

26th November 2004

The FSA's Methodology for Cost-Benefit Analysis

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EXECUTIVE SUMMARY

In 2004 NERA Economic Consulting was asked by the FSA to review the current methodology used by the FSA to undertake cost benefit analysis (CBA) of policy and regulatory reforms. Under the Financial Services and Markets Act (FSMA), the FSA is obliged to undertake CBA of the policy and regulatory reforms implemented by the FSA. CBA is currently carried out by the FSA's policy-makers, with some involvement of the economists in the Economics of Financial Regulation (EFR) team as advisers.

This report presents our analysis and recommendations for:

1. Changes to the FSA's existing methodology for ex ante cost-benefit analysis (CBA).
2. Design of a methodology for ex post CBA of discrete policy areas.
3. Design of a methodology for conducting CBA of the cumulative effects of regulation.

Our other deliverable for this project is some guidance material for ex ante CBA, illustrating the CBA process we envisage for policy-makers who do not have a background in economics.

Ex ante CBA

Our review has found that the FSA's ex ante CBA methodology is basically sound. However, the FSA has experienced some difficulties with the implementation of the methodology in the past. In our review of the ex ante CBA methodology we have sought to (i) point to ways in which the FSA can optimise its use of CBA and (ii) suggest ways of simplifying the methodology to make it more accessible to those without a background in economics.

Discussions with a range of stakeholders in the CBA process revealed a number of issues that have come out of FSA's experience to date with conducting ex ante CBA. These are:

- Policy makers may sometimes regard CBA as a final step in obtaining sign off for a policy proposal.
- CBAs tend to focus primarily on compliance costs, with less attention paid to other market impacts.
- The EFR is not always satisfied with the quality of economic analysis produced by policy-makers, particularly on market impacts.
- Policy makers, who generally are not economists by training, lack the technical expertise or resources to produce analysis that meets the expectations of the EFR.

With these issues in mind, we have made recommendations for changes to the ex ante CBA methodology and reflected these in our Guidance for policy makers. However, it is also important to address the CBA related process, organisational and resource issues. These matters are outside our remit but are nonetheless important and, in recognition of this, the FSA has commissioned separate research by John Howell review these aspects of the implementation of CBA. Our key recommendations for changes to the FSA's ex ante CBA methodology are the following.

Impact analysis

There should be a greater emphasis on analysing the impacts of the policy in depth before attempting to quantify costs and benefits. Quantitative analysis should focus on the major impacts.

Analysing benefits

The FSA should include more high level research into the benefits of financial regulation in its economic and consumer research programmes, with a view to finding quantitative evidence on the benefits of regulation that could be used in individual CBAs. Whilst this is not a requirement of the FSMA, we believe it will contribute to a more disciplined way of appraising the impact of regulation. We fully recognise the inherent uncertainties in quantifying future benefits and, in particular, linking them directly to regulatory changes. It is nevertheless important to emphasise that the process of searching for evidence on benefits will encourage more rigorous assessment of the impact of regulations, even if the results are unclear.

Risk and uncertainty

Risk and uncertainty over policy impacts or cost/benefit estimates should be addressed by (i) explicitly identifying significant risks or areas of uncertainty, (ii) using scenario analysis to test the policy under a range of possible outcomes, and, in certain cases, (iii) committing to ex post review of key risks identified.

Our other recommendations are as follows.

High level CBA

We endorse the Regulatory Policy Committee (RPC's) requirement for early, high level CBA. If properly implemented, this should be effective in terms of influencing the development and choice of policy options, improving the quality of consultation, informing discussion on EU legislation, and identifying the information and skills needed to develop the policy. We recommend that the RPC review the effectiveness of high level CBA against these objectives a year after implementation of changes to the CBA process.

CBA of European Directives

With respect to EU directives, we recommend that the FSA produce high level CBA at an early stage in the development of draft Directives - this analysis should be taken into account in formulating the FSA's negotiating position or in discussions with HM Treasury, as appropriate. We understand that the FSA has in fact started doing this since the beginning of 2004.

On publication of a Directive text, policy makers should use high level CBA to assess options for implementation of the Directive minimum. Thereafter, policy makers should focus resources on CBA of any super-equivalent provisions.

Complex CBAs

In structuring complex CBA exercises, it is important to ensure as far as possible that the baseline (counterfactual) is meaningful to firms and other parties asked to contribute. The FSA may wish to consider analysing the compliance costs of policy packages as a whole, while analysing the market impacts by individual policy component.

Engaging stakeholders in CBA

The FSA should engage the industry and consumer groups in the CBA process from an early stage. Early involvement should involve in-depth dialogue with representative organisations and a small number of firms (a focus group approach). If needed, a survey could be used at a later stage to gather information from a large, representative sample of firms, identified with the assistance of the industry associations.

Estimating compliance costs

One of the more difficult aspects of conducting CBA is in forming an objective view of compliance costs, particularly if firm survey data are used in building cost estimates. Firms are naturally subjective in forming a view of the costs involved in implementing regulations and may use widely differing assumptions in building up their overall cost estimates. We believe the FSA can do more to form an objective view of the costs in reviewing survey data. This may be achieved by developing and maintaining a data-base of standardized parameters and assumptions to be used in estimating certain compliance costs (eg number of firms in each sector, salaries and overheads, discount rate). Such a database may help achieve greater efficiency and uniformity in reviewing and using survey data and in analyzing market impacts.

Ex post CBA

We believe ex post CBA can be most valuable for policies where:

- There was significant uncertainty about the impact of the policy before implementation;
- Similar interventions are proposed in other areas;
- Ongoing costs are high relative to sunk costs.

We recommend that ex post analysis investigate specific policy impacts in depth, rather than necessarily attempting an evaluation of the total net impact. For example, compliance costs should only be addressed in ex post analysis where these are thought to be significant to the overall cost-benefit balance, and where ex post analysis is likely to yield significantly improved estimates over ex ante analysis.

The detailed methodology should be tailored to the specific policy being reviewed, taking account of the questions the exercise seeks to answer, and types of evidence available. Similarly the timing should be determined on a case by case basis. We would expect that, in most cases, ex post CBA would be undertaken within two years or so of policy implementation.

The FSA should state clearly and publicly the criteria it will use to select policies for ex post CBA. The analysis should ideally be conducted by someone who is independent of the policy area in question, drawing on the relevant policy-makers for advice.

Cumulative CBA

The term “cumulative CBA” could be used to describe a number of different exercises. It is important to consider (i) how analysing the cumulative impacts of regulation can add value to the policy process and (ii) how best to structure this type of analysis into a coherent programme.

Our view is that attempting to analyse the combined costs and benefits of regulation in a market will typically be prohibitively difficult because of the complex interactions that take place over time between the FSA's regulation, taxes and other Government interventions, firms' strategies, changes in technology and so on. We believe that there are less difficult but still useful ways in which the FSA can monitor the cumulative impacts of regulation, for example through surveying practitioner and consumer representative opinion.

We believe the best way for the FSA to investigate the *cumulative impacts* of regulation would be to undertake a series of individual research projects. Examples of potentially valuable exercises include analyses of:

- The extent to which the fixed costs of regulation act as a barrier to entry to financial services sectors;
- The relative significance of regulatory change compared with ongoing regulatory costs;
- How regulatory costs and benefits in the UK compare with those in other jurisdictions.

The methodology for such studies would need to be determined on a case by case basis.

If the FSA wants to implement a more systematic programme of cumulative impact analysis, to be rolled out over different markets in turn, we suggest the following:

- The objective should be to draw conclusions about the overall effectiveness of regulation in a market, rather than attempting to derive a figure for the net present value of regulation in that market;
- The analysis should focus on finding evidence of regulatory impacts, and comparing these with regulatory objectives.

If the FSA decides to take this kind of approach, we recommend piloting the exercise on two markets to determine whether this kind of analysis is in fact valuable.

1. INTRODUCTION

This report is submitted by NERA Economic Consulting. It covers the first three of four projects tendered by the Financial Services Authority (FSA) in connection with the Financial Services and Markets Act (FSMA) two year review (the “N2+2” review). The three projects are:

1. Recommendations for any appropriate changes to the FSA’s published methodology for conducting *ex ante* cost-benefit analysis (CBA) of proposed rules and guidance about rules.
2. A methodology for *ex post* CBA and of discrete areas of the FSA’s handbook.
3. Cumulative CBA: a methodology for conducting CBA of the cumulative effects of regulation in the financial services industry.

The fourth project, covering practical implementation of the new methodologies, is being undertaken separately by John Howell.

The requirement to produce CBA should be viewed in the broader context of the move towards evidence-based policy-making across government. In this context, regulators, agencies and government departments are making increasing use of CBA and related tools such as regulatory impact analysis (RIA). The FSA has a strong commitment to, and track record in, conducting CBA.

However, all organisations experience difficulties in applying CBA techniques, both in terms of producing high quality analysis and making good use of it to improve the quality of decisions taken. A great deal of thought has been given to refining and improving approaches to CBA and RIA, both by the regulators, government departments and agencies themselves, and by over-arching bodies such as the Regulatory Impact Unit of the Cabinet Office and the National Audit Office.

The FSA's review of its approach to CBA therefore takes place against a background of extensive work by other organisations in this area. We have sought to draw as far as possible on this body of experience in formulating our analysis and recommendations.

The report is structured as follows:

- In section 2 we briefly discuss the framework within which the FSA conducts CBA, the FSA’s existing methodology, and experience to date with applying that methodology to new rules and guidance. We offer some comments on the scope for improving CBA through changes to the methodology, as opposed to other aspects of the framework for conducting CBA that may need to be revisited.

- In section 3 we discuss some key issues in ex ante CBA and offer recommendations for changes to the existing methodology. These recommendations are designed to address some of the issues identified in section 2 and make the methodology more user-friendly for policy-makers who do not have a background in economics.
- In section 4 we cover ex post CBA. We discuss how ex post evaluation can add value to regulatory policy-making, and make recommendations as to how the FSA should structure its programme of ex post CBA work.
- In section 5 we cover cumulative CBA. Again, we discuss how this type of analysis might be useful in the FSA context, and propose an approach to undertaking cumulative CBA on a systematic basis.
- In Appendix A we summarise the framework for conducting ex ante CBA and the FSA's existing methodology.
- In Appendix B we provide a summary of the relevant literature on CBA, highlighting specific examples of CBA work from other sectors and countries.
- Appendix C contains a bibliography.
- Appendix C contains a brief description of the World Bank's evaluation programme, by way of example.

The accompanying document contains some guidance material designed for users who do not have a background in economics, which the FSA can use in training or guidance documents as it sees fit. This material reflects the recommendations made in section 3.

2. CURRENT METHODOLOGY AND PRACTICE

The FSA is required, under the Financial Services and Markets Act (FSMA), to conduct and publish CBA of proposed rule changes. The FSA has, therefore, been undertaking CBA since its creation and has an established methodology for doing so. The methodology was developed by the FSA and validated externally and has been applied by the FSA in the development of its policy proposals since 2000.¹ Appendix A summarises the context within which the FSA undertakes CBA and summarises the existing methodology. In this section, we briefly review the experience of FSA staff in applying it.

CBA is currently undertaken by FSA policy-makers with some advisory input from economists in the EFR. In our review we interviewed several FSA policy makers to obtain their views on the existing CBA methodology and on the CBA process more generally. We discussed the FSA's experience to date with members of the EFR team. We also met with representatives of the FSA's Consumer Panel and Practitioner Panel.

A number of important themes emerged from these discussions. Some are methodological issues, and we have addressed these in section 3. Others are process or organisational issues, and we have raised these with John Howell who is conducting a separate study for the FSA. This is the fourth project mentioned on page 1.

The major themes from the comments we received are:

- Policy makers do not always use CBA as an integral part of the policy process but sometimes regard it as a final step in obtaining sign off for a policy proposal.
- Policy makers find CBA useful in some cases but in others, particularly where policy is non-discretionary (eg implementing EU directives), they do not believe the exercise to be valuable.
- EFR is not always satisfied with the quality of analysis produced by policy-makers, particularly on market impacts. Policy makers, however, do not feel they have the technical expertise or resources to produce analysis that meets the expectations of EFR.
- Both EFR and policy makers said that CBAs tend to focus too much on compliance costs, with insufficient attention paid to the analysis of market impacts. Similarly, the Consumer Panel told us they are concerned about the fact that published CBAs often present "hard" costs but "soft" benefits. They asked that more effort should be made to estimate benefits to consumers.

¹ The FSA and its predecessor organisations were doing CBA previously but the current version of the methodology dates from June 2000.

- The practitioner panel expressed concern that CBA is used to justify policy decisions that have already been made, rather than to inform those decisions in the first place. This impression may persist even when it is incorrect, since the published consultation paper may set out only the preferred option and its costs and benefits. Explaining how CBA has been used up to that point to reject other options and refine the proposals could enhance the credibility of CBA with the industry. It is crucial that the industry regard CBA as a credible and useful process if firms are to be engaged constructively in providing information for CBA.

We have made recommendations for changes to the methodology with a view to addressing some of the issues identified above. Process, organisational and resource issues, however, are outside the scope of this report. We have passed on our comments on these aspects of the CBA process to John Howell who is examining these issues separately.

3. EX ANTE CBA

The FSA is under a legal obligation to conduct *ex ante* CBA. Clearly, an objective of CBA must be to meet this requirement. Beyond this, however, what should it aim to achieve?

The FSA's existing CBA methodology is presented in Practical Cost-Benefit Analysis for Financial Regulators, Version 1.1. ("the Guide").² The Guide identifies several motives for the conduct of CBA in addition to the need to meet FSMA requirements:

- To help achieve the FSA's aim of delivering cost effective regulation.
- To improve the quality of regulation (increasing the confidence of the industry and the public in the regulatory process).
- To help explain why the proposed rules are compatible with the FSA's other general duties.

The National Audit Office (NAO) has observed that it is the process of doing a regulatory impact assessment (RIA), more than the document itself, which adds value.³ The same should hold true for CBA. The value lies in its contribution to the quality of decision making by the FSA, rather than in the results themselves. By extension, it is the overall quality of the analysis and the use to which it is put by the organisation that matters, rather than the accuracy of the estimates, that matters.

The Regulatory Impact Unit (RIU) of the Cabinet Office suggests that the RIA process should help policy makers to:⁴

- Think through the full impact of a proposal.
- Identify alternative options for achieving the desired outcome.
- Assess both regulatory and non-regulatory options.
- Ensure the consultation exercise is meaningful.
- Inform negotiations in the EU .
- Determine whether benefits justify costs.
- Determine whether particular sectors will be disproportionately affected.

² FSA (2000)

³ Ashcroft (2003) p155

⁴ Cabinet Office (2003) p5

As suggested in section 2, formal analysis of costs and benefits needs to be better integrated with the FSA's policy cycle, including the developing MFA procedures. It should be a core regulatory tool, not a burdensome procedure. In what follows we make some suggestions, from a technical perspective, as to how to achieve this.

Our recommendations for changes to the existing methodology on ex ante CBA are in the following areas:

1. Timing of CBA.
2. CBA of non-discretionary policy.
3. Distributional issues.
4. Defining the baseline.
5. Identifying policy impacts.
6. Engaging the industry in CBA.
7. Making better use of compliance cost information.
8. Dealing with risk and uncertainty.

We discuss each in turn below.

3.1. Timing

A CBA that is carried out when all the important decisions have in practice been made adds little value. On the other hand a CBA carried out at an earlier stage may lack much of the information available later about costs and benefits. In the context of developing regulatory policy, a "final" CBA will only be of substantial value if it is the end product of a succession of analytical studies of the proposal, from its formulation.

The National Audit Office cites starting early as a key determinant of a successful RIA.⁵ Specifically, the NAO has found that starting early increases the potential for the RIA to add value by:

1. Influencing the development and choice of policy options.
2. Improving the quality of consultation.
3. Informing discussion on EU legislation.
4. Identifying the information and skills needed to develop the policy.

⁵ National Audit Office, *Better Regulation: Making Good Use of Regulatory Impact Assessments*, 15 November 2001

Consistent with this, the FSA's CBA Guide recommends integrating CBA into the policy development process from the earliest stages, rather than leaving it as an "add-on" at the end.⁶ It also recommends using "rough and ready" CBA at an early stage to evaluate policy options.⁷

Until recently, CBAs were sometimes carried out relatively late in the decision making process.⁸ The FSA's Regulatory Policy Committee (RPC) requires market failure analysis to be conducted as part of the initial stage of policy formulation but, until the beginning of 2004, it was not a requirement to conduct a high level CBA at the same time. This is an important factor behind the perception of CBA as a last minute box ticking exercise (see section A.3). By the time a CBA exercise was undertaken, most of the major decisions had already been made, with usually only one policy option under consideration.

This reduced the scope for the CBA to add value, since CBA is, in practice, at least as useful for comparing the relative costs and benefits of new policy options as it is for comparing a single proposal with the "do nothing" alternative.

Leaving the CBA late also increases the likelihood that policy makers will be biased in favour of the policy in undertaking CBA. The FSA has recognised that there is a risk of partiality in CBA produced by policy makers and has dealt with this by having EFR provide independent challenge. We believe that having policy-makers start CBA at an earlier stage should reduce the likelihood of serious disagreement between EFR and policy makers further down the line. The FSA shares this view. Since the beginning of 2004, the FSA has started to undertake high-level CBAs at an initial phase of policy formulation, both to inform policy choice as well as to develop a position on EU negotiations on financial policy and regulation. The formation of the Regulatory Policy Committee (RPC) and associated requirement for high level CBA at an early stage should be a significant improvement in this regard. The introduction of high level CBA is consistent with Green Book and Cabinet Office guidelines, both of which recommend an early appraisal before undertaking a full RIA. It is too early, however, to comment on how the new arrangements are working in practice.

We recommend that the RPC review whether its requirement for high-level CBA has been effective a year after implementation of the recommendations in John Howell's report. Effectiveness should be considered against the four criteria listed above.

We endorse the steps taken by the FSA since January 2004 to use early, high level CBA to compare policy options.

⁶ Pg 8, the Guide.

⁷ FSA (2000) p12

⁸ This view is shared by the FSA's practitioner panel - see Financial Services Practitioner Panel, *Annual Report 2003*, March 2004, p7

3.2. Directives and Non-Discretionary Policy

We understand that the FSA is currently reviewing its position on CBA of EU directives. There are a number of considerations.

First, FSMA requires a CBA on all rule changes, including those over which the FSA has no discretion. However, it is clear that there is limited scope for CBA to add value in areas where FSA policy makers genuinely have no discretion.

Second, we understand that existing practice is to take a minimal approach to CBA of Directive minimum requirements and focus resources and effort on super-equivalent provisions. However, we are aware of industry concerns over how the implementation of EU Directive requirements will work alongside existing regulations, particularly if the existing rules combined with Directive rules may result in a duplication of regulation. This suggests that the FSA may need to take a broader view of its discretion, searching more widely for alternative approaches to implementing Directive requirements.

Third, we understand that FSMA does not require a CBA where the FSA's policy is super-equivalent to the Directive but where that policy is already in effect through the existing rules. Nonetheless, CBA could be used in these circumstances to explore whether the existing rules should be modified in the light of the proposed Directive, and to justify their continuance if not. For example, it may be that other aspects of the Directive are designed to achieve the same objective as the super-equivalent rules, in which case it might be appropriate to relax those rules. However, it may be that MFA is a more appropriate tool for assessing the rationale for super-equivalence in the UK context.

Fourth, we understand that there have been suggestions from industry that the FSA should initiate CBA on proposed EU Directives at an early stage, to inform and strengthen the UK's negotiating position and improve the quality of the resulting legislation. This echoes the NAO's view of the role of RIA, outlined above, and is consistent with Cabinet Office guidelines on RIA of European proposals, summarised in Table 3.1.⁹ We recognise that in most cases it is HM Treasury, rather than the FSA, which is responsible for international negotiations but even in these cases there may be scope for the FSA to have input into the early discussions.

The FSA's CBA Guide recommends undertaking CBA at the negotiation stage, in part because a CBA at this stage can provide much of the material needed for the CBA of the FSA's implementing rules.¹⁰ The International Strategy and Policy Co-ordination Department (ISPCD) within the FSA seeks to achieve this by coordinating between policy

⁹ Cabinet Office Regulatory Impact Unit, Better Policy Making: A Guide to Regulatory Impact Assessment, January 2003, preface pages and chapter 5

¹⁰ Pg 8, the Guide.

makers, EFR and those responsible for EU negotiations at HM Treasury, with the view to developing a UK negotiating position on EU Directives.

Table 3.1
Cabinet Office Guidance on RIA of European Commission Proposals

Stage of Proposal	Form of Assessment Required
Under discussion within European Commission	Initial assessment of options, risks, costs, benefits, who will be affected and why non-regulatory action is deemed to be insufficient.
Commission issues formal proposal for new legislation or for amendments to existing legislation	Identification of a clear set of priorities and issues that may cause most difficulty. Development of robust arguments into partial RIA based on informal consultation.
Issue proposal for public consultation	A partial RIA covering all key aspects is required to go out with the consultation document. A covering letter can draw attention to key points.
As a proposal changes during negotiation	Update RIA when the proposal changes significantly, eg at Common Position or following European Parliament amendment.
Adoption of European legislation	Refocus RIA to consider options for implementation.
Issue draft regulations for public consultation	Partial, refocused RIA is required to go out with consultation document. A covering letter can draw attention to key points.
Legislation presented to UK Parliament	Full RIA should accompany all secondary legislation submitted to Ministers for approval. Final RIA is needed with UK primary or secondary legislation when presented to Parliament.

With respect to CBA of EU directives, we recommend the following:

- **The FSA should continue to produce high level CBA at an early stage in the development of draft Directives and this analysis should continue to be taken into account in determining the UK negotiating position.**
- **On publication of a directive text, policy makers should consider a range of options for implementation of the Directive minimum, in consultation with General Counsel. They should use high level CBA to assess policy options.**
- **Following agreement of the Directive minimum, policy makers should focus resources on CBA of super-equivalent provisions (as is currently the practice).**
- **Where existing rules are super-equivalent to a Directive, CBA could be used to assess whether the existing rules should be relaxed in the light of implementation of the rest of the Directive.**

3.3. Distributional Issues

In its basic form, CBA is concerned with analysing, and where possible quantifying and valuing, the net social benefit associated with, in this case, regulation.¹¹ The net social benefit of a regulation is equal to the total benefit (both financial and non-financial) accruing to individuals across the economy, minus the total opportunity cost of implementing the change.¹² In this sense, CBA is neutral with respect to the distribution of benefits and costs and is not concerned with pure transfers between individuals. By contrast, policy is frequently concerned with transfers and distributional issues (eg with respect to income, gender or ethnic origin of individuals, and location or size of firm).¹³

The Green Book considers distributional issues in detail, stating that any distributional effects identified should be stated explicitly and quantified as far as possible. At a minimum, this requires appraisers to identify how costs and benefits accrue to different groups in society. Where necessary and practical, it might involve explicitly recognising distributional effects within a project's net present value (NPV), for example through the use of distributional weights.¹⁴ The RIU's guidance on RIAs specifies that a small firms impact test (SFIT) should be carried out as part of every RIA (possibly with the assistance of the Small Business Service).¹⁵

Distributional issues may be less of a concern for the FSA than for government departments. Nonetheless, given its statutory objectives, the FSA will be interested, at a minimum, in transfers between firms and consumers – FSMA specifically mentions consumer protection as a prime objective and is, therefore, not neutral over income gains to consumers versus

¹¹ We recognise that the FSA is legally obliged to analyse costs and benefits separately, rather than netting off.

¹² The approach whereby costs and benefits are summed across society is known as the Kaldor-Hicks potential compensation test – see Boardman. A (2001)

¹³ Furthermore, with respect to income, there are economic and political grounds for valuing financial costs or benefits to a low-income person more highly than those to a high-income person. First, income has diminishing marginal utility – in other words a low-income person derives greater utility from £1 than a high-income person. Second, a more equal income distribution may be viewed as a benefit in itself. This is a corollary of diminishing marginal utility but is also a view that many people hold for a different reason - that utility depends on relative income as well as absolute income. Third, many people believe in the “one person-one vote” (opov) principle. Where effects are measured according to a variable correlated with income, high-income consumers will have more impact on the results than will low income consumers. The opov principle suggests that this is unfair since influence should be equal between individuals regardless of their income.

¹⁴ This works by assigning an index of superiority to the different groups impacted by the project. The index may reflect a variable such as income. The NPV of the project is then recalculated controlling for the size of each group weighted by the superiority index. The difficulty of such approaches is that weights generally have to be determined on a subjective basis. However, one commonly used weighting approach is the assumption of equal weights for all people, regardless of income, in areas such as health or education, even though those with higher incomes would generally be willing to pay more for a given benefit. This is not problematic as the judgement is widely accepted across the political and social spectrum.

¹⁵ Cabinet Office Regulatory Impact Unit, *Better Policy Making: A Guide to Regulatory Impact Assessment*, January 2003

industry profits.¹⁶ Other distributional aspects that may be of interest include impacts on different types of firm (eg small firms, firms that cater specifically to vulnerable consumers) and consumer (eg differentiated by financial literacy or income).

The FSA's CBA Guide explicitly states that an assessment of the impact of policy options must include "non-economic" factors, such as fairness and equity, as well as economic factors revealed by the CBA.¹⁷ The Guide also recommends that the distribution of costs and benefits be analysed as they may be of broader policy interest.

The Guide also requires a CBA to contain a small business "litmus test" and a consumer impact assessment.¹⁸

We do not think it necessary that every CBA be subject to a requirement to consider distributional impacts or impacts on particular stakeholders (eg small firms). Our view is that the need for distributional analysis should be decided on a case by case basis.

In any case, it is important to establish from the outset whether or not distributional analysis is needed, as this will affect the scoping and resource requirement of the CBA.

We suggest that the views of the RPC be sought on this matter.

Where distributional issues are central to the policy or where there are sensitivities about particular stakeholder groups, we believe it will be adequate to identify the costs and benefits to key stakeholder groups. In particular, we would expect most CBAs to identify the likely gains to consumers and regulated firms. We do not believe that undertaking weighted CBA or otherwise adjusting quantitative estimates to reflect distributional concerns will add significant value to the FSA's CBA process.¹⁹

¹⁶ The standard economic welfare objective is usually defined as the maximisation of consumer and producer surplus. However, that is in the context of competitive markets where producers are not expected to be able to earn super-normal profits in the long run. In regulated network industries, which are not competitive, the relevant criterion is usually defined as the long-run interests of consumers, including future consumers (eg Utilities Act 2000). This requires that the companies operating in the industry be able to expect to earn a reasonable, risk-adjusted rate of return.

¹⁷ FSA (2000) p10

¹⁸ FSA (2000) p18

¹⁹ If the FSA did wish to pursue such an approach for a particular CBA, Annex 5 of the Green Book contains useful guidance

We recommend that, typically, costs and benefits be disaggregated to show how different stakeholders will be affected.

3.4 Defining the Baseline

The baseline is the reference scenario relative to which the costs and benefits of a regulation are measured. Specifying the baseline is fundamental to CBA and has a major impact on how the costs and benefits are viewed.²⁰

The baseline scenario is what would happen if the regulation were not implemented – in other words, it is the same as the “do nothing” policy option. Where the market is not expected to change significantly in any relevant respect over the time period of the analysis, the baseline will be the status quo. Where the market is changing or expected to change, defining the baseline will require an assessment of likely future developments (in the absence of the regulation under consideration).

The most complicated situation is when a regulation has several component policies, or several regulations are due to come into effect at once. Such cases are infrequent but typically very high profile - examples include FSA regulation of mortgage and general insurance intermediaries, and Basel II. In such cases, there is an important decision to be made about the grouping of the component policies for CBA purposes – doing a separate CBA for each component policy may not be feasible.

Policy makers told us they found CBA particularly difficult in such cases, in part because dividing up the work into manageable pieces made it difficult to gauge the overall impact.

The question of policy groupings for CBA comes back to the issue of defining the baseline. To analyse the incremental impact of each component policy separately, the baseline should be strictly defined as the scenario in which all other components of the proposed regulation go ahead. However, this approach may give rise to an unrealistic baseline scenario. To obtain useful information from firms (discussed in section 3.6 below) it is crucial that the baseline be a scenario they can reasonably envisage.

In our experience, firms may have difficulty attributing compliance costs to particular regulations. For example, mortgage and general insurance intermediaries had a reasonable idea of the additional compliance costs they might face under the FSA’s regime (eg an additional compliance officer) but had great difficulty allocating this cost between separate regulations for authorisation and conduct of business, for example. Firms could relate to a baseline of the status quo but not to one of partial implementation of the proposed regime. For this reason it may make sense to analyse en bloc the compliance costs of a proposed

²⁰ We recommend using the term “baseline” rather than “counterfactual” in the guidance. The relevant term in FSMA is “appropriate comparison”.

package of regulatory changes. This is to capture the fact that firms generally respond strategically (for example, providing training or recruiting new staff) to a package of proposed regulatory changes, particularly if the timing of their implementation is relatively close (say, within a year) or if the regulatory changes are closely related. There are serious difficulties with ex ante CBA of individual policies within a larger policy package, or where other regulatory developments are anticipated. In these situations, there may be a case for ex ante cumulative CBA, to assess the total impact of forthcoming regulatory change on a market. We understand that the FSA is currently considering this kind of analysis for the life insurance sector. It may still be possible to analyse the market impacts of component policies separately.

In carving up “jumbo CBA” exercises, consideration should be given to ensuring that the baseline is meaningful to firms.

We recommend that, in certain cases, the FSA consider analysing the compliance costs of a complex policy package as a whole

3.5. Emphasising Policy Impacts

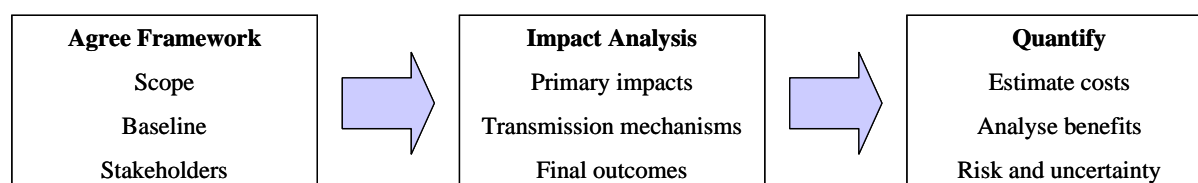
As discussed in section A.3, the steps in the current methodology are:

1. Specify the policy goals, and identify constraints and policy options.
2. Decide upon the scope and depth of the analysis.
3. Assess the costs and benefits of the policy options (and their distribution), using the six “impact areas” (direct costs, compliance costs, quantity of goods sold, quality of goods sold, variety of goods on offer, and impacts on competition).
4. Illustrate the costs and benefits and any other advantages and disadvantages of the policy options identified.

We believe some of the difficulties experienced with CBA in the past (see section 2) will be addressed through analysing the impacts of the policy properly before attempting to quantify costs and benefits. The RPC has, since January 2004, started to do this by requiring high-level CBAs, focusing on market impacts of key regulatory reforms.

Figure 3.1 provides an overview of the step-by-step methodology we propose. We have provided an outline of the proposed guidance corresponding to this methodology.

Figure 3.1
Overview of Proposed Methodology



The methodology is organised into three phases:

1. **Agree framework** – this phase broadly corresponds to steps 1 and 2 in the existing methodology.
2. **Impact analysis** – this phase was previously part of step 3 but we believe it needs to be emphasised and drawn out more clearly. The component parts of this phase are discussed in more detail below.
3. **Quantification** – this phase corresponds to step 3 in the existing methodology, while distinguishing between quantification (which is often feasible to some extent) and valuation (which is less often feasible). It also comprises an extra, final step – identifying risk and uncertainty – which is discussed in section 3.8 below.

3.5.1. Identifying policy impacts

Having agreed the framework, the first step in doing the analysis should be to identify the likely effects of the policy and, in particular, any changes in behaviour on the part of firms, consumers, or other parties.

A great deal of the potential value of CBA lies in the process of thinking through what the impact of the policy is likely to be. The question of how to quantify and value the impacts comes later.

Starting the analysis by asking “what will change if this policy is implemented?” brings several benefits:

- The question leads on to consideration of *incremental* costs and benefits.
- It should encourage policy-makers to think broadly about the impacts of the policy from the outset, rather than focussing primarily on compliance costs. Policy makers should think about how firms will react to the new rules, both in terms of whether/how they would need to change the way they do business to comply, and in terms of how they might react strategically.
- It should help policy makers identify *unintended* consequences of the proposed regulation. (The Practitioner Panel expressed a concern that CBA tended to focus too much on the intended impacts of policy.) Policy makers should try to think openly

about how firms and consumers will react to the rules, rather than focusing exclusively on what the rules are designed to achieve.

We would argue that impact analysis should be the starting point for the CBA whether the exercise is being undertaken at a high level at an early stage, or whether it is a full CBA for publication. We understand that this has been happening to some extent since the beginning of 2004. However, the methods for investigating impacts will depend on the stage of policy development – these are discussed in section 3.6 below.

There are many possible ways to approach impact analysis and we do not recommend mandating a particular methodology. The relevant section of our proposed guidance offers some possible starting points for the analysis but does not prescribe a particular approach.

3.5.2. Analysis of costs and benefits

Having identified the major impacts of the policy, the next step should be to think about the transmission mechanisms through which the policy will operate until final economic outcomes are identified. Our guidance covers possible transmission mechanisms (the relationships between cost, price, profitability and volume) to assist policy makers with this step.

We understand that there is sometimes a lack of common understanding in this area between policy makers and EFR, particularly in terms of what constitutes an "economic" cost or (more often) benefit. This in part reflects the lack of economic expertise amongst policy-makers. Few are trained economists with the skills and experience required to analyse market impacts. Whilst strengthening the training provided to policy makers would help improve their capacity for undertaking CBA, it would be difficult to bring policy makers up to a level where they could match the economic analysis capability of fully trained economists. For this reason, it is important that policy makers work under the guidance of economists in the EFR unit in undertaking CBA .

We recognise that the six impact areas were introduced to help policy makers identify economic outcomes. In practice, however, we believe this approach has significant limitations:

- It encourages policy makers to start CBA from the wrong end. By looking for volume effects or impacts on competition, there is a tendency to skip over the policy transmission mechanisms, whereas an understanding of the transmission mechanisms is crucial to identifying all the costs and benefits.
- There is a tendency to take the impacts that are already known about or anticipated (the ones the FSA is attempting to bring about), fit them into a category, and fail to look for other effects. Starting with first order policy impacts and working through

the transmission mechanisms to final outcomes should improve the chances of picking up on unintended consequences.

- Policy makers find the six impacts areas constraining, which adds to the perception of CBA as a tick-box exercise.

We also recognise, however, that it is not acceptable simply to take a less rigorous approach to defining economic costs and benefits.

Our guidance material offers some pointers for identifying economic costs and benefits.

3.5.3. Prioritising the analysis

A pitfall in cost-benefit analysis is the temptation to sometimes focus on the areas where costs and benefits are most readily valued in monetary terms, rather than on those areas where impacts are likely to be most significant. This may be another factor behind the focus on compliance costs in many CBAs – it is usually difficult to assess the competitive implications of authorisation requirements but more straightforward to estimate postage costs.

We would strongly argue that the quality of CBAs would be improved significantly by a more proportionate treatment of the different impacts identified. The steps we suggest for achieving this are:

- Starting the analysis by identifying the impacts of the proposed policy, rather than starting by looking for costs and benefits that can be valued.
- Prioritising the subsequent analysis, starting with the most important impacts and working downwards (rather than starting as now with direct costs, and so on).
- Facilitating the estimation of compliance costs so that this becomes a relatively minor exercise – this is discussed in section 3.7.

We recommend that policy makers prioritise the impacts before beginning the quantitative analysis. Policy-makers should not spend a great deal of time deliberating about the relative magnitude of each impact at this stage, but they should make a conscious effort to prioritise the work so as to focus on the most important impacts.

3.6. Engaging the Industry

The kinds of information that should be sought for CBA purposes include:

- Information on who will be affected by the regulations, including not only the firms directly affected but any others that compete in the same markets;

- Information on how firms will need to change their business processes to comply with the rules and what this might cost;
- Indications of how firms will react strategically to the rules; and
- Information firms may have about how customers will react (eg estimates of price elasticities).

However, obtaining useful information from the industry is one of the most difficult aspects of CBA. Policy-makers told us they found it difficult to get usable cost information from industry - the quality of responses to CBA questions in consultation papers was, on the whole, very poor.

The NAO also recognises that persuading businesses to comment on the likely impact of something that might or might not happen in the future is a real challenge. They suggest that judicious use of face-to-face and group approaches may add value to paper-based consultation.²¹

At present, the main mechanisms for engaging the industry are:

- *Pre-consultation discussions with trade bodies and other industry representatives.* We understand from the Practitioner Panel that pre-consultation has improved in recent years – they now feel it works reasonably well. However, as discussed in section 3.1, CBA has sometimes in the past been undertaken much later in the process so the FSA has not previously sought industry's assistance in CBA at this stage.
- *Surveys of market participants conducted specially for the CBA exercise.* In our experience, these surveys are typically stretched to meet two conflicting objectives:
 - To include a representative sample of market participants (different segments of the market, different sizes of firm, different business models, etc) - this requires a large sample.
 - To reveal the underlying cost drivers, not just total cost estimates (in part to account for upward bias in firms' cost estimates - see discussion in section 4.3). This requires in-depth, face-to-face interviews with market participants.

It is not normally possible to meet both objectives in a single survey with the time and resources typically available for a CBA exercise. The less homogenous the market, the more difficult it is to meet either objective.

²¹ National Audit Office, *Better Regulation: Making Good Use of Regulatory Impact Assessments*, 15 November 2001, section 2.10 onwards

- *CBA questions in consultation papers.* We understand from policy makers that the quality of responses to these questions is typically very poor, with only a small minority of firms providing quantitative information. Even where firms provide cost estimates, these are difficult to interpret or compare.

The advice of the Practitioner Panel was to engage the industry early and in depth, which chimes with the experience outlined above. If firms are not engaged early, they will not believe that their participation will make a difference to the policy outcome and will not be willing to spend the significant resources needed to understand the policy proposals and their implications, gather cost information, etc. (See also the discussion on the wider issue of the credibility of the FSA's CBA process in section 2.) On the other hand it is important to recognise the vested interests of industry in maintaining the status quo. This may result in firms over-emphasising costs in the hope that they will discourage the FSA from implementing reforms. This is particularly risky at an early stage when policies have yet to be fully developed and, hence, the potential consequences less well understood, resulting in a lower overall quality of CBA.

We recommend that the FSA engage the industry in the CBA process from the initial, high-level CBA onwards. Early involvement should involve in-depth dialogue with industry associations and a small number of firms (a focus group approach). The objectives at this stage should be to:

- **Gather qualitative information on how firms and consumers might react, including what firms will need to do to comply, and**
- **Identify data needs for the full CBA.**

Later on, a simple survey could be used to gather quantitative information in comparable form from a large, representative sample of firms.

The FSA should undertake the task of identifying firms and individuals within firms to participate in these exercises jointly with the industry associations. The industry associations would be responsible for:

- **Advising on representative samples; and**
- **Spreading requests for participation in these exercises across their member firms.**

We recognise, however, that the advantages of engaging the industry early must be balanced against the risk that firms gain a disproportionate influence in policy development (regulatory capture). It is, therefore, important also to consult consumer representatives at an early stage in the process.

3.7. Compliance Cost Information

The policy makers we spoke to said that there is a lot of duplication of effort in estimating compliance costs for different CBA exercises and suggested it might be helpful to establish a central database containing cost and other information that would be applicable to multiple CBAs. This seems a sensible suggestion, particularly given the desire to reduce the emphasis on analysing compliance costs relative to other aspects of the CBA (see section 2). It may also improve consistency across CBAs and help detect bias in firms' survey or consultation responses.

While we understand that there is a limited amount of information that is applicable across different CBAs, we believe nonetheless that there are certain types of information or standard estimates that it would be worthwhile maintaining centrally.

We recommend that standard estimates of the following be derived and updated centrally:

- **Number of firms, advisers, etc operating in different markets**
- **Number of customers and transactions in different markets**
- **Salaries for key positions**
- **Overheads as a percentage of salaries**
- **Administration costs (postage, printing etc)**
- **Discount rates²²**

3.8. Estimating Benefits

We also believe there is scope to centralise work on estimating benefits. Attempting to value the benefits of financial regulation is difficult and requires greater research resources than would typically be available for the CBA of an individual policy proposal.

However, we believe that there is scope to undertake quantitative analysis of the benefits of financial regulation at a more general level, on the grounds that such research might be relevant to several future individual CBA exercises (as well as potentially being valuable in its own right). It might be possible in this way to develop some rules of thumb or "ready reckoner" approaches that could be used in future CBAs to estimate benefits, or at least to

²² We suggest using the discount rates published in the Green Book (the social time preference rate for consumption) rather than separate estimates of the cost of capital for regulated firms. The Green Book rates have the advantages of being (i) common to all and (ii) easy to establish (unlike regulated company WACCs).

identify upper or lower bounds for their value. This could help address the problem that published CBAs tend to present “hard” costs and “soft” benefits.

For example, it might be possible to conduct willingness-to-pay research on the regulation of different general insurance products. We understand that SIB conducted this kind of research into the benefits of regulating custody.²³

It would be possible to conduct this kind of research under the aegis of the FSA's existing economic and consumer research programmes. Gathering market information from a general research programme would help the FSA in critically evaluating the information it receives from firms in a CBA exercise, and may be particularly valuable in analysing market impacts.

The FSA should consider including research into the benefits of financial regulation in its research programmes.

3.9. Risk and Uncertainty

Since CBA is undertaken without perfect foresight, it is important to consider how to deal with risk and uncertainty.

As discussed in the following chapter, the test of a good *ex ante* CBA is not only whether it comes up with an accurate estimate of *ex post* costs but more importantly whether it provides useful input into the development of a successful policy. In undertaking CBA, it is important not to focus solely on obtaining a point estimate, but to place sufficient emphasis on understanding key risks and sources of uncertainty, to ensure that the policy is robust under a range of possible outcomes and that key sensitivities are identified. This aspect of CBA is increasingly emphasised for good practice as reflected in the space devoted to it in the most recent (2003) Green Book.

Analysing sources of uncertainty may also help to identify gaps in information or understanding, and to assess the potential value of new information.²⁴ This may be particularly useful at early stages in the development of a policy, for example in producing a plan for investigating costs and benefits in more detail, as required by the RPC (see section A.2).

Furthermore, where significant uncertainty exists, it is important to acknowledge and understand competing points of view. Openly recognising uncertainty and conflicting

²³ FSA (2000), p36

²⁴ Hahn and Dudley (2004) p2

views about likely outcomes has the potential to build rather than erode public confidence in the decision-making process.²⁵

It is also important to consider the impact of differing levels or patterns of compliance. Although the basic assessment should assume 100% compliance, it may also be useful to explore alternative scenarios, where compliance is a key risk.²⁶

Where significant uncertainty exists, scenario analysis should be used to test the policy under a range of possible outcomes.

In publishing the CBA, the FSA should identify any significant areas of uncertainty or risks to the success of the policy, including some illustration of the range and likelihoods reported.

In certain cases, the FSA should commit to, or identify triggers for, subsequent, ex post review of key risks identified, where this would be feasible and potentially valuable for ongoing policy development.

Where it seems likely that ex post review may be needed, any information required for such a review on the pre-implementation state of the market should be collected at this stage.

Ex post review is discussed further in the following section.

²⁵ Bailey et al (2002)

²⁶ NAO (2004) para 10

4. EX POST CBA

Ex post CBA is carried out much less often than ex ante CBA.²⁷ This is partly because of limited resources but also because of difficulties in untangling the impacts of regulation from other noise in the market. The more time that lapses between the introduction and ex-post evaluation of regulation, the more difficult it is to isolate the impacts of the regulation from other market events. Nonetheless, interest in ex post evaluation is increasing among governments and regulators, although much of the effort to date has been on evaluating regulatory tools and institutions rather than assessing the outcome of specific policies.²⁸

The World Bank is probably the best example of an organisation that has a significant track record of undertaking extensive ex post evaluation on a regular basis. We provide an overview of the World Bank's approach to evaluation in Appendix C.

In our view, there is no single methodology for ex post CBA that could sensibly be applied in all situations where an ex post review of a particular policy is called for. As discussed below, our view is that ex post CBA should be a much less generic exercise than ex ante CBA, with many of the key methodological decisions being taken on a case by case basis. This is consistent with the World Bank's approach.

There are two particular reasons why the methodology for an ex post CBA exercise needs to be tailored to the specific policy being reviewed:

- Policies should be chosen for ex post CBA where there is the potential for this to be a valuable learning exercise. With this in view, the most important questions for ex post CBA to address will vary from one policy area to another.
- Ex post CBA should be evidence-based. Ex ante CBA necessarily requires assumptions - the value in ex post CBA lies in using evidence to replace those assumptions. The starting point for designing a methodology for ex post CBA should, therefore, be the available evidence. The type of evidence that is available, and thus the type of analysis that is feasible, will vary significantly from one policy area to the next.

For these reasons we have not proposed a single methodology or produced guidance for ex post CBA, as we have for ex ante CBA. In any case, we understand that ex post CBA will be undertaken primarily by specialist economists who are not in need of a "layman's guide". Furthermore, the basic concepts applicable to ex post CBA are the same as those used for ex ante CBA (baseline, distributional issues, etc).

²⁷ Ashcroft (2003) p161, Bailey et al (2002) p255

²⁸ OECD (2003) p3

Instead, we discuss the objectives of ex post CBA of specific policies and the circumstances in which this kind of exercise is most likely to add value. We then go on to discuss the main difficulties with ex post CBA and suggest some possible approaches.

4.1. Adding Value

As discussed in the previous chapter, the value of ex ante CBA lies in its contribution to the decision making process. An ex ante CBA can be very valuable without necessarily providing a good prediction of ex post costs.²⁹

By the same token, the value of ex post CBA does not lie in testing the accuracy of ex ante estimates. Instead, the value lies in the lessons that can be learned and applied to policy making in the future. This is consistent with the FSA's view that the value in ex post reviews of its own activities is in learning lessons rather than judging effectiveness.³⁰ Similarly, the Green Book states that ex post CBA is designed to ensure that lessons "are widely learned, communicated and applied when assessing new proposals".³¹

However, ex post CBA is a resource-intensive way of learning from experience. In many cases, the success of a policy can be evaluated and lessons for the future identified without undertaking a full, formal CBA. There are many other kinds of *ex post* review that may be more appropriate than CBA, for example systematic monitoring of regulatory effectiveness and/or investigations into unintended regulatory effects.³²

There is most scope for ex post CBA to add value when:

- There was significant uncertainty about the impact of a policy before implementation, and ex post analysis may provide guidance on policy refinement. As discussed in the previous chapter, there is often significant uncertainty in ex ante CBA, typically because it is not clear how firms and/or consumers will react to a rule change. Where the uncertainty is particularly critical to the cost/benefit balance of the policy, and where not all the costs of the rule change are sunk (see below), there is clearly a case for reviewing the outcome ex post, with a view to refining the policy if need be. Examples where this approach might be useful include the menu approach (CP04/3) and unbundling and soft commissions (CP176).³³

²⁹ See also Harrington (2000)

³⁰ Financial Services Authority (2002)

³¹ HM Treasury (2003)

³² OECD (2003) p14

³³ An analogous example from another sector is *ex post* analysis of the costs and benefits of 100% opening of the electricity market in the UK, which looked at customer switching rates and other indicators to assess how competition was developing among electricity retailers. See NAO (2001c) and MacKerron (2001).

- Similar interventions are proposed in other areas, and ex post analysis may provide a useful learning experience. Ex post analysis should provide information not only about the particular intervention but also about the “class” of such interventions.³⁴ Where regulation is to be extended to a new market (eg home reversion schemes) it may be useful to investigate how similar interventions have affected markets that are already regulated (eg equity release mortgages).

In both cases, it may be appropriate to do a partial CBA, investigating one aspect of the policy or one type of impact, rather than attempting a total evaluation. For example, where the key question is “how have consumers reacted to the regulatory change?”, the study should focus on analysing evidence of consumer behaviour. In this case, if ex ante CBA suggested that compliance costs are a relatively minor issue, there would be little value in making new compliance cost estimates. If, on the other hand, the ex ante CBA suggested potentially significant compliance costs, the ex post review should cover these. The important point is that the focus of ex-post analysis should be on the key impact areas of a policy change rather than attempting to put a monetary value on (or revise ex-ante estimates of) the net impact of policy changes.

The specific objectives of the study and the learning points sought should determine the scope of the exercise. This is consistent with the World Bank approach (described in Appendix C).

In considering which policies should be subject to ex post CBA, it is important to distinguish sunk costs from ongoing costs. Sunk costs are irreversible costs that firms have incurred as a result of the regulation. Examples might include the purchase of additional risk monitoring software, time spent developing new procedures, etc.

Where a project has high ongoing costs relative to sunk costs, ex post CBA may have value as a direct input to ongoing policy review, as well as being a more general learning process. Compared with construction projects and other fixed investments where the majority of costs are sunk on completion of the project, financial regulation has relatively low sunk costs. This suggests that the scope for ex post CBA to add value in financial regulation may well be higher than in many other areas of public policy, even those which make extensive use of ex ante CBA.

We recommend that ex post CBA be undertaken where:

- **There was significant uncertainty about the impact of a policy before implementation**
- **Similar interventions are proposed in other areas**

³⁴ See Boardman (2001)

- **Ongoing costs are high relative to sunk costs**

We recommend that ex post CBA focus on investigating specific policy impacts rather than necessarily attempting an evaluation of the total net impact (ie attempting to reproduce an ex ante CBA on an ex post basis).

4.2. Credibility

Ex post CBA may also contribute to accountability. However, if ex post CBA is discretionary rather than standard or compulsory (like ex ante CBA), it will have limited credibility – the FSA should not risk appearing to undertake ex post CBA only on those policies for which it expects favourable results.

For the reasons discussed above, and in view of the possible resource implications, we do not believe the FSA should commit to a comprehensive programme of ex post reviews – rather, ex post CBA should be carefully targeted. The FSA should establish the credibility of its ex post CBA programme by stating publicly its objectives for ex post CBA and the criteria used to select policies for analysis. There should also be clear guidelines for the selection of policy areas for ex post CBA, for example this could be a decision for the RPC.

The credibility of the findings of an ex-post CBA will be enhanced if there are clear guidelines for selecting the policy for analysis and the team that carries out the CBA. There is a risk that, even with clear guidelines, an ex post CBA carried out by staff who were involved in developing and implementing the policy will be seen to lack independence. An ex post CBA will have greater credibility if it is undertaken by an independent party– i.e. not by the people responsible for developing and implementing the policy.³⁵ In institutions like the World Bank, where ex post evaluations are regularly carried out as a matter of policy, they are never done by the staff who developed and implemented the policy, or by the staff who did the initial ex ante appraisal. We recognise, however, that the FSA does not have the resources of the World Bank and that it may not be feasible for all ex post CBAs to be carried out by an independent party. For this reason we recommend that, in addition to selection criteria, the RPC provide guidance on ensuring the independence of ex-post CBAs through, for example, independent oversight or internal review.

Notwithstanding concerns about independence, it is important that those responsible for the policy in the first place have some involvement in, or are consulted during, the ex post CBA process, (i) because they will have valuable information about why certain decisions were taken, and (ii) because they should have a right to comment on any review of their work before it is circulated or published.

³⁵ Ashcroft (2003) p162

In our view this balance is best addressed by having the ex post review undertaken by an independent party, but with extensive consultation with those responsible for designing the policy.

We recommend that the FSA state clearly and publicly the criteria it will use to select policies for analysis and the team that will carry out the analysis

We recommend that ex post CBA be conducted by staff who are independent of the policy area in question, with the involvement of policy staff.

For particularly controversial or otherwise high profile policies, we recommend that ex post CBA be undertaken by a party external to the FSA.

4.3. Comparing Ex Ante and Ex Post Results

Although we do not believe that the primary purpose of ex post CBA is to test ex ante estimates, we recognise that the results of ex post and ex ante CBA will inevitably be compared (if, as we assume, the results of ex post CBA are published). Such comparisons may have some value in helping to improve future ex ante analysis. It is therefore important to understand why differences between ex ante estimates and ex post figures might arise.

Research on comparing ex ante and ex post assessments of the costs of complying with environmental regulation has found that the predicted costs of compliance often exceed actual costs.³⁶ Although this research focussed on environmental regulation, there would appear to be useful analogies with financial regulation. Further research suggested that the main reasons for differences between ex ante and ex post assessments were:³⁷

- Affected firms have an incentive to inflate their estimates of the costs of compliance in the policy formulation stage. The regulator has incomplete information which makes it difficult to correct for this.
- Firms will work hard to lower the costs of compliance once the regulations have come into effect.
- Firms may develop technological solutions to regulatory compliance costs which, ex ante, were impossible to predict.

³⁶ Haq et al (2001)

³⁷ Bailey et al (2002)

This last factor may be more obviously relevant for environmental regulation, but in our view it can also be significant in financial regulation. The emergence of the technology-driven IFA network as a business model is an important example of a technological response to financial regulation.

We do not recommend that ex post CBA be designed specifically for comparison with ex ante estimates. Nonetheless, we recommend that the FSA use its experience of ex post CBA to identify lessons for correcting bias in ex ante CBA.

4.4. Timing

There are two primary considerations with respect to the timing of ex post CBA. The first is the length of time it takes for the effects of a new regulation to manifest themselves. The full effects of a new regulation may not be observable for some time because changes in consumer and firm behaviour are often lagged with respect to regulatory changes. It is therefore important to consider how long it will take for the effects of new regulation to feed through fully into firm and consumer behaviour (ie to reach the new equilibrium).

However, it may not be necessary or even desirable to delay ex post CBA until the effects have fed through in full. Where the policy is on a “watch-list”, it may be appropriate to investigate whether it has started to work as it should relatively soon after implementation.

The second consideration is how long a time period is needed to provide sufficient data to support quantitative analysis. Observing costs over a long period will make it easier to distinguish the effects of regulation from the effect of changes in other variables, eg by using panel data.

However, there are also disadvantages to leaving ex post CBA until a long time after policy implementation. First, this increases the difficulty of determining a counterfactual, not least because the market to be investigated is likely to have faced many other external influences (see discussion in section 4.5 below). Second, and more importantly, the value to be gained from the ex post CBA exercise will tend in many cases to diminish over the time as the lessons that can be learned decline in relevance.

On balance, we recommend ex post CBA normally be undertaken fairly soon after policy implementation (within two years or so). However, the precise timing should be determined on a case by case basis.

4.5. Counterfactual

For ex post CBA, the term “counterfactual” is accurate – the scenario in question is what would have happened if the regulation had not been implemented. Identifying a counterfactual after the fact is, however, notoriously difficult.

It can be difficult to disentangle the effects of more than one regulation in the same field. (This is also an issue for ex ante CBA, as discussed in section 3.4, and one of the main motivations for cumulative CBA, as discussed in the following chapter.) Also, it is not clear how far the counterfactual should include other changes that have occurred in the markets concerned: in theory, the counterfactual should exclude any changes that occurred as a result of the regulation, but causality is very hard to establish.

Options for specifying the counterfactual might include:

- *The state of the market before the regulation came into effect.* This has the merit of being conceptually simple and thus easy for firms and other parties involved in the study to relate to. (See the discussion in section 3.4.) Where the need for ex post CBA is envisaged at the time of policy implementation (eg because of uncertainty about how market participants will react), information should be collected at this time for use in specifying the counterfactual when the ex post CBA exercise is undertaken.
- *Independent assessments of how the market might otherwise have developed* (for example brokers' notes or other published forecasts). Where the counterfactual is unknowable, there is scope to dispute the results of a CBA on the grounds that a particular counterfactual was chosen to support a particular point of view. To minimise the scope for dispute, it is helpful to use a counterfactual scenario that is in some way objectively defined. For example, Newbery and Pollitt's ex post study of the costs and benefits of electricity privatisation defined the counterfactual according to a document outlining the proposed industry strategy in place before the privatisation proposals.³⁸

The appropriate counterfactual should be determined case by case.

4.6. Sources of Information

As discussed above, the starting point for ex post CBA should be the available evidence. However, the type of evidence available will vary case by case. In this section we make some suggestions about potential sources of information.

4.6.1. Compliance

Whereas ex ante CBA assumes full compliance with proposed regulations, ex post CBA might, in some cases, seek to assess the actual extent of compliance, where this has an important bearing on the costs and benefits of the policy, including their distribution across different groups.

³⁸ Newbery & Pollitt (1997)

Assessing the extent of compliance may be particularly important when conducting ex post CBA on voluntary standards, codes of practice or guidance but should still be considered in cases where compliance with specific rules is mandatory.

4.6.2. Compliance costs

In theory, in ex post CBA it should be possible directly to observe costs instead of estimating them. However, firms have fairly aggregate records of cost information (and consumers have even less detail). For example, a firm may be able to estimate the total cost of its compliance department last year but may be unable to say how much of that cost was associated with FSA regulation (as opposed to voluntary codes of practice, internally imposed risk limits, etc) let alone how much was associated with a particular policy (eg authorisation).

For this reason, many of the issues discussed in section 3.6 for ex ante CBA are also relevant to ex post CBA. However, ex post CBA ought to be easier than ex ante because there is more observable information about market impacts and firms' behaviour. Nonetheless a survey-based CBA will still need to take account of the vested interest that firms have in maintaining the status quo. As with ex-ante CBA, those undertaking ex-post CBA will need to critically review the responses received from firms.

Instead of surveying firms, an alternative (and more objective) approach would be to use share price information to look for evidence of the impact of regulation (or other events) on listed firms. We understand that the FSA is already using ex-post event studies to investigate the impact of rule changes on market behaviour, as demonstrated by share price movements. Such event studies also require qualitative information, obtained through surveys, to illuminate findings from data analysis.

Whilst ex-post CBA has a role in providing policy makers with more information, it may not always be worthwhile revisiting compliance cost estimates. If (i) ex ante estimates of compliance costs were small and (ii) there is no *prime facie* reason to think that compliance costs have been significantly higher than predicted, there is little value in re-surveying firms to establish new compliance cost estimates.

4.6.3. Benefits and other costs

There are several types of information that may be useful for estimating benefits and other costs on an ex post basis.

Perhaps the most important kind of information that becomes available ex post is sales information. Both price and volume information is readily available for traded markets. For other markets, information may be available from industry associations, or from firms on request. This information can be used to value changes in the volume of products sold.

Consumer research is potentially significantly more valuable for ex post than for ex ante CBA, since one can obtain more reliable responses to questions about what consumers actually did, than about what they might do in a hypothetical situation. However, consumers must also be able to identify the specific impact of the identified change and separate it from other changes in policy and the economic environment. This is not always straightforward in practice.

Even with better scope for using consumer research, it may not be possible to value intangible benefits (eg increased variety of products) in monetary terms. However, other quantitative indicators (eg average number of quotes obtained) may be observable.

Other benefits will be no more observable ex post than they were ex ante. For example, a reduction in the risk of bank failure is not observable except over a period of several years (including a full economic cycle) because bank failures have a lumpy distribution which means that changes in that distribution can only be observed over long periods of time.

It may be possible to use proxies for some benefits. For example, changes in the amount of capital that banks hold or changes in VaR exposures could be taken as indicators of changes in the risk of bank failure. However, such measures are not particularly informative if they are directly mandated by the regulations – in this case they tell you only about the level of compliance (discussed above).

5. CUMULATIVE CBA

Both ex ante and ex post CBA deal with the incremental impacts of individual rules. However, regulators are coming under increasing pressure to assess the cumulative impacts of regulation on firms and markets.³⁹

The term “cumulative CBA” could be used to describe a number of different types of analysis. As with ex post CBA, it is important to consider (i) how analysing the cumulative impacts of regulation can add value; and (ii) how best to structure this type of analysis into a coherent programme.

5.1. Estimating Total Costs and Benefits

The FSA has already commissioned a study to assess cumulative compliance costs.⁴⁰ The study investigated four particular aspects of compliance costs:

- The range within which firms believe their regulatory compliance costs lie;
- How those costs had changed since N2, and what had caused those changes;
- The relationship between compliance costs and the quality of compliance; and
- Lessons on how regulated firms could reduce compliance costs.

With respect to the findings on total compliance costs, the Practitioner Panel commented that they found the results difficult to interpret and had not found the study particularly helpful in understanding the burden of regulation on firms. This was because of the difficulty in defining the market scenario that would pertain in the absence of any regulation whatsoever.

Most markets have been subject to some form of regulation for many years, which means that defining what the market would look like (how many firms there would be, how firms would operate, what costs would be, how consumers would behave, etc) in the absence of regulation is a highly speculative exercise.

We discuss the importance of using a meaningful baseline in the context of ex ante CBA in section 3.4. and we reiterate the point here. Constructing a counterfactual is problematic because firms and policy makers find it difficult to envisage a hypothetical situation of what the market might look like (and how they might behave) in the absence of regulation. Using an abstract counterfactual (for example a market completely devoid of regulation) makes the

³⁹ See for example OECD (2002) p48, FSA Practitioner Panel (2004) p6

⁴⁰ Europe Economics (2003)

results of the CBA exercise difficult to interpret (the cost of regulation is £Xmn greater than what?) and, if the counterfactual can easily be disputed, so can the results.

Largely for these reasons, our view is that cost-benefit analysis is *not* necessarily the most effective way for the FSA to monitor the overall burden of regulation or to assess whether its regulation is proportionate.⁴¹ We believe there are other approaches to monitoring the overall burden of regulation, for example an annual survey of opinion among practitioners and consumer representatives about the cost-benefit balance. This approach would provide a direct indicator of proportionality without necessitating an explicit valuation of costs and benefits. However, as with a CBA exercise, firms' responses to a survey need to be treated with caution given their predisposition to maintain the status quo.

Instead of proposing a methodology for "total" CBA, we suggest the FSA consider:

- A series of individual research projects into aspects of regulatory impact that are not picked up by either ex ante or ex post CBA exercises.
- A series of market studies to assess how well the overall body of regulation addresses the market failures identified in a particular market, or meets other regulatory objectives.

We have provided some further thoughts on these options in the following sections.

5.2. Standalone Research Projects

Possible research topics that fall under the broad heading of cumulative regulatory impacts include:

- *The structure of firms' compliance costs.* The Green Book suggests CBA should distinguish between fixed costs, variable costs, semi-variable costs and semi-fixed or step costs.⁴² It warns, however, that this can be a complex task as costs may vary differently with different factors.

At present, the FSA only distinguishes one-off and ongoing costs, and we believe this is the appropriate approach for ex ante CBA. However, there may be a case for additional research to explore firms' cost structures in more detail. This could shed light on the differences in regulatory compliance costs between large and small firms, and the extent to which the fixed costs of regulation act as a barrier to entry in financial services markets.

⁴¹ Financial Services and Markets Act, section 2(3c)

⁴² HM Treasury (2003) 5.16

- *The significance of regulatory change compared with ongoing regulatory costs.* This is a topical issue, given the large volume of EU legislation and other regulatory change that the industry has had to absorb in recent years.
- *How regulatory costs and benefits in the UK compare with those in other jurisdictions.* This may be of interest in terms of international competitiveness and also because studying overseas markets may shed some light on the reasons why particular problems are experienced with markets in the UK.
- *The likely net impact of a series of forthcoming regulatory changes.* As discussed in section 3.4, there are serious difficulties with ex ante CBA of individual policies within a larger policy package, or where other regulatory developments are anticipated. In these situations, there may be a case for evaluating a package of policy reforms, particularly if they are being implemented simultaneously, to assess the total impact of forthcoming regulatory change on a market.

These topics might be suitable subjects for one-off pieces of research, as was the compliance cost study mentioned above. It is not obvious, however, that any one of them could or should form the basis for a systematic programme of analysis.

Policy areas and senior management could submit bids for cumulative CBA subjects, and a certain number of projects could be approved each year by a research committee or similar (perhaps the RPC), along the lines of the existing economic research programme.

It is not possible to define a common methodology for such projects – the methodology will need to be determined on a case by case basis.

5.3. Market Studies on Regulatory Effectiveness

If the FSA wishes to implement a systematic programme of cumulative impact analysis, that could be rolled out across different markets in turn, we would suggest designing a programme to assess overall regulatory effectiveness in particular markets, rather than total costs and benefits as such. In what follows, we suggest a broad approach for such a programme.

While we have attempted to come up with a meaningful and coherent programme, we emphasise (as with ex post CBA) the importance of tailoring the detail of the methodology to individual cases and, in particular, to the available evidence.

If the FSA wishes to pursue this kind of programme, we recommend piloting the exercise on two markets to determine whether this kind of analysis is valuable.

5.3.1. Structuring the analysis

The objective of the analysis would be to make an overall assessment of the main impacts of regulation in a market, and compare those impacts with the relevant market failures or regulatory objectives for that market. This should enable an overall assessment to be made of the effectiveness of the regulatory framework in achieving its objectives.

One example of this kind of approach was the NAO's review of the effectiveness of the Occupational Pensions Regulatory Authority (Opra).⁴³ The NAO decided for a number of reasons that looking for the counterfactual in this instance was not the best approach. Instead, it looked at the alignment between risks to pension scheme members and Opra's activities. The NAO had previously used a similar approach in assessing the work of Postcomm, the postal services regulator.

We suggest structuring the analysis as follows:

- Define the market for the purposes of the study, as discussed above.
- Identify any market failures and the statutory objectives relevant to that market. From these, produce a list of key regulatory objectives in that market.
- Identify the major impacts of regulation in that market, quantifying wherever possible. As with ex ante and ex post CBA, we regard identifying the impact of regulation as the most important step, and we discuss how to proceed with this step in section 5.3.2 below.
- Compare the impacts with the regulatory objectives. This should provide an overall assessment of how well the regulatory interventions have met the regulatory objectives in practice. Specifically:
 - Attempt an evidence-based assessment of which types of regulatory intervention have had the most significant impact on the market. This will in part reflect the distinction between regulation that aims to change the behaviour of all market participants, and that which aims to ensure high standards across the market (and has an impact, therefore, only on "laggard" firms). However, it may also highlight areas where regulations are ineffective or have become obsolete and could therefore be scaled back or rationalised.
 - Identify any unintended consequences of regulation, and make an assessment of whether these contribute to or detract from the achievement of regulatory objectives.

⁴³ Ashcroft (2003) p165

We give examples of the kind of output that might be obtainable from this type of analysis in section 5.3.3 below.

While we believe this kind of analysis is potentially valuable, we emphasise the importance of taking a pragmatic approach and not over-engineering the analysis. The focus should be on looking for evidence of regulatory impacts, rather than producing a conceptual "regulatory map" of the market.

We envisage that the overall assessment would be presented in qualitative terms but would be underpinned by quantitative analysis. The objective would not be to obtain a single figure for the net present value of regulation in a particular market. Instead, the aim would be to reach a set of conclusions about the impact of regulation in that market that would support further action if needed.

5.3.2. Evidence of regulatory impacts

Strictly speaking, identifying the impacts of regulation in a market requires a counterfactual. However, as discussed above, defining a counterfactual in this context is problematic. Instead we suggest taking a piecemeal approach to gathering evidence about the major effects of regulation, without necessarily defining a single counterfactual scenario.

Possible methods of investigation might include:

- Reviewing time series market data to identify changes in variables (eg product price, volume, share price) that would appear to be attributable to the introduction of specific regulations.
- Reviewing information on regulatory activity and events (eg number of enforcement actions brought).
- Conducting in depth interviews with a small number of firms to get their views on the major impacts of regulation in their markets. This could be a combination of:
 - Asking firms what they regard as the major costs and constraints that regulation imposes on their business.
 - Asking firms how their business has changed in response to regulation in the past.
 - Hypothetical discussions of deregulation (essentially ex ante analysis of deregulation): if the FSA deregulated this market tomorrow, what would be the first five things you would change about the way you do business?

It may also be possible to review consumer research to assess what consumers value about the current system. For example, do they most value the fact that advisors have to be qualified, that criminals cannot be authorised, that there are rules governing advisors'

conduct, or that there exists an opportunity for compensation if they are sold an unsuitable product? This would be an additional use for the type of research into consumer benefits discussed in section 3.8 in the context of ex ante CBA.

5.3.3. Scope

In principle, we suggest that the scope be defined in terms of the relevant economic market, in other words a good or service that firms are competing to provide (eg current accounts). This will facilitate the analysis of market impacts, in addition to impacts on firms.

We recognise, however, that in some cases it may be more practical for the analysis to cover a particular group of firms, where the applicable regulatory framework transcends a number of economic markets. For example, pet insurance is, strictly speaking, a separate economic market from car insurance. Nonetheless, the regulatory framework is the same across most types of general insurance broking, and many of the firms provide several types of insurance. In this case, it would probably make sense to analyse the cumulative impact of regulation on the activity of insurance broking, as well as on individual economic markets.

5.3.4. Examples

Below we present two examples of the kind of output we envisage from this type of exercise. (N.B. the findings are purely hypothetical.)

5.3.4.1. *Market for financial advice*

Impact	Evidence	Comment
Reduction in the number of tied advisers over the last two decades	PIA/FSA authorisation figures Trade association estimates	Providers have found that direct sales is an increasingly uneconomic distribution channel. This reflects, in part, increased compliance costs.
Emergence of IFA networks	As above	IFA networks have emerged partly in response to small firms' demand for compliance services. There may be some concerns about the market power of the large IFA networks in determining commission levels.
Improvement in consumer satisfaction	Complaints received by the Ombudsman	Anecdotal evidence from firms suggests this is attributable to the exit from the market of disreputable firms, rather than a change in behaviour on the part of firms still in the market.

5.3.4.2. *Deposit-taking and lending*

Impact	Evidence	Comment
Firms hold more capital as a result of regulatory capital requirement	Regulatory return data shows that firms change the amount of capital they hold when their regulatory requirements change, even when they have a buffer.	Capital requirements achieve their objective of ensuring a more efficient allocation of capital in the industry than would prevail in the absence of regulation.
Banks lend more to sectors whose regulatory risk-weighting is low relative to the "true" probability of default	Anecdotal evidence based on firms' internal credit risk models	Risk-based capital requirements do distort capital allocation decisions.
Consumers understand that banks are authorised	Consumer research	Authorisation has a direct impact in terms of improving depositor confidence. (It may also have an indirect impact via the low rate of bank failures.)

APPENDIX A. FRAMEWORK FOR CONDUCTING EX ANTE CBA

We focus on two aspects of the framework within which the FSA undertakes ex ante CBA: (i) the legal requirements enshrined in Financial Services and Markets Act 2000 (FSMA); and (ii) the policy-making framework within the FSA. We then go on to summarise the existing methodology.

A.1. Legal Requirements

A.1.1. Requirements to conduct CBA under FSMA

Section 155(2a) of FSMA requires the FSA to conduct and publish a CBA of proposed rule changes. In addition, if final rules differ from the proposed rules, then section 155(6b) requires the FSA to publish a CBA. Similarly, section 157(3) requires the FSA to conduct and publish CBA of any proposed general guidance on rules.

We understand that the intentions underlying these provisions are:

- To provide checks and balances on FSA powers
- To counterbalance both:
 - The institutional incentives that regulators have to over-regulate
 - The danger of regulatory capture by the industry, particularly given that financial services is a powerful industry, and that there are extensive consultation and representation requirements in FSMA.
- To encourage evidence-based policy making, and well-informed responses to FSA consultations, and thus enhance the credibility and reputation of the FSA.

As far as we are aware, no other UK regulator is subject to a statutory requirement to undertake CBA, although others are subject to requirements to analyse regulatory impacts.⁴⁴

A.1.2. Exemptions from conducting CBA under FSMA

FSMA sets out several conditions under which it is *not* necessary for the FSA to publish a CBA. Section 155(8) exempts FSA from publishing a CBA of a proposed rule change if the FSA considers that:

⁴⁴ Ofcom has a statutory requirement to "carry out and publish an assessment of the likely impact" unless it is very small. The Health and Safety at Work act requires impact analysis "so far as is reasonably practicable". This enshrines a principle of proportionality but is more flexible than a requirement for formal CBA.

- There will be no increase in costs;
- The increase in costs will be of minimal significance; or
- The delay involved in consulting on the proposed changes would be prejudicial to the interests of consumers.

Although these requirements exempt the FSA from publishing a CBA, the FSA will still need to consider whether or not the proposed rule change will increase costs and whether or not any increase is of minimal significance only.

In addition to the above exemptions from publishing a CBA, a CBA is not required in relation to rules made under certain provisions of the FSMA (see section 155(9)).

A.1.3. Definition of CBA in FSMA

Section 155(10) states “*Cost benefit analysis*” means an estimate of the costs together with an analysis of the benefits...” In other words, FSMA requires at a minimum that CBA be a quantification of the costs and a qualitative analysis of the benefits of a proposed rule change.

A.1.4. Other relevant provisions of FSMA

The FSA’s regulatory objectives, and the duties to which it is required to have regard in performing its functions, have a bearing on the conduct and use of CBA.

In discharging its general functions the FSA must have regard to:

- “*the need to use its resources in the most efficient and economic way*” (Section 2(3a)); and
- “*the principle that a burden or restriction which is imposed on a person, or on carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction*” (Section 2(3c)).

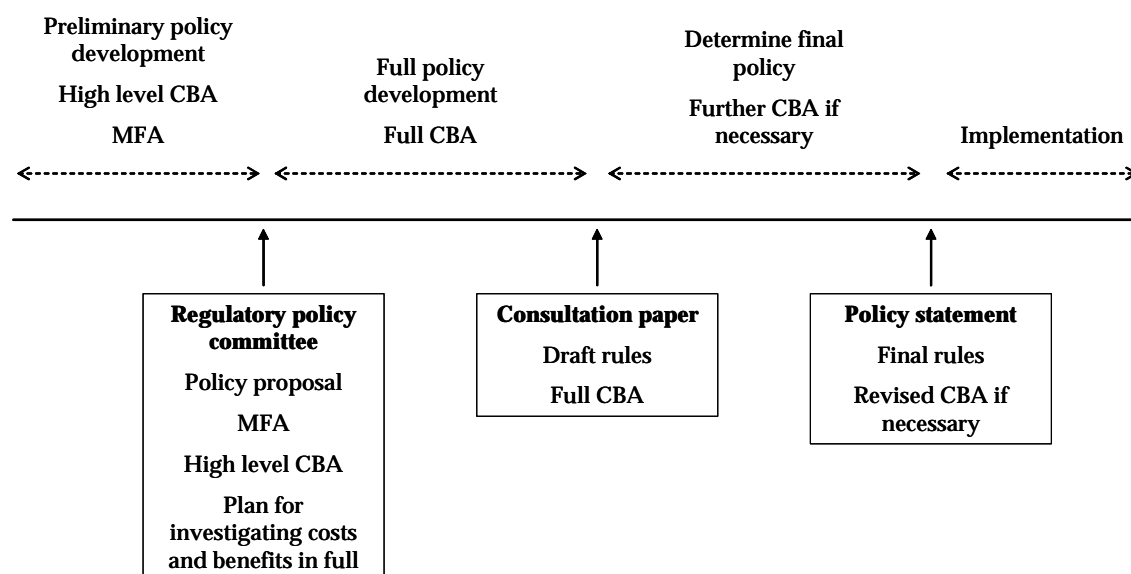
The need for the FSA to have regard to using its resources in the most efficient and economic way should influence the level of resources the FSA devotes to conducting CBA. (We return to this subject in section 3.5.3.)

The proportionality requirement applies not just to situations in which FSMA requires a CBA to be published, but to the FSA’s discharging of its general functions. Even in circumstances where FSMA does not explicitly require a CBA, proportionality could be interpreted as requiring analysis of the expected costs of regulation relative to the expected benefits.

A.2. Policy-Making Framework

In this section we summarise our understanding of how CBA fits into the policy making framework. This is illustrated in Figure A.1.

Figure A.1
FSA Policy Making Framework



A.2.1. Policy development

The FSA has established a regulatory policy committee (RPC) to provide an early review and sign-off of policy initiatives.⁴⁵ Policy-makers are required to submit their policy proposals to the RPC together with:

- An analysis of the relevant market failure;
- A high level CBA; and
- A resourced and credible plan for investigating costs and benefits in full.

We discuss the relationship between the MFA and high level CBA in more detail in section A.2.3 below.

Where there is more than one policy option under consideration at this stage, high-level CBA is potentially a very powerful tool for choosing between options. Even where it is not possible to estimate the monetary value of a policy option, it may be possible to demonstrate

⁴⁵ The RPC comprises senior executives (the Chief Executive, Chief Operating Officer, Managing Directors, General Counsel, etc). It does not include non-executives.

conclusively that one option has a better cost-benefit balance than another. In other contexts, CBA is often used to choose between alternative options for large fixed investments (eg in transport infrastructure).

In practice, we understand that policy development frequently consists of working up and refining a single proposal, rather than considering several alternatives at once. In this case, high level CBA is mainly useful as a tool for structured analysis of the likely consequences of a policy.

Before submission to the RPC, policy-makers must obtain sign-off from the EFR that the high-level CBA and market failure analysis (MFA) are fit for purpose.

Following RPC approval, the policy team develops the policy further, with a view to publishing draft rules and a full CBA in a consultation paper (CP).

A.2.2. Publication of consultation paper

Policy-makers are required to prepare a full CBA for inclusion in the CP containing the draft rules. At this stage, there may be options under consideration in certain areas but the main shape of the policy will be clear.

Before the CP is published:

- EFR has to sign off on the CBA;
- The consumer panel and practitioner panel review the paper; and
- The FSA Board approves the paper.⁴⁶

Following consultation, policy makers publish a policy statement (PS) describing the key findings from the consultation process and any changes to the proposed policy. As discussed in section A.1.1 above, if the final rules differ significantly from the draft rules, further CBA is required.

A.2.3. MFA and CBA

The requirement to produce a MFA was introduced at the beginning of 2004 and EFR has developed guidance for policy makers undertaking this analysis.

The MFA should establish whether there is an economic rationale for intervention. It should examine whether the problem observed is due to a material market failure that is relevant to the FSA's objectives or is due to existing regulation, in which case regulatory change may be

⁴⁶ The FSA Board includes the Chairman, Chief Executive, Managing Directors and non-executive Directors

the right response. There should, therefore, be a clear link between the MFA and the policy options proposed, and consequently between the underlying market failure identified and the benefits of a policy proposal. This should help in terms of thinking about the market impacts of the policy (discussed in section 3.5).

A.3. Current Methodology

Policy makers are responsible for conducting CBA, with technical support from EFR. EFR is also responsible for signing off the CBA, as discussed above.

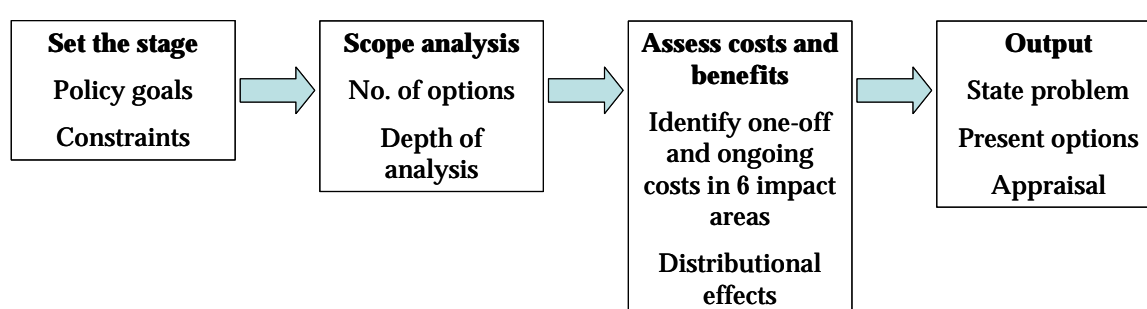
The FSA's existing CBA methodology is presented in Practical Cost-Benefit Analysis for Financial Regulators, Version 1.1 ("the Guide").⁴⁷ This was designed to help policy makers who may not have a background in economics to undertake economically robust CBA. This is supplemented by training courses and training guides.

In addition, the FSA has published Occasional Papers on the method and conduct of CBA.⁴⁸ It has also prepared case studies of various regulatory proposals, which are made available to policy staff on request.

The FSA states in the Guide that it was written on the assumption that CBA is used to evaluate new policy proposals (*ex ante* CBA) but that the same techniques apply equally to *ex post* CBA.⁴⁹ Nonetheless, the FSA has not undertaken *ex post* CBA to date.

The Guide sets out four key steps for conducting CBA, as shown in Figure A.2.

Figure A.2
Four Step CBA Methodology



The intention in setting out these four steps was to integrate the conduct of CBA within the policy making process. We summarise each of these four steps below.

⁴⁷ FSA (2000)

⁴⁸ Alfon and Andrews (1999), Simpson et al (2000)

⁴⁹ FSA (2000), p6

Step 1: Set the stage

1. Specify the policy goals
2. Identify any constraints that must be satisfied and any other factors to consider in the analysis (eg the effects of a proposal on small businesses and the socially excluded). However, the Guide states that “*in most cases ... CBA will evaluate the economic impact of policy options with regard to the UK as a whole, without incorporating other social policy constraints.*”⁵⁰

Step 2: Determine the scope of the analysis

1. Determine the number of policy options to consider. The Guide emphasises the importance of including options that outside parties believe are worth considering, to give those parties confidence in the process.
2. Determine the depth of the analysis for each policy option. Bearing in mind the obligation to use resources in the most efficient and economic way, the Guide recommends that the scope of the analysis, the cost of which increases as the scope increases, is determined by whether the policy is a “major” policy or a “minor” policy. Major policies should entail a wider scope of analysis to increase the probability that the best policy option is selected.

Step 3: Assess the costs and benefits

The Guide sets out six impact areas for categorising the costs and benefits of a policy:

1. Direct costs – the costs to the FSA of implementing, monitoring and enforcing the policy
2. Compliance costs – the costs to firms of complying with the policy
3. Quantity of the good sold
4. Quality of the goods offered
5. Variety of products offered
6. Efficiency of competition

The Guide recommends that if it is not possible to quantify costs and benefits that a qualitative estimate should be conducted to enable:

- A judgement on whether or not the policy option yields net benefits
- A ranking of the policy options under consideration.

⁵⁰ FSA (2000) p11

The Guide also specifies:

- How to deal with distributional issues and impacts on particular stakeholders (discussed further in section 3.3)
- That CBA should distinguish between one-off and ongoing costs;
- That consideration should be given to the number of firms, consumers and transactions likely to be affected by the policy options (to help understand the stakes involved); and
- That it may be more feasible or appropriate to place upper and/or lower bounds on costs and benefits of alternatives, rather than producing point estimates.

Step 4: Provide an output

1. Provide a statement of the problem that the policy is designed to address.
2. Present the main option(s) considered.
3. Provide an appraisal setting out the costs and benefits of those options, quantifying them or (if quantification is not possible) being explicit about the trade-offs involved. The appraisal should also set out key assumptions on which the analysis is based.

APPENDIX B. LITERATURE REVIEW

We have reviewed approaches to cost-benefit analysis (CBA), regulatory impact analysis or assessment (RIA) and other related techniques whose objective is to assess the implications of a policy and determine whether it will produce a net benefit.

We have incorporated the key findings from our review of the literature into the discussion and recommendations in the main body of this report and into our outline guidance document for *ex ante* CBA. In this appendix we summarise the main documents that establish best practice in *ex ante* CBA in the UK and present examples of all three types of CBA from other sectors and jurisdictions.

B.1. UK Best Practice

There are three documents that outline standards and best practice recommendations for the conduct of CBA:

- The Treasury's "Green Book: Appraisal and Evaluation in Central Government" outlines a general approach which should be applied to RIAs and other cost-benefit analyses by all government departments and agencies. The guidance in the Green Book focuses on encouraging a more thorough, long-term and analytically robust approach to appraisal (*ex ante* CBA) and evaluation (*ex post* CBA).
- The Cabinet Office's Regulatory Impact Unit has published a document entitled "Better Policy Making: A Guide to Regulatory Impact Assessment (RIA)". This document is aimed at providing guidance on the conduct of RIA in response to a consultation with policy makers. The completion of a RIA is mandatory for all proposals (legislative and non-legislative) that are likely to have a direct or indirect impact (whether benefit or cost) on business, charities or the voluntary sector. This includes proposals that reduce costs on business and others, as well as those that increase them.
- Since December 2002 the National Audit Office (NAO) has been responsible for independently evaluating RIAs conducted by Government departments. The NAO has produced a document "Better Regulation: Making Good Use of Regulatory Impact Assessments" which outlines its findings from an examination of a sample of RIAs and the lessons that can be learned. It also recommends further steps that departments could take to improve the RIA process.

In our view these three documents encapsulate UK best practice standards for conducting CBA. We recognise, however, these guidelines apply to central government departments and agencies. Neither HM Treasury nor Cabinet Office guidelines apply directly to the FSA.

The NAO identified a number of key differences between FSA CBA and the central government RIA process:⁵¹

- The FSA is a regulator of competitive markets (as opposed to monopoly networks). This means that analyzing the economic impacts of regulation is particularly crucial. The FSA has a dedicated economics team who actively help policy makers analyse the economic impacts of regulation and are involved in policy making in an advisory role from an early stage.
- The FSA states in its guidance that even where there is no legal requirement to produce an analysis, it will generally wish to carry out at least a preliminary analysis to reduce the possibility of making a policy error and to establish the scale of likely benefits.
- The FSA is clear that the objective in analysing benefits is to develop a conclusion on the relative costs and benefits and not to measure benefits independently of costs. This reflects the importance of the proportionality condition in the FSA's statutory obligations; the resources dedicated to regulation should be proportionate to the effects.
- The FSA has to publish information on its performance against its statutory objectives, which include consideration of the principles of good regulation. It expects the CBA to feed into its reporting on the proportionality and targeting of regulation, coupled with evaluation of how regulation has performed in practice.

In the remainder of this section each class of CBA is considered in turn with respect to any benchmark standards that apply. This approach emphasizes the point that there are different requirements attached to each class. Ex-ante CBA being the area which is most heavily standardised.

B.2. CBA in Other Sectors

B.2.1. Ex-ante assessments

The NAO review of RIAs contains many examples of good practice in other sectors.⁵² Below, we highlight a number of these that illustrate different aspects of *ex ante* CBA.

⁵¹ NAO (2001a) p32

⁵² NAO (2001a)

B.2.1.1. Distributional impacts

Consulting small businesses to improve motor salvage (Home Office)

The Home Office undertook a "small business litmus test" consultation by writing to three small businesses which had been nominated by the Federation of Small Businesses and a trade association. This produced responses that resulted in improvements to the regulations. For example, one business drew attention to the existence of a Local Act that imposed some similar regulatory requirements. To avoid duplication, a power was put in the Vehicles (Crime) Act 2001 enabling the Secretary of State to repeal Local Acts which duplicated provisions.

Regulation of credit unions

An RIA on regulation of credit unions considered the symmetry of the impact on large and small businesses.⁵³

B.2.1.2. Measuring costs and benefits

Costing the contained use of genetically modified organisms regulations (Health and Safety Executive)

Organisations undertaking activities using genetically modified organisms are required to notify the Executive. The proposal was to revise the details of this requirement. In estimating costs to businesses the analysis among other things, the proposal required those affected to provide training for employees, to familiarise themselves with the requirements. The Executive had a detailed knowledge of the business processes affected by the regulation. This enabled it to estimate the number of employees who would need to be trained at each organisation affected by the proposals. It then estimated the cost of training per organisation, including that of staff time, and extrapolated the total cost over all organisations. The HSE also estimated other costs arising from the proposals, for example the costs to themselves of administering and monitoring the proposals.

Regulating retail records of vets and pharmacies (Department of Environment and Rural Affairs)

When the Agency sought to cost the options for regulating retailers' records, they needed a detailed knowledge of day-to-day record keeping within veterinary practices and pharmacies. They did not have this knowledge, nor any obvious means of estimating the costs. They wrote to three veterinary practices and two agricultural pharmacists asking for the cost of complying with their draft regulation. They also obtained figures for the number of businesses affected from the two main representative bodies. The Agency recognised the

⁵³ HM Treasury (2001)

problems of relying on others to supply cost data. They carried out some simple analyses to test the validity of the data, such as comparing the information between organisations and checking with suppliers on the reasonableness of an estimate for capital equipment costs. The information obtained enabled the Agency to present costed options in a revised RIA.

Costing the contained use of genetically modified organisms regulations (Health and Safety Executive)

In estimating benefits to businesses they noted that the main aim of the proposal was to simplify the notification process, for example by reducing the time necessary to notify activities, and to exempt some activities from the process. The proposal was expected to result in time and cost savings to the organizations affected. The Executive calculated projected benefits by estimating how much time the proposals would save those affected, attaching a monetary value to the time saved. Although the Executive recognised that some benefits were unquantifiable, clear identification of the different types of benefits allowed them to quantify others.

Valuing fatal casualties (Department for Transport)

The Department for Transport (DfT) has a requirement to estimate the risks of death and injury as part of cost-benefit analysis. Prior to 1988, the DoT method of valuing fatal casualties was based on human capital costs together with a notional estimate for the value of pain, grief and suffering associated with a fatality. From 1988, however, the value of a fatality has been based on 'Willingness To Pay' (WTP) methodologies and a value of £500,000 (1987 prices) for a road traffic fatality was introduced as the WTP component of the cost of a road traffic fatality. This figure was based in part, but not entirely, on a major WTP CV study of public preferences regarding road safety. This is a clear case where using a survey based approach is preferable due to the difficulty in measuring certain costs and benefits associated with injury or death.⁵⁴

B.2.1.3. Negotiation of European Directives

Costing the contained use of genetically modified organisms regulations (Health and Safety Executive)

This example (discussed above) also illustrates how *ex ante* CBA can be used in the context of a European Directive. The project successfully estimated costs, showing that if the regulation went further than was necessary to implement the Directive, they would increase business costs by some £7 million a year.

⁵⁴ Department of Trade and Industry (1997)

B.2.2. Ex post evaluation

As discussed in section , there are limited examples of *ex post* reviews. Here we summarise work by the Performance and Innovation Unit on ex post evaluation, and present five examples of *ex post* CBA or other assessment.

B.2.2.1. Performance and Innovation Unit

The Performance and Innovation Unit conducted a review of procedures for evaluating implemented policy across Whitehall.⁵⁵ They found that (based on a recent Cabinet Office study) evaluation is not conducted according to systematic practices across departments. The same report found that there have been a number of high profile policy initiatives which have been the subject of careful monitoring and evaluation, conducted in a context which is tuned in well to learning lessons and applying the results of pilot work.

B.2.2.2. Department for International Development (DfID)

The Cabinet Office found that in some departments the lessons from evaluation are valued and systematically embedded into the policy formulation process. For example, DfID has a detailed set of office instructions, used by specialists and administrators alike, which sets out the role of evaluation within project cycle management. This guidance describes how evaluation can be integrated into the process of project management, from the point of drawing up the project proposal, through to implementation and monitoring to the point of completion of the project.

B.2.2.3. New Deal

The Cabinet Office also found that there have been a number of high profile policy initiatives which have been the subject of careful monitoring and evaluation. Pathfinders for the New Deal for Young People is an example of this approach. In this case, three evaluation reports in December 1998 identified gaps in the provision for the most marginalised and disadvantaged, with subsequent corrections to remedy those deficiencies.

B.2.2.4. Department of Trade and Industry (DTI)

A further example of policy evaluation integrated into the policy process is the ROAME (Rationale, Objectives, Appraisal, Monitoring, and Evaluation) framework used to design and implement policy at the DTI. The ROAME framework is based on a circular process starting with the publication of a ROAME statement. Interim steps include the undertaking of an evaluation exercise, the publication of an evaluation report and the use of that report to feed back in to policy discussions on new programmes.

⁵⁵ Performance and Innovation Unit (2000a)

The DTI's stated objective in carrying out an evaluation are to 'ensure activities remain relevant, and that they provide a cost effective way of meeting their prescribed objectives'. They also specify the role of evaluation in informing future decisions by feeding into the Resources and Allocations Management framework and spending reviews and informing future policy decisions. Evaluations are based on a number of indicators (the scope is aimed at being wider than performance indicators). These indicators include impact on hard business (sales), intermediate business outcomes (productivity, innovation), business capabilities, business processes, technology and links to science base, rate of rejections for finance and cost of finance, and the effect on the availability of business services. These indicators are not designed to be applied to all projects but they are hoped to encompass the majority of impacts which can be measured.

The DTI do not deal with the issue of identifying the baseline in conducting an ex post CBA. The assessment of costs and benefits is primarily against outturn targets. However, they do suggest that in addition to quantifying costs and benefits against the relevant indicators a cost effectiveness analysis is carried out. This entails comparing costs and benefits against similar programmes that have been evaluated according to the same guidelines.

B.2.3. Cumulative CBA

Analysis that might be termed cumulative CBA is not widespread across government departments (or indeed private sector organizations). This is no doubt due to the complexity of such a task and the fact that there is usually no obligation to carry out this type of research.

However, one area where cumulative impact assessment is an integral part of the CBA process is in environmental impact assessment. This example differs from what the FSA has in mind, however, in that it relates to *ex ante* assessment of cumulative effects.

The objective of carrying out a cumulative effects assessment is that the impact of a project on an environmental resource may be insignificant when addressed in isolation but significant when evaluated in the context of the combined effect of all past present and reasonably foreseeable future activities. In its guidance on environmental impact assessment, the Asian Development Bank defines a cumulative effect as one that is "additive or interactive in nature and results for multiple activities over time".⁵⁶

The Asian Development Bank recommends a specific approach to analysing cumulative effects. It recommends that each environmental impact assessment include a preliminary assessment on the existence of cumulative affects and make recommendations as to whether a full cumulative assessment is necessary. A full cumulative assessment requires the drawing of boundaries within which cumulative effects will be considered, identifying and

⁵⁶ Asian Development Bank (2003)

predicting future resource use and impacts, and evaluating the significance of the cumulative effects that are predicted to take place.

The idea of a cumulative assessment is based on the idea of the level of acceptable risk or the threshold above which impacts cannot go. In the environmental context this could be the probability that an additional threat to a population will lead to its extinction.

This form of analysis is particularly relevant to environmental issues because of the extent of interactions between elements of the same (or competing) ecosystems.

B.3. CBA in Other Jurisdictions

There are a number of jurisdictions other than the UK where there is an explicit legislative requirement that a calculation of costs and benefits be included with submissions of regulatory proposals to the legislature. In New Zealand and Australia these requirements take the form of a Regulatory Impact Statement. In the US costs and benefits are presented in a Regulatory Flexibility Analysis. Many other jurisdictions have a process in place to conduct CBA in advance of policy changes without having in place a statutory requirement.

In this section we consider the approach to CBA in the US, New Zealand and Canada.

B.3.1. Ex ante reviews in the US

The Performance and Innovation Unit compares policy analysis and regulatory impact analysis between the UK and the US.⁵⁷ The report notes that the US has a generally superior level of analysis and suggests this is in part due to “the nature of the US constitution which pits administration against Senate and generates a competitive interest in modelling”. It goes on to note that this administrative structure is not directly transferable to the UK. The report also notes that there is a legislative requirement in the US that every proposal estimated to cost more than \$100m annually must undergo a formal CBA.

The Office of Management and Budget (OMB) is responsible for guiding Federal agencies on the development of regulatory analysis⁵⁸ It is also required to produce regular reports on the costs and benefits of Federal regulation.⁵⁹

B.3.1.1. Objectives

The OMB states that the objective of CBA is to “provide decision makers with a clear indication of the most efficient alternative, that is, the alternative that generates the largest

⁵⁷ Performance and Innovation Unit (2001)

⁵⁸ Section 6(a)(3)(c) of Executive Order 12866, “Regulatory Planning and Review”, the Regulatory Right-to Know Act

⁵⁹ Hahn and Dudley (2004)

net benefits to society (ignoring distributional effects)". They go on to specify that a CBA provides "useful information for decision makers and the public, even when economic efficiency is not the only or the overriding public policy objective". There are two types of analysis suggested by OMB: benefit-cost analysis, and cost effectiveness analysis. The former is comparable to CBA, whilst the latter is used where the monetisation of benefits is not possible or prohibitively difficult.

B.3.1.2. Distributional issues

The OMB specifies the requirement to analyse distributional effects as a separate part of a regulatory analysis, this should include how both benefits and costs are distributed among sub-populations of particular concern. This approach is authorised under Executive Order 12866. Where distributional effects are thought to be important, the effects of various regulatory alternatives should be described quantitatively to the extent possible, including the magnitude, likelihood, and severity of impacts on particular groups. They also require information on the streams of benefits and costs over time in order to provide a basis for assessing intertemporal distributional consequences, particularly where intergenerational effects are concerned. This is similar to the approach recommended in the Green Book.

B.3.1.3. Knock on effects

The OMB's guidance covers ancillary benefits and countervailing risks. This means participants not only consider the direct benefits and direct costs of rulemaking but also any important ancillary benefits and countervailing risks.

An ancillary benefit is a favorable impact of the rule that is typically unrelated or secondary to the statutory purpose of the rulemaking (e.g., reduced refinery emissions due to more stringent fuel economy standards for light trucks) while a countervailing risk is an adverse economic, health, safety, or environmental consequence that occurs due to a rule and is not already accounted for in the direct cost of the rule (e.g., adverse safety impacts from more stringent fuel-economy standards for light trucks).

B.3.1.4. Measuring costs and benefits

The OMB outlines a wide range of options of the estimation of costs and benefits. They state that the monetisation of values is preferred. Where this approach is not possible a CBA should attempt to quantify units based on an appropriate metric (i.e. number of lives at serious risk per annum). Where monetisation or quantification is not possible careful analysis should be carried out based on qualitative data. The distinction between estimating costs and estimating benefits is minimised in the OMB approach - the approaches below could be applied to either variable.

The specific methods they recommend are:

- Where opportunity cost is the appropriate concept for valuing both benefits and costs, willingness-to-pay analysis should be used to capture the notion of opportunity cost by measuring what individuals are willing to forgo to enjoy a particular benefit. An alternative measure of opportunity cost is willingness to accept compensation for not receiving the improvement/regulatory change.
- Revealed preference methods can be used to estimate the value of goods and services based on actual market decisions by consumers, workers and other market participants.
- Where there are minimal market imperfections and government intervention, market prices are the most accurate measure of the marginal value of goods and services to society. However, where market imperfections exist or the government is active in the market, prices may not reflect the true value of goods.
- Some goods and services are indirectly traded in markets, which means that their value is reflected in the prices of related goods and services that are directly traded in markets. Their use values are typically estimated through revealed preference methods. Examples include estimates of the values of environmental amenities derived from travel-cost studies.
- Stated Preference Methods (SPM) estimate both use and non-use values of goods and services. They have also been widely used in regulatory analyses by Federal agencies, in part, because these methods can be creatively employed to address a wide variety of goods and services that are not easy to study through revealed preference methods.
- Where collecting data through a revealed or stated preference approach is prohibitively costly, a benefit transfer model can be employed. Benefit transfer involves transferring existing estimates obtained from indirect market and stated preference studies to new contexts (i.e., the context posed by the rulemaking). The principles that guide transferring estimates from indirect market and stated preference studies should apply to direct market studies as well.

B.3.2. An ex post review in New Zealand

In New Zealand an ex post review was implemented of the Securities Act (1978) and the Securities Regulations (1973). The rationale of this review is described as follows: “it has become apparent that there are a number of ambiguities in the law. Also, there have been sophisticated developments in financial products that leave commercial and other

fundraisers uncertain as to the requirements of the law. The structuring of the products and the methods by which they are offered continue to develop, often very quickly”⁶⁰

The review also pinpointed a number of areas of where changes in the market had prompted the need for a review. These included:

- Product convergence
- Globalisation
- Regulatory convergence
- The information technology revolution
- Product innovation

The review of the regulations was conducted in two stages. Stage One involved a technical review of the regulations with a view to simplification and modernization of regulations to reduce compliance costs. The Ministry received suggestions for changes to the regulations from various stakeholders. Examples of these areas included the overall relationship between matters included in prospectuses and investment statements, issues relating to employer superannuation schemes, short form prospectuses, term life insurance policies and half yearly financial statements for collective investment schemes including unit trusts.

Stage Two of the review re-examined the way in which the regulations implement the Act. It required an assessment of the costs and benefits of different methods of regulating offer documents and advertisements for securities, taking into account developments that have occurred in the environment in which securities markets operate since the regulations were developed.

B.3.3. Cumulative evaluation in the US

The US OMB conducts an annual assessment of the total annual costs and benefits of existing Federal regulatory programmes and existing legislation. This process is mandatory under Section 645(a)(1) of the Executive Order.

The objective of aggregate estimates is to assess the total benefits that derive from a system of regulation and provide an indication of the importance of regulatory reform. However the OMB recognise that real economic improvement will come from expanding regulatory programmes that provide net benefits and contracting those programmes that produce net

⁶⁰ Ministry of Economic Development of New Zealand (2000)

costs - knowing the total cost is therefore of little value. For this reason the OMB does not recommend devoting significant resources to this project.⁶¹

The approach taken by the OMB is to aggregate monetised costs estimates from a variety of sources that cover the major regulatory programmes in place in the US. The sources are a variety of academic studies and the OMB estimates required for all projects valued at over \$100 million per year.

Aggregating benefits from a set of individual regulations poses some serious problems:

- The level of uncertainty in possible benefit estimation is unknown - this makes it hard to compare benefit estimates of different regulations
- There is no basis for aggregating benefits in a manner that might preserve information about the likely distribution of aggregate benefits
- Benefits, like costs, may be presented as monetised, quantified, or in narrative forms. It is often the case that the benefits are not monetisable and therefore aggregation is impossible.

The OMB estimates aggregate benefits by using existing estimates of the net benefits to social regulation and applying the ratio between the benefits of social and environmental regulation to get an estimate of total social and environmental regulation. They make no attempt to include and estimate of other categories of regulation.

B.3.4. An example of cumulative evaluation in Canada

The Ontario Securities Commission (OSC) set up a Regulatory Burden Task Force with the mandate:

- To canvass market participants with a view to identifying instances where the regulatory activities of the OSC create efficiency impediments and associated cost impacts for market participants that are not justified by the public interest benefits derived from such activities; and
- To recommend to the OSC measures which it should consider implementing to alleviate regulatory burdens upon market participants without impeding the ability of the OSC to fulfill its statutory responsibilities to investors and the capital markets.

61 The Office of Management and Budget, The Executive Office of the President, Report to Congress on the Costs and Benefits of Federal Regulations.

The approach of the task force was two fold:

- It selected and consulted groups of market participants, including registrants, issuers, investors, self-regulatory organizations (SROs), industry associations, and/or advisors to such persons or organisations. The consultation asked participants to provide (anonymously) concerns, complaints, comments and suggestions relevant to the mandate set out above.
- The task force asked junior and senior OSC Staff members for their comments regarding complaints or expressions of concern they have received from market participants and what improvements and efficiencies they believe might be instituted.

APPENDIX C. WORLD BANK EVALUATION PROGRAMME

In this Appendix we provide an overview of the approach to ex post evaluation taken by World Bank (the Bank). Given the difference in both subject matter and organisational capacity, the approach is not directly applicable to the FSA context. Nonetheless, it provides a good example of an evaluation programme which is coherent and credible, yet flexible in terms of the detailed methodologies used.

It is also an example of an organisation which takes ex post evaluation very seriously, spends considerable resources on evaluations (typical evaluations cost up to \$500,000⁶²), and has succeeded in establishing a culture which seeks to learn from past experience by using ex post evaluation to establish the facts, not to lay blame. It is widely thought that World Bank policy has improved as a result of this programme.

The Bank has a separate department responsible for undertaking evaluations: the Operations Evaluation Department (OED). This is an independent unit within the Bank reporting directly to the Bank's Board of Executive Directors.

The Bank uses an objectives-based approach to evaluation. This involves assessing:

- **Outcomes** – outcomes are evaluated by considering three factors:
 - the *relevance* of the intervention's objectives in relation to country needs and institutional priorities;
 - *efficacy*, i.e. the extent to which the developmental objectives have been (or are expected to be) achieved; and
 - *efficiency*, i.e. the extent to which the objectives have been (or are expected to be) achieved without using more resources than necessary.
- **Sustainability** - OED's sustainability measure assesses the resilience to risk of net benefit flows over time by answering these questions:
 - At the time of evaluation, what is the resilience to risks of future net benefits flows?
 - How sensitive is the project to changes in the operating environment?
 - Will the project continue to produce net benefits, as long as intended, or even longer?

⁶² World Bank (2004)

- How well will the project weather shocks and changing circumstances?

Sustainability reflects the resilience to risks of a project as measured by the likelihood that its estimated net benefits will be maintained or exceeded over the project's intended useful life.

- **Institutional development impact** - this measure evaluates the extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources. OED evaluates each project's success in fostering such changes.
- **Bank and borrower performance** - OED assesses both the Bank's own performance and the performance of the borrower country. It assesses how good a job each partner has done during the different stages of the project cycle. Bank performance is judged on the extent to which services provided by the Bank ensured quality at entry and supported implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project). Borrower performance evaluates the extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements.

OED does not mandate a particular evaluation methodology, instead taking the view that the approach should be adapted to the specific context, the evaluation questions and priorities, the main stakeholders who have an interest in the findings, the speed with which the information is needed, and the available resources.⁶³

OED has produced a document that outlines some possible tools, methods and approaches.⁶⁴ This document provides an overview of a number of techniques but emphasises that the list is not comprehensive, nor are the techniques viewed necessarily exclusive to one another – some are substitutes while others are complementary. The techniques reviewed are:

- Performance indicators
- The logical framework approach
- Theory-based evaluation
- Formal surveys:
 - Multi-topic household (or living standards measurement) survey

⁶³ World Bank (2004) and World Bank (2002)

⁶⁴ World Bank (2002)

- Single topic household survey
- Core welfare indicators questionnaire
- Client satisfaction (or service delivery) survey
- Citizen report cards
- Rapid appraisal methods:
 - Key informant interview
 - Focus group discussion
 - Community group interview
 - Direct observation
 - Mini-survey
- Participatory methods:
 - Stakeholder analysis
 - Participatory rural appraisal
 - Beneficiary assessment
 - Participatory monitoring and evaluation
- Public expenditure tracking surveys
- Impact evaluation
- Cost-benefit and cost-effectiveness analysis (used for investment appraisal as well as programme appraisal)

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