



Financial Services Authority

A Guide to Market Failure Analysis and High Level Cost Benefit Analysis

November 2006

Market Failure Analysis and High Level Cost Benefit Analysis

Principles of conduct

1. FSA staff are expected to use Market Failure Analysis (MFA) and High Level Cost Benefit Analysis (CBA) when proposing any policy initiative that is likely to have material market-wide impacts.
2. Typically, such initiatives will be in the form of rules or principles but sometimes initiatives in other forms will have material effects on markets. In these cases too, we need to use MFA and possibly CBA to ensure that our regulation is proportionate and genuinely risk-based.
3. There are a few exceptions to these requirements. For example, when the FSA is implementing the minimum terms of an EU directive, there is no point in carrying out an MFA. Details of the exceptions are set out in this Guide, immediately after the Introduction.
4. MFA and CBA need to be done at the start of the policy making process, not at the end.
5. The MFA will be largely conceptual in nature. It will tell decision-makers in plain language whether the FSA can improve on the market solution to whatever the problem is.
6. The CBA will also be largely conceptual in nature to begin with and will not normally exceed a page in length. It will tell decision-makers in plain language whether the particular measure that is proposed is likely in reality to correct the market or regulatory failure in a way that produces net benefits.
7. A partly or even fully quantified CBA may need to be prepared later. (This would be to meet any relevant requirement in the Financial Services and Markets Act or when the balance of interests is hard to determine.)

Market Failure Analysis and High Level Cost Benefit Analysis

A guide for policy makers preparing papers for the Regulatory Policy Committee

This extensively revised guide is designed for use by policy makers in the Financial Services Authority (FSA), with the help of advisers from the Economics of Financial Regulation Department (EFRD).

Market failure is the FSA's stated rationale for intervention in markets. If market failure is not present, intervention will bring net economic costs.

But all markets are imperfect to some degree. The mere presence of imperfections does not justify intervention. The main purpose of this guide is to provide a rigorous but non-technical means of determining when intervention is economically justified and when it is not.

It really is important to be sceptical about the case for intervention in markets. Governments and regulators are also prone to failures and markets can work even when the odds seem massively stacked against them. If you want to read about famous cases of this, type "Cheung The Fable of the Bees" into your web browser.

While the approach set out in this guide will produce reliable, fit-for-purpose answers in the majority of cases faced by the FSA, there are circumstances in which a more technical approach may be warranted. Under the arrangements made pursuant to the Treasury's review of the FSA that took place two years after the Financial Services and Markets Act came into force, EFRD is expected to take responsibility for economic analysis in such cases (and will organise external support as necessary). For example, markets in which consumers suffer from "bounded rationality" may be challenging to model. For material on that, type "De Bondt and Thaler" into your web browser. Similarly, markets with few suppliers and at least one significant barrier to entry may require particular types of modelling. If you want to see how this works, you will need to consult a text such as Jean Tirole's Handbook of Industrial Organisation, of which there are several copies in EFRD.

November, 2006

Market Failure Analysis (MFA) and High Level Cost Benefit Analysis (CBA)

A guide for policy makers preparing papers for the Regulatory Policy Committee (RPC)

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Introduction

1. This guide explains how to produce the MFA and high level CBA that the RPC needs to see if it is to approve policy projects. The guide is for use by FSA policy makers, with the help of EFRD, on issues that are not entirely straightforward from an economic perspective. In simple cases, you should be able to produce your RPC paper from the short companion texts *Developing your MFA for RPC papers* and *Developing your high level CBA for RPC papers*. EFRD will be pleased to advise which those cases are and to provide other assistance as appropriate.
2. "Market failures" are departures from the economists' notion of a perfectly efficient market. This notion is, for practical purposes, a device used to facilitate analysis. It is very useful in MFA because it helps us to identify whether or, far more likely, to what extent market failures are present. It is of general application – it is not just about the kind of markets in which securities and similar instruments are traded. It is not a depiction of reality as real markets almost always have elements of market failure.
3. What then are the main characteristics of a "perfectly efficient market"? It is a market in which, first, consumers and producers take decisions that reflect all possible, relevant information, i.e. the market failure "information asymmetry" is absent. Secondly, prices reflect *all* costs, including costs to third parties, i.e. the market failure "externality" is absent. Thirdly, firms cannot profitably charge prices in excess of "marginal" cost (which is the saving in a firm's total cost when output is lowered by a very small unit, and in the long run includes the cost of capital) i.e. the market failure "market power" is absent.
4. You will find an explanation, description and examples of these three market failures in Annex 1. There are other market failures but we believe that focussing on these three will capture the relevant substance of market failure and avoid undue complexity.
5. Why does the presence and extent of these market failures matter? In an efficient market firms produce at the lowest possible cost, in terms of resources used, and consumers buy the products they want at the minimum possible price for a given quality. Moreover, at this price, supply and demand are in balance. To the extent that transactions lack these characteristics, there is a "welfare loss" - a waste of resources - which regulation may be able to address. But regulation can only be justified by a market failure when it can improve on the market solution to that market failure. As Callum McCarthy wrote:

“In the FSA's work, a principle we have enunciated...is that regulatory action should only be taken when there is market failure. Now this is in fact a weak definition of the circumstances of when regulatory action is justified, since all realistic markets – that is all markets which exist in practice – have some elements of market failure...It is an argument too often deployed by those who favour intervention that any market failure justifies intervention. The strong – and to me correct – test goes beyond that: there must be both market failure and the prospect that intervention will provide a net benefit. This involves recognising that regulatory intervention has a cost and...a probability of failure. Identification of a market failure should not lead to the assumption that regulatory failure is less likely, or less costly. It is an open and empirical question, which needs analysis on a case by case basis.” (Hence the need for CBA.)

6. **MFA in RPC papers must therefore explain the *economic* case for FSA intervention. But keep in mind that the FSA is not concerned with market failures or any other “problems” that do not create risks to the FSA's objectives.¹ Also, while intervention where there is no market failure will yield economic costs that exceed economic benefits (i.e. a welfare loss), it might be justifiable on other grounds relating to the FSA's objectives. To make sound decisions, the RPC needs to know whether there is an economic case for intervening, a non-economic case or both.**
7. Here are simple definitions of *economic* costs and benefits that enable us to distinguish them from other advantages and disadvantages of proposed regulation. For our purposes, economic benefits (increases in welfare) arise when regulation corrects or counteracts a market failure or a regulatory failure (see 11 below). They also arise in other circumstances that do not concern us here. Economic costs (reductions in welfare) arise when regulation absorbs resources, such as computer systems or labour spent on compliance, or otherwise causes a market to work less like a perfectly efficient market. This document gives no guidance on non-economic costs and benefits. But, if relevant, these must be shown separately in RPC papers, ideally in the high-level CBA (see Annex 4). RPC papers must tell RPC whether the MFA/CBA supports the proposals and, if they do not support the proposals, what does. EFRD does not sign off non-economic material.
8. This note sets out a simplified and pragmatic approach to MFA and high level CBA. It will enable policy makers to present the economic case for new regulation to the RPC in an effective way and we strongly recommend its use. Your EFRD contact will provide any help you reasonably need to produce a reliable MFA/CBA for your policy proposal.

¹ Of course, the necessary connection between market failure and welfare loss means that market failure will typically give rise to risks to the consumer protection objective. See also “Note” at the end of Annex 1.

A prior question: do I need MFA/CBA in my RPC paper?

9. The answer is that usually both are needed. This applies to regulatory and deregulatory proposals. (If we propose to remove rules that are correcting or compensating for a market failure, economic costs are likely to result.) But there are cases in which MFA and/or CBA in an RPC paper would add little value and can, with EFRD's agreement, be omitted. Those cases are:

- **MFA and CBA** are not needed in papers about process or FSA resource allocation.
- Should there be an RPC paper about an EU "Regulation", **MFA and CBA** would not be needed as EU "Regulations" have direct effect in the UK: strictly, the FSA has no role in implementing them. But if the FSA proposes to retain rules that overlap a Regulation, this needs to be justified by MFA/CBA.
- **MFA** is not needed (but **CBA** is²) where the only course *open* to the FSA is to implement the terms of a "maximum harmonisation" EU directive. An exception to this is where the FSA proposes to retain rules that address the same market failure as the new ones: MFA is needed to determine whether the retained rules will still provide benefits.
- For other EU directives, **MFA** is not needed (but **CBA** is³) because the FSA has no choice but to intervene in the relevant markets and the purpose of the MFA is to determine the economic case for intervention. *But there are exceptions to this:* MFA is needed where the FSA is considering options such as:
 - A. Deregulation; or
 - B. Extending a directive's requirements to a market not falling within the directive's scope; or
 - C. Proposing superequivalent provisions in markets that do fall within a directive's scope; or
 - D. Retaining rules that address the same market failure as the new ones.

² Even where formal MFA is not needed as a screening device to determine whether the FSA ought to intervene in a market, any CBA required will still have to be based on an analysis of the relevant market.

³ See footnote 2 above.

Deregulation is likely to be a relevant option since, if a directive increases the requirements in one area, other requirements in that area or the requirements in a complementary area often can be reduced, provided that the directive's requirements effectively target the relevant market failures.

Important note

The focus of this Guide is on proposals originated by the FSA and the implementation of EU directives. But, in an era of increasing “maximum harmonisation”, the contents of EU directives themselves are of ever greater importance to UK markets. **It is therefore strongly urged that the contents of this Guide be used to enhance the FSA’s contributions to the process of negotiating directives and EU regulations.** This can be done when, for example, proposing in RPC papers the line that the FSA should adopt on specific issues. The value of this to UK stakeholders, including the FSA itself, in helping to avoid needlessly burdensome regulation should not need to be stated. But it is worth mentioning the context - the improvements to the policy making process that are going on in Europe. The Commission has published and committed itself to following highly credible guidelines on impact assessment. The Level 3 Committees are making their own arrangements for impact assessment, in the belief that this will increase the credibility of their advice to the Commission. Several Governments and regulators in other EU member states are now using or trialling cost-benefit and related methodologies. The Treasury of course welcomes economic evidence and the Better Regulation Executive expects Government Departments to provide it, including in the context of the EU. So using this Guide to provide such evidence is entirely in keeping with the general direction of policy making and the outputs are becoming increasingly familiar to those with whom the FSA is dealing. Put another way, the FSA has tended to see itself as being ahead of the game in this field. To stay there, the FSA will have to work harder.⁴

Main contents of MFA and CBA in RPC papers

⁴ Crucially, the FSA is using MFA to decide *whether to undertake projects* that may lead to regulation. Other organisations tend to produce impact assessments only at the end of projects, when a great momentum towards regulation may already have been built. Moreover, the FSA's organisational arrangements for such projects institutionalise a genuinely independent challenge that influences the decisions on whether to proceed.

10. The MFA and the high level CBA should deal with six questions (three each).

MFA:

- A. What is the relevant economic market or markets?
- B. What are the material market failures and/or regulatory failures – see next paragraph - in the relevant market(s) now?
- C. If no intervention or no further intervention takes place, will an improvement in welfare take place? Will the market failures be corrected in the short term?

High level CBA:

- D. What broadly are the regulatory options for the FSA?
- E. What are the economic and other costs and benefits of the options, relative to doing nothing?
- F. What is the plan for further CBA work?

Regulatory failure

11. The paragraph above mentioned “regulatory failure”, which is an important concept in this guidance. Regulatory failure matters because, like market failure, it is an economic justification for further regulatory intervention (including deregulation). What then is regulatory failure?

- For our purposes, regulatory failure means an intervention whose economic costs were higher or economic benefits lower than was originally expected such that the net effect is harmful or more harmful than it need have been. This typically happens where regulation has unforeseen and unintended effects arising from interaction with a specific characteristic of the market affected.
- For example, an intervention may have been intended to increase welfare but in fact reduced it by distorting rather than facilitating competition (or by not being correctly targeted on the relevant market failure).
- Equally, it may have been expected that an intervention in pursuit of FSA objectives would reduce welfare but the reduction may in practice have been much greater than expected. This might happen because of unforeseen effects of the intervention on

other economic markets or because demand in the targeted market was much more sensitive to price increases than the FSA believed it to be.

- On the latter point, it is important to keep in mind that regulatory interventions generally do increase the cost of producing financial services. What needs to be analysed is the effect of the cost increases:
 - Will the costs be reflected in prices? i.e. will costs be passed to consumers? Typically, cost increases will tend to be absorbed by producers to some extent for a brief while but be very largely - if not fully - passed on to consumers in the long run, with the possibility of more than 100% passing on when the producers have some market power and entry (or exit) is easy.⁵
 - If costs are reflected in prices, by how much will sales fall? This depends on the “price elasticity of demand”: the ratio of change in demand to demand *divided by* the ratio of change in price to price: $(dq/q)/(dp/p)$, i.e. % change in quantity/% change in price. If elasticity is high, regulation can impose greater economic costs than expected – because consumers cease to buy goods or services to which, save for regulation, they would have allocated their resources. If you are not sure what this means, please ask EFRD⁶.

⁵ Imperfect competition usually emerges because indivisibilities make it impractical and wasteful for the good or service to be produced by large numbers of independent firms. So average cost is likely to tilt down, if shown on a graph with average cost on the y axis and numbers produced on the x axis. If marginal cost, which will be less than average cost, tilts down too, prices may well rise by more than 100% of any rise in costs. If there is free entry, this excess pass through result is almost certain in the long run. In the presence of an entry barrier, imperfect competition results become more unpredictable. (Pass through may be less than 100%.) In perfect competition, 100% long run pass through into prices is usually assumed.

⁶ This guide is written in plain language where it can be. Most of the unavoidable technical terms used are explained in the sentences in which they appear. A few terms are explained in the short glossary at the end of the guide.

Market failure analysis

12. MFA is a type of microeconomic analysis. Microeconomic analysis typically involves identifying relevant markets, applying economic principles to them in order to form a view about how these markets are working and then seeking data to throw light on whether that view is – or is not – likely to be correct. Our suggested methodology for MFA follows this approach.
13. The output of your MFA need not be complex. Attached as Annex 3 is a completed MFA that uses the format of this note's short companion text *Developing your MFA for RPC papers*. This format should be used for your results, unless there is a good reason not to. You might find it helpful to look at Annex 3 as you progress through the various stages of the MFA set out here. It should give you confidence that the necessary output is achievable – and it will clarify by example what some of the steps set out here really mean.

A. What is the relevant economic market or markets?

14. Economic markets are the unit of account for economic analysis. The same regulations may affect different economic markets in different ways. So we must establish the relevant economic market or markets at the very beginning of the market failure analysis. How do we go about this?
15. The starting point for a policy initiative is typically a perceived risk to the FSA's objectives (RTO) or a commitment to implement an international agreement, such as an EU directive, in the UK. The nature of the RTO or the scope and subject of the international agreement will give strong clues about the economic market or markets that need to be examined in the MFA. But in general there is unlikely to be a straight read-across between the RTO or international agreement and a single economic market. For example, a risk to the consumer protection objective may arise from the market failure "information asymmetry" and affect the economic market for pensions and the probably separate economic market for short-term investments.
16. Economic markets are where potential buyers and sellers interact. Defining economic markets is not an exact science but a set of goods or services that are close substitutes for each other are often classified as a market. Unit trusts and investment trusts are such

substitutes because of their close resemblances, which many consumers will recognize; car insurance and mortgages are clearly not.

17. Thus, for our conduct of business rules, we may often identify the relevant economic market(s) by identifying which of the products affected are close substitutes for each other. Where they are not obviously close substitutes, the safer course is to assume that they are in separate markets. To help with this, a broad brush list of the economic markets that may be affected by FSA regulations is set out in Annex 2.
18. The FSA makes rules about the quality and quantity of capital and other resources that a regulated firm must have to provide its services. These rules affect many markets at the same time. But this does not necessarily make the MFA complex. For example, bank capital standards may affect a range of markets for credit, such as the market for personal loans and the separate market for corporate bonds. But in both cases the same market failure is relevant: the decisions taken by banks do not reflect all the costs of their operations, and all the costs are not reflected in banks' prices. The costs to third parties – a “negative externality” - are omitted. See explanation in Annex 1.
19. Market definition can be complex and lengthy, as in some disputes between competition authorities and major firms, but nothing like that is proposed for the MFA in RPC papers. Usually, all that needs to be clear is the broad market or markets that are affected by the proposals.
20. But we need to be alert to spot complexity where it is present. For example, we should look out for specific effects on particular types of products. Thus rules affecting “mortgages” might have particular effects on credit-impaired mortgages, which are probably in a separate economic market of their own because they appeal to a distinct set of consumers: consumers of credit impaired mortgages do not have access to regular mortgages, while consumers of regular mortgages do not want to be subject to the terms of credit-impaired mortgages.

B. What are the material market failures and/or regulatory failures in the relevant market(s) now?

21. Once we understand, from step A, which economic markets we are concerned with, we can proceed to see whether there is an economic case for new or different regulation in those markets. In broad terms, this means checking whether:

- economic principles suggest that the relevant markets are affected by an uncorrected market failure or regulatory failure (steps B1-B4 below); and
- economic evidence suggests that any such failure is material to the RTO that we are seeking to address (step B5 below).

22. Step B is the core of the MFA. Luckily, the task of identifying market failures is made much easier by the fact that particular market failures are principally, *though not exclusively*, associated with particular FSA objectives. The procedure therefore is:

- Step B1: determine which FSA objective is the main motivation for the initiative and then consult the table below on which market failure is likely to be relevant;
- Step B2: determine whether this market failure – and/or another one – is in principle relevant by considering the nature of the relevant economic market; *for this purpose, assume the complete absence of all financial regulation*;
- Step B3: determine whether any relevant market failure identified in step B2 has in principle been cured by appropriately targeted regulatory intervention (including rights or obligations created by primary legislation or the common law);
- Step B4: determine whether a regulatory failure is in principle relevant; this may be in addition to a market failure or, where an RTO has been identified but steps 2 and 3 suggest that this is unlikely to be due to a market failure, regulatory failure may be the sole cause;
- Step B5: check that any relevant market and/or regulatory failure actually is material to the RTO that concerns us.

Once we have carried out steps B1 to B5 it will be clear whether there is a material market and/or regulatory failure in the relevant economic market(s). If there is not, then net economic benefits cannot be achieved. This would mean that there would be no economic basis for regulatory intervention, and that is what the MFA in the RPC paper

should say. In such cases, we can ignore step C in this guidance and proceed to step D, the high level CBA. Note that where there is no economic case for intervention the high level CBA will include only non-economic benefits but will need to cover both economic and non-economic costs. Note also the FSA's stance against intervening in markets, unless there is market failure and the prospect of net benefits, as described in Callum McCarthy's statement in paragraph 5 of this guide.

23. Step B1. Use the table below to determine which market failure is most likely to be relevant to the RTO. Knowing which market failure we are *most likely* to be looking for – information asymmetry, externality or market power - simplifies our analysis of the relevant market, although the relationships in the table below are not exclusive. Explanations of these market failures are in Annex 1. For simplicity - some types of market failure overlap each other - and due to their limited relevance, we do not include "Public Goods" or "Incomplete markets", two well-known categories of market failure. But material on them is referenced in the "Further reading" at the end of this Guide.^{7 8}

FSA objective to which RTO relates	Likely market failure
Market confidence	Negative externality; market power
Consumer protection	Information asymmetry; market power
Public awareness	Positive externality
Financial crime	Negative externality

24. Step B2. Determine whether the market failure identified in step B1 or another market failure is in principle relevant to the RTO. This is done by analysing, at a high level, the nature of the relevant economic market. For this purpose, assume the complete

⁷ Public goods are ones that it costs nothing for an extra individual to enjoy AND from whose enjoyment it is very hard or impossible to exclude individuals. As a result of the second characteristic, public goods are typically under-supplied by the private sector: there is no profit to be had. Incomplete markets arise where a good or service is not supplied despite individuals being willing to pay more for it than the cost of supply. This can be caused by information problems affecting suppliers or consumers.

⁸ A related point is that on rare occasions the private sector cannot supply a service at a price that consumers are willing to pay but the public sector can, as a result of the advantages of centralisation/co-ordination or the law of large numbers or an element of compulsion reducing the costs of the legal process. It might sometimes be helpful to think of the Financial Ombudsman Scheme or the Financial Services Compensation Scheme in this way.

absence of all financial regulation. This is not as hard as it might seem. Various studies⁹ have shown that much, though certainly not all, of what financial regulation requires would in any event be done by most firms, in order to maintain client confidence and their own solvency. **Focus on the nature of the relevant product, the nature of the firms and consumers in the market and how they do, or would, interact with each other in the absence of relevant financial regulation.** For example:

- Would pensions be easy to understand if firms were not required to disclose information designed to meet standards of content and presentation set by the regulator on the basis of consumer research?
- Would pension firms have realistic incentives not to exploit consumers if their actions were not policed by the regulator?
- Would consumers be at an information disadvantage relative to pension providers if the regulator did not intervene on their behalf?

The aim here is to establish whether, without regulation, any market failure would arise. One overall way of thinking about this is to imagine that the benefits/changes that the existing regulation was designed to achieve no longer persist in the market. Another way is to suppose that the relevant existing regulation suddenly became ineffective: what kind of behaviour would result? Be sure to use the example in Annex 3 as you read this step.

25. Key points on how to carry out this analysis are set out in the following paragraphs. The material in Annex 1 should also be used in this part of the MFA: as it describes and gives further examples of the market failures, it can contribute to the diagnosis of whether a particular market failure is present in the specific economic market being analysed.

Step B2 continued – the nature of the product

⁹ Deloitte, The Cost of Regulation, 2006.

http://www.fsa.gov.uk/pubs/other/deloitte_cost_of_regulation_report.pdf

Europe Economics, Cost of Compliance, 2003.

http://www.fsa.gov.uk/pubs/other/cost_compliance.pdf

Franks, JR., Schaefer, SM., & Staunton, MD. "The direct and compliance costs of financial regulation", *Journal of Banking and Finance*, Vol 21, Issues 11-12, Dec 1997, pgs 1547-1572.

26. The crucial point about **the nature of the product** is the level of uncertainty attached to its performance at the time of trade. Information asymmetry (see Annex 1) is unlikely to be material when one can cheaply learn what a product is really like before buying it. If, however, one only learns about the quality of the product through experiencing it, information problems are more of a risk. And many financial products are of the "credence" variety. This means that their true value may never be established or established only a long time after the point of sale, possibly with difficulty and residual uncertainty.
27. If the product's true nature and quality are easily ascertainable before purchase, information asymmetry is unlikely to be a serious problem. If the product is of an "experience" nature or even of a "credence" nature, information asymmetry may still not be a serious problem. Consider whether independent and reliable agents are supplying the missing information at a price that consumers can afford. Check whether trustworthy signals of quality, such as guarantees or brands that can rationally be relied upon as signals of future performance, are playing a significant role in the relevant market. But if there are no such agents or signals, it may well be safe to assume that "experience" or "credence" goods are the subject of significant information asymmetry.
28. The nature of the product is more straightforward in relation to the other categories of market failure. Some firms offer products whose absence would have widespread effects on the economy as a whole. Loans are an obvious example. Thus reckless lending may be associated with credit crunches, if it leads to the collapse of lending firms. Similarly, it could be that reckless underwriting reduces the availability of insurance, leading to an inability on the part of firms in the real economy to undertake their favoured projects. These are examples of negative externality. Try to identify which unrelated parties could suffer as a result of the product being sold in the market you are analysing.
29. Products whose nature is such that it costs a vast sum to produce one and very little more to produce a million may well give rise to market power. These are typically products that depend on major investments in infrastructure or networks. Clearing banking is a possible example.

30. To identify whether a *product* may be associated with market power, and thus be a risk to the market confidence and consumer protection objectives, one useful step is to consider the structure of the costs of producing it. This may be suggested by firms' financial statements: was the original cost of the "fixed assets" on the balance sheet high relative to operating costs? If so, it may be that entry to the market depends on the ability to incur significant sunk costs and these (along with cost disparity for entrants and switching costs – see below) can have implications for how contestable a market is. (Where a market is not very contestable, market power may arise.)
31. The two paragraphs above deal with market power based on the nature of the product. They refer mostly to natural monopoly as described in Annex 1 of this document. Market power can also arise from other causes such as firms acquiring high market shares, it being costly for consumers to stop dealing with certain firms ("switching costs") and barriers that prevent new firms from entering economic markets. Policy makers should keep in mind that the FSA is *not* a competition authority and has no objective of combating market power as such. The Office of Fair Trading and the Competition Commission and, in some areas, the EU Competition Authorities are specifically charged with sorting out abuse of market power, mis-pricing, collusion and the like, for financial as much as non-financial firms. Also, the FSA does not set prices, although it may require disclosures that will tend to lower prices where market power, which can arise from information asymmetry, has damaged the interests of consumers and therefore brought the FSA's consumer protection objective into play. The FSMA requires the FSA to "have regard" to the need to minimise adverse effects on competition when carrying out its general functions, which include making rules, principles or codes and setting general policy for supervision and enforcement.

Step B2 continued – the nature of firms and consumers

32. When considering **the nature of the firms and consumers in the market, and how they interact with each other**, it is important to keep in mind that their behaviour is influenced by the nature of the product (above) and to analyse the incentives of each player. Economic analysis typically proceeds on the basis that firms and consumers will act in accordance with their economic incentives. This means, loosely speaking, that one

should predict firms' and consumers' responses to regulation by assuming that they will pursue their economic interests.

33. **Consumers** do not always know what will serve their economic interests:

- It is safe to assume that consumers picking unit trusts are seeking a trade-off between risk and return that is best for them.
- Some consumers believe that this can best be done by picking unit trusts with low charges. Other consumers believe that this can best be done by picking unit trusts that have performed well in the past. The consumers who rely on past performance as a guide to the future probably do not know that most of the relevant (risk-adjusted) statistical evidence does not support their belief, at least over the time horizons relevant to a typical consumer's investments and in the presence of switching costs.
- The proportion of consumers who follow each of these two strategies can be estimated by consumer research or by observing the types and prices of products that consumers actually buy. (And, if regulation provides evidence about which of these strategies is more likely to be successful, it is reasonable to suppose that some consumers will switch to it, thereby achieving a benefit.)

34. In analysing incentives, it is important to take account of the fact that the behaviour of consumers will vary considerably. As a starting point, economists assume that individuals seek to maximize their utility (the benefit that individuals derive from consumption), subject to the constraint of their income. In general, “utility” is expected to increase with consumption and financial assets provide the means for future consumption. But utility is not directly measurable (although inferences about it can be drawn from asking consumers what they are willing to pay for specific goods or services) and:

- Different individuals will differ in, for example, their preferences between consumption at different dates.

- Different individuals will put very different implicit valuations on risk.
- Different individuals will have different attitudes towards the costly but pro-competitive activity of searching among products offered. Individuals who value their time very highly, or who find finance hard to understand, or who think there is little to be gained by detailed consideration of financial products, will react little to changes in prices, but display inertia in their financial activities. Such individuals are likely to remain subject to significant information asymmetry.

35. An important step is to assess how sophisticated and well-resourced are the relevant consumers - or their agents/advisers, if the incentives of those agents/advisers are clearly to act in the interests of the consumers they serve. Unfortunately, it is all too easy for the agents and advisers of unsophisticated consumers to act in their own interests rather than those of the consumer, precisely because the consumer does have information problems. This is especially the case when the value of the execution or advice is hard to assess (as in the case of experience or credence goods, or when it is not straightforward to get information about alternative trades, as in the case of some transactions in securities and derivatives) and/or repeat transactions are distant in time or unlikely.

36. It might be thought more straightforward to analyse the incentives of **firms** because firms surviving in the market tend to know where their economic interests lie. (Firms that do not know this tend to become insolvent in markets with free entry and exit!) In fact, there are three main approaches to the theory of the firm (these partly reflecting ownership structures and obligations) and they – the different ownership structures in particular - have consequences for expectations about firms' behaviour.

37. One case is of the firm as a coalition, embracing staff and/or customers (and suppliers) as well as top management and shareholders. Outcomes are determined by tacit or explicit negotiation, with payoffs sensitive to such things as perceived "threat points", information structure, move sequences in the "game" played out between the stakeholders, whether/how often game is repeated, players' patience and perceptions of outside options. One application of this theory in the context of financial services might

be in analysing expected differences between the behaviour of mutuals, supposed to deliver best outcomes to their customers, as against public limited companies, answerable to shareholders.

38. A second case is simpler. Shareholders own the firm, and delegate running it to a single manager. In very special circumstances, the manager simply follows the shareholders' interests and, let us assume, always acts to maximize profit. But, more typically, verification costs, asymmetric information and manager risk aversion lead to a contract that is imperfect, and fails to maximize shareholders' utility. An extreme example of this in the financial sector is the Lloyds' underwriting syndicates impoverished by commission-hungry agents taking on dubious business. The Worldcom and Enron cases are other, well-known examples.
39. A third case may be relevant to the small, advisory firms in the financial sector as it is the classic owner-managed firm, with risk neutrality imposed. Here, textbook maximisation of expected profits is assumed (although, when a surplus can be sustained, it is not axiomatic that expected profits will be maximized). For example, if firms know that consumers of their products lack the memory or cognitive power to understand the consequences of the contract terms or are short-sighted in their decision-taking, would firms exploit this "bounded rationality"? In the present context, the economic answer is "yes", if consumers have little prospect of realising what has happened or, if they do realise, have little prospect of punishing the firm. (This would imply that reputation is unlikely to be a powerful incentive for firms not to exploit information asymmetries, and therefore consumers, when problems are only likely to become apparent beyond the time horizon that concerns the firms.)
40. Similarly, reputation and other competitive pressures¹⁰ may do little to force firms to deal with the "externality" relevant to market confidence since that externality is third party losses caused by the bankruptcy of firms. And it seems unlikely that many consumers will refuse a bank's cheap offer on the grounds that the offer increases systemic risk! In fact, competitive pressures are unlikely to force firms to take account of either externality

¹⁰ In simple and general terms, competitive pressures are strong when rivals can credibly demonstrate to consumers that they are offering an equivalent product at a lower price or a better product at the same price.

listed in the table above and, by construction, competitive pressures do not force firms to abstain from exploiting market power. But of course every case must be judged on its individual merits.¹¹

41. As a rule of thumb, assume that most or all retail consumers are unable to overcome problems of information asymmetry, whereas business consumers might. But, again, judge every case on its individual merits. For example, the Myners Report (a recent report for HM Treasury on certain aspects of financial markets) is not complimentary about the practices of corporate trustees, while some consumers have low information costs and so can buy cheaply.
42. **Step B3. Determine whether any relevant market failure identified in step B2 has in principle been cured by appropriately targeted regulatory intervention.** Step B2 tells us whether we can in principle expect to find a particular market failure in a specific economic market, given the nature of the products and actors in that market. It ignores existing regulation. But of course most or even all of the economic markets that can be said to fall within the scope of the Regulated Activities Order under the Financial Services and Markets Act (FSMA) have already been affected by FSA regulation. We therefore need to know whether a market failure that we expect to find in an economic market that is giving rise to an RTO has in principle already been resolved by appropriately targeted regulatory intervention – or by the general law.
43. To determine whether regulation has in principle corrected a market failure, we need to take the specific details of the market failure that we have identified in step B2, list the main features of the FSA regulation and the general law that impact on the relevant economic market and then map the regulation to the specific market failure. This mapping may already have been carried out in the CBA published when the regulation

¹¹ For example, it is worth checking that an externality is not of a kind that can reasonably be expected to be internalised through bargaining between interested parties. (Internalisation means that the costs are borne by the party that causes them, which removes the case for regulatory intervention.) One approach to this is to try to identify whether there is a party with whom the creator of the externality has a strong commercial incentive to bargain about the externality. Another approach is to establish that such bargaining is simply not feasible. One example of this is when externalities fall on future generations, which of course are not in a position to articulate their interests. Of particular interest in financial services is that co-ordinated (Coasean) bargaining between the relevant parties seems inconceivable when it is the taxpayer or deposit insurer or bank shareholder or creditor who picks up the cost of speculative behaviour by the managers of banks. On Coase, see the section on Further Reading at the end of this guide.

was introduced, unless the regulation was “grandfathered” under the transitional arrangements put in place when the FSMA came into force. It is important that regulation addresses, directly or indirectly, all points in a transaction at which the transaction may be materially affected by market failure. Otherwise, the transaction outcome may be no better than it would be in the absence of regulation. Equally, regulation should not address such points more than once or address points in the transaction that are not affected by market failure, as this would impose needless costs and therefore be a regulatory failure.

44. Here are two, typical examples of the kind of analysis that step B3 can involve in practice:

- If we have identified an information asymmetry, we should consider whether regulation has somehow filled the information gap, for example by providing the *relevant* information in an accessible format, mandating that it be provided or somehow mandating the outcome that would have been expected had there been no information asymmetry. Into the latter category might fall regulation that creates a strong incentive for those who hold private information to reveal it to their customers or not to exploit it. In assessing the strength of regulatory incentives, it is important to consider whether the parties targeted by the regulation believe that they are likely to be caught if they fail to comply – and how much they care about being caught (which may vary according to when they think they will be caught). From an economic and practical perspective, much depends on how profitable non-compliance would be. In other words, if, at the expected rate of being caught, regulatory enforcement penalties plus any consequent losses are sufficiently low that the expected value of cheating is higher than the expected value of complying, we should expect cheating rather than co-operation to occur.
- If we have identified a negative externality, we should analyse whether regulation is likely to have forced those creating the externality to internalise its costs to an appropriate extent (which would prevent the negative externality from being “over-produced”). In other words, we need to check whether regulation requires the creators of the externality to take proper account of it in their decision making, as a

result of being made to bear costs that are proportional to the externality. Thus we expect regulation that appropriately targets this market failure to impose significant costs on producer firms with respect to risks that are large and likely to materialise. So, for example, if we find that capital standards allow banks to take on certain types of very risky asset – or insurers to take on any potentially huge liabilities - without setting large amounts of capital aside (either through direct “haircuts” or through Individual Capital Requirements), we may well decide that “over-production” of the negative externality is likely to occur. We would then conclude that regulation has not dealt with the externality. Where internalisation of costs within the producer firms is not feasible, we should check whether regulatory mechanisms for managing externalities and protecting society from them are in place.

45. Step B4. Determine whether a regulatory failure is in principle relevant to the RTO.

Sometimes it will be clear that the RTO we observe is highly likely to be associated with a specific market failure and that regulation has not so far been appropriately targeted on that market failure. On other occasions, the position will be less clear. Either way, step B4 is important: we need to consider whether regulatory failure may, in principle, be an additional or alternative cause of the RTO since this may determine whether there is an economic case for further regulatory intervention.

46. Again, what is “regulatory failure”? As already explained, regulatory failure refers to situations in which regulation has economic costs higher or economic benefits lower than was originally expected such that the net effect is harmful or less beneficial than it could have been.¹² Here is an example. Regulatory actions designed to warn consumers about unscrupulous firms can damage the reputations of all firms in a market. The result may be to lead some (e.g. risk-averse) consumers to forego transactions that they would otherwise undertake. When consumers do not act on the preferences that they would have in a perfect market, there is a welfare loss – an economic cost. This cost may exceed the net welfare gain derived from stopping consumers dealing with (the few) unscrupulous firms.

¹² The latter part of the definition is important because the gains to be made by deploying any available regulatory resources on revisiting regulation that produced net benefits on a smaller scale than was feasible may be greater than those to be had by revisiting areas in which regulation produced net costs.

47. In the identification of regulatory failure, there are at least four possibilities to keep in mind.

- First, the relevant market may not have been subject to a material market failure and the RTO in it that we observe may be due to existing regulation. This could be regulation that was wrongly prescribed for this market¹³ or regulation that was intended to affect another market but unexpectedly impacted on this one too.
- Secondly, the relevant market may have been subject to a material market failure and regulation was introduced that was successful in correcting it: the RTO we observe may be due to a different market failure and have another cause. It may, for example, be a side effect of the successful regulation or of other regulation.
- Thirdly, the relevant market may have been subject to a material market failure and regulation was introduced that actually made it worse.
- Fourthly, the relevant market may have been subject to a material market failure and regulation was introduced that has so far failed to work but may do so in due course.

48. In all of these cases, the analysis that we need to undertake is the same. We need to analyse at a high level in what ways one would expect the incentives and therefore, in principle, the actions of the actors/potential actors in the relevant market to have been changed by *all* aspects of FSA regulation that are likely to bear on the economic market(s) in which the RTO has been identified. Most importantly, we need to consider whether those changes are a cause of the RTO that we observe. Thus we need to isolate the aspects of the market – behaviours or product characteristics, etc – that characterise the RTO and then form a view about whether they are caused by regulation. Here are some examples.

¹³ To be sure, we and other regulators work hard to achieve our objectives in appropriate ways. But we should be open-minded to the possibilities of errors, which can arise for various reasons. See for example Stigler, G, The Theory of Economic Regulation, Bell Journal of Economics 2, 1971. pp 3-21.

- High prices (1). Are authorisation requirements so high that entry to the market could now be very difficult, possibly leading to the market failure “market power” and consumer detriment (an RTO) in the form of excessive prices?
- High prices (2). Could the level of Individual Capital Requirements for concentrated, specialised firms ration the availability of specialised financial products, leading to consumer detriment from excessive prices?
- Misbuying (1). Could, say, projection rates in retail investment business exacerbate information problems by causing consumers to believe that particular rates of return are highly probable or even guaranteed, leading to consumer detriment in the form of ill-informed choices between saving and consumption?
- Misbuying (2). Could regulatory requirements such as, say, the menu of commissions payable to financial advisers, lead to competition around false focal points, which is an information problem that can cause consumer detriment? (False focal points of competition are matters that strongly influence choices in practice but that would, if consumers were fully informed, be regarded as immaterial relative to, say, the price/quality trade-off.)
- Low prices. Could a market perception that regulators have “underpriced” a risk (in terms of the capital requirement applied) lead to intense competition to offer a product at a price too low to remunerate firms’ own capital, given the expected losses? This could create externalities and those could be a risk to the FSA’s market confidence objective.

A general point to watch for is that regulation can cause herding behaviour, such as the irrational pricing of loans due to regulatory arbitrage in the bullet above. Herding behaviour may be both a distortion of competition (to which the FSA must have regard) and a threat to the FSA’s objectives.

49. To the extent that the regulation identified under the paragraph above is regulation that was targeted on a market failure in the economic markets that are giving rise to the RTO,

some of the analysis required here will already have been carried out under step B3 above. But additional analysis is still likely to be needed. Step B3 may have told us whether regulation ought in principle to have corrected a market failure. Now we need to know whether that regulation had any relevant side-effects. Also, as already mentioned in this section, regulation that was meant to have impacts in other economic markets may also have had impacts in the market giving rise to the RTO.

50. Analysis of the impacts of past regulation is also important because it must bear heavily on the design of the FSA's response to the present RTO:

- We may wish simply to remove pieces of regulation that are the cause of RTOs (unless doing so would unleash a still bigger RTO).
- We will presumably wish to steer clear of measures similar to ones that have definitely failed in the past, and to be clear about the reasons why they failed: did they or did they not correctly target the relevant market failure?
- We will need to decide whether existing regulation that seems to be correctly targeted on a market failure should be given more time to work. (See C. below.)

51. **Step B5. Check that any relevant market and/or regulatory failure actually is material to the RTO that concerns us.** Steps B2, B3 and B4 are analyses of principle. After carrying them out, we should be clear about whether the RTO with which we are concerned is in principle due to regulatory failure and/or market failure. Equally, we may have concluded that there is no relevant market failure and no relevant regulatory failure. In this case, there would seem to be no economic justification for regulatory intervention. Either way, it is important to extend the analysis in principle with evidence-based analysis. We need to check that any market or regulatory failures we have identified actually are material to the RTO that concerns us – or that the apparent lack of such failures is borne out by market data. Thus step B5 is looking for evidence of what is really happening in the market.

52. Very often the original motivation for the policy initiative of which the MFA forms a part will actually be evidence that the market is “failing”, although it might have been labelled as evidence of an RTO. Such evidence will greatly facilitate step B5, the purpose of which is to determine whether there are market data that:

- suggest a causative link between a market and/or regulatory failure and the RTO that concerns us;
- show that the magnitude of the market and/or regulatory failure is such that it makes sense for the FSA to do something about them. This is the “materiality” condition.

53. Obtaining and assessing information about the state of regulated markets is of course a fundamental aspect of regulatory policy making. We shall therefore not address the basic elements of these activities. It is, though, worth:

- drawing attention to the kind of information about markets that is useful in the type of economic analysis being described here;
- making the obvious but important point that the nature of the market failure or regulatory failure that we are considering should alert us to the kind of data that we will need if we are to assess their presence in and impact on the relevant economic market(s).

54. For identifying uncorrected market failures, the following examples may be helpful:

- a wide dispersion of market prices for essentially the same product may indicate information asymmetry (although in some markets – for example, retail loans - price differences may appropriately reflect differing risks);
- so might survey or other evidence that shows a lot of consumers buying products that do not suit their needs – the FSA's consumer research experts will be pleased to advise about consumer research;

- so might the persistence in the market of product offerings with “dangerous” features;
- persistent excess profits (i.e. profits that persistently exceed the normal risk-adjusted rate of return¹⁴) may indicate market power;
- so might widespread wasteful or extravagant practices in firms (as excess profits are often dissipated by management slack);
- prices that do not reflect the true risk to the providers of financial products may indicate externalities;
- so might (irrational) herding behaviour - see above.

55. For identifying regulatory failure, the following examples may be helpful:

- if the regulatory failure may be that disclosure has misled consumers in a particular way, we should check whether consumers’ product choices have shifted in the expected direction since the disclosure was introduced;
- alternatively, we could use the results of consumer surveys to determine whether consumers are misunderstanding the disclosures or transactions in the ways expected;
- alternatively, we could check whether firms’ product offerings have changed to exploit consumers’ misunderstanding of the disclosures;
- if the regulatory failure may be the creation of market power through the setting of very high minimum standards that few can meet, we could look for evidence of price increases that seem not to be driven by changes in firms’ input costs;
- alternatively, we could look for exits of firms from the market, which may be apparent from the FSA’s central register or the giving up of FSA permissions;

¹⁴ The intuition here is that investors expect to be remunerated according to the amount of risk that they are taking on. Returns in accordance with those expectations are “normal”. In practice, this often needs to be assessed by comparing returns on securities offered by different firms with similar businesses.

- alternatively, we could look at data on market shares and market concentration.

56. Specific, additional ways in which data can be used to draw economic inferences are listed under Step C below. These may also be useful here.

57. Tell the RPC whether the evidence suggests that we are addressing uncorrected market failure, regulatory failure or both or neither of these.

C. If no intervention or no further intervention takes place, will an improvement in welfare take place? will the market failures be corrected in the short term?

58. If Step B suggests that there is no material market or regulatory failure, record the result and a brief explanation of it in the MFA to be included in the RPC paper.

59. Even if step B5 does show that there are relevant and material market and/or regulatory failures, there is not necessarily an economic case for regulatory intervention. Such a case also depends on it being clear that the RTO will not otherwise be resolved – step C – *and* on the cure being preferable to the current ill – steps D and E.

60. How then does one determine whether market failures are likely to be corrected in the short term? In general, if there is a material market failure per step B5 above, it is unlikely that firms and consumers acting for their own benefit will cure it. The chances are that, if a market solution were possible (given current technology), someone would already have created it. But it is not safe simply to assume that where there is a significant market failure (or even regulatory failure) fresh intervention is justified. One therefore needs to marshal facts and data in order to consider questions such as:

- is there evidence that the market failure arose only recently?
- was regulation that targeted the market failure introduced only recently?

- is there now evidence of new entrants who are likely to undermine the market power of incumbent firms? This may be apparent from the FSA's authorisation data.
- is the price of products falling in a way that suggests that market solutions to information asymmetry are starting to work?
- is the mix of products being sold changing in a way that suggests that market solutions to information asymmetry are starting to work?
- is there an increase in consumer complaints to the Financial Services Ombudsman about products in the relevant economic market, perhaps in response to a media campaign? (Again, this could indicate that information asymmetry is reducing.)
- is the gap widening between the price of products that can cause major externalities and the price of similar products that are unlikely to cause such externalities?
- is there evidence of a decrease in firms' herding behaviour, which would suggest that the market is somehow providing mechanisms to discipline behaviour, a bi-product of such discipline being a reduction in externalities?
- is there evidence that it has become profitable for firms to provide information?

61. It is also important to think laterally in this area. Markets tend to be dynamic not static and the ways in which they are changing need to be considered:

- external factors (such as a new tax regime or a financial scandal in another country) or new entrants, perhaps bringing new ideas from other industries or other countries, may be changing the market and correcting the market failure;
- again, a change in technology or the availability of fresh information (for example, as a result of accounting or legislative changes) may correct or modify the market failure;

- or it could be that the existing regulation is only a partial solution to the market failure but that it has unleashed the forces of competition and these are in the process of solving the residual problems.

62. All the relevant circumstances need to be considered and an explanation of the judgement made about whether the market will cure itself must be given in the RPC paper.

MFA - conclusion

63. The point of MFA is to provide a rigorous analysis of whether or not there is an economic case for regulatory intervention. It is not enough to tell the RPC that an RTO is associated with signs of detriment that may be due to market failure. In summary, the MFA section of RPC papers needs to say one of two things. These are:

- We examined economic markets XYZ. We found no uncorrected market or regulatory failures relevant to and material to the RTO that we are addressing. Any case for intervention is entirely non-economic.
- We examined economic markets XYZ. We found the following uncorrected market and/or regulatory failures: ABC. These are relevant to and material to the RTO that we are addressing because they cause LMN. The evidence is RST. These failures therefore provide an economic case for regulatory intervention, subject to the results of the CBA (below).

The link between MFA and CBA

64. The starting point for MFA as set out here is an FSA objective and references to the link with RTOs have been made throughout the text. Thus it should be clear in any completed MFA how correcting the market failure or, if the failure cannot be corrected by FSA action, how introducing economic incentives to produce outcomes closer to those of the efficient market, will further the FSA's objectives¹⁵ and produce benefits.
65. It may be helpful to connect these ideas through a simple example. There may be a **market failure**, say information asymmetry, which leads to consumers buying the wrong product. This is an **RTO**, as it affects the consumer protection objective. Regulation that corrects the information asymmetry can produce **benefits**, for example by causing some consumers who would have bought the wrong product to buy the right product. (The benefit is the increase in **utility** – the satisfaction that people derive from consuming goods or services - that such consumers experience.) The regulation is also likely to bring **costs**, for example in the form of resources spent on disclosure. And keep in mind that some problems in markets are "facts of life" that regulation cannot sort out.
66. As just hinted, the economic case for FSA intervention does not only depend on there being an RTO, a market failure and some regulatory mechanism for correcting or offsetting that failure. It also depends on there being an FSA regulatory option whose benefits really will outweigh its costs. This is addressed in the CBA, which explores both the costs arising from intervention and how increasing economic efficiency by addressing market or regulatory failures translates into beneficial market impacts such as increases in the quality, quantity and variety of services offered and sold. How to assess this cost-benefit balance through high level CBA is the subject of the next section of this guidance.

¹⁵ The FSA can in principle correct information asymmetry by mandating that market participants share information. The FSA cannot itself correct market power (for example by ordering firms to give up market share) but it can reduce exploitation of market power by, for example, increasing consumer awareness. The FSA cannot correct externalities by directly preventing firms from failing but it can make firms internalise some costs of their failure, which may reduce the incidence of the externality.

High level CBA

67. The approach to high level CBA set out below is consistent with the FSA's standard approach to CBA – which is explained in the CBA manual ("Practical Cost-Benefit Analysis for Financial Regulators") at <http://www.fsa.gov.uk/pubs/foi/cba.pdf>. The standard approach uses a six-part impact analysis: what are the likely effects of the proposed regulations on the quantity, quality and variety of services offered/sold, the efficiency of competition, and the FSA's direct costs and firms' compliance costs?
68. The FSA's standard approach to CBA was reviewed by NERA, an economic consultancy, as part of the N2+2 Review of the FSMA. NERA confirmed that the approach is basically sound but recommended that we give emphasis to identifying market impacts before proceeding to estimate any costs or benefits. NERA also prepared a simple guide to CBA and recommended that it be used for training purposes, especially for those who find the FSA's standard approach challenging. NERA's guide is available from your usual contact in EFRD. It may be sensible to use NERA's guide in the preparation of relatively simple CBAs. Certainly use the example given in Annex 4 of this guide.

D. What broadly are the regulatory options for the FSA?

69. FSA regulation operates through markets in the sense that it tries to influence how firms and consumers interact in markets. Regulation of quality (e.g. "fit and proper" rules) affects fundamentally the conditions for the supply of financial services. So may regulation of quantity (e.g. capital standards). Quantity regulation can also directly affect demand for financial services (e.g. compulsory levels of PII for financial advisers may increase consumer confidence and therefore increase demand).
70. Quantity and quality regulation cause additional resources to be used in the production of financial services. This is an economic cost. Such regulation may also lead to higher prices. This is a further economic cost, *if* (as will typically be the case) consumption is reduced and consumers' surplus therefore reduced by more than just paying for the additional resources that regulation forced firms to use.

71. It is worth mentioning in passing that the notion of consumers' surplus can be a useful way of getting at "utility", which, as already mentioned, is what consumers are assumed to be trying to maximise. Consumers' surplus is the excess of what consumers are willing to pay for a good or service over the price that they have to pay to get that good or service in the market. Naturally, willingness to pay for a given good or service is usually not the same for all consumers. But when FSA regulation increases the cost of producing a service and this is reflected in a higher price, it lowers the surplus of all consumers who continue to buy the service – and those consumers who cease to buy the service lose all the surplus associated with the transaction that, save for regulation, they would have undertaken. (Consumers who cease to buy the service will, however, offset some or most of their loss by deploying their resources in their next best use.)
72. So it is important to keep the costs of quality and quantity regulation in mind when developing policy options. Design of the policy options available to the FSA is otherwise beyond the scope of this note except to emphasise the following very important points:
- the policy option's ability to act on the relevant market failure is crucial from an economic perspective: addressing facts of life will not produce economic benefits; for example, it is a market imperfection that the future performance of funds is unknown but this is a fact and not per se a market failure; there is, however, a market failure - information asymmetry – if firms know more about the likely distribution of future returns than do their customers;
 - policy option design has significant consequences for the costs and benefits of intervention, so cost-benefit considerations must influence development of options; principles and codes will allow efficient compliance, thereby lowering transaction costs, but need to be designed carefully to avoid the costs of uncertainty and opportunistic behaviour;
 - options that are not correctly targeted on any market or regulatory failure that is causing the relevant RTO are of course unlikely to produce any economic benefits – and will almost certainly produce economic costs;

- there is an obvious trade-off between missing the best option/having further options to fall back on if one's preferred option turns out to be flawed or impractical and the resource-intensive task of option appraisal;
- the FSA regulatory toolkit, accessible via the FSA's "Arrow" (risk assessment and mitigation) software, is helpful.

E. What are the economic and other costs and benefits of the options, relative to doing nothing?

73. It is important that costs and benefits of different options are identified against a well-defined baseline. Where the FSA is developing its own regulation, the baseline should normally be the status quo. This can be defined as "The FSA does nothing and the market continues in its present state". Under this simple approach, one would, for example, ignore possible industry trends towards what the FSA's proposed rules mandate. Thus, if 80% of firms presently do not run a system that the FSA deems to be necessary, the cost of the FSA imposing that system would be the cost of 80% of firms implementing and running that system.

74. To the extent that the FSA is implementing the minimum requirements in an EU directive, the same baseline should apply. To the extent that the FSA is considering superequivalence (for example, choosing a higher calibration for a risk than the one set out in a directive), it may make sense to use the directive minimum, plus any existing, overlapping rules that are being retained, as the baseline for decisions about the superequivalence. Where a directive does not set a minimum and instead requires member states to choose between options, it may make sense to treat the least cost option as if it were a minimum requirement to be assessed against the baseline. The other options could then be assessed against that "minimum" as if they were "superequivalent". Where the FSA proposes to retain any existing, overlapping rules, the baseline should in simple cases be the directive minimum plus any proposed superequivalence. But where there are many inter-related sets of rules, the sensible approach is likely to be to test each set against a baseline of the most probable specification of all of the other sets.

75. You may see economists' references to the "counterfactual". While a baseline is a fixed starting point or comparator, developing a counterfactual requires more effort. It depends on developing a set of assumptions about what would happen to the relevant markets and variables in the absence of the regulation being considered. One can then describe what, at various points in the future, the world would be like if the proposed regulation were not introduced. The comparison that yields the costs and the benefits of the proposals is then between this counterfactual world and the world as it is expected to develop under the proposed regulation. It will rarely make sense to look many years forward, given the scope for other things, such as technology, to change. EFRD will be pleased to advise on whether it is worth developing a counterfactual as described here or whether, as is very often the case, it is acceptable just to assume that the status quo will continue.

76. The high level CBA should rarely be much longer than a page. Given that it is being prepared at an early stage in the policy process, it may have to be in significant part a summary of qualitative evidence. However, compliance costs, including "administrative burdens" as defined under the Government's Standard Cost Methodology (on which, see the section on Further Reading at the end of this Guide), should be quantified in broad terms and the analysis of benefits, while it may be largely an analysis of principle, should refer to any empirical evidence that is readily available and/or include a detailed description of the mechanism (causation) by which benefits will arise. Remember that the purpose of the high level CBA is to help the RPC make an informed decision about whether FSA intervention is justifiable. The CBA should be written with this in mind.

77. The CBA needs to explain how – and to what extent - the options would correct or otherwise counteract the market failures identified. This is fundamental to establishing that the intervention would produce economic benefits. Especially given the constraints on length, we recommend that high level CBAs should analyse the economic impacts of the regulatory options in terms of three factors, namely:

- impact on firms and their behaviour;
- impact on consumers and their behaviour; and

- changes in the nature of the transactions carried out in the market.

Any direct cost to the FSA and compliance costs for firms should also be mentioned. Note that, if these are not small relative to the market impacts of the proposals, then the proposals are likely to risk being disproportionate. It is also important not to include lots of detail about FSA and compliance costs in RPC papers just because the details are available. The RPC wants to be informed about the likely material impacts of proposals and these should not be obscured by needless complexity.

78. The analysis of changes in behaviour should help develop the analysis of changes in transactions in the market i.e. changes in the quantity of goods sold, quality of goods sold, variety of goods offered, and efficiency of competition.¹⁶ Note that neither firms' behaviour nor consumers' behaviour can be considered completely in isolation. Firms' behaviour is influenced by consumers' behaviour and vice versa, as described in the material on MFA above. It is very important that the CBA should explain how – and to what extent - each regulatory option would bring about the changes in behaviour necessary to deal with the relevant market failure. Note that the focus on the changes in behaviour likely to be caused by the intervention is the same regardless of whether the FSA is using rules, guidance about rules, principles, codes or any other instrument. Just as in a more rules-based regime, CBA in a more principles-based regime needs to be based on explicit assumptions about supervision and enforcement, as these provide firms with the incentive to comply.

79. Changes in regulation can affect competition in ways that impact materially on consumer welfare¹⁷, and the FSA is required to have regard to the effects of its regulation on competition. Thus important economic impacts of regulatory options include whether they are likely to lead to significant exits from the market (especially where there are already few players), new barriers to entry or effects that differ markedly from firm to firm. Also, it will be important to note any likely effects on the nature or vigour of price competition or on the way that firms differentiate and market their products.

¹⁶ In general terms, competition is considered to be efficient when firms compete on price and quality rather than false focal points such as the past performance of (most) investment funds. Thus the presence in the market of many firms advertising rival products does not necessarily mean that competition is efficient (when information asymmetries are present).

¹⁷ In economic terms, social welfare is the total "well being" of a community.

80. The analysis must be consistent with the MFA and build on what the MFA says about how the market is working. That way the benefits of correcting or otherwise counteracting market failures will be neatly captured in the CBA. The CBA must even be consistent with the MFA when the reason for proposing a specific measure is not economic. This is to capture in the CBA any negative impacts on the market that are likely to arise from regulation that is not based on economic considerations.

81. As already mentioned, non-economic costs and benefits that are relevant to the FSA's objectives need to be included in the CBA. Where regulation imposes a cost on group A and delivers an identical benefit to group B and changes nothing else, there may be no “economic” costs or benefits. All we may have is a “transfer”, and it may be entirely legitimate for the FSA to cause such transfers in the pursuit of its objectives. Such transfers need to be included in the high level CBA prepared for the RPC.

82. Four further high level issues may arise in CBAs:

- Costs and benefits to persons not resident in the UK - **if these are material**, they ought to be brought into account to the extent that they concern persons resident in other member states of the EU. Beyond the EU, the question is one of judgement. Even costs and benefits to those who are resident in other member states of the EU should be recorded separately from costs and benefits to UK residents.
- Welfare weights - where the FSA's objectives imply that the FSA should help one group at the possible expense of another (see previous paragraph), it may be appropriate to apply weights to the economic or other benefits expected to arise for the favoured group, although there will have to be sound and clearly articulated reasons for doing this.¹⁸ For example, increasing the scope of the compensation scheme will, if we ignore effects on future behaviour, bring only net economic costs. This is because the initial result will be transaction costs, which are an economic cost,

¹⁸ Even where such reasons can be articulated, the size of the weighting will inevitably be a matter of judgement. There is a risk that such judgements will be influenced by a wish to secure a predetermined result. To counteract this, a disciplined approach to using welfare weights is essential. See, for example, the following paper prepared for the Office of Fair Trading: Cowell, F, and Gardiner, K. (1999), Welfare Weights, Report to the UK Office of Fair Trading, available at www.oft.gov.uk/NR/rdonlyres/.

and compensation payments, which are an economic transfer. But the extension may still be justified if the weight applied to the benefit to the transferees (a group that gets support as a result of the FSA's objectives) means that the excess of this benefit over the cost to the transferors is greater than the transaction costs.

- Economic benefits that are not relevant to the FSA's objectives - for example, the Treasury might want the FSA to encourage saving in order to secure the future economic benefit of a reduction in the economic distortions associated with taxation. Such benefits should be noted in the CBA and labelled explicitly.
- The Government wants independent regulators to monitor and reduce “administrative burdens” (the cost of firms reporting to the regulators/Government) and “third party information costs” (the cost of firms giving information to people other than the regulators/Government), although it recognises, especially for third party information costs, that the supply of information may be crucial to achieving policy objectives. Such costs will in any event be highlighted in CBAs wherever they are material to the decisions to be taken. In other cases, they may need to be recorded, as part of the policy making process, in a manner reflecting the Government's approach, provided that the Board of the FSA has agreed to do this. Your usual contacts in the General Counsel's Division or EFRD will advise on the latest position.¹⁹

83. See Annex 5 for guidance on the costs and benefits to be included in a high-level CBA.

F. What is the plan for further CBA work?

84. The paper presented to RPC merely needs to say that the plan for carrying out the CBA has been agreed with EFRD. The aim is to assure the RPC that the costs and benefits identified will be investigated in sufficient depth to enable final policy decisions to be made on the basis of materially complete information. That is the criterion that EFRD

¹⁹ The main advantage of recording, for example, administrative burdens even when they are not material to a decision is that it enables government and regulators to make an overall assessment of the level of such burdens, and to set and monitor targets for reducing them. Where feasible, however, it is preferable to assess the *overall* costs of regulation and, where these are high, to assess whether they are justified by the *overall* benefits. See, for example, http://www.fsa.gov.uk/pubs/other/deloitte_cost_of_regulation_report.pdf and <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/061.shtml>

will apply in agreeing the plan for further CBA work. Thus, for example, the plan needs to explain in very broad terms, what further work is envisaged and what resources will be used. If external consultants will be used, this should be mentioned and some indication given of the likely scale and nature of their involvement. Experience shows that where realistic plans are not made, CBA projects are just as capable as other unplanned projects of foundering, usually at great cost in terms of the leisure time of those involved!

Concluding observations

85. The MFA need not necessarily come to a conclusion about whether there is definitely an economic case for intervention. But if it does not, it must make clear what further questions will have to be answered in order for a conclusion to be reached and must set out what further work will be done in order to answer those questions.
86. Wherever possible, the MFA and high level CBA should be based on objective evidence. The Cabinet Office, in its "Professional policy making for the Twenty First Century", sets out a useful definition of appropriate evidence for policy making:

"Good quality policy making depends on high quality information, from a variety of sources – expert knowledge; existing domestic and international research; existing statistics; stakeholder consultation; evaluation of previous policies; new research, if appropriate; or secondary sources..."

Inevitably, parts of many MFAs and high level CBAs will have to be based on the judgements of FSA staff rather than evidence – and economic evidence is often circumstantial and typically probabilistic not proof of causation. But the MFA and high level CBA should always make clear which parts are based on evidence and which on judgements.

Annex 1: explanation, description and examples of the market failures

In brief, the key concept about market failure is this. If markets for all goods and services produced in positive quantities work well, each good or service will be priced at a level that matches (i) marginal benefit, measured in money, and (ii) marginal cost. Market failure arises when marginal benefit is unequal to marginal cost – too little or too much is bought and utility is not maximised.

In broad terms, the three market failures that matter most in this guide arise when:

- externality/third party effects make social marginal benefit (or cost) differ from the “private” marginal benefit for buyer (cost to seller);
- some buyers (or sellers) are imperfectly informed, so that their mistaken estimates of actual marginal benefit (marginal cost) lead them to take incorrect decisions;
- market power, on the part of seller(s) or buyer(s), leads them to exploit their influence over the price, which they no longer take as given – leading, typically, to under-provision of the good in question.

More detail on each of these is supplied in turn below.

1. **Externalities.** A good or service generates externalities if its production or consumption affects the welfare of economic agents (people or firms!) other than its original producers or consumers without prices reflecting such effects: think of people living next to busy rail tracks, for example. Externalities may be negative and/or positive. They are “negative” for those on whom they impose costs and “positive” for those who gain from them. Negative externalities occur in production when decisions adopted do not take account of all the costs which result from the firm’s actions but which are not borne by the firm. The classic example of this in financial services is systemic risk in the banking sector, where the failure of one bank may lead to runs on other banks and hence to problems for those other banks and their customers. Consumer fraud may be regarded as a negative externality in consumption. Financial crime also bears negative externalities in terms of the costs people incur in defending themselves against it and in being involuntarily associated with it.

2. The provision of generic information about financial products can be a positive externality. There is a demand from consumers for such information, but it may not be worthwhile for any one firm to expend significant resources in providing it, because much of the benefit would accrue to its competitors. The result is that the market – if left to its own devices – does not provide as much generic information as consumers would be willing to pay for.
3. **Imperfect and asymmetric information.** Individual decisions are affected by imperfect information about quality (that can be unobservable ex-ante), price (information on which can be very costly to obtain) and the future (data on which can be unavailable!).²⁰ Information is a source of market failure if it is understandable by, useful to and not available to one or both of the consumer and the seller. "Useful" means that the information could change the behaviour of the party who lacks it. Excessive costs of accessing information may give rise to this market failure. Some products (or the firms supplying them) may be so complex that disclosure, by itself, cannot enable customers to make informed choices. In financial services, the outcome of a contract may depend on the provider's financial soundness and competence for decades into the future. This information cannot be known at the point of purchase.
4. Information asymmetry can work both ways. A product provider may be selective about the information that it gives the consumer: it prefers not to reveal information that puts the product in a bad light. Equally, a purchaser of life insurance may not disclose that he or she has health problems. An important area in which information asymmetry may explain the market outcomes that we observe is where one party to a transaction (the principal) uses an agent to act on his/her behalf. The principal aims to sign a contract that aligns the agent's interests to his/her own. But it can be hard for the principal to monitor the agent (an information problem) and the agent may have incentives to take specific decisions that are not aligned with principal's interests. An important example is when a consumer (principal) uses an IFA (agent) who is remunerated through commission paid by the product provider. Another example is when the consumer (principal) uses a fund manager (agent) to invest his or her funds.

²⁰ It is a "fact of life" that markets fail to provide information that cannot be known. This type of market imperfection is not really a market failure – there is no asymmetry and nothing that can be done – and so does **not** provide a rationale for regulatory intervention (beyond warning those who may not be aware of the information gap that it cannot be filled).

5. **Market power** is exercised when prices are changed solely by the decision of a few market players: prices are set by these firms with limited regard to customers or competitors, such that revenues above the marginal cost of all production inputs (including the market cost of capital) can persist rather than be eroded by competitive pressures.²¹ Market power can arise if firms collude and agree on a price strategy or if there is de facto collusion. Market power is also exercised through the use of brands, when prices and costs are not really interlinked (the brand premium may far exceed the cost of creating the brand). It can also result from consumer inability to discipline producers, probably due to information asymmetries, so that a false competitive focal point may drive transactions. One effect of "fit and proper" requirements or conduct of business requirements is to create an entry barrier that reduces the strength of competitive pressures.
6. There is also the case of natural monopoly. This arises where sunk costs are very large relative to unit production costs, so that average costs are decreasing for any volume of production for which there is demand. If there are these economies of scale in production or there are network economies in distribution, a single producer or distributor seems the most efficient means of satisfying all demand. Aside from huge sunk costs acting as a barrier to entry giving rise to natural monopoly, non-natural monopoly may be created by other barriers such as regulation.

Note

As emphasised in the Introduction, market failure analysis concerns the detection of deviations from the economists' notion of a perfectly efficient market and identification of mechanisms that may correct those deviations. This can provide an *economic* rationale for regulatory intervention in a market. It is important to note that from this perspective:

- there is no difference between the surplus obtained by consumers and the surplus obtained by producers: saying that there is a market failure is tantamount to saying that there is a "deadweight loss" in the economy and correcting the failure can increase the sum of the consumers' and producers' surpluses;

²¹ The marginal cost of a unit is lower than the average cost of a unit. In monopolistic competition with free entry, the "Cournot" oligopoly price gravitates to average cost in the long run. Cournot was a nineteenth century economist who formulated an influential one-stage game in which competition took place through quantity.

- the issue is whether the FSA can make UK residents/those who are entitled to benefit under the FSMA net better off (intervention may create only winners but, if it would lead to winners and losers, would the gains exceed the losses?);
- plain transfers between, say, UK shareholders and UK consumers are neither “good” nor “bad” for welfare.

The reason for emphasising these points is to be clear about the limits of MFA. Its important role is to help the FSA or other regulator to see when intervention will make society as a whole worse off (on an unweighted basis) and when intervention can make society as a whole better off. None of this of course prevents the FSA from intervening in markets for non-economic reasons (to the extent that this is feasible under FSMA and consistent with any commitments to which the FSA has validly bound itself). Section E above on high-level CBA discusses welfare weights and other issues that may be relevant in that context.

Finally, the two criticisms typically made about regulators using MFA by free-market economists seem not to be valid in the context of the FSA’s use of MFA²²:

- the criticism that all markets have imperfections and that MFA can therefore be used to justify intervening in any market is irrelevant because the FSA’s definition of market failure includes the condition that regulation must be able to improve on the market outcome²³;
- the criticism that the government or regulator cannot know the outcome of the perfectly efficient market²⁴ and cannot therefore sensibly use MFA to pursue it seems irrelevant because the FSA is not trying to create perfect markets (which may never exist) or their outcomes; the FSA is using MFA for the more modest goal of pursuing its statutory objectives in a way that is likely to lead to welfare improvements.

²² There are also the critical views of the “Austrian” economists who emphasise the benefits, especially in terms of innovation, of very large firms enjoying market power.

²³ Thus the FSA seems to be broadly aligned with the positive views about the role of competition set out by the neoclassical economists who contributed to: T Cowen (Editor), *The Theory of Market Failure* (Fairfax, George Mason University Press, 1988).

²⁴ See, for example, T Arthur, P Booth, *Financial Regulation, the State and the Market: is the Financial Services Authority an Unnecessary Evil?* Institute of Economic Affairs (Oxford, Blackwell Publishing, 2006).

Annex 2: rough list of economic markets that may be affected by FSA regulations

Note: in many cases, the economic market may be a more specific product market sitting below the general headings in this list. This distinction may be by product type or even by, say, single premium versus regular premium versions of the same product. It needs to be determined case by case. See Part A of the main text above.

1. Account-based banking

- Deposit-taking services offered to private consumers and some small businesses
- Deposit-taking services offered to larger business customers
- Current account services (including overdrafts) offered to private consumers and some small businesses
- Current account services (e.g. overdrafts) offered to larger business customers

2. Other lending, including secured lending

- Provision of mortgages to private consumers and some small businesses
- Provision of mortgages to impaired credits
- Provision of mortgages to larger businesses
- Provision of loans to private consumers and small businesses
- Provision of loans to larger business customers
- Provision of loans to sovereigns
- Provision of international trade finance services (letters of credit/guarantees, etc)
- Factoring

3. Corporate finance services

- Securitisation and credit enhancement
- Bond issuance services, including underwriting
- Provision of corporate financial advice (mergers and acquisitions, tax driven balance sheet management schemes, structured/asset backed finance, treasury advice, etc)

4. Wholesale markets services (e.g. in bonds/equities/derivatives)

- Market making
- Brokerage

5. **Infrastructure services**

- Provision of trading infrastructure
- Provision of clearing and settlement infrastructure

6. **Investment, fund management and related services**

- Provision of investment and pension advice to retail customers
- Provision of life assurance advice to private consumers
- Provision of pension and other investment products to retail customers
- Management of retail investment and pension funds
- Provision of investment advice to institutional customers
- Fund management services offered to institutional clients
- Provision and management of hedge funds
- Hedge fund advisory services
- Securities brokerage services offered to retail customers
- Securities brokerage services offered to institutional customers
- Provision of retail custody services
- Provision of wholesale custody services

7. **General insurance and related services**

- Provision of general insurance to private consumers and some small businesses
- Provision of general insurance to larger business customers
- Provision of general insurance distribution/brokerage services to private consumers and some small businesses
- Provision of general insurance distribution/brokerage services to larger businesses
- Provision of funeral plans

Annex 3: MFA: model output

Note: this is PURELY illustrative not a statement of policy on bundling and softing.

The main purpose of this template is to help you to use the analytical structure in this guidance to write the MFA section of an RPC paper. The right hand column should provide the material needed to write an acceptable MFA for the RPC.

<i>Question</i>	<i>Response</i>
<p>1. Do I need an MFA?</p> <p>In general the answer is “Yes” unless you are:</p> <ul style="list-style-type: none"> • implementing a maximum harmonisation directive <i>and</i> neither deleting other rules nor retaining overlapping rules; or • implementing another type of directive <i>and</i> neither deleting other rules nor retaining overlapping rules nor proposing super equivalence. 	<p>The proposals for RPC directed toward soft commissions and bundled brokerage arrangements (SC and BBAs) do not fall under either of the two exceptions. Therefore an MFA is required.</p>
<p>2. What is the relevant economic market(s)?</p> <p>Specify the markets relevant to the policy decision. Many markets may be relevant for regulations that affect a firm as a whole.</p> <p>Economic markets are where potential buyers and sellers interact. These markets are often (but <i>not</i> always) defined by product. Where products are not obviously close substitutes, the safer course is to assume that they are in separate markets. An indicative list of broad markets is in EFRD's Guide to MFA/high level CBA. It will sometimes be useful to specify markets more narrowly.</p>	<p>The UK economic markets relevant to the problem are as follows:</p> <ul style="list-style-type: none"> • The market for management of wholesale and retail investment funds; and • The market for brokerage services, including trade execution and all ancillary services.
<p>3. Is the Risk To Objectives that prompted the policy initiative - including rule deletion or super-equivalence/retention of overlapping rules - due to a market or a regulatory failure (see below) in the relevant market(s) now?²⁵</p> <p>First, identify from the relevant FSA objective</p>	<p>Consumer protection is the relevant objective. Therefore we need to look out for information asymmetry or market power.</p> <p>As with all charges, commission costs affect investment returns. But since</p>

²⁵ For rule deletion, use sections 3 and 4 to assess whether there is now no relevant and material market failure or, if the context is implementation of a directive, whether implementation will deal with the market failure that the existing rules addressed and therefore make them redundant. BUT, where the proposed deletion relates to a regulatory failure, see below. For retaining rules that overlap new requirements in a directive, assess whether they address a market failure not covered by the directive minimum/any proposed superequivalence.

<p>the market failure most likely to be found:</p> <ul style="list-style-type: none"> • market confidence or financial crime: negative externalities; • consumer protection: information asymmetries or market power; • consumer awareness: positive externality. <p>Secondly, state whether, <i>in the absence of all financial regulation</i>, the nature of the products, firms and customers suggests that the likely market failure and/or another one is probable in the relevant market(s). Give your reasons:</p> <ul style="list-style-type: none"> • do firms have significant information that customers lack – information asymmetry; • can the failure of firms in the relevant markets materially damage the interests of <i>unrelated</i> parties – negative externality; • can firms get away with charging well above cost for their products – market power. <p>Thirdly, has any probable market failure found above in principle been cured by appropriately targeted regulatory action? Check past CPs.</p> <p>Fourthly, is the RTO partly or wholly due to <i>regulatory failure</i>? Regulation may distort markets (e.g. by creating moral hazard or false focal points of competition). Any such "regulatory failure" should be noted / explained as it is an economic rationale for intervention.</p>	<p>commission is charged directly to customers' funds, transaction by transaction, the total cost to each fund, and the value of the bundled or softed services acquired, are opaque. Opacity is associated with "information asymmetry". In the present case, the opacity is avoidable. It is not a "fact of life".</p> <p>In the absence of financial regulation, most investors and trustees would lack the information to determine in whose interests their agents, the fund managers, are acting. The fund managers themselves have conflicts of interest between directing business to brokers in order to achieve "best execution" for investors, and using brokers who offer additional services that reduce the fund managers' own costs. The results may be over-consumption of these services, over-trading or poor execution decisions (from the investors' perspective). It also appears that the majority of fund trustees and investors lack the bargaining power necessary to obtain the information that would enable them effectively to monitor their fund manager's expenditure on bundled and softed services. They may also be unable to use the available information effectively.</p> <p>The market failure stemming from SC and BBAs has not previously been cured by regulatory action, such as rules on best execution, which has not been specifically targeted on them.</p> <p>The RTO from SC and BBAs does not relate to any form of regulatory failure.</p>
<p>4. What is the evidence that establishes that the market/regulatory failure is material?</p> <p>Here you should note the data or sources that have persuaded you that the market/regulatory failure is present and is material enough to an RTO to warrant FSA intervention. This might include evidence on profits, on pricing behaviour, on consumer detriment, or on the</p>	<p>Commissions paid by fund managers to brokers on trades executed for their funds are a significant cost of fund management. According to Deloitte & Touche, in 2000, UK fund managers paid about £6.55billion in commissions from their customers' funds to UK brokers. As much as 40% of commission may pay for additional services such as investment</p>

ways in which an event may affect third parties, the market, or the financial system as a whole.	research and market information technology, through “bundled” (or “full service”) broking or “soft commission” arrangements, rather than trade execution.
<p>5. <i>Will the market/regulatory failure be corrected in a reasonable timeframe in the absence of further intervention?</i></p> <p>If no additional regulatory action is taken, will the market/regulatory failure and risks to FSA objectives disappear? State your reasons.</p> <p>Existing regulation (if recent), new entry, changing technology or market behaviour may lead to a market failure becoming less important over time without further regulatory action. Use market data to assess how likely this is.</p>	<p>In the absence of any regulatory action, the market failure and risks to FSA objectives discussed above are unlikely to disappear.</p> <p>As long as many fund trustees and investors lack the bargaining and processing power necessary to obtain and utilise the information that would enable them effectively to monitor their fund manager’s expenditure on bundled and softened services, the market failure is likely to persist. Existing regulation, new firm entry and changing technology are unlikely by themselves to alleviate it.</p> <p>Some larger funds are, however, putting pressure on fund managers to offer more transparent contracts. It is not clear <i>to what extent</i> this will alleviate the market failure. It would be risky to rely on smaller and less sophisticated funds benefiting from the actions of those with more sophistication and bargaining power unless plausible mechanisms for this happening can be found in an analysis of competition in the relevant markets. (In many markets suppliers are adept at segmentation that permits them to continue to offer differentiated products to consumers whose requirements are broadly similar.)</p> <p>Thus, overall, there is a case for fresh regulatory intervention.</p>

Annex 4: High-level CBA: model output

Note: this is PURELY illustrative not a statement of policy on bundling and softing.

The main purpose of this template is to help you to use the analytical structure in this guidance to write the CBA section of an RPC paper. The right hand column should provide the material needed to write an acceptable CBA for the RPC.

<i>Question</i>	<i>Response</i>
<p>1. <i>Does your paper propose only the implementation of the minimum standards in an EU directive - in a context in which there are no existing overlapping rules - and therefore lack an MFA?</i></p> <p>If the answer is “yes”, you will have a single option. So references to “options” in the rest of this document should be read as “proposed policy”. Now go to question 3 below.</p> <p>If the answer “no”, go to question 2 below.</p>	<p>No, the proposals for RPC concerning soft commissions and bundled brokerage arrangements (SCs and BBAs) follow from an HMT review and not from implementation of an EU directive.</p>
<p>2. <i>What are the regulatory options for the FSA?</i></p> <p>Describe briefly the different choices the FSA has, including do nothing.</p> <p>It is very rare that there is only one possible solution to a market failure.</p>	<p>The MFA on SCs and BBAs identified the key market failure as asymmetric information between fund managers and clients: SCs and BBAs are opaque pricing arrangements, which pass the costs of non-trade execution goods and services to clients. This exacerbates the misalignment of incentives between fund managers and clients, leading to over-consumption of non-execution services, over-trading, or poor execution of trades, over which clients exert little discipline. Thus, the regulatory options need to tackle the lack of transparency in commission costs (in particular inclusion of costs that lack an economic justification for treatment as a transactions charge) and in the principal-agent relationship between clients and managers.</p> <p><i>Option 1:</i> expand existing disclosure requirements to show, on a fund-by-fund basis, the breakdown of commission payments between the costs of execution and the costs of additional goods and services;</p> <p><i>Option 2:</i> restrict the range of goods and services additional to trade execution that can be softened and bundled; and</p>

	<i>Option 3:</i> require fund managers to value the goods and services (other than trade execution) that are softened and bundled, and rebate an equivalent amount to client funds.
<p>3. What is the appropriate baseline for CBA of FSA options?</p> <p>For an FSA discretionary action, the baseline is normally what the world would be without the rule – what we are trying to assess is the incremental impact of the proposed rule change</p> <p>To the extent that the FSA is considering superequivalence, use the directive minimum (plus any retained overlapping rules) as the baseline for that part of the analysis. For analysing any retained overlapping rules, use the directive minimum plus any proposed superequivalence as the baseline.</p>	<p>Given that this proposal does not deal with a directive and that the counterfactual (the likely future situation regarding the market failure) is unlikely to be much different than the current situation, the appropriate baseline would appear to be the status quo.</p>
<p>4. Whose behaviour would be affected by the options, and in what ways?</p> <p>This is central to comparing options. What would be the direct effects of the proposed changes on the behaviour of different kinds of consumers and firms, and why?</p>	<p>Under all the options, fund managers must reveal more information than they currently do about the costs of the non-trade execution goods and services that they "purchase". If there is an increase in useful information on these costs, this could potentially lead to more effective client discipline of managers. This could make managers more choosy about consuming goods and services and put more competitive pressures on providers.</p>
<p>5. Relative to the baseline in 3, what are each option's material economic costs and benefits? Separately identify any of these that are not relevant to FSA objectives.</p> <p>This involves drawing inferences from the behavioural responses in 4. Think through the changes in the transactions carried out in the market that will likely result from the interaction of all the initial responses identified. For example, if more firms enter or exit because of the proposed change, how would that affect prices</p>	<p>For each of the proposals, the benefits would generally be similar, although see below for specific differences.</p> <p>The economic benefits could include:</p> <ul style="list-style-type: none"> (a) a reduction in potential excess consumption of non-trade services by fund managers, which can lead to reductions in management costs; (b) a reduction in potential excessive trading by fund managers, which can lead to a reduction in costs; and (c) potentially increased competitive pressures, giving rise to reduction in costs, improved quality, increased variety, and loss of business by inefficient firms, all of which should lead to improved fund industry efficiency.

<p>and competition? Focus on major costs and benefits.</p> <p>Address economic benefits by considering: <i>In what ways, and how far, would each option reduce or eliminate the market failures that have been identified in the MFA and that are considered relevant to the FSA's objectives?</i></p> <p>If there are material economic costs and benefits not related to FSA objectives, record them. A recent example is effects on savings behaviour of the simplified advice regime: the FSA has no objective to affect savings levels but there may be a social benefit from such effects and the FSA must choose the "most appropriate" way of pursuing its objectives.</p>	<p>Note that these benefits will not emerge, especially under option 1, unless clients effectively discipline funds over their costs, which will depend on the type of goods and services that are affected and information revealed under the different options. More on this below.</p> <p>The direct economic costs include:</p> <ul style="list-style-type: none"> (d) FSA's and market participants' one-off direct costs in implementing the proposal for all options; and (e) FSA's and market participants' ongoing costs in complying with the proposal (options 1 and 3). <p>In addition, there may be additional economic costs, depending on the specific range of services considered and information revealed under each option:</p> <ul style="list-style-type: none"> (f) increased transactions costs, as well as potential loss of economies of scope and efficient pricing methods (particularly for advice and research services and particularly under option 2); (g) loss of some types of providers; (h) potential distortions from estimates of costs of services for which it is unfeasible to un-bundle some of the activities. (i) increased complexity of information and emergence of focal points that lead to suboptimal choices. (j) potential under-investment in some activities for which there may be positive externalities or for which optimal volumes are difficult to determine in advance (e.g., research). <p>There are no material economic costs and benefits not related to FSA objectives.</p> <p>Overall, option 2 is the most certain to correct the market failure but it brings a greater risk of costs/regulatory failure than options 1 and 3. "Mixed bundling" (an option to consumers to take services bundled or unbundled) typically provides economic benefits and would be prevented to the extent that option 2 is implemented. Option 1 may be cheaper to implement than option 3 but it is wholly reliant on recipients of the disclosures understanding them and doing something with them. Option 3 may be the most satisfactory from an economic perspective because it forces hidden costs into the price of the service, thereby enabling meaningful price competition to take place, and aligns the incentives of fund managers and their customers: the fund managers will have an</p>
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	incentive to economise in their activities (an incentive that noise in fund performance currently blunts or removes) because they will be uncertain about the extent to which they will be able to recover rebated costs in higher prices for their services.
<p>6. <i>Relative to the baseline in 3, what are each option's non-economic costs and benefits?</i></p> <p>First address material non-economic benefits by considering: <i>How, and how far, would each option promote the FSA's objectives in ways not captured in the MFA?</i> Separately identify any material non-economic costs and benefits that are not relevant to FSA objectives.</p>	<p><u>Option 1:</u> <i>Benefits:</i> More reliant on market discipline solution and thus may be more favourably received by industry. <i>Costs:</i> Failure of mechanism wholly to address market failure could undermine FSAs credibility.</p> <p><u>Options 2 and 3:</u> <i>Benefits:</i> If more effective in addressing market failures than option 1, could enhance credibility of FSA. <i>Costs:</i> Greater likelihood of unintended consequences (e.g., reduction in independent research?) could undermine FSA credibility.</p>
<p>7. <i>What is the evidence on which this assessment is based? Are there any significant gaps in the evidence?</i></p> <p>Summarise the sources of data and evidence. Indicate what additional evidence is needed to fully assess the proposed measures.</p>	<p>The review of institutional investment in the UK, prepared by Paul Myners for HM Treasury (2001), identified problems from the use of SC and BBAs. Although limited information existed, competition indicators pointed to the likelihood that anti-competitive effects of these arrangements were likely not significant. However, this did not rule out inefficient market outcomes due to the principal-agent problem of incentive misalignment. Further work was considered to be needed to assess what was being softened and bundled (e.g., if a large percentage of softened and bundled goods and services were not related to trade execution and could therefore be unbundled, it was likely that clients could benefit).</p>
<p>8. <i>Has a plan for further CBA work that is adequate to deal with the costs and benefits above been agreed with EFRD?</i></p>	<p>A consulting firm has been commissioned to undertake a study of SCs and BBAs in the UK market and in other markets where these arrangements occur.</p>

Annex 5: high level CBA: the range of costs and benefits to be covered

1. The high level CBA is not statutory, so we are free to cover in it as many – or as few – costs and benefits as we like. But there are two reasons why we should choose to cover a wide range of costs and benefits.
2. One reason for covering a wide range of costs and benefits is to make the high level CBA as useful as it can be. If we limited it to, say, economic costs and benefits that relate to the FSA's objectives, it might neglect costs and benefits that are important to the decision that the RPC needs to make.
3. The other reason for covering a wide range of costs and benefits is economy of effort and consistency of analysis. The high level CBA can and should form the nucleus of the published, statutory CBA. It should therefore cover the costs and benefits that must be dealt with under FSMA, sections 155, 157, etc.
4. Sections 155 and 157 of the FSMA require the FSA to publish an estimate of the costs and an analysis of the benefits that will arise from changes in rules and general guidance. The terms "costs" and "benefits" are not expressly limited to ones relating to the FSA's objectives or limited in any other way. (The Minister mentioned in Parliament that the requirement was meant to capture economic costs but this may have been to emphasise the difference from the Financial Services Act, 1986, where the requirement was restricted to compliance costs.)²⁶ Section 157 may be altered under regulatory reform legislation now being promulgated.

²⁶ There is other evidence in the FSMA that the FSA is not expected to limit its considerations to costs and benefits that relate to the statutory objectives:

- Section 2 requires the FSA in its decision making to "have regard to" a range of matters that are distinct from its objectives. CBA is a tool that helps the FSA in its decisions. Therefore our CBA cannot be limited to costs and benefits relevant to the objectives.
- Section 2 also requires the FSA, in setting forth its proposals, to explain why they are the "most appropriate" means of pursuing its objectives. How could the FSA be sure that its proposal is "most appropriate" if it neglects to consider, say, the impact of major capital standards on the ability of businesses in particular non-financial sectors of the economy to raise finance? Therefore important economic or non-economic effects of our proposals on markets that are not relevant to our objectives need to be brought into account.

5. So it makes sense for the high level CBA to cover not just economic costs and benefits that relate to the FSA's objectives but also, where they are relevant, the following:
 - other economic costs and benefits;
 - non-economic costs and benefits, whether or not they relate to the FSA's objectives.
6. Naturally, EFRD will not offer formal advice on - or clearance of - non-economic costs and benefits, although we will seek to ensure that they are clearly distinguished from economic costs and benefits. The distinction between economic and non-economic costs and benefits is not always straightforward. A transfer between two groups of equal wealth is certainly a cost to the transferors and a benefit to the transferees and these need to be shown separately in the CBA. But they are probably not "economic" costs and benefits for society as a whole since it is neither better off nor worse off. On the other hand, a transfer from a more wealthy to a less wealthy group involves a net economic benefit, if the transferee group derives a higher marginal utility per £.
7. Again, measures designed to make it more costly to commit financial crimes may yield benefits in terms of the FSA's objectives but will not necessarily yield economic benefits. Similarly, increased consumer awareness is an "objectives" benefit but it may reduce, increase or have no effect on consumer surplus and so may be an economic cost, an economic benefit or neither of these.
8. An obvious question to ask about the costs and benefits listed in paragraph 5 above is: what does "where they are relevant" mean? The answer lies partly in the FSMA, which requires the FSA to prepare a CBA as a discipline on its own policy making and to publish the CBA to improve the quality of its consultation. Thus the CBA needs to include the costs and benefits that external stakeholders might reasonably be supposed to care about and the costs and benefits that ought to influence our decision.
9. The rest and, in practice, the bulk of the answer lies in common sense. The law does not tell us what to do in individual cases. We need to make judgements. In the case of the costs and benefits to be included in CBAs, we need to deploy a strong notion of materiality. If a cost or benefit is unlikely to be material to our decision or to our stakeholders, it is unlikely to be "relevant" and can safely be omitted.
10. It can also safely be said that costs and benefits that are relevant to the FSA's objectives or to the principles of good regulation in section 2 of the FSMA are the ones that are most likely to be relevant. Beyond this, however, it is difficult to generalise.

11. Finally, it is worth spelling out some of the issues that arise in assessing the benefits of retail regulation in particular. Much retail regulation is designed to help consumers buy suitable rather than unsuitable products. When that happens, there is a net benefit to society if the additional consumer surplus resulting from buying a suitable rather than unsuitable product exceeds the costs associated with the (relevant) regulations. Where, as is typically the case, the consumer pays the costs of the regulation, the net benefit (or cost) to society is also the consumer's net benefit (or cost).
12. But this is not the only possible effect of retail regulation. For simplicity, consider the position where retail regulation does not result in a shift in actual purchases. Does the absence of such a shift mean that the regulation imposes net costs on society that will likely be borne by consumers themselves? The answer is "yes" or "no": it depends on the circumstances. Since the answer will be "yes" unless the regulation brings benefits other than changes in the products consumed, it is worth considering what the other specific benefits of the FSA's retail regulation might be. They appear to include:
- Regulation may reduce consumers search or transaction costs, for example by requiring firms to provide information in a standard format.
 - Regulation may increase the value that consumers place on products by reducing the level of uncertainty about the products, for example through product specification as in the case of collective investment schemes. This may be important for risk-averse consumers. It may lead to the further benefit of some consumers entering the market when they would otherwise have been deterred by uncertainty.
 - Regulation may increase the quality of products, for example through the production of "insurance" in the form of the Ombudsman and the compensation scheme.

In any case where the above benefits are present, the crucial question is whether their value is likely to be greater or less than that of the associated costs. It is worth bearing in mind that:

- Reduced uncertainty may reduce the value that consumers place on products or advice because some of the information supplied may make consumers aware of risks or problems of which they were previously unaware.
- Regulation may create moral hazard, leading consumers to place irrationally high values on products.

Further reading

Needless to say, the ideas underlying this guide were not invented in EFRD. There is a considerable literature on market failure and the economics of regulation. Since the guide is intentionally non-technical, it mostly does not refer to the literature in the main text, although some of the books and papers mentioned there are important. Those wishing to learn more may find the following short list of additional reference materials to be useful.

1. On theoretical underpinnings, see: Bator, Francis M, *The Anatomy of Market Failure*, Quarterly Journal of Economics, volume 72, 1958, pp. 351-379.
2. On the basics of welfare economics, the nature of market failure and the potentially valuable role of state intervention, see: Stiglitz, Joseph E, *Economics of the Public Sector*, WW Norton & Company Limited, 2000, pp. 55-155.
3. On information problems, see Akerlof, George, *The Market for Lemons: Quality uncertainty and the Market Mechanism*, Quarterly Journal of Economics, volume 84, 1970, pp. 488-500.
4. On externalities (and other sources of market failure) in finance, see Houben, Aerd, Jan Kakes, and Garry Schinasi, *Towards a Framework for Safeguarding Financial Stability*, IMF Working Paper 04/101, 2004.
5. On market power, see Posner, Richard A, *Natural Monopoly and its Regulation*, The Cato Institute, 1999.
6. On how markets may solve seemingly intractable problems, see Coase, Ronald H, *The Lighthouse in Economics*, Journal of Law and Economics, volume 17, 1974, pp. 357ff. Coase's "The Problem of Social Cost", which appeared in the same journal in 1960, is also very interesting.
7. On government/regulatory failure, see Demsetz, Harold, *Information and Efficiency: Another Viewpoint*, Journal of Law and Economics, volume 12, 1969, pp. 1-21.
8. For the latest on better regulation, impact assessment and the standard cost methodology, visit the websites of the Better Regulation Executive and the National Audit Office.
9. On technical issues in CBA, including some case studies and "The Costs and benefits of analysis" by I.M.D. Little and J.A. Mirrlees, see Layard, Richard and Stephen Glaister (editors), *Cost-benefit Analysis*, Cambridge University Press, 1994.

Glossary

CPs	Consultation Papers – Before the FSA makes any rules or regulations, we must publish our proposed rules and regulations and take account of comments on them. So we publish consultative papers seeking comments on new, or on amendments to existing, rules.
Grandfathered	A grandfathered rule is a rule that was made under, say, the Financial Services Act 1986 but is deemed by dint of a legal instrument to be valid under the Financial Services and Markets Act 2000 (FSMA) even though it was not made under the processes required under the FSMA for the making of valid rules.
Risk Neutrality	Under this assumption, the management of firms is taken to seek to maximise expected profits regardless of the level of risk that this requires them to take on. Consumers are typically assumed to be " risk averse ", meaning that they will prefer to trade off some of their return against a reduction in risk.
RPC	Regulatory Policy Committee – a Committee at the FSA chaired by the Chief Executive. The Committee was formed to drive policy from the top down and to direct the FSA's approach to policy issues from an early stage.
RPC Paper	Regulatory Policy Committee Paper.
RTO	A risk to the FSA's statutory objectives and the basis on which the FSA allocates its resources.

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