direct costs and compliance costs). As the GPD says:

“A CBA adviser has been allocated to each handbook module and you should know who yours is....CBA colleagues in EFR also stand ready to give training, but the CBAs

themselves will have to be undertaken in local policy areas.....CBA colleagues are expected, on appropriate occasions, to challenge CBA outputs – or the absence of such outputs”.

2.2.5 Panels,

The three Panels provide the opportunity for the FSA to obtain external stakeholder input with regard to an initiative. There is provision for pre-consultation in Stage 1, consultation with all Panels in Stage 2 (before detailed CBA) and consulting with the Consumer Panel and the SBPP in Stage 3. The Panels’ role is primarily to comment on market impacts.

2.2.6 Staff Experience of CBA and Training

FSA policy makers come from a wide range of backgrounds, and new recruits are not required to have any prior experience of CBA, or a background in economics, finance or quantitative science, though this would obviously be helpful. EFR is a specialist department comprising about a dozen economists including a number of highly regarded specialists in the economics of financial regulation. The FSA runs a bi-monthly two-day internal course in CBA for policy makers of all backgrounds.

2.3. EXPERIENCE OF CBA

2.3.1 Activity and External Reputation

The following table illustrates the growth in CBAs undertaken in relation to CPs since 1999:

| Table 1: CPs and CBAs 1999 - 2003 | | | | | |
|--|-------------|-------------|-------------|-------------|-------------|
| <i>Year</i> | <i>2003</i> | <i>2002</i> | <i>2001</i> | <i>2000</i> | <i>1999</i> |
| <i>CPs</i> | 45 | 44 | 38 | 41 | 19 |
| <i>CBAs</i> | 42 | 41 | 27 | 29 | 8 |
| <i>% CPs with CBAs</i> | 93 | 93 | 71 | 71 | 42 |

Source: FSA. The low percentage of CPs with CBAs in 1999-2001 reflects the fact that, under transitional provisions in the FSMA, new rules that broadly reflected the rules of predecessor regulators were effectively exempted from CBA.

In the course of this work the FSA has built up considerable knowledge in the process and content of CBA of financial regulation, and enjoys an international reputation in this area among the international regulatory community. Within the industry, however, there has been criticism of the FSA's approach to CBA based mainly on a perceived failure to reflect true costs, especially compliance costs, and adequately quantify benefits (although the FSMA does not require quantification of benefits). More recently, however, there has also emerged a growing recognition from industry (e.g. in the ABI Paper) that in fact the FSA has used CBA effectively, for example to identify and abandon initiatives that are disproportionate.

Encouragingly, many sections of industry would now rather have some CBA than no CBA at all, and there is growing demand for rigorous CBA based on hard evidence as a framework for dialogue and with greater participation of industry in the data gathering process. External commentators have highlighted how the FSA's use of CBA has often been of a higher standard than the use of RIA and equivalent arrangements by many UK and EU government departments.

3. WORK UNDERTAKEN

3.1. Overall approach

The overall approach was to:

- Develop an understanding of the goals of, and legal and organisational arrangements for, CBA at the FSA;
- Develop an understanding of the attitudes to CBA of the various actors in the FSA's CBA process;
- Use the results of the first two steps to produce recommendations for embedding CBA more deeply in the FSA's policy making process, with a view to building on the considerable progress made and increasing the extent to which the FSA achieves its CBA goals.

Success in the second step noted above was crucial to developing recommendations that are realistic and helpful. We therefore set out below further details of how we went about understanding the FSA's policy making culture.

3.2. Interviews

We talked to Directors, policy HODS and other specialists. Interviewees were asked to SWOT (outline strengths, weaknesses, opportunities, and threats relating to) the use of CBA at FSA and illustrate their comments by reference to specific examples.

3.3 Questionnaire

We prepared a six-part questionnaire regarding CBA with 80 questions focusing on ownership, significance, perceived problem areas, as well as attitudes and solutions to problems regarding CBA. The questions were designed to provide insight into five dimensions, which are known to affect attitudes towards conduct inside organisations⁸ and thus influence the CBA process.

Line policy makers were asked to complete the questionnaire and provide background data. They did so in groups of 5 - 6 respondents. They were asked to state their own opinion or agreement on, or with, a subject and give their impression of their peers' opinion or agreement on or with the same subject. This produced two variables for each subject, the respondent's score for their own opinion ("self variable") and their score of their peers' opinion ("peer variable") The questionnaires were designed to take 30 minutes to complete.

The results of this work were interpreted by inspection of a dataset created in SPSS from the answers to the questionnaires.

3.4 Group Sessions

Following completion of the questionnaire, respondents engaged in free discussion moderated by the questionnaire administrator. The seed question was whether the

⁸ Authority, behaviour, controls, distortions, external events. See OECD WP Vol. VIII No 77 pages 47 - 48.

questionnaire had touched on all relevant issues. A member of the group was asked to take notes that were then compared with the notes taken by the questionnaire administrator. The sessions were designed to take 30 minutes.

4: RECOMMENDATIONS

1. Our central finding is that, while there is a clear and undoubted commitment to the value and necessity of CBA by Top Management, there is a gap between the expectations of Top Management and the culture of Line Management, which tends to be sceptical towards CBA. It sometimes seems not to be regarded as an integral part of the policy process, but as a burdensome “add-on”. This, at times, is reinforced by a lack of necessary skills and insufficient resourcing in, for instance, necessary training. These findings underpin our recommendations.
2. The central challenge is to change this culture so that CBA is regarded as:
 - A positive and absolutely essential contribution to developing effective and efficient regulation
 - An integral, early and continuous part of the whole policy process rather than an “add-on”
 - A central feature of the policy-makers’ job
 - A high priority and a commitment
 - Integrated with market failure analysis.

The positive culture of CBA that exists in parts of the FSA needs to be developed across the whole FSA and to be backed by adequate resourcing both in terms of personnel and their training. Appropriate incentive structures need to be put in place.

3. Experience elsewhere indicates that any resistance to CBA can be broken down and we are confident that culture can be changed. While there is usually no simple

quick fix in cultural matters, we are encouraged that Top Management are fully aware of this challenge and show a determination to act.

4. On the basis of our analysis and findings, we make four recommendations to help the FSA to build on achievements to date and Top Management's determination to effect change in this area. These are stated here at a high level of generality but specific actions will be discussed with the FSA in detail and reflected in the FSA's response to this report.

Recommendation 1

CBA should be seen to enjoy full Top Management sponsorship, including endorsement and monitoring of its routine use.

By making it plain to all policy makers that it is convinced of the advantages and effectiveness of CBA and wishes it to be used as standard practice, Senior Management will put the onus on policy makers to justify their actions in those exceptional cases where policy is made without proper use of CBA.

Controls by Senior Management (i.e policy division directors) on the due use of CBA will increase the likelihood that policy makers will be called to account, and discourage them from going against top management's policy on use of CBA without a compelling case for so doing.

Enforcing use of CBA in all stages of policy processes leading to regulation or alternatives to regulation will promote a standardised framework of analysis that helps achieve the underlying objective - the identification and appropriate analysis of all material issues.

Recommendation 2

FSA should take action to embed firmly use of CBA as a means of organising and conducting analysis of issues as policy is developed.

By requiring all policy divisions to follow the FSA's CBA procedures and that these procedures are developed and implemented in line with best practice, the FSA will

ensure that standards of policy making are improved and maintained in all areas. The enforcement of a common approach in all policy areas will also provide a channel for better identification and treatment of issues and the accumulation of knowledge over time. It will also have benefits in improved communication within FSA and between FSA and external stakeholders.

Recommendation 3

There should be clear lines of responsibility for the conduct of CBA, confirmed and enforced by top and senior management

The laying down of formal responsibilities for CBA within and between divisions by senior and top management will ensure there is no doubt as to when and what things should be done and by whom. This and the opportunity to settle any residual issues directly with senior management will help to promote efficient workflow by avoiding procedural problems. Supervision of the conduct of CBA will highlight where a department requires more support or where it is not pulling its weight.

Recommendation 4

The use of CBA should be appropriately resourced to ensure there are enough well qualified staff available to conduct CBA.

Given how little policy makers' time is spent on CBA and the low level of specialist skills that many policy makers have, the FSA should review if it has sufficient resources to undertake CBA within the policy divisions in the way it wishes, and whether any shortfalls are best met by internal efficiencies or by further recruitment.

Attention to this recommendation will ensure that the FSA's aims to develop further the level of its CBA are not frustrated by lack of staff ready and willing to conduct CBA but unable through lack of experience to do so.

Annex

Terms of Reference

"... Practical implementation of the new methodologies¹¹. The FSA has found in the past that there have been some cultural barriers to use of CBA early in the policy making process. In recent months, we have undertaken extensive work to improve business processes, including with respect to CBA. In this project we are seeking recommendations on how to optimise the implementation of the new methodologies in practice, with a view to ensuring consistent, timely and transparent CBA. The focus of this work will be on culture, skills and project governance."

¹¹ For *ex ante*, *ex post* and cumulative CBA developed in a parallel project by NERA