

Taking forward the FSA's approach to studies of proportionality

Introduction

1. This paper discusses the role that compliance cost surveys play in the FSA's analysis of proportionality, the latter being our approach to determining whether the costs of regulations that have been introduced are justified by their benefits. We focus on the compliance costs of existing regulations, rather than compliance costs of proposed regulatory changes, for which we conduct compliance cost surveys as part of Cost Benefit Analyses. We briefly present past compliance cost surveys we have published and lessons we have learned from these studies. The paper also introduces the background to the latest compliance cost survey – The Regulation of Retail Investment Products: An Initial Assessment of the Impact of Recent Changes – and briefly summarises the results of this study. We conclude by discussing how we plan to take forward our work on compliance costs and invite comments.

Background

2. We are required to have regard to the proportionality of financial regulation: any burden or restriction imposed should be proportionate to the benefits expected from it. Proportionality is one the Principles of Good Regulation included in the Financial Services and Markets Act.
3. To assess proportionality we need an estimate of incremental compliance costs and indirect costs, the latter being the negative effects of regulation (i.e. reduction in consumers' welfare or firms' profits), which result from factors other than the FSA recharging its direct costs to firms and firms expending resources on compliance costs. We also need an analysis of the benefits. Researching these costs and benefits is challenging because:
 - estimating compliance costs places a burden on firms that participate in our research because they do not collect this information for other purposes, and so a balance must be struck in obtaining this data between burden and rigour;
 - estimating indirect costs and benefits relies on credible identification of how markets would have changed in the absence of the relevant changes in regulation (because we are interested in the changes in the quantity, quality and variety of services offered and sold that are attributable to changes in regulation rather than to other market dynamics); and
 - to analyse benefits we also need to understand changes in behaviour and in the value that firms or consumers place on goods and services, and be able to attribute this to regulation, which requires detailed economic analysis.

4. Surveys of incremental compliance costs incurred by firms provide one of the pieces of evidence we need to help us to understand the proportionality of our regulation.

Past surveys of compliance costs

5. Over the past few years we have conducted several of these surveys:

	Europe Economics ¹ (2003)	Deloitte ² (2006)	Real Assurance ³ (2006a)	Real Assurance ⁴ (2006b)
Research Objective	To measure the level of incremental costs and the change in them since N2 ⁵	To measure the level of incremental costs	To measure the level of incremental costs	To measure the level of incremental costs
Regulatory Scope	All FSA regulation applicable to the financial sectors within scope	All FSA regulation applicable to the financial sectors within scope	All administrative returns to the FSA and other statutory bodies	All FSA requirements for disclosure to third parties
Financial Sectors	Banking and Credit Managing Investments Retail (sales, advice and brokering) Insurance and Pensions Capital Market Operations Exchanges, Counter parties and Others	Corporate Finance Institutional Fund Management Investment and Pension Advice	All	All
Compliance costs	On-going One-off	On-going	On-going	On-going
Rule by rule cost estimates?	Broad areas of regulation	Rule by rule	Rule by rule	Broad areas of regulation
Methodology for gathering cost data	Interviews and a survey	Survey based on general ledger	Mixed, based on Standard Cost Model; data from the FSA and Deloitte; questions added to an existing survey; and an email survey	Mixed, based on Standard Cost Model; Interviews; Survey; and FSA data.
Sample size	52	68	202 (all sources)	24

6. The main difference between these compliance cost surveys was in the approaches they took to gathering compliance cost information from firms. The report by Europe Economics was based on a survey of firms followed up by interviews with them. Firms were first asked to estimate the total of all the costs they incurred related to risk management and client confidence, and were then asked how those costs would change if FSA rules and oversight were withdrawn. Firms were also asked to compare the incremental costs of compliance in 2002 with those in 1998, to measure the effect of the FSA becoming the single regulator for the UK's financial services industry.

1 Europe Economics (2003) Costs of Compliance: www.fsa.gov.uk/pubs/other/cost_compliance.pdf

2 Deloitte (2006) The Cost of Regulation Study, commissioned by the FSA and the Financial Services Practitioner Panel: www.fsa.gov.uk/pubs/other/deloitte_cost_of_regulation_report.pdf

3 Real Assurance (2006a) Estimation of FSA Administrative Burdens: www.fsa.gov.uk/pubs/other/Admin_Burdens_Report_20060621.pdf

4 Real Assurance (2006b) Estimation of FSA Third Party Administrative Burdens: www.fsa.gov.uk/pubs/other/admin_burdens.pdf

5 On 1 December 2001 (a date we refer to as N2) the FSA became the single regulator for the UK's financial services industry, replacing the bodies that previously regulated separate sectors of the industry.

7. Europe Economics reported that these questions were difficult for firms to answer, since they needed to make a comparison with a hypothetical situation that proved difficult to envisage. They found, however, that firms attempted to answer the questions in the way intended, by identifying what they would need to do differently in the absence of regulation. Given the difficulty of the task, Europe Economics asked firms to provide responses that were ‘roughly right’. They checked responses that included inconsistencies against the responses from peers, but firms did not hold data that allowed the responses to be audited.
8. The study by Deloitte was based on a detailed analysis of costs recorded in the general ledgers of firms, i.e. an auditable source. Firms were asked to categorise costs by the financial markets in which they operated. They were asked to split these costs into types of business activity, such as marketing and advice and sales. Deloitte then asked them to judge the proportion of costs incurred in respect of regulated activities, and for each regulated activity to identify which costs would not be incurred in the absence of regulation.
9. Deloitte conducted a workshop and helped individual firms to complete the questionnaire. Nevertheless, this was a very detailed study and the final report noted the substantial time commitment from firms who responded to the survey. The level of resource needed from firms and the FSA to undertake such a detailed study makes this a difficult piece of research to repeat.
10. The two studies by Real Assurance were of administrative burdens. The first study in 2006 (2006a) was of the incremental cost of supplying information required by the FSA and the second study (2006b) was of the incremental cost of disclosure requirements. The approach used by Real Assurance was based on the Better Regulation Executive’s (BRE) Standard Cost Model (SCM). The SCM approach advocates face-to-face interviews with a small sample of firms to help the researcher gain a clear understanding of how compliance fits within a firm’s business model, and consequently the activities, and associated costs, that are incremental costs of regulation.
11. Due to time constraints the study of FSA administrative burdens used an email survey of firms. This was combined with other sources of information, namely, data from the Deloitte study and questions added to a regular survey of firms who make applications for permissions from, or make notifications to, the FSA. This survey is conducted by NOP. Real Assurance made use of market data on wage rates, but not from the source specified by BRE, which was found to underestimate wages in the financial services industry.
12. The second study of the incremental costs of disclosure to clients was based on a survey of firms followed up with telephone discussions. Since most of the costs were related to transactions, the information gathered from firms was also combined with FSA data on numbers of transactions. Again for this study, market data were used, where possible, and Real Assurance exercised judgement to produce estimates, rather than rely on calculating averages from small samples of data, which reflected considerable variation in responses, even after validation with firms.

13. The above studies all took different approaches. The terms of reference for the latest survey of compliance costs by LECG were drawn up in light of the experience of these past studies. The sections below describe the background to the study by LECG and give a short summary of the findings.

Latest survey of compliance costs

14. The latest compliance cost survey – The Regulation of Retail Investment Products: An Initial Assessment of the Impact of Recent Changes followed up earlier research, in particular the Cost of Regulation Study by Deloitte in 2006.
15. The research focused on the advised sale of retail investment products over the period mid-2006 to mid-2008, and the effect of us introducing the Conduct of Business Sourcebook (COBS), changes in supervisory approach, and the Treating Customers Fairly (TCF) initiative. TCF is not a change in rules but the research tested whether the recent focus on it had in practice altered regulatory expectations, or whether any costs reported by firms were in fact due to becoming compliant with the existing standard. Eighteen firms participated in the study, including product providers, bancassurers and financial advisors, the latter category included both large and small firms. The research was carried out by consultants LECG.
16. The terms of reference for the latest study of compliance costs were drawn up in light of the experience of the studies we had previously published. For the latest study, we required a strategic approach, based on developing an understanding of representative types of business model, in order to identify incremental compliance costs. The study was based on a small sample of firms so that relatively detailed information could be gathered, while the burden on the sector could be kept to a minimum. Given that the study focused on a recent set of regulatory initiatives, it was hoped that firms would be able to make available business plans and project documents which recorded how their approach to compliance had changed, providing an auditable source of data. The terms of reference also required the use of market data and the exercise of judgement in producing independent estimates of incremental compliance costs.
17. In a departure from previous compliance cost surveys, the terms of reference specified that the study should include an assessment of the benefits of regulation, arising from improved mitigation of market failures or the removal of regulatory failures. The inclusion of this element in the study was important because we aim to understand the proportionality of our regulatory regime, not just the compliance costs.
18. The approach to analysing benefits specified in the terms of reference was based on work by Oxera, which advocated identifying a causal chain of steps through which benefits would arise.⁶ The steps in this theoretical ‘mechanism’ through which benefits may arise are then assessed against evidence to determine if the benefits are likely to arise in reality.

⁶ Oxera (2006) A Framework for Assessing the Benefits of Financial Regulation:
www.fsa.gov.uk/pubs/other/Oxera_report_20060622.pdf

Findings of the latest research

19. Here, we briefly describe the findings in relation to the three initiatives covered in the research.

COBS

- Firms mainly incurred one-off costs. These arose mostly from reviewing the changes between the previous Conduct of Business (COB) sourcebook and COBS, which ranged from £0.00 to £0.57 per sale.⁷ Some firms decided to change their service and cost disclosure documents, but this decision was taken for commercial, rather than regulatory, reasons. The aim of these changes was to make the documents clearer and more engaging. A number of advisory firms interviewed made changes to their financial promotion procedures, by working more closely with manufacturers and ensuring better targeting of customers.
- Firms reported that they were waiting for the outcome of the Retail Distribution Review (RDR) before making further changes to their business strategy.
- These findings are broadly consistent with the initial report of the COBS Post-Implementation Review.⁸

Change in supervision approach to be more outcome-focused

- Firms did not report experiencing a change in supervisory style, for example, a less prescriptive approach based on application of principles, during the period studied.
- This may reflect the understandable prudential focus of supervisors of bancassurers, and the study could not take account of the impact of the Supervisory Enhancement Programme and the Small Firms Enhanced Supervision Strategy, both of which we introduced after the period reviewed in this study.

TCF

- Firms did not supply evidence that the TCF initiative had altered regulatory expectations and therefore costs incurred were treated as deferred incremental costs, i.e. the costs of becoming compliant with the principle, rather than a fresh change in the level of incremental costs. Otherwise, there would be an element of double-counting since TCF was included in the 2006 Deloitte report.
- On a per sale basis, the range of one-off TCF costs was £3.50 - £16.54 per sale and for on-going costs it was £3.10 - £34.10 per sale.⁹ Firms incurred costs in the areas of senior management oversight; training; and compliance advice. However, there was a range of approaches to compliance, and some larger firms reported incurring only very small costs. The costs were higher per transaction for smaller firms as the costs included a significant element of fixed costs.

⁷ The cost estimates reported should be treated as indicative because they are based on data from a small sample of firms.

⁸ FSA (2008) Conduct of Business Sourcebook (COBS) Post Implementation Review: 2008 Statement on Interim Findings: www.fsa.gov.uk/pubs/other/COBS_review.pdf

⁹ The cost estimates reported should be treated as indicative because they are based on data from a small sample of firms.

- The analysis found some consumer benefits may arise as a result of the positive changes already made by firms, such as greater scrutiny of sales by senior management, but they had been made too recently for it to be possible to measure with confidence the effect on consumer outcomes during the period the research was conducted. Following the incorporation of TCF into routine supervision from 1 January 2009, testing of consumer outcomes is a key part of core supervisory processes.

Next steps

20. This study generated some useful findings, which are being incorporated into the post-implementation review of COBS, which will be published in 2010, and in the ongoing supervision of TCF.
21. We will take forward what we have learned about the analytical approach used in the study. First, business documentation about the compliance changes firms had instigated in response to the regulatory initiatives, such as project plans, was only available in a limited number of cases. This required LECG to make use of the judgement of their industry advisory panel in a number of cases.
22. Secondly, it was difficult to assess the benefits resulting from the changes firms had made, as they had been made relatively recently. Typically the initial steps in a benefit mechanism could be verified but not later ones, i.e. consumer outcomes. The crucial piece of evidence missing for LECG's analysis was a link between changes made by firms and improved consumer outcomes, especially an improvement in the quality of advice. Evidence on this may be obtained from mystery shopping exercises or a review of case files, and requires a before and after comparison. To obtain this information relies on firms making such evidence available, if it exists, or us undertaking a separate study, which, either way, would be a very resource intensive exercise.
23. More generally, firms are not necessarily the best source of evidence of the benefits consumers experience from conduct of business or prudential regulation.
24. By attempting to include an assessment of benefits using the information we could obtain from firms, we believe the latest compliance cost survey took our approach as far as we could to draw conclusions about proportionality. Researching benefits and indirect costs will in most cases require different methodologies and different sources of data. In future, we propose to:
 - not continue conducting standalone compliance cost surveys;
 - only conduct compliance costs surveys where this forms part of a research strategy to examine proportionality, for instance, as part of a post implementation review or a study of an important piece of regulation likely to be subject to review in the near future.

Contact us

25. We would welcome feedback on this proposal, or any suggestions as to how we might develop our approach to compliance cost surveys. Please send any comments to david.humphry@fsa.gov.uk